



Holland Views – Dollar Tree – Price: \$81; M Cap: \$19,295m

## A cash compounding colossus

We believe we have found a new business with almost all of the traits we look for. It is also in or near our sweet spot, being a great compounder but with an easy to understand value consumer proposition. It has a history of great returns and has excellent capital allocation credentials.

US-based ultra-discount retailer Dollar Tree, we conclude, has three angles of value that attract us to its shares. These are:

1. It is a simple business with a long track record, excellent longstanding management and operates in a duopoly with a high market share.
2. It looks undervalued against the quality of its business model, cash generating capacity and growth potential.
3. Its owner earnings (cash) we think are 25% above the reported net income. Further, its reported earnings are possibly under earning today as 50% of its sales might well see a longer term margin recovery.

We have looked closely at this company for some weeks now. The sizable (game-changing) acquisition by Dollar Tree of its competitor Family Dollar in 2015 makes assessing *the trend* of the company's past achievements a little harder to analyse (but far from impossible). However, it is the long-lasting effects of that acquisition that throw up today's opportunity in the possibly depressed margins and returns and the depressed share rating vs. peers that has resulted.

Before this acquisition in 2015, Dollar Tree was a compounding colossus, growing organically and generated prodigious amounts of cash in the process. As a sweetener to encourage you to read on, we disclose in Fig.1 below that Dollar Tree's Book value per share compounded at 13% pa in the 15 years to 2014 notwithstanding that, over the same time, an average c.78% of annual net income was returned to shareholders. Square that!!

We think this could be an exceptional investment offering some compelling long-term cash compounding to investors prepared to study.

Fig.1: A hell of a track record

1998-2014	\$m
Average ROE	26%
Cumulative Reported Net Income	4,753
Cumulative Capital Returned to shareholders	-3,698
aggregate capital return as % of Net Income	78%
BVPS cagr	13%
Holland est of Cumulative 'Owner Earnings'	6,032
as % of Net Income	127%

Source: Bloomberg, Holland Advisors

### This report is split into three sections

1. The first gives a pictorial view of this sub-sector showing the attractive traits that it possesses and how the stock market considers it favourably.
2. The second looks at Dollar Tree and seeks to show it as a better/or a least as good an operator as its peers despite a much lower share rating.
3. Lastly, we look at the prodigious cash generation this company has now produced for 20 years. Our analysis showing how annual owner earnings are 25% above reported Net Income.

### First, a refresher on the qualitative attributes we seek – A company should:

- Seek to deliver excellence to customers and treat/train its employees well to ensure industry-leading products and drive long term loyalty of the product or service offered.
- Make the high returns that we are all attracted to and also be primed to maximise growth opportunities.
- Have Management who are open and honest about the opportunities, business drivers and hurdles in their industry. They should also express clarity in understanding what type of company it seeks to be in order to maximise shareholder value.
- Know how to use shareholder capital as wisely as possible for all types of expansion or efficient balance sheet structure.

## Mr Market ‘gets’ that Dollar Stores – in scale – are a great model

The ultra-discount ‘dollar store’ retail market in the US is comprised almost entirely of three brands, Dollar General, Dollar Tree and Family Dollar. Dollar Tree acquired Family Dollar in 2015. Dollar Tree has remained a true \$1 store – everything costs a dollar - the other two brands sell multi-priced assortments.

