A Loan Bear Warns Dollarama's Glory May Be Fading

David Milstead, Globe and Mail
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Companies command a premium valuation when they record industry-leading growth and ring up a series of positive earnings surprises. That is, they do until they don't – inevitably, top-line expansion starts to slow, profits fall back into line and valuations fall back to more normal levels.

Where's the bear?

Is Dollarama, (DOL-T32.49-0.26-0.79%) perhaps the most popular stock in the Canadian retail sector, in imminent danger of falling into the latter category from the former?

Heavens, no, say the bulk of the Bay Street analysts following the company. Dollarama is "a best-in-class retailer," says TD Securities Inc.'s Jessy Hayem, with a "well-deserved premium valuation." It is "one of the few proven and consistent organic growth stocks in Canadian retailing," says Desjardins Securities' Keith Howlett. Perry Caicco of CIBC World Markets agrees: "There is no stopping" Dollarama.

One analyst, ***Veritas Corp.'s Kathleen Wong***, is sounding a discordant note, however. She's looking at Dollarama's sales figures and seeing signs of slowing – a phenomenon she says will only get worse as the company's competition grows.

As a result, she slapped a "sell" rating on Dollarama earlier this year.

Is Ms. Wong just plain wrong? Or is she right a little too early, which often looks like the same thing?

Let's take a moment for the bull case. In its most recent quarter, Dollarama exceeded already lofty expectations for its earnings per share and same-store sales growth. Most impressive, it's jacked up its gross margins by 1.4 percentage points, to 35.7 per cent. The company that once sold everything for a dollar has managed its cost inflation well, successfully introducing higher price points. Now, 44 per cent of Dollarama's sales come from items selling for more than $1.

"Across our coverage universe of retail and consumer stocks, Dollarama continues to be our preferred name in the discretionary space," said Mr. Howlett. "Management is executing against the company's strategic priorities, both prudently and with impressive precision. The company has a long runway of growth ahead of it."

Many of the analysts with "buy" ratings boosted their earnings estimates and/or price targets, with projections of Dollarama's peak price in the next 12 months hitting as much as $40.

That implies a rich stock will be even more richly valued. It has higher multiples than any of the most prominent U.S. dollar-store retailers, based on the past 12 months' results; a $38 target price is roughly 18 to 19 times estimates for the current year.

The Case Against Rich Valuation

Veritas's Ms. Wong has a three-point argument against the current Dollarama valuation. She notes the company has posted declines in store traffic, as measured by transaction counts, in each of the past two quarters; she believes it is reaching the saturation point for selling products at prices above $1; and that neither trend can get better as competition intensifies.

Looking at Dollarama's numbers over the past 11 quarters tells the tale. Transaction counts, which consistently gained more than 1 per cent and sometimes exceeded 3 per cent, were indeed negative in each of the past two quarters. The proportion of revenue coming from sales of units priced at more than $1 rose rapidly at first, but has flattened in the last three quarters.

Gains in the number of transactions, coupled with larger transaction sizes, drive same-store sales growth, she notes. The weakening of both trends makes her believe Dollarama will settle in at same-store sales growth of 3 per cent starting in the next fiscal year – not the 7 per cent or more it had been posting in past quarters.

Ms. Wong also views the competitive landscape as intensifying, with Dollar Tree (DLTR-Q66.980.901.37%) planning to build from its 2010 acquisition of Dollar Giant, and Big Lots (BIG-N33.050.220.67%) converting the existing Liquidation World chain to its format starting late this year. (Dollar Tree, she notes, announced a first-quarter same-store sales growth number of 7.1 per cent, including a 5-per-cent increase in traffic.)

The bullish analysts, who write off Dollarama's first-quarter traffic issue as weather-related, are not nearly as concerned about the competitive issue. CIBC's Mr. Caicco says Canada's dollar-store industry will grow by 60 per cent before the end of the decade, to 2,700 stores, including at least one more U.S. entrant; Dollarama, he says, could have 1,100 of them (compared with 650 today). "For the next five to six years, there is nothing in these scenarios that we believe would impair the growth or depress the profitability of Dollarama."

If that's the case, Dollarama's stock will continue to be pricier than anything on its shelves. Investors, however, would be wise not to discount ***Ms. Wong's*** advice.