Why Hexo’s (TSX:HEXO) Stock Offering Is Bad News for Cannabis Stocks

Description

Amid a low-volume trading week in which the markets where only open for three days, **Hexo** (TSX:HEXO)(NYSE:HEXO) announced an equity offering. On the surface, there is nothing wrong with equity offerings. High-growth companies do it all the time, as they need cash to fund growth. Depending on the size of the company, they may also be limited in their borrowing capacity, and as such, issuing stock may be the most effective way to raise cash. Furthermore, there is also nothing wrong with an offering at a discount to market price — it happens frequently.

What stands out about Hexo’s offering is the timing and the sheer size of the discount. For starters, it is not best business practice to announce good news at time when most investors are on holiday break. In fact, it is the perfect time to announce bad news, as there are fewer eyes to notice. It is not unlike releasing bad news after the markets close on a Friday.

Unfortunately for Hexo shareholders, there was no hiding last week’s bad news. The $25 million offering caught investors by surprise, and at US$1.67 per share, it represented a 15% discount to the company’s last closing price. Ouch. The market did not react well and sent its share price tumbling, as it closed the week at $2.10 per share — a 52-week low. It hasn’t closed at such a low price since 2017.

It is the last bit of bad news before the year is out and a fitting end to what has been a tough year for the industry. Fraught with negative headlines — illegal operations, questionable acquisitions, changes in leadership, and missed estimates — the cannabis industry has been decimated. No, I am not overreacting. As of writing, the Canadian Marijuana Index is down 55% this year, and for its part, Hexo has lost 60% of its value in 2019.

Why the offering is a bad sign

With respect to the offering, the big discount to market price is a concerning sign. It wasn’t that long ago when institutional investors were lining up to offer cannabis stocks access to much-needed capital to expand. Given the strong demand, pot stocks often received favourable terms, which helped spur significant production capacity.

The problem now, however, is that demand for recreational marijuana hasn't been as pronounced as expected. As such, there is now excess capacity, and production growth will come at a greater cost. A 15% discount to market price, which was already significantly depressed from yearly highs, is a sign that the days of easy money are firmly in the rear-view mirror.

Think about all the acquisitions at ridiculous multiples over the past couple of years. We could see a year in which write-offs take centre stage, as cannabis companies re-evaluate their assets.

Likewise, the equity offering may be the first of many to come. It appears banks are no longer chomping at the bit to lend these producers money. At least not at favourable rates, which is most likely why Hexo tapped into the direct equity offering market. Make no mistake; despite big revenue growth, they are burning through cash and are not yet profitable. They will need additional capital to expand.

Given this, it doesn't look as though the bleeding is over. Since the start of the cannabis craze, I have warned investors that the industry is speculative at best. Although I have no doubt there will be some strong investments in the space, over the short term, it is still a gamble.

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