Are Cannabis Stock Investors Too Harsh on Organigram?

Description

Cannabis producer **Organigram Holdings** (TSX:OGI)(NASDAQ:OGI) stock suffered a 12% decline on Tuesday after the pot firm released poor fiscal first-quarter 2021 financial results. Among other shortcomings, investors in Organigram stock dislike the company's 23% year-over-year decline in quarterly net revenue. That was a horrible performance, of course, but should the market punish the cannabis stock on this data point?

Organigram in persistent revenue underperformance?

Gross revenue for fiscal Q1 2021, at $25.3 million, was 11% lower than comparable sales a year ago. Quarterly net revenue, at $19.3 million, showed a worse 23% one-year decline. Falling average selling prices contributed to the weakness. However, we can trace the negative growth trend from a bumper November 2019 quarter.

Organigram's stock price continues to suffer under the curse of a one-time surge in wholesale sales during the November 2019 quarter (the company's fiscal Q1 2020). During that historic quarter, wholesale sales comprised an unusual 38% of revenue, pushing gross revenue to $28.4 million. The cannabis company has struggled to match this historic result in four consecutive quarters.

An opportunistic wholesale deal with a single customer propelled fiscal Q1 2020 results. As previously feared, such a deal has never repeated again.

The non-recurring sale affected the company in two ways.

Firstly, it set a high-performance bar the company has failed to reach in several subsequent quarters. Selling prices have continued to decline, as price competition intensified in the industry. Wholesale deals have been scarce too due to market oversupply.

Lower revenue readings give the impression of a persistent negative sales growth and poor management execution on the cannabis stock. Yet this may not be a true reflection of the company's sequential sales performance.

Secondly, cannabis wholesale sales are exempt from exorbitant excise taxes. The tax drag on non-wholesale invoices requires significant volume growth to match, yet excise taxes also increase with transaction volumes. With wholesale deals almost gone, excise taxes on $25.3 million sales last quarter were 81% higher than excise taxes on $28.4 million of sales 12 months ago. This weighed heavily on gross margins.

Pathetic margins

The cannabis stock had worse challenges aside from falling revenues. Investors are right to punish Organigram stock for its pathetic gross margins reported on Tuesday.

Falling average selling prices, higher taxes, inventory charges, and a 47% year-over-year increase in the cost of sales damaged the company's gross margins. Gross profit was a negative $16.7 million. The reading stays negative after taking out non-cash changes in the fair value of inventory and biological assets.

The company's adjusted gross margin shrank to 10% of sales, down from 41% a year ago.

Understandably, Organigram has a significantly reduced production rate after laying off a quarter of employees last year, and that wasn't enough to fully absorb fixed costs. OGI utilized just 40% of its grow rooms during the quarter. Management expects low productivity to persist during the current quarter ending February 2021.

At the same time, employment costs keep rising, as salaries increase to retain staff in a highly regulated industry. Selling, general, and administrative (SG&A) expenses increased by 18%, as salaries and insurance costs escalate.

Weak margins are a cause for concern for OGI stock investors, but the outlook isn't too bad.

Positives on cannabis stock Organigram's outlook

The marijuana market in Canada is increasingly competitive, and average prices are going down, which is bad for the entire industry. However, Organigram has committed to innovation.

Adult-use net revenue increased by 30% year over year, as the company launched value brands like SHRED. "Q1 2021 Canadian adult-use recreational gross and net revenue grew sequentially 14% and 11%, respectively, from Q4 2020," management highlighted in the latest earnings release. Meaningful sales growth is actually underway.

Management's focus has since turned to high-margin, high-THC premium products, which the company has kept launching over the past six months.

The company has been re-hiring employees lately, as it works on increasing production and curating new high THC strains, which could be on the market later this year.

Further, the ever-increasing number of retail stores across the country and in key growth provinces could support industry sales growth, as legal cannabis encroaches deep into illegal market territories. Coupled with massive product launches expected at Organigram this year, growth is very much likely.

On another positive note, the company reported positive cash from operations during the past quarter. It’s not enough to guarantee self-funding, but it’s still something.

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