HEXO CORP HEXO S

October 20, 2019 - 11:57am EST by puppyeh

			2019	2020
Price:	3.60	EPS	0	0
Shares Out. (in M):	292	P/E	0	0
Market Cap (in $M):	1,051	P/FCF	0	0
Net Debt (in $M):	-130	EBIT	0	0
TEV (in $M):	921	TEV/EBIT	0	0
Borrow Cost:	Tight 15-50% cost			

Description

Thesis Summary: When it comes to shorting, I focus on irretreviably bad businesses burning tons of cash that have a high chance of ending at zero, even if the stock is already down a lot and/or is a tough borrow (see my prior writeups on Nio, Japan Display, Sharp, etc). Hexo Corp (TSE: HEXO), a Canadian cannabis licensed producer (LP) based in Quebec, fits the bill perfectly. While this was of course a better short 3-6 months ago, HEXO is quite likely to see a further material decline in its stock, perhaps all the way to zero, in the next 3-4 quarters because it competes in a commodity market with the worst supply/demand imbalance I have ever seen (Canadian cannabis); it is burning oodles of cash; and it is quite likely to trip covenants on its debt in Jan 2020. Even if it survives as a going concern thru the end of next year, it is highly likely to be continually rerated lower by the market from its still lofty valuation levels (6x FY20E EV/sales, and >2x book value) as the market realizes the company will imminently enter distress, is structurally unprofitable, and will need to trade closer to recoverable asset value (hint: a lot lower than book value). Apparently the new CFO (since May) thought similarly, because he jumped ship less 4mos into his tenure – just before the co pulled 2020 guidance and then announced they were going to dump product on the market at a 50% DISCOUNT to prevailing retail rates. More on that later.

HEXO is dual listed on the TSE and the NYSE; borrow is available, but very expensive, at 40-50% rates. Clearly this is a 'shoot him in the back' kind of short, and that is not for everyone. Still, I think this has a long way to fall and it won't take a year if the view is correct, so I view it as a highly alpha-generating idea even net of the high borrow cost. The fully-diluted market cap today is around $1.1bn CAD and it trades $10-15mm CAD a day, so this is actionable for most all funds.

This will not be a long writeup; I am happy to answer questions in the comments. There are three main points to the thesis:

1. Canadian cannabis is the worst commodity market you will likely ever see and the price war is about to get epic

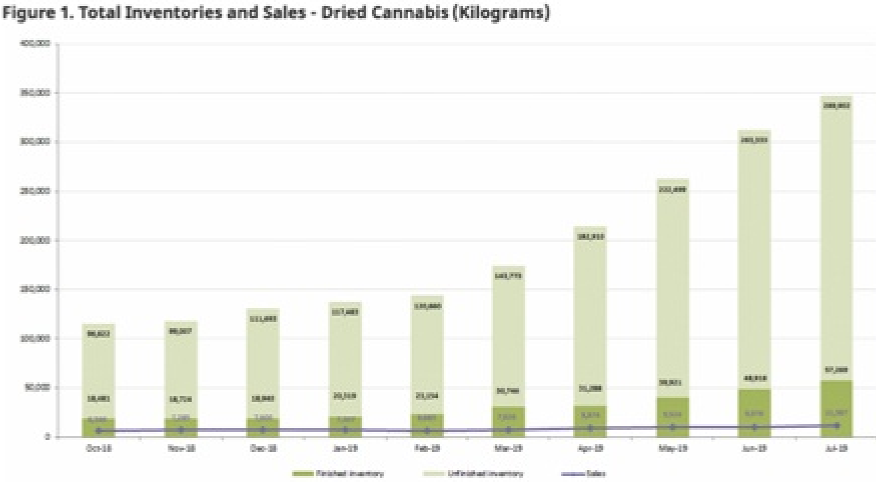
2. HEXO's idiosyncratic issues

3. Scale of cash burn, likely covenant breach and consequences for the stock

Problem 1: Canadian Cannabis – the hunger games are coming

Canada is drowning, absolutely drowning, in cannabis. Others have written coherently about this (see Kuppy's great synopsis here https://adventuresincapitalism.com/2019/07/15/shareholders-must-stoned/, and there was a good write-up on Canopy Growth here on VIC), so I don't need to repeat what has been said. Suffice to say that marijuana in Canada has simply followed the pattern of endless other commodity bubbles from yesteryear: too much capital, irrational exhuberance, a massive over-estimation of demand that led to insane over-build of capacity and inventories and now – late in the game – the inevitable crash. It is becoming eminently clear that the vast majority of cannabis consumers were already serviced by the black market (at 50% cheaper rates than the legal stuff) and that all the new capacity that every LP has rushed to add is simply malinvestment waiting to be written off. Here is the latest data (thru July) from Health Canada, showing the disparity between demand (actual sales) and supply (finished and unfinished inventories):

Figure 1. Total Inventories and Sales - Dried Cannabis (Kilograms)



