Why Dollarama Inc. (TSX:DOL) Stock Is Plunging Sharply

Description

The year 2018 has been difficult for **Dollarama** (TSX:DOL) so far. After reporting a weak first quarter, the discount retailer reported an even weaker second quarter. The market was used to Dollarama reporting better-than-expected quarters.

Shares plunged dramatically following disappointing results, falling over 17% on Thursday, the biggest decline since December. This is the worst collapse of the stock since its entry on the TSX nine years ago. The sell-off continued on Friday; the stock dropped almost 4% during that day.

This is a major setback for Dollarama, whose stock has provided a significant and consistent performance in recent years. The Montreal company has been one of the best-performing stocks on the TSX for nine years.

Disappointing results

What caused Dollarama's stock plunge is rather disappointing results in fiscal 2019 second quarter.

Although generally in line with analysts' expectations, the results were surprising because same-store sales increased by only 2.6% — far from the 6.1% recorded last year. This performance was well below the expectations of most analysts, who were expecting a 5% increase in sales. Same-store sales growth was especially strong last year because of souvenir sales geared to Canada's 150th anniversary.

Dollarama has also lowered its forecast for the current year. The company expects sales of comparable stores to increase by 2.5-3.5% for the full year in 2019, which is lower than the initially established range of 4-5%, because of its decision to delay price increases.

Dollarama executives told analysts in a conference call that they had decided to delay increasing prices for now because the cost of its imported goods has been more stable than expected and cost reductions introduced last year have offset the impact of higher minimum wages. The company followed its competitors who haven't passed on the increase in minimum wage in Ontario to consumers.

Dollarama generated sales up 6.9% to $868.5 million compared with $812.5 million last year. Analysts expected sales of $887.6 million.

Nevertheless, net income increased by 7.6% from the same quarter last year to $141.8 million. Dollarama was also able to improve its gross margin from 39.6% to 39.7% of sales.

Diluted net earnings per share amounted to $0.43, up 13.2% from $0.38 last year, missing analysts' estimates by only $0.01.

Bottom line

While Dollarama's quarter was disappointing, I think the market overreacted. Sales were weaker than expected, but a rise of 7% is still high. Dollarama managed to increase its adjusted profit by 13%, which is still good considering competitors' pressure and the impact of the minimum wage rise. Earnings are expected to rise by 10% per year on average over the next five years, which is lower than Dollarama's past growth rate, but it's still pretty decent for a retailer.

Due to the stock price dropping sharply, Dollarama's P/E ratio is becoming more reasonable at 26.8, while still high.

The plunge may represent an opportunity to buy Dollarama on the dip. Management has plans to open more stores, targeting as many as 70 new openings this fiscal year. It is also launching an e-commerce site to sell items in bulk in Quebec, which could generate further revenue if the initiative is successful. In addition, the company is gaining efficiencies related to cash-handling and labour scheduling.

But Dollarama may have to increase prices to remain competitive, and if consumers aren't willing to accept paying more, it could weigh down on the retailer's shares.

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