Fig.2: Three brands now within a market duopoly

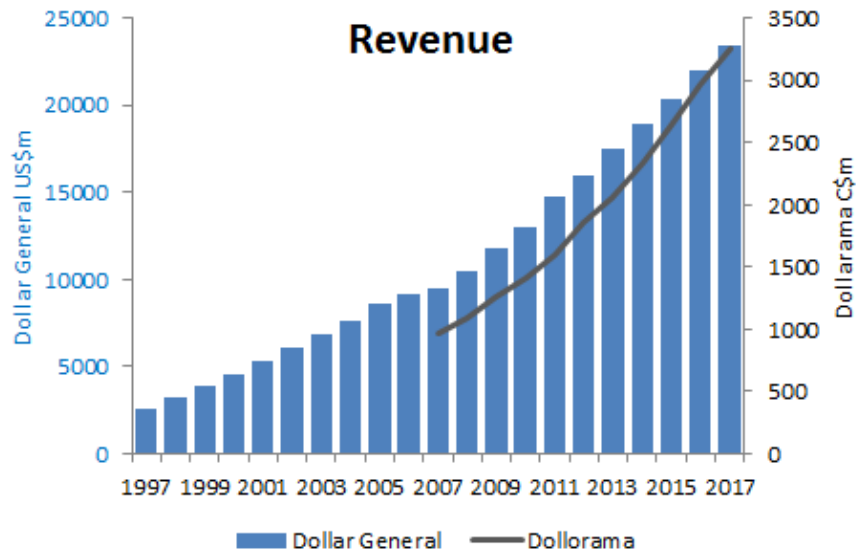


Source: Fortune.com

Post Dollar Tree’s acquisition of Family Dollar it now has 14,800 stores (under its two brands) across the US, its main rival Dollar General has 14,500. Whilst industry data is not easy to come by we estimate today that these two have c.80-90% market share of the dollar store format in the US (competitors mentioned are Fred’s and Five Below but only have twelve hundred stores between them). In Canada a sizable operation has also been built by Dollarama of c.1200 stores.

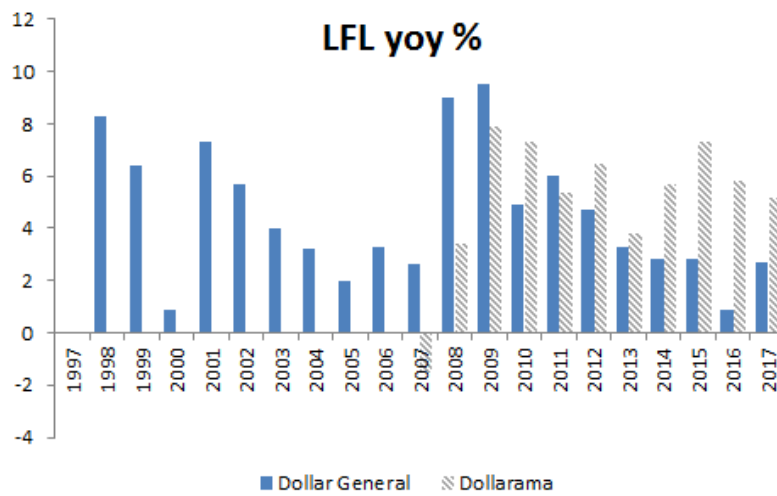
Below, for starters, we show a collection of charts for peers Canada-based Dollarama and US-based Dollar General. The combination of which, we think, clearly illustrates the strong and long lasting growth these companies (and this sector) have experienced – the vast majority achieved organically. It also shows the impressive returns on equity that have resulted.