Putting the above graph into simple terms, in July, 11.5t of cannabis was sold (legally) in Canada but finished inventories are 5x as much and WIP across the market 25x higher (!), and this imbalance is getting worse every month. In fact ***the inventory build in unfinished product each month the last 4-5 months is 2-3x the total monthly consumption across the whole market.*** You think there are a lot of unsold Teslas stuffed in parking lots across the US? Every second warehouse from Saskatoon to St John is filled to the brim with weed that nobody wants to buy. Remember pot has been legal (in flower/bud/oil forms, not vapes/edibles/beverages, etc) for basically a year now, and there has been a steady increase in consumption, as the chart shows. But *usage would have to jump at least another 15x* to make a dent in the inventories still inexorably being created by all those idiot LPs…

OK, you may ask, why haven't prices cratered yet? Well, the LPs have simply sold a lot less than they have been producing (in an effort to support prices) – partially because they hoped/prayed demand would improve; and partly to maintain the game a little longer. Each successive quarter, though, the imbalance between product sold and product produced has, quite clearly, gotten more ridiculous.

HEXO is a case in point. In the Oct'18 quarter (the first legalization period last yr), they produced 3550kg but sold only 950kg (dried product, adult-use only); in the Jan'19 quarter they produced 4938kg and sold 2537kg (so not a huge difference); but in the Apr'19 quarter the differential exploded, with 9804kg produced but only 2759kg sold. Of course now is the right time to mention that HEXO alone has built a greenhouse in Gatineau capable of churning out 108,000kg of product a year (meaning even last Q they were at 30-40% of capacity) AND they just bought another LP with 42,000kg of capacity (called Newstrike), taking company-wide capacity to 150,000 kg – or ***just a cool 5x more capacity than their current annual run-rate sales*** (around 35,000kg/yr). These numbers are not unique, but are emblematic of behavior across the industry. As I said, Canada is drowning in cannabis…

So prices haven't dropped yet (thru April), but it is inevitable they will start dropping like a stone, and soon. HEXO gave the first warning of this in a recent PR where they withdrew 2020 sales guidance and suggested 4Q (through July'19) sales would be just $15mm (or almost inline with 3Q sales despite previous guidance that they would double). The commentary around the guidance cut was scary, as well – 'lower than expected sell through', 'early signs of pricing pressure' were specific call outs – and no doubt we will hear more on the upcoming call (this Thurs, Oct 24). More on that shortly.

Problem 2: HEXO's idiosyncratic issues

HEXO is based in Quebec, and a very large majority (~80%) of their near-term revenues come from their status as a licensed supplier to this particular province. There are some real benefits to being Quebec based – lower electricity costs (hydro-derived); generally lower labour costs – but these seem to have been outweighed by much stricter regulation. Thus, for example, HEXO has specifically called out the local regulators as being slow to allow derivative cannabis products (sprays, oils, gels, etc) that have higher margins and have been allowed in other provinces much faster; HEXO has apparently also been hampered by the slower pace of retail openings in the province (again a function of regulatory oversight). This will become a further problem when/if cannabis beverages are legalized and allowed in the province (something that was meant to become law by October 2019 but the HEXO CEO is already walking back, as discussed in this video https://www.bnnbloomberg.ca/hexo-s-new-discount-bulk-pot-offering-not-a-loss-leader-ceo-1.1333089) since, with the Molson Coors, JV, HEXO is really counting on cannabis beverages to make it a real player from next year.

Otherwise, the major idiosyncratic issue with HEXO is that they have bitten the bullet on massive price cuts and so they are likely to see their margins slashed – and their carried asset values obliterated – sooner than anyone else. Just last week, HEXO has fired the first shot in the price wars by announcing a new bulk purchase brand, 'Original Stash', where they will be selling dried product for the all-in price of $4.5/gram to the consumer. Since the average retail price across the country is $10/g, and the average illegal price is $5.5/g, HEXO is ***essentially under-cutting the legal market by 50% and the illegal market by 20%, impact on their margins be damned.***

What will the impact be on HEXO margins? Well, in Q1-3 this year, they managed gross margins in the mid-40s % and net ASPs (ie, removing 18% excise tax) of $4.3-4.8/gram. In other words HEXO was making gross profits per gram of around $2 (actually $1.9 last quarter, and $2.25 in Q2) – and will likely report lower GMs again in the upcoming Q4 given the abysmal pre-announcement on revenues – but the important takeaway is that if they are willing to sell in bulk at $4.5/g all in, given the excise tax (call it 18%) and the wholesale discount (guided historically at 35%), HEXO's ***net ASP on bulk sales may be as low as $2.4-2.5/gram.*** So gross margins may literally fall from 45% to 20%, overnight – and this is before the competition shoots back. Of course, the company is hoping to make some of the margin back on volume… but this is a race to the bottom scenario, and most all major competitors – including those like Canopy and Aurora with significantly more scale in production – will just be forced to cut alongside, or to even lower levels (after all, they have much bigger greenhouses than HEXO they need to fill). How will the market react when HEXO is first to report collapsing gross margins and large impairments both to existing inventories and biological asset valuations (which today are marked using assumed ASPs of $4.95/gram, or basically double the likely ASP of Original Stash)?

