The Best Way to Reward Dollarama Inc. Shareholders

Description

If you'd bought **Dollarama Inc.** (TSX:DOL) shares in its October 2009 IPO and are still holding them, stand up and give yourself a big round of applause. You're up 43.9% on an annualized basis over the past eight years.

There's not much you say about this kind of return except WOW. Long-term returns like these are like catching lightning in a bottle — it rarely happens.

As we close out 2017, the markets are entering the ninth year of a bull market — experts are split on how long this good fortune can continue — it becomes harder to know if you're overpaying for a stock you want to buy and more difficult to hang on to the ones you already own.

Dollarama's situation is particularly vexing

Here you have a business that added 17 net new stores in the second quarter, while delivering 6.1% same-store sales growth — 40 basis points higher than the growth a year ago — and a 24.1% increase in operating income.

Dollarama now has 1,125 stores across the country with 69% in two provinces: Ontario and Quebec. The combined population of the two provinces is 22.4 million people, or 29,512 people per store.

At the same number of people per store in the other provinces and territories, Dollarama should have approximately 481 stores — 43% more than its current footprint outside Ontario and Quebec. And that assumes Ontario and Quebec are maxed out, which is unlikely.

Suffice to say, there is plenty of expansion left for Dollarama.

What to do with free cash flow?

Free cash flow is the money left over after the company has taken care of the daily expenses of its business. How businesses allocate that capital is critical to future success. Too much in one area leaves less available for another.

The two capital-allocation levers most investors are concerned about are dividends and share repurchases. They are used by management to reward shareholders for their commitment to the company.

In June, I suggested that Dollarama cut back on its share repurchases and instead increase the dividend to as much as a $1 annually — more than double its current rate of $0.44.

My rationale was simple.

Dollarama paid just less $100 per share for its stock over the past year for a 28% return on its investment. At the time of the article, Dollarama stock was trading around $125, so it's made another 29% in the five months since.

Fool contributor Brad Macintosh recently commented that Dollarama's forward P/E of 30 is higher than its five-year average of 24, suggesting a correction in 2018 is a possibility; I would agree.

In the trailing 12 months ended July 30, Dollarama's free cash flow was $565 million. In those 12 months, it's repurchased $701 million of its stock and paid out $48 million in dividends. This means it's used approximately $184 million in debt to reward shareholders over the past year.

Its net debt as of the end of the second quarter sits at $1.4 billion — double what it was two years ago.

The solution

I would make three capital-allocation moves to better position the company for the future while still rewarding shareholders.

First, I would slow the share repurchases considerably, covering only the dilutive effect of share-based compensation. In the past five years, Dollarama has reduced its share count by 24% to 114.7 million.

If it paid out 44 cents every year without increasing the dividend, it would have saved itself $16 million per year.

Translation: You might be getting a slightly bigger piece of the pie, but it comes at the expense of dividend income.

Second, as I said previously, I'd double the dividend payout or more. Even at a buck a share, it's paying out just $115 million annually, about one-sixth what it uses for share repurchases.

Finally, I'd take the $440 million or so in free cash flow left over after share repurchases (for share-based compensation) and an increased dividend payout and pay down the debt over the next couple of years.

Why?

Unless it plans to make an acquisition in the U.S. or internationally, which isn't the worst idea in the world, rising interest rates are going to weigh on future profits. Also, it will be good to less indebted should the economy go into recession.

Bottom line on Dollarama

Good capital allocators know when to stop buying back shares. Now is the time to do so.

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