
# 3 Reasons to Be Wary of Canopy Growth Corp (TSX:WEED) and Cannabis Stocks in General

### Description

I remain stuck between the excitement of a booming emerging industry — the cannabis industry — and the not so exciting financial and market realities of it. And then there are the nerve-wracking realities of cannabis stocks' valuations and the expectations that are baked into them.



Here are the three main reasons that I remain cautious.

## Highly valued stocks have the farthest to fall

**Canopy Growth** (TSX:WEED)(NYSE:CGC) stock is 54% higher year to date and is only 18% off its October 2018 highs. Canopy stock trades at 135 times sales, and although sales growth is high, this is still a very generous multiple.

**Aurora Cannabis** (TSX:ACB)(NYSE:ACB) stock is 84% higher year to date and only 13% off its 2018 highs in a year that has thus far been impressive.

But we know that valuations on these stocks are lofty, signalling somewhat of a bubble, and although the cannabis industry is a rapidly growing one, maybe valuations are ahead of themselves, and maybe it will take a long time before actual fundamentals catch up, eventually leaving investors with the short stick.

In a market that appears tenuous, these highly valued stocks have the farthest to fall.

## Bottom-line financial results are not good

The reality of lacklustre bottom-line financial results should leave investors at least a little bit skeptical.

I mean, it's great to achieve strong sales and sales growth, but it is a very different thing to make good money off it. Making good returns on investment is of paramount importance, and this is clearly not happening yet, as these companies are still in growth mode with heavy investments overwhelming results.

Canopy is losing money at a feverish pace; losses continue to mount, as expenses increase dramatically to fund the company’s growth plans. For example, SG&A expenses in the latest results represented 54% of net revenue versus 43% last year. While this is to be expected, as the company is embarking on a very aggressive growth strategy, it is nevertheless something investors should watch, as it is falling to the bottom line, significantly reducing earnings and cash flow numbers.

As for Aurora, it too has reported big increases in revenue. In its latest quarter, Aurora reported strong sales growth, with sequential revenue growth topping 80% and year-over-year revenue growth coming in at an impressive 363%. But with this, we are also seeing costs creep up, and the company’s reported net loss was $238 million.

## Risks of an emerging industry

In an emerging industry, the risks are plentiful.

It is difficult to know which companies will survive and thrive, and it is difficult to foresee the issues that can potentially derail a company.



By its very nature, an emerging industry is fraught with many unknowns and risks.

Is the market pricing in this risk?

## Final thoughts

I go back to my main recommendations for those investors who would like to participate in the potential upside of the cannabis industry: own a basket of cannabis stocks, take profits, and trade around short-term mispricings.

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