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What's it really worth? Shopify's stock has doubled this year, but new competition is on the horizon

DAVID MILSTEAD INSTITUTIONAL INVESTMENT REPORTER

The Ottawa software company has vaulted into the big leagues of e-commerce. It now has a \$45-billion market value – and the price is rich. Read this before you buy the stock

People are going to spend hundreds of billions of dollars online. And Shopify Inc., with its wildly popular software designed to run e-commerce websites, is going to take a good cut of the pie.

The big question is just how big Ottawa-based Shopify's slice will be. It's a \$45-billion question, actually – the company's stock market value. Born 15 years ago and launched on stock markets in 2015, Shopify's rocketing share price has propelled it from upstart to Canadian champion, and it is now country's most valuable technology company by far.

Every decade, it seems, Canada produces a tech star that bursts onto the global scene with a hot new business and a stock price that flies into the stratosphere. In the 1990s it was Nortel Networks Corp. with its fibre-optics networking operations, which grew to be a giant that, at its peak, accounted for more than one-third of the value of the TSE 300 index (now known as the S&P/TSX Composite).

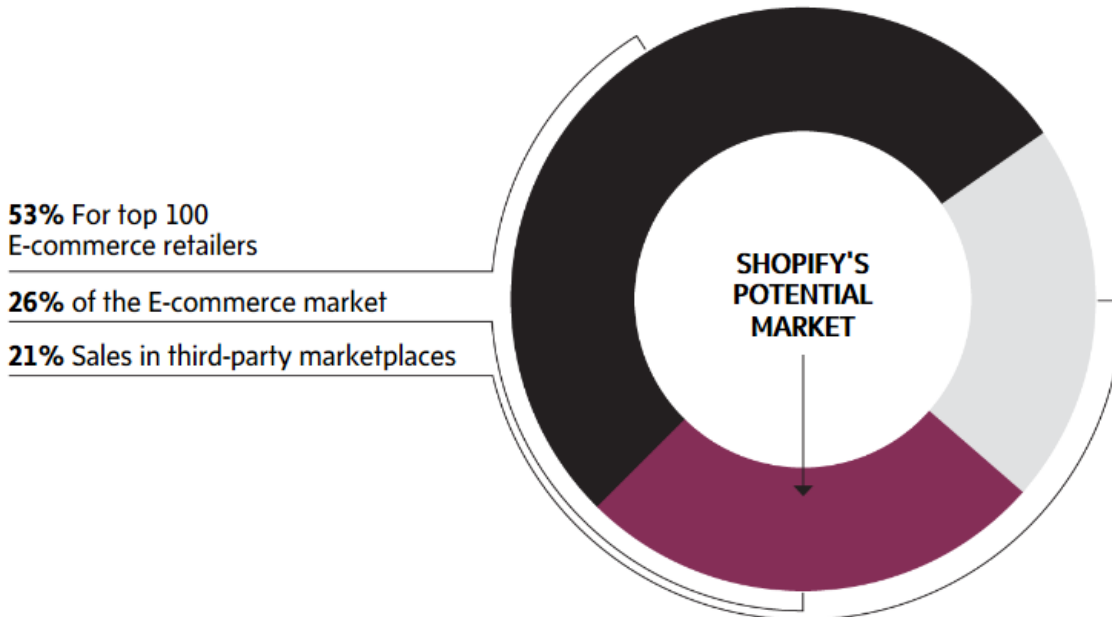
In the 2000s, Research In Motion Ltd., since renamed BlackBerry Ltd., soared in value as consumers around the world flocked to its groundbreaking smartphones.

Canadian investors know all too well how Nortel and BlackBerry wound up: They crashed and burned as their competitors caught up to them, or their markets shifted too fast for them to adjust.

Now, Shopify is Canada's tech darling and its huge stock market value makes it the country's 15th-largest public company, ahead of Canadian Pacific Railway Ltd. and energy giant Canadian Natural Resources Ltd.

