Is This the Beginning of the End for Marijuana Stocks?

Description

June was a strong month for the S&P/TSX Composite Index, which rose 2.15% in 30 days. However, marijuana investors could be forgiven for not noticing this, as their results were a little different. While almost every other TSX sector rallied in June, marijuana sustained some of its worst losses of the year, after **Canopy Growth** (TSX:WEED)(NYSE:CGC) posted a quarterly report showing its largest net loss ever.

Of course, marijuana stocks are still growing sales by leaps and bounds. **Aphria** (TSX:APHA)(NYSE:APHA) in particular grew by 617% year over year in its most recent quarter — and shows no signs of slowing down. At the same time, it's becoming clear that adult-use cannabis sales haven't saved marijuana stocks from the biggest problem they're facing. I'll explain what that problem is in just a minute. First, let's take a closer look at the marijuana industry's recent financial performance.

Out-of-control losses

It's well known that marijuana producers are losing money. On the surface, there's nothing out of the ordinary about this: early-stage startups usually run losses, and most of these companies were founded fewer than five years ago.

However, what's alarming is that marijuana losses just keep growing bigger and bigger — not only in total but also as a percentage of revenue. In Canopy's most recent quarter, it lost $323 million on revenue of $97 million, meaning its losses were three times greater than sales. Of course, Canopy's Q4 losses included non-operating items: the company's operating loss in the quarter was "only" $160 million. Still, the fact that Canopy's losses keep mounting shows that it — along with other marijuana companies — has a spending problem that's getting out of hand.

It should also be noted that although marijuana producers are investing in future growth, not all of the costs can be justified that way. Canopy, for example, is seeing ballooning share-based compensation, which reached $182 million in fiscal 2019.

Slowing recreational sales: the biggest potential problem for marijuana producers

Part of the reason marijuana stocks got so bullish is because of the anticipated sales boom that was going to come from legal recreational weed. The sales boom did materialize. However, there are signs that it may be simmering down.

In its most recent quarter, Aphria — which otherwise performed very well — saw a 35% decline in its recreational cannabis sales compared to the prior quarter. In the past, I have written that recreational cannabis may have benefited from a "novelty effect" in the first quarter of legal sales, which may eventually wear off. Aphria's recent results corroborate that theory, although it should be said that other marijuana producers had different results.

One possible reason Aphria saw its recreational sales decline is because it doesn't have the retail presence some of its competitors do. Whereas Canopy has its own chain of branded Tweed stores that sell the company's products exclusively, Aphria still depends to a large extent on third-party vendors. This may explain why Canopy is gobbling up more adult-use revenue. However, that company is losing even more money than Aphria is, so it's not clear that even growing recreational cannabis sales will save the marijuana industry.

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