



## Cannabis Stocks Are Not a Risk Worth Taking

### Description

Cannabis has been legal in Canada for around six months, and the numbers are starting to pour in. Years of speculation on the viability of this sector, analysis on potential profitability, and guessing as to the potential for the nascent industry are starting to be compared against the actual numbers. The results are coming in, and investors are faced with real numbers that should answer the question: Are these stocks worth the price we paid for them, or did we overpay?

A number of companies in the industry have provided a couple of quarters of results since cannabis became legalized. [Larger players like Canopy Growth \(TSX:WEED\)\(NYSE:CGC\)](#), [Aurora Cannabis \(TSX:ACB\)\(NYSE:ACB\)](#), and [Cronos Group \(TSX:CRON\)\(NASDAQ:CRON\)](#) have started showing after-legislation results, and the outcomes are mixed.

### Revenues are great!

One bright spot of basically every cannabis stock is stunning revenue growth. Canopy increased revenues by 350% year over year. Aurora had similarly positive results in its second-quarter 2019 results quarter with net revenues surging 363% over the same quarter a year before. Cronos was almost as positive with [revenues increasing](#) by 186% in its third-quarter report over 2017.

### But unfortunately...

Revenues are a good indicator of how much money is brought in, but they are not a great way to determine if the company is profitable. Revenues, while important, are not a good indicator of a company's total potential. After all, if you spend more than you bring in, no matter how much you bring in, you are eventually going to get into trouble. What is important is the company's ability to generate earnings and cash.

It is still unclear whether these companies can begin to generate real money. In the fourth quarter of 2018, Canopy increased its basic earnings per share by 210%. Earnings are also now positive, which makes it seem more investable than was previously the case. Aurora operated with a year-over-year loss. Cronos also operated at a loss year over year in the third quarter. Earnings in these stocks are still volatile, seemingly increasing and decreasing with each quarter. This makes it extremely difficult to

get a read on the true profitability of cannabis companies.

## The bottom line

There are some bright spots in the numbers coming from cannabis companies. Revenues are growing at an incredible rate, indicating that there must be some sales happening somewhere. Unfortunately, revenues alone do not make a compelling case for investment. Earnings and free cash flow are the most important indicators.

Earnings and cash flow should keep people away from the space, at least for now. From quarter to quarter, it is difficult to tell whether the companies are making money from all those revenues or not. Free cash flow is essentially non-existent. This is the wild west of cannabis investing, and investors need to be comfortable with the fact that they are still speculating before they get in.

Of course, cannabis companies are still spending a lot to keep growing, and they are in the early stages of that growth. Some of these investments might pay off in the long term, like the medical side of most of these businesses. But I just can't get excited about all the cash burn going on in the sector. Cannabis companies' best-selling product still seems to be their shares, and I am not a big fan of dilution.

Although real numbers have started to come in, the fact remains that it is still too early to tell what a mature cannabis industry will look like or when they will start making real money. It is likely that consolidation and cash burn will continue for now. Furthermore, many of the companies in the space, including these current leaders, will perhaps cease to exist or combine with other companies in the future.

Only time will tell what the final results and who the ultimate survivors will be. So, why bother trying to guess now? I prefer to wait until companies actually make money consistently before giving them mine.

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2. NASDAQ:CGC (Canopy Growth)
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4. TSX:ACB (Aurora Cannabis)
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