JUST HOW BIG IS SHOPIFY'S POTENTIAL MARKET?

Veritas Investment Research believes Shopify won't get many customers from the 100 biggest U.S. e-commerce retailers. As for small retailers, many use eBay, Amazon and other third-party marketplaces to sell goods. Shopify has apps that help merchants use those sites, but it collects much less in fees for those transactions. So after deducting those marketplaces from its calculation of Shopify's revenue opportunities, Veritas estimates that the company may only be able to tap into about one quarter of all online sales.



THE GLOBE AND MAIL, SOURCE: VERITAS INVESTMENT RESEARCH

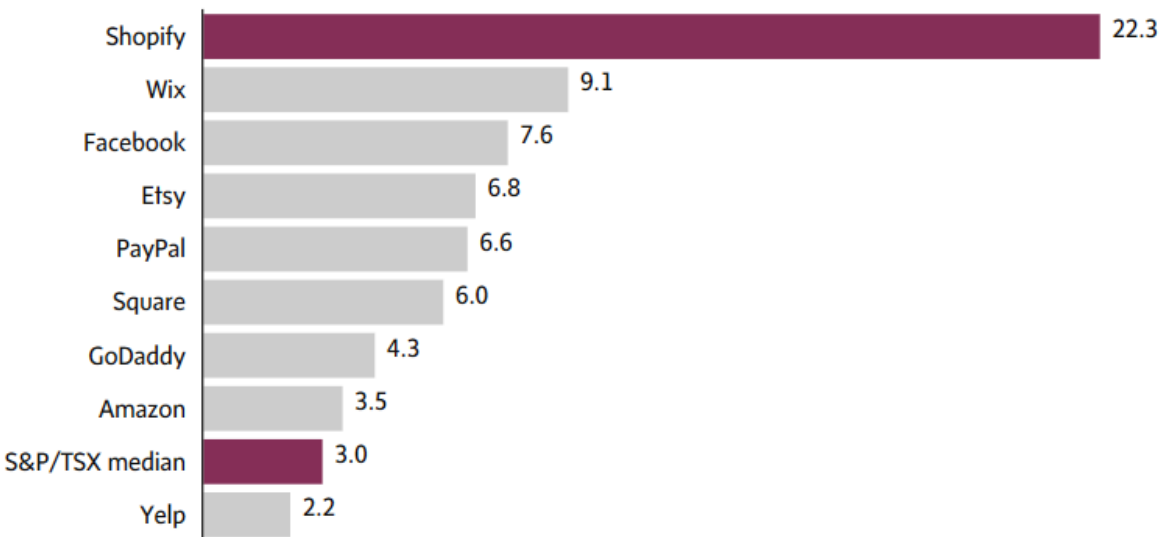
Obviously, Shopify and its ambitious co-founder and CEO, Tobias Lutke, want to avoid the fate of Nortel and BlackBerry. But daunting competitive challenges loom – enough of them, it seems, to raise questions about just how much risk Shopify investors are taking.

Just about everyone agrees that Shopify is a great company with a solid strategy. The bulls on Shopify's shares – and there are many – see a company with a best-in-class product, happy customers and an almost limitless opportunity as online commerce grows and Shopify expands its offerings to retailers. "To be honest, they essentially have no competition," Gus Papageorgiou, an analyst at PI Financial Corp., said in an interview.

Yet even though Shopify's share price has declined by more than 25 per cent since its peak this past August, the stock remains very expensive. The company has never turned a profit, and isn't expected to in 2020, so there's no way to value Shopify on its earnings. And investors are paying more than \$20 for every dollar of sales Shopify records – which is more than twice the price-to-sales multiple for many other well-known growing tech companies.

