Shopify Is An Exceptional Company But Its Stock Is Risky

Summary
Shopify has greatly benefited from the pandemic, which has accelerated the shift from conventional shopping to online shopping.

The stock has rallied 230% in the last 12 months and thus it has reached a market capitalization of $134 billion.

Due to the low barriers to entry in its business, Shopify lacks a wide business moat.

Shopify (SHOP) has enjoyed a breathtaking 230% rally in the last 12 months and thus it has vastly outperformed the S&P (SPY), which has gained only 19% during this period. Shopify has exhibited tremendous business performance and has exciting growth prospects ahead, as there is ample room for the company to keep growing for several years. Nevertheless, as the stock has reached a market capitalization of $134 billion and it is trading at an exceptionally rich valuation level, it has become risky.

Business overview

Shopify provides a cloud-based commerce platform, which helps companies become much more efficient in the current business landscape, in which competition has become fiercer than ever.

Shopify benefits from a strong secular trend, namely the shift of consumers from brick-and-mortar shopping to online shopping. This secular shift has greatly accelerated this year thanks to the pandemic, which has rendered online shopping much more attractive than physical shopping. Many merchants were caught off guard in the seismic shift caused by the pandemic and thus Shopify has enjoyed impressive business momentum this year.

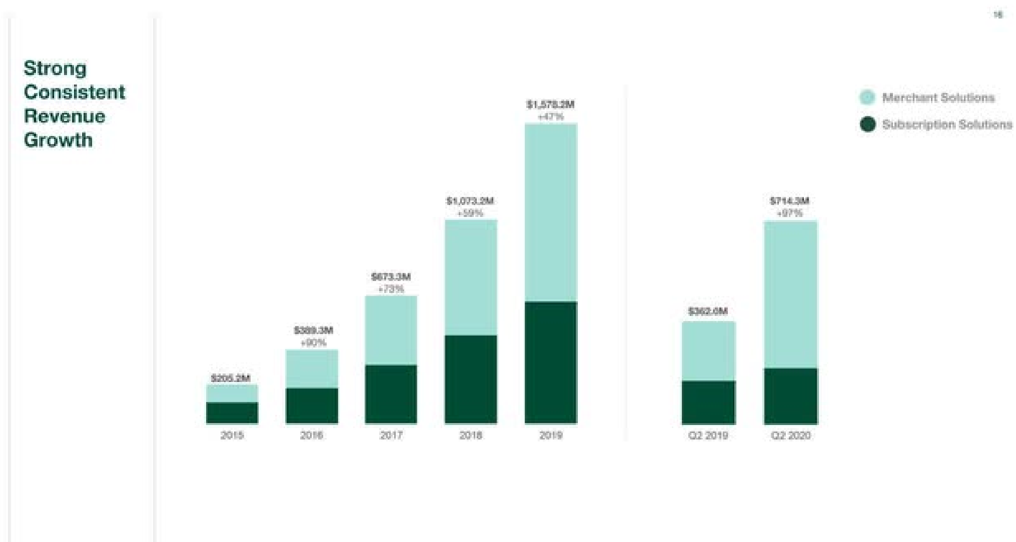
The tailwind from the coronavirus crisis was evident in the results of Shopify in the second quarter, which was marked by unprecedented lockdowns. Its gross merchandise volume jumped to its highest level in more than five years while the stores selling on Shopify sold 1.5 times what they sold in the fourth quarter of 2019, the strongest quarter of the year from a seasonality point of view. Moreover, the total revenue of Shopify essentially doubled over the prior year's quarter and it smashed the analysts' earnings per share estimates ($1.05 vs. consensus of $0.02).

Shopify has also taken advantage of the need of merchants for liquidity amid the pandemic. Numerous U.S. merchants accessed capital from Shopify in the second quarter while the company also offered financing to merchants in the U.K. and Canada for the first time. As a result, funding in the second quarter jumped 65% over the prior year's quarter and the cumulative funding of Shopify in all the regions reached $1.2 billion at the end of the second quarter. While financing is not the core business of Shopify, it can be an additional growth driver, particularly under the harsh economic conditions prevailing right now.

