Why I Just Bought Shares of Shopify Inc.

Description

When **Shopify Inc.** (TSX:SH)(NYSE:SHOP) went public in May, it quickly became Canada's hottest technology stock. For that reason, its share price traded at very lofty levels by almost any standard.

As would be expected, there were certainly sceptics. For example, Barrie McKenna of *The Globe and Mail* wrote an article titled "Flocking to high-flying Shopify may just be wishful thinking", in which he said the company could be the next **BlackBerry** or Nortel.

Yet Shopify continued to exceed expectations, posting very strong quarterly numbers in July. Its U.S.-listed shares even reached a high of US$42 in early October, well above its US$25.68 closing price on day one.

Then over the last couple of months, Shopify's stock price declined by 30%, even though the company reported outstanding quarterly results in early November. The shares now trade back around the US$26 mark, which has created a perfect opportunity.

Why have the shares declined?

When Shopify went public, employees were forbidden to sell shares until November 17. This is known as a "lockup period" and is common for companies that begin trading publicly.

So as the lockup period neared its conclusion, investors knew there may be a wave of new sellers. This was not good for the stock price. And those fears turned out to be well founded–on November 17, Shopify's stock price shrank as much as 6.7%, more than four times the average daily trading volume. The shares remain at about that level today.

There is a point to this: Shopify's declining stock price wasn't caused by fundamentals. In other words, the company's prospects are as bright as ever. The only difference is that the shares are more affordable.

How does one value such a stock?

Shopify still does not post a net profit, which makes valuing the company tricky. So why do I think it's undervalued?

Well, to answer that question, it's important to recognize that Shopify's merchants are extremely valuable. On average, Shopify generates more than US$1,000 of revenue per year from each merchant, with gross margins exceeding 50%! Better yet, this revenue number is consistently growing, and the merchants tend to be extremely loyal. So it's not unreasonable to say that each merchant is worth US$5,000 to Shopify.

From there you can do some quick math. Shopify has 200,000 merchants right now. Multiplying that by US$5,000 equals US$1 billion in value. On top of that, Shopify is spending less than US$1,000 on sales and marketing for each new merchant it adds. This creates tremendous value for the company–using these numbers, Shopify has added US$200 million in value through the first three quarters of this year.

All of a sudden, even after deducting some overhead costs, Shopify's US$2.2 billion market value doesn't look so expensive after all.

The upside

There are plenty more growth opportunities for Shopify. It will gain many more customers from a recent agreement with **Amazon**. The company can transition into managing ecommerce for larger merchants through Shopify Plus. And it is always expanding its portfolio of offerings, which should help increase revenue per merchant.

In other words, this stock may look expensive at first, but with so many opportunities for the company, the shares may actually be a bargain. It's a risk I'm willing to take.

CATEGORY

1. Investing
2. Tech Stocks

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