Should You Buy HEXO (TSX:HEXO) Stock After the Latest Meltdown?

Description

The meltdown in the shares prices of Canadian cannabis stocks shows no sign of letting up, but contrarian investors with an eye for an opportunity are wondering if the sell-off is simply out of control.

Tough times

The last two years have witnessed some volatile moves in the prices of marijuana stocks. The sector saw a massive rally ahead of the legalization of recreational cannabis sales.

Shortly after the market opened, the industry ran into a headwind with supply shortages and distribution challenges putting the brakes on consumer enthusiasm.

Share prices fell as much as 50% from October to late December 2018. A broad-based pullback in the overall equity market likely contributed to part of the decline.

In January, the sector rallied on renewed optimism and the positive momentum pretty much carried right through the end of April, when many stocks in the Canadian cannabis sector hit new highs.

Since then, the trend has been negative and the rate of decline has recently picked up steam.

What's going on?

Compliance concerns and bad behaviour by the bosses at some of the industry's leading players likely set the ball rolling on the pullback, but the realization that lofty revenue predictions were way out of line has probably had a larger impact.

A slow rollout of physical retail locations in Ontario and Quebec is one reason that marijuana companies are missing revenue targets.

Tighter regulations in the wake of compliance scandals has made the situation worse. As a result, the latest wave of quarterly results has been broadly negative with large losses and reduced revenue projections for the coming year.

Banks and other sources of capital are taking a step back, making the situation even more dangerous for pot companies and their investors.

The need to scale up production facilities and develop new cannabis-related products requires significant capital. If companies don't have access to funds, they can run out of cash and be forced to shut down or liquidate the assets. Some marijuana producers will inevitably survive and thrive, while other risk disappearing completely.

Let's take a look at one troubled pot stock to see if it deserves to be on your contrarian buy list.

HEXO

HEXO (TSX:HEXO)(NYSE:HEXO) told investors in June that it was still on track to generated $400 million in revenue in fiscal 2020. The management team even said that revenue for fiscal Q4 2019, which ended July 31, would be about $26 million.

In October, HEXO came out with a warning that its upcoming Q4 2019 results would be worse than expected. In addition, the company abandoned its fiscal 2020 outlook.

The final Q4 net revenue number came in at just $15.4 million, and the new guidance for Q1 2020 is for revenue of less than $18 million. Even at the top end, that puts the annualized 2020 revenue projection at less than $100 million.

HEXO lost $56 million in Q4 2019 and is cutting 200 jobs in an effort to preserve cash. The company announced $70 million in new funding, which sounds positive, except the cash is primarily coming from company insiders.

The stock topped $11 per share in April and now trades for $2.20. This puts the market capitalization at just over $560 million.

Should you buy HEXO?

HEXO could become a takeover target, given the attraction of its leadership position in Quebec and its drinks partnership, Truss. If a bidding war emerges, contrarian investors might score a nice short-term gain.

That said, there is no guarantee a buyout will occur, and potential bidders could simply stay on the sidelines until the rout has run its course, or at least until the stock is at a much lower level.

Pot stocks continue to tumble and the daily drops are getting ugly. Until there is clear evidence of a bottom, I would avoid HEXO and its peers.

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