

Focus Stock Report

June 15, 2011

Dollarama Inc. (DOL, \$31.93, 1-SO, \$39.50 target)

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A BRIGHT LIGHT IN AN OTHERWISE TOUGH RETAIL ENVIRONMENT

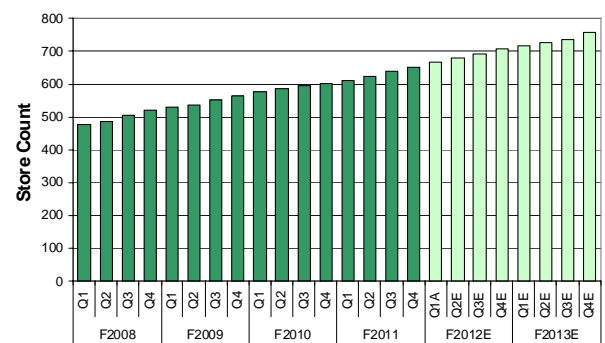
Dollarama was founded in 1992 when Mr. Larry Rossy, CEO and a third generation retailer, transitioned a 44 store general merchandise retail chain launched by his grandfather in 1910 to a single price point “dollar store” concept. Dollarama is Canada’s largest dollar store retailer with 667 stores located throughout the country. The company has close to five times the number of stores of its nearest competitor and is the only nationally-based player. Dollarama offers 4,500 consumable, general merchandise, and seasonal products that range in price from \$0.65 to \$2. In its June 9 earnings release, the company introduced a quarterly dividend of \$0.09/share, representing a dividend yield of 1.1%.

Our investment thesis is based on above-average growth in virtually every key retail metric: store count, same-store sales growth (SSSG), and gross margin. These metrics, combined with ardent cost control, have led to an EPS compound annual growth rate (CAGR) of 36% over the past four years. With a substantially larger store base now, earnings growth is naturally expected to decelerate. Scotia Capital is forecasting an EPS CAGR of 16% over the next two years, driven equally by increased store count (see exhibit 1) and same-store sales growth. Based on the current per capita penetration rate, the company believes that there is presently the potential for at least 900 Dollarama stores in Canada, 35% more stores than currently. Another driver of earnings growth has been Dollarama’s introduction of items priced over \$1 (see exhibit 2).

Q1/F12: Dollarama Delivers Seventh Straight Quarterly Earnings Beat

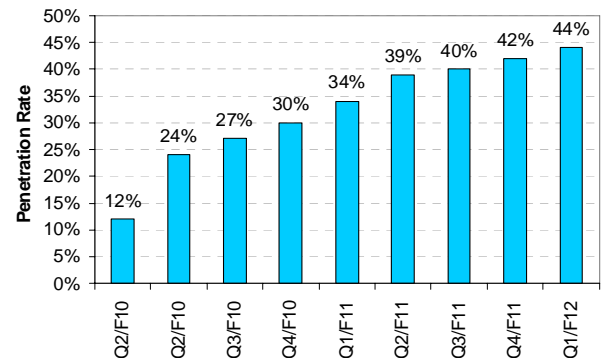
- Dollarama's results continue to demonstrate the resiliency of its operating model. And this quarter saw another beat on the bottom line with EPS of \$0.40, up 34.3% from \$0.30 last year, and 11% above consensus of \$0.36. Stronger gross margins, up 142 bp, primarily drove the beat. The other welcome news on the back of yet another strong quarter was the reinstatement of a dividend. DOL announced a quarterly dividend of \$0.09, representing a 22% payout ratio and a 1.1% dividend yield. We believe investors will welcome Dollarama's decision to share its excess cash with shareholders.
- Sales growth was solid at +11% (vs. 10.4% estimate), driven by the addition of 56 new stores and SSSG of 3.4%, on top of a +8.6% comp last year. The ongoing heightened penetration of above-\$1 items helped drive a higher basket, up 6.3%. However, the number of transactions declined 2.8% due to poor weather. This had been flagged by management on their Q4 conference call. Management noted that while weather impacted spring and early-summer, traffic is starting to improve. For Q2 we look to improved traffic trends and forecast SSSG to rise 4% (+7.8% last year).
- In Q1, 44% of sales came from products priced above \$1, up from 42% in Q4/11 and 34% a year ago. We do think DOL may be nearing a peak on this metric, but could see some further upward moves (perhaps up to 50% over time). Management discussed the possibility of adding price points above \$2. While DOL is content with the current pricing strategy and CEO, Larry Rossy, said the company wants to stay below \$2 for as long as possible, it noted that if inflation in China continues to ramp and the company sees exciting value in

Exhibit 1: Growth in Store Count is Expected to Remain Consistent



Source: Company reports, Scotia Capital

Exhibit 2: Penetration of Items >\$1 Continues to Rise



Source: Company reports

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items in the \$2 to \$3 range, it may eventually consider adding a few hundred items in that range.

