Should Cannabis Investors Buy Aphria (TSX:APHA) Stock's Current Dip?

Description

Canadian cannabis firm **Aphria's** (TSX:APHA)(NYSE:APHA) stock has taken a severe beating to trade 32% lower after the company released its fiscal Q3 2019 results on April 15, and the share price has never recovered since, even after the overly positive news of a key tender win in budding Germany. Should investors consider buying the current valuation lows?

The company is an intriguing marijuana play right now, not only as a result of negative publicity recently but on an operating efficiency and worrying growth trend basis, too.

Why did the stock take a beating?

Marijuana investors are very much appreciative of high top-line growth right now, and they seem willing to forgive temporary operating losses, but a 240% quarter-over-quarter revenue growth for the reported quarter wasn't enough to impress the market.

The company's revenue growth didn't come from the most desired source.

Although quarterly revenues jumped to over $73 million, about 78% of the top line was composed of distribution revenue mainly from the recently acquired CC Pharma: a Europe-based pharmaceuticals distributor.

Core cannabis operations, the capital markets' main focus, suffered an agonizing 23% sequential decline in volumes during the quarter, led by a poor show in recreational sales segment, which saw a 19% sequential decline in average selling prices before excise taxes, and consumer sales declined by nearly 35% for the quarter.

I'd be more concerned about the future growth story in the core growing and sales operation than in the low-margin pharma distribution revenues, which rarely attract much valuation multiples today.

Simply put, distribution revenue isn't exactly as highly regarded as local cannabis sales and export revenues. So, when internally grown product sales plunge by double digits within three months, and management blames mere packaging and logistical challenges, investors have some reason to fret.

From a valuation standpoint, the previous owners of CC Pharma accepted the meagre cash consideration of just $28.8 million (and a potential contingent payment of $35.7 million) for 100% of their equity position in a company with an annual revenue run rate of over $390 million. The distribution business doesn't attract much investor attention, yet it dominated the revenue line.

Sharply declining adjusted gross margins, much as a result of the high contribution from distribution revenue, and mounting operating losses added to the disappointment and the share price got punished as the core business dangerously underperformed, shaking investor confidence.

Further, the company took an impairment charge of $50 million, an 18% writedown in LATAM Holdings assets' carrying values, and this could be a troubling and further confirmation of earlier short-seller claims of overvalued acquisitions, throwing an egg right in the face of bullish investors. If this acknowledgement gives more ammunition to the five current lawsuits, the company may end up recognizing some uninsured legal losses from investor claims.

Should you buy the stock right now?

Aphria has become a much more serious contender to the growing Germany medical marijuana market leadership after emerging as one of the three winners in a heavily contested tender for local production. The other successful bidders were **Aurora Cannabis** and little-known **Wayland**.

The tender win combined with the wide 13,000 pharmacy distribution reach for CC Pharma, could make Aphria a strong competitor to market leadership in Europe, wrestling it out with **Canopy Growth**, Aurora and other leading growers, mainly from the Netherlands.

That said, the company doesn't have the critical E.U. GMP (Good Manufacturing Practices) certification that could allow it to ship product to Germany right now, and I had a problem with management's choice of cGMP (U.S current GMP) certification, which seemed to mostly target the Americas, yet there were good, legal, growth prospects in Europe. There are new efforts to get this certification for the Avanti Lab now.

The company's eventual receipt of a grow licence from Health Canada for its extended flagship facility was bullish news, and this will lower production costs and improve product volumes during the second half of this year, but there's one new concerning development: slower-than-desirable cannabis retail sales growth in Canada where December, January, and February sales numbers were flatter, yet inventories are piling up.

If logistical challenges persist and market demand remains stagnant, Aphria stock may still underperform peers in the near term, even as productivity improves, but the low valuation multiples on the shares make room for a good rebound in the long term.

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