Dollarama Inc.: Is it Time to Be Wary of This Great Growth Story?

Description

Most businesses start to suffer as the economy worsens. **Dollarama Inc.** (TSX:DOL) is not like most businesses.

It goes something like this: folks tighten their belts when the economy is bad. They avoid buying things like new cars, furniture, and other big-ticket items. They also start looking for ways to cut back on everyday spending.

The local Dollarama store can help with that last part. It sells things like Christmas decorations at lower prices than most of its competitors, which appeals to consumers at this point of the economic cycle. People want to cut back, but don't want to give up decorating for Christmas. This is exactly where Dollarama wants to be.

It isn't just the economy that's helping Dollarama. Management has taken some smart steps, such as approaching food companies about manufacturing specific-sized products just for Dollarama stores. And expanding the store selection into items that sell for $2 or $3 was a genius move as well.

Dollarama is also benefiting from a secular growth trend. According to analysts, Canada has room for hundreds of additional dollar stores before the market gets as saturated as in the United States. South of the border, dollar stores are an old concept; they're relatively new in Canada.

All of this had led to great returns for shareholders. Over the past five years, it's been one of the best performing stocks on the TSX, rising more than 520%. Even thus far in 2015, shares are up more than 50%. That's an amazing return, especially when compared to the rest of the market.

And yet, after all that, I'm starting to turn cautious on Dollarama shares. There's one simple reason why.

Valuation

In today's market, growth is somewhat lacking. Why do you think so many companies are aggressively buying back their own shares? If there's nothing else to do with the money, things like share buybacks and increased dividends become the default choice.

Because growth is so hard to come by, investors are willing to give it a bigger premium than at any time in the last few decades, with the possible exception of the tech bubble of the late 1990s.

Dollarama is a perfect example of this. Shares currently trade hands at more than 35 times earnings, which is approximately twice as expensive as the entire market. It doesn't get much cheaper on a forward P/E basis either–the company has a P/E ratio of 31.8 times projected 2016 earnings and trades at 27.9 times what analysts expect the company will earn in 2017.

If there's any company that deserves a high valuation, it's Dollarama. It reported sales growth of 14.1% in its last quarter, fueled by a 7.9% increase in same-store sales. Gross margins were up compared to the same quarter in 2014, as was EBITDA. And earnings per share increased nearly 50%, rising from $0.51 to $0.74.

There aren't many companies in Canada that are capable of putting up growth numbers like Dollarama, yet are big and liquid enough for hedge and mutual funds to easily buy.

But what happens if growth stumbles, even just a bit? Over the years, there have been hundreds of companies like Dollarama that have traded at high multiples based on huge expectations. Just about every one of them did not deliver great returns to investors once growth inevitably slowed.

The issue isn't with Dollarama's results, its management, or even its long-term growth potential. Those are all still great. The issue is the price investors have to pay for these great qualities. Personally, I'm not willing to pay such a price. I suggest other investors take a critical look at Dollarama's valuation as well.

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1. Editor's Choice

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Date
2025/07/08
Date Created
2015/11/30

Author
nelsonpsmith