Fig.3: A growth market



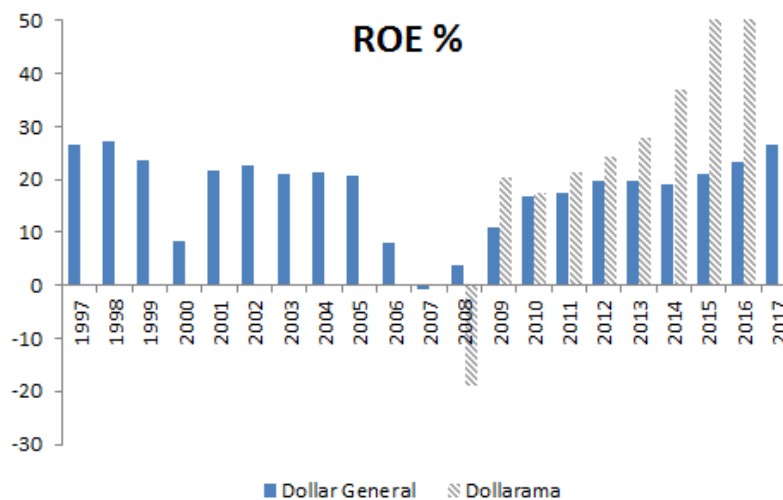
Source: Bloomberg

Fig.4: LFL sales growth



Source: Bloomberg

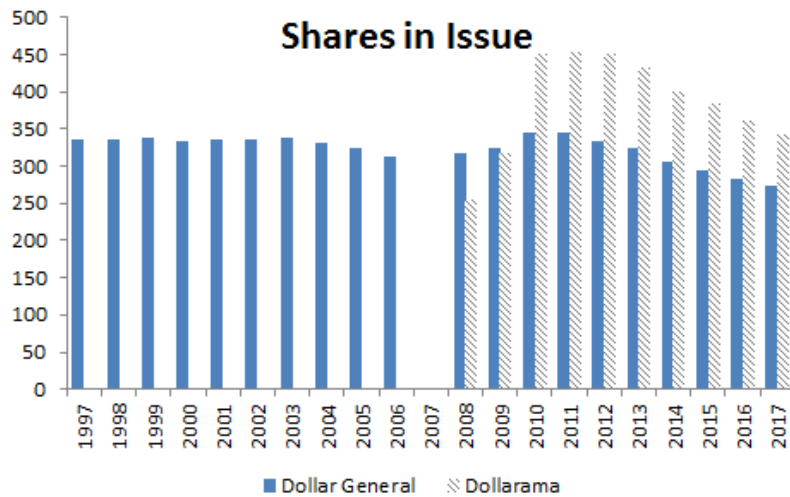
Fig.5: Returns on equity



Source: Bloomberg

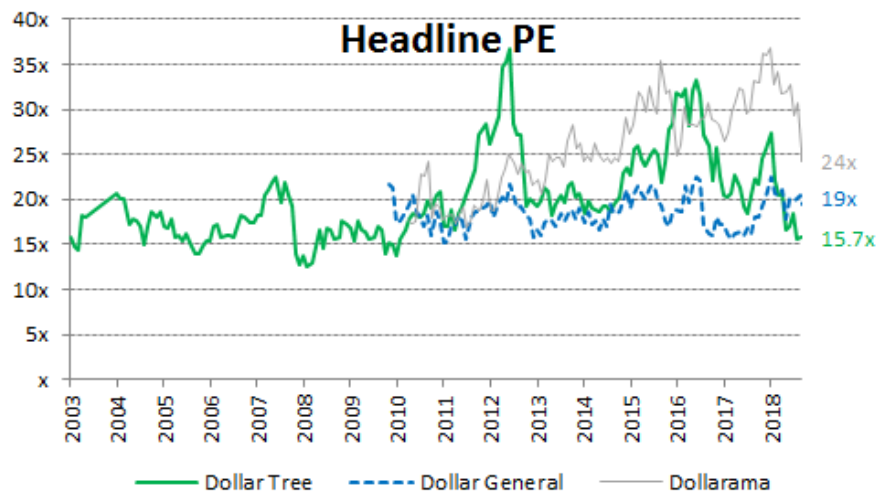
The next chart shows re-purchasing of their own stores by these two companies as they find themselves with excess capital (Dollar Tree did the same pre-2014). And lastly unsurprisingly Mr Market has mostly (excepting Dollar Tree today) rated the sector shares highly.

Fig.6: Becoming cannibals



Source: Bloomberg

Fig.7: But not all priced the same by Mr Market of late (since 2015)



