VERITAS INVESTMENT RESEARCH

THE VERITAS SNAPSHOT | **BUY**

December 7, 2012

Current Price	$61.09
Intrinsic Value Estimate	**$65.00**

Dollarama Inc. (TSX: DOL) Q3-F2013 Summary

Dollarama Q3-F2013 In-Line; Maintain BUY Rating and Revise Intrinsic Value Estimate to $65.00 (from $66.00)

Dollarama Inc. ("Dollarama") reported steady Q3-F2013 results, with FD EPS of $0.68, compared to consensus of $0.70 and $0.55 in the same quarter last year. Normalized FD EPS was $0.71, after adjusting for a non-recurring payroll-related charge of $3.1 million, resulting from the exercise of stock options. Gross profit margin (excluding 6.2% in occupancy costs) improved by 48 bps, to 43.44%, due to an improvement in merchandise margins and lower inventory shrink, partially offset by higher occupancy costs. Normalized EBITDA increased by 20%, to $86.6 million, while EBITDA margin improved by 91 bps, to 18.91%, primarily due to good expense control and gross margin expansion, partially offset by higher rent expense. The company repurchased a total of 1.6 million shares during the quarter at an average price of $61.97, financed entirely with free cash flow.

Dollarama announced it is on track to open 75 to 80 stores in F2013 (up from 65 to 70 previously) and plans to open 75 stores in F2014. We have adjusted our projections to reflect the accelerated growth strategy. However, we believe the accelerated store openings will result in higher sales cannibalization and we have lowered our same store sales growth ("SSSG") assumptions accordingly. We now expect Dollarama to achieve SSSG of +6.7% in F2013 and +6.0% in F2014, down from +7.0% previously. As a result, our intrinsic value estimate is now $65.00, down from $66.00 previously. We maintain our BUY recommendation for the following reasons;

- Our proximity analysis* of the Canadian dollar store industry shows there are roughly 468 optimal locations for new dollar stores to open before the market experiences significant saturation. If we assume Dollarama and Dollar Tree grow at a combined rate of 120 stores per year, the Canadian market can handle roughly four additional years of aggressive growth. We believe Dollarama is willing to absorb short term cannibalization in its existing markets in order to maintain its market share dominance in the long term;

- With the introduction of items at $2.50 and $3.00 in July 2012, Dollarama now offers many items that are distinct from its current offering, and, in many cases, offer steep discounts compared to retailers such as Walmart and Amazon. We believe Dollarama's multiple price point strategy will continue to boost average transaction size, particularly in F2014, as higher priced items gain more traction; and

- Dollarama reported a normalized SG&A margin of 18.33%, down 65 bps from Q3-F2012, and continued to make progress on several of its productivity initiatives. Dollarama has been using data provided by its POS system for store replenishment purposes since early July 2012, allowing the company to reduce inventory growth and lower working capital requirements. The company plans to begin reducing the number of in-store physical inventory counts beginning in F2014, which we estimate will result in savings of more than $15 million in labour costs over the next two years.

*Please refer to our report "Another Look at Dollarama," published on Sept. 19 2012, for a comprehensive analysis of Dollarama and our upgraded recommendation.

Key Observations in Q3-F2013

Q3-F2013 same store sales growth ("SSSG") was impressive at +6.6% vs. +5.1% in the same quarter last year. The strong SSSG was driven by a +4.9% increase in average transaction size (due to continued introduction of new merchandise >$1.00 price point and increased penetration to 57% of sales vs. 49% of sales in the same quarter last year) and a +1.7% increase in traffic (due to a weak comparison of-0.1% traffic comps in the same quarter last year).

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Figure 1 shows that the strong SSSG has been supported by the introduction of new merchandise above the $1.00 price point since Feb. 2009, while the increase in traffic lagged significantly. As we indicated previously, we do not expect Dollarama to report positive traffic comps in Q4-F2013, as they will be lapping the strong +4.0% in traffic reported in Q4-F2012. Also, weather conditions are less likely to be favourable in winter 2012 relative to winter 2011. Management's comments on the conference call were consistent with our observations. We anticipate average transaction size will continue to increase in F2014 as the multiple price point strategy gains traction and additional items are introduced above the $2.00 price point, which should help offset potential weakness in traffic comps. However, we believe the impact of products above the $2.00 price point on average transaction size will not be as strong as Dollarama's previous multiple price point expansion.

