Warning: Why Canopy Growth (TSX:WEED) Could Keep Plunging

Description

Last week was not a good one for **Canopy Growth Corporation** (TSX:WEED)(NYSE:CGC).

After some of its competitors announced solid earnings — including a few who told investors they were profitable — Canopy Growth disappointed the market when it announced adjusted EBITDA of negative $92 million.

That came on net revenue of just over $90 million, which was lower than analysts expected. Yes, it's true: Canopy Growth managed to lose more than $1 on each $1 worth of sales.

In fact, once we factor in a big one-time cost on the extinguishment of some warrants, Canopy lost more than $1.2 billion in its most recent quarter. Needless to say, investors weren't happy about all this bad news, and the stock is off approximately 20% since those earnings were announced.

But in Canopy's defense, there was some good news with these earnings. Revenue shot up 94% compared to the same quarter last year. The company also harvested nearly 41,000 kilograms of product, versus a previous estimate of 34,000 kilograms. And it still has $3.1 billion worth of cash on its balance sheet. The company is in good shape today.

But that doesn't mean shares will keep going higher, however. In fact, I'd argue that both Canopy and most of its competitors will see their shares plunge even further. Here's why.

Oversupply is coming

One of the biggest things that should concern marijuana investors is potential oversupply in the market. This might not seem possible; after all, it was just a few months ago every cannabis retailer was screaming about product shortages. But there are a couple of reasons why I think it's coming.

First off, pot companies are seeing the price they get per gram slowly shrinking. In its most recent quarterly report, Canopy told investor that it had an average selling price of $7.56 per gram of cannabis sold in the quarter. But that's down 15% from the same quarter last year, which saw prices average

$8.94 per gram.

The recreational side is seeing prices fall even faster. In Canopy's previous quarter, which ended March 31st, it told investors it got an average of $7.28 per gram of marijuana sold into the recreational market.

This quarter, the one ending June 30, saw the price per gram sold to the recreational market plunge to $6.35 per gram — a decrease of nearly 13%.

On the plus side, overall prices held up better on a quarter-over-quarter basis, increasing approximately 1%.

One of the reasons why Canopy's results were so disappointing is the company is spending big money to increase production. Once current expansion plans are completed, the company expects to have 5.6 million square feet of indoor growing space. Canopy isn't alone in ramping up production, so is all of its competition.

This begs the following question: at what point will there be too much production capacity? I'd argue that day is coming up quickly. It might even be upon us today.

Canopy's goodwill

Canopy hasn't just counted on internal expansion to deliver the growth the market desperately expects from the company. It has also been an acquisition machine, doing many deals over the last couple years.

There's just one problem. All these acquisitions have created a massive amount of goodwill on the company's balance sheet. As of June 30, Canopy's balance sheet has $1.9 billion worth of goodwill versus total assets of just over $8.6 billion.

If the marijuana market continues to weaken, Canopy will be forced to write off some of this goodwill. This will decrease the overall value of the company and — perhaps most important — force it to post quarterly results that will look very bad on the surface.

The bottom line

If you're a believer in marijuana stocks over the long-term, investors should look for better ways to play the sector than Canopy.

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