Canadian Tire Corporation Limited or Dollarama Inc.: Which Is the Better Buy Right Now?

Description

It is a week to the day when **Dollarama Inc.** (TSX:DOL) announced monster first-quarter results, yet its stock has barely budged. What gives? Isn't it Canada's best example of successful retail in this country? Arguably, it is.

But perhaps investors are thinking twice about paying nosebleed prices for Dollarama's stock when they can own **Canadian Tire Corporation Limited** (TSX:CTC.A), Canada's other great retailer, for much less.

At this moment in time, Canadian Tire could actually be a better buy than Dollarama. Here's why.

Valuation

Discussions of this kind always start at this point. There's no way around it. Intrinsic value is, as Warren Buffett has suggested in previous annual reports, "the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life." But, of course, we know that this calculation is anything but precise. In fact, it's truly undeterminable.

That said, I'm going to use MoneyChimp.com's Buffett Value Formula to ballpark the value of both companies' stocks.

The calculation requires you to answer five questions:

1. What were the earnings per share for the last 12 months?

2. What's the earnings growth rate over the next five years?

3. What's the sustainable earnings growth rate after five years?

4. What's your level of confidence expressed as a percentage of these projected future earnings?

5. What's the risk-free rate of return?

Using these parameters, I quickly calculated Dollarama's current share price of $92.27 (June 14th closing price) to be 34% of its approximate intrinsic value of $271.98, while Canadian Tire's current share price of $138.62 is 26% of its approximate intrinsic value of $544.52.

By this extremely imprecise method, Canadian Tire is the cheaper stock. But, like all calculations, they're open to interpretation. So, let's look at some of the other financial metrics investors use to evaluate stocks.

The big ones are price-to-earnings, price-to-sales and price-to-book ratios. For this type of quick back-of-the-napkin comparison, I simply add all three numbers together, and the lower one wins. Again, it's not meant to be precise. It's just a quick barometer. Dollarama's and Canadian Tire's numbers are 57 and 19, respectively.

You can quibble all you want about my methods, but it's safe to say Canadian Tire is the cheaper of the two stocks. That doesn't necessarily make it better, but it does make it the better value play.

Business profitability

Here, there is no question that Dollarama does a better job controlling expenses and delivering profitable growth. In 2015 Dollarama's operating margin was 19.1%, 100 basis points higher than the year before. More importantly, they were more than double Canadian Tire's at 8.2%.

However, year over year, Canadian Tire actually managed to increase its operating margin by 120 basis points on a slight decline in revenues. That can be explained by a 121 basis-point increase in gross margins year over year to 33.7%. While headed in the right direction, it's not enough to better Dollarama, which has increased operating margins each year since its IPO in 2009.

Annually, Dollarama generates about 50% of the operating profits that Canadian Tire does on about one-fifth the revenue. That's cost control efficiency to the max.

Other stuff

Dollarama does one thing very well: it sells lots of cheap merchandise quickly and efficiently. That's why it's so successful. You have to tip your hat to it. Shareholders have done well as a result of this excellence.

Canadian Tire, on the other hand, has seen good days and bad in years gone by in its role as Canada's most iconic retail store. However, since it purchased Forzani Group in 2011, it's seen more good days than bad, and I believe it will continue to do so.

Consider that Canadian Tire has two things Dollarama doesn't: a financial services business and a real estate investment trust. The two segments delivered $608 million in operating income in 2015, about half of Canadian Tire's total operating profits. When you buy Canadian Tire stock, you get revenue and profit diversification not found at most retailers.

Imagine if Canadian Tire were able to get its retail business firing on all cylinders—it's probably 12-18 months away from that given the state of its online business—the price of its stock would skyrocket.

Bottom line

Dollarama is a great company, but Canadian Tire is easily the better buy right now.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:CTC.A (Canadian Tire Corporation, Limited)
2. TSX:DOL (Dollarama Inc.)

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