Coronavirus Will Crush Cannabis Stocks: An Industry Reckoning Is Looming

Description

Cannabis stocks will suffer significantly because of the coronavirus pandemic. The outbreak couldn't have occurred at a worse time for an industry that has been rocked by controversy ever since the pot bubble burst in early 2019. The pandemic has set an ominous tone for troubled cannabis stocks in an industry already facing plenty of headwinds. There are signs of further losses and bankruptcies ahead.

Loss-making industry

Leading cannabis stock **Canopy Growth** (TSX:WEED)(NYSE:CGC) has been bleeding red ink for some time. It reported a massive $1.8 billon loss for the nine months ending December 31, 2019. That was after a $671 million loss for its 2019 fiscal year. Canopy Growth is burning through cash at a frantic rate. By the end of its fiscal third quarter 2020, Canopy Growth's cash had fallen by 36% compared to the end fiscal 2019 to $1.6 billion.

The cultivator's high operating costs, which are a result of energy-intensive indoor cultivation, are weighing on its profitability. For the third quarter, Canopy Growth produced dried flower for $2.74 per gram, which was higher than its competitors.

Weak outlook

The earnings outlook for cannabis stocks, including Canopy Growth, is poor. Simply put, the global legal cannabis market is not as large, nor will it grow as fast as many pundits a have claimed. Canopy Growth founder and former CEO Bruce Linton in 2018 proclaimed the legal marijuana market would be worth an eye popping US$500 billion globally.

Recent estimates indicate sales will be worth significantly less than that amount. By 2019, the global legal marijuana market was valued at US$18 billion, or less than 4% of Linton's figure.

Meanwhile, analysts are giving conflicting projections. Some believe the legal global cannabis industry will expand at a compound annual growth rate (CAGR) of 22%, making it worth US$76 billion by 2026.

Others have projected a 31% CAGR with sales forecast to reach US$115 billion after six years.

In February 2020, consultancy Grandview Research stated that the global legal cannabis sales will have a CAGR of 18%, making them worth US$74 billion by 2027.

Still, those figures appear optimistic, despite being lower than earlier estimates.

Substantial hurdles

There are significant obstacles that will prevent the legal cannabis industry from growing — a key one being that cannabis remains a U.S. federal schedule one drug. That significantly reduces the willingness of financial institutions to provide funding to cannabis companies because of the fear of legal sanctions. As a result, the industry has long suffered from a shortage of capital.

This is being exacerbated by the coronavirus pandemic. Financial institutions, including the major banks, are winding down lending and bulking up cash reserves in anticipation of a massive spike in impaired loans and credit losses.

Government strategies aimed at controlling the pandemic are forcing consumers to stay at home for all but crucial activities and the closure of non-essential businesses. This has seen marijuana dispensaries closed in many jurisdictions. That will trigger a steep decline in sales for an industry already struggling with profitability.

The coronavirus has also pushed legislative reform aimed at legalizing or decriminalizing cannabis on to the back-burner. That — coupled with the reluctance of legislators in many jurisdictions to legalize the consumption of cannabis — will prevent the global market from expanding as appreciably as anticipated.

For these reasons, cannabis stocks will be imnpacted by weaker earnings growth for the foreseeable future. This — along with a looming credit crunch — will cause the pace of bankruptcies in the cannabis industry to accelerate.

Rising bankruptcy risk

Among the most vulnerable is **Aurora Cannabis** (TSX:ACB)(NYSE:ACB), which has lost 66% for the year to date. Aurora reported a worrying $1.3 billion fiscal second-quarter 2020 loss, which included $1 billion of impairment charges. If that didn't sound alarm bells for investors, Aurora's precarious financial position should.

By the end of March, Aurora had $205 million in cash, or less than half of its $544 million in outstanding long-term debt. Near-term debt maturities are placing considerable pressure on the company. The difficulty associated with obtaining finance sees Aurora intending to raise equity capital of up to US$350 million to strengthen its balance sheet, which will dilute existing investors.

For these reasons, don't bet on Aurora to recover. If the economic fallout from the coronavirus is as severe as predicted, Aurora may even cease to be a going concern.

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