Of course the third idiosyncratic issue facing HEXO in particular is executive turnover. I alluded to it in the introduction, but a relatively high-profile CFO (ex Nutrisystem) was hired to much fanfare in May; he abruptly left earlier this month, and we just had the guidance cut. I am particularly troubled by this departure because HEXO has not even reported the July'19 quarter yet (the company's Q4), but the CFO clearly had a very good look at the Oct'19 quarter as well (his departure was announced Oct 4), so I am quite confident whatever bad news we hear on Thurs re the July quarter is not the end of it. In fact I think the CFO leaving now is a failsafe to make sure he is at least a couple of quarters removed from real financial/cashflow trouble, which appears to be around the corner for the company…

Problem 3: Cash Burn and imminent liquidity troubles

Like many Canadian LPs, HEXO has been burning a lot of cash, through a combination of lack of operational scale; unfavorable working capital movement (the aforementioned increases in inventories); and high capex (building out greenhouses and processing, etc). Unlike some other names, HEXO does not look particularly levered, with last reported unrestricted cash of $173mm against term loan debt of just $35mm. The company also garnered perhaps $70mm in cash when it acquired Newstrike, as well as another $40mm from exercised warrants in the soon-to-be-reported Q4. All good, right?

Not so fast. The company burnt $55mm/qtr average the last 3Qs, and I think they will burn closer to $70mm in the upcoming Q4 (a combination of lower ASPs, higher cash out to W/C thru inventory build; and more capex associated with finishing the Gatineau capacity and the Newstrike property retrofits). Thus, all told – and accounting for the warrant cash and acquired Newstrike cash – I think the company will enter next fiscal (recall this means from August this year) with maybe $210mm cash or so, ie, *barely 1yrs cash at current burn rates.*

Things gets complicated by the fact that the term loan has fixed charge coverage (>1.25:1) and total leverage (<3:1) covenants that kick in from Jan'20 that are basically impossible to be met (the company is still negative EBITDA and the CFO just quit, remember?). Thus, unless renegotiated, that loan will likely need to be repaid, perhaps as soon as the end of this year/early next year – reducing available cash well below $200mm, perhaps to the $170-180mm range. If my cash burn estimates for the upcoming 4Q are even ballpark, the company will at this point (call it by calendar year end) have <3 quarters worth of cash remaining…and all this before gross margins invariable cliff-dive from the mid-40s to the 20s (or lower).

All this may not be enough to get a 'going concern' mentioned in the upcoming Q4 report, but I certainly think there could be some alarm bells ringing by the time next quarter rolls around to be reported (the October quarter, likely reported in mid-December). At this point and even assuming some diminution in capex (as facility construction should be mostly completed) I can't see how cash burn doesn't fall to lower than say $40mm meaning the available cash as at end Oct may well be sub $150mm, pro-forma for losing access to the Term Loan, and given the near-term cash burn history at the company and obvious disarray in the underlying market, the stockmarket should begin to price this as a distressed asset. The company would be sensible to dilute shareholders (again) thereafter, likely in early January, to provide a cash cushion heading into the term loan – no matter the price – adding a further fillip to the short, if the stock somehow manages to hold up north of 2x book value.

What's it actually worth in a distressed scenario? Well, net assets pro-forma for Newstrike are probably somewhere around $550mm, but of this most of the tangible value is in cash (which is being burnt away) and then PP&E ($175mm today, likely $220mm post Q4) but which is simply excess greenhouse and buildings (almost none of it is land). What is that worth in a market like this? No one would miss it if it disappears…Otherwise the Molson JV is marked at $48mm but that is only because HEXO gave Molson $41mm in warrants (struck at $6/share or something) which they impute as the value of the JV – realistically they only put $7mm cash into the venture and they have no products on the market yet so who knows if a) Molson is committed and b) what the real value to an acquirer is. Inventories and biological assets are the other big category ($50mm as of last balance sheet, likely much higher, maybe $70mm(?) as of July'19) and as you have probably guessed this isn't worth the paper(s) its rolled in given all of the above.

So adding it all up I wouldn't be surprised to see the market extract a significant discount to book value for at least the PP&E, the inventory, the biological assets, and the Molson JV, if or when the cash balance gets low enough (and the TL gets pulled) to get the market worrying about going concern risk. That could be as soon as this upcoming report (though unlikely) but in my view much more likely in mid-Dec or thereafter with the Jan'20 report (due early March). Thus I could easily see this trading well below book value – implying a 60%+ return on the short side in 4-5months. Ultimately this probably heads much lower but that is a decent starting point for the short.

I do not hold a position with the issuer such as employment, directorship, or consultancy.
I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

Q4 earnings (this Thurs)

Q1 earnings (mid-Dec)

Potential TL covenant breach and/or repayment to avoid covenant breach (early Jan/maybe Feb)

ongoing price wars in Canadian cannabis

Messages

Subject questions
Entry 10/21/2019 02:27 PM
Member AtlanticD

Thanks for offering to take questions. I'm new to this space, and I have 3:

1. Is there some nuance that would cause a sell-side analyst, lets call him "Jeffrey", to disagree with your assertion that the broad market is oversupplied (Jeff thinks its only oversupplied "in low quality flower and diluted oil")?