Price to sales

Last 12 months



THE GLOBE AND MAIL, SOURCE: S&P GLOBAL MARKET INTELLIGENCE

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Some analysts look at that lofty valuation and wonder whether Shopify can grow as quickly or as large as the stock price suggests it must – particularly if the company can't win over big corporate customers that might be able to develop their own systems, or can't compete with social media platforms, such as Instagram or Pinterest, that are adding e-commerce functions for online retailers

"Any sane person would say, 'Can this company really grow revenues that fast for that long?' Morningstar analyst Dan Romanoff said in an interview. "There's not a lot of companies that have that kind of track record, to say that there's a precedent out there for that."

The company was born in 2004 when Mr. Lutke launched a business selling snowboards online and found that software options were lacking. He built his own e-commerce software, which he licensed to other retailers, then established Shopify in 2006.

The platform was enthusiastically adopted by budding entrepreneurs and small businesses who lacked the technical skills to develop their own online selling systems.

Shopify now boasts more than one million merchants on its platform – a number that has increased by 30 per cent in just the last 12 months. Collectively, these merchants sold more than US\$15-billion worth of stuff in 40 countries through Shopify in the company's third quarter ended Sept. 30.

Shopify

Daily closes, in U.S. dollars as of Thursday



THE GLOBE AND MAIL, SOURCE: BLOOMBERG

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Many of these merchants are tiny. But some, such as the BBC, Gatorade, Gund and KKW Beauty, a cosmetics company launched by Kim Kardashian West, are well-known brands that are boosting Shopify's profile as the company expands globally and embraces different languages and currencies.

In its early years, Shopify simply sold monthly subscriptions for its software, collecting extra money for each transaction a user processed. But over time, company has added new services, such as payment-card processing, online postage sales, point-of-sale hardware for its customers to sell merchandise in stores and even short-term business loans.

Shopify has also started moving up the food chain from serving the smallest online businesses to considerably larger ones. The bigger retailers are customers of the more elaborate "Shopify Plus" platform. Many analysts believe that no other company currently offers this one-stop approach—and the platform gets better as it gets bigger.

Shopify's basic subscription fees range from US\$29 to US\$299 a month, depending on the complexity of the business and the features needed. The Shopify Plus platform can cost US\$2,000 a month. Shopify calls the rest of the new offerings "merchant services."

More ways to collect money from its clients, plus hooking ever-bigger retailers to the Shopify system, have made for a sexy growth story, and investors have responded. As of Friday, Shopify's shares are up 17-fold since its May, 2015, IPO on the New York and Toronto stock exchanges.

The company joined the blue-chip S&P/TSX 60 earlier this year. At Shopify's Aug. 27 Canadian-dollar high of \$543.76 on the TSX, the company had a market capitalization that topped \$60-billion.

"By any measure, it's ahead of the competition. It is the platform of choice for entrepreneurs, small businesses and increasingly larger businesses to launch their e-commerce operations. And we have no issue with that," **Chris Silvestre**, an analyst at **Veritas Investment Research**, said in an interview.

In a recent research report, however, **Mr. Silvestre** questions whether people are overestimating Shopify's potential customer base, referred to in financial-speak as the "total addressable market."

In a recent investor presentation, Shopify says it regards that total market as "anyone who wants to make more money from their site than what they pay for it."

More specifically, the presentation has an image of inverted pyramid with a huge number of entrepreneurs at the wide base at the top, and a small number of the biggest brands near the point at the bottom.

In the middle, US\$70-billion of merchandise sold each year by small and medium-sized businesses. "The way it's shaped, it gives you the impression that there's a much bigger market out there," **Mr. Silvestre** says. "So, it really does leave a lot to the imagination."

But **Mr. Silvestre** says investors shouldn't plan on Shopify powering the websites of the world's largest retailers. By and large, they have complex needs, the ability and resources to develop their own solutions and the desire to retain control over them. Mr. Silvestre estimates Shopify is used in less than 4 per cent of the websites of the top 500 U.S. e-commerce retailers.

Mr. Silvestre also says Shopify faces a challenge when its merchant customers choose to depart from their own websites and sell on other platforms, such as Amazon or eBay. Social media sites such as Instagram and Pinterest are also developing payment tools and systems that allow users to buy things without ever leaving the app.

Shopify has apps that allow its customers to sell on those sites, as well as their own websites. But the Amazons of the world can take a much larger share of a merchant's transaction costs than Shopify collects when a customer sticks to its own Shopify-powered website.

Mr. Silvestre cuts the total e-commerce pie in half by subtracting the biggest retailers, and cuts the remainder nearly in half once again when estimating the effect of alternative platforms. The result, he says, is a total addressable market of just one-quarter of e-commerce sales – not all of them, as he figures some of the most optimistic investors may assume.

"I get [that Shopify has] a whole bunch of really fast growing amazing companies, amazing brands, organizations that want to go direct to the consumer," said **Mr. Silvestre**. "But there is a hard limit on the size of the opportunity, and that's the size of the total e-commerce market. And if we just start making some deductions, it becomes pretty clear that there is a limit to this market. And it's probably less than what people expect, very likely to be smaller than people expect."

What does that limit mean for Shopify's share price? **Mr. Silvestre's** US\$275 "fair value" estimate, published Oct. 15, is now slightly below Friday's New York Stock Exchange closing price of US\$297.73.

Other analysts, such as Mr. Papageorgiou of PI Financial, have a more bullish view of Shopify's total addressable market. He said it is essentially immeasurable. It's nearly impossible to quantify the number of merchants worldwide likely to spring up and start selling their products online. Any estimate must also take into account the growth of companies after they join Shopify's platform, because their swelling top lines mean more fees for Shopify.

Mr. Papageorgiou points to Allbirds Inc., a San Francisco-based shoemaker and retailer. The company likely began paying about US\$360 a year for the Shopify platform, but it's now generating an estimated US\$100-million in sales a year. (The privately-held company doesn't release financial figures.)

Allbirds pays Shopify 0.25 per cent of sales, Mr. Papageorgiou says, which translates to US\$250,000 a year. That doesn't include the fees when the company's customers use a credit card to make a payment on its website.

"It's a very, very big market," Mr. Papageorgiou said.

In an interview, Harley Finkelstein, Shopify's chief operating officer, said the company estimated the size of its potential market prior to its IPO in 2015 at about 10 million SMBs (small and medium sized businesses) in the company's core market, and 46 million worldwide. That's still a tantalizing 10- to 46-times the size of Shopify's current roster of merchants.

But Mr. Finkelstein says that the early estimates didn't include merchants who don't see themselves as SMBs, which suggests that Shopify's total addressable market could be far larger.

"I don't think that when Kylie started she called herself a retail SMB," Mr. Finkelstein said, referring to Kylie Jenner, the reality-TV star who launched Kylie Cosmetics on Shopify. According to Forbes, Ms. Jenner's business generated an estimated US\$360-million in sales last year.

Mr. Finkelstein said that if you add up the revenue generated by Shopify's U.S. merchants on the platform, the combined theoretical entity would be the third-largest online retailer in the United States. That puts the company behind Amazon and eBay, but ahead of Walmart and Apple.

Size now allows Shopify to create its wide suite of offerings at a great price. "This is important because what it allows us to do fundamentally is go and negotiate on behalf of these merchants in a way they couldn't do for themselves," Mr. Finkelstein said.

One of Shopify's newest offerings is "fulfillment": A merchant sells something, but Shopify is in charge of pulling it from inventory, packaging it and shipping it to the buyer. Unlike online postal services or even point-of-sales systems, fulfillment can require immense cash spending on land, warehouses, forklifts and employees. There's also a company called Amazon.com Inc. that has spent billions of dollars to first offer two-day "Prime" shipping, then same-day service and then some deliveries in just hours.

Shopify said it would spend about US\$1-billion launching its fulfillment services, then in September announced a US\$450-million deal to buy 6 River Systems Inc., a robotics company that promises to boost efficiency in those services. Mr. Finkelstein said any fears that Shopify is going to spend wildly and try to take on giant Amazon – which he describes as a "partner" in e-commerce, not a competitor – are wrong.

