Will the Canopy Growth Corp. (TSX:WEED) Rally Go Up in Smoke?

Description

Last month, news that **Constellation Brands Inc.** (NYSE:STZ) had purchased 38% of **Canopy Growth Corp** (TSX:WEED)(NYSE:CGC) started a massive rally in Canopy shares. Trading at $32 at the start of the month, they were at 59.64 at the end of August. That's a whopping 86% gain in just a few weeks!

If you had bought shares in Canopy Growth and held them until now, you'd be sitting pretty.

But is it still wise to get in today?

While the stock is very hot right now, it might not be a great long-term play, and the main reason might surprise you.

To explain what I mean, I first need to ask a question that few are willing to ask.

Is legalization actually good for cannabis stocks?

On the surface, this seems like a silly question. Legalization will increase legal cannabis sales dramatically. It will take revenue that's currently going to the black market and divert it to publicly traded companies. It will reduce the regulatory issues that cannabis companies currently face (e.g., Health Canada guidelines and prescription checking). How could any of this be a bad thing?

Believe it or not, it could be.

Precisely because the recreational market is less regulated, it could actually drive cannabis companies' margins down. In many jurisdictions where cannabis has been legalized, the price of cannabis has fallen as a result. This would probably be bad news for cannabis companies, most of which already have negative earnings.

Cost of revenue is a massive issue for these companies. If legalization drives prices down, then it could become an even bigger problem. And this is an issue that disproportionately affects Canopy, whose costs are rapidly mounting.

So far, I've outlined a sector-wide problem that may or may not impact Canopy. This alone merits taking a critical look at Canopy shares. However, there is another factor that's specific to Canopy that may cause even more problems for the company.

Dilution of equity

When Constellation purchased its Canopy shares, it bought them direct from the company, not on the stock market. This means that the purchase will create new shares and dilute each shareholder's percentage of ownership in the company. It will also add about $4.5 billion to the company's assets, which will offset the dilution in the short term but it remains to be seen whether the company will use the new funds profitably.

Canopy's plan is to spend the money on international expansion. It wants to become the #1 supplier in 11 of the countries in which it operates. If successful, this will no doubt increase Canopy's revenue. However, Canopy's main issue is not revenue but bottom line earnings: the company has a negative net income, and the loss grows larger every quarter. Increasing the company's international footprint won't help that.

What the company needs is a way to improve its margins. R&D investments, especially in areas like new cultivation, storage and distribution techniques, could help here. The company doesn't seem to be investing much in these areas, instead focusing on growing sales (at a high cost). As a result, Canopy is vulnerable to possible downward pressure on prices in the era of legalization. If that happens, the rally we're now witnessing may indeed go up in smoke.

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andrewbutton