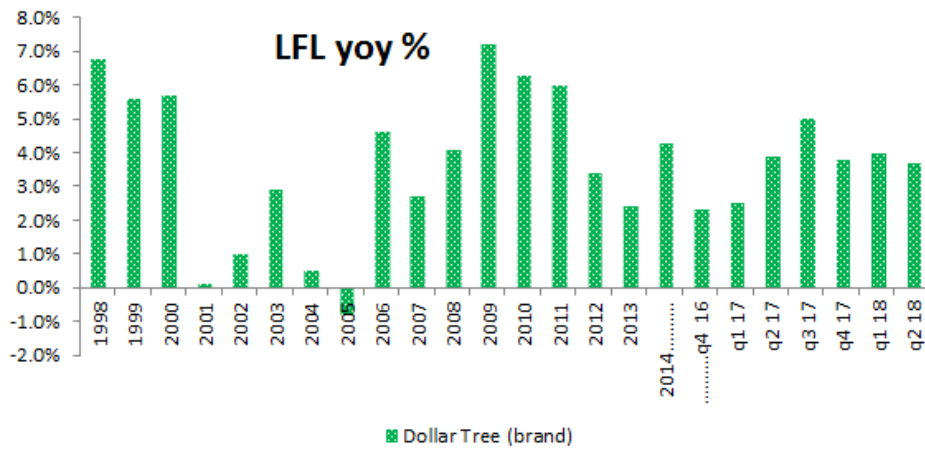
Source: Bloomberg

### How does Dollar Tree compare, operationally?

The chart above shows that today Dollar Tree’s PE rating – for the first time in its history – lags that of its sector peers. However when we study Dollar Tree’s longer term track record we can find little justification for this.

Yet more charts below show that up to 2014, Dollar Tree actually had higher margins and ROEs than Dollar General; Fig.8 also shows that not only did its core operation (Dollar Tree brand) have good LFL sale growth until 2014, but in fact they have remained good since its big acquisition as well.

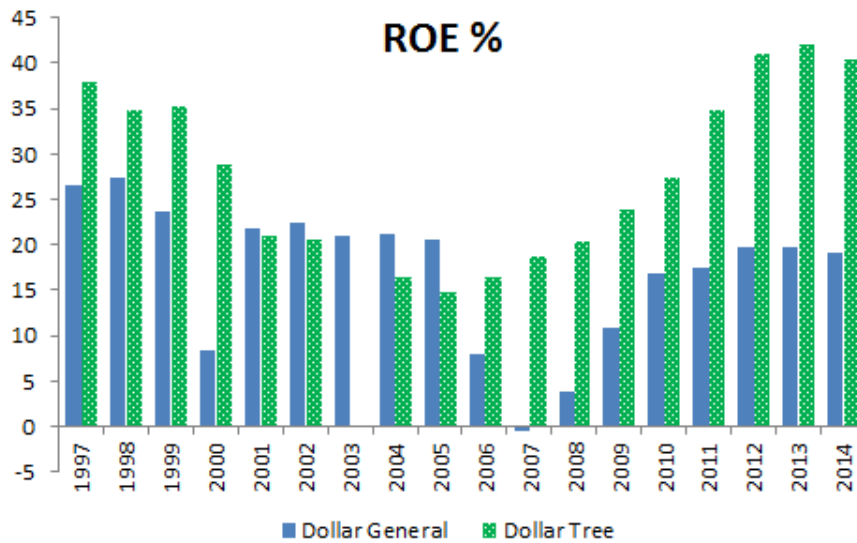
Fig.8: Consistency of growth



Source: Bloomberg, Dollar Tree 10Qs

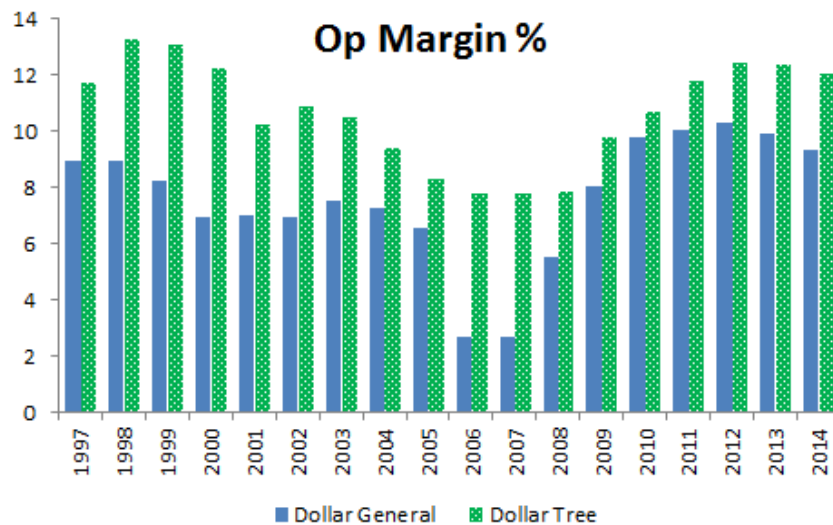
It should be noted that Dollar Tree just like Dollar General and Dollarama has grown its (entirely leasehold) store base by c.9% cagr (1998-2014) and 3% cagr in the last two years).

