Do Energy and Environmental Impacts Mean Marijuana Stocks Will Go up in Smoke?

Description

Money continues to pour into marijuana stocks at a feverish clip, despite growing fears that legal cannabis cultivators are the latest iteration of a market bubble. While cultivators such as **Canopy Growth** (TSX:WEED)(NYSE:CGC), **Aurora**, and **Cronos** have made outstanding gains of 35%, 58%, and 163%, respectively, over the last year, industry insiders are claiming there is further massive upside ahead and short sellers are circling.

While it is difficult to determine whether now is the time to short marijuana stocks, it is certain they are in an asset bubble that will eventually burst, causing tremendous losses for investors.

It appears that cannabis stocks have entered the mania stage of a bubble. The industry is attracting considerable capital from less-sophisticated investors, as industry insiders continue to expound the substantial demand that exists for legal marijuana. Many of these pundits point to U.S. federal legalization, which may be further off than the optimists believe, as being the most crucial event required to open the floodgates to world legal cannabis consumption. It is argued that when this occurs, it will propel first-mover marijuana companies like Canopy sky high.

Nonetheless, these champions of legal cannabis use appear to be ignoring several threats to their bullish thesis. Key among them is growing competition. The legal cultivation of marijuana doesn't have a particularly wide economic moat, and the barriers to entry are not especially steep.

It is easy for cultivators of other legal crops, such as cut flowers, to transition to cannabis, because it requires similar skills, knowledge, and infrastructure. There is also the proliferate volume of legal cannabis cultivators in the U.S., where cultivation or use in some form is legal in 41 states and it was estimated that there are over 3,500 wholesale cultivators. The rapid growth of cannabis cultivation in North America has been likened to a race to the bottom, where scale, productivity, and large production volumes are the ultimate goals.

Another peril is that cultivating cannabis in Canada and other jurisdictions with similar climatic extremes is costly. It takes significant amounts of energy to power the greenhouses used for indoor cultivation, where lighting, heating, and ventilation systems are essential 24 hours a day, making them intensive users of electricity.

It is estimated that on average, one kilogram of marijuana grown indoors has an energy cost of US$2,500 per kilogram to produce. Indoor cannabis cultivation is claimed to use roughly 10 times more electricity per square foot than a standard office building. This means as companies like Canopy ramp up production, their costs will grow exponentially, particularly once the environmental impact of such intensive energy use is considered.

Scientists believe that producing one kilogram of marijuana on average emits 4,600 kg of carbon dioxide. This is equivalent to the emissions of three million average U.S. cars and 73 times the 63 kg of carbon, on average, that the Pembina Institute estimates is produced when a barrel of bitumen is extracted from the oil sands.

Canada's oil sands are ranked as one of the largest emitters of greenhouse gases domestically, and data indicates that could be overtaken by cannabis cultivation. This certainly takes the shine off marijuana's green image of being an environmentally friendly product, which forms an important part of the industry's marketing.

In an environment where reducing carbon emissions has become a government priority, with carbon taxation a key regulatory tool, there could well be significant additional costs ahead for cannabis cultivators.

In Canopy's fiscal third-quarter 2019 report, it noted an average production cost of $6,400 per kg sold before including other operating expenses, such as research and development, marketing, and distribution. Canada's leading cultivator has 4.4 million square feet of licensed capacity and is developing another 1.3 million square feet.

As Canopy ramps up production from indoor cultivation, its costs will grow at an exponential rate, impacting margins in an industry where the value of the global cannabis market and the rate at which it will grow is uncertain. This is before considering the impact of carbon taxes on Canopy's operating costs.

The direct and indirect energy as well as environmental costs associated with indoor cannabis cultivation mean that those companies operating in jurisdictions like Colombia with favourable year-round climates for cultivation will have an advantage over those operating solely in Canada.

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