Is Aphria Inc. (TSX:APHA) Stock a Buy Before Earnings on Friday?

Description

Aphria (TSX:APHA)(NYSE:APHA) is set to release its second-quarter earnings report for Q2 2019 on January 11 before market open, and investors are eagerly anticipating the first installment of adult-use cannabis results from the low-cost marijuana producer covering the three months to November 31, 2018.

The firm will be the first to give the market a more in-depth look into this new growth market, as its results cover more than a full month of recreational marijuana sales. I expect a good quarter, and the market could be in for a positive surprise.

A potential revenue beat

Analyst revenue estimates for the quarter are reported at $38.8 million thanks to an expected massive sales volume boost from recreational marijuana sales since October 17 to give a top-line growth rate of 356% from a comparable quarter in 2017 and a sequential 192% jump from the $13.3 million from medical cannabis sales in a most recent quarter.

The company had an adult-use cannabis supply order of 5,000 kilograms of cannabis from the provinces in October last year after signing supply agreements with all Canadian provinces for an annualized supply for 30,000 kilograms in the first year of legal sales. Due to product shortages, I expect the order was fully supplied.

At an estimated wholesale price of $5.50 a gram (in line with reported comparable sales prices from competitors), and assuming full supply from accumulated inventory, I would expect the company to generate about $27.50 million from adult-use cannabis sales.

Some medical marijuana revenue might have been lost to the new legal market. The company sold some 1,788 grams of medical cannabis during a previous quarter for $13.3 million, and if roughly 10% of these were cannibalized, revenue could easily go above $39 million — an easy top-line beat!

Aurora Cannabis and **Canopy Growth** reported marginal declines in medical cannabis right before recreational sales debuted last year. The same could be expected here.

A surge in operating margins?

The company holds an impressive record of 11 successive quarters of uninterrupted positive adjusted operating earnings (adjusted EBITDA) from cannabis operations, which was unfortunately interrupted after the Nuuvera acquisition and cost increases during the quarter ended August 31, 2018.

A sharp increase in sales volumes after October 17 could boost operating earnings. We could see a welcome return to positive operating profitability in the upcoming report, and this could be a new trend poised to last longer.

That said, gross margins will most likely shrink in the near term, as more product is sold into the low-margin adult-use wholesale market, and they could suffer further as the company increasingly sources product from its 140,000 kilograms per annum Aphria Diamond facility, where it has a 51% equity stake. Product from this facility will be acquired at an "agreed upon transfer price."

Higher sales volumes since October could lead to a significant short-term increase in operating margins, but I expect a sustained marginal decline in margins going forward, as wholesale sales dislodge higher-margin direct-to-client medical cannabis revenues, while higher inventory costs from transfer priced product chew into gross profits.

Operating cost containment may not yet be a priority for management right now, as the company executes for growth and incurs massive market development expenditures and acquisition-related expenses, and this could continue to suppress margins and potentially result in an earnings miss.

Foolish bottom line

A stellar performance in the upcoming quarterly earnings report could somewhat exonerate the company and quicken the market's forgiveness of a potential management scandal, and we could witness a surge in the share price should the numbers exceed market expectations.

The last time I checked, the company had gone over budget with its Part IV and Part V expansions at Aphria One facility, which was scheduled to achieve a production run rate of 110,000 kilograms per annum by this January and expected to reverse the temporary increase in "all-in" cash costs per gram. Investors will be looking forward to a favourable update on productive facilities completion and production ramp-ups.

The recent talk of **Green Growth Brands's** intention to launch a hostile takeover bid for the company has revived new interest in the stock, and a good quarter could bring new momentum and provide a potential for a quick profitable trade, but I wouldn't recommend the stock for a long-term hold right now, as potentially damaging investor class-action lawsuits in February could inflict new pain.

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Date
2025/08/25
Date Created
2019/01/07
Author
brianparadza