



Get Ready for Cronos Group (TSX:CRON) to Soar

Description

Marijuana stocks have pulled back sharply in recent weeks, as concerns over their ability to post profitable earnings and their sky-high valuations grow. It is easy to understand these fears with many such as **Cronos Group** ([TSX:CRON](#))([NASDAQ:CRON](#)) having made massive gains over the last year.

Cronos has seen its stock gain 154%, even after accounting for recent weakness, while industry heavyweight **Canopy Growth** is up by 46%. Only **Aphria**, which was battered by a controversial [research report](#) toward the end of 2018, has lost ground to be down by 17%. This has led many investors to question whether cannabis cultivators can maintain the massive growth momentum witnessed over the last two years or whether a [reckoning is looming](#).

Growth constraints

A key concern is that the global marijuana market won't expand as significantly over the long term as analysts are predicting. This is for a variety of reasons, notably the social stigma attached to marijuana consumption, the lack of preparedness by authorities on how to regulate as well as monitor its use, and the long lead-in time to establish medical applications. So far, Canada and Uruguay are the only countries to have fully legalized its recreational use.

The high costs associated with intensive indoor cultivation of marijuana means that it may not be as profitable as insiders believe. The industry's low barriers to entry and lack of a wide economic moat mean that competition will grow at an exponential rate, creating what some analysts claim will be a race to the bottom, as cultivators expand their operations to boost economies of scale and cut costs so as to be profitable.

Nonetheless, this shouldn't deter investors, especially when it is considered that increasingly steep regulation and a growing global backlash against tobacco companies is squeezing their market share and bringing the future viability into question.

Tobacco giant **Altria Group's** revenues have remained relatively flat over the last five years, and the opportunity to expand its product range, and hence sales, is shrinking at a rapid clip, as ever-steeper

regulation of tobacco products is introduced. There is every indication that the tobacco market will continue to shrink at an ever-greater clip, as health concerns and regulation virtually squeeze it out of existence.

For these reasons, Altria entered a strategic partnership with Cronos, making a \$2.4 billion investment in December 2018, which gave it a 55% stake in the cannabis cultivator. This gives Altria access to the legal marijuana market and control of a leading cultivator that has 325,000 square feet of indoor production facilities and an extraction lab.

Cronos has also been developing a global footprint with licensed cultivation facilities in Australia and Israel, along with acquiring acreage in Colombia, where its subsidiary has applied for a licence. When this is coupled with Altria's extensive marketing, distribution, as well as manufacturing infrastructure and deep regulatory understanding from operating in a similar industry, it is easy to see Cronos becoming a leading marijuana producer.

The impending legalization of marijuana edibles, extracts, and topicals on or before October 17, 2019, will give cannabis stocks a solid lift as demand for cannabis-infused products skyrockets. In some quarters, it is estimated that this event alone could add \$1.6 billion to the value of the domestic legal marijuana market, by opening recreational consumption to consumers who don't smoke but are looking for an alternative to alcohol. This event will give Cronos's sales a solid boost in a domestic market that consultancy Deloitte believes will be worth almost \$9 billion.

Cronos also recently entered a supply agreement with **MediPharm Labs**, which it estimates will be worth somewhere between \$30 million and \$60 million. That will give its short-term sales a lift, while it expands its production facilities and distribution network.

Foolish takeaway

Despite marijuana stocks appearing to be in a bubble, the latest decline in Cronos stock, which sees it down by 19% over the last three months, has created an opportune entry point for investors.

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