# Shopify Inc. Chooses Dilution Over Debt

## Description

It's been almost two weeks since **Shopify Inc.** (TSX:SHOP)(NYSE:SHOP) sold as many as 6.3 million of its Class A subordinate voting shares to investors at US$91 per share. Including the 15% over-allotment for underwriters, Shopify raised $561.2 million, which it will use to fund further growth.



With interest rates still very low, despite a couple of rate hikes in the past year, investors were right to wonder about the company's plan of action. Since the news, SHOP stock has stalled around the US$90 mark.

**Did it need money?**

Before we debate if an equity offering was the only option for Shopify to raise additional cash, let's examine if it needed additional funds in the first place. As part of its share offering, Shopify increased the maximum amount it could raise in the future from the public by five-fold to US$2.5 billion.

"We're growing quite rapidly," Katie Keita, Shopify's head of investor relations said. "This is a way to ensure we will be able to strengthen our balance sheet to fund various growth initiatives."

Fair enough.

At the end of March, it had just $396 million in cash and is likely to continue losing money for the foreseeable future. Borrowing the money would simply speed up the rate at which it burns through the US$957 million it has on its balance sheet after the offering.

But I still wonder if Shopify needs the money.

In the trailing 12 months ended Q1 2017, Shopify had an operating loss of US$42 million on US$444 million in revenue. That means it's losing US$1 for every US$10.57 in revenue. Growing revenues in Q1 2017 by 75% and annually by almost the same amount, Shopify could lose as much as US$64 million in fiscal 2017.

So, if continues to grow at this rate and doesn't figure out how to stem the losses, it's conceivable that, without this input of equity, it would run out of cash in the next two to three years.

But not in the next 12 months.

A quick look at its quarterly report shows that Shopify generated US$1.3 million in free cash flow in the first quarter — a significant improvement over the same quarter a year earlier when it had negative free cash flow of US$2.1 million.

It's possible existing shareholders got diluted unnecessarily.

**Here's why it's a good thing**

No one likes to have their shares diluted, but in the case of Shopify, it makes sense for a couple of reasons.

The first has to do with Henry Singleton, one of the greatest capital allocators of all time, who used stock and debt like a scrambling quarterback uses his arms and legs to move the ball downfield at will.

Singleton ran an industrial conglomerate called **Teledyne** from 1960, when he co-founded the entrepreneurial company with George Kozmetsky, until 1986.



When Teledyne's stock was expensive, he'd use it to make acquisitions; when it wasn't, and interest rates were reasonable, he'd borrow as much as could to finance the company's growth while also repurchasing its stock when it was cheap.

By almost any metric, Shopify stock isn't cheap. Using it as currency at a time when investors are willing to pay almost anything to own it is a smart move, in my opinion.

It's possible the company believes it has enough cash, but it's planning to make some acquisitions in the next 12-24 months, and having the cash component of any deal ahead of time gives it the ability to move quickly to close an acquisition.

I couldn't tell you what it's looking at, but if it is looking, getting its ducks in a row makes an awful lot of sense to me.

**Bottom line**

As I said earlier, nobody likes to get diluted, but in the case of Shopify, I believe it's the smarter choice over debt.

Five years from now, I can practically guarantee you won't be concerned about how your position was diluted back in 2017.

I might be wrong, but I think this shows Shopify's management is sharper than most. We'll find out soon enough if I'm right or not.

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