

## Evaluating Shopify: A Comprehensive Stock Report

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Founded in 2006, Shopify is a truly revolutionary business with more than 2 million online merchants in more than 175 countries. It isn't like other E-commerce platforms such as Amazon where you normally purchase goods from. Rather it allows merchants and businesses to set up online stores to sell products and services of their choice. Shopify's platform has a variety of tools that greatly assist with this, as detailed in the following sections.

Shopify's business is made up of mainly two segments:

- **Merchant Solutions (~74% of 2023 revenue)** comprises numerous services such as advertising, shipping management, raising capital and so much more. For instance, one particularly popular merchant solution is Shopify Pay which charges fees for payment processing and currency conversion. This is anywhere between 2.4% to 2.9% of the GMV of the transaction depending on the subscription plan.
- **Subscription Solutions (~26% of 2023 revenue)** meanwhile only include the sale of subscriptions to Shopify's platform, the registration of domain name and the sale of themes and apps.

Shopify has a compelling lead over its competitors in terms of usability and functionality. The platform is fairly easy to navigate, even for non-tech-savvy users, which makes it easy for clients to set up and manage their business operations. Additionally, Shopify is capable of scaling to meet the needs of expanding businesses, offering features such as automatic upgrades and the ability to manage high volumes of traffic and transactions. Accordingly, Shopify has the highest market share amongst its competitors at 28% with WooCommerce trailing at 17%.

Usually with platform businesses, the strong become stronger by allowing others to build on top of them. For instance, Meta Platforms, which owns Instagram and Facebook, provides basic functionality while users generate the majority of the content. Similarly, with Shopify, external developers have built most of the functionality which is a quicker process than if Shopify did it themselves. This approach has enabled Shopify to continuously innovate and remain at the forefront of its industry.

### Financials:

The company did report solid financial earnings in Q1 with revenues up 23% and strong free cash flow growth. The growth was driven across both segments with merchant solutions registering a growth of 20% to 1.4 billion and subscription solutions up 34% to 0.5 billion. Some other notable numbers were that gross profit increased by 33% to \$957 million as gross margins expanded from 47.5% to 51.4%.

However, despite strong business growth, net margins were still negative. The negative net margins along with a weaker outlook led to the stock falling 18% post results.



## Forward Outlook:

- ***Strong growth in the e-commerce business***

Shopify has consistently outpaced e-commerce growth by a wide margin across the years, posting 45% compounded revenue growth between 2019 and 2023. Accordingly in 2023, Shopify made up 4.9% of the global eCommerce market which was 1.2% higher since 2017. Nonetheless, the company is still a long distance away from e-commerce giants such as Amazon. However, as Shopify continues to leverage its numerous competitive advantages as stated above, it is positioned to bridge this gap over time.

- ***Gain in market share driven by AI***

Shopify is actively working on integrating AI into its platform to enhance functionality and user experience, a key competitive focus in the E-commerce industry. The company is at the forefront of this integration, investing heavily in R&D to attract numerous developers to launch their tools to the platform's extensive user base. Recently, Shopify also launched Shopify Magic, an AI-powered tool that assists businesses with time-consuming tasks, such as product description writing and customer communication. As Shopify continues to advance its platform with AI, the company is well-positioned to attract an increasing number of customers.

- ***Improving profitability***

During the pandemic, Shopify overextended itself and ended up with a large sum of debt, forcing the company to sell its logistics business. However going forward, there are positive signs of revenue growth and disciplined spending which I believe will result in growth margin expansion going forward. Bank of America analysts also believe that Shopify is “turning a corner” by better balancing growth and profitability. This is being done by maintaining a ‘disciplined, limited headcount growth’ trajectory as a core tenet for operating leverage.

Another particularly interesting possibility is for Shopify to “price for value” by adjusting subscription fees, especially for enterprises with greater than \$10 million in sales. Currently, enterprise merchants pay anywhere between \$5k - \$30k, which to put things in context is less than the cost of a minimum wage worker. Shopify has already increased its subscription fees in the past year without negatively affecting retention or growth. Hence, there is a longer-term possibility to increase Shopify Plus monthly fees by \$100 which J.P Morgan estimates could potentially generate an additional \$30 million in incremental annual revenue.

## Key Risks:

- ***Economic slowdown:***

The company is highly dependent on small businesses which can be highly vulnerable during times of economic slowdown. In today’s current environment, there is still lingering

speculation regarding a recession as there are some signs of softening in consumer spending and business investment.

- **Increasing Competition:**

The E-commerce market is highly concentrated with new and established players continuously aiming to innovate and expand their offerings. One notable company is Amazon which seems to be encroaching on Shopify's territory with Buy with Prime and Multi-Channel Fulfilment.

- **CyberSecurity Threats or System Failures:**

Shopify normally deals with sensitive data and therefore may be vulnerable to security breaches or system failures which can tarnish the company's reputation. As a result, there may also be increased oversight and regulations imposed.

**Valuation:**

While I believe Shopify is an outstanding company, it is also important to consider the valuation of the stock. I expect Shopify to show a healthy high-teens growth in revenues over the next 5 years which combined with improving margins should lead to a strong growth in free cash flows. Typically companies that are growing fast and moving towards profitability and higher cash flows are difficult to value on a multiples basis. Most analysts use EV/FCF or EV/sales to value Shopify, which indicates a promising outlook and aligns with Morningstar's price target of \$76.42, suggesting a 26% upside.

**Recommendation:**



Fig 1. Price Chart of Shopify, Source: Bloomberg



As evident from the Price Chart, Shopify has been down big as of late which can certainly be frightening. Though as investors, investing for the future, Shopify has a great amount of upside. The company has generally always seen good growth in terms of market share, but profitability now also seems to be improving. In the coming years, Shopify is likely to keep on conquering small American businesses but will now do so more profitably.

**Other Notes:**

Short interest as a percentage of free float is quite low at around 1.7%, indicating a lack of pessimism despite the stock's underperformance following its Q1 results. Additionally, the put-call ratio is also low at 0.4, reflecting a bullish sentiment among options traders. However, the technicals are weak, as the stock is currently trading below its 200-day average, which is likely to offer some resistance. Moreover, a three-month at-the-money call option is priced at approximately 9%, suggesting significant volatility and an expensive cost for options traders.



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