Canopy Growth (TSX:WEED) Offers No Near-Term Upside

Description

Before I begin, I would like to preface this article by stating that I am a huge fan of **Canopy Growth** (TSX:WEED)(NYSE:CGC). In December, I wrote that Canopy was the best name in the (then-undervalued) marijuana sector based on forward outlook. Now that we're two quarters into legalized recreational use, however, there is an impetus on the industry's management teams to deliver on their promises and convert those forecasts into cold, hard numbers. Unfortunately, the last round of sector-wide earnings was anything but assuring, and, based on the numbers that Canopy delivered a few weeks ago, I just don't see much potential for the stock in the near term.

Margin issues

One thing that caught my eye right off the bat were Canopy's margins. For example, sales and marketing as a percentage of revenues were 49% in fiscal 2018 but jumped to 61% for fiscal 2019. General and admin costs also surged 10% to 66%, and, more importantly, cost of goods sold came in at 69% for 2019, up from 48% the year prior.

Yes, I understand that at this stage in the game, we cannot expect the cannabis names to be remotely close to profitability on the bottom line, but negative margins at the operating level and the unpredictability of the figures mean we cannot establish any sort of real trend to project margins going forward. However, bear in mind that Canopy is sitting on $4.5 billion of cash, so all these expenses are well funded for the time being.

Sales slump

Another issue worth pointing out from Canopy's Q4 numbers is the slowdown in total sales, with 9.3k kgs sold in the last quarter compared to 10.1k kgs in Q3. Furthermore, Canopy realized lower medical marijuana prices in Q4 of $8.17/gram, down from $8.49/gram in Q3, while aggregate recreational revenues combined across all channels, medical revenues, and international revenues all decreased from Q3. In fact, the only revenue channel that grew in Q4 was "other revenues," which more or less were entirely attributable to Canopy's acquisition of vaporizer brand Storz & Bickel in December.

Canopy's near-term future and valuation

Canopy's latest report raises more questions than answers. The unpredictability of the operating expenses combined with possible regulatory overhang and delays (for instance, edibles legalization has already been delayed to December from October of this year), makes projecting Canopy's forward earnings a challenging affair.

Moreover, while Canopy has guided positive EBITDA by 2021, I just don't see how this possible, with the many selling, distribution, and supply chain issues that are going to be facing the company, especially after edibles come online.

Furthermore, even if positive EBITDA is reached, the figure will be too small to for any meaningful forward multiples. Instead, I believe Canopy should be valued on its forward sales basis — along the lines of a high-growth tech name with negative cash flows.

Assigning a forward seven times multiple (a generous estimate since ride-sharing names like **Lyft** trade at just four times 2021 earnings) to expected $1.3 billion in net 2021 revenues, we reach a fair value of $47 for Canopy's stock. Bump up the net sales estimate to $1.5 billion, and we get $52. In other words, post-Q4 numbers, Canopy is fairly priced here and is neither a conviction buy nor a sell, and I would expect the stock to remain range bound until the next quarter. That said, for a contrary opinion for Canopy's bullish case, please refer to my colleague David Jagielski's article here.

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