Marijuana Stocks: Is the Latest Crash in Pot Stocks a Buying Opportunity?

Description

After the legalization-inspired rally in Canada, marijuana stocks are tumbling and many investors are wondering what the reason is for this sudden weakness.

During the five-day slump that started after Oct. 17 legalization of pot in Canada for recreational use, many leading cannabis stocks have lost more than quarter of their values.

Canopy Growth (TSX:WEED)(NYSE:CGC), the country's largest marijuana producer, was trading 10.8% lower to $54.46 on the Toronto Stock Exchange at the end of Monday's session.

Its stock has tumbled 28.4% since hitting an all-time high on Oct. 16. **Aurora Cannabis** (TSX:ACB), which also hit record highs on Oct. 16, has plunged 28.4% the same period, while **Tilray Inc.** (NASDAQ:TLRY) is down 23.5%.

There are two possible justifications of this sudden change of hearts by investors. First is about supply shortages in Canada, where provincial and private retailers are struggling to keep up with the strong demand for recreational pot across the country.

Five provinces, including Ontario and Quebec, counted about 172,000 orders placed on the first day of sales, leading some government agencies and private retailers to issue product shortage warnings.

Manitoba warned consumers that supply shortages could last as least six months, while Quebec highlighted that cannabis oils, capsules, and pre-rolls would be in short supply.

That potential supply-demand imbalance, if allowed to persist, could dampen the future profitability of some of the leading producers. "While it was difficult for provinces and experts to predict just what the demand for cannabis would be once legalized, the actual demand far exceeds any reasonable expectations," said Quebec-based **Hexo Corp**. in a statement.

Another concern making investors nervous is the execution risk once the legalization phase is over. We don’t have much idea about the marijuana companies’ actual potential of producing, marketing, and selling the product. There will be many failures in this stage, and investors need to be extra careful in picking their investment.

The Toronto-based debt-rating agency DBRS Ltd. said in a note yesterday that some of the biggest marijuana producers should have “junk” ratings and that many licensed producers (LPs) are likely to fail. “Although the development of the sector may benefit all licensed producers, not all will perform equally and many will fail,” the agency wrote, adding that the sector’s credit quality is currently low.

“At the outset, DBRS believes that the largest LPs in the cannabis sector exhibit characteristics consistent with the low, non-investment-grade [or junk] range of the credit ratings spectrum — in the B range.” A “B” rating is two notches below investment grade.

Bottom line

I believe the latest weakness in marijuana stocks hasn’t run its course, even after the massive beating of the past five days. As the market focus shifts to the execution, we’re going to experience a bumpy and potentially very risky ride in the cannabis space going forward.

Investors should wait on the sidelines for another week or so before looking for attractive entry points. In this space, sticking with the biggest names, such as Canopy, Aurora, and Tilray, is a good strategy.

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Date
2025/08/27
Date Created
2018/10/23
Author
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