Shopify Inc.’s (TSX:SHOP) Shares Are at Risk of Falling

Description

Shopify (TSX:SHOP)(NYSE:SHOP) shares are probably the most brittle shares on the TSX. Downside risk at this point is much higher than the upside potential. The stocks had an amazing run and awarded investors incredibly over the past couple of years, so it is in no way a loser. But at this point, it has run up to the level that any negative news, either towards the market as a whole or the company itself, could result in a significant downswing in the share price.

While I am not forecasting any particular doom scenario, I want to make investors aware of the possibility that this growth stock could be reaching a point of severe fragility. Shopify shareholders should have a strategy in place to mitigate potential losses.

It has few factors to support the share price

The stock currently trades at a huge premium, which makes the share price extremely susceptible to downside moves. Growth stocks in general share this quality. At the moment, Shopify sports a negative trailing price-to-earnings ratio (P/E), essentially meaning it is not making any money. On a forward P/E basis, essentially a guess about its future earnings, the company is expected to trade at a multiple of over 500 times earnings.

To put this in perspective, for most people, a reasonable valuation would be between 10 and 20 times earnings. At the current multiple, investors are paying for future earnings much higher than what is expected today.

Most people look at revenue growth, especially in the absence of earnings, as a metric to justify stock prices. Shopify’s revenue has been impressive, with fourth-quarter revenue reported to have grown by 54% over the same quarter of 2017. Another positive factor was the fact that its recurring revenue, the more stable aspect, grew by 42% to become over a third of total revenue.

These numbers are impressive, supporting the thesis that Shopify is a good and growing business. Shopify also has no debt, which is amazing. But these facts do not necessarily justify the price that investors are paying today. The company will not go broke, but the shares will not stay at nosebleed levels forever.

Protect your holdings

If you made some money on Shopify and still hold the shares, I am not recommending you sell your entire holding. This is a good company; the share price is simply inflated. You should, however, take steps to ensure that you protect your capital as best you can. You can essentially do this in three ways.

1. Create a dividend

Shopify does not pay a dividend, which can make holding the stock a little difficult for many investors, especially during times of volatility. Selling a few shares can give you a capital gain that stands in for a corporate dividend. I try to create a dividend of around 10% each year from my dividendless shares. When the market pulls back, I have the cash to buy more shares and peace of mind that I got money returned to me before the pullback.

2. Take advantage of all your options

Using options to protect your portfolio is another way to ensure you will retain your gains if Shopify's shares start to collapse. Buying protective puts below the share price, say 20% below the current price, can protect your gains. Think of it as insurance on your stock. If the shares fall, you can either choose to exercise the option to sell the shares or sell the option for a profit to mitigate the loss.

3. Do nothing and buy shares if Shopify falls

Shopify should do well over the long term. If the shares fall, you can simply buy more at a reduced price. Personally, I do not have the stomach to watch dividendless growth stocks fall hard and quickly, so I prefer to use one or a combination of the other two strategies to protect my gains.

What's the bottom line?

Shopify is a good company, but there is a severe risk of a downturn. The shares are very expensive and are trading on momentum. Any change in sentiment, towards the economy or towards the company, could result in a sharp fall. If you own the shares, protect your gains now before the likely downturn in price.

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