Why Did CannTrust Holdings (TSX:TRST) Stock Fall 19% on Thursday?

Description

Marijuana stock **CannTrust Holdings** (TSX:TRST)(NYSE:CTST) traded sharply lower on March 28 after the once highly profitable cannabis firm released fourth quarter and full-year 2018 results before market open in the morning that shocked the loyal investing public.

Shares closed 19% lower, and the big question is whether the latest set of financial results was disappointing enough to justify such a large price drop in a single day, or did retail investors and trading algorithms overreact?

A top-line growth of 131% to $16.17 million from a comparable quarter in 2017 and a year-on-year revenue growth of 120% to $45.65 million for the year 2018 didn’t impress investors. as the company reported a staggering quarterly loss that dwarfed earlier profitability and dragged the full-year results into the red.

Let’s see what could justify the negative market reaction to the company’s latest report.

Very low market prices

The company sold 3,407 kilograms of cannabis at an average net price of just $4.75 per gram in the quarter, while it had sold 1,364 kilograms at an average price of $8.37 in a previous quarter. Sales volumes jumped 150% quarter-on-quarter, but a 43% drop in the average net price was a recipe for a margin contraction disaster.

Net prices fell across the board as new excise taxes took effect on October 17, and the company decided to fully absorb the excise tax on medical marijuana sales with a negative impact on revenues and margins.

The sales mix for CannTrust is largely to blame for the poor margin performance.

The company sold 67% of its dried cannabis into wholesale and recreational markets that experienced the biggest net price drop averaging 34% from the third quarter. Only a third of dry cannabis was sold into the medical market at an average net price of $7.10 a gram, 19% lower than third-quarter prices.

Likewise, marijuana extracts sales consisted of 95% of revenues from Canadian medical sales, where the average net price dropped by more than half from the previous quarter.

The company saw its sales concentrated into weaker market segments, and there's no sign this trend may change soon, as pricing power is severely limited while competition is ever increasing with increasing industry productive capacity.

High production costs

A cash cost of sales per gram of $2.94 remains on the steep side in the face of declining market prices, although this was a marked improvement from the $5.16 a gram incurred in the same quarter in 2017.

The company ranks among the industry's high cost producers today, but there are hopes that costs may continue to decline, as the recently completed capacity expansion increases production and average cost are spread over more crops and output later this year.

First negative gross margin

Given the lower product prices and high costs above, the gross margin before fair value adjustments was a mere 35%, far worse than **Cronos Group**'s 44% for the same quarter.

Fair value changes in biological assets contributed an unrealized loss of nearly $14 million and resulted in a negative gross profit margin 51%!

CannTrust investors had become used to positive quarterly net profits, and the sudden gross loss before operating expenses was a hard pill to swallow.

Even worse, the company saw increased operating expenses as business grew, and incurred more marketing and promotion expenses in launching new recreational brands and higher professional fees upon listing on the NYSE and up-listing to the TSX.

Any future growth drivers?

I'm impressed by the 16% sequentially growth in active patients during the fourth quarter to 58,000 patients, and management revealed a further 16% increase in medical cannabis patients during the first quarter of 2019 to 67,280. Revenue growth could accelerate into the future and gross margins may start improving as productivity increases this year.

The expansion of a flagship production facility will see increased productivity and potentially lower production costs and free up some margins, while the construction of a new outdoor grow facility is expected to significantly lower the company's production costs on plants grown for extraction-based products.

That said, the company has guided for first quarter 2019 adjusted EBITDA to remain consistent with fourth-quarter 2018. That was an $8.5 million loss.

Investor takeaway

The company broke a recent record of six consecutive quarters of positive net profit, and the stock needed to get punished, but investors might have overacted to the negative news. A 35% gross margin is unhealthy, but there is room for lower production costs as a bigger facility come online this year.

Valuation could improve over the course of 2019, but there is the big risk of a wave of weakening investor interest in the hyped industry, this happens almost every year since 2017.

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