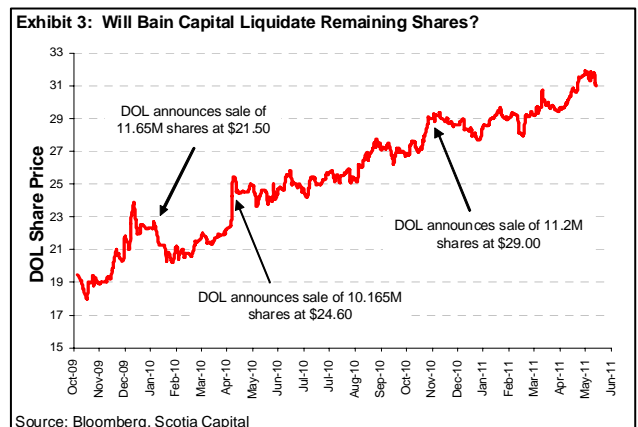
- DOL continues to actively manage its margin, sourcing over half (54% in F11, up from 53% in F10) of its purchases from overseas. Management again noted that the company aims to keep gross margin in the range of 36%. The company's ability to maintain high gross margins in an environment of high energy costs and other inflationary forces is a key competitive advantage.

Deleveraging Continues Even as Store Count Grows and Dividend is Introduced

- DOL continues to reduce its debt levels and use cash to add stores. The company's debt dropped from \$445M last year to \$367M at the end of Q1. Dollarama incurred an interest expense of \$4.4M in Q1, down from \$6.4M last year. DOL should continue to see some earnings growth derived from ongoing balance sheet deleveraging. Management will continue to focus on using its cash flow to repay debt, add stores, and (now) pay dividends.
- The company added 15 stores in Q1 and 56 over the last four quarters. DOL expects to add 50 stores in F12, but noted that it is finding real estate availability is the limiting factor. Store growth will be focused in the West (30%-35%) and Ontario (45%). Over the longer term we see room for in excess of 900 units across the country.
- In the past, management has noted that stores close to a Wal-Mart outperform other stores. The company said that it looks forward to Target entering Canada and that having stores near a Zellers that is slated to be converted to a Target will also help the company by increasing traffic. Management even noted that in some cases they may consider relocating stores to be closer to Target stores when current leases end.

Is there a liquidity event on the horizon?

- Following the third and fourth quarters of F10 and Q3/F11, Bain Capital and senior management sold off a portion of their stake in the company. In January, DOL sold 11.7M shares at a 4% discount to the prior trading days close. In April, the amount was 10.2M shares at a discount of 3.1%. In December, Bain sold 11.2M shares at a discount of 1.3% (see exhibit 3).
- With approximately 9.2M shares still owned by Bain, there is a possibility of another secondary offering in the coming months, particularly in light of 82% appreciation since the IPO. With Bain's ownership level no longer considered a "control block," Bain may dispose of its remaining shares through a direct trade with institutional investors, thus eliminating the need for a secondary offering and prospectus.



High Valuation Multiple is Warranted

- Reflecting the strong Q1 results, Scotia Capital increased its EPS forecast to \$1.96 and \$2.19 in F12 and F13, respectively. We continue to expect top- and bottom-line growth driven by strong SSSG, unit growth, and improved operating efficiency. Sales trends will likely be driven by the new pricing initiatives and increased penetration of electronic payment. We look for square footage growth of 8.9% and 7.5% in F12 and F13, respectively. We forecast SSSG of 3.7% in F12 and 3.5% in F13. This reflects the recognition of a tough comparison to comps in F11 but also continued benefits from the multiple price point strategy and electronic payments, which we believe will drive average transaction sizes higher.

