



What's Driving the Carnage Among Cannabis Stocks?

Description

Shares of Canada's top pot company **Canopy Growth** ([TSX:WEED](#))(NYSE:CGC) has continued to fall in October 2019. In the first 10 days of this month, Canopy is down 10%. The weakness in the marijuana space is still driving stocks lower and making investors head for the exit.

Cannabis stocks moved lower after Hexo revised outlook

The **Horizons Marijuana Life Sciences ETF** is down 11.6% while top pot stocks such as **Aurora Cannabis**, **Aphria**, and **Hexo** have declined 12.7%, 13.1%, and 29% respectively in the first 10 days of October.

Canopy Growth stock is currently trading at \$27.33, its price back in February 2018. Canopy stock had risen from \$9.5 in the start of 2017 to a peak of \$76.68 in April this year. The stock is currently trading 64% below its record highs.

Other pot stocks and ETFs such as HMMJ, Aurora, Aphria and Hexo are also trading 61%, 69%, 71%, and 66%, respectively below their 52-week highs.

Several pot stocks lost significant value on October 10, after [Hexo Corp. revised its forecasts](#) for the July quarter and has withdrawn its guidance for fiscal 2020. While Hexo led the decline with a 23% drop yesterday, Canopy, Aurora, Aphria and HMMJ too fell by 10.3%, 8.8%, 14.1%, and 8.3% respectively.

How big is the illegal cannabis market in Canada?

Hexo's revised forecast comes a month after Aurora Cannabis missed analyst estimates as well as its own forecast when the company reported [results in September](#). Now, investors will be concerned over analyst forecasts across the cannabis industry that pointed to robust growth in 2019 and beyond.

With several companies missing estimates, were these demand forecasts overly optimistic? Is the

illegal cannabis market in Canada severely impacting sales for regulated companies? According to a CBC News report, there is a huge price gap between the legal and illegal pot producers in the country.

The report states that the illegal market sold cannabis at \$5.93/gram in the second quarter, down from \$6.51/gram at the end of December 2018. Comparatively, the cost of legal cannabis has increased from \$9.82 to \$10.65 in this period. This has widened the price difference from 34% in December 2018 to 44% at the end of the June quarter.

According to Brad Poulos, a lecturer at Ryerson University who was interviewed with CBC news, the legal marijuana companies are taxed and have to account for the cost of doing business, reducing the profit margins. Cannabis companies pass these costs on to the customers that drive up prices.

Poulos stated, "There's an excise tax built in. Then, depending on the province, there's GST and HST on top of that. There's compliance costs that legal cannabis producers have that the illicit market doesn't have to worry about. Add it all up and there's quite a cost disadvantage."

While cannabis was legalized for recreational use in Canada last October, a considerable 42% of total sales still take place in the illegal market, according to a report from the *Canadian Press*. This is mostly due to high pot prices in retail and online stores.

Oversupply a grave concern

As a significant portion of cannabis users purchase products from illegal markets, it's adding to the build-up of inventory levels for top marijuana stocks. Cannabis Benchmarks has estimated the total supply in June to be more than five times the demand.

This increase in inventory will lead to companies lowering product prices, albeit this will also impact profit margins. We know that several cannabis companies are loss-making and will not be posting an adjusted profit in the near future.

Investors expected several pot companies to move higher as we get closer to the second wave of cannabis legalization. But the bloodbath in cannabis has extended into the last quarter of 2019. When will it stop?

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