HEXO Stock: Should the Cannabis Heavyweight Be Part of Your Portfolio?

Description

Shares of Canadian cannabis giant **HEXO** (TSX:HEXO)(NYSE:HEXO) have grossly underperformed the broader markets since the start of 2019. HEXO stock is currently down 94% from all-time highs and has burnt significant investor wealth.

While most major indices, including the TSX, have continued to trade near record highs in 2021, HEXO has lost over 43% year to date as well. Does this make it an attractive contrarian bet, or should you stay away from this marijuana heavyweight?

HEXO has a weak balance sheet

HEXO has managed to increase its revenue from $4.93 million in fiscal 2018 to $80.78 million in fiscal 2020 that ended in July. However, this top-line growth has come at a heavy price. HEXO, similar to several other marijuana producers, has invested significantly in capital expenditures to expand its cannabis production capacity. The company has also pumped in billions of dollars to acquire other licensed producers and gain traction in a nascent but rapidly expanding market.

In order to fund these acquisitions and its expansion plans, HEXO raised capital via debt and equity. As it remains unprofitable, HEXO's shareholder dilution has accelerated at a rapid pace, as the cannabis producer has accumulated around $265 million in operating losses in the last three fiscal years. Comparatively, its total sales between fiscal 2018 and fiscal 2020 were less than $135 million.

HEXO and its peers are finding it difficult to improve profit margins due to a lower pricing environment. Canada's illegal cannabis market continues to thrive, eating into the addressable market for licensed producers. Further, cannabis is a highly regulated industry, which has resulted in a slower-than-expected rollout of retail stores in major provinces.

These factors have, in turn, led to high inventory levels, multi-million-dollar write-downs, and widening losses. Between July 2020 and April 2021, HEXO's inventory levels have risen by almost 50%, which suggests the company is struggling to offload products, despite a resurgence in demand for cannabis products.

HEXO valued its inventory at $94 million at the end of the quarter ended in April 2021. Comparatively, its net revenue stood at just $22.6 million in fiscal Q3.

Recent acquisitions will be a key revenue driver for HEXO stock

HEXO has continued its acquisition spree this year and announced three big-ticket purchases in 2021. This includes the buyout of Zenabis Global, Redecan, and 48th North. While HEXO will issue shares for the acquisitions of Zenabis and 48th North, it will have to pay over $400 million in cash to Redecan, which is also the largest privately owned cannabis producer in Canada.

We can see that investors can brace for another round of shareholder dilution going forward given that HEXO's loss per share is forecast at $0.48 for fiscal 2021 and $0.07 in fiscal 2022. Given its outstanding share count of 276 million, HEXO's net loss might touch $19.3 million next fiscal year, while its revenue is forecast at $262 million.

Additionally, the company also has over $100 million in debt on its balance sheet, which will require regular interest payments. A loss-making company will find it difficult to service its debt, exposing shareholders to further dilution.

HEXO stock is valued at a market cap of $713 million, which suggests its forward price-to-sales multiple of less than three is more than reasonable given its revenue growth estimates. However, the company will have to race towards profitability to reduce cash burn and improve its financials.

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Date
2025/06/30
Date Created
2021/09/18
Author
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