The Dark Side of Marijuana Stocks

Description

Marijuana stocks are among the most fashionable investments on the TSX. With some stocks in the sector up as much as 70% year to date, they've been beating the market with ease. If you'd invested $1,000 in **Canopy Growth** three years ago, you'd have $23,000 in the bank today — and that's not the only marijuana stock that has made investors rich. The weed sector as a whole has been beating the market and making many investors happy in the process.

However, all is not well in weed land. In addition to those investors who have gotten rich investing in Canopy and similar stocks, there are those investors who have lost it all buying the wrong weed stock at the wrong time. In addition, there are some reasons for skepticism toward the entire marijuana sector — skepticism that even the best companies in the industry should not be exempt from. We can start by looking at one of the most obvious problems facing the sector as a whole.

Sky-high valuations

You're probably aware that marijuana stocks are expensive. Growth sectors usually tend to have high P/E ratios, and there's no reason for marijuana to be the exception. However, the valuations in this particular sector are really something else. **Tilray**, for example, currently trades at 111 times sales — and that's after months and months of its stock tanking. Other top stocks in the sector have price/sales ratios as high as 140 and price-to-book ratios well over 10.

These are nosebleed prices that can only be justified by continued growth. And while marijuana stocks have indeed been growing revenue at a rapid pace, there's some uncertainty as to whether domestic weed sales will remain strong after the initial novelty of legalization wears off. This concern is justified by reports that some weed smokers are returning to black market dealers, who offer lower prices, and by the fact that **Aphria** (TSX:APHA)(NYSE:APHA) reported a decline in recreational sales in its most recent quarter.

Acquisition uncertainty

Speaking of Aphria, its recent history demonstrates yet another concern area for marijuana stocks: acquisitions. In recent months, cannabis producers have been gobbling up their competitors in a furious scramble to capture market share and intellectual property. The problem is that many of these acquisitions added no revenue or earnings power to the acquiring companies.

Aphria was particularly harshly criticized for how much it paid for some of its acquisitions last year, which formed the basis for a short attack against the company. Aphria shares eventually rebounded after the short attack subsided, but the big question remains.

Foolish takeaway

Marijuana, like any other sector, will probably see some big winners and big losers in the years ahead. Right now, it's hard to say exactly what will happen. However, we're already beginning to see the fortunes of the big-name companies starting to diverge, which makes it easier to tell which weed stocks to avoid.

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andrewbutton