

The Quality Of New Shopify Merchants Is Significantly Deteriorating

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We had a lot of success with our initial [Shopify report](#) and we believe we significantly advanced the short case, initially put forward by [Citron Research](#). We provided hard data to back up claims about customer churn and added much more. Since we published the initial report we have uncovered something worthwhile for a follow up report. Very worthwhile.

We believe we have found evidence that clearly shows the quality of Shopify new customer adds is significantly deteriorating and the most recently acquired cohorts of customers will show much larger churn and shorter customer lifetimes. This will catch up with Shopify very soon and will have a very serious detrimental effect on growth in its Subscription solutions segment and its sky-high valuation currently sitting at \$17.5 billion as of July 16.

In our initial report we described how Shopify caught the Wall Street bug and became completely addicted to its constantly rising valuation attained because of its hypergrowth (almost 1,000% return since [IPO](#)). This hypergrowth was made possible by Shopify significantly expanding its total addressable market by pitching its solution as a make money online scheme (an easy way to make money online with little effort – by becoming a drop shipper and peddling items from AliExpress.com with a 5x markup) as opposed to targeting standard online merchants. Shopify's massive revenue growth was/is heavily reliant on acquiring very large amounts of low quality customers that have very short customer lifetimes, as our previous research has shown (Shopify doesn't disclose customer churn numbers, for good reason). For Wall Street to take the bait, Shopify had to/has to keep on increasing the number of new customer additions, otherwise the huge churn of its customer base would catch up with them and Wall Street would instantly realize this is no standard SaaS business with 5-10-year customer lifetimes.

We believe Shopify has reached a point where its race to add more and more new customers is becoming increasingly more difficult, more expensive and what is most important, the quality of the newly added merchants is significantly deteriorating in comparison to the quality of merchants signed up in prior quarters.

How have we come to this conclusion?

In our initial report we came up with a very novel approach to analyze Shopify churn by analyzing the [.com zone file](#), essentially a list of all active domains (with information where they are pointing) in the .com universe. We identified all domains hosted by Shopify and analyzed domains that churned off or were added to Shopify. This is how we were able to make conclusions on Shopify customer churn rates and customer lifetimes.

After the publishing of our initial report we stumbled onto something very interesting. We were taking a look at where the domains hosted by Shopify are registered (all domains have to be registered at domain registrars, GoDaddy being the most notable example). As of July 7. 2018 there was a total of 778,511 .com domains hosted by Shopify. This is how they were split between registrars:

Tucows	246087	31,61%
GoDaddy	322139	41,38%
Namecheap	47051	6,04%

Other	163234	20,97%
Total	778511	100,00%

GoDaddy, Tucows and Namecheap is where over 79% of all .com domains hosted by Shopify are registered. We will focus our analysis on these three registrars. The *Other* category encompasses all the remaining registrars in the world. The largest in the *Other* category were Google, 1&1 Internet, Network Solutions, Public Domain Registry, and eNom.

Through our tests we found out that when somebody sets up a store at Shopify and doesn't have a domain name and wishes to register one through Shopify.com, Shopify registers this domain name through Tucows. Shopify is a Tucows domain reseller (it outsources domain registration to Tucows).

For some reason we then thought it might be a good idea to see if customer churn differs by registrar. It did. Significantly.

By observing changes in domains hosted by Shopify on a day to day basis we counted the number of unique domains that cease to be hosted by Shopify (i.e. churn off) by registrar across a 27-day period. These were the results:

