



Is HEXO Stock a Buy Post Q3 Earnings?

Description

Cannabis producer **HEXO** ([TSX:HEXO](#))(NYSE:HEXO) is a marijuana growth stock of promise after significantly weathering bankruptcy risks this year and delivering double-digit revenue growth numbers in the most recent fiscal Q3 2020 report.

Could HEXO stock deliver outsized investment returns in the long-term?

New data points paint an encouraging picture of the company's potential to profitably grow its market share in the evolving pot market but shares remain beaten down for good reasons.

Is Hexo rising to the top?

The company recently rose one spot to become the fourth-largest Canadian pot seller by volume. Management has set its sights on toppling **Aurora Cannabis** and **Aphria** to the number two position nationally — behind industry leader **Canopy Growth**.

Total kilograms sold during the quarter surged to 9,598 after a 42% sequential growth in adult-use volumes. A 30% sequential growth in net revenue to \$22 million was an encouraging feat given a turbulent few quarters of massive revenue charges due to troubling sales returns and price concessions.

Price concessions do continue to be a stubborn blemish on the company's income statement. However, provisions for product returns have stabilized quarter on quarter. Such stability is welcome, as it reduces relative revenue uncertainty.

The race to the top remains a tough one however. Competitors have responded to the company's low-price competition strategy and they can produce more volumes at very low costs per gram.

Trending toward positive EBITDA

Recent restructuring exercises, lay-offs, and asset disposals weaned the company's operations of excess cost drivers. Reduced costs help the company maintain a low production cost run rates, a status that is necessary for management's chosen low price competition strategy to be successful.

Encouragingly, adjusted EBITDA losses narrowed from \$8.5 million per quarter by February this year to \$4.3 million in the latest quarterly earnings report. The operating profit measure could improve with further revenue growth and operating efficiencies.

The company appears on course to achieve its positive EBITDA target during the first half of fiscal 2021, which begins in August this year.

Market demand growth to boost HEXO earnings

Pantry loading boosted cannabis sales heading into COVID-19 lockdowns. It's uncertain whether high demand for consumer cannabis will sustain, but sales could remain strong with new retail store openings and lower pot prices as licensed producers tap deeper into black market strongholds.

More than half (55%) of the company's sequential sales volume growth came from its value brand Original Stash. New product offerings boosted Q3 revenue too. Market share wins give testimony to the success of management's chosen growth strategy, especially given that adjusted gross margins remained high at 40% during the recent quarter.

Although the medical marijuana market has disappointed, new products and ventures into new geographical markets have helped the company maintain respectable sales volume growth rates.

I'm keen to see how the partnership with Molson Coors will fare in the cannabis-infused beverages market as well as in the Colorado CBD market in the United States.

Working with a de-risked balance sheet

The marijuana firm's liquidity risks were significantly reduced with recent [equity raises](#). Market chatter about potential bankruptcy is distant now, as new liquidity has been raised. However, new share issues mean high shareholder dilution, which are happening during the company's worst valuation period.

Potential threats to investment returns

The COVID-19 pandemic has slowed down the rate of new store openings in the provinces, thus limiting near-term upside.

Further, the company has been successful in Quebec (where it commands a 30% market share) and in Ontario. However, market penetration remains a challenge in other provinces and price concessions have been high in new markets. HEXO therefore remains a regional actor with a higher geographical concentration risk.

Most noteworthy, an aggressive price competition strategy only wins if competitors ignore the attacks.

The strategy favors large, high volume focused, low-cost producers but it can be a disastrous race to an unknown bottom.

I wonder if the company can sustain retaliatory attacks given its weak balance sheet.

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