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- Dollarama, in our view, warrants a premium valuation to its U.S. peers. The shares currently trade in line with the U.S. counterparts and DOL, in our view, has a stronger operating model. DOL operates in a less developed and growing dollar store market and has a dominant foothold in the discount retailing space in Canada. We see continued upside and look for multiple expansion as DOL continues to prove its ability to drive both the top and bottom lines. Our \$39.50 one-year target price reflects an 18 times calendar 2012E EPS multiple. See exhibit 4 for a valuation comp table.

Exhibit 4: Dollar Store Valuations

Ticker	Rating	Curr.	06/10/11 Price	EPS (Cal)				P/E (Cal)				EV/EBITDA (Cal)				PEG	Div. Yield	
				2009	2010	2011E	2012E	2009	2010	2011E	2012E	2009	2010	2011E	2012E			
Dollar Store Comparables																		
Dollarama Inc.*	DOL.TO	1-SO	CAD	\$31.96	1.18	1.63	1.96	2.19	27.2	19.6	16.3	14.6	14.9	11.4	10.2	9.3	1.2	1.1%
99 Cents Only Stores*	NDN.N	NR	USD	\$20.23	0.64	0.99	1.12	1.22	31.6	20.4	18.1	16.6	12.2	8.8	7.9	7.3	1.9	0.0%
Dollar Tree*	DLTR.O	NR	USD	\$61.75	2.27	3.16	3.85	4.36	27.2	19.6	16.0	14.2	11.4	9.2	8.2	7.4	1.1	0.0%
Family Dollar Stores*	FDO.N	NR	USD	\$52.36	2.23	2.77	3.31	3.81	23.5	18.9	15.8	13.8	10.0	8.6	7.8	7.2	1.1	1.3%
Fred's Inc*	FRED.O	NR	USD	\$13.86	0.62	0.73	0.87	1.00	22.2	18.9	16.0	13.8	7.7	6.8	6.0	5.4	1.1	0.0%
Dollar General*	DG.N	NR	USD	\$32.57	1.20	1.77	2.22	2.56	27.1	18.4	14.7	12.7	11.6	9.0	7.7	7.0	0.9	0.0%
Average									26.5	19.3	16.1	14.3	11.3	9.0	8.0	7.2	0.4%	

Source: Reuters, Scotia Capital estimates.



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We have a three-tiered rating system, with ratings of 1-Sector Outperform, 2-Sector Perform, and 3-Sector Underperform. Each analyst assigns a rating that is relative to his or her coverage universe.

Our risk ranking system provides transparency as to the underlying financial and operational risk of each stock covered. Statistical and judgmental factors considered are: historical financial results, share price volatility, liquidity of the shares, credit ratings, analyst forecasts, consistency and predictability of earnings, EPS growth, dividends, cash flow from operations, and strength of balance sheet. The Director of Research and the Supervisory Analyst jointly make the final determination of all risk rankings.

Ratings

1-Sector Outperform

The stock is expected to outperform the average total return of the analyst's coverage universe by sector over the next 12 months.

2-Sector Perform

The stock is expected to perform approximately in line with the average total return of the analyst's coverage universe by sector over the next 12 months.

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The stock is expected to underperform the average total return of the analyst's coverage universe by sector over the next 12 months.

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Risk Rankings

Low

Low financial and operational risk, high predictability of financial results, low stock volatility.

Medium

Moderate financial and operational risk, moderate predictability of financial results, moderate stock volatility.

High

High financial and/or operational risk, low predictability of financial results, high stock volatility.

Caution Warranted

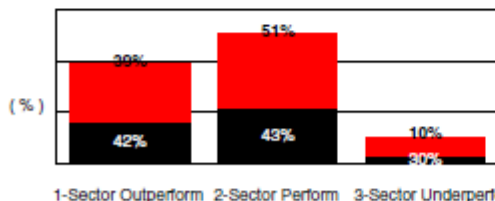
Exceptionally high financial and/or operational risk, exceptionally low predictability of financial results, exceptionally high stock volatility. For risk tolerant investors only.

Venture

Risk and return consistent with Venture Capital. For risk-tolerant investors only.

Scotia Capital Equity Research Ratings Distribution*

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* As at May 31, 2011.

Source: Scotia Capital.

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None.

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