2. in reading the part about Quebec's regulation holding them up, I was trying to ponder the degree to which that is explanatory/backward-looking vs. forward-looking (in which sense I would think it is an opportunity once there is eventually more retail, etc.). That latent demand might not even have to be enough to make the stock fairly valued, but could it be enough to improve EBITDA enough to make them more solvent than one might think?

3. It looks like the stock was up a bit on Thursday due to the Molson Coors JV. I read that Tilray/BUD haven't figured out THC formulations yet, and I'm wondering if there is a pie-in-the-sky bull case you've seen on HEXO's JV potential should they come to dominate THC beverages for a while?

Subject Re: questions
Entry 10/21/2019 04:32 PM
Member puppyeh

no worries. here we go:

1. i haven't seen the Jefferies report, but the simple data from Health Canada is pretty irrefutable, and the very fact that HEXO is willing to cut prices so massively to move product suggests the S/D imbalance is gargantuan and market wide. I am unsure how to determine between low quality and high quality flower (this is subjective to the consumer, and branding etc), but the premise of this being a commodity in massive oversupply would suggest that surely - given the quantum of oversupply is so obvious - the oversupply will drag down prices for all varieties, even if there is a bit of a lag. this needs to be proven out but again I am making a call here on pricing given the willingness to cut for bulk sales at the low end of the market.

2. perhaps this is a little backward looking wrt basic products (flower, oil, etc). the problem is the entire growth narrative for HEXO in particular is built around new products - specifically beverages - and so Quebec's traditional conservatism is a big problem because this is a new product category subject to potentially stricter regulation, yet it is also the one moonshot the company has with their Molson JV. as for helping them improve EBITDA a bit - in isolation, yes, if more retail locations get opened up, its possible there is at least the opportunity to generate more sales and get some momentum - but I just think in he context of cratering prices and rampant competition this won't be all that accretive. I'm not sure I mentioned in the writeup, but HEXO was not selling particularly well even in Quebec (they were the no 3 brand there, according to some sell-side reports), their home market, so its not like they are without competition. Everyone has too much weed and everyone will rush to fill new retail locations with their product if Quebec gets their act together; HEXO has made the gambit they will win share on price, we will have to see if that's what happens.

3. Yes, this is the wild card/big hope for the company. The problem is beverages are not even available for sale yet (though they should be in some parts of the country shortly, perhaps by year end). My call is basically the co will run close enough to out of cash before this market has a chance of developing (if indeed it ever does). The company can show you some very blue-sky narrative around the potential market size out 5-10yrs but I don't think it really matters if they are running out of cash and/or they can't fund in the equity market.

Subject new convert, CC delayed
Entry 10/23/2019 12:38 PM
Member puppyeh

HEXO rescheduled the CC for a few days (to next week) citing 'additional time required to finalize its year end filings', and also announced a $70mm private placement convert at 8% coupon, to a group of insiders, including the CEO. Interestingly the converts are being priced in the money ($3.16 strike vs current stock of $3.3), not exactly a great sign.

This suggests to me the bankers have already given notice that the TL will be pulled, given the covenant breaches upcoming, and the company is getting out in front of it with this issuance. The delay to earnings - given this is for July numbers, not September - also doesn't inspire much confidence. I do expect a pretty horrific print next week.

I guess the muted reaction is telling you much of the disaster is already priced in - but given the willingness to issue highly dilutive paper to only insiders, with no obvious need for cash now, I do think bearish trades in options (selling 1y calls, for example), make a ton of sense here.

Will update thoughts again post print.

Subject private placement
Entry 10/23/2019 12:38 PM
Member azia1621

http://pdf.reuters.com/htmlnews/htmlnews.asp?i=43059c3bf0e37541&u=urn:newsml:reuters.com:20191023:nGNX4yd4Z5

Cash infusion offers a short lifeline, but I imagine this is meant to soften the blow of horrific earnings, which have now been delayed.

Subject Re: new convert, CC delayed
Entry 10/23/2019 01:19 PM
Member katana

OK, Credit Boy, can you quantify just how bad this convert is relative to "normal"? I am used to seeing an A+ business like Workday issue converts at a 0.25% interest rate (not a typo) and a 37.5% conversion price premium. This one is 8% and -4%. If they had offered 0.25%, the price premium would need to be what, -30%? Or a 37.5% conversion premium would have required 20% interest? Or are these numbers so extreme that these sort of calculations just approach #DIV/0!?

Subject Re: Re: new convert, CC delayed
Entry 10/23/2019 02:04 PM
Member vincent975

Tough to compare this to regular converts since Workday is liquid and hedgeable whereas Hexo has to be held outright or hedged at a very expensive cost. Bond floor is also difficult to determine to put it mildly. Converts that need to be owned outright will always come way cheaper.

To me, this is a de facto stock offering with seniority in the capital structure. That said, insiders putting money in should be construed positively even if it's a dilutive convert. Also, wouldn't insiders want to first disclose bad information before striking a convert? Not involved in the situation.