Date	Registrar	Domains Lost	Date	Registrar	Domains Lost
2018-06-10	tucows	363	2018-06-24	tucows	493
2018-06-10	godaddy	234	2018-06-24	godaddy	209
2018-06-10	namecheap	31	2018-06-24	namecheap	56
2018-06-10	other	109	2018-06-24	other	154
2018-06-11	tucows	960	2018-06-25	tucows	500
2018-06-11	godaddy	514	2018-06-25	godaddy	253
2018-06-11	namecheap	89	2018-06-25	namecheap	66
2018-06-11	other	251	2018-06-25	other	131
2018-06-12	tucows	669	2018-06-26	tucows	571
2018-06-12	godaddy	96	2018-06-26	godaddy	289
2018-06-12	namecheap	35	2018-06-26	namecheap	53
2018-06-12	other	104	2018-06-26	other	175
2018-06-13	tucows	770	2018-06-27	tucows	490
2018-06-13	godaddy	532	2018-06-27	godaddy	289
2018-06-13	namecheap	97	2018-06-27	namecheap	66
2018-06-13	other	251	2018-06-27	other	165
2018-06-14	tucows	1009	2018-06-28	tucows	534
2018-06-14	godaddy	144	2018-06-28	godaddy	297
2018-06-14	namecheap	60	2018-06-28	namecheap	70
2018-06-14	other	178	2018-06-28	other	197
2018-06-15	tucows	558	2018-06-29	tucows	559
2018-06-15	godaddy	259	2018-06-29	godaddy	300
2018-06-15	namecheap	85	2018-06-29	namecheap	74
2018-06-15	other	249	2018-06-29	other	219
2018-06-16	tucows	417	2018-06-30	tucows	536
2018-06-16	godaddy	187	2018-06-30	godaddy	259
2018-06-16	namecheap	47	2018-06-30	namecheap	79
2018-06-16	other	124	2018-06-30	other	194
2018-06-17	tucows	523	2018-07-01	tucows	494
2018-06-17	godaddy	273	2018-07-01	godaddy	224
2018-06-17	namecheap	71	2018-07-01	namecheap	54
2018-06-17	other	203	2018-07-01	other	169
2018-06-18	tucows	352	2018-07-02	tucows	No Data
2018-06-18	godaddy	168	2018-07-02	godaddy	No Data
2018-06-18	namecheap	38	2018-07-02	namecheap	No Data
2018-06-18	other	81	2018-07-02	other	No Data
2018-06-19	tucows	565	2018-07-03	tucows	307
2018-06-19	godaddy	288	2018-07-03	godaddy	139
2018-06-19	namecheap	67	2018-07-03	namecheap	27
2018-06-19	other	178	2018-07-03	other	80
2018-06-20	tucows	557	2018-07-04	tucows	560
2018-06-20	godaddy	291	2018-07-04	godaddy	295
2018-06-20	namecheap	68	2018-07-04	namecheap	81
2018-06-20	other	212	2018-07-04	other	174
2018-06-21	tucows	511	2018-07-05	tucows	508
2018-06-21	godaddy	307	2018-07-05	godaddy	308
2018-06-21	namecheap	85	2018-07-05	namecheap	68
2018-06-21	other	206	2018-07-05	other	178
2018-06-22	tucows	537	2018-07-06	tucows	492
2018-06-22	godaddy	294	2018-07-06	godaddy	260
2018-06-22	namecheap	81	2018-07-06	namecheap	71
2018-06-22	other	199	2018-07-06	other	189
2018-06-23	tucows	529	2018-07-07	tucows	544
2018-06-23	godaddy	257	2018-07-07	godaddy	298
2018-06-23	namecheap	89	2018-07-07	namecheap	95
2018-06-23	other	184	2018-07-07	other	205

The average number of domains per day churning off by registrar was as follows:

Tucows	552
GoDaddy	269
Namecheap	67
Other	176
Total	1064

Now, we obviously have to take into account the total number of domains hosted by each registrar in combination with the number of domains churning off to determine the churn rate per registrar. We divide the total number of domains per registrar by the average number of domains churning off per day to get a Days To Churn number. Days To Churn is a hypothetical number that shows how long it would take for all domains to churn off if no new domains would be added to Shopify. Here are the results:

Registrar	Total Domains	Domains Churning/Day	Days To Churn
Tucows	246,087	552	446
GoDaddy	322,139	269	1,198
Namecheap	47,051	67	702
Other	163,234	176	927

