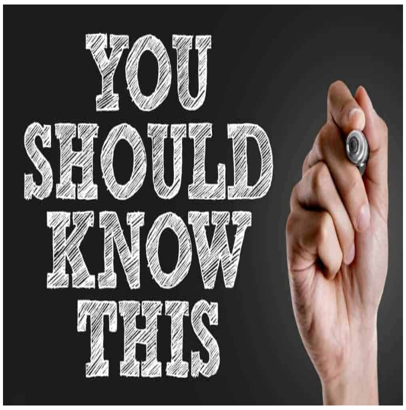

Dollarama Inc. (TSX:DOL) Stock Is Down Big, but Here's Why You Should Still Stay Away From This Retail Stock

Description

Down 35% from its 2018 highs, **Dollarama Inc.** (TSX:DOL) stock may have investors thinking of snatching it up on weakness.

In its former glory, Dollarama stock commanded a price to earnings multiple of 35 times, as sales were skyrocketing and margins continued to rise.

These days, this retail stock is trading at multiples of just over 20 times, so much cheaper, but here is why I do not think this represents a buying opportunity just yet.

Same store sales growth has slowed significantly

In the fourth quarter of fiscal 2019, same-store sales growth came in at a lacklustre 2.5%. While 2.5% growth is still growth, it does not compare to levels of a few years ago.

Back, then same-store sales growth topped 8%, as traffic was rising and price points increasing.

Fast forward to today and we can see the opposite trends taking hold. Traffic is falling (4o basis point traffic decline in the latest quarter) and it appears that increases in prices have had a negative effect.

The problem is that as prices at Dollarama rise, it moves the retailer into the same space as other discount chains, which leaves it competing squarely against retailers like Walmart, for example. This is changing the competitive environment for the company and the value proposition.

Guidance for same-store sales in 2020 and 2021 is for 2.5% to 3% growth, so it remains below what investors had gotten used to.

Falling margins

Gross margin growth has decidedly stalled, and having peaked at 39.8% in 2018, we have seen it falling since.

The latest gross margin was 39.3% amid an increasingly competitive retail environment, and we can expect this trend to continue as the macro environment can be expected to remain difficult.

Guidance for gross margin in 2020 and 2021 is 38% to 39%, so we can see that there is more downward pressure to come.

Similarly, operating costs having been rising, and operating margins falling significantly. Dollarama's operating margin began to fall back in 2017 when it fell to 15.5% from more than 17%. While cash flows remain strong, this has certainly had a negative effect on the stock price.

While free cash flow generation remains impressive, I believe that earnings estimates on the stock are at risk.

The last three quarters saw the company report earnings that were below expectations, and while these misses were not big ones, they are still three consecutive misses.

Earnings growth has come down to levels closer to 10% compared to earnings growth of almost 25% a few years ago.

Final thoughts

Lower same-store sales growth, lower margins, and lower earnings growth mean that investors should not expect Dollarama's multiples to move anywhere near what they were in its heyday.

I would stay away from Dollarama and move to other retail stocks that are more defensive in nature.

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