Growth prospects

As the secular shift from conventional shopping to e-commerce is only in its early stages, Shopify still has ample room to continue growing for more than a decade. To provide a perspective, in its latest conference call, management stated that the total addressable market for Shopify is $78 billion and the company has captured just a tiny portion of this market so far.

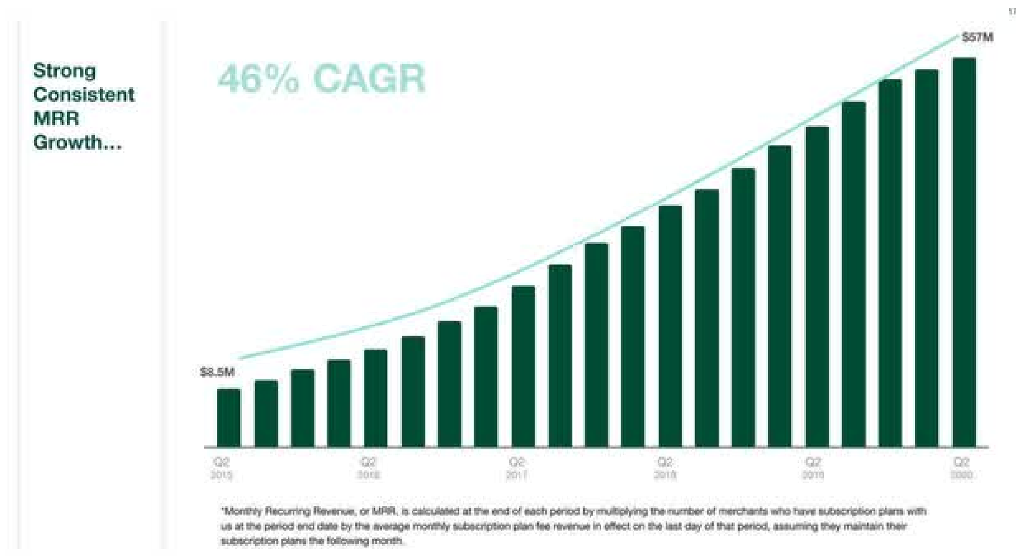
The growth potential of Shopify is also evident from the impressive performance record of the company, which is characterized by consistent revenue growth, without any intervals, and has absolutely no signs of fatigue.



Source: Investor Presentation

As shown above, Shopify has grown its revenue at eye-opening double-digit rates every year in the last five years.

It has also grown consistently its monthly recurring revenue, which is equal to the number of merchants who have a subscription plan times their subscription fee.



Source: Investor Presentation

Shopify has grown its recurring monthly revenues at a 46% compounded average annual rate over the last five years.

Recurring revenues are important, as they result in reliable cash flows and thus provide a strong buffer in the event of an unforeseen downturn. It is costly and inefficient for merchants to switch from Shopify to another platform and hence the recurring revenues of Shopify are reliable, particularly given that the merchants who have resorted to Shopify have done so in order to enhance their efficiency.

It is also worth noting that Shopify has become the largest holding of the stock portfolio of Lone Pine Capital, currently comprising 8% of the portfolio. Lone Pine Capital is well known for having outperformed the broad market by an exceptionally wide margin since its foundation, in 1997. The fund has been able to outperform the broad market thanks to the exceptional competency of its founder, Stephen Mandel, in identifying stocks with immense growth potential, especially in the tech sector. The large investment of Lone Pine Capital in Shopify is a great endorsement to the quality and the growth potential of this company.

Valuation – Risk

Due to its extraordinary rally, Shopify is currently trading at a price-to-earnings ratio of 457. This is an extreme valuation level but the company is growing at a fast pace and hence this earnings multiple does not reflect the full valuation picture. A more informative measure is the fact that the stock is currently trading at 23.0 times its expected earnings in 2027, as analysts expect Shopify to grow its earnings per share 20-fold, from $2.39 this year to $47.41 in 2027.

