This Insane Figure From Aphria Inc. (TSX:APH) Supports Tilray Inc.'s (NASDAQ:TLRY) Valuation but Threatens the Entire Cannabis Industry

Description

Low-cost marijuana producer **Aphria** (TSX:APH) announced an unbelievably cheap productive capacity expansion budget in June 2018 that could see the cannabis player increase its productivity by 30,000 kilograms annually from its facilities. The insanely low build-out cost significantly bolsters **Tilray's** (NASDAQ:TLRY) stock valuation.

Aphria's directors approved a $20 million capital expenditure (capex) budget increase for Aphria Diamond, the company's newer production facility, and a further $10 million build-out at the company's first production facility for a combined $30 million budget increase.

The first $20 million is expected to increase cannabis output by 20,000 kilograms per annum at Diamond, while the $10 million budget for the other facility, Aphria One, could add 10,000 kilograms of dried marijuana output per annum.

In other words, just $1,000,000 in additional capex may add 1,000,000 grams to annual productive capacity at both facilities.

Actually, an additional $1 in capex adds a gram to the company's annual cannabis output, and the production facilities are depreciated over 20 years!

One can only imagine the potential payback period for the company when productivity can be expanded so cheaply, when volumes increase in a legalized adult-use market, and when economies of scale kick in to drive average costs per gram lower.

How does this support Tilray's valuation?

The concern by some investors is that Tilray has "too low" productive capacity, with an expected capacity build-out at 912,000 square feet by end of this year, as compared to **Aurora Cannabis's** 2,305,000 square feet right now and 4,505,000 square feet by mid-year 2019.

Actually, Tilray's low productive capacity saw its average cost per gram sold increase for the three and six months ended June 30, 2018, from the comparable periods in 2017, primarily due to sourcing product from other licensed producers to support demand growth, and this is only during the medical-marijuana-only era.

The company will need more product to fully compete in the recreational market, and if expansion costs can be as low as Aphria has shown, the company can quickly and easily scale up. Management has done well focusing on the higher-level aspects of the business, building high-value, intangible assets where it matters the most, including penetrating the U.S. drug market!

The low build-out-cost-profile tag dispels investor worries about capacity growth, especially now that the company has gone public and has access to cheap financing (with some dilution, of course).

That said, the low capex requirements are a significant threat to the whole industry.

A threat to the industry?

Low capital requirements for new production facilities present very low barriers to entry in the cannabis sector and increase the serious risk of product oversupply, leading to ever-declining operating margins and commoditization of the product. Valuation multiples are therefore severely threatened for industry players' equity offerings in the long term.

Health Canada has increased its rate of licencing for cannabis licence applications. The new producers have ambitions of expanding operations and can do it cheaply. New supply growth may hurt product pricing strength.

The low-cost structure for the industry may also mean that Canadian growers face the serious risk of losing their international market grip, as new local players in those territories source financing to build production facilities, especially in agriculture-favourable climate states like Jamaica, Lesotho, and Zimbabwe, where labour costs are significantly low.

Foolish bottom line

The cannabis space is a new growth industry that is maturing fast and mutating rapidly, changing from mostly dried flower sales in 2016 to premium oils and jelly capsules in 2017 and to increased drug development efforts this year, which justifies marijuana producers' categorization under the pharmaceuticals sector.

Marijuana-infused beers, and potentially CBD-infused beverages, add to the hype and confusion on how investors should think about this "wonder weed," and that's driving stock prices very high.

Low capex requirements may support some companies' valuation thesis today, but they mean cut-throat competition in the industry, only the fittest will survive, and the leading players seem capable of winning as of now due to first-mover advantages.

However, the stray valuations on cannabis equities are concerning, as share prices could significantly correct and investment losses may be severe. Tilray's share price may plunge in January when the majority shareholder, Privateer Holdings Inc., begins to take profits upon lockup-period expiration.

Be sure to tightly monitor portfolio exposure to marijuana and re-balance accordingly.

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