



U.S. Legalization Won't Save Cannabis Stocks

Description

Cannabis stocks are down this year, as they have been down most years post-legalization. In the lead-up to Canadian federal legalization, cannabis stocks rallied, as huge merger and acquisition deals shook up the industry and investors expected huge revenues from legal pot. The revenue increases actually happened, but cannabis stocks didn't rally. The problem was twofold:

1. Cannabis stocks got too expensive before legalization hit.
2. The cannabis firms' costs grew more than revenue did, leading to ever-larger losses.

Basically, people were right that legalization would cause cannabis revenue to increase, but that didn't translate to profits. So, cannabis stocks fell shortly after legalization hit and didn't stop falling.

This year has been a pretty typical one for cannabis stocks: they've been [going down](#). However, we've seen a rally here or there, mainly when rumours of U.S. federal legalization start to swirl. It's true that federal legalization in the U.S. would likely cause legal cannabis sales to spike. The benefits, however, would end there.

Canadian legalization didn't save cannabis stocks

We know that U.S. legalization won't save cannabis stocks because Canadian legalization didn't do so. After cannabis was legalized in Canada, sales increased — a lot. In 2019, most Canadian cannabis companies were posting hundred percentage point sales increases. However, their costs increased even more than sales did, so they didn't achieve profitability. In fact, their losses grew.

This situation continues to this day. In its [most recent quarter](#), **Canopy Growth** ([TSX:WEED](#)) delivered the following:

- \$122 million in revenue, down 22%
- \$1.83 billion in operating expenses, up 828%
- -\$2 billion in net income, down from a positive number
- -\$5.38 in earnings per share, down from a positive number

It was a pretty weak showing. At this point, WEED's revenue is declining along with profits. Initially, the post-legalization rush to try legal pot caused strength on the top line, though the bottom line was negative. The top line strength is now disappearing as well.

Cannabis companies have no pricing power

The fundamental problem with cannabis companies is that they have no pricing power. "Pricing power" means ability to set prices; if you lack this, then you take whatever price the market offers. Cannabis is a commodity; customers view different brands basically interchangeably. Canopy Growth has invested a lot of money into building up its "Tweed" brand, but most consumers would rather have the cheaper weed than Tweed's weed. This isn't helped by the fact that there are many competitors in the legal weed space. Basically, cannabis just doesn't have the economics for high profits.

So, U.S. legalization won't save cannabis stocks. If it goes the same way Canadian legalization did, it will just cause a temporary sales spike that does not produce profits and is reversed a few years later. It's quite likely that cannabis stocks would rally if the U.S. announced that it was federally legalizing cannabis. Investors tend to react to news swiftly, and they don't usually take the time to consider the financial ramifications of the news at hand. "U.S. legalization" has a bullish sound to it, but the investor experience after Canadian legalization shows that it wouldn't change much. Higher sales don't mean anything if costs grow even faster.

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1. Cannabis Stocks
2. Investing

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Author

andrewbutton

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