



Shopify Inc.: Up 56%, But Can it Go Higher?

Description

Over the past year, **Shopify Inc.** ([TSX:SHOP](#))([NYSE:SHOP](#)), the software-as-a-service platform for businesses to launch their own e-commerce websites, has appreciated in value 56%. Over the past few months though, it has been trading sideways, leaving investors wondering whether Shopify can go higher or if this is all that's left.

I believe that Shopify is nowhere near its peak for two reasons. First, in its core geographies, it is only targeting about 10 million small- to medium-sized businesses (SMBs) with a \$10 billion total addressable market. The global business is 46 million SMBs with \$46 billion in the total addressable market, so there are a lot of businesses not using Shopify.

Second, the software as a service (SaaS) business is built on subscriptions. Rather than charging a one-time installation fee, SaaS businesses generate revenue each month from their customers. This is useful because the revenue is predictable, but also because it makes your business sticky. The cost (in time) to change to a different provider is greater than the cost you're paying per month, making this platform very lucrative.

And what's fantastic is that it's not just SMBs on the platform. *The Economist*, Budweiser, the Los Angeles Lakers, and other big brands have their e-commerce sites built on Shopify, so it can target both big and small shop owners.

Shopify also has its merchant solutions product line. Rather than having to set up a separate payment provider or manage shipping, customers can do that right through the Shopify platform. While this is low margin, it is directly tied to the amount of goods sold because Shopify gets a cut of the transaction fees as well as the shipping costs. And there is also Shopify Capital, which provides working funds for inventory and then takes the money back over time based on the store's sales.

All in all, Shopify is a complete e-commerce provider that allows shops to get started for as cheap as \$29 and as high as \$179 per month. It offers all of the services a store owner would need to smoothly operate.

But how are the numbers?

Revenue has been consistently increasing over the past few years. In 2015, it had \$205.2 million in revenue—up 95% from 2014. And if we look at Q3 2016 versus Q3 2015, its revenue was \$99.6 million—up 89%. The SaaS model has had incredible monthly recurring revenue. In Q1 2012, its monthly recurring revenue was \$1.1 million. Fast forward to Q3, and it's hitting \$16.3 million. That's an 81% compound annual growth rate.

Another factor is the incredible growth in gross merchandise value. With its merchant solutions product, the more that is sold, the more Shopify makes. In 2014, Shopify store owners sold \$3.8 billion. In 2015, they sold \$7.7 billion. Comparing Q3 2016 to Q3 2015, stores effectively doubled their goods sold to \$3.8 billion.

One final factor is that the cost to run the business is going down. Its operating leverage (the percentage of revenue) in 2012 was 84%. By 2015, that had dropped to 58%. Comparing Q3 2016 to Q3 2015, that operating leverage has dropped from 58% to 55%. The lower this goes, the more profitable Shopify becomes.

And it is definitely showing gross profits. From 2014 to 2015, its gross profit increased by 80% to \$111.1 million. And comparing Q3 2016 to Q3 2015, gross profit increased by 83% from \$28.7 million to \$52.5 million.

The reality is quite simple: Shopify is only targeting about 20% of the total small- to medium-sized business market and has plans to grow. And due to its predictable revenue, it can make smart investments in expanding the platform. While it is up 56%, I believe that there is more room for this stock to grow as it expands around the world.

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