



Marijuana Investors: Why Profitability May Be Far, Far Away for Canopy Growth (TSX:WEED)

Description

Year one of legal cannabis is [finally over](#). And pot investors are bidding it good riddance, with shares of most pot stocks shedding more than half of their value over the time frame.

Foolish investors were warned, though, as I noted that the [black market](#) had the potential to derail expectations in the first year of legalization.

Now that many cannabis stocks, including **Canopy Growth** ([TSX:WEED](#))(NYSE:CGC), are a far cry away from their all-time highs, I think investors need to re-adjust their expectations if they're thinking about going against the grain, as negative momentum across the sector continues to pick up traction.

All pot stocks, even the "high-quality" ones with big-league investors, are falling knives right now. And those beginners looking to reach out could get seriously hurt if their expectation is to make a quick buck from a sudden reversal on some positive industry news.

A major sore spot in Canopy's last quarter was the fact that the firm was getting further away from its goal of achieving sustained profitability numbers. Canopy has been spending money hand over fist, and as the legal-to-illegal cannabis price spread continues to widen due to the proliferation of the cannabis black market, margins could continue to falter over the intermediate term, as the investors wake up to the reality of being invested in a highly commoditized industry.

I've warned investors that Canada's regulatory environment had set the stage for a highly commoditized product and that it'd be nearly impossible for one firm to differentiate itself from the pack.

Now that we're in year two of legalization, many investors are waking up to that fact. And cannabis companies are violently correcting in spite of the edibles tailwind and potential "Cannabis 2.0" catalysts that have been widely covered by the mainstream financial media.

When will the pain end?

Probably not until the legal-to-illegal cannabis price spread is narrowed.

Last week, **Hexo** ([TSX:HEXO](#))(NYSE:HEXO) announced its intention to go after the budget cannabis market by offering cheaper marijuana flower (starting with a product called Original Stash) to be more competitive with black market bud.

Management's "aim" is to "disrupt the illicit market" and "educate consumers" of the value of "regulated and tested product." While there may be some value in such a product through the eyes of black market cannabis users, I think there's no substitute for competitive prices in such a commoditized market.

In a report conducted by Statistics Canada, approximately 40% of Canadian cannabis consumers get their weed from the black market. Hexo's budget bud move, I believe, will be a necessary margin-eroding first step before sustained profitability can be reached.

Like in the U.S. brokerage scene, I suspect Canopy Growth and other major producers will follow suit by offering their own line of budget bud.

While that bodes well for top-line growth over the medium term, I see margins continuing to slip, as cannabis producers start getting more competitive with their pricing.

For now, weak-handed investors will continue selling. So, if you're looking to jump into marijuana today, you'd better be in it for the long haul, because we may be at least another year or two away from sustained profitability numbers, as the industry looks to combat the black market.

I think Canopy is attractively valued in the grander scheme of things, but the stock could continue free-falling over the near term, as investors fret over continued margin erosion and net losses. I'd get some skin in the game today if you're looking to initiate a long-term position, but be ready to buy more on further weakness, because Canopy could easily halve again before it returns to all-time highs.

Stay hungry. Stay Foolish.

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2. NASDAQ:HEXO (HEXO Corp.)
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