Best,

Vincent

Subject Re: Re: Re: new convert, CC delayed
Entry 10/23/2019 02:22 PM
Member puppyeh

hey katana - vincent's points are good, there is no credit bid/bond floor here and borrow is 40% so yeah its tough to work out what the theoretical cost of debt is on an instrument like this. Suffice to say true double-digits cost of (unsec) debt financing, with a reasonably in the money equity kicker. Not quite Wework spreads but close enough...

As for insiders putting in $$ - we don't actually know how much $$ is coming from the management team (that detail was conveniently left out). One of the founders, Adam Mirron, left the company earlier this year, so I doubt he is really committing much capital.

We can debate whether this is a good or bad, clearly, but we will know soon enough. Normally a delayed earnings release, especially after an abrupt CFO departure, is a bad sign; the printing of extremely-expensive financing, in advance of releasing stale numbers, is another warning sign. Yes this stock is down a lot but that is a fair amount of red flags.

I added to my short today.

Subject more restructuring announced
Entry 10/24/2019 04:31 PM
Member puppyeh

i have never seen a company complete a distressed/cheap financing, and announce massive layoffs, in advance of actually reporting the numbers - but this is what HEXO has done. i guess they really want that bar low for when the report comes in on Monday...

https://www.globenewswire.com/news-release/2019/10/24/1935234/0/en/HEXO-Corp-aligns-its-operations-with-its-2020-expectations-reduces-cost-structure.html

While I'm a little worried about positioning into the now delayed report, I think the numbers and tone will be abysmal. Remember the reported numbers are only thru July and yet all these emergency-type measures are being rushed out now, so I imagine the current quarter (thru Nov) is likewise terrible, and thus consensus 2020 numbers still have a long way to come in.

Subject Other pot grower shorts - Kuppy & Puppyeh
Entry 10/25/2019 09:40 AM
Member katana

Looks like Kuppy flagged the entire group in July but declared victory and moved on after the group fell -25% in a month. They all kept falling straight down another 25% from the July price. I haven't done work on any of these. Hexo was the #6 market cap on that list and has roughly fallen in line with the others, which does make it seem like the best short candidate today. But what if Hexo falls materially next week and the others don't? Might it be a better risk/reward at that point to just short a basket of the larger ones? Or do you think it would still be better to gun for a zero on the one whose details you know best?

Subject Re: Other pot grower shorts - Kuppy & Puppyeh
Entry 10/25/2019 10:13 AM
Member hkup881

I gave up b/c the borrow cost was too high, the puts were too expensive and I'm not the sort of guy to sell calls for a few % and risks a massive squeeze (which only gets your puts assigned).

I made some and moved on...

I still think most of these companies go to zero. It's a capital intensive commodity business. Try growing corn with prices dropping 25% a quarter as supply doubles each quarter and see how long you last....

Subject Re: Re: Other pot grower shorts - Kuppy & Puppyeh
Entry 10/25/2019 11:25 AM
Member puppyeh

Outside of HEXO, I am still short CGC (outright short) and TLRY (short calls) today. Both of these are much smaller (and not just due to performance) from mid-year. To kuppy's point, borrow is punitive in most all other names, and I am also somewhat wary of a squeeze.

i chose Hexo to write up now because I thought - before the very sudden pre-emptive financing and restructuring - that it would file in a year. That is less likely now, but I still think it will likely derate to adjusted book or lower in the coming quarters.

TLRY is highly unlikely to be able to refi the converts (at least without a deep in the hole equity offering) but most of the money has been made and borrow is punitive now. Of the other names, most of them are not levered enough; or have some exposure to the US market (which is much better). I need to brush up on Aurora, however.

Subject Q4 'earnings' initial thoughts
Entry 10/29/2019 04:58 AM
Member puppyeh

Perhaps not surprising, but this is an unmitigated disaster. They burnt around $123mm cash in the quarter (I was expecting $70mm), and remember this is stale data (only to July). This was mostly a function of massive inventory build - stuffing their warehouses, see notes below - and a bit of receivables build as well - stuffing the channel. It is no surprise they are rapidly cutting prices to try to salvage solvency because at this rate they wouldn't have lasted another 6months. ASPs and margins are in freefall (down 15pts QoQ) and they haven't really started pushing the cut price product yet.

Entering August they had only $139mm of cash, and still the $33mm Term Loan liability (along with $3.5mm in owed excise taxes). Clean net cash was thus around $100mm in August - and given ongoing cash burn - probably close to or under $50mm a few weeks ago, explaining the cheap convert and restructuring. Looking at these results, it seems pretty clear the public markets would never have funded $70mm of new money on those terms (I expect the stock to drop to $2 CAD pretty quickly, that is around tangible book today).

