Pricey Weed Stocks: A Lesson From Cheap Oil

Description

When West Texas Intermediate danced around US$100 per barrel, the energy sector could do no wrong. From 2011 to 2014, the market was awash with oil and gas IPOs, mergers and acquisitions, risky debt, and inflated share prices.

The sales pitch was all about the amount of the hot commodity that any given company could produce. Broadly speaking, margins were strong and investors were buying stocks based on how quickly companies could get oil out of the ground.

When the party was over, however, it turned out that it wasn't all about quantity — it was about costs. Disciplined energy companies that pursued projects with the best economics are still alive and well today.

Unfortunately, producers that succumbed to exuberance paid the price. Often laden with debt and running a loss on every barrel, companies took write-downs on reserves that had become worthless and many closed their doors entirely.

But, you might well ask, what does this have to do with marijuana stocks?

Surely demand for cannabis must continue to outstrip supply, supporting market prices?

Surely margins are outstanding and weed companies should soon be rolling in profits?

Well, maybe not.

In the interest of making the connection between the two themes I'm discussing, we will use **Canopy Growth** (NYSE:CGC)(TSX: WEED) purely illustratively.

The emphasis on capacity

Open up the management's discussion and analysis documents for pretty much any weed company's latest quarter and a few things are going to repeat themselves again and again: expansion, production, capacity, and heaps of figures about greenhouse square footage.

It's déjà vu all over again.

Several short years ago we were reading nearly identical documents talking about ramping up production of barrels of oil equivalent per day, newly purchased hectares of land, and probable reserves.

When I read speculative numbers about supply and very little mention of material sales, it gives me the goodwill and intangibles chills; it makes me wonder whether it will all go up in smoke.

Consider the following sentence about the value of their inventory in Canopy's report for the year-ended March 31, 2019: "Because there is no actively traded commodity market for [cannabis] plants or dried product, the valuation of these biological assets is obtained using valuation techniques where the inputs are based upon unobservable market data".

To me that reads like somebody just handed himself or herself a degree in creative accounting.

Show me the margins

Your local drug dealer wouldn't sell marijuana if it weren't profitable. Period.

Conversely, weed companies have been continuously selling their investors on the notion that the next variation on their product will be the one that makes it all worthwhile.

First, there was the promise of making big bucks from Health Canada and medicinal marijuana.

Next, the dough was going to come from recreational dried plant.

Hold on, CBD is where the ball really gets rolling.

Don't worry: money-maker edibles will be legal in the fall.

What's next, folks?

Year over year, Canopy's fourth-quarter overall average sale price fell around 11% to about $7.49 a gram. Further, the decline in the fair value of its biological assets amounted to just over $77 million in Q4 alone.

Gross margin before fair value impacts in cost of sales – what a mouthful – is a non-IFRS accounting measure for a reason.

The teachings of black gold

All of the above is to say that commodities, be it oil, gold, or weed, fluctuate in value and tend to go through periods of intense investor interest.

The problem, then, is finding disciplined producers that can keep costs under control and focus upon sustainably increasing shareholder value over the long run.

When doing your research on marijuana stocks, don’t forget the lessons that we learned from oil.

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