Bankruptcies Ahead for Troubled Cannabis Stocks: Is HEXO (TSX:HEXO) Next?

### Description

After a nine-month saga, which began with Health Canada identifying irregularities at **CannTrust**, the cannabis cultivator finally filed for bankruptcy protection. The arrival of the coronavirus pandemic and its ensuing economic fallout will trigger further bankruptcies among cannabis stocks. The industry has delivered spectacular returns for investors until the bubble burst in April 2019.



Leading Canadian cultivator **Canopy Growth** delivered a whopping 124% for shareholders between the end of April 2018 and April 2019. Since then, it has been all downhill, because the cannabis bubble rapidly deflated. The largest marijuana ETF the **ETFMG Alternative Harvest ETF** has plunged by 66% over the last year, while its third-largest holding Canopy Growth has lost 64%. There are signs that cannabis stocks are facing a particularly bleak future.

## Falling sales

The coronavirus pandemic has forced the closure of pot shops, as governments across the world shutter non-essential services. Canopy Growth was one of the first to act, temporarily closing its corporate-owned retail locations across Canada. Ontario removed cannabis dispensaries from its list of essential businesses at the start of April, forcing them to close.

Social-distancing rules, travel bans, and the requirement that people stay at home for all but essential activities is weighing heavily on legal cannabis sales.

These events will apply considerable pressure to legal marijuana cultivators and sellers in an industry already struggling with profitability. Leading Canadian cultivator Canopy Growth posted a massive $1.8 billion loss for the nine months ending December 31, 2019.

## Lower availability of credit

Another crucial problem, aside from a loss of sales**,** is that credit will become more difficult to obtain during the coronavirus crisis. That is a serious problem for an industry already battling a lack of access to capital. The stock market crash has rattled investors, making it virtually impossible for cannabis companies to raise equity.

Credit is drying up, as banks and other institutions brace themselves for a deluge of loan losses and credit defaults. The largest U.S. lender, **JPMorgan Chase**, has suspended business loans that are aren't guaranteed by the federal government.

Worse still, most institutions have significantly restricted their lending activities. They are doing this to bulk up their balance sheets, as they prepare for an avalanche of loan defaults, spike in impaired loans, significantly higher lending loss provisions, and deluge of borrowers seeking to restructure existing facilities. That will essentially inflame an already tight funding environment.

The coronavirus credit crunch will prevent legal cannabis companies from accessing urgently needed capital to keep their operations afloat in an environment where sales are expected to decline sharply, placing pressure on cash flow and earnings.

## Bankruptcies will soar

This will cause the bankruptcy rate to soar across an industry where many participants lack the financial resources to weather such a calamity. It is smaller participants that are the most at risk. Canada's fifth-largest cultivator **HEXO** (TSX:HEXO)(NYSE:HEXO) is under considerable financial pressure. In its fiscal second-quarter 2020 results, HEXO flagged that it lacks enough resources to remain a going concern. The cultivator was also forced to raise $40 million in equity before the end of this month under its revised debt convents.



While that was a substantial amount in the current difficult operating environment, HEXO this week completed a $46 million public offering. That has allowed HEXO to comply with its debt covenants and fund working capital requirements. The offering was dilutive for existing shareholders and didn't raise enough funding to prevent HEXO from having to go to the markets for further capital.

The cultivator is experiencing regulatory issues with its Niagara growing facility. HEXO reported $266 million of writedowns and impairment charges for the fiscal second quarter. The issues responsible for those charges have yet to be fully resolved. HEXO's precarious financial position will be impacted by additional impairment charges during 2020, making it vulnerable to bankruptcy.

## Looking ahead

Cannabis stocks are under considerable pressure. The coronavirus pandemic has magnified the issues already afflicting the legal cannabis industry. A key hazard is that capital is drying up, as financial institutions prepare for the inevitable recession and influx of loan defaults. For these reasons, bankruptcies will continue to grow during 2020. Many cannabis stocks, particularly those like HEXO that are managing a precarious financial situation, are highly unappealing investments.

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