Fig.9: A history of better returns too



Source: Bloomberg

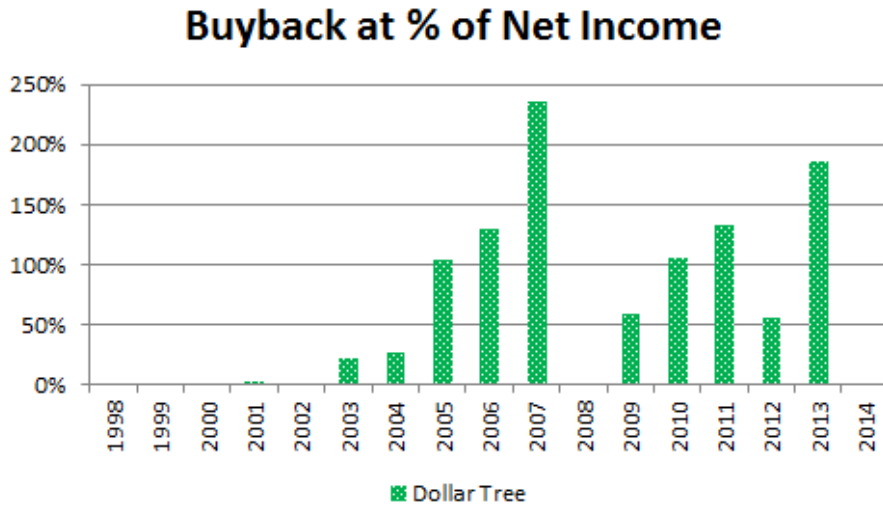
Fig.10: Better margins



Source: Bloomberg

The other aspect of Dollar Tree that we have found very compelling is its cash generation. This we will discuss later in the report. However we think the following charts are illustrative of a company that has not only operated well by growing organically, and made good shareholder returns, it has also allocated well too.

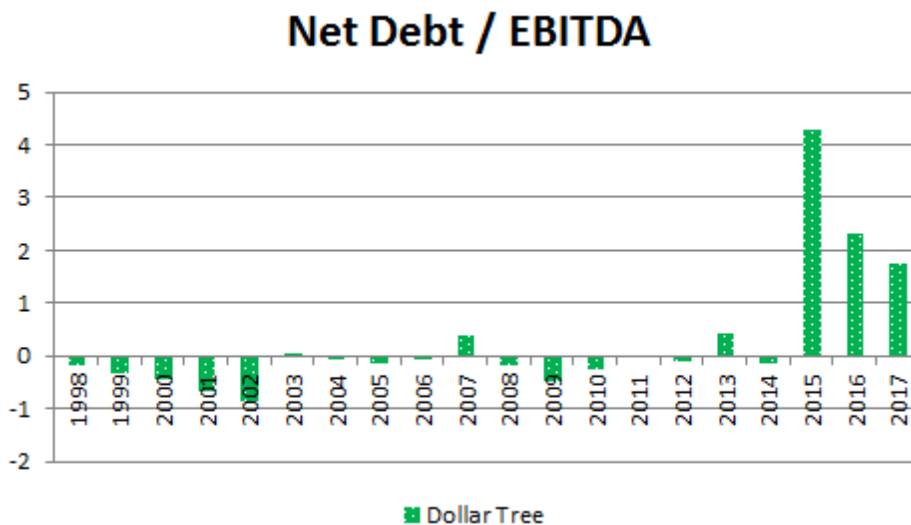
Fig.11: Strong capital allocation



Source: Bloomberg

Like its peers Dollar Tree did the right things with excess cash when it found itself in possession of it pre-2014 – it retired a good portion of its stock. The Family Dollar acquisition we will discuss shortly, but what is notable is the unprecedented scale of debt this company took on to undertake this deal (previously the business had always been net cash). The resulting debt to EBITDA ratio rose to 4.3x in 2015. However with growth in EBITDA and cash generation this ratio has dropped to less than 2x in only two years. This is a huge level of real cash production considering that the company is also still expanding its store footprint (see CAPEX table later).

