Are Cannabis Stocks the Next Big Short?

Description

The *Big Short* is a movie about a group of U.S. investors who identified the unsustainable U.S. housing and credit bubbles that emerged in the mid-2000s. Against the market consensus they shorted the U.S. housing market and reaped tremendous profits when it imploded, sparking the greatest financial calamity since the Great Depression. Since then profit hungry U.S. hedge funds have been frantically searching for the next big short.

One of the architects of the big short, Steve Eisman, is targeting Canadian banks because he believes that they are vulnerable to what he describes as a normalization of the credit cycle. His thesis rests on the belief that as growth worsens and heavily indebted Canadian households come under greater financial pressure**,** the volume of impaired loans will rise at a rapid pace, thereby placing considerable pressure on their profitability and balance sheets. This sees four of the Big Five banks among the 10 most shorted stocks on the TSX, with the largest Canadian mortgage lender **Royal Bank of Canada** ranked as the most shorted.

While Canada's banks are facing significant head winds, it's highly unlikely that they will experience a significant deterioration in credit quality or earnings. It isn't without reason that shorting Canadian banks have become known as a widow makers trade, having cost hedge funds tremendous amounts of money over the last decade.

One Canadian industry caught in a bubble of growing proportion is the cannabis industry, making it a prime candidate for the next big short. There are signs that Canadian cannabis stocks could be the next big short because most are trading at nosebleed valuations and have yet to demonstrate their profitability.

Companies like **Canopy Growth** (TSX:WEED)(NYSE:CHC), **Cronos Group** (TSX:CRON)(NASDAQ:CRON) and **Hexo** have experienced massive run-ups in their value over the last two years, gaining 687%, 822% and 449%, respectively. The meteoric rise of cannabis stocks possesses many of the fundamental characteristics of a market bubble.

These include sensationalist claims regarding marijuana's revolutionary pharmaceutical and health benefits, extremely optimistic predictions about the size of the legal cannabis market, manic buying, and a parabolic price curve. Prominent short-seller Andrew Left of Citron Research in late-2018 claimed that the industry is heavily over valued while announcing that he is short-selling Canopy and Cronos.

In fact, Canopy is now the sixth most shorted stock on the TSX, while in recent months there has been a significant increase in the amount of short-selling of Hexo where the value of short positions grew by 67% since mid-April. Upon reviewing some fundamental valuation metrics, the extreme valuations of cannabis stocks becomes clear.

Canopy's price-to-sales ratio, which is essentially a measure of its market value compared to the revenue it is generating, is a whopping 142 times the value of its sales, while Cronos is trading at an astronomic 358 times revenue. Those nosebleed ratios are unsustainable indicating that both cannabis producers could very well be heavily overvalued.

To put that into perspective using a comparable industry, alcohol stocks have a far lower price to sales ratio. Diversified brewer **Molson Coors Canada** is trading at a mere 0.6 times its revenue, while winemaker **Andrew Peller** has a ratio of 1.5. Leading U.S. liquor company **Constellation Brands**, which took an almost 10% stake in Canopy last year, is trading at roughly five times its sales. It is extremely difficult to see how cannabis cultivators such as Canopy and Cronos can bridge the valuation gap despite claims by some industry analysts of massive growth ahead for the legal marijuana industry globally.

Pulling it together for investors

Analysts claim that global cannabis sales will be worth US$146 billion by 2025, or roughly 16-times the US$9.3 billion estimate for 2016, representing a compound annual growth rate (CAGR) of around 35%. Even if Canopy or Cronos can grow their sales at that rate, using their last reported trailing 12 months of net revenue and current market capitalization, by 2025 they will still have unsustainable price-to-sale ratios of around 13 and 86 respectively, thereby indicating that they are currently heavily overvalued.

There are also a range of emerging threats to the ability of Canadian marijuana cultivators to grow sales at such a substantial rate. Burgeoning competition because the industry lacks significant barriers to entry coupled with a constricted market and the threat of cashed up U.S. cultivators entering the fray once marijuana is federally legalized means that Canadian cannabis stocks will battle for market share in an industry where growth will remain constrained for some time to come.

CATEGORY

1. Cannabis Stocks
2. Investing

TICKERS GLOBAL

1. NASDAQ:CGC (Canopy Growth)
2. NASDAQ:CRON (Cronos Group)
3. TSX:CRON (Cronos Group)
4. TSX:WEED (Canopy Growth)

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