Concerns About HEXO Stock Post Q1 Earnings

Description

HEXO Corp. (TSX:HEXO)(NYSE:HEXO) released its fiscal first-quarter 2020 results on Monday. As the stock traded over 3% lower for the day, the market clearly wasn't impressed with the latest earnings instalment.

The biggest highlight was the 25% sequential decline in operating expenses after the company terminated 20% of its workforce and suspended cultivation at some facilities. But investors can't bank on operating cost reductions to lead to sustainable profits for a growth operation. This is a strategy mainly reserved for mature companies in mature industries.

Marijuana investors may be more concerned about top-line growth and respectable margins, but the company disappointed on both these fronts.

Quarterly net revenues declined sequentially from $15.4 million in the most recent previous quarter to $14.5 million, even as consumer cannabis sales volumes increased sequentially by 5% to 4,196 kilograms during the same period.

In a desperate attempt to move volumes in a saturated market, the company has made price concessions to the channel and is providing for product returns, which has hurt margins. Gross margins before fair value adjustments continue to trend lower, down to 31.5% of net revenue for the just-reported quarter, due to provisions on pricing and provisions for returns.

Margins could remain severely depressed as volumes increase for the company's new value brand, *Original Stash*. Management has gone into stiff price competition mode as it tries to push volumes in the hope of gaining market share and de-congesting its sales channels, where some old product that has been on shelves may need to be archived.

I'm afraid that price competition alone may not save individual firms as it triggers a downward spiral in product prices for the whole industry as competitors follow suit to defend their market share. It's therefore surprising that management hopes to achieve operational profitability during calendar year 2020, given the tight market conditions.

During the quarter, the company recorded an impairment loss on inventory of $25.5 million composed of $15.4 million related to excess supply of trim and mill products, $4.4 million related to bulk purchased products, $3.4 million related to a surplus of oil products, and $1.2 million related to finished goods samples "which are required to be archived by Health Canada."

These kinds of impairment losses aren't typical of a standard growth stock, and the company's CFO further commented during the earnings call that management is "closely monitoring inventory levels as well as assessing applications for inventory in our 2.0 products and will continue to keep (the market) updated on a quarter-by-quarter basis regarding any further impairments that may be required."

Impairment charges could still continue in the next quarter, and that's not so good.

Other issues to ponder on

It was a huge relief to learn that Health Canada was lenient concerning cultivation done in an unlicensed Block B at subsidiary Up Cannabis's facility, and the inventory won't be destroyed as was the case at **CannTrust.**

This is a welcome development, and understandable considering that this was a communication error and the mistake wasn't intentional, unlike the scandal at CannTrust.

Another issue is that the company's auditor has reserved its opinion on the company's quarterly results due to an error in consolidating deferred taxes at subsidiaries.

Beware the upcoming dilution

HEXO will soon launch an at-the-money (ATM) financing program to raise new equity capital. The program will limit transactions to 10% of the company's market-cap during a prior month. Issuing equity during the current industry valuation lows will definitely dilute existing shareholders much more that it could have had the new shares been issued at other times.

Bottom line

Cannabis 2.0 could still help bring back some mojo to the company's stride, but shares may trade sideways for longer as margins remain subdued and impairment charges may persist. The goal of achieving profitability during the 2020 calendar year isn't likely to be attained.

Holding an already existent position may be okay, and you can buy at these bottoms if you are bullish on the company's long-term prospects, powered by partnerships, but if you aren't comfortable with the elevated risk, new money may be best placed elsewhere.

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