Shopify (SHOP) Stock: Bargain or Trap?

Description

Shopify (TSX:SHOP)(NYSE:SHOP) stock has lost more than a third of its value since November last year. Canada's most successful tech company is now in a bear market, which is why I fulfilled my patriotic duty and added the stock to my portfolio last week.

However, since then, I've been wondering if I made the right decision. Is Shopify a bargain or a falling knife that has much further to plunge? I'm sure plenty of other investors are wondering the same. This is why it's time to take a closer look.

Why is Shopify dropping?

There's no way to pinpoint why a stock moves the way it does. But in Shopify's case, I believe there are two key reasons it is dropping: growth and sentiment.

Let's start with market sentiment. Rising interest rates have made tech stocks with high valuations less appealing. Nearly every growth stock has dipped lower in recent months, and Shopify is part of that basket.

However, Shopify has been more transparent about its outlook than most of its peers. The management team made it clear that the growth rates experienced since the dawn of the pandemic were temporary. Demand for online shopping was "pulled forward." In other words, the growth rate going forward is likely to be significantly lower.

These two factors have already shaved off 35% of Shopify's market value in two months. Now, investors must consider whether future growth rates justify the current valuation.

Outlook

In 2020, revenue expanded 86%. Shopify's management later warned that this was a temporary bump, and that the growth rate would be lower in 2021. We don't have numbers for the whole year, but the third quarter of 2021 seems to be in line with this expectation. Revenue expanded just 46% year over year in this recent quarter.

Going forward, growth could slow even more. Annual revenue in 2022 could be 30-40% higher than 2021. In my opinion, investors should factor in this slower pace of growth for the foreseeable future.

Valuation

At its peak last year, Shopify stock traded at 60 times annual sales, which was a clear indication of overvaluation. At the time of writing, that price-to-sales (P/S) ratio is down to 33. That's higher than most of the stock market and higher than Shopify's long-term average, too. Since going public, Shopify's median P/S ratio is 18. If the ratio reverts to the mean, there could be more downside risk.

That's based on numbers and factors that we know. What we don't know is how Shopify's other growth ventures are likely to perform in the future. For instance, the company has bolstered its payments product in recent years and cemented a deal with **JD.com** that could help it expand in China. Shopify has also launched a crypto Non-Fungible Token platform for merchants that adds another potential catalyst for growth.

If any of these projects deliver on their promise, Shopify's current valuation could seem justified. This is why I'm holding onto the stock and will potentially accumulate more if the price keeps dropping.

Bottom line

Shopify stock is down and could have further to drop. But it's an irresistible growth stock that may never trade at a "bargain," which is why I'm holding onto my stake.

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vraisinghani