This Is the Most Important Driver for Cannabis Investors!

Description

For cannabis investors who continue to hold positions in any of Canada's cannabis producers, every news cycle seems to bring unwanted negative news, driving volatility in the sector and valuations lower, as many take money off the table after a wild ride that has seen valuations reach astronomical levels.

Determining what precisely has driven this volatility and scared many investors away is difficult, as there are a number of headwinds that have materialized over the past year that investors can point to. In this article, however, I'm going to point out what I believe is the core issue that drives many of these headwinds and will continue to provide headaches for investors moving forward.

Here it goes: the long-term price cannabis producers can expect to receive for a gram of cannabis is much, much lower than what producers are seeing today.

Analysts and investors base valuations on forward-looking forecasts related to various key inputs. For commodities, the key driver for sector-wide valuations is the price of said commodity. Gold mining companies expect to see higher valuations when the price of gold increases, and the same goes for marijuana. The media can spew a bunch of fancy verbiage to get investors to believe that "Cannabis 2.0," or infused beverages, oils, vaping products, or other value-added products will increase the average price of cannabis over time, but I believe the opposite will be true (and will need to be true). Here's why.

Taxation on cannabis in Canada right now amounts to $1 a gram, plus sales tax, meaning producers will receive the difference between the taxed retail price and the markups on the distribution and retail channels. With most distribution happening at the provincial level in the form of government-run distribution companies, these markups can be higher than many expect and are likely to grow over time, as the government will continue to use cannabis as an indirect form of tax revenue, similar to alcohol, cigarettes, and other "sin" categories.

Right now, when you add up the cost of producing a gram of cannabis (many companies can produce low-quality cannabis for less than $1 a gram), with taxes, SG&A costs, interest payments, and markups built in, one will realize that the very cheapest a customer could pay for a gram of weed is at or higher than much of Canada's black market, which sells marijuana for around 50% of the legal price on average.

Canadian cannabis companies need to drop prices if they want to gobble up market share from the black market. Most producers have an affordable low-cost option, such as **Canopy Growth's** Tweed brand, but prices in the low-cost segment are still far too high.

Bottom line

I expect margins to continue to be eroded for cannabis producers at a rate that will result in much higher negative cash flow (cash burn) than many anticipate and am therefore bearish on this sector at this point in time. For investors looking for a good entry point, I'd wait at least 12 months before even looking at this sector again.

Stay Foolish, my friends.

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