Dollarama: background and strategy

Dollarama – Incorporated October 20, 2004 and IPOd October 16, 2006 at 17. 50/share. It was originally founded in 1992 by the current CEO, Larry Rossy who was a third generation retailer. Rossy took over his family business in 1973 and transitioned this store into the Dollarama store chain that we know today (4). The strategy behind Rossy and Dollarama's success from its launch was as follows:

Adopt a fixed price point dollar store concept

Pursue a network expansion strategy in Canada, leading to stronger brand awareness and sales. As of January 29, 2012 Dollarama has 704 corporate stores. Their goal is to increase stores by 60 each year (previously 50 stores until 2012). As of December 5, 2012, they were at 761 stores and thus on target to meet their goal.

Source merchandise overseas to lower costs and enhance the product offering

Dollarama expanded their strategy further by enhancing their product offering through the launch of multiple price points, $1 until February 2009 then adding, $1. 25, $1. 50 and $2 options. With their increased success, Dollarama decided to increase their dividends by 22% which was paid as of May 4, 2012. Furthermore, as of July 2012, Dollarama expanding the price point option again adding $2. 50 and $3. 00 in select stores.

The dollar store industry differentiates itself from the rest of the Canadian retail market in the following ways:

Low fixed prices

Convenient locations and large store sizes

Large product offering of both branded and non-branded merchandise

Small/Individual sized product quantities as opposed to Costco for example

No-frills self-serve environment, meaning no service representatives to help navigate through the stores or ask for advice.

Typical merchandise carried by dollar stores include: party supplies, seasonal merchandise (Halloween costumes, holiday decorations, etc.), household products and cleaning products, paper and plastic, health and beauty care products, pet supplies, toys, food and novelty items. Their current mix as of the third quarterly report is 49% General Merchandise, 14% Seasonal and 37% Consumables.

Dollarama chooses its location when putting in a new store very carefully. The criteria used to evaluate a particular area is based on the traffic in the area and retail activity, the presence and/or absence of competitors, the population demographics in the area, rent and occupancy costs per square foot, and the location of existing Dollarama stores in the area. Dollarama has the highest penetration of stores in Quebec with 236 stores (as of 3rd Quarter results) per capital. They have been growing the most in Ontario with 29 new store locations by end of 3rd Quarter versus 6 new stores in Quebec. Dollarama believes they are underpenetrated in Ontario and Western Canada.

Current Map of Stores according to each Province (3rd Quarter Results)

Dollarama also attributes part of their success to the locations they use, the size of the stores and its format to ensure effective displays and their suppliers and distributor operations. That said, Dollarama’s greatest success has been dependent on their brand awareness, perceived value to the consumer and visibility over their competitors.

Brand Awareness: According to a survey of 4, 420 Canadians over 18 years old in June 2012, 93% of Canadians are familiar with their brand with Quebec and Ontario representing the largest percentage of 99% and 97%.

Perceived Value to Consumer: According to the same survey above, customers believe that Dollarama offers more than 100% more value than competitor’s prices with the $2. 00 items representing over 200% more value!

Visibility: Dollarama is the largest dollar store chain in Canada by 6 times as much as its competitors and has 89% more stores.

Dollarama target market is women ages 25-44 years old with annual incomes of $20, 000 to $80, 000. Given the range in income, the introduction of $2. 00 items and now starting to introduce items up to $3. 00 across Canada will allow Dollarama to capture more wallet share of this demographic on the higher end of the income.

Dollarama’s main competitors within the dollar chain space are Dollar Tree and Dollar General (both US companies that are expanding into Canada). Other competitors include Shoppers drug mart, Loblaws and other destination shopping centres though they have a much higher price point.

With growing competitors coming from the US, it is important that Dollarama protect their visibility and brand awareness through rapid market growth through store openings.

Financial Analysis

Price Waterhouse Coopers (PWC) audited the financial statements pertaining to Dollarama for the period of February 1st, 2010, January 30, 2011 and January 29, 2012. PWC's role is to express an opinion on the financial statements in accordance with the general accepted auditing standards (GAAP).

The two main components of the financial statement assessment was to assess the company's profitability, their solvency and the presence of any red flags. For the purposes of evaluating profitability year-over-year and solvency, please see Exhibit 1

Profitability

As you can see from Exhibit 1, the year-over-year profitability in terms gross profit shows an increase of 17%. Not only did we see an improvement in sales but also in the cost of goods sold which attributed to the gross profit. Furthermore, the operating net income is also on the rise showing an increase of approximately 28%! In analyzing the Balance Sheet, under assets there is a large amount attributed to goodwill. The same amount is being added year-over-year from February 2010 to January 2012. The amount represents approximately 50% of the assets which could be dangerous if there is an impairment of the goodwill which could cause a huge hit to the net income. Given the goodwill has remained steady over the last 3 years and profitability is also increasing, we do not feel it is a major red flag but certainly something to consider going forward and to watch.

Solvency

The next section looks at solvency of the company and in particular how liquid the company is. Again, we turn to Exhibit 1. The current ratio shown in Exhibit 1 measures whether the company has enough resources to repay its short-term debt (over the next 12 months). Acceptable ratios are typically between 1. 5 and 3 to 1. Dollarama current ratio is considered healthy as it lies within industry standards and furthermore has increased year-over-year. This shows that the company is strong in its ability to repay its short-term obligations. The next line under the current ratio is the debt to equity ratio. This ratio measures the shareholder’s equity and debt used to finance Dollarama’s assets. If a company has a high debt to equity ratio it shows that Dollarama is financing its growth largely from equity. A healthy ratio would be represented as less than 1. As you see from Exhibit 1, Dollarama has less than 1 and decreased down to 0. 57, a 28% decline. That said, It is important to note that a healthy company that is expanding would always want to take advantage of leverage opportunities so while having less debt is a good thing, missing out on opportunities is not.