I need to go through the details and listen to the call but for now a few other observations:

- in 4Q the difference b/w what they produced (16,824kg) and what they sold (4,800kg) - ie around 12,000kg in a single Q - is more than 2x the TOTAL amount of product they sold since legalization

- Adult use ASPs fell more than I expected, from $4.3/g to $3.5/g QoQ. Clearly these numbers will continue to head much lower given the state of play

- they started selling product in a new category, 'wholesale', and volume was not insignificant (already 15% of adult use volumes), at $0.56g - or a 90% discount to their gross ASP for adult-use products. This is worrying as means they were already dumping product as early as July

- Given the above gross margin fell to 30%, or around 15pts of compression vs recent history - and all this before the wholesale, lower volume dumping begins in earnest.

- They shut capacity at Gatineau and abandoned one of their warehouses at Niagara acquired through the Newstrike acquisition, meaning titular capacity now is 'only 80,000kg/yr' (vs 150,000/yr before). Even if they triple sales next year (very optimistic) this would still only get them 40-50% utilization on the new capacity and given the compression in ASP (lets say to $3/g, again very generous) I still only get to $120mm revenues which means consensus is still miles too high

- The business they acquired, Newstrike, had reported $100mm of cash on B/S at year end but they only reported $50mm cash inflow from the acquisition so that part of the business seems to be highly cash burning too

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Subject a couple more thoughts post CC
Entry 10/29/2019 01:23 PM
Member puppyeh

i highly recommend anyone looking at the space (katana, atlantic) listen to the HEXO call because it gives a great overview of all the challenges facing the industry.

I actually came away from listening to the call (and a closer examination of the financials) more, not less bearish, on the entire space, and I have added to all my cannabis name shorts today (HEXO, CGC, CTST, and TLRY). I think the muted reaction today is a function of positionining into the call (note HEXO is outperforming all the other names today but has underpeformed the last month), but consensus needs to come down a lot and I think sell side will increasingly talk about going concern risk here.

Here are a couple of additional things from the call/docs:

- many of the questions on the call were related to the underlying cash position of the company. P 13 of the financial statements made it clear that without the emergency $70mm convert, there would have been a going concern note in the accounts. The company mentioned cash in October was only $54mm and that they hope to get to EBITDA profitability sometime in 2020 - though this appears to be contingent upon the market 'stabilizing', there is no formal guidance being given anymore

- the co is in the process of setting up an ATM facility. Since I think - even on pro forma numbers - they will be very low on cash by early next year - I expect them to sell a large amount of stock anywhere close to this price (still pro-forma $900mm CAD market cap and 2x book value) assuming the stock stays here. Stocks with active use of an ATM often do very badly

- the co disclosed they are already taking provisions for returned (excess) product ($3.8mm in 4Q), and expect this to continue across the industry

- the co disclosed they were unwilling (or unable) to force their distribution partners (SQDC) to purchase the contractual volumes they agreed to (this likely boomerangs across the sector)

- the co wrote down $17mm of obsolete inventory in the qtr - but STILL built $80mm net of inventory

- $114mm of acquired intangibles w/ the Newstrike acquisition relate to that co's production and cultivation licences - but a large portion of the Newstrike capacity was then shut down, so I expect this number to be largely impaired in coming quarters

- $112mm of goodwill was added to the balance sheet w/ the Newstrike acquisition - ditto. Put together these amounts ($235mm) represent >30% of book value

- during the call the CEO said he thought the business was a mid-40s gross margin business longer term, driven largely by alternative products like 'vapes and beverages'. Then an analyst reminded him that beverage sales only come from the JV, which flows through below the line (thus not affecting GMs). The CEO concurred, but didn't change his margin assessment...pretty telling imho

- the co called out the specific legalization risk around Cannabis 2.0 and gave a 6mo window (first half of calendar 2020) for getting beverages into stores...meaning to me at least two more quarters til beverages can make any contribution. In this time the company will likely burn another $70mm minimum

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Subject 3Q earnings season in Canadian cannabis - quick update
Entry 11/17/2019 12:58 PM
Member puppyeh

Most of the larger Canadian cannabis plays have reported 3Q (ironically, not HEXO yet, that will be in Dec I believe), and by golly is there blood in the streets. Just to pick a few datapoints at random:

- ACB is being forced to amend some near-term (Mar2020) converts to force conversion for discounted shares, and they hit their existing ATM hard (at successive all-time lows) in 3Q, labeling that facility 'strategically valuable'. They also talked down supply/demand until mid 2020

- CGC burnt $800mm+ in 6mos in their current fiscal, and a cool $440mm in a single quarter. They took a huge provision for product returns ($33mm vs total retail revenue of $47mm) meaning we have no idea what true ASP is for their retail business. They also talked down the market aggressively, also suggesting supply/demand balance would probably not be a 1H 2020 event. There remain a large number of idiosyncratic issues w CGC (stubbornly high costs, particularly stupid/aggressive acquisition spend), but at least they have something of a cash cushion left (STZ is kicking themselves)

- TLRY said much the same though is more bullishly posturing for Cannabis 2.0 - because they appear borderline insolvent today (their extant converts due '23 trade at 56c), and need to raise capital via an ATM facility - which they are already monetizing (around 10% of ADV today, probably goes up)

- many of the other names (TGOD, ACB, etc) announced scaling back production and/or lower capex and/or cost cutting. Any of the names with leverage and smaller scale (TLRY, HEXO, CTST, TGOD, etc) are in likely existential crises over the next 6mos, unless 2.0 blows the doors off and we get a relief rally that allows them to sell stock to delever. I doubt that occurs fast enough to save the remaining equity value in many of these names, though it remains a risk.

