Cannabis Investors: HEXO (TSX:HEXO) Stock Could Be a Steal at $2

Description

Cannabis stocks have suffered a massive fall from grace in the first year of nationwide legalization, with **HEXO** (TSX:HEXO)(NYSE:HEXO), formerly known as Hydropothecary, taking on substantially more damage than that of its bigger siblings in the space.

At the time of writing, HEXO stock is down a staggering 74% from its May 2019 high. After recently announcing plans to combat the cannabis black market with its own line of budget bud, it appears as though HEXO has fired the first shot in what could be a vicious price war that could narrow the price spread between legal and illegal weed. The company is shooting down near-term profitability hopes in the process.

Black market blues

Like its bigger brothers, HEXO recently reported unimpressive quarterly results, which exacerbated the downward move amid the perfect storm of industry-wide pessimism. Many marijuana investors have been waking up to the fact that marijuana is nothing more than a commodity — a commodity with a black market that's alive and well.

Fortunately, HEXO realizes this and management appears to be gearing up for the next stage of the nascent market that'll see margins erode. That means focusing efforts on driving operational efficiencies through the roof to make an economical, budget product that's capable of winning over the business of cannabis consumers who've stuck with their illicit dealers in spite of legalization.

While HEXO desires to help illicit cannabis users recognize the "value" to be had in well-tested legal weed, it will ultimately be weed quality and the price paid that will dictate whether licensed producers like HEXO will win over the business of cannabis users who are being supplied by the black market.

At current levels, HEXO isn't fairing too well even with high cannabis prices as they are, with $56.7 million in losses as of the last quarter, up from $10.5 million in losses year over year.

With potentially falling prices in the forecast for legal pot, HEXO's cash bleed has the potential to accelerate drastically, and it's this disturbing profitability downtrend that has so many ditching the stock as well as the sector.

To add even more salt in the wounds of the company, HEXO cut its revenue forecast for the fourth quarter (thanks, black market!) and pulled back on the outlook for 2020, which could have the potential to be disastrous should price wars be the story of year two of legalization.

More recently, HEXO slashed 200 jobs as management sets its sights on profitability. The cuts, which include some executive positions, are adjustments for "expected revenues" to "ensure the long-term viability" of the firm. Given the current trajectory, I don't see HEXO reaching profitability as other cannabis producers look to lower the bar with a budget bud of their own.

Green future?

There's no easy solution to combating the black market.

And unfortunately, producers like HEXO are going to need to endure potentially more pain in 2020 before any sustained upward trends in profits can be had.

Does that mean you should avoid HEXO at $2 and change?

If you've got an investment horizon that spans more than five years, I'd actually be a buyer of the stock in spite of the industry challenges that lie ahead. Weak-handed investors have left the name in droves, and the stock now trades at 17.9 times sales, which isn't that absurd anymore given the long-term growth potential.

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