Caution: Dollarama Inc. (TSX:DOL) and Roots Corp. (TSX:ROOT) Feel the Pinch

Description

It seems that consumers are feeling the pinch from record debt levels and rising interest rates.

And they're taking **Dollarama Inc**. (TSX:DOL) and **Roots Corp**. (TSX:ROOT) along for the ride.

I have been warning about this risk, and now there appears to be a softening in sales momentum, along with high expectations that are taking a toll on these stocks.

Dollarama

With its second quarter fiscal 2019 sales falling short of expectations, Dollarama stock got pummeled on Thursday, falling almost 20% — this despite the fact that the company raised its 2019 outlook and saw an increase of 13% in EPS.

At the end of the day, Dollarama stock has been very richly valued for some time now, as investors have come to expect strong increases in sales.

And this quarter's 2.6% increase in same-store sales is not one that would warrant such rich valuations.

While I've always been impressed with the company's stellar performance, I have been wary of its valuation, as expectations had risen so high and multiples became inflated. This, along with rising interest rates and debt levels, has me concerned.

Year-to-date, the stock is down 13.6%, reflecting this reality.

We are now seeing same-store sales continuing to slow, and gross margins continuing to increase, and we can expect that these trends will continue into fiscal 2019.

The stock is now trading at 25 times this year's EPS expectation, which is down from the 29 times P/E multiple it was trading at a few weeks ago.

Earnings are expected to increase in the mid-teens range, and although margins are coming in strong, the reductions in sales momentum is concerning.

So I remain on the sidelines, watching closely for an entry point into Dollarama stock.

Roots Corp. (TSX:ROOT)

Roots is trading below its IPO price once again, as the stock continues its volatile ride.

I do not view valuation as a problem; in fact, it is quite low and attractive at less than 10 times earnings.

But with second-quarter results below expectations, the challenges remain, as same-store sales increased a very modest 1.1%, expectations have been slashed.

With slowing consumer spending, the company will have added difficulties with its expansion to the U.S., which has proven to be a very risky move even in the best of times.

Canadian Tire Corporation Ltd. (TSX:CTC.A)

With one of the most recognizable brand names and $13.5 billion in revenue, Canadian Tire has an unrivalled position in the Canadian retail industry.

Canadian Tire stock is pretty much flat year-to-date, and while it will be vulnerable to weakness in consumer spending, it offers a diversification that is unmatched by the previously discussed retailers, so will be less affected.

In the last 10 years, annual dividends have grown at a compound annual growth rate of 16%, and currently, the dividend yield is 1.47%.

In summary, I think retail stocks are vulnerable at this point after a period of very strong performance, and I would favour the more defensive retailers today, as rising interest rates and household debt make me nervous about consumer spending going forward.

CATEGORY

1. Investing

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

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Author
karenjennifer