Canopy's Stock-Based Acquisition at a 66% Premium: What's in it for Investors??

Description

Canopy Growth's (TSX:WEED)(NYSE:CGC) stock price fell 5% on Thursday after the leading cannabis firm announced its acquisition of a competitor at a 66% premium to Wednesday's closing prices.

The company announced on Thursday a stock-based acquisition of well-placed competitor **(The) Supreme Cannabis Company** (TSX:FIRE) in a deal valued at $435 million. FIRE shareholders will receive 0.01165872 WEED shares for every Supreme share held and receive $0.0001 cash per share on top. I don't see the cash portion as material as just about $73,469 in cash could change hands in a multi-million dollar deal.

The big picture is that Canada's largest cannabis firm by market capitalization is moving to consolidate its cannabis market share in Canada. Supreme Cannabis's common shares closed up 49% on Thursday. Investors in Supreme's stock have a chance to take part in a U.S.-centered growth opportunity. What could Canopy Growth's stock investors celebrate in this transaction?

How will a FIRE acquisition benefit Canopy Growth stock investors?

I could glean two fundamental reasons why Canopy Growth has been prepared to pay a 66% premium on Supreme's stock in the announced deal. These include a near-term market share growth and profitability boost, and a scalable production asset for premium strains that are a favorite for Canadian consumers.

Supreme brands for superior profits

Firstly, the small marijuana firm has a very competitive recreational brand that's gaining traction in Canada. Canopy Growth is attracted to Supreme Cannabis's premium brand and growing market share. Analysts expected Supreme Cannabis to grow its revenue by 55.8% year-over-year to $77 million during the calendar year 2021.

Supreme Cannabis's 7ACRES, and 7ACRES Craft Collective brands have resonated well with Canadian recreational marijuana consumers. The 7ACRES brand ranks supreme in the premium flower market, and its sub-brands have gained wide adoption in the vapes and pre-rolls segments. FIRE's recreational marijuana sales surged by 70% quarter-over-quarter by December 31, last year. Most noteworthy was a 98% increase in sales volumes during the quarter and a 3% increase in average selling prices for Supreme's flower and pre-rolls in Canada.

As Canopy seeks to hold onto its market share in an increasingly competitive market, scooping such brands whilst they are still cheap looks a good idea. Management expects the combined firm to control a 13.6% market share in the Canadian recreational pot market.

Most noteworthy, Supreme reported two consecutive quarters of positive adjusted EBITDA during the second half of calendar 2020. The company is already profitable by this operating profit measure. This should fit very well with Canopy's near-term profitability targets.

Scalable premium pot production capabilities

Secondly, there was a mention of FIRE's scalable, low-cost production facility in Ontario among the expected benefits. Premium strain production can at times be a risky trial and error endeavor, but Supreme's Kincardine facility has been consistently producing premium marijuana strains at reasonable costs per gram. I would expect Canopy Growth to retain the production team and not to meddle with processes there. Perhaps the acquired facility could add some competitive advantages to CGC as it struggles to contain its operating costs.

Beware of touted synergies!

Most noteworthy, the integrated firm expects to save about $30 million in operating costs over the first two years. Such synergistic cost benefits aren't always a given. Legendary investor Warren Buffett always warns about basing an acquisition on synergistic benefits. They may not be realized at all. I remain skeptical of the third benefit that Canopy Growth expects to realize post the Supreme Cannabis integration.

Cheap valuation for Supreme's stock

Supreme had about $42 million in cash by mid-February this year. That was enough to meet the company's low capital expenditure and operating needs for several quarters to come.

Canopy Growth will pay about 5.7 times Supreme's projected revenue in the calendar year 2021. This is potentially a very cheap valuation. In comparison, analysts expected CGC to generate about $742 million in revenue this calendar year, up 44.5% year over year. The market values the company at 18.4 times its 2021 sales, even as it chews deep into its cash hoard. This makes FIRE look like an absolutely cheap bargain, even at a 66% premium.

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