Comparing 3 Dollar Store Chains: Why Dollarama (TSX:DOL) Earns Last Place

Description

Canadian dollar store chain **Dollarama Inc.** (TSX:DOL) certainly has performed extremely well for investors over the past decade. Shares of the dollar store chain have increased nearly ten-fold since the company's launch on the TSX less than 10 years ago.

While shares of the company are down year to date by approximately 20%, expectations are that the company may return to former glory once concerns laid out in Dollarama's most recent earnings report play out.

The majority of the outsized performance Dollarama has garnered in recent years can be attributed to the company's monopoly-like presence in most Canadian cities. Smaller competitors do exist in most markets, but for the most part, Dollarama has expanded strategically and quickly to control urban centres and areas that other dollar store chains may not have been able to penetrate due to high operating costs and barriers to entry.

In this article, I'm going to compare Dollarama with two U.S. peers **Dollar Tree, Inc.** (NASDAQ:DLTR) and **Dollar General Corporation** (NYSE:DG) to provide perspective on where Dollarama is outpacing its peers, and where it may experience headwinds in the long term.

From the perspective of an investor concerned about margins and the health of Dollarama's underlying businesses, the Canadian company earns full marks for outperforming its U.S. peers. Dollarama's net margin and operating margin (15.9% and 22.3%, respectively) outpace Dollar Tree (7.6%, 8.6%) and Dollar General (7.1%, 8.5%) substantially.

I would attribute this significant margin differential to higher average prices at Dollarama combined with lower labour costs on average than its U.S. peers, supported by a monopoly-style hold on the dollar store environment in Canada and less competition overall in Canada.

This margin advantage certainly translates into a valuation multiple premium for Dollarama, a premium that's been reduced recently due to the recent slide in Dollarama's share price, but one which remains substantial. Investors will be required to pay in excess of 22-times earnings for Dollarama shares compared to an average of less than 15 times earnings for either Dollar Tree or Dollar General, a 50%

premium.

Questioning whether such a premium is warranted must be viewed from the lens of how the landscape is expected to change for Dollarama in the medium to long term. Increased operating costs due to minimum wage hikes and rents in the company's prime locales will certainly provide headwinds.

I believe these headwinds will be compounded by an unwillingness of Dollarama's management team to raise prices which, while good for the consumer, will likely erode the margin advantage Dollarama holds today compared to its U.S. peers.

It appears Dollarama may feel the pain of lower long-run margins, such as those held by its much larger U.S. peers over time. Expansion into less profitable markets, activities aimed at keeping competition low (i.e., high-priced acquisitions), and rising operating costs are all headwinds the company is beginning to feel more than ever.

Given its current valuation premium compared with its North American peers, Dollarama is a company I would avoid, and would thus encourage investors looking for growth to look elsewhere.

Stay Foolish, my friends.

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1. NASDAQ:DLTR (Dollar Tree, Inc.)
2. NYSE:DG (Dollar General Corporation)
3. TSX:DOL (Dollarama Inc.)

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chrismacdonald