3 Reasons to Sell Dollarama Inc. (TSX:DOL)

Description

Dollar stores have proliferated across North America ever since the financial crisis of 2008. Montreal-based **Dollarama** (TSX:DOL) has been at the epicenter of that trend in Canada. Ever sce it went public in 2009, the company has expanded its footprint across the country from 585 stores to over 1200.

Over the same period, shareholders have had a greater run. This stock grew from $3.25 at initial public offering (IPO) to over $56 last year, a return of 17 times over nine years. Dollarama is now a national brand with a market capitalization of $11 billion and a 0.45% dividend yield.

However, the stock took a sudden turn last year and is now down by more than a third. The retailer failed to meet analysts' expectations last year, delivering a $133.4 million profit in the third quarter, or $0.41 earnings per diluted share against the $0.42 per share analysts were expecting.

Does this present an excellent buying opportunity for a high-growth retailer or a fundamental change in the company's prospects? In their recent research note, Spruce Point Capital raised a number of red flags for the company. Based on their data, I think there are three reasons why investors may want to reconsider the bullish thesis on Dollarama:

Insiders are offloading their stake

Founder and Chairman Larry Rossy announced he is stepping down as chairman last year. Since he took the company public, Rossy has sold nearly 75% of his shares. He wasn't the only one selling over that period. Insider trades have nearly all been sales since 2014. The Rossy family wealth is derived from their stake in Dollarama, but they collective control only 5% of the outstanding shares.

Insiders not holding onto their shares and offloading at regular intervals isn't very encouraging for investors. The fact that institutional investors own less than 47% is another reason to worry about the company's shareholding pattern.

The stock is more richly valued than peers

Metro, Big Lots, Dollar Tree, and **Dollar General** are all trading at price-to-earnings (PE) ratios of between 8.65 and 19.5. By comparison, Dollarama trades at a PE ratio of 22.5. The company's dividend yield is also considerably lower than the competition.

Part of the reason for this rich valuation could be the fact that Dollarama tends to have thicker profit margins than the average dollar store. The company's earnings before interest, taxes, depreciation, and amortization (EBITDA) are more in line with luxury stores like **Tiffany & Co.** (24%) than Metro (7%).

A greater valuation for higher profitability seems logical, but investors must consider the risk of margin erosion through growing competition.

The market is heading for saturation while competition intensifies

Canada already has the second-highest retail property footprint in the world, behind the U.S. This makes Dollarama's historic rate of expansion less sustainable over the long term. Meanwhile, other stores are upgrading their inventory, lowering prices, and offering heavy discounts.

Dollarama is likely to face intense competition in the dollar store segment, as price-conscious customers are less likely to be brand loyal. If it gets involved in the discount wars, margins could be eroded.

Bottom line

Canada's retail sector is heading for a transition point and Dollarama isn't prepared for a slower growth phase with tighter margins. Meanwhile, the stock trades at a premium to other dollar stores and insiders have been offloading their stake in recent years.

For investors, it may be better to wait and watch for signs of either renewed growth or mature valuations.

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