Shopify (TSX:SHOP) Is on Sale! Should You Buy?

Description

Shopify Inc (TSX:SHOP)(NYSE:SHOP) went on a substantial dip last week. Falling nearly 10% on Thursday, it went as low as $1,340, the lowest it had been in many months. The move appeared to be related to broader weakness in tech stocks. The NASDAQ got hammered on news that the US Federal Reserve was raising interest rates, and SHOP fell along with its peers.

The latest material news from Shopify itself was positive. On the Black Friday/Cyber Monday weekend, the company grew its GMV by 23% year-over-year. The strong growth showed that the company was still able to thrive with its COVID-19 tailwinds fading.

Shopify, as many readers will know, posted record earnings in 2020 thanks to the COVID-19 pandemic. The pandemic-induced retail closures led to an increase in online shopping, which helped SHOP achieve 86% revenue growth for 2020. The company also achieved positive earnings and operating cash flow for the year. After Shopify's record-breaking 2020, many doubted that the momentum would continue into 2021. Revenue growth was so strong that year that many questioned whether the company could continue to grow from such a strong base. In 2021, Shopify proved the naysayers wrong. While its growth decelerated compared to 2020, it was still above average.

With the record Black Friday numbers in the bag, it looks like SHOP will deliver strong growth for the fourth quarter as well. In this article, I will explore whether the stock is still a buy, based on its recent pullback and expected Q4 earnings.

Valuation

The most obvious implication of SHOP's recent pullback is its impact on the stock's valuation. When a stock dips 37%, it gets cheaper, not only in dollar terms but relative to underlying earnings. Thanks to the stock falling about so far from its highs, it is now much cheaper relative to fundamentals than it was before. Some highlight valuation numbers for SHOP include:

- Price-to-earnings based on GAAP earnings: 40
- Price-to-earnings based on adjusted earnings: 166

- Price-to-sales: 32
- Price-to-book: 12

These are much lower multiples than Shopify had for much of its history. In the years following its IPO, it was not at all uncommon for the stock to trade at 50 or 60 times sales. Today, it trades at a lower multiple to GAAP earnings! So we're seeing the valuation of Shopify come down a lot. The question is, why?

Why SHOP is falling

While it's impossible to say what every investor who sells a given stock is thinking, it appears that Shopify's selloff is related to three developments:

1. Sector-wide weakness
2. Rising interest rates
3. Deceleration

Factors one and two are related. The Fed is set to raise interest rates this year, and that's taking a bite out of gains throughout the tech sector. The higher a company's earnings growth, the more an interest rate hike eats into its discounted cash flow valuation. Shopify has extraordinarily high growth in both revenue and earnings, so its present value is negatively impacted by interest rate hikes.

Factor three is a concern no matter what the interest rate is. When a company's rate of growth slows, it becomes less valuable than it would have been had the growth been maintained. Analysts have already adjusted their earnings per share estimates to reflect deceleration, but with growth stocks as a whole selling off, Shopify may have a harder time maintaining its valuation even if it's in line on earnings.

Why I sold

Before concluding this article, I should make one last comment:

I actually bought Shopify last week, only to sell it a couple days later. My reasoning was that, although Shopify is a strong company, its slowing growth means that it's still expensive even after the pullback. There are definitely prices at which I'd become interested in this stock again. But I'd want to see sub-$1,000 before I'd be really eager to buy back in.

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