Is it Time to Short Canopy Growth (TSX:WEED)?

Description

Canadian cannabis stocks have soared over the last year to see industry leader and member of the S&P/TSX 60 Index **Canopy Growth** (TSX:WEED)(NYSE:CGC) up by a whopping 118%. The money continues to flow into the industry. There are claims that many industry players are heavily overvalued, and this has sparked a rush among hedge funds and other speculative traders to short some of Canada's top marijuana players.

Significant short interest

The short interest in Canopy has grown considerably in recent months. It is ranked as the sixth most-shorted stock on the TSX with 17% of its total share float being sold short. There have also been calls by controversial short-seller Andrew Left of Citron Research to short Canopy, which has been a costly exercise for him because it has gained 42% since he made that announcement in November 2018.

The big question for investors is, are household names like Canopy heavily overvalued and will they collapse in coming months?

There are signs that the market value of many big-name Canadian cannabis stocks is heavily inflated, despite their massive spending to expand their operations internationally. Canopy is trading at a massive 143 times the value of its sales, and the leading marijuana cultivator has yet to report an annual profit, meaning that it has a negative price-to-earnings ratio. That nose-bleed ratio is extremely worrying; unless Canopy can exponentially boost sales revenue, it appears heavily overvalued.

Canopy has been aggressively growing sales, reporting fiscal third-quarter 2018 net revenue of $83 million, which was 3.5 times greater than the previous quarter and almost four times higher than a year earlier. On a trailing 12-month basis that totals $187 million and if the latest quarterly net revenue is annualized, that points to annual sales being worth roughly $332 million.

Assuming a reasonable price-to-sales ratio for a marijuana company of around two, then using thatfinal projected net revenue figure, Canopy would have a market cap of around $664 million. This is 33times less than its current value, indicating that Canopy's stock could be heavily inflated.

Growing market for cannabis

Domestic and global demand for legal marijuana products are expected to soar exponentially in coming years, which helps to support Canopy's lofty valuation. Analysts from **Canadian Imperial Bank of Commerce** anticipate that Canadians will be using 800,000 kgs of marijuana annually by 2020, valuing the industry at around $7 billion.

Grand View Research believes that the global legal marijuana market will be worth US$146 billion by 2025 compared to US$18 billion currently, which represents a 35% compound annual growth rate (CAGR). Barclays made a similar forecast estimating that the legal global marijuana market, which it predicted was worth around US$14 billion for 2018, will have a US$272 billion value by 2028, again depicting 35% CAGR.

If Canopy was able to grow sales at the same clip, then by 2020 net revenue for that year would $341 million. When using the earlier assumptions, that gives it a market cap of $682 million, or 33 times less than its current value of $22.2 billion. While those are particularly rough figures using a variety of ever-changing assumptions, they demonstrate that Canopy could be heavily overvalued.

A key concern voiced by short sellers is that global demand for cannabis may not expand as significantly as Canopy and other industry participants anticipate. Only Canada and Uruguay have legalized the recreational consumption of marijuana meaning that the market is quite constricted. The significant social stigma still attached to its recreational use means that there is unlikely to be a flood of jurisdictions globally legalizing its use. While the medical benefits of cannabis are widely recognized, it is doubtful that there will be any enormous expansion in the volume of clinical applications.

There is also significant competition among marijuana producers, as highlighted by the **North American Marijuana Index**, which has 47 constituents. Competition will keep growing because the regulatory and other barriers to entry are not particularly steep, meaning that the industry doesn't possess a wide economic moat.

Pulling it all together for investors

With signs that valuations for the legal marijuana industry are at nosebleeds levels, there is certainly some justification for shorting Canopy.

However, it has demonstrated that it can grow revenue at a decent clip, and it finished 2018 with over $4 billion in cash. That, when combined with its aggressive acquisition strategy, which gives it a rapidly growing global presence, and the considerable hype surrounding cannabis stocks, it is unlikely that Canopy's price will collapse any time soon.

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