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“Shopping” for a good deal?

It doesn’t seem that long ago, when it seemed we had a new leader in town. In the aftermath of the peak hysteria of Covid in March 2020, Canadian based “E-commerce” leader Shopify Inc. was taking the market by storm. The company was in the figurative right spot at the right time when the world of business overnight was closed to in-person visitation. Businesses worldwide had to shift gears and figure out in rapid fashion how to continue operating in an internet-only based world. Shopify, which operates a “cloud”-based commerce internet platform designed for small and medium sized businesses, helps these businesses promote themselves and execute sales using the “web”, tablet and mobile storefronts, social media storefronts, as well as more traditional “brick-and-mortar” and “pop-up” shops. They allow merchants to manage products and inventory, process orders and payments, build customer relationships and leverage analytics and reporting. In a year in which interpersonal face-to-face relationships were an impossibility, could you ask for a better business solution? The company “went public” with its “IPO” (Initial Public Offering) in May 2015 at $USD17 (or $1.70 post its 10 for 1 stock split). Understandably, with the challenges businesses faced in a Covid-world, the company’s revenues soared. Its stock caught the imagination of retail investors and they drove up its price by November 2021 to $US169 (taking into account the 10 for 1 “stock split”). It rose a massive 166% in 2020, and another 25% in 2021. At its peak valuation, Shopify’s shares (with a value of $CAD121.3 billion) displaced Royal Bank of Canada, with its value of $120.5 billion, as “Canada’s most valuable company.”

The last three companies that beat out Royal Bank for the title of “Canada’s most valuable company” had a terrible final chapter to their “success” story. The most recent was drug maker Valeant Pharmaceuticals International Inc. (formerly “Biovail”) in July 2015. Shortly after achieving this dubious title, the stock plummeted under the controversy as to its business practices, accounting and drug pricing. The company later changed both its management and its name to Bausch Health Company. Prior to that debacle was of course Canada’s previous two Canadian high-tech “phenomes” in Nortel Networks (in 2000) and Research in Motion (later named Blackberry), the inventor of the smart phone, which briefly surpassed Royal Bank in 2007 until it took on mighty Apple’s iPhone in 2008. Nortel filed for bankruptcy in 2009 and while Blackberry is still in existence, it’s stock is worth a pittance of its former glory, trading at $7.80 versus its peak of over $125 in early 2008, giving new meaning to the expression “the bigger they are the harder they fall”.

In my newsletter for July 2020 entitled, “Benchmarking to the index?”, I tried to explain why using the stock market indices to benchmark (judge) the performance of one’s own portfolio often makes no sense, despite the media’s constant focus on index performance. When the stock in a company founded within six years can be worth more, on several hundred million dollars of net profits, than a company incorporated in 1896 producing about $4 billion of net profits per year on a diversified base of business operations, it is no wonder a stock market index can get massively skewed and create a “FOMO” attitude in investors. This “Fear of Missing Out” can drive people to assume risk and “invest” in areas that go beyond logic to the extent

that this behavior can no longer be called investing. At its peak, Shopify's P/E (price over earnings) ratio was **698**. In late July 2022, after a plunge of **over 70%** so far in 2022, this traditional valuation metric for Shopify is "only" **269**. In contrast, Royal Bank's P/E ratio is currently **10**. At current prices that means for every dollar of actual net earnings, investors are willing to pay $10 in the case of Royal Bank and $269 for Shopify. There is no doubt that as a high-tech company with little physical infrastructure or inventory and few employees hampering profits, Shopify could command a higher P/E ratio than Royal Bank. It's growth rate and its potential growth rate going forward are much higher than that of "old stodgy" Royal Bank, but at some point there has to be a limit to this differential, and its current valuation at 269 times earnings is in the realm of pure fantasy. At its former P/E ratio of 698, an investor in Shopify's stock is banking (excuse the pun) on a growth rate of literally astronomical proportions that is mathematically impossible to maintain – in plain language this means the stock has nowhere to go but down, way, way down. To buy the stock at that valuation one has to subscribe to the "greater fool theory", wherein a buyer can only hope that a greater fool than themselves will buy the stock from them in order for them to make a profit.

Whether Shopify's stock goes the direction of its predecessors only time will tell. In the meantime, consider that to get to $4 billion a year in net earnings it took Royal Bank many, many decades as a public company. Contrast that longevity and that focus on achieving long-term profits, which resulted in such success, with the recent comments of Shopify's CEO after the company reported terrible results in their latest quarterly earnings in July 2022. In his memo, CEO Tobi Lutke noted that his company made a "**bet**" that the pivot to e-commerce in the face of Covid, would "permanently leap ahead by five or even 10 years. It's now clear that **bet** didn't pay off." While to an outsider it seemed self-evident that Covid was a one-time phenomenon, Lutke, perhaps caught up in the hype of his own success, commented that, "What we see now is the [business] mix reverting to roughly where pre-Covid data would have suggested it should be at this point." In other words, if our peak valuation seemed too good to be true, it was…

Bottom line

This market has been a challenging one for investors with the all-pervasive "noise" of economic statistics (inflation, oil prices, housing and labour numbers), and geo-political events (like the Russian invasion of the Ukraine). The real challenge however is to ignore this "noise" and to continue to focus on the only numbers that really count – one's personal "long-term" financial planning or wealth building goals. In this context, while "betting" on a "sure thing" investment in an exciting company that captures one's imagination can seem like a much better way to build wealth than the drudgery of building wealth one day, one year and one decade at a time, history says otherwise.

Global benchmarks
As at July 31, 2022 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	-5.7%	-0.2%	9.5%
S&P 500 TR - **US$**	-12.6%	-4.6%	13.4%
NASDAQ Composite - **US$**	-20.8%	-15.6%	14.9%
MSCI Europe Index Price Return	-17.5%	-15.2%	0.1%
MSCI Emerging Markets	-18.3%	-20.2%	-2.4%
China S.E Shanghai A Price Return	-14.7%	-5.9%	3.2%
MSCI World Index Price Return	-13.9%	-8.2%	6.8%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - **US$**	-20.0%	-19.6%	-1.8%
10-year U.S. T-Bond - **US$**	-8.6%	-10.5%	-0.6%
Long GOC Bond (2053)	-20.3%	-18.2%	-6.3%
10-year GOC Bond	-8.3%	-9.2%	-1.5%
5-year GOC Bond	-4.8%	-6.0%	-0.3%
3-month CDN T-bill	0.2%	0.2%	0.6%
US$/CDN$ (1.2793)	1.3%	2.6%	-1.0%

Source: RBC Capital Markets Quantitative Research

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