



Does Shopify (TSX:SHOP) Stock Deserve its Ridiculous Valuation?

Description

Shopify ([TSX:SHOP](#))([NYSE:SHOP](#)) stock is expensive. Shares are priced at 25 times forward sales. For comparison, **Tesla** trades at 1.8 times forward sales. **Facebook** trades at 7.6 times forward sales. Even **Alteryx**, a software company that grew revenues at nearly twice Shopify's pace last year, trades at just 18.8 times forward sales.

Companies that trade at a richer valuation than Shopify are few and far between. But expensive things are often worth it. Since 2015, Shopify shares have returned a whopping 1,167%. The company has grown like a weed, but so has the valuation. That's caused many analysts to sour on the stock, even as they remain highly optimistic about the company's prospects.

Is Shopify stock ready to double or triple again, or has the valuation created a high-risk situation?

It's crazy

Shopify's valuation *is* crazy. Compare it to history, the market overall, or even its industry — Shopify stock is ridiculously expensive. But you could have said that about countless tech stocks over the last decade. Yet despite their sky-high valuations, many of these stocks have made incredible investments. We're not talking 10-15% annual returns. These stocks have returned *thousands* of percent.

So, what's off here? How can expensive stocks outperform the market for years at a time? The issue is simply that the market doesn't know how to value these companies. Modern tech companies are largely [new phenomenon](#).

First, they're asset-light businesses, meaning that very little capital needs to be reinvested to grow rapidly. Compare a software company against a car manufacturer. To build more cars and grow sales, the manufacturer often needs to spend *billions* to upgrade and expand facilities while hiring more employees and sourcing parts and equipment. The software company, however, only needs its customer to connect to the internet and click download. There's often *zero* incremental cost to acquiring a new customer.

Second, these tech businesses are often *platforms*. A platform is exactly what it sounds like — an infrastructure in which other things are built on top. This is hugely powerful. If you built a bunch of houses on top of a single platform of concrete, you couldn't switch platforms without ripping up the entire neighborhood. The same is true of tech platforms, and Shopify is a prime example. When you launch a Shopify store, inventory, shipping, payment processing, customer service, and marketing are all integrated. These services are built *on top* of the Shopify platform. If you switch platforms, you lose your entire business.

Lastly, these companies are often incredibly profitable, even if the financials indicate otherwise. As stated, software platforms like Shopify don't necessarily need to spend any money to acquire a customer. And once the customer is acquired, they're stuck in the system, and thus highly profitable. The key word here is *necessarily*. Just because Shopify can acquire customers for free doesn't mean it can't acquire these customers faster by spending a little money.

In every year since 2014, Shopify has posted an operating loss. But look at gross profit. In 2018, Shopify earned US\$596 million in gross profit off just US\$1.1 billion in sales. That's incredible! Where did the losses come from? Mostly through sales and marketing spending, which accounted for US\$454 million. The point here is that Shopify is incentivized to grow as quickly as possible, and despite the accounting numbers, the underlying business is incredibly strong and profitable. Investors and analysts frequently underappreciate that fact.

What about now?

So, Shopify's valuation is crazy, but that's simply because our idea of what a "crazy" valuation is doesn't fit with how a modern software company scales. There's a point at which any stock becomes overpriced, but Shopify has consistently proven worthy of a sky-high multiple. As its platform grows and solidifies, there are many scenarios in which the company doubles and triples in size yet again. You may be better off searching for the *next* Shopify, but I'm still a fan of the original.

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Date

2025/07/25

Date Created

2019/09/22

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