Aurora Cannabis Inc. (TSX:ACB): Surprises From Latest Earnings Release

Description

Aurora Cannabis (TSX:ACB) has emerged as one of the most promising growth stories in the cannabis sector and one of the few marijuana stocks that could be expected to strongly lead in the new adult-use market soon to be legalized next month.

The company's latest quarterly installment, which doubled as its annual financial results for fiscal year 2018, could rank as one of the most communicative set of annual filings by a cannabis company, and I applaud management for the high-quality disclosure in this space, save for only one point of interest: namely, I feel the company could have done better by disclosing the hard grams and litres of cannabis oils it held for supply in the recreational market.

I can somehow forgive this "omission" today, as the company seems to be ramping up production as fast as it can, with a record number of facilities expected to be operational by end of year, and I couldn't help but smile when the chief corporate officer informally impressed on analysts that the company's inventory is very fresh, not stale.

That aside, there were a few surprises and concerns in the latest earnings release that could be worth highlighting.

Unusual decline in active registered patient numbers

The market had become used to the fact that medical marijuana registered patient numbers are growing, and they will continue to grow, probably indefinitely, but Aurora pulled off a negative surprise during the quarter.

Active medical cannabis patients declined 5% to 43,308 during the quarter, and that was a first.

These patients could have migrated to other producers or delayed purchases to future periods, or they simply left the market, and the last possibility could be scary for the budding sector in terms of anticipated demand growth.

For starters, medical purchases are usually known to be sticky in nature, as consumption is not that discretionary. If customer medical purchases can decline, then how much volatility should then be estimated for recreational sales?

Gross margin growth

Aurora's gross profit margin on medical cannabis, as measured before the most subjective fair-value adjustments, grew 25% sequentially to 74% of sales, and the margin was 28% better than the 58% generated during a comparable quarter last year.

This achievement is impressive given that the average production cost had increased by 11% sequentially. The quarterly figure was the best over four consecutive quarters, thanks to an increase in average selling prices and increased oil sales.

Parabolic net income growth

Aurora's most recent quarterly net income increased to $79.3 million compared to a net loss of $20.8 million in the previous quarter, even when operating expenses skyrocketed.

The increase was primarily a result of unrealized non-cash gains on derivatives and marketable securities. The company's investment portfolio could introduce serious risks to the bottom line if it performs poorly going forward, yet the company may have no control of valuation.

Increase in cash cost to produce

Cash cost to produce per gram increased 11% sequentially from the previous quarter, although the measure was down 11% for the comparable period a year ago.

CanniMed's higher production costs have pushed the cost profile higher, and I would hope that the inclusion of MedReleaf's results in the next quarterly installment as well as the proclaimed low-cost profile for flagship Aurora Sky could help dampen this cost growth as the company enters recreational market where the competition will be severe, and some provinces will buy product at wholesale prices, and the producers will see very low margins.

In this scenario, being a low-cost producer becomes a critical competitive advantage.

Europe export revenue performance

Given the company's statement that it had chosen to constrain international sales "in order to continue servicing the Canadian market, while building inventory in preparation for the Canadian adult consumer-use market," one would naturally expect to see a decline in export sales in the financial statements.

It's therefore surprising that, with this background, Aurora actually generated $2.6 million in exports to Europe during the quarter, 13% higher than the previous quarter.

Is Aurora therefore promising the market explosive export revenue growth during the next quarterly installment now that there is new supply from MedReleaf and given the ramp up in production during the quarter to September 30, 2018?

Germany seems hungry for more product.

Investor takeaway

Costs are rising as the company executes for growth and readies for the adult-use market, requiring higher sales levels for the company in the new market for profitability prospects to be realized, but good potential is showing too.

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