**Dollarama Inc.**

Candice Wang | 416.871.1589 | wyuan90@gmail.com

**Investment Thesis**

* **Dollarama continues to grow rapidly and profitably in Canada, driven by its industry-leading position, strong same-store growth and ambitious expansion plan.** Dollarama is the industry’s largest player as measured by its revenue. According to the report of IBISWord (2016), Dollarama’s annual revenue accounts for approximately 56.4% of total industry revenue, ahead of 5.2% market share gained by the second-largest player Dollar Tree. The sales momentum of Dollarama continues to exceed expectations. The company reported the highest same-store growth in 3Q 2017 among its peers in the US and Canada. In addition, Dollarama opened 18 new stores during the same period, indicating that the company remains on track to open its targeted 60 to 70 news stores at the end of FY2017. Management of Dollarama believes that the Canadian dollar store is still underpenetrated and reaffirmed the 1,400-store mark in the Annual Report of FY2016.

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|  | **Dollarama is posting the highest same-store sales growth among its peers** | | | | |  |
|  |  | **Fiscal year end** | **Most recent reporting period** | **SSSG (%)** | **Sales growth (%)** |  |
|  | Dollarama Inc. | Jan-31 | 3Q ended Oct-30-2016 | 5.1% | 11.2% |  |
|  | Dollar General | Jan-29 | 3Q ended Oct-28-2016 | (0.1%) | 5.0% |  |
|  | Dollar Tree | Jan-30 | 3Q ended Oct-29-2016 | 1.7% | 1.1% |  |
|  | Five Below | Jan-30 | 3Q ended Oct-29-2016 | (0.2%) | 17.6% |  |

* **Dollarama integrates defensive business with cyclical business to offers a productive business model which enables the company to maintain stable sales and earnings during both economic upturns and downturns.** Grocery retail stores industry and dollar stores industry are two type of industries that are able to benefit from plummeting consumer sentiment and contracting incomes. Dollarama is an combination of both industry criteria by offering an assortment of general merchandise and consumable products priced at no more than $4.00. Dollarama also offers a selection of seasonable products specifically themed for seasonal holidays such as Thanksgiving, Halloween, Valentine’s Day and Christmas. Revenue generated from seasonable products has driven by the increasing demand of low cost and disposable holiday-themed goods and decorations.
* **Dollarama is able to generate solid free cash flow to allow it to increase cash distributions to shareholders through dividends and share buybacks.** The company’s current Normal Course Issuer Bid (NBIC) allows for the repurchase of approximate 5.87 million common shares, representing 5.0% of the common shares issued and outstanding on June 7, 2016. During Q3 2017, Dollarama repurchased 1.57 million common shares for total consideration of $157.8 million. The consistent NCIB execution has boosted the EPS CAGR approaching 14.11% as of FY 2016.

**Investment Risk**

* Management of Dollarama did not revise upwards its guidance for full year of FY2017 despite the strong Q3 2017 performance, indicating that SSSG and gross margin could weaken in the last quarter of the fiscal year.
* Increase in square footage growth and new stores could result in cannibalization of existing stores. Cost of sales and SG&A associated with new stores could have short-term negative impact on earnings.
* Dollarama purchases a majority of its imported products from China using US dollars. Dollarama does not hedge its exposure to fluctuations in the value of the Chinese renminbi against the US dollar. Therefore, the company’s cost of sales is affected by fluctuation of foreign currencies against the Canadian dollar.

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| **Rating** | **Buy** |
| **Risk** | **Average** |
| **12-month target** | **C$107.34** |

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| Symbol | DOL, TSX | |
| Sector | Consumer Discretionary | |
| Closing price | C$101.32 | |
| 52-week range | C$70.29 - C$104.94 | |
| Avg. daily value traded ($MM) | | C$30.58 |
| Shares O/S (MM) | 118.56 | |
| Market cap ($MM) | C$11,960 | |
| Net debt ($MM) | C$1,084 | |
| EV ($MM) | C$13,160 | |
| Dividend yield (%) | 0.4 | |
| Year-end | Jan-31 | |

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| **Financial Estimates** | | | | |
| **Annual** | **2015** | **2016** | **2017E** | **2018E** |
| EPS (C$) | 2.21 | 3.00 | 3.40 | 3.89 |
| P/E (x) | 45.94 | 33.78 | 29.81 | 26.05 |
| EBITDA (C$MM) | 423 | 549 | 621 | 686 |
| EV/EBITDA (x) | 31.14 | 23.95 | 21.18 | 19.18 |

**Valuation**

The $107.34 price target is based on 27.6x F2018E EPS and 13.5x F2018E EBITDA.

