Why Canopy Growth (TSX:WEED) Is a Buy After the Recent Pullback

Description

Canopy Growth (TSX:WEED)(NYSE:CGC) has declined by over 20% since it reported its fourth-quarter earnings on May 29. The lower-than-expected sales and higher EBITDA losses dragged the company's stock down. Its net losses for the quarter stood at $1.3 billion. The company burnt over $300 million of cash during the quarter. More importantly, the company's market share declined during the quarter due to a shift in customer preferences towards value products.

Despite these drawbacks, I believe Canopy Growth has strong growth prospects with sufficient capital to support its growth initiatives and move towards profitability.

Canopy's growth potential

Canopy Growth is focusing on optimizing its product portfolio, expanding its value products, and gaining market share in Cannabis 2.0 product category to drive its sales.

Canopy Growth had too many low-velocity SKUs (stock-keeping units), which were consuming more resources and creating a bottleneck for the supply chain. So, the company has decided to reduce its SKUs to focus more on high-velocity products. This initiative could make the company's supply chain more agile and aid in meeting customers' demand.

Over the last few quarters, value products have increased their share in overall cannabis sales. But the company's market share has declined due to increased competition. So, the company is working on the development of high THC products, optimizing the moisture content in its flower products, and to price its products competitively, which could increase its market share in the value product category.

Despite Canopy Growth's phased approach toward the introduction of Cannabis 2.0 products, customers have received its products well. The company has already launched four cannabis-infused beverages, two vape product products, and various cannabis-infused chocolates. The company has also planned to introduce new products in the future. During the present quarter, the sales contribution from Cannabis 2.0 products has increased.

BDS Analytics predicts the U.S. CBD market is expected to reach US$20 billion by 2024. However, the market is highly fragmented, providing an excellent opportunity for a company like Canopy Growth to establish its position. The company entered the market in December 2019 through its First & Free brand. Meanwhile, the company is also expanding its product line through its subsidiaries This Works and BioSteel. The company, in collaboration with Martha Stewart, looks to introduce advanced CBD products in this fiscal. So, I am bullish on Canopy Growth's sales growth prospects.

Initiatives that could improve Canopy's margin

During the fourth-quarter earnings call, Canopy Growth's management had announced it will focus on just the top three cannabis markets: the U.S., Canada, and Germany. Meanwhile, in other markets, such as the Asia Pacific and Latin America, the company has implemented an asset-light model.

So, the company has undertaken a series of layoffs in the last few months and expects further cut down on its headcount. The company has reduced its production capacity by 40% to better align its production with the demand. All these initiatives could significantly lower the company's SG&A (selling, general, and administrative) expenses, and improve its margins. Also, I believe the growth in high-margin Cannabis 2.0 products could support its margin expansion.

Bottom line

With the cannabis sector still in the emerging stage, it provides an excellent opportunity for growth. Meanwhile, cannabis companies have problems raising capital, as the U.S. federal government has classified cannabis under Schedule 1 drug. So, maintaining high liquidity is essential.

At the end of the last quarter, Canopy Growth had $2 billion of gross cash. Given the strong liquidity, high growth potential, and efforts to improve its margins, I believe investors with a long-term horizon should utilize the recent pullback in Canopy Growth stock to accumulate it.

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