



## We're Months Away From Bankruptcies in the Cannabis Sector

### Description

In early 2019, if someone were to suggest that by the end of 2020, we'd start seeing bankruptcies in Canada's cannabis sector, you would most certainly have concluded they were smoking something.

Here we are a year later, and these concerns don't seem so far-fetched. Cannabis companies have exhibited a general lack of fiscal prudence over the past year. Examples include paying ridiculous (mostly paper) premiums to acquire each other in a frenzy that seemed worse than the dot-com bubble, in hindsight.

### Aurora Cannabis

In this article, I'm going to use **Aurora Cannabis** ([TSX:ACB](#))(NYSE:ACB) as an example to show just how close we are to seeing bankruptcies materialize in this sector (or at least a tonne of acquisitions at discounts instead of premiums).

Aurora was one of the companies I've identified in the past as being ridiculously valued. At one point, Aurora topped 135 times sales — a mind-blowing valuation. Today, the company is worth approximately \$800 million with annualized sales of \$247.9 million. This means Aurora is now priced around 3.5 times revenue. While still ridiculously high, it's not outrageous.

We're still years away from classifying this stock as "cheap," but it is nice to see that financial markets seem to have regained some semblance of sanity of late. Stock prices across the cannabis sector are down in the 70-90% range from peaks for most producers over the past year. This reality makes it much harder for cannabis companies to raise billions of dollars in equity, as they were previously able to do. Aurora Cannabis is now worth "only" \$800 million. That means the most this company could look to raise in equity markets is a few hundred million, before dilution would absolutely wreck existing shareholders.

### A smoking load of debt

The problem is, Aurora has \$1.4 billion in debt due over the next five years, making a couple hundred million seem petty. This debt was taken on to fund capital projects, which are still a long ways from producing profit in any meaningful amount. This means Aurora will likely be forced to refinance this debt down the road at much higher interest rates.

The company is also burning through a tonne of cash. Aurora will also likely need to raise more debt to fund its contractual obligations, which will not go away. Aurora, like most cannabis producers, has announced plans to cut capital expenditures for fear of incurring too much debt in the near term. But without a meaningful “real” stream of cash flow, any “profit” shown by the company is paper profit; this relates to ridiculous accounting rules that allow cannabis producers to book the value of the plants they grow before they are sold. This debt will become unrecoverable, and write-offs will ensue, with bankruptcies taking hold of the sector as a whole.

I’m not suggesting such a situation is imminent for Aurora, or any cannabis producer in particular right now. However, I believe that smaller producers that do not have similar access that Aurora has to capital markets will begin to go bankrupt before the end of this year. Trade carefully.

Stay Foolish, my friends.

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**Date**

2025/08/16

**Date Created**

2020/03/06

**Author**

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