Are Cannabis Stocks Still Overvalued?

Description

Cannabis stocks have been in the doldrums of late as a lack of profitability across the industry, growing fears that the global market is smaller than originally estimated, steep regulatory requirements and high production costs weigh on the industry.

Even Canada's legalization of cannabis edibles and derivative products on 17 October 2019 did little to move the needle. Consequently, most cultivators, including industry leader **Canopy Growth** (TSX:WEED)(NYSE:CGC), which is down by 38% since the start of 2019, have been roughly handled by the market. There are a range of reasons for this with one of the most worrying being the emergence of a cannabis supply glut.

Weaker demand

Product inventories are estimated by industry analysts to be capable of meeting over 80% of demand and continue to grow as cultivators' ramp-up growing capacity and operations.

Most growers had been anticipating that demand would be far greater than is being experienced and that the legalization of edibles would bolster it further, leading to a supply shortfall.

That hasn't occurred with Canada's licenced producers having only completed around $1.1 billion of sales in the year after legalization. That is lower than original estimates that forecast that the domestic market could be worth up to $5 billion annually.

Many analysts are slashing their original estimates, with it now estimated that Canada's legal pot market will be worth $5 billion in two years time compared to a forecast of $8 billion a year ago.

Another risk is the growing likelihood that the U.S. federal ban on marijuana will be removed by Congress allowing states to legalize the plant and allowing banks as well as other financiers to provide capital to an industry starved of investment.

That will trigger a flood of new cultivators entering the U.S. cannabis industry sparking a race to the bottom as they and existing growers' ramp-up operations to expand production to reduce costs through increased scale to be competitive.

This will further increase supply in a global marijuana market, where it is uncertain as to how much demand truly exists. While analysts believe that it could be worth US$89 billion or more by 2024 that appears overly optimistic, particularly when Canada's experience is considered and that it was valued at US$10 billion in 2018.

Much of the optimism is based on the belief that many jurisdictions across the globe would legalize recreational consumption of marijuana during the foreseeable future but that is not occurring.

There are signs of reluctance among governments globally to legalize recreational marijuana because of the stigma associated with its consumption and a lack of preparedness to regulate cannabis effectively, which doesn't bode well for the industry and further reduces the attractiveness of investing in Canadian cannabis stocks.

Those factors along with a lack of profitability are weighing heavily on pot stocks and don't support their rich valuations. Canada's largest cultivator Canopy is trading at 25 times sales despite reporting substantial losses over the last year.

It is now scaling back non-core operations, mainly in Latin America, in a bid to become profitable after reporting a fiscal second quarter 2020 loss of $374.6 million which was 13% greater than a year earlier.

Canopy's significant loss can be blamed on a sharp increase in sales and marketing, R&D and general and administrative costs which shot-up by 51%, 513% and 137% year over year respectively. That substantial increase in indirect costs can be attributed to Canopy focusing on expanding its suite of products, distribution network and supporting infrastructure, which are critical if it is to maintain its leading role.

Canopy would need to grow sales by roughly 25-times their trailing twelve-month value to justify its current market value. What's more worrisome is that Canopy's second quarter net revenue declined by 26% compared to the previous quarter because of weaker cannabis prices, which, along with the factors, indicates that it may not be able to boost sales revenue to the required level.

Foolish takeaway

The headwinds ahead for cannabis stocks makes it difficult to justify their current valuations, indicating that even after recent large declines they are still overvalued. For these reasons, large cultivators like Canopy will likely see their stock weaken further, making them unappealing investments at this time.

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