



Cannabis Edibles Legalization Fails to Save Pot Stocks, Including Hexo (TSX:HEXO)

Description

The legalization of cannabis edibles and derivative products last month has failed to give cannabis stocks a desperately needed lift. Leading cultivators **Aurora Cannabis**, **Canopy Growth**, and **Aphria** have been heavily [marked down](#) by the market since the start of 2019, losing 54%, 36%, and 23%, respectively. Even **Hexo** ([TSX:HEXO](#))(NYSE:HEXO), which is positioning itself to become a market leader in the edibles space through an alliance with **Molson Coors** and is the first major grower to join Food & Consumer Products of Canada, has been hammered, losing 45% for the year to date.

This has sparked considerable speculation that it has created an opportunity to acquire quality marijuana stocks, which are poised to soar once Health Canada's waiting period ends and approved cannabis edibles are available for sale. This is expected to occur on December 17, 2019, and, according to industry participants as well as analysts, will give demand for legally cultivated cannabis a significant lift, which will be a boon for the major cultivators.

Declining outlook

If the experience of Colorado and California is anything to go by, the introduction of legally available edible cannabis products will be met by a stampede of demand, causing the consumption of cannabis flower to soar. Canada's edibles and extracts market is estimated to be worth up to \$2.7 billion.

The considerable pent-up demand for those products, beverages, vapes, and other extract-based products will give demand for legally cultivated marijuana a notable boost. That should translate into higher sales and hence earnings for the major cultivators. Edibles are also far more appealing to many consumers because of the stigma associated with smoking dried cannabis flower.

Nonetheless, there are signs that Cannabis 2.0 may not have the anticipated effect. Health Canada has advised that only a limited selection will be available in December, while provincial regulatory bodies have advised that there will be a slow introduction of products.

There are also fears that the introduction of edibles will lead to a spike in hospital admissions, as has occurred in Colorado. That will trigger greater regulatory scrutiny at provincial and federal levels.

Rising uncertainty over the supply of cannabis edibles combined with growing flower supply and sharply lower-than-anticipated demand for cannabis over the year since it was legalized bode poorly for cultivators. This magnifies fears that pot stocks are trading with lofty valuations and won't be able to expand sales as predicted, or profit in an industry where profitability appears elusive for most participants.

Hexo reported a \$57 million loss for its fiscal fourth quarter 2019, which was just over five times greater than a year earlier. It is also burning cash at a tremendous rate with operating expenses growing more than fourfold compared to the same period a year earlier.

There was also a sharp increase in the number of shares issued on a fully diluted basis, which grew by a whopping 29% year over year to 303 million shares. That is bad news for existing shareholders, because it indicates that they are being diluted by Hexo, as it uses equity to fund the expansion of its business in an environment where its market value is falling.

On a positive note, Hexo finished the latest reported quarter with almost \$114 million in cash and negligible long-term debt of \$30 million.

Foolish takeaway

The dilution of existing shareholders, a nosebleed valuation that sees Hexo trading at over 15 times sales, and never having reported a profit in an industry with an [uncertain outlook](#) make it an unattractive stock. Those factors indicate that Hexo could have further to fall, even with the legalization of marijuana edibles, beverages, and extract-based products, making it an unattractive investment at this time.

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Author

mattsmith

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