



Is Aphria (TSX:APHA) a Risky Overvalued Play on Marijuana?

Description

After a scathing [research report](#) from Quintessential Capital Management that called **Aphria** (TSX:APHA)(NYSE:APHA) a “shell game with a cannabis business on the side” the market value of Canada’s second largest marijuana cultivator collapsed.

Since then Aphria’s stock has recovered, rising by 17% since the start of 2019, which still sees it trailing well behind the likes of **Canopy Growth** and **Aurora Cannabis**, which have firmed by a whopping 69% and 63%, respectively, over the same period.

This, along with moves by Aphria’s management to ‘right the ship’ combined with the assumed massive growth potential of the global cannabis market has sparked considerable speculation that the marijuana cultivator is undervalued. That is despite infamous short-seller Andrew Left expressing considerable doubts about Canadian marijuana stocks and their nose-bleed valuations.

Lower market value than its peers

Aphria appears significantly cheaper than many of its peers. It is trading with a price that is 19 times its sales and 22 times forecast 2019 earnings compared to Canopy Growth’s price to sales ratio of 140 and negative forward price to earnings ratio.

Analysts from a range of institutions are estimating that the global legal marijuana market will expand at a compound annual growth rate (CAGR) of around 35% between now and 2025 to be worth up US\$146 billion.

For the fiscal third quarter 2019, Aphria reported net revenue of \$73.6 million, which was over three-times higher than the previous quarter and an impressive seven-times greater than a year earlier.

That incredible sales growth can be attributed to the cultivator aggressively expanding its operations and ramping up the production capacity of its operations over the last year.

If it is assumed that Aphria can grow sales at the same pace as predicted for the legal global marijuana

market, which is feasible because of its operational scale and international presence, then based on its latest quarterly revenue annual net-sales will be worth somewhere around \$462 million by the end of 2020.

While much of this is guesswork, in an [earlier article](#) on Canopy, I used a price-to-sales ratio of two, which appears appropriate for a cannabis cultivator. On that basis, Aphria's market cap using the projected figures above would be around \$924 million, which is around two-and-a-half times less than its current market cap of \$2.3 billion.

While this indicates that Aphria is still overvalued, it is certainly not in the nosebleed territory inhabited by the likes of Canopy and other major marijuana cultivators. There is every sign that if analysts' forecasts regarding the growth of the domestic and global legal cannabis are realistic Aphria could close that valuation gap.

Improved operational focus

Aphria has also made significant headway with resolving the issues raised by Quintessential Capital, which saw CEO Vic Neufeld and cofounder Cole Cacciavillani step down from their executive roles and retire from the company.

Aphria also took a hit some big hits on its fiscal third-quarter 2019 results, including a non-cash impairment charge of \$50 million against the value of the Latin American assets acquired in the \$280 million deal in 2018. It was that acquisition that was at the centre of Quintessential Capital's allegations.

There is the potential for further impairment charges for those assets despite Aphria's special committee determining in February 2019 that they exist, are developing according to the company's plans and that the consideration paid was reasonable.

This is because the legal marijuana industry is highly speculative and immature plus those Latin American assets have yet to prove their operational viability, which means there is no proven data available that can be used to accurately value assets.

What does it mean for investors?

Nonetheless, it does appear that the worst is behind Aphria and that the company is in the process of clearing the decks as well as improving its operations. While there is most certainly further pain ahead, the combination of a more realistic market valuation, Aphria's renewed focus on operational improvement and enhanced management oversight does increase its appeal as a speculative play on marijuana.

If Aphria can convince the market that it has put all of the issues raised by Quintessential Capital behind it, then its stock will soar once again.

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