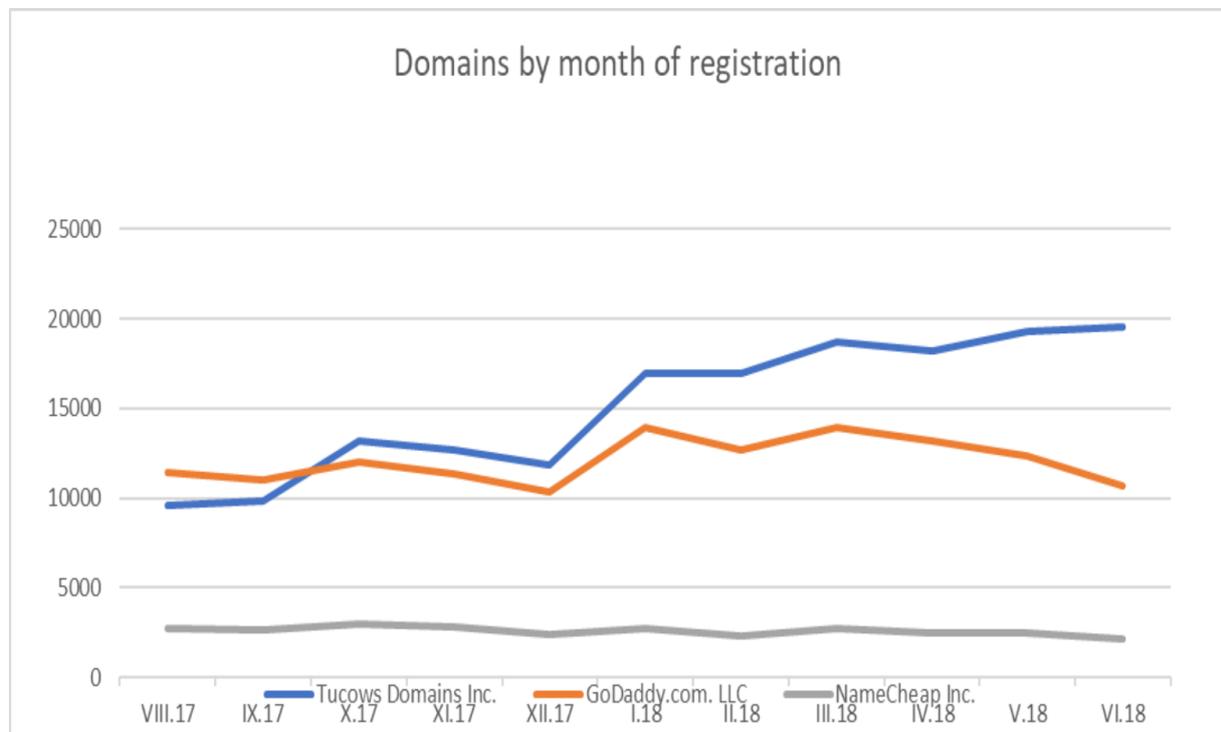
As you can see the churn is massively worse for domains registered with Tucows than with GoDaddy, Other registrars and Namecheap. When comparing Tucows to GoDaddy, Tucows domains have a **2.68x** larger churn rate. In comparison to Other domain registrars, Tucows is **2.07x** worse. In comparison to Namecheap, Tucows is 1.57x worse.

How is it possible that the domains registered at Tucows churn so much worse? We think that the people registering domains through Shopify.com (=Tucows) are very different to the people registering domains through GoDaddy, Namecheap or *Other* registrars.

Our belief is that the people registering domains via the Shopify website (=Tucows) are much more likely to be of the sort that have been driven there with a promise of becoming rich in drop shipping by one of Shopify's affiliate partners or by Shopify's own marketing targeting these individuals. Often, it's also the first domain they have registered in their life. On the contrary, we think that people registering their domain with GoDaddy, NameCheap or *Other* registrars have a higher likelihood of actually being a serious merchant, already having an existing business, having more technical skills, probably having more experience with running a website etc. This determines their higher quality (much less likely to churn, longer customer lifetime). The explanation why NameCheap comes relatively closest to Tucows we believe is that it is a discount registrar and that determines the quality of merchants with domains registered there (smaller percentage of businesses etc.)

An obvious next step in our investigation was to analyze changes in the number of new registrations (that started being hosted by Shopify) at each domain registrar over time. We did this by looking at all domains currently hosted by Shopify that were 1 year or younger, as per their registration date,

and grouping them by their month of registration. We looked at domains registered for the date range July 7, 2017 to July 7, 2018. A chart is worth a thousand words:



As you can see, up to September 2017 there were more domains being registered at GoDaddy than at Tucows that were hosted by Shopify. But from October 2017 onwards Tucows overtakes GoDaddy. Starting from January 2017 the numbers being registered at Tucows start massively accelerating.

This is the basis for our argument that the quality of newly signed up Shopify merchants is significantly deteriorating because the registrar mix is massively tilting in favor to Tucows. We know customer churn is significantly higher at Tucows than at other registrars. This will come to haunt Shopify in future quarters when the churn of these very low-quality customers starts catching up.

We believe Shopify management made a conscious decision to seriously step up marketing spend in the beginning of 2018 to try to keep showing large topline growth in subscription solutions revenue (the most coveted type of revenue with high gross margin) because its growth in this revenue segment was showing signs of deceleration. Even after significantly increasing the number of new domains that Shopify began newly hosting in Q1 in comparison to Q4, y-o-y subscription revenue still managed to decelerate 6 percentage points from 67% in [Q4 2017](#) to 61% in [Q1 2018](#). Sales & marketing spend as a percentage of Subscription solutions revenue on the other hand increased from 71.52% in Q4 to 75.63% in Q1 2018! We expect this revenue deceleration to continue in coming quarters with marketing spend staying very high.

