



Dollarama Inc.: Is This Great Stock Poised to Dive?

Description

For investors lucky enough to have owned **Dollarama Inc.** ([TSX:DOL](#)) since the company's 2009 IPO, to say it's been a nice ride is a massive understatement.

Shares of Canada's largest chain of dollar stores have pretty much headed straight up. On a split-adjusted basis, they've gone from \$9 per share all the way up to the current price of \$89.38. That's a return of more than 815%, which doesn't even include dividends. Who knew that selling cheap stuff would turn out to be such a good business?

But these days, there may be storm clouds brewing on the horizon. Dollarama shares have gotten so expensive that earnings need to grow quickly to keep up. If that happens, great; investors should be happy with the results. But if the company stumbles just a little bit, the share price could really take it on the chin.

The earnings risk

Thus far in 2015, shares of Dollarama are up more than 50% as investors speculate cash-strapped consumers will flood its stores looking for cheaper versions of the goods they normally buy at **Wal-Mart** or **Loblaws** stores. Studies have shown this tends to happen when the economy is struggling.

Recent results show investors might be onto something. Compared with the same quarter last year, the company's second-quarter results saw total sales up 14.1%, with EDITDA increasing more than 35% to \$146.9 million. Earnings per share shot up 45% from \$0.51 to \$0.74. Same-store sales also saw a big boost, climbing nearly 8%.

Needless to say, those are terrific numbers, especially in a world where many Canadian specialty retailers are doing so poorly that they're forced to shut the doors.

The issue with such good numbers is they've lifted Dollarama shares to nosebleed valuation levels. Shares currently trade hands at more than 35 times earnings, a multiple that's about twice as expensive as the TSX Composite as a whole.

Analysts are bullish on the company, but not that bullish. Earnings for 2015 are expected to come in at \$2.83 per share, with growth slowing in 2016. Earnings in 2016 are expected to grow to \$3.23 per share. That's still an annual growth rate of 14%. But is 14% growth worth paying 35 times earnings for?

It's not like the shares would be cheap if the company hit its growth target either. Shares currently trade hands at 27.6 times 2016's projected earnings. There's a lot that can go wrong if the company doesn't hit its ambitious growth targets.

What's next?

I enjoy going to Dollarama, except for the part when I drop \$20 after going in for a couple of \$2 items. There's just so much useful, cheap stuff in there.

One thing that's obvious is the company's attempt to push items worth more than \$1. According to the latest earnings, 76.5% of sales were from items worth more than a loonie. There's even talk of getting rid of most dollar-priced items altogether, as a weaker Canadian dollar increases import costs.

It makes me wonder what exactly the company can do next to goose profits. It can't raise prices too high or it risks alienating its core customer base. And while there's potential to continue opening new stores, Dollarama is getting big enough that opening 50 new stores per year really won't move the needle as much as it used to. It's still an impressive feat, but is it impressive enough to justify 35 times trailing earnings?

I still think Dollarama is a terrific company. Management is doing all sorts of right things. The issue is just with valuation. The market has Dollarama priced as though growth of 30%, 40%, or 50% in earnings will continue indefinitely. If that doesn't happen, shareholders could be in for a nasty surprise.

CATEGORY

1. Investing

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1. TSX:DOL (Dollarama Inc.)

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