PALOS

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Weekly Commentary

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By Charles Marleau CIM® and William Mitchell CIM®

Back to Basics for Shopify

Last Thursday, **Shopify Inc. (SHOP: TSX,NYSE)** reported strong Q1 results prior to the opening of the markets. Gross Merchandise Volume (GMV), which represents the total net value of orders processed, was US$50 billion for the first quarter showing an increase of 15% year-over-year (y-o-y) or 18% on a constant currency basis. First-quarter revenue was $1.5 billion, up 25% y-o-y or 27% on a constant currency basis. A resilient consumer and strength in Europe were key drivers.

Although performance exceeded analysts' expectations, the bigger story was the organizational changes being implemented by management. First, Shopify announced an agreement to sell its logistics and fulfillment business to San Francisco based **Flexport** (private). Flexport is an end-to-end shipping company with expertise in transportation, goods insurance, cross-border clearing, and cargo tracking. Moving forward, Flexport will become the official logistics partner and Shopify will receive a 13% equity interest in addition to the current ownership share. The agreement includes most of the Shopify Fulfillment Network (SFN) platform and **Deliverr**, a fulfillment start-up company that Shopify acquired for US$2.1 billion (cash and stock) last July. The SFN app will continue to be offered to Shopify merchants.

The second major announcement was the planned reduction of approximately 20% of Shopify's workforce. Some employees will be moved to Flexport. On the earnings call, CFO Jeff Hoffmeister remarked that while the decision to reduce the number of employees was "extremely difficult", the change would enable the company to quickly attain its "ideal shape and size" and to build on current "momentum". The changes will allow Shopify to focus on the "highest impact" areas of the business which include finding new opportunities and providing greater value to merchants.

Also, during the earnings call, company President Harley Finkelstein highlighted the accomplishments of three "core focus" areas: expanding from "first sale" to "full scale", going global, and expanding customer "relationships". The first of the core three will strive to expand awareness of the cutting-edge e-commerce solutions being used by existing customers. To this end, Shopify signed agreements with IBM Consulting and Cognizant to grow the merchant base and expand the offering. Ramping to "full scale" will require infrastructure and the ability to "handle massive traffic volumes". Q1 saw a record set with the highest throughput flash sale in company history.

Regarding the "global" initiative, action is being taken to drive greater cross-border penetration by making it easier for merchants to transact internationally. Shopify's **Markets Pro**, currently in the early stages of development, will allow merchants to navigate tax-compliance, weigh international shipping options and arrange for the prepayment of duties. The product is expected to roll out this summer in the U.S. and in the U.K. later in the year. The third core area will

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target the building of consumer relationships that will empower brands to enhance customer relationships using Shopify's full suite of e-commerce solutions which include the **Shop App** (online shopping), **Shop Pay** (checkout solutions) and **Audiences** (target advertising). Audiences allow **Shopify Plus** merchant access to machine-learning algorithms designed to improve results across social media platforms like Google and Facebook.

While management expects free cash flow to remain positive in subsequent quarters and GMV growth for Q2 to be similar to Q1, severance related to workforce cuts is expected to trim US$140 to $150 million and an impairment charge between $1 billion to $1.5 billion is expected in relation to the logistics sale. On the flip side, capital expenditures and payroll will be significantly lower moving forward. So, while Q2 will not be a "normalized quarter", Mr. Finkelstein stated that today's version of Shopify is the "most optimistic" and "most focused" and that opportunities for the future are "massive".

Investors obviously liked the results as well as the post-earnings call. Shares jumped 23.4% during Thursday's session on the TSX and added an additional 6.8% on Friday. SHOP shares are currently up 76.4% for 2023 which follows a bear market tumble of 72.9% in 2022. Numerous analysts on both Wall Street and Bay Street raised their price targets and earnings guidance following the positive news. **The Palos Equity Income Fund**, the **Palos Income Fund LP** and the **Palos-Mitchell Alpha Fund** are currently invested in SHOP.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.54	6.01%
Palos Equity Income Fund - RRSP	PAL101	$6.81	5.07%
Palos WP Growth Fund - RRSP	PAL213	$12.57	0.89%
Palos-Mitchell Alpha Fund [3]	PAL300	$9.04	13.75%
S&P TSX Composite (Total Return with dividends reinvested)			7.11%
S&P 500 (Total Return with dividends reinvested)			8.31%
S&P TSX Venture (Total Return with dividends reinvested)			7.98%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			3.44%
Canadian Government 10-Year			2.91%
Crude Oil Spot			US $71.34
Gold Spot			US $2,024.80
US Gov't10-Year/Moody BAA Corp. Spread			223 bps
USD/CAD Exchange Rate Spot			US $0.7477

[1] *Period ending May 5th, 2023. Data extracted from Bloomberg*
[2] *Fund is priced annually*
[3] *Fund is priced weekly on Tuesdays*

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Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca