Is HEXO (TSX:HEXO) a Value Trap?

Description

At first glance, **HEXO** (TSX:HEXO)(NYSE:HEXO) seems like the rare value play in an overvalued sector. As of writing, the company has an enterprise value under a billion dollars, and based on management's projections of a $400 million run rate for fiscal 2020, we are looking at a stock that is trading at just 2.3 times forward sales. But before you make a contrarian purchase here, consider these following factors.

Inventory backlog

HEXO enjoys considerable home-field advantage in protectionist Quebec, but this quality has become a double-edged sword. For example, HEXO was one of the few LPs that had the inventory to fulfill its supply agreements in the opening days of legalized marijuana, selling some 970 kg and 2,587 kg (and equivalent) of recreational marijuana in Q1 and Q2 of 2019.

Unfortunately, almost 10 months into legalization, sales in HEXO's home province have begun to come down. That means we could possibly see the province renegotiate year-two supply volumes downwards, which could lead to an increased inventory backlog, working capital requirements, and cash flow issues.

And although management should be commended for expanding outside Quebec, inking supply deals with Alberta, bear in mind that HEXO will face fierce competition in the western provinces, particularly around its higher-margin oil brands such as the sublingual spray "Elixir."

Cash flow woes

HEXO ended Q3 with ~$173 million in the bank. However, cash flows from operations were negative $44 million (a lot of it due to the aforementioned working capital issues), while purchases of PPE jumped to $103 million from $24 million, as the company looks to meet its lofty expansion goals.

With so many drivers in the pipeline (U.S. expansion, CBD, increased product offerings, R&D,

Belleville ramp up, etc.), the next question to be asked then becomes, how exactly is HEXO going to generate funds to meet its increased capital intensity, especially as an equity raise here would absolutely destroy its share price?

Naturally, the company's hopes then hinge on securing a Fortune 500 partner (by management's admission, it's currently in talks with 60 potential backers), but should a white knight fail to materialize, we could see increasing cash flow headwinds in the way of its scale up.

Margin compression and revenue mix

HEXO's revenue mix coming out of Q3 was not exactly promising, with dried flower responsible for ~84% of total sales. This is concerning, as dried flower prices have been coming down across the sector, and brand stickiness is extremely difficult to achieve within this channel.

Furthermore, with the market facing a wall of supply in the coming quarters, we can anticipate further erosion of sequential pricing power and margins, as evident by HEXO's Q3 flower price of $5.29/gram compared to $5.83/gram in Q2. And before you mention that HEXO's fourth-quarter revenues are set to double, note that this includes consolidated revenues from **Newstrike**, and organic revenues could very well be flat compared to Q3.

Regulatory hurdles

Finally, according to HEXO's management team, there are two key risks standing in the way of $400 million in sales for 2020: execution risks, such as failing to complete Belleville in time, and regulatory risks. In regards to the latter, the Quebec government announced that it will be looking into banning all cannabis edibles as well as skin creams, even as the rest of the country legalizes these products later this year. Unfortunately, with HEXO being tied at the hip to Quebec (91% of rec sales in Q3 came by way of the SQDC), any such regulatory burdens will be detrimental to its revenue target.

The bottom line

Even with all these concerns, HEXO is cheap compared to its peers. If we forget the magic $400 million target and conservatively shoot for $300 million, HEXO is still trading at just 3.1 times 2020 sales — a far cry from a name like **Cronos**, which trades at seven times that amount. Based on this notion then, it appears HEXO is nearing the bottom, and its risk to reward is starting to look very appealing. Taking this into account, HEXO could very well be a value play in a bloated sector, especially if it overcomes its key risks while highlighting its strengths.

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