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Are Pot Stocks About to Plunge?

Description

2019 has been a terrific year for Canada's top marijuana stocks, but I'm not sure it's going to last.

Both **Canopy** (TSX:WEED)(NYSE:CGC) and **Aurora Cannabis** (TSX:ACB)(NYSE:ACB) have helped lead the TSX Composite Index to a nice return thus far in 2019, with the index flirting with a 10% gain in the middle of February.

Canopy leads the way with a 59% return, while Aurora is lagging a little behind. Still, the Edmonton-based company has still delivered a 40% return to investors thus far in 2019. And both stocks have seen their shares go down a little in the past week.

I'm not so convinced this is the beginning of a new normal, however. Here are a few reasons why investors should be cautious today.

Shortages abound

Product shortages are plaguing the legal marijuana industry, and from the looks of it, there's plenty of blame to spread around.

The producers are quick to point out the numerous problems with building an industry from scratch, which is certainly true. These folks have to invest millions in growing facilities and to hire staff, acquire seeds, arrange an entire logistics network, streamline back office processes, and a million other details I'm forgetting. It's a gargantuan task, and there were bound to be some hiccups.

Another issue is getting government approvals. Critics say the rules Ottawa imposes on pot growers are much stricter than needed and are having a major impact on how much product gets to market. Health Canada, meanwhile, is telling the media it's doing everything possible to get growing operations approved.

The truth probably lies somewhere in the middle. Meanwhile, marijuana retailers are hiring staff to scour inventory websites to snatch up supply as soon as it hits the market. That's how backed up these businesses are.

It’s difficult to justify a big move upwards in pot producer stocks when the underlying business is riddled with problems, even if these concerns aren’t entirely the producers’ fault.

Valuation concerns

Something doesn’t make sense to me.

How do we have marijuana producers who, on the one hand, are dropping the ball on supply (even if that isn’t entirely their fault), yet, on the other hand, we have sky-high valuations that imply huge sales gains for every pot producer?

Let’s take a closer look at Aurora’s valuation as an example. In its most recent quarter, Aurora did $62 million in gross revenue. If we annualize that figure it, gets us to approximately $250 million in sales. Aurora has a market cap of $9.4 billion, giving it a price-to-sales multiple of 37.6 times.

If Aurora converted every dollar in sales to profit — which is impossible, of course — it would still take investors nearly 40 years to get their original investment back.

Things are even bleaker when we look at profits. Analysts expect both Canopy and Aurora to post losses in both 2019 and 2020.

The only thing justifying these excessive valuations is potential. But perhaps the future isn’t as bright as investors think.

A commodity product

While there are a few products I insist on buying a certain brand and nothing else, for the most part, my fridge and cupboards are filled with generic brands.

I bought chicken breasts last night. Did I care about what brand they were? No. I simply picked up a package from the shelf that looked good.

Marijuana has similar potential. Sure, customers might like a certain strain with a specified potency. But that can be easily imitated.

As the industry matures, there’s likely to be more entrants entering the growing market. This will inevitably push prices lower. Generic-brand cannabis will arrive, and like my chicken breast experience, nobody will care about the difference.

In fact, this may be already happening. In its most recent quarter, Aurora disclosed it got a lower selling price per gram versus the quarter before. The average selling price of dried cannabis fell 26% on a quarter-over-quarter basis. That can’t be encouraging.

The bottom line

Simply put, the marijuana industry has too many challenges to justify sky-high stock valuations. Issues like product shortages, weak pricing, and logistical difficulties aren't going to go away quickly. All that's holding pot stocks up today is investor sentiment. And as we saw in late 2018, when that goes away, the underlying shares go down a long way very quickly.

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1. Editor's Choice

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