How High Can Canopy Growth Corp (TSX:WEED) Go?

Description

Piper Jaffray analysts re-rated **Canopy Growth** (TSX:WEED)(NYSE:CGC) on Friday and raised its stock price target from US$40 to US$60. The company believes the near-term prospects of the legalized marijuana market in North America justify the new valuation.

A 50% rise in the target price from one of the most well-known and prestigious Wall Street investment banks is a big deal. Canopy's stock popped by as much as 10% on the news. Now, the stock trades at US$48.5, indicating upside of nearly 20%.

In their research note, the analysts say they expect the global market for marijuana to expand by double-digit percentages every year for the foreseeable future. They estimate the global recreational and medical market could be worth as much as US$500 billion over the long term or close to US$50 billion in the near term.

At the moment, Canopy's annual sales are a little over US$100 million, while the company's market capitalization has just crossed US$16.6 billion. In other words, the stock is trading at a price-to-sales (P/S) ratio of 166.

That P/S ratio doesn't seem silly when you consider the fact that the company's last reported quarterly earnings were for a period that ended on September 30. Recreational weed sales were officially legalized in Canada on October 17. So, this upcoming quarterly report will be the first glimpse at how much money Canopy can generate from its products.

In fact, I think most investors will have to wait a few years to see the true potential of the legal marijuana industry across the globe. If the legalization drive is successful in Canada, and if there's a move towards legalization on the federal level in America after the 2020 presidential election, the global weed industry could be in for a massive windfall.

However, Canopy Growth will have to expand sales by an order of magnitude to justify its current valuation. I'll make a few assumptions based on Piper Jaffray's estimates. Assuming the market is worth US$500 billion by 2030, Canopy captures 10% of this market, and the average alcohol or tobacco company trades at a P/S ratio of five, the company's valuation works out to $250 billion, or $1,077 per share.

That's an impressive return of 15 times over a period of 12 years, or 25% compounded annual growth. In my opinion, that sort of growth can justify the near-term risks of holding Canopy's stock.

However, Canopy will need ongoing support from **Constellation Brands** to bolster its distribution network, an uninterrupted wave of marijuana legalization across the world, and a strategy to preserve net margins to achieve this growth.

Bottom line

Canopy is already the leading firm in a nascent industry. If it can preserve its dominance, and if more countries across the world replicate Canada's move to legalize weed, the company could make $50 billion in annual sales by 2030. That would justify its current valuation.

However, long-term investors need to brace for near-term volatility and keep a close eye on the company's next quarterly earnings report, which is due on February 14.

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