The Main Problem With Growth Stocks

Description

Growth stocks such as **Canopy Growth Corp.** (TSX:WEED) and **Dollarama Inc.** (TSX:DOL) can deliver extraordinary price appreciation. In only 12 months, investors in Canopy Growth and Dollarama have seen their investment more than double, increasing by 1.5 times, respectively.

However, I've shied away from both stocks for one reason — more so for Canopy Growth than for Dollarama — they're expensive.

Canopy Growth hasn't yet turned a profit, which makes it a speculative investment today. However, today's buyers are hoping for future growth potential from the legalization of marijuana, which could come as soon as July 2018.

Since I took notice of Dollarama stock a couple of years ago, it has become even more expensive. However, there's good reason for Dollarama's high multiple.

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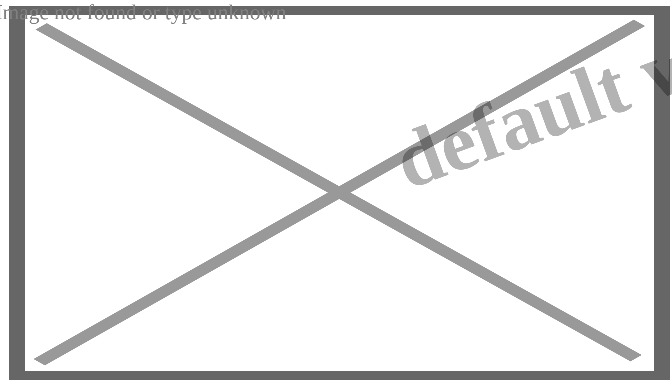

The company has been growing at a rapid rate. In the last three fiscal years, Dollarama increased its earnings per share by 28.7% on average per year!

That said, Dollarama is trading at a higher multiple than it has in the past few years, in which it experienced higher growth. In other words, as the stock has gone up, new buyers are paying more for the stock, which is expected to experience slower growth in the near term.

At about $156 per share, Dollarama trades at a price-to-earnings multiple north of 35, while its three-year normal multiple is about 25.8. For the next three to five years, Wall Street Consensus expects the company to grow its earnings per share by roughly 17% per year.

Today's buyers are paying a PEG ratio (or P/E to growth ratio) of about two, which is on the expensive side of the spectrum to pay for growth. Whether Dollarama stock will continue its rise depends on how high a multiple the market is willing to pay for Dollarama's above-average growth.

There are concerns about the saturation that will eventually occur in the dollar-store market in Canada. However, this likely won't happen anytime soon, and will probably happen gradually. However, as the company's growth slows, it may experience multiple contractions that could cause the stock to drop.

Investor takeaway

It can be dangerous to overpay for a company. This is less so for growth stocks, such as Dollarama, which has a proven history of extraordinary revenue and earnings growth.

Moreover, Dollarama's operating margin has improved every year since 2010, which indicates that the company is running more efficiently and benefiting from economies of scale as it increases the number of stores.

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