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| **P/E Based Sensitivity Table** | | |  |  |  |  |
|  |  | **Terminal Year EBITDA Multiple** | | | | |
|  |  | 11.5 x | 12.5 x | 13.5 x | 14.5 x | 15.5 x |
|  | 4.9% | 99.8 | 107.9 | 116.0 | 124.1 | 132.2 |
|  | 5.9% | 96.0 | 103.8 | 111.6 | 119.3 | 127.1 |
| **WACC** | 6.9% | 92.4 | 99.8 | 107.3 | 114.8 | 122.3 |
|  | 7.9% | 88.9 | 96.1 | 103.3 | 110.5 | 117.7 |
|  | 8.9% | 85.5 | 92.5 | 99.5 | 106.4 | 113.4 |
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| **EV Based Sensitivity Table** | | | | | | |
|  |  | **P/E Multiple** | | | | |
|  |  | 25.6 x | 26.6 x | 27.6 x | 28.6 x | 29.6 x |
|  | $3.80 | 97.0 | 100.8 | 104.6 | 108.4 | 112.2 |
|  | $3.85 | 98.3 | 102.1 | 106.0 | 109.8 | 113.7 |
| **EPS** | $3.90 | 99.5 | 103.4 | **107.3** | 111.2 | 115.1 |
|  | $3.95 | 100.8 | 104.8 | 108.7 | 112.7 | 116.6 |
|  | $4.00 | 102.1 | 106.1 | 110.1 | 114.1 | 118.1 |
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**Market Overview**

The Dollar and Variety Stores industry in Canada is currently in the growth phase of its life cycle. As one of the fastest growing industries in the retail store, the industry revenue is anticipated to grow at an annualized rate of 2.0% to 5.5 billion over the five years to 2012, according to IBISWorld. As the economic recession and volatility resulted in contracting incomes, an increasing number of consumers restored to spending their dollars more carefully. Therefore, shopping at dollar stores that offer smaller quantities items sold at lower prices became a viable option.

Due to improving economic conditions, the disposable income level and consumer sentiment are expected to return to its pre-recessionary level. Therefore, the next five years to 2021 are likely to be challenging for operators in the industry to hold on to the customers they acquired during the recession. However, there is still a growth opportunity in the Canadian dollar store market. As at January 31, 2016, there were approximately 24,000 people per dollar store in the Canadian dollar store market, compared to 12,000 people per dollar store in the US market[[1]](#footnote-1). The review of dollar stores’ penetration rates support the confidence that there are untapped market shares in Canada.

**Company Description**

History

Dollarama Inc. was founded by Larry Rossy in 1992 and is headquartered in Montreal, Quebec. In October 2009, Dollarama completes its initial public offering and its shares start trading on the Toronto Stock Exchange under the ticker “DOL”.

Today Dollarama is the is the largest chain of dollar stores in Canada with 1,069 stores as at October 30, 2016. The company has more stores than its five largest competitors combined. Its core markets are in Ontario and Quebec, and has a similar presence to its competitors in other provinces. Dollarama is expecting to continue increasing its footprint across Canada.

The company is operated under a nonfranchise business model which all stores are corporate-owned and operated. Each store offers a broad spectrum of consumer products, general merchandise and seasonal items that are sold at fixed price points up to $4.00. Adoption of the multi-price point strategy enable Dollarama to tap into a broader market segment.

Ownership & Corporate Structure

Dollarama, Inc., a Canada incorporated public company, owns two material subsidiaries as shown below. operates the Dollarama business while Dollarama International Inc. exports and sells products to Dollar City, a Central American dollar store chain.

Products and Pricing

Dollarama offers a mix of national-label and private-label everyday consumer products, general merchandise and seasonal items. Unlike other dollar stores who offer somewhat more of a treasure hunt of items, Dollarama aims to provide consistently available everyday products, seeking to drive more returned visits and acquire more new customers.

