1 Number That Tells You When to Buy Shopify (TSX:SHOP) Stock

Description

It's been a dramatic year for shareholders. **Shopify** (TSX:SHOP)(NYSE:SHOP) stock has nearly tripled over the first eight months of the year, before collapsing 25%. Currently trading at $400 at writing, the stock price seems range bound as investors brace for the company to report third-quarter results on October 29.

Technology analysts and institutional investors seem divided about the company's prospects. Scott Galloway, a professor at New York University's Stern School of Business, has called the company an **Amazon** (NASDAQ:AMZN) killer, while notorious short-seller Andrew Left of Citron Research has issued a bearish call on the stock.

Depending on your perspective, Shopify is either an unparalleled ecommerce growth story or an overpriced fever dream of growth-hungry investors who missed the boat on Amazon. There's only one way to settle the debate, in my view:

Follow the cash

Tech investors love to use Amazon as an example of a company that spent many decades losing money before ultimately conquering a market and delivering exceptional returns.

Amazon's net margins have always been razor-thin, while founder Jeff Bezos has been focused on expanding operations by launching in new markets, offering a smart speaker and developing an enterprise cloud services division. As a consequence, the company reported a net loss until recently.

Investors assume other hyper-growth companies like Shopify are on a similar trajectory and that their patience will ultimately be rewarded with market dominance and a handsome valuation. However, investors tend to miss the underlying factor that made Amazon so successful: free cash flow.

The Seattle giant hasn't had to raise external funding since the early 2000s, as it's been self-funding its growth through steadily expanding operating cash flows and positive free cash flow since early-2004.

To be successful, Shopify now needs to demonstrate that it can generate free cash flows and sustain its growth without diluting shareholders or issuing more debt. Here's how that's working out:

Shopify's funding

In early September, Shopify announced that it would issue 1.9 million new shares at $317.50 per share to raise about $600 million in funding. Not only is this a sign that the company is still looking for external cash, but it's also an indication that management believes the stock is overvalued, placing the issue price below market.

However, there is some good news for investors. Shopify reported positive free cash flow (FCF) for the first time this year. The company generated $10 million in FCF over the three months ended June 30, 2019, which means the company is getting close to self-funding.

Meanwhile, the company has plenty of cash, low debt and a high growth rate. If it can report another positive cash flow next week, investors can expect a spike in valuation.

At the moment, Shopify stock is trading at 28 times operating cash flow, which is reasonable for a high-growth company in my opinion.

Bottom line

Investors need to pay close attention to Shopify's operating and free cash flows every quarter to figure out if the company can continue expanding without raising more debt or diluting shareholders further.

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