Canopy Growth Corp (TSX:WEED) Is Oversold: Is Now the Time to Buy?

Description

The **S&P/TSX Index** is hitting new highs, gaining a whopping 17% year to date. To put that into perspective, the Index has closed above 17% only twice since the financial crisis, and it's safe to say that the **TSX** is enjoying a strong year. Unfortunately, this rising tide did not raise all ships.

Every week, I scour the oversold list looking for bargains. The most commonly used momentum indicator is the 14-day **Relative Strength Index** (RSI). A 14-day RSI above 70 indicates that the stock has entered oversold territory and may be due for a short-term pullback.

On the opposite end of the spectrum, a 14-day RSI below 30 is an indication that the stock is in oversold territory and may be due for a short-term bounce. This is the list I am most interested in.

As of writing, there are 54 companies whose stocks are on the oversold list — a fairly high number given that the **TSX Index** is in overbought territory (RSI of 77).

This week's list has a different feel, however. On a quick glance, it's dominated by cannabis companies. The **Horizons Marijuana Life Sciences Index** (TSX:HMMJ) is also on the list.

It's rare to see Exchange-Traded Funds (ETFs) on the oversold list, as they're typically more diversified and less volatile.

This is sign that the entire industry is under pressure, which isn't entirely surprising since **Canopy Growth Corp** (TSX:WEED)(NYSE:CGC) posted disappointing quarterly results.

Canopy is the bellwether stock for the industry. On Thursday, Canopy Growth posted second-quarter results that missed expectations.

It posted a net loss of $1.08, missing expectations by $0.73; revenue of $76.6 million was $21.9 million (27%) lower than expected. These were certainly fairly significant misses.

Canopy's stock price cratered and lost 14.38% on the day of trading. Apart from the headlines, there were several other warning signs. Although revenue grew 228% over the second quarter of 2018, it only managed to grow by 3% sequentially.

This is a worrisome sign, as these stocks are priced as hyper-growth companies. Low single-digit, quarter-over-quarter revenue growth simply isn't going to cut it.

Furthermore, the company is burning through cash at an alarming rate. It consumed $359 million, an 81% increase over the previous year. Expenses are up and inventory is growing, an indication that demand isn't keeping up with production.

Foolish takeaway

Thanks to its price crash, Canopy's stock has now entered oversold territory. With an RSI of 29 and at trading at a two-year low, is now the time to pick up shares? Unfortunately not.

The bubble appears to have popped, however — an inevitability given that the industry was trading at ridiculous valuations. That said, although valuations have come down considerably, stocks such as Canopy still aren't cheap.

Canopy isn't going to become profitable any time soon and is trading at 25 times sales. There are plenty of other high-growth stock trading at cheaper valuations with much less risk.

There is also the headwind of current market dynamics. Given the race to production to meet expected demand, inventories rose too quickly, and the industry is now producing more than it can sell.

Something has to give; either production will need to be curved or prices will have to decline considerably. Either way, it will have a negative effect on companies such as Canopy Growth.

My investment thesis on the industry hasn't changed; it remains speculative at best.

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