I remain short in reasonable size across many of these names and HEXO is still my largest short of them all. While I am somewhat wary of positioning given the extended pull-back, there are a few particular idiosyncratic issues that really jump out: they are yet to report their latest qtr (remember what they reported a few weeks ago was just the numbers thru July, all the comps have shown the most recent qtr was much worse); they seem to be having some licensing issues (which at the least should crystallize large intangible writedowns on acquired assets from Newstrike); their emergency convert has not closed yet (apparently) and they need the liquidity quite urgently; and of course, I still think fair value even as a going concern is closer to $1/share.

Subject fairly shocking disclosure in PR announcing the $70mm convert closed
Entry 12/06/2019 04:36 PM
Member puppyeh

GATINEAU, Quebec, Dec. 06, 2019 (GLOBE NEWSWIRE) -- HEXO Corp. (“HEXO” or the “Company”) (TSX:HEXO; NYSE:HEXO) is pleased to announce the closing of its previously announced private placement of unsecured convertible debentures for aggregate gross proceeds of $70 million (the “Offering”).

The Company intends to use the net proceeds of the Offering for working capital and general corporate purposes.

“This financing demonstrates that investors are confident in HEXO,” said Sébastien St-Louis, co-founder and CEO of HEXO. “As we continue to focus on market share, growth, and becoming a leader in our industry, **increasing our cash on hand to over $70 million** allows us to continue working towards these goals.”

Since HEXO has $114mm of gross cash (excl ST investments, etc) as of yr end, the above disclosure seems to imply they burnt >$100mm in 1Q alone. There could be other moving pieces (more cash into investments, etc) but BAML thought cash on hand was only $64mm in mid-October so this seems plausible. If that's the case, the emergency convert just bought them one more quarter.

I expect an ATM to be filed as soon as the 1Q report (Dec16) hits, and be actively used out of necessity.

Subject Re: fairly shocking disclosure in PR announcing the $70mm convert closed
Entry 12/06/2019 06:18 PM
Member katana

You are inferring too much. $71m, $171m, and $1,071m are all "over $70m."

Subject Re: Re: fairly shocking disclosure in PR announcing the $70mm convert closed
Entry 12/07/2019 02:17 AM
Member puppyeh

am i though? if a distressed co had $171mm not $71mm, they would say 'over $170mm', in a situation like this, no?

we find out in a week and change anyhow

Subject 1q 'earnings'
Entry 12/16/2019 01:32 PM
Member puppyeh

Another terrible qtr. Clean cash burn was $80mm and the co ended the Q with just $73mm in gross cash (and ~$30mm in net cash, net of TL and excise taxes). ASPs fell 10% QoQ (ok on an adjusted basis netting out returns and provisions they were flattish but these are likely to occur every quarter). The business essentially stopped growing at the topline and it seems unlikely to really return to growth until 2H 2020 - the business today is still on >5x EV/sales and structurally unprofitable.

Yes the $70mm convert closed a week ago but on the call they also disclosed cash balance was just $90mm today (mid-Dec) meaning they have already burnt another $50mm or so since end-Oct (well ahead of my Q2 burn rate, I had them burning $50-55mm total in the current Q). The co will imminently set up an ATM and will have to monetize it as quickly as possible since on this math they are already <2 qtrs of gross cash and I still think they lose access to the term loan come end-Jan (when the TL covenants kick in and Hexo should fail them). To my mind it is very difficult to see terminal equity value for the stock that is not serially diluted in the coming months through any means available to the company.

The call is once again instructive in that many of the issues facing the company appear fairly structural in nature. Hexo will be unable to participate meaningfully in the first phase of Cannabis 2.0 because Quebec is the strictest province, by far (v slow rollout of 2.0 products and no vapes, etc); while Hexo's 2.0 beverage products will only be launched 'over the course of the 1H of 2020.' Meanwhile the co continues to lament the slow pace of retail rollout across Canada - with the CEO on the call now suggesting the full retail fleet won't be built out until 2021 or 2022.

Elsewhere its clear the company is structurally unprofitable, given the CEO was unwilling to provide a gross margin break down for Original Stash - the discount product designed to clear inventories and compete with the black market - despite being asked directly about it on the call. 'Getting to Adjusted EBITDA positive in 2020' may theoretically be possible if sales growth comes from mid-year but given the pace of inventory impairments ($25mm of impairments in 4Q, or almost 1.5x adult revenues!) what good are the adjusted numbers.

The stock has bounced - it is very heavily shorted - and clearly its a very difficult time to be short anything. That said, I expect it to continue to grind lower almost through force technical selling as the company is forced to monetize the stock price in a downward spiral to fund the ongoing cash burn in the business.

