HEXO Stock Price to Fall If Management Misses Tight Deadline

Description

Canadian cannabis producer **HEXO**'s (TSX:HEXO)(NYSE:HEXO) stock fell over 28% after earnings on Monday and the share price could fall further in April. The company's latest quarterly financial results for fiscal Q2 2020 show management is racing against time to avoid a potential bankruptcy situation. The clock is ticking fast.

Perhaps we can have a quick look at quarterly performance before discussing management's race to beat two critical deadlines in April.

Were HEXO's Q2 2020 earnings really that bad?

Not really.

The company reported a 17% sequential growth in net revenue for the quarter to January 31. Adult-use cannabis segment volumes surged 57% sequentially as a recently launched value brand *Original Stash* steals the show in Canadian marijuana retail stores.

However, realized prices per gram continue to fall as Original Stash's sales volumes increasingly contribute to the company's sales revenue. The company is fighting the underground market with legit pot at matching prices, and its value brand is getting listed in a more provinces. Price competition has intensified, but at the expense of gross margins.

Excise taxes eating into margins

Unfortunately, as low-priced offerings grew in volumes, excise taxes as a percentage of revenue are rising too. Excise taxes are volume based, and the company is pushing higher volumes at reduced average prices. Excise taxes comprised 27% of gross revenue over the past six months, up from 18% historically.

But that's not a very big issue, there were bigger matters that dragged the company's stock price down on Monday.

Persistent cannibalization, and a lost segment

Medical cannabis sales volumes continue to decline for a fifth consecutive quarter. Patients seem to be switching to lower priced recreational offerings. The firm also registered zero wholesale revenue for the second quarter in a roll.

Anyway, this segment could be dying fast if we consider the current market oversupply after everyone ramped up production last year.

Persistent write-downs, massive impairment charges

Massive inventory write-downs continue, and significant write-offs were made as previously warned.

A $16 million inventory charge was levied during the reported quarter. This time, the write-down is mainly due to a concentrated bulk purchase under a supply agreement acquired through Newstrike. Management believes contract prizes were negotiated in bad faith "…at prices well in excess of market." The supply agreement is already under litigation.

The company recorded over $250 million in assets and goodwill impairment charges during the quarter, while operating expenses ballooned to $281.5 million against quarterly net revenue of $17 million.

Business is just bad right now, but this is not as concerning as the critical liquidity issues raised that threaten the company's going concern status today. Management has to act fast to avoid a spiral of negative and self-reinforcing events.

Potential default in weeks — and a magnified bankruptcy threat

Management has issued a going concern note in the company's financial statements that seeks to explain the fact that the company is significantly underfunded and may be unable to meet its financial obligations over the next 12 months without new financing. Yet the equity markets are drying up.

Further, the company needs new capital in a few weeks' time or it will breach a critical financial covenant tied to a $65 million syndicated bank loan. In the recently revised loan terms, management has been given up to April 30, 2020 to raise new equity from the market or else the company will default on its loan terms.

According to the updated covenants, the company should raise at least $15 million in new equity by April 10. Further, management should secure at least $40 million from equity investors by April 30.

Given the current market crash and a COVID-19 stricken financial market, times couldn't have been worse. The company is scurrying for new financing during a global crisis. Management might fail to meet the tight deadlines.

I hope things will work out fine. If they don't, a default could take place in April, potentially triggering a downward spiral that could quickly result in a bankruptcy situation — HEXO's stock price could plunge in April.

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Date
2025/08/26
Date Created
2020/03/31
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