Dollarama (TSX:DOL): The Perfect Defensive Buy on the Dip?

Description

Dollarama (TSX:DOL) stock is dipping again, with shares now 9% off its 52-week high. As investors get ready to prepare their defences for the recession that's just around the corner, does it still make sense to bet on the "growthy," recession-resilient business amid the recent growth-to-value rotation? Or could Dollarama be in for another nasty plunge that could see shares be cut in half, as the appetite for growth fades?

A terrific defensive business to own through a recession

As a discount retailer with deep penetration across Canada, Dollarama allows Canadian consumers to get the most out of every dollar. With solid relationships with suppliers, Dollarama is able to command low prices, producing a huge value proposition that's virtually unmatched as far as brick-and-mortar retailers are concerned.

As times get tough, Canadians need their dollar to go even further, and it's times like these when quality discount retailers like Dollarama will shine.

Yes, the experiential factor matters in brick-and-mortar retail and Dollarama has been quite lacklustre in this department. But when a recession hits, brick-and-mortar experiences go out the window, as Canadians look for necessities at the lowest price possible.

Now, we've yet to see how Dollarama stock reacts as it falls into a recession. While the defensive nature bodes well for the company through economic downturns, the premium growth multiple attached to the stock could work against it, as the appetite for growth plummets in severe crashes.

No matter how "defensive" a stock seems, it can still be subject to massive downside if the price of admission is too high prior to a recession. And at 27.6 times trailing earnings, Dollarama stock doesn't appear to have much of a margin of safety.

Gross margins under pressure

Dollarama recently clocked in a mediocre Q2/F20 quarter with an EPS of $0.45, missing the mark by a penny. Same-store sales growth numbers of 4.7% were encouraging and show management has a response to the growing competitive pressures in Canada's discount retail scene. Unfortunately, gross margins pulled back by 140 bps on a year-over-year basis on products to get more traffic in its stores.

In a game of who has the lowest margins, few firms can outdo **Amazon.com**, and as it continues bolstering its discount product "add-on" offerings across Canada, I suspect margin pressures could be the new norm for Dollarama.

As such, I don't believe the ridiculously high 27.6 times trailing P/E or 20.9 times cash flow make for a reasonable price of admission, as the appetite for growth stocks continues to fade.

Sure, Dollarama is defensive, but the premium price tag, I believe, leaves the stock vulnerable to substantial downside in a market crash. As such, I wouldn't touch the stock with a barge pole at these nosebleed-level valuations, despite its favourable defensive characteristics.

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