We even think that Shopify may be hitting a limit on the number of new domains that it can add, at least in the .com universe. Here is the breakdown of 1 year and younger .com domains hosted by

Shopify split by the month of their registration (we include only 11 full months since our data set is for July 7. 2017 to July 7. 2018):

Registrar	VIII.17	IX.17	X.17	XI.17	XII.17	I.18	II.18	III.18	IV.18	V.18	VI.18
Tucows Domains Inc.	9626	9879	13204	12727	11838	16991	16915	18682	18220	19301	19586
GoDaddy.com. LLC	11439	10995	12000	11336	10333	13934	12699	13958	13223	12326	10700
NameCheap Inc.	2737	2668	2950	2803	2448	2752	2337	2708	2477	2492	2150
Google Inc.	1096	1085	1218	1183	1129	1438	1289	1337	1341	1364	1131
PDR	624	490	635	734	817	1057	1212	1174	951	987	621
1&1 Internet SE	578	593	720	668	611	789	751	756	618	587	538
eNom. Inc.	212	151	208	131	130	225	205	369	398	385	310
Name.com. Inc.	283	247	267	260	164	208	180	207	205	160	167
NameSilo. LLC	168	157	155	183	132	198	224	249	267	272	231
FastDomain. Inc.	222	207	228	224	179	233	181	192	181	174	111
Total	26985	26472	31585	30249	27781	37825	35993	39632	37881	38048	35545
Tucows share of total	36%	37%	42%	42%	43%	45%	47%	47%	48%	51%	55%
Total doma per quarter					89615			113450			111474

As you can see, the total number is actually slightly smaller in Q2 2017 than in Q1 2017 – 113,450 domains to 111,474. The customer quality continues to deteriorate with Tucows share hitting a record of 55% in June 2018. Compare that to 36% in August 2017.

At the same time sales & marketing spend as percentage of subscription solutions revenue has been edging up:

	Q1 2018	Q4 2017	Q3 2017	Q2 2017	Q1 2017	Q4 2016	Q3 2016	Q2 2016
Subscription revenue	100,198	93,918	82,435	71,598	62,080	56,387	49,839	43,674
Sales & marketing	75,784	67,174	58,314	54,872	45,334	39,016	32,777	29,413
%	75.63%	71.52%	70.74%	76.64%	73.03%	69.19%	65.77%	67.35%

Expressed in US \$000's

It's also pretty obvious that buying this marginal growth is becoming very expensive as diminishing returns of marketing and churn of the customer base are kicking in. For example, the absolute gain of subscription solutions revenue from Q4 2016 to Q1 2017 is pretty similar to the gain from Q4 2017 to Q1 2018: \$5,693 to \$6,280. But sales & marketing spend was incomparable: \$75,784 in Q1 2018 compared to \$45,334 in Q1 2017! Yet, Wall Street doesn't seem to care. Yet.

We believe our research of the .com zone file clearly shows that the quality of newly acquired Shopify merchants is significantly deteriorating. Shopify is doing whatever it can to keep showing steep growth in its Subscription solutions segment at all cost, because growth in this segment is significantly decelerating (6 percentage points between Q4 and Q1) as opposed to Merchant solutions revenue, which is not. This is very important because Subscription solutions revenue carries a high gross margin (76.9% in Q1 2018) in comparison to Merchant solutions (41% in Q1 2018). Shopify is resorting to acquiring increasingly larger numbers of customers we wouldn't be ashamed of classing as junk, just to fuel its addiction of a constantly rising share price. Our research also shows that acquiring new customers is becoming increasingly costlier with sales & marketing spend as a percentage of subscription revenue edging higher over the last 8 quarters.

We think that Shopify is in the final innings of its game with Wall Street. This is what happens when your growth is based on steroids – they come to collect their dues. Subscription revenue is set to

decelerate further even with sales and marketing spending staying stubbornly high. It will become increasingly obvious Shopify will never be able to show any significant operating leverage and become wildly profitable, unless it turns itself into a pay day lender (Shopify Capital tripled its outstanding merchant cash advances in Q1 2018 y-o-y to \$60.4 million) making loans with 30-50% APRs. Even if it does, we still don't think investors would be willing to value this kind of revenue at 16.5x 2018 expected revenue, which is the revenue multiple Shopify is trading at as of July 16. (Source: Bloomberg).

Our 1-year price target is **\$60-65**. 60%+ downside.

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