3 Reasons Why Passing on Shopify Inc. Could Be a Huge Mistake

Description

Shopify Inc. (TSX:SH)(NASDAQ:SHOP) is Canada's hottest technology stock, and one of the hottest stocks on the Nasdaq exchange. For this reason, it trades for over 10 times revenue, a sky-high valuation for an unprofitable company. So, it's understandable that many investors would be turned off.

But passing on Shopify could be a big mistake. Below we look at three reasons why.

1. Loyal customers

In the past I've written about the appeal of companies that make subscription-based revenues. These companies tend to be relatively immune from competition, especially when switching costs are high for their customers. Shopify is no different, with nearly two-thirds of revenue coming from subscriptions. The rest comes from "Merchant solutions," which is also recurring in nature.

And here's the best part: customers on average pay only about US$1,000 per year to Shopify. This is not a lot of money for the mission-critical service that Shopify provides. Meanwhile, switching to a competitor would be extremely risky and time-consuming for any customer. So, Shopify's customers are essentially wedded to the company.

Having such a strong base of customers, each of which pay a recurring fee, puts Shopify in a very powerful position. For example, the company could raise prices and almost certainly get away with it. Even raising prices by $100 per year would add an extra $16 million per year in revenue, all of which would fall to the bottom line.

2. Not as unprofitable as you would think

When most companies want to grow, they must make an investment first. For example, a manufacturer may have to build a new factory. A miner may have to build a new mine.

Likewise, technology companies such as Shopify must spend money in order to grow. In this case, the investment would go into sales and marketing. But here there's an important difference: this money gets counted as an expense on financial statements.

This makes Shopify look unprofitable, just because it reinvests all its earnings back into the business. Last year alone, the company spent $46 million on sales and marketing. When excluding that number, Shopify would have made $24 million in profit.

3. The right kind of growth

Shopify spends big money to grow its business. Big deal. Any company can do that. So, how do we know Shopify is getting enough bang for its buck, especially when the company is losing money?

Well, as mentioned, Shopify spent $46 million on sales and marketing last year. And the company added over 60,000 merchants at the same time. So, it cost about $750 to find each new customer. With each customer generating about $600 per year in gross profit, and showing fantastic loyalty, that sounds like a fantastic return on investment.

It's safe to say that Shopify is creating lots of value as it grows (this can't be said for all companies). And with the company growing at 100% per year, that's a lot of value. If the company can keep up this growth rate for just a few years, shareholders should see some fantastic returns.

CATEGORY

1. Investing
2. Tech Stocks

TICKERS GLOBAL

1. NYSE:SHOP (Shopify Inc.)

Category

1. Investing
2. Tech Stocks

Date
2025/07/21
Date Created
2015/06/08
Author
bensinclair