

Tom's Recommendation: Shopify

Tom Gardner | July 15, 2016 | [Buy Recommendation](#)

CURRENT PRICE: [SHOP](#) \$ 918.32 \$ 13.51 (1.5%) ČwàG! Ýr B~ŠÖG'AMAAQAL IN ù

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Those of you who have boxes of online purchases piling up on your doorsteps may be surprised to hear that e-commerce accounted for only 7.8% of total U.S. retail sales in the first quarter of 2016, according to the U.S. Census Bureau. But online sales growth is in the high teens year over year, even as the overall market increases. My team's recommendation this month, e-commerce platform provider

Shopify ([NYSE: SHOP](#)), allows merchants to capitalize on this trend by providing a one-stop shop for all aspects of a business's commerce operations — desktop, mobile, and social media storefronts, and even physical retail transactions — all for a low monthly fee. And it's been so successful that **Amazon.com** ([NASDAQ: AMZN](#)) bowed out of a similar line of business and instead formed a relationship with Shopify.

From Snowboards to SaaS

Shopify was founded by snowboarder and programmer Tobias Lütke in 2004, when Lütke and a friend were trying to start an online business to sell high-end snowboards. But Lütke found that the available e-commerce software was useless, so he built his own. From that new software platform (with roots in an obscure Japanese programming language), Lütke created Shopify, which turned out to be a much better business than selling snowboards. He still owns more than 10% of common shares outstanding, aligning his interests with ours as shareholders.

Today, Shopify provides the e-commerce backbone to 275,000 stores, fortified by more than 1,000 mostly third-party apps that let store managers customize the online experience they want their shoppers to have. It's an extremely flexible cloud-based platform,

WHAT IT DOES

Shopify is a Canadian software-as-a-service (SaaS) company that operates Web, mobile, social media, and point-of-sale commerce transactions for merchants for a monthly fee.

WHY BUY

- Shopify's opportunity is increasing as e-commerce expands within the growing retail industry.
- Founder, chairman, and CEO Tobias Lütke exhibits visionary leadership and owns 10% of shares.
- As Shopify gains recognition, its expenses should decrease while margins remain high, leading to profitability and earnings.

KEY FACTS

- **Headquarters:** Ottawa, Ontario
- **Website:** [www.shopify.com](#)
- **Recent Price:** \$32.49
- **Risk Rating:** 9 out of 25 — Jawbreaker
- **Position in Industry:** Entrepreneur's Partner
- **Market Cap:** \$2,743

for which Shopify charges monthly subscription fees ranging from \$9 to \$299, plus a cut of the transactions. Shopify links social media to mobile and physical stores to provide a multichannel integrated solution.

Small businesses are Shopify's bread and butter, but the company also counts global brands like Google parent **Alphabet** ([NASDAQ: GOOG](#)), **Tesla Motors** ([NASDAQ: TSLA](#)), and the L.A. Lakers among its clients through its Shopify Plus product (which runs up to \$5,000 per month). Shopify CFO Norman Jones estimates the total addressable market to be even larger, at 46 million companies.

Shredding the Market

The adaptability of Shopify's software solutions has powered the company's explosive growth. Gross merchandise volume has increased from \$1.6 billion (with 84,000 merchants) in 2013 to \$3.8 billion (with 144,700 merchants) in 2014 to \$7.7 billion (with 243,500 merchants) in 2015. If Shopify achieves the low end of management's full-year 2016 revenue guidance of \$337 million, it will ring up a whopping 94% four-year CAGR.

Although Shopify is generating a net loss, its \$190 million in cash, no debt, and positive operating cash flow suggest that it's off to a great start. With a nearly 79% gross margin on its subscriptions revenue and about 25% gross margin (although highly variable) in Merchant Solutions — payments, shipping, and more — Shopify delivers positive operating cash flow with low capital needs. And we expect it to become more profitable as it grows. After all, the company will be able to spread its marketing and development costs across a larger group of customers. Rapid sales growth paired with margin improvement — a combo we love — has potential to catapult earnings and the stock price.

Risks and When We'd Sell

Anytime a new venture meets with success, competitors appear overnight. Shopify is no different, with BigCommerce, Woo, Wix, and others trying to elbow in on the fast-growing e-commerce market. But Shopify's products seem to win out, with rave reviews and consistent No. 1 ratings. The company's ability to attract merchants, keep its subscribers, and incrementally increase its relationships with its customers are key here, so if retention or Shopify's strong standing eroded, we might look elsewhere.

The market's valuation of Shopify bakes in high expectations for growth, and because the company is not yet profitable, this means investors need to be ready for a bumpy ride. With its leading position in a huge and growing industry, Shopify seems well able to continue meeting high expectations, but if any of its key metrics faltered, we'd consider emptying our carts.

Finally, as with any software company that processes payments, potential security breaches pose a huge risk. If a software glitch or malicious attack disrupted business for Shopify's customers, they could leave the service or be hurt badly enough to be unable to stay in business. Shopify works hard to stay ahead of hackers and other security threats, but if the worst happens, we'd want to think carefully about whether to check out.

The Foolish Bottom Line

Shopify's business has been nearly doubling or more than doubling each year for the past few years, and with millions of merchants out there looking for better ways to manage their online business, the market opportunity is huge. With its founder-led culture, innovative and flexible product line, and market leadership, Shopify offers investors great potential bang for their buck. We recommend adding Shopify to your portfolio today.

- **Cash/Debt:** \$189.5 / \$0
 - **Revenue ('14/'15/TTM):** \$105 / \$205 / \$241
 - **Earnings ('14/'15/TTM):** (\$22.3) / (\$18.8) / (\$23.2)
 - **Insider Ownership:** 16%
 - **Biggest Threat:** Security breaches wreak havoc on the company's business.

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