Should You Buy Dollarama Inc. (TSX:DOL) on the Big Dip?

Description

On Thursday, after reporting its fiscal second-quarter results, **Dollarama** (TSX:DOL) stock fell as much as 20% and recovered some lost ground to decline by 17% by the market close.

For Dollarama, it's all about growth. It needs high growth to maintain its high multiple. However, with growth tapering off, the market had no choice but to capitulate the stock. Did the market go too far?

Let's first review Dollarama's recent results.

Q2 results

The company did a decent job of increasing sales by 6.9% to $868.5 million. However, it was subpar from the company's recent 10-13% growth. It had comparable store sales growth of 2.6%, but that was dwarfed by the exceptional growth of 6.1% in the previous year.

For the quarter, Dollarama grew its EBITDA by 7.9% with an EBITDA margin of 26%. Its diluted earnings per share increased by 13.2% to $0.43, thanks partly to a 3.6% reduction in the number of its outstanding shares.

What about results for the first half of the fiscal year?

Dollarama increased its sales by 7% to $1,624.5 million and increased its EBITDA by 8.5% to $396 million. Its diluted earnings per share increased by 10.6% to $0.73, thanks partly to a 3.9% reduction in the number of its outstanding shares.

The business

At the end of fiscal Q2 (i.e., the end of July), Dollarama had 1,178 stores in Canada. This fiscal year it plans to add 60-70 stores. Its dollar stores offer a wide range of consumer products, general merchandise, and seasonal items at attractive prices of up to $4 each.

There's intense competition in the value retail space, not only with respect to price, but also the location of the stores, the quality of the products, product availability, customer service, etc.

In the first half of the fiscal year, Dollarama sourced 56% of its purchases overseas. While Dollarama buys products from +28 countries, the majority of its overseas products come from China, for which it pays in U.S. dollars.

As a result, the foreign exchange fluctuations between the Chinese currency, the U.S. currency and the Canadian currency will have a direct impact on how much Dollarama pays for its products. Tariff disputes, including the uncertainties around the North American Free Trade Agreement (NAFTA), will also be a drag on the stock.

Investor takeaway

Instead of the roughly 10-13% sales growth we've seen in each of the past few years, Dollarama's sales growth dropped to 7% in the first half of this fiscal year. Further, management expects the EBITDA margin to reduce to 23.5-25% this fiscal year. These are going to have a direct impact on its bottom line.

Assuming a more conservative earnings-per-share growth rate of 10-12%, at $43.12 per share as of writing, Dollarama trades at a price-to-earnings multiple of about 28.4 and a PEG ratio of 2.36-2.84.

So, the stock still looks pricey. Investors are better off looking elsewhere for growth for now.

That said, Dollarama is a great business. If you still like the company, wait for the stock to find some support before buying. Dollarama has some strong support at $40. See if the company can hold at that level first.

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