Unfortunately, the estimates of analysts are unreliable in such long-term horizons, as many unexpected headwinds may show up over such long periods. Moreover, one could rely on such long-term forecasts if Shopify had a wide business moat and thus it essentially operated without any effects from competition. However, this is not the case for Shopify.

The business of e-commerce platforms has very low barriers to entry, as it does not require much capital to build such a platform. This business is the exact opposite of utilities or telecommunications companies, which have to spend enormous amounts to build the infrastructure required to serve their customers and thus there are too high barriers to entry in these businesses. On the contrary, in the business of Shopify, new competitors, with competency in information technology, can enter the market with very low amounts of invested capital.

BigCommerce Holdings (BIGC) is an example of a competitor which conducted its IPO just two months ago. The company develops e-commerce software and offers it to online retailers. BigCommerce has provided its software to approximately 60,000 online stores in 120 countries so far. In the same way, many other competitors can show up in Shopify's business. These competitors will not only affect the pace of growth of Shopify in the future, but they will also limit the subscription fees it charges to its merchants.

On the bright side, the growth potential of this business is so immense that Shopify can continue growing at a high rate for a considerable period, without being affected by its competitors, particularly given its strong business momentum. On the other hand, it is too risky to forecast that Shopify has a decade of uninterrupted, relentless growth ahead in this fast-changing business, which has essentially no barriers to entry. The market has already priced 7 years of tremendous growth in the stock of Shopify, thus rendering the stock highly vulnerable in the event of business deceleration.

It is also important to note that Shopify has reached a market capitalization of $134 billion. This is 72% higher than the total addressable market of $78 billion of the company, according to its management. To provide a perspective, Costco (COST) and Target (TGT) have market caps of $166 billion and $82 billion, respectively, and Shopify is just about to exceed the market cap of Exxon Mobil (XOM), which currently stands at $146 billion. While these large-cap companies are not competitors of Shopify, their market cap is useful in understanding how much growth the market has already priced in the stock of Shopify.

Earnings

While analysts expect Shopify to grow its earnings per share 20-fold over the next seven years, from $2.39 this year, to $47.41 in 2027, it is important to note that Shopify has never made a profit in the last eight years. The company has grown its revenue at a tremendous pace throughout this period but its losses have only widened. This is certainly a red flag for the profitability potential of this business model.

It is also worth noting that the second quarter of this year was the first quarter with a meaningful profit in the last eight years. As Shopify enjoyed a strong tailwind from the lockdowns caused by the pandemic in that quarter, it is only natural to wonder how the results will be affected when the pandemic subsides. On the bright side, the existing customers of Shopify are not likely to terminate their subscriptions and hence the revenues of Shopify are not likely to decrease if the pandemic subsides. However, its growth pace will certainly be affected whenever the coronavirus crisis subsides.

Final thoughts

Shopify is an exceptional company, which helps other companies adapt to the challenging business environment of the new decade, and thus it has exciting growth potential ahead. However, the market has already priced the growth of the company in the next seven years in the stock. As there are very low barriers to entry in its business, Shopify may decelerate at some point in the future due to pressure from its competitors or the end of the pandemic. It is also much harder for a company to keep growing at a breathtaking pace as it grows bigger. Whenever Shopify decelerates, its stock will have significant downside risk due to its lofty valuation. At its current valuation level, Shopify would be investable only if it had a wide moat in its business.

On the other hand, all the above do not mean that the Shopify's stock will plunge anytime soon. The company has strong business momentum, which is likely to remain in place for a while thanks to the impact of the pandemic on most retailers. As a result, the stock can maintain its positive momentum and its premium valuation for a considerable period. Nevertheless, it is not a sound strategy to rely on the rich valuation of a stock and try to profit from its momentum.

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