Is There More Upside to Dollarama Inc.'s Shares or Is it Time to Take Profits?

Description

Investors in **Dollarama Inc.'s** (TSX:DOL) stock have done very well. The stock has a five-year return of 531%, a two-year return of 115%, and a one-year return of 66%. And the stock is currently trading at a 52-week high of just under $71. Is there more room to go up or is the stock set for a period of underperformance?

Before we get into this, let's briefly review the company's most recent quarter, as well as the macro environment for the company.

Stellar 2014 results

In the fiscal fourth quarter ended Feb 1, 2015, same-store sales increased 8.5%, operating margins increased 4.3% to 21.1%, and the company announced a 12.5% quarterly dividend increase to $0.09 per share (from $0.08 per share).

Also, Dollarama added an additional 27 stores in the quarter while still increasing margins, so the company keeping its costs under control.

Positive macro view

With the sharp decline in the price of oil, consumers have more dollars in their pockets, which should be good for Canadian retailers in general. Furthermore, the retail market here in Canada is in the process of being shaken up. Sears is in trouble and Target is leaving Canada, both of which are positives for remaining retailers such as Dollarama.

So, what are the concerns that I have for the stock that leave me with a tempered view?

The foreign exchange is not working in Dollarama's favour

With the fall in the Canadian dollar, Dollarama is experiencing pressure, given that most of their products are sourced from suppliers in Asia using U.S. dollars. The company has already passed on some of this to customers by increasing the price on some $1 items by $0.25. Going forward, management has stated that the company may have to think about raising its prices to above $3, depending on what happens with foreign exchange rates.

The problem with this is that as prices at Dollarama rise, it slowly moves the retailer into the same space as other discount chains and leaves it competing squarely against retailers like **Wal-Mart**, for example. This changes the competitive environment for the company and the value proposition.

Even small increases in pricing can shift shoppers' attitudes towards the store. Shoppers will start to pay more attention to the quality of the product they are taking home from the store, and that can't be a good thing for Dollarama.

Valuation

The stock currently trades at a P/E ratio of 32 times, with an expected growth rate (based on consensus expectations) of 17%. Furthermore, it trades at a price to book of over 12 times. While the company's ROE of over 35% is impressive, this is also a lofty valuation multiple. The company undoubtedly continues to perform well financially, but there often comes a time when the market gets ahead of a company's fundamentals, as I believe is the case for Dollarama.

So, while at first glance the future looks bright for the company, which continues to expand its store base by adding 400 stores in the next few years, there are risks lurking in the background that have me thinking that investors should look for another company in this space to invest in instead. At the very least, the stock looks like it is at risk in the short term due to its valuation having gotten ahead of itself.

One such alternative that is posting good growth numbers is **Canadian Tire Corporation Limited** (TSX:CTC.A), which is trading at a much more reasonable P/E multiple of 17 times trailing EPS, and 16.2 times forward consensus EPS estimates. The expected EPS growth rate for 2016 is 10%, and in 2014 the company posted same-store-sales growth of 2.4% at the Canadian Tire banner stores, 6.9% at FGL Sports, and 3.1% at Mark's Work Wearhouse.

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1. Editor's Choice

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