Figure 1
Quarterly Same Store Sales Growth Breakdown Q1-F2010 to Q3-F2013

	Q1-F10 4-May-09	Q2-F10 2-Aug-09	Q3-F10 1-Nov-09	Q4-F10 31-Jan-10	Q1F11 2-May-10	Q2F11 1-Aug-10	Q3F11 31-Oct-10	Q4F11 30-Jan-11	Q1-F11 2-May-10	Q2-F11 1-Aug-10	Q3-F11 31-Oct-10	Q4-F11 30-Jan-11	Q1-F12 1-May-11	Q2-F12 31-Jul-11	Q3-F12 30-Oct-11	Q4-F12 29-Jan-12	Q1-F13 29-Apr-12	Q2-F13 29-Jul-12	Q3-F13 28-Oct-12
Increase in No. of Transactions (Traffic)	3.5%	1.4%	1.1%	3.3%	1.9%	1.4%	1.6%	-0.7%	1.9%	1.4%	1.6%	-0.7%	-2.8%	-0.5%	-0.1%	4.0%	4.5%	2.7%	1.6%
Increase in Average Transaction Size	4.0%	5.6%	6.2%	5.8%	6.6%	6.2%	6.3%	6.1%	6.6%	6.2%	6.3%	6.1%	6.3%	5.3%	5.2%	3.8%	3.5%	4.5%	4.9%
Same Store Sales Growth	7.5%	7.0%	7.3%	9.3%	8.6%	7.8%	7.9%	5.3%	8.6%	7.8%	7.9%	5.3%	3.4%	4.7%	5.1%	7.9%	8.1%	7.3%	6.6%
% of Sales from Units >$1	12%	24%	27%	30%	34%	39%	40%	42%	34%	39%	40%	42%	44%	48%	49%	50%	51%	56%	57%

Source: Company reports

Figure 2 shows the recent quarterly gross profit margin before and after occupancy costs. The 48 bps gross profit margin improvement (before occupancy costs) in Q3-F2013 was ahead of Q2-F2013, but lagged behind the 84 bps improvement in the same quarter last year. We believe gross margin expansion is limited at Dollarama and will settle at current levels of 36% to 37% (42% to 43% before occupancy costs).

Although we anticipate Dollarama will continue to refine its sourcing capabilities through enhanced operating leverage and scale, the company will need to offset mounting inflationary pressures and increasing transportation costs in order to maintain its gross margin. Also, management indicated on the conference call that recent appreciation of the Renminbi relative to the U.S. dollar is beginning to have a modest pricing impact on products sourced from China. We do not expect gross margin to expand in Q4-F2013.

Figure 2
Quarterly Gross Profit Margin Before and After Occupancy Costs, Q1-F2011 to Q3-F2013
(Amounts in millions of Canadian dollars)

	Q1F11 2-May-10	Q2F11 1-Aug-10	Q3F11 31-Oct-10	Q4F11 30-Jan-11	Q1F12 1-May-11	Q2F12 31-Jul-11	Q3F12 30-Oct-11	Q4F12 29-Jan-12	Q1-F13 29-Apr-12	Q2-F13 29-Jul-12	Q3-F13 28-Oct-12
Sales	311.9	343.5	355.7	408.7	346.3	387.5	400.3	468.7	398.0	441.0	458.0
Gross Profit	127.8	141.8	149.8	178.5	147.2	165.2	172.0	211.3	170.3	189.1	199.0
Gross Profit Margin	**40.96%**	**41.29%**	**42.12%**	**43.67%**	**42.51%**	**42.63%**	**42.96%**	**45.09%**	**42.78%**	**42.89%**	**43.44%**
Y-o-Y Change	0.73%	1.86%	1.43%	**-0.96%**	1.55%	1.34%	0.84%	1.42%	0.27%	0.26%	0.48%
Rent Expense	20.8	20.7	21.2	22.3	23.5	23.0	23.9	24.9	25.8	26.6	28.4
Rent as % of Sales	6.65%	6.01%	5.96%	5.47%	6.78%	5.94%	5.97%	5.32%	6.49%	6.03%	6.20%
Gross Profit Margin - Rent Margin	**34.31%**	**35.27%**	**36.15%**	**38.20%**	**35.73%**	**36.68%**	**36.99%**	**39.77%**	**36.29%**	**36.85%**	**37.24%**
Y-o-Y Change	0.96%	2.03%	1.4%	**-0.92%**	1.42%	1.41%	0.83%	1.57%	0.56%	0.17%	0.25%

Source: Company reports, Veritas estimates

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Dollarama Inc. (TSX: DOL) Q3-F2013 Summary

Dollarama Accelerates Store Growth

Dollarama announced it will open a total of 75 to 80 new stores by the end of F2013, up from its previous guidance of 65 to 70 stores. This is the second time Dollarama has increased its guidance for new store openings in F2013. Management also indicated the company plans to open 75 stores in F2014. Dollarama continues to open smaller locations in urban areas, at roughly 7,000 to 8,000 sq. ft., and estimates 10% to 15% of locations opened in F2014 will be under this format. Dollar Tree maintained its previous guidance of opening roughly 36 stores in F2013 on its Q3-F2012 conference call. There were 761 Dollarama stores as of Q3-F2013 and 129 Dollar Tree stores in Canada as of Q3-F2012.

In our recently published report "Another Look at Dollarama" we concluded the Canadian market could handle an additional four years of aggressive growth from Dollarama and Dollar Tree, assuming both chains open a total of 120 stores per year, based on the number of optimal locations available derived from our proximity analysis. As we expected, Dollarama is accelerating its store growth strategy to take advantage of real estate opportunities as competitive pressures mount, particularly in key markets such as Ontario.

Management indicated cannibalization risk may be greater for new locations opened in existing markets relative to historical store openings. As a result, we have increased our store projections for Dollarama and lowered our SSSG assumption to adjust for the impact of cannibalization on the existing store network. We have also modestly increased our rent expense assumptions to reflect the competitive pricing pressures in the real estate market. Although Dollarama may temporarily weigh more importance on quantity vs. quality, we believe the strategy of cherry picking desirable locations in the near term will help offset competitive pressures from Dollar Tree in the long run.

Dollarama remains a BUY.

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