Is Canopy Growth Corp (TSX:WEED) Stock a Buy Before Thursday Earnings?

Description

Leading cannabis and hemp producer **Canopy** (TSX:WEED)(NYSE:CGC) is expected to report its quarterly earnings results for the period ended December 31, 2018, aftermarket on February 14, and the upcoming instalment could be full of surprises.

Smaller producer **Organigram Holdings** did surprise on revenue, gross margin growth, and record-low production cost performance in its latest earnings, which covered early adult-use market sales to November 30. Could we expect the market leader to pull off a similar impressive performance?

Probably, yes, but let's look at where the good news could emanate from in Canopy's upcoming quarterly results.

Revenue growth

Analyst earnings estimates place expected three months revenue in the lower to upper $60 million range, with some consensus estimates at $62 million, while others expect a $66 million top-line reading.

It seems like analysts have significantly revised down expectations after a wide miss during a previous quarter, where expectations ranged in the $60 million range and revenues came in at $23 million — a whopping 10% sequential decline from a previous quarter, but this could set the company up for a wide margin of surprise.

For a start, the company had an inventory position of 31,214 kilograms of dried cannabis, 21,499 litres of cannabis oils, and 1,497 kilograms of soft gel capsules at September 30, and there were reports that the recreational use market was severely undersupplied during the quarter.

Aurora Cannabis managed to generate $47.6 million in net cannabis revenue (and $62 million ingross revenue) during the same quarter. Canopy's dried cannabis inventory was over four times biggerthan Aurora's grams sold during the quarter and the company was evidently much more capable of delivering large batches of product into a highly undersupplied cannabis market. Management stated that they had doubled their product shipments in November.

A quarterly net revenue reading over $70 million could still be a conservative estimate.

Gross margins

Canopy has been suffering from uneconomically low gross margins (calculated before fair-value adjustments) during the last two consecutive reported quarters, with the previous quarter reading coming in at 28% of sales. The IFRS gross margin after fair-value effects was agonizingly negative during the previous quarter.

The company blamed the poor margins on high cash operating costs of subsidiaries not yet cultivating or selling cannabis, and to the impact of destroyed plants while awaiting Health Canada licensing.

New excise taxes since October 17 have a significantly negative impact on margins, but I still expect the company to report improved gross margins after receiving new licensing for facilities. However, it may require another quarter for the damaging effects of delayed licensing to be fully diluted away as recently licensed facilities increasingly contribute to quarterly harvests.

Margins should also improve as the company sells more product (and cash costs are spread across may sales units) and production economies of scale kick in.

Operating expenses

Canopy incurred a staggering $180 million in operating expenses in a previous quarter, but a significant proportion of these costs are not likely to be recurring in the near term.

Selling, marketing, and distribution expenses of $39 million last quarter could sequentially go down marginally like they did at Aurora Cannabis, which recorded a 23% sequential decline on this expense line in its latest results released on Monday. Marketing expenses increased in the September quarter as cannabis producers heavily advertised their brands before the restrictions of the Cannabis Act came into effect on October 17.

General and administrative expenses could remain flatter. Share-based compensation expenses do vary in timing, but I expect the $50 million in acquisition related milestone payments in a previous quarter to not show up on the quarterly income statement this time.

Acquisition-related expenses may remain high, as the company acquired leading hemp research firm ebbu Inc. during the quarter, restructured its investment in TerrAscend, and completed the **Constellation Brands** investment

Overall, I expect operating expenses to come lower than a previous reading in the upcoming earnings report.

Could we see a surprising positive EBITDA?

Not so fast.

A positive EBITDA reading would be a great stock moving piece of news, but it's too early to expect this kind of super performance, as revenue generation is yet to reach operating breakeven points.

Investor takeaway

Canopy could surprise on revenue in the upcoming report, and the market could love an improvement in gross margins. The stock could see some gains after a earnings surprise on Friday, but long-term investors should watch the troublesome operating cost element to gauge future profitability.

Happy investing, Fools.

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