HEXO to Raise $1.2 Billion: Where Will the Cash Be Invested?

Description

Cannabis producer **HEXO** (TSX:HEXO)(NYSE:HEXO) filed a new regulatory form on Thursday last week that allows the firm to raise up to $1.2 billion in fresh equity capital over the next two years. The filing, called a *base shelf prospectus,* allows the company to issue batches of new shares from time to time within the next 25 months.

Before the latest filing, HEXO allowed its previous base shelf prospectus to expire in December. The company didn't require any new financing at that time. It was well funded and liquid enough given its current operating needs. Now that a new $1.2 billion equity raise is on the horizon, what has changed?

HEXO sets sights on new growth projects

In last week's filling, management revealed that it intends to use the new equity to finance capital projects, potential future acquisitions, potential international expansion, for general corporate uses and debt repayments from time to time, but what strikes me the most is the clear mention of expansion into the United States. U.S. expansion is simply part of international expansion. However, management decided to be more explicit with its desire for business engagements south of the border.

HEXO has been in advanced negotiations with world-class consumer packaged goods (CPG) companies. The company promised, in an earnings conference call in March, to reveal the results of those discussions in due course. The market is still waiting for deal announcements. The latest $1.2 billion base shelf prospectus filing means the company is expecting some big partnerships.

Growth stocks usually require new financing. HEXO's new projects will require new capital.

Where will the capital go — the U.S. or Canada?

The company recently received additional licenses for its Centre of Excellence manufacturing facility in Belleville, Ontario. HEXO is more capable of signing on new partners in Canada onto its "Powered by HEXO" platform and entering new royalty-bearing agreements. However, I doubt that the company could channel significant money into Canada at this time. Its Canadian platform is well set and ready to run.

Given management's growing focus on the U.S. CBD market, I would expect big news on the U.S.-led international growth front. After successfully establishing the *Keystone Isolation Technologies* joint venture in Canada, the company intends to build similar cannabinoid extraction facilities in the United States.

In the company's most recent *Management Discussion and Analysis* (MD&A) filed in March, management had this to say: "Globally, our growth strategy first starts in the United States. We believe partnering with large, established, global CPG companies, who wish to enter the cannabinoid industry as a means of brand proliferation, will provide the greatest long-term value to our shareholders."

HEXO U.S.A. was established with hemp-focused operations. The company launched CBD products in Colorado, in partnership with Molson Coors. It could sign on some bigger names in new hemp product development as it expands through partnerships in America. Investors should be bullish.

That said, I am just concerned that the company is raising too much money.

Beware the dilution!

Although the company won't necessarily raise $1.2 billion in one big transaction, current shareholders face significant dilution. An amount of $1.2 billion is just too significant a sum for an $800 million company to raise. New investors could bring 1.5 times more capital than what the company is currently worth. Current shareholders' interests and influence in the firm are at risk of massive dilution. Concerned parties have to participate in the upcoming periodic share issues to maintain voting influence.

It appears that management is extremely ambitious about their plans to grow the business.

That said, as long as new equity helps management unlock new growth opportunities, dilution shouldn't be a big concern. The decision whether to buy more HEXO stock as it dilutes shareholders should therefore be influenced by two things: one's faith in management and an assessment of U.S. regulatory changes and market potential for amplified revenue and cash flow growth.

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