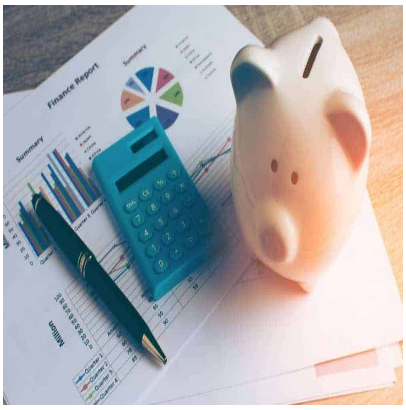

Canopy Growth Corp (TSX:WEED): What to Look Forward to in the Upcoming Earnings Report

Description

Canopy Growth Corp. (TSX:WEED)(NYSE:CGC) stock tumbled 10% after the leading marijuana grower posted a mixed bag of financial results showing staggering operating losses in its annual financial results in June this year. The company is set to release its first quarter (Q1, 2019) results for the three months ended June 30, 2018 on August 14, and investors are wondering what could be in store this time.

A repeat of the sharp spike in Canopy's share price volatility after the June financial report is feared. The cannabis giant's stock is among the very few marijuana equity issues trading in positive territory so far this year, and a disappointing result could wipe out the 20% year-to-date gain on the ticker.

Here's what I am looking forward to in Canopy's earnings next week.

Improving revenue growth trend

The company's 5% sequential quarterly revenue growth during the first three months of this year wasn't impressive given the high valuation multiples on the stock. A double-digit growth would be desirable this time given the over 10% growth in patient numbers to over 82,000 between April and June of 2018.

The previous quarterly results were significantly boosted by a surprise rise in Germany sales, thereby implying slow to negative Canada revenue growth. I doubt if Germany exports could sustain further surprises, as sales to this market have been erratic before.

Canada sales should pull up, but patient numbers growth during the last reported quarter did not translate into significant revenue expansion, and I would be worried if the same trend repeats.

Oil sales growth

Cannabis oils and jelly capsules are value-added products that have helped lift Canopy's average selling price per gram of cannabis over the past several months to $8.43 by March 2018, but at 23% of revenue, the two product lines' proportionate share in the firm's top line haven't grown fast enough over the previous three quarters.

An improvement in the oils and capsules sales component would be a desirable development. This improves revenue diversity and quality as we enter the recreational market era, and there is just one more quarterly report before recreational sales kick off in October.

Growing operating losses

Investors have seen worsening operating results over the past two quarters as the company geared up its preparations for the adult use market.

I do not expect operating costs to decrease just yet.

The biggest components of operating expenses have been share based compensation, employee compensation and benefits, and depreciation and amortization expenses, in that order. All these are sticky expenses for a growing firm, and considering the rise in the stock since March, share-based compensation expense may be higher this time.

A new production cost metric?

The company suspended reporting its average cost of producing a gram of cannabis recently. No replacement metric was given last time, but the CEO argued that a measure based on the milligrams of tetrahydrocannabinol (THC) and cannabidiol (CBD) should be a better measure of production costs than just the cost of producing the whole flower.

The proposal makes sense for cannabis oils and capsules where these extracts are sold prominently, but could be controversial on traditional dried leaf and flower products, and makes cost comparisons across producers even more difficult.

This new cost measure would be an interesting test of **Aurora Cannabis Inc.**'s claims that its investee, Radient Technologies Inc.'s proprietary extraction technology, is superior to other competing technologies in the new industry.

Could Aurora think of beating Canopy to this cost metric?

Extraction costs will be a significant component in the new cost measure, and we could see this metric demonstrated in the coming quarterly report, but I am not confident Canopy could start reporting the complex measure this fast. Maybe later.

Foolish bottom line

Canopy is a leading player in the nascent industry, but its lead is being seriously challenged by an aggressive Aurora Cannabis Inc. Sustained high revenue growth rates will please investors, while efforts to contain operating expenses could be welcome. I like the inventory build-up on Canopy's balance sheet, but the 15,726 kilograms in dry cannabis by March isn't that big enough to feed into the company's 67,000 kilograms provincial annual supply agreements.

I will be watching inventory levels too.

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Date
2025/08/19
Date Created
2018/08/10
Author
brianparadza