Amazon owns its warehouses, while Shopify is minimizing the cash outlay by partnering with third-party companies, he says. And while Amazon is rolling out expensive same-day delivery, Shopify is happy to stick with two days, which it expects is more than enough for its merchants.

Same-day delivery, Mr. Finkelstein said, "is probably more important for Amazon products – for toilet paper or detergent or diapers. But for a beautiful pair of shoes or a cool bracelet or great T-shirt, or anything, for that matter that is sold on Shopify, we think two-day delivery is going to be absolutely sufficient – and will delight consumers."

For now, Shopify's top-line revenue suggests it has been making the right calls. The total in the third quarter increased 45 per cent, year-over-year, to US\$391 million. Analysts expect the company is on track

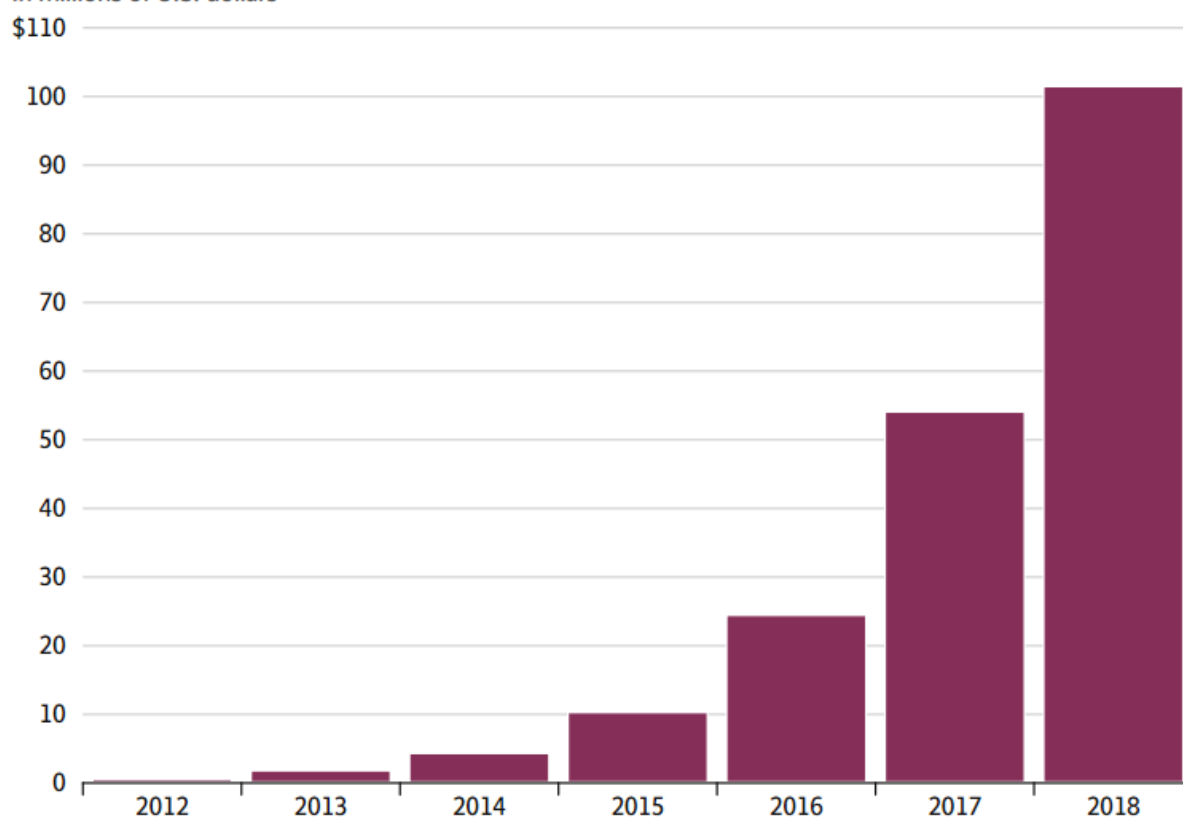
to surpass US\$1.5-billion in sales for 2019, also up 45 per cent from 2018. That's meteoric growth from 2014, its final year as a private company, when it recorded US\$105 million in sales.