Subject more highly dilutive financing - 50% effective discount to spot
Entry 12/26/2019 09:34 AM
Member puppyeh

HEXO raised $25mm (USD) at $1.67, a 15% discount to last. The issue came with 1:2 5yr warrants struck at $2.45 - which, using the last close of $2.04, are worth around $1.6-1.7 each (given this is a 110v stock). Even if we adjust spot to $1.65 (where HEXO is trading pre-market), the value of the warrant is still $1.25. In other words the true cost of issuance - for barely 6 weeks worth of burn - was around $1 USD/share ($1.67 issuance minus fair value of the attached warrant, 1:2 per share bought).

The optics are clearly very concerning. They were willing to raise a minimal amount of capital at an effective 50% discount to current. Perhaps because setting up an ATM - something they signposted numerous times - would not raise enough $$ and quickly enough?

This still seems a one-way train here. Whoever bought this offering would seem highly incented to dump both stock (and l-t options) ASAP given the rate of burn. I still expect some form of ATM transaction to be announced, and still think the stock has 40% near-term (next 3 mos) downside as these new shares (15mm) are absorbed by the market much closer to the acquirors' cost basis.

Subject Author Exit Recommendation
Entry 01/01/2020 08:04 AM
Member puppyeh

The author has recommended exiting the position

Subject Re: Author Exit Recommendation
Entry 01/01/2020 08:13 AM
Member puppyeh

i closed half of my short at 2.05 avg today to clean up into year end. full disclosure, i still have a modest short position in this name as i expect the name to continue to grind lower through the force of dilutive capital raises, and consider fair value probably 50% below current. so why close on VIC, you say? borrow cost has increased to 80%; there will be no hard catalysts until the next Q report (mid-March); and it has become increasingly difficult to carry heavily shorted positions in this kind of market so I am booking a good chunk of my profits here.

this idea returned 45% gross since I posted, in 70 days. I paid an avg of 60% borrow cost during this time (11.5% over 70 days), meaning net performance on this idea was +33%, versus the Canadian benchmark (TSX Comp) +4% in this time, so the idea generated 37pts of alpha - during an extremely difficult time to be short anything. Most of the tenets of the short thesis - structural market oversupply; poor product positioning; chronic cash burn needing to be funded through increasing equity raises on worse terms; a quasi-going concern note in the accounts - came to fruition.

i will continue to update the board as i remain involved in a smaller size.

Subject re-upping the short
Entry 02/09/2020 06:45 AM
Member puppyeh

I have re-upped my short in HEXO and added to my ongoing shorts in TLRY and CGC. late last week we saw a partial capitulation from TLRY (cutting 10% of their workforce) and a full capitulation from ACB (cutting 15-20% of workforce, turfing the existing management team; big goodwill writedown, etc). In particular the language around the ACB capitulation was eye-opening: '*Management today announced sweeping changes intended to rationalize the cost structure and balance sheet going forward. The Company believes this will better align the business financially with the current realities of the cannabis market in Canada while maintaining a sustainable platform for long-term growth.* Furthermore ACB guided to zero revenue growth in its 3Q (the forthcoming quarter) - despite anemic growth in 2Q and of course the supposed benefit from 2.0 ramping...pretty much a disaster.

Since this is coming from the company that just restruck its upcoming converts to force them to equitize, and since we are now basically 2+ months into Cannabis 2.0, I think its safe to say 2.0 thus far has been very disappointing. Whether this is a demand problem, or due to ongoing massive inventories in the system; or due to the languid pace of new story openings, its largely irrelevant. ACB - one of the largest players but also one with a cost and balance sheet problem, they still had $500mm or so of net debt pro-forma, I believe, despite tapping $300mm of their ATM in a quarter alone - is effectively cutting off a leg to save the patient. Its quite clear that the relaxation in debt covenant terms simultaneously announced was precipitated only by slashing and burning at the cost structure and capex plans in place. This is perhaps doable for ACB (though I suspect more equity dilution will be forthcoming) but what does this say about the weaker players? I expect a further disastrous reporting season, another leg lower as Cannabis 2.0 'improvements' get progressively pushed out, and all these names continue to equitize their debts at the cost of large equity dilution.

HEXO I believe is particularly at risk since they were unable to even set up an ATM facility; still have some term debt outstanding; and all the other reasons I mentioned in the writeup. furthermore HEXO also lost another director on Friday, and announced the change in their auditor from MNP to PWC. while not core to the thesis I think this basically guarantees a massive impairment of all the balance sheet intangibles at the next quarterly report. TLRY has the ATM but also still a very large debt burden (the converts) which seem quite unlikely to be refinanced. CGC is cash rich but just a more liquid sector short on canadian cannabis.

Subject Re: re-upping the short
Entry 02/28/2020 10:25 AM
Member puppyeh

for anyone who cares, i exited the rest of my HEXO and CTST shorts, and cut my remaining TLRY short in half today. Still keeping CGC (though TLRY now largest short of the group). nothing really new, just the price action of late, absolute levels now extremely low (on HEXO/CTST), and seeing better opps on the short side elsewhere