Dollarama adopts a multi-price point strategy, offering products sold at fixed price points ranging from $0.77 to $4.00. The proportion of products priced above $1.00 has been increasing over recent years. Selling items over $1.00 helps Dollarama boost revenue and improve profit margins.

Source: Company reports

Stores and Warehouses

As at October 31, 2016, Dollarama operated 1,069 stores in all Canadian provinces. Over 69.0% of total stores is located in Ontario and Quebec. Management of the company is expecting to continue to deploy expansion strategy and reiterates the 1,400-store mark in the annual report of FY2016. The average store size has increased from 5,272 square feet in 1998 to $9,942 square feet in 2016. Opening new stores and expanding store size assisted Dollarama in driving customer loyalty and trip frequency, while further requirement of capital expenditure would dampen profit margins and the impact of cannibalization is expected to increase. (Pleasure consult Investment Risks for further details).

Dollarama primary uses warehouses to store goods directly imported from overseas. The company recently invests in a new warehouse of 500,000 square feet in Montreal, Quebec. It is expected to be available for use before the end of FY2017. The new facility will accommodate the warehousing requirements as Dollarama continues to expand its store network, but a modest negative effect on profit margins should be expected as the investment in new warehouse. As of October 2016, Dollarama owns one distribution centre which distributes approximately 91% of its products to stores across Canada. The sole location of distribution centre would cause higher transportation costs as distributing products to regions which are far from Quebec, but management has not mentioned any plan to invest in new distribution centres outside of Quebec.

Suppliers

Dollarama has a well-diversified supplier base, none of them accounts for over 3% of Dollarama’s total purchases. Approximate 44% of total imported merchandise is sourced from North American suppliers and 56% of total imported merchandise comes from other 30 countries. Since the majority of merchandise is imported from China using US dollar, the company’s cost of sales is affected by fluctuation of foreign currencies against the Canadian dollar. (See Investment Risks for more information).

Competition and Market Position

Dollarama has a commanding lead over other dollar stores in terms of its footprint. The chart below summarized the growth of the five largest dollar store chains in Canada since 2012. The smaller dollar store chains may see their market share shrink as Dollarama and Dollar Tree continues to expand.

Dollar Tree is Dollarama’s most comparable competitor, but there are notably differences in market size, merchandise and price points between them.

* IBISWorld reports that Dollarama accounts for approximately 56.4% of total industry revenue, compared to 5.2% of total industry revenue acquired by Dollar Tree. Within Canada, Dollarama is generating most of the growth of the total dollar store segment, while Dollar Tree shows modest store network growth.
* Dollarama offers multi-price points up to $4.00 since adding $3.50 and $4.00 price points in August 2016. Dollar Tree prices all products at $1.25. The single point price strategy may limit the company’s ability to adjust to a decline in the Canadian dollar by increasing prices of products but to absorb the cost of currency decline within its gross margin.
* Dollarama believes that offering consistently available everyday products helps drive more visits. In contract, Dollar Tree offers consumers a treasure hunt shopping experience.

**Financial Information**

Sales

Dollarama’s sales have grown at a five-year CAGR of 13.3% from FY2012 to FY2016. The company reported 11.2% growth in sales to $738.7 million in Q3 2017 from $664.5 million in Q3 2016. The stronger-than-expected sales growth was driven by an impressive 5.1% SSS increase as consumers continue to seek value in the context of week macro dynamics.

Gross Profit

Gross margin has been consistently increased from 37.5% in FY2012 to 39.0% in FY2016. In Q3 2017, gross margin essentially remained flat at 39.5%, compared to 36.9% of sales in Q3 2016. Dollarama continues to remain gross margin at high level, complying with the annual guidance range of 37% to 38%.

EBITDA

Strong EBITDA has driven by better-than-expected gross margin and strong SG&A leverage. The improvement in cost of sales and SG&A as a percentage of sales is mainly the result of continued execution on productivity and cost reduction initiatives.