But already, Shopify is revealing some growing pains that could challenge some of the more optimistic scenarios underpinning the stock. Growth in year-over-year merchant solutions revenue, while still impressive, has slowed to 50 per cent from 68 per cent in the third quarter of 2018, according to RBC Dominion Securities. Similarly, growth in subscription revenue has decelerated to 37 per cent from 46 per cent a year ago.

Profits are another question. Many investors seem to believe Shopify can keep up a blistering sales pace for some time, and they assume the company will turn those sales to profits. To date, Shopify has not produced positive net income and, on average, analysts do not expect it to next year. Shopify is a heavy user of stock in its employee-pay programs, having awarded more than US\$100 million worth in 2018. It releases an "adjusted" profit figure that removes the cost of stock-based compensation – and therefore, shows occasional profitability.

Shopify stock-based compensation

In millions of U.S. dollars



THE GLOBE AND MAIL, SOURCE: SHOPIFY

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Analysts aren't anticipating that Shopify will generate real profits any time soon. Goldman Sachs analyst Christopher Merwin, for example, expects that the company will continue to invest in growth initiatives such as its fulfillment network and international expansion.

For now, investors will have to make do with operating income, a hypothetical measure of profit from its existing operations that doesn't include expansion initiatives. Mr. Merwin forecasts operating income will rise to US\$330.3-million in 2022, up from an expected US\$37.4-million in 2019.

Shopify's current stock price values the entire company at 22 times its sales for the past 12 months, according to S&P Global Market Intelligence. Among nine tech companies **Veritas's Mr. Silvestre** assembled for comparison, none trade for more than 10 times sales. The median price-to-sales ratio in the S&P/TSX Composite is less than three, according to S&P. (See chart.)

A gigantic run-up in Shopify's share price in early 2019 cooled some analysts' heels. Many made so-called "valuation calls" – in essence saying, "We love the company, but we don't love the stock at this price."

Todd Coupland, an analyst at CIBC World Markets, downgraded Shopify in June to a lukewarm "neutral" recommendation from "outperformer," arguing that the upside potential has been priced into the stock. He was one of four analysts who downgraded the shares to neutral from mid-May to late June, according to Bloomberg. Mr. Coupland reiterated this recommendation in late October, after Shopify reported its third-quarter financial results.

Ken Wong, an analyst with Guggenheim Securities Inc., wrote that after an "active week of investor dialogue" following his May downgrade, "we found that approximately 30 per cent of conversations were in the bull camp, 20 per cent questioned the multiple but see no definitive negative catalyst, another 20 per cent were clearly negative and 30 per cent that are watching events unfold on the sidelines, possibly looking for a better entry point."

The percentage of analysts who say Shopify is a buying opportunity has tumbled to 53 per cent, down from 68 per cent at the start of the year and 100 per cent three years ago, according to Bloomberg. Still, their average target price, a forecast for the next 12 months, is US\$356.20, or nearly 20 per cent more than Friday's closing price.

The most cautious analysts say, however, that it's hard to see how Shopify, as successful as it has been, can keep this up.

Morningstar's Mr. Romanoff has modelled Shopify's cash flow over the next 15 years – a task, he acknowledges, would be easier with a more mature company. He says the fair value of the company's stock is just US\$175, about US\$100 below current prices.

The current share price, he argues, implies revenue growth of 25 to 30 per cent every year for the next 15 years. "I don't think they can grow that fast," he says. He says Shopify's annual revenue gain could slip to 23 per cent as soon as 2023. "But again, if you own the stock, or you want to buy, you obviously have to believe there's upside, and that's something that needs to happen to make the math work."