Don’t Expect Canopy Growth (TSX:WEED) to Rebound in 2020

Description

After many cannabis stocks soared to record highs in 2017 and 2018, sparking claims that the industry was in a massive asset bubble, there are signs that it has finally burst and 2020 will be a tough year for cannabis investors. Leading cultivator **Canopy Growth** (TSX:WEED)(NYSE:CGC) has seen its share price collapse, falling by 47% over the last year, as a series of monster losses weigh on its market value.

The largest industry exchange-traded fund (ETF), **ETFMG Alternative Harvest ETF**, a market-cap weighted index of cannabis firms operating globally across all parts of the supply chain, which has Canopy as its largest holding, lost a whopping 47%. There are signs of worse to come for cannabis investors, despite some pundits claiming that marijuana stocks are very attractively valued and poised to rebound during 2020.

Lack of profitability

A key reason or the sharp collapse in the value of cannabis stocks has been the industry’s ongoing battle to attain profitability. Canopy has reported some poor results over the last year, which have left investors, including **Constellation Brands**, substantially underwhelmed and fearful that it will never deliver value.

For its fiscal second quarter 2020, Canopy reported a net loss of almost $375 million, and that came on the back of a whopping $1.3 billion loss for the first quarter and a $670 million loss for the 2019 fiscal year. There are growing indications that profitability may be some way off for many industry participants.

The global legal marijuana market is proving to be far smaller than many such as Canopy originally anticipated. There were initially inflated estimates from industry insiders citing anywhere from US$250 million to US$500 million within roughly a decade. In a June 2019 presentation, Canopy claimed that the market for legal cannabis products globally was worth $250 million.

Those claims now appear excessively optimistic. Industry analysts claim the industry may be as worth as little as US$30 billion, while more optimistic reports state figures of anywhere between US$41 billion and US$67 billion, well shy of the figures being quoted only two years ago. This is applying considerable pressure to the market value of many cannabis stocks, with many trading at nosebleed valuations.

Even after the sharp decline in the value of its stock, Canopy is valued at 27 times sales, indicating that revenue would have to grow roughly sevenfold if it were to trade with a ratio like companies in comparable industries — for example, packaged liquor or tobacco.

Based on Canopy's fiscal 2019 results, it would need to generate sales worth a whopping $1.8 billion to achieve that and appear fairly valued. That appears virtually unachievable because of limited international opportunities and Canada being the only truly accessible market for legalized recreational marijuana use.

Furthermore, it is estimated that Canada's legal marijuana market will be worth around $3 billion in revenue during 2020, and that the market is highly competitive with an ever-increasing number of legal cannabis growers. There are also claims that a legal cannabis supply glut is emerging in Canada because of the significant volume of cultivators, growing production, and a lack of retail distributors. Even the legalization of cannabis beverages and other derivative products failed to substantially boost legal cannabis sales, nor has it averted the potential for a supply glut, which will weigh on wholesale marijuana prices, further impacting Canopy's revenue.

Foolish takeaway

Cannabis stocks exhibited all the signs of a traditional asset bubble, and while it has finally burst, there is still a long way to go until most marijuana stocks are trading at reasonable valuations. This, combined with growing supply and a smaller-than-expected global market for legal cannabis products, is weighing heavily on Canopy's outlook and profitability.

There are signs that the stock is still trading at a nosebleed valuation and won't unlock value for investors for some time to come, making it an unattractive investment.

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