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|  | **Dollarama's Financial Results** | | | | | | | | |  |
|  | *(C$ thousands)* | **FY2012** | **FY2013** | **FY2014** | **FY2015** | **FY2016** | **Q1 FY2017** | **Q2 FY2017** | **Q3 FY2017** |  |
|  |  |  |  |  |  |  |  |  |  |  |
|  | **Sales** | **1,602,827** | **1,858,818** | **2,064,676** | **2,330,805** | **2,650,327** | **641,012** | **728,968** | **738,708** |  |
|  | *Total Sales Growth %* | *12.9%* | *16.0%* | *11.1%* | *12.9%* | *13.7%* |  | *13.7%* | *1.3%* |  |
|  | **Cost of Sales** | **(1,002,487)** | **(1,163,979)** | **(1,299,092)** | **(1,471,257)** | **(1,617,051)** | **(404,149)** | **(449,391)** | **(447,239)** |  |
|  | **Gross Profit** | **600,340** | **694,839** | **765,584** | **859,548** | **1,033,276** | **236,863** | **279,577** | **291,469** |  |
|  | *Margin %* | *37.5%* | *37.4%* | *37.1%* | *36.9%* | *39.0%* | *37.0%* | *38.4%* | *39.5%* |  |
|  | *Growth %* | *17.0%* | *15.7%* | *10.2%* | *12.3%* | *20.2%* |  | *18.0%* | *4.3%* |  |
|  | **SG&A** | **(305,121)** | **(339,662)** | **(363,182)** | **(398,678)** | **(435,816)** | **(102,946)** | **(110,942)** | **(116,972)** |  |
|  | *Margin %* | *(19.0%)* | *(18.3%)* | *(17.6%)* | *(17.1%)* | *(16.4%)* | *(16.1%)* | *(15.2%)* | *(15.8%)* |  |
|  | *Growth %* | *9.4%* | *11.3%* | *6.9%* | *9.8%* | *9.3%* |  | *7.8%* | *5.4%* |  |
|  | **EBITDA** | **295,219** | **355,177** | **402,402** | **460,870** | **597,460** | **133,917** | **168,635** | **174,497** |  |
|  | *Margin %* | *18.4%* | *19.1%* | *19.5%* | *19.8%* | *22.5%* | *20.9%* | *23.1%* | *23.6%* |  |
|  | *Growth %* | *26.2%* | *20.3%* | *13.3%* | *14.5%* | *29.6%* |  | *25.9%* | *3.5%* |  |
|  | **Depreciation & Amortization** | **(33,336)** | **(39,284)** | **(47,898)** | **(38,309)** | **(48,085)** | **(13,527)** | **(14,006)** | **(14,666)** |  |
|  | **EBIT** | **261,883** | **315,893** | **354,504** | **422,561** | **549,375** | **120,390** | **154,629** | **159,831** |  |
|  | *Margin %* | *16.3%* | *17.0%* | *17.2%* | *18.1%* | *20.7%* | *18.8%* | *21.2%* | *21.6%* |  |
|  | *Growth %* | *27.5%* | *20.6%* | *12.2%* | *19.2%* | *30.0%* |  | *28.4%* | *3.4%* |  |
|  | Interest Expense - Net | **(16,555)** | **(10,839)** | **(11,673)** | **(19,956)** | **(21,395)** | **(6,634)** | **(7,289)** | **(8,517)** |  |
|  | **EBT** | **245,328** | **305,054** | **342,831** | **402,605** | **527,980** | **113,756** | **147,340** | **151,314** |  |
|  | Income Tax Expense | **(71,854)** | **(84,069)** | **(92,737)** | **(107,195)** | **(142,834)** | **(30,604)** | **(40,988)** | **(41,256)** |  |
|  |  |  |  |  |  |  |  |  |  |  |
|  | **Net Income** | **173,474** | **220,985** | **250,094** | **295,410** | **385,146** | **83,152** | **106,352** | **110,058** |  |
|  |  |  |  |  |  |  |  |  |  |  |
|  | Average Diluted Shares O/S | 75,563 | 75,190 | 72,046 | 133,956 | 128,420 | 123,152 | 120,662 | 119,496 |  |
|  | **Earnings per Share** | **2.3** | **2.9** | **3.5** | **2.2** | **3.0** | **0.7** | **0.9** | **0.9** |  |
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**Comparable Analysis**

Looking for data…

1. Dollarama Annual Information Form, Fiscal Year Ended January 31,2016, Page 8 [↑](#footnote-ref-1)