



2 Marijuana Stocks I'd Buy on the Verge of an Industry Purge

Description

It's been a bloodbath for marijuana investors who bought and held cannabis stocks in the post-legalization era thus far.

With profitability still a long way off because of a potential price war to better compete with the black market, even more pain could still be in the forecast for marijuana investors who are thinking the "Cannabis 2.0" tailwind is worth buying into.

With **HEXO** firing one of the first shots in what could be a legal cannabis price war with its line of [budget bud](#), I think it's about time that investors stop looking to cannabis stocks as "special snowflakes" with differentiated products that are immune from the "substitution effect."

According to statistics compiled from Statistics Canada, around 40% of Canadian cannabis users are supplied by the black market. Ever since legalization came into effect, legal bud prices have gone up. All the while, illicit marijuana has become cheaper, and a considerable chunk of cannabis users that smoked weed prior to legalization are still using the black (or grey) market as their primary source of cannabis.

Such users of illicit cannabis see no incentive to pay almost double the price to get legal bud when black market sales aren't really being cracked down on by federal regulators.

Is a "dot-com-esque" cannabis crash on the horizon?

Big-league licensed producers (LPs) realize that a tonne of sales are being lost to the black market, and with no government action to reduce the spread between legal and illegal weed, a price war could be brewing in year two of legalization to win the business of illicit cannabis users.

In such a scenario, where budget bud becomes a top seller, the LPs' margins are going to be in for a big squeeze. Less-efficient LPs are going to find themselves deeper in the red, and of these, the ones with ugly balance sheets could find themselves either going belly up or getting scooped up at rock-bottom multiples.

Like in the dot-com bust, the coming "cannabis purge" could see many poorly run small-cap producers go bust and send shockwaves across the entire sector. And while the lights go out on the industry, a few firms will survive such an onslaught and rise to become one of the few firms that'll continue to operate (and likely make a big profit) in five years from now.

Such survivors, which will likely include **Aurora Cannabis** ([TSX:ACB](#))(NYSE:ACB) or [Canopy Growth](#) ([TSX:WEED](#))(NYSE:CGC), will enjoy the perks that come with a greater share of the cannabis market and evolve to become more like well-established behemoths like in any other sin market.

Moreover, a few dominant players in the space will have greater control in dictating the price of legal weed, not to mention the possibility that federal regulators may give the green light on branded products at some point down the road once there are fewer LPs to police.

Aurora's cost advantage

Aurora has the advantage of outstanding margins and process-driven initiatives that will drive greater operational efficiency moving forward.

Yes, Aurora isn't profitable yet, but of all the firms out there, I think it's the closest to moving sustainably in the green. Its size and margin advantage, I believe, make it a firm that can survive and even better itself in a cannabis purge.

Canopy's incredible partnerships

As for Canopy, the company has the advantage of having **Constellation Brands** in its corner and access to its deep pockets. Although Canopy's margins aren't the best in the world, the company is positioning itself as a force to be reckoned with as a survivor in the post-purge era.

Canopy's been wheeling and dealing at the international level, and with celebs like Drake, Martha Stewart, and Snoop Dogg on board, the company could pop like a bat out of heck if regulators were to ease up on product differentiation in the future.

Foolish takeaway

A massive cannabis crash could wipe out a substantial chunk of the less-than-stellar junior marijuana producers out there. Canopy and Aurora are two names that will likely survive, thrive, and allow for multi-bagger gains over the long haul.

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Author

joefrenette

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