Red Flags

The first potential risk was raised earlier in the profitability section pertaining to the large weighting towards goodwill. The next could be a red flag with the rate at which the debt to equity ratio is decreasing especially considering growth in the number of stores is a key strategy for Dollarama. The final red flag seen was in relation to the Inventory Turnover. Inventory turnover measures how quickly the inventory is being sold within a given period of time. Typically a healthy company will show inventory turnover to be increasing. This means they are using their inventory well and not having inventory stay on their shelves for long periods of time. If we refer again to Exhibit 1, we see that Dollarama's Inventory Turnover is decreasing year-over-year which is a bad sign. Overall, we see that the turnover ratio is high but we need to account for the decrease. Part of the decrease could be due to the introduction of $2 items which are not selling as quickly but are much more profitable. This is something that should be further examined in the quarterly reports going forward to ensure the ratio does not decrease at too fast a rate.

After going through the financials, we are pleased with the overall picture of the company though we were unable to secure additional information from the reports available. We solicited Dollarama directly but they too did not provide us with the same store sales. Same store sales is an important metric especially for a company that is in growth mode as we want to ensure that profitability is not coming solely from the new stores. The risk here is that the existing stores are no longer profitable and could become an issue down the road in addition an added risk of sustainability as they reach saturation of the market.

Sustainability

Exhibit 2 outlines the major competitors in the US market: Dollar General, Dollar Tree and Family Dollar. The total number of US stores = 19, 500 with

Dollar Tree representing 22% market share or 4, 300 shores. As demonstrated above, Dollar Tree has been increasing their footprint in Canada due to the opportunity to expand dollar store's versus that of the US which may have reached saturation. According to Dollarama's investor presentation based on the third quarter report, currently there are 29, 000 thousand people per 1 dollar store while in the US there are 14, 000 per dollar store. As such, there is a demand and opportunity for more dollar stores in Canada to close this gap. It is for this reason that we see US giants such as Dollar Tree entering the arena. The important thing is to see how quickly we will reach the point of saturation and what type of growth will be expected going forward. Similarly it is important to understand the demographics and expand in the right areas. For example, Dollarama believes they have capitalized on the bulk of the opportunities in Western Canada though they feel they are underrepresented in Ontario & Western Canada where they have been putting a greater focus on expansion.

Investment Evaluation

In evaluated the potential for Dollarama to be added to a pension fund it is first important to better understand the criteria to which pension fund managers look for in a particular investment. Traditionally, pension funds are 60% equity investment holdings and 40% Fixed-Income/Bond holdings[1]. Given the volatility and lower than expected rates of returns we've seen over the last 5 years, many pension fund managers have had to readjust their expectations and rethink this traditional model going forward.

The focus now is enhancing returns given the low interest rate environment we are still faced with and thus looking at ways to mitigate ways differently.

The average target for long-term returns is to achieve approximately 6% while 36% of pension fund managers believe this to be unrealistic and feel they are unable to achieve such a target[2]. For example, Canada Pension Plan (CPP) which is believed to be one of the best pension plans in the world let alone in Canada may have trouble meeting this target as well based on the 2012 Annual Report from the CPP Investment Board. According to the report, the 5 year return as of fiscal 2012 end was 2. 2% while their 10 year number was 6. 2%[3]. While they are on target for the long-term number, they have a major challenge going forward given the last 5 years. Essentially, the next 5 years are crucial for pension funds to get back on track. The shift is therefore looking at investments in terms of risk or return profiles versus asset classes such as fixed-income versus equities[4]. What we are seeing therefore is a move to a liability driven investment (LDI) model; approximately 60% have either adopted the model or have plans to going forward[5].

LDI approach is essentially a balancing act between their assets and future liability pay outs. The focus therefore is on cash flows to be able to make those payments. They use a predictive model based on retirement withdrawals to accurately forecast what these payments will look like. Part of the strategy involves selecting assets with long timeframes such as real estate holdings or long-term bonds which can more predictably match their long-term payouts. Therefore, when assessing equities it becomes that much more important not to give up too much on the downside. Equity investments that over lower risk profiles, lower volatility and better growth prospects than the index over the long-term.

Dollarama is a business which is an excellent choice in periods with lower economic growth and uncertainty. It is a recession proof business as those that may previously not have shopped at dollar store chains, will begin looking at lower priced more economic solutions for themselves and their families. These businesses strive in these periods. The economic forecast going forward remains relatively uncertain. With fiscal cliff worries and huge debt levels in the US, high unemployment levels globally and European debt fears, it is important to look for businesses that won’t be negatively affected with potential bad news or in a low global economic growth market.

The other advantage that Dollarama brings is its ability to adapt as they have recently adjust their price model upwards allowing them to expand their product offering and appeal to a wider audience. As such, Dollarama is able to grow as the economy also grows ensuring they don’t lose the clients they gained during the recession.

Dollarama has the highest brand recognition of all dollar store chains which means it is an established business and has a good reputation in the market place. They are in growth mode looking to capitalize on the opportunities that exist in lower penetration markets, and catch up with the United States (US). Although they may reach a point of saturation such as that of the US in the next 5 years, looking at the financial numbers of the 3 biggest competitors in the US, their net incomes remain with over 20% growth on earnings per share.

While there are some red flags that were raised in the Financial Analysis section we do not feel they poise a large threat but as noted do feel it is something that should be monitored. The final reason for our recommendation to add a 5% weighting in a pension plan is the committed Dollarama has shown to their shareholders by recently increasing and paying out a dividend. Furthermore, adding a company that would pay out a dividend aligns in the cash flow goal of the plan.