1 of My Favourite Marijuana Stocks May Now Be Range Bound

Description

One of my favourite pot stocks, **Supreme Cannabis** (TSXV:FIRE), announced a $90 million bought deal financing agreement last week. The announcement caught the market off guard. Unfortunately, the structure of the deal may limit the company's upside. Let me explain.

Financing details

The company entered an agreement with underwriters to purchase $90 million aggregate principal amount of convertible debentures. It jumps to $100 million if exercised in full. What is a convertible debenture? In simple terms, it's a loan that can be converted into common stock.

In this case, they are convertible at a price of $2.45 per share. Of note, this represents about a 10% premium over its current price of $2.22 per share.

The debentures will pay 6% annual interest until the date of maturity, which is 36 months (or three years) from issuance.

Here is where it gets interesting. The company has the right to force the conversion of these debentures if the weighted average trading price of Supreme's common shares is equal or above $3.43 per share for 10 or more consecutive days.

Potential manipulation

To the untrained eye, the financing does not raise any red flags. I am here to tell you, however, that the $3.43 price point may represent a ceiling for the company's share price over the next 36 months.

If the share price rises and begins to trade close to $3.43 per share, wily investors who hold these debentures can short the stock. Why? Because they know they can cover their short by selling their debentures.

Seems far-fetched? Unfortunately, it’s not. Supreme has struck similar financing deals in the past, and investors saw this exact scenario play out.

Why raise funds?

The bought deal comes at an odd time. According to recent information, the company’s 7Acres expansion was fully funded through the end of the year. It also has approximately $56 million in cash on the books. As such, why the urgent need for financing?

As per the company, it “intends to use the net proceeds from the offering for capital expenditures for capacity expansion, working capital and general corporate requirements.” This is a general statement and doesn’t provide much clarity.

It’s not all bad

Let’s say, for argument’s sake, Supreme’s stock price has difficulty breaking through the $3.43 ceiling due to short sellers. It still represents 55% growth from today’s share price. Although it may not seem like much when compared to the industry’s recent surge, it’s still a fantastic return.

There was also a tidbit of information buried in the company’s release that is worthy of mention. Supreme “views the completion of the offering as an important milestone in qualifying for graduation to the Toronto Stock Exchange.” This would increase liquidity and the company’s reputation among investors. It could be the catalyst the company needs.

Supreme is one of the cheapest pot stocks in the industry based on expected 2019 sales and earnings before interest, taxes, depreciation, and amortization (EBITDA). Most of its peers are trading at astronomical valuations — valuations that are not sustainable over the long term.

As such, don’t be surprised if Supreme outperforms the industry average over the next 12 months.

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mlitalien