2 Reasons Why Hexo (TSX:HEXO) Is Still a Buy

Description

Hexo Corp (TSX:HEXO) is testament to how quickly things can change in equity markets in general, and in an industry as volatile as the marijuana industry in particular. Just a few months ago, the firm seemed well positioned to become marijuana royalty. However, a round of disappointing financial results have played a critical role in dragging its stock price down.

Since late April, shares of Hexo are down about 40%. Still, there are several reasons why Hexo may still be worth considering. Let's remind ourselves of two of these reasons.

A move to increase its production capacity

Many pot companies have been spending small fortunes to increase their production capacity. As sales of marijuana are increasing quickly, only those capable of supplying the market will capture a notable share of the market. Hexo struggled in this area, however, lagging behind many of its competitors in its effort to ramp up its production capacity.

But this problem should be rectified soon. The firm completed the first harvest in its 1 million square feet expansion in early April. This facility is projected to generate about 108,000 kilograms of dried cannabis flower per year.

Further, in a move that reverberated throughout the marijuana sector, Hexo acquired Newstrike Brands Ltd, an Ontario-based pot company. This deal gave Hexo access to additional cultivation space, increasing its total cultivation space to 1.8 million square feet, and its projected annual production capacity to 150,000 kilograms of dried cannabis per year.

The acquisition also extended Hexo's reach within Canadian territory, and the combined entity has supply agreements with nine provinces.

Hexo managing to increase its production capacity is important since the firm is one of the leading pot companies in Quebec, the second largest Canadian province. Last year, Hexo signed a supply deal with Quebec to provide 200,000 kilograms of cannabis over a five-year period, with Quebec retaining the right for a sixth-year option.

This is the largest provincial supply agreement to date, which means that much of Hexo's product is tied up to a direct revenue source for the foreseeable future.

Derivative markets

Hexo has been making noise elsewhere. The firm announced a partnership with beverage maker **Molson Coors Brewing** in August of last year. The resulting venture is known as **Truss Beverages** , and its stated purpose is to create cannabis infused beverages.

By way reminder, though recreational uses of pot are now legal in Canada, all this means is that private consumers can purchase dried cannabis legally.

Derivative products — such as cannabis infused beverages and edibles — are still very much illegal. However, that is likely set to change by the end of the year.

These derivative markets are very promising, too, especially due to their higher margins. While the dried cannabis market may suffer from a supply glut eventually, the probability of this happening within derivative markets is much lower. In short, the opportunity is too big to pass up, and Hexo is very well positioned to profit from it.

Although the pot company owns a minority stake in its joint venture with Molson Coors Brewing (about 42.5%), it has a leg up on most of its peers since few have made significant moves to profit from this market.

The bottom line

As icing on the cake, Hexo's valuation is fairly mild by industry's standard, with a price-to-future earnings ranging between the mid30s to early 50s depending on various future earnings' estimates. This, however, compares favourably to that of many of its peers, some of which have P/E ratios well above the 100 mark.

With an increasing production capacity and a solid supply agreement to unload its product, as well as a unique position within the upcoming cannabis-infused beverage market, Hexo still looks like a buy.

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