Fig.12: The cash generation is consistent and the consistency of allocation is also very clear



Source: Bloomberg

## The deal that will define this company – Family Dollar

Any investor that chooses follow us down this path will need to read much around this deal to fully understand what is being presented to them today. We have done just that (and would be happy to share a reading list to help others). We make some summary thoughts below however:

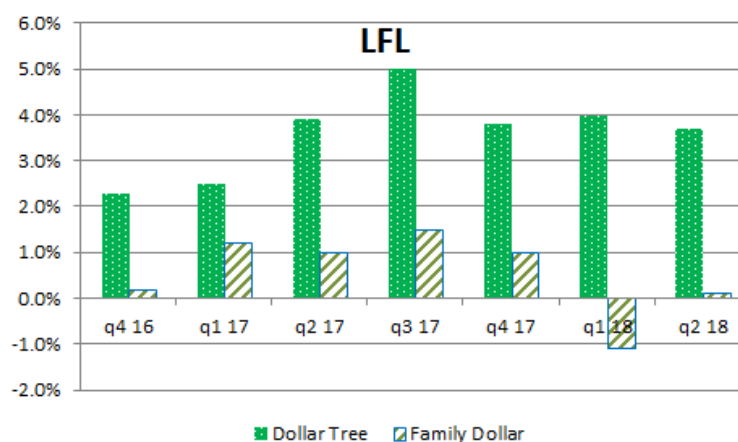
- Dollar Tree did not have to do this deal – they had a wonderful record of organic growth and industry leading returns prior to it.
- They were disciplined during the bid ultimately winning despite their then larger competitor Dollar General offering c.8% more for Family Dollar.
- A few years prior to the deal Family Dollar had become too promotional allowing gross margins and some pricing to rise – it paid a high price as customers deserted it and the tactic ultimately proved a fatal mistake. EDLP integrity and the relationship it builds with customers is something we believe strongly in and as such we have been very pleased to find that Dollar Tree understands and obsesses about this also.
- At the time of the deal Dollar Tree talked of hoping it could one day recover the combined groups margins back to their own pre deal level (today's group EBIT margin is 8.9% vs. 2014 level of 12%).
- The easy part of the Family Dollar margin recovery was the delivery of c.\$300m pa synergies – which were projected and delivered.
- The much harder part of any Family Dollar recovery is whether it can one day operate at a more attractive margin:
  - Here Dollar Tree are clear – they have and will continue to invest in price, range and service;
  - They realise that they will only win (i.e. get some positive operating leverage – i.e. margin rises) if their customer wins (i.e. like the product and value and buy more);
  - This is the thinking of a customer-focused business that we love to see.
  - Considered another way this is the 'hard way' to grow profits, but 'the right way'.
- We believe Dollar Tree saw this deal for what it was – a once in a generation chance to consolidate this sector from three players to two:
  - The deal stacked up from the synergy pay back alone;
  - But the real bargain might be what a proven operator like Dollar Tree can do with a mis-managed (but huge – c.8,000 store portfolio) in the longer term.

### Where we are on this today

The above bullets are the short version of a great deal of history. Today's position we would assess as being that Mr Market has seen the synergies delivered and now is looking for the same quick fix of Family dollar LFL sales to improve to mirror those of Dollar Tree.

We would assess that mending broken brands takes a lot longer to fix than cost saving do to be realised and the falling rating of Dollar Tree's shares just reflects its slightly less clear investment story vs. its peers.

Fig.13: Family Dollar &amp; Dollar Tree LFL since the deal



Source: Holland Advisors, Dollar Tree 10Qs

In fact we will be upfront and say we have no better insight than a reader as to whether the Family Dollar business can see significant improvements in sales or margins. What we do know is that no such recovery is priced into the shares at all. This business seems stable and makes good returns thus it is not a drag on the group. Additionally, and importantly the core Dollar Tree branded stores have shown no ill-effects post the merger.

Thus we find ourselves concluding that Dollar Tree shareholders in addition to the value we will highlight in the next (cash) section are being offered a free option on what a good/great value retailing team can achieve with an under-earning sizable and complimentary store base.

## Cash is King

When looking at the accounts or past financials of Dollar Tree one thing stands out – that being the significant cash generation. We noticed how on a repeatable annual basis the groups free cash flow was in excess (by a significant clip) of its reported net income. As believers in the process of double entry bookkeeping rather than fairy dust we set about to understand how this could be the case.

We have spent c.20 years now studying how cashflows and reported profits can differ. Outside of acquisitions there are only a small number of reasons:

- When cash tax and P+L taxes differ
- If working capital is either a drain on cash resources or occasionally a boost in negative working capital companies
- That the depreciation of assets being charged to the P+L account differs from the real cost of maintaining those assets.
- Provision chicanery or creative accounting.

In Dollar Tree's its cash and P+L taxes costs look pretty similar. Dollar Tree does require working capital to grow but not a great deal. Our work suggests it added only \$120m to working capital in the 5 years to 2014, during which time its sales almost doubled to \$8.6bn. Today it is investing a little more in working capital behind its Family Dollar brand to improve ranges and availability, but such working capital will not be a significant drag or boost we conclude to future cash generation.



### Sustainably low maintenance CAPEX

The main item of difference we are interested in is the depreciation/amortisation charge and the cashflow CAPEX.

Fig. 14: Capital spending

Dollar Tree	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Capex	-182	-139	-175	-189	-131	-165	-179	-250	-313	-331	-326	-481	-566	-632
Depreciation	129	141	159	159	162	158	160	164	175	191	206	488	638	611

Source: Bloomberg

At first glance this table looks normal, but it is important to overlay the real business on these numbers. This is a company that during the 16 year period to 2014 increased its store estate from 2,735 to 5,367 and the earnings power of the entity rose in line with this expansion (+232% 1998-2014). Whilst its stores are leasehold there is clearly opening costs to each. On digging further, the company – whilst not explicitly disclosing a ‘maintenance’ CAPEX spend in dollar terms has given regular disclosures of ‘remodelling CAPEX’ with all other CAPEX associated with new store openings. On average we estimate the company only spends c.30% of its total CAPEX maintaining its estate.

This plausible estimate (based on some real figures of site remodelling costs we found) suggests an over-depreciation of assets in the P+L accounts and in turn a level of owner earnings (i.e. earnings before growth investment) that is higher than many might expect.

### Fool me twice – Shame on me

A simple recalculation of the company’s earnings power taking into account just the maintenance CAPEX suggests an earnings figure c.25% greater than the annual reported net income (see table on front page). However over the years we have learnt to check and check again before declaring we have found a money tree. As a result one of your authors (the hard working one) set about checking out this thesis of excess cash generation. He did so by investigating the aggregate flow of all cash in the company during the years 1998-2014. As a non-acquisitive company with simple accounts it was a reconcilable exercise. The results we believe, back up our thesis of owner earnings being c.25% above net income, both in the past AND now. Importantly we tested this over a long period and one where the group was reporting consistent LFL sales growth (i.e. no showing no notable deteriorating in the franchise quality either in the period or after it).

### Our 1998-2014 study in brief

- Starting net cash was \$28m vs. ending net cash of \$181m
- Cumulative CAPEX was \$3,069m
- Cumulative depreciation was \$2,123
- Cumulative share buy backs was \$3,698
- Cumulative net income was \$4,753

During this period Dollar Tree grew its sales by 16% pa and its profits by a similar figure. It also grew its book value per share by 13% pa. However it did so whilst returning an average of 78% of net income annually to shareholders.

As stated above this was only possible because the required maintenance CAPEX to look after the existing estate was far less than the depreciation charged in the P+L account<sup>1</sup>. The bulk of Dollar Tree’s capital expenditure is used to new store fit-outs. In other words, this means that the

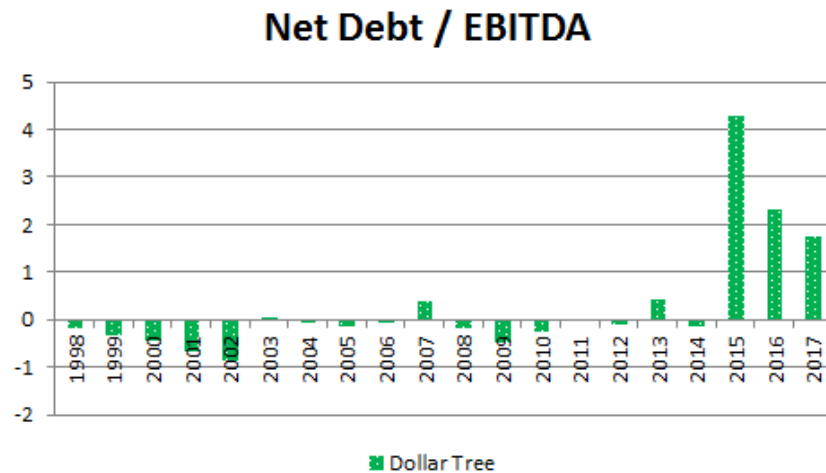
<sup>1</sup> Simplistically, Dollar Tree spent \$3bn on capital spending but we think only 30% (or c\$1bn) was attributable to maintenance/remodelling spending. This \$1bn compares to the c\$2.1bn depreciation over the period (i.e. 50% of that expensed)

D&A that is expensed through the income statement is far greater than the maintenance capital actually needed of the business. As a result the group had more than sufficient cash to pay most of its earnings out to shareholders AND invest in new productive assets too. Importantly whilst our back test ended 4 years ago we still see all these traits in the business today.

#### [Prodigious cash generation post 2014 too](#)

The scale of the ‘bet’ Dollar Tree made in acquiring Family Dollar can be seen in the chart below in terms of the Net debt it took on to finance the deal.

Fig.15: Deleveraging – as it promised it would



Source: Bloomberg

A company that was structurally (and you might say, culturally) net cash suddenly had net debt/EBITDA of 4.3x. What is of great interest from a cashflow analysis perspective today is how fast this ratio has now fallen. The swift decline has been due to a) the group’s cash generation and b) the fact that it can invest to grow its earnings capacity. Only two calendar years after the deals completion net debt/EBITDA has fallen to 1.8x. Like you, our clients, we see many companies make leveraged acquisitions – we have never seen the leverage fall this quickly afterwards however.

#### [Show me the money](#)

In our lifelong study of Mr Market we have noticed a trait that he often displays – we call it ‘show me the money’. Simply put when a company is growing and raising its profitability (say through rising margins) and is buying its own shares back Mr Market will interpret these traits in a ‘*look at him – he is the poster child*’ manner. This can be seen in the strong ratings of Dollar General/Dollarama today. However Mr Market is not so good on detail and even less good on future potential earnings power and this is where we think the opportunity lies in Dollar Tree today.

Dollar Tree was also that poster child in 2008-2014 then its sizeable, industry consolidating, acquisition confused the picture. Now it seems to Mr Market to have slower headline LFL sales and no buy back of shares (as it is paying down debt). Its peers thus have a simpler message to interpret and higher PE ratings as a result.

We think Dollar Tree is:

- a) A cashflow compounding monster;
- b) Has margin recovery potential due to the long term work it can undertake in Family Dollar;
- c) Will one day again become a stock market loved share either due to point b) coming true or just as its debt pay-down matures and it once again returns to becoming an aggressive buyer of its own shares.

Lots of cash generation annually combined with possibly higher margins and higher PE's could create a lollapalooza result for the owners of its shares.

## Conclusions/Reflections/Queries

We are new to this industry in the US and thus mindful of the pitfalls that can result from early enthusiasm. As our work progresses on this company we will look to:

- a) Refine/recheck our understanding of the cash generating capacity of the company;
- b) Take time to understand the growth opportunities, or their limitations, that remain for the sector (both inside the US and out);
- c) Better understand the capital cycle of this wider sub-industry; and
- d) Get a better understanding of the management and the alignment of their interests with shareholders.

Having read much about this sector we are struck by how it is a microcosm of all we look at in markets. The compounding, buy backs, cashflow and customer focus traits we often look for are seemingly on display at the company level. At the sector level there is also evidence of past over-expansions and mismanagement of the customer offer and the damage to the franchise that resulted (Family Dollar). Also there is the player that went to private equity and returned to the market (Dollar General) and one that has remained quoted and chose to be the consolidator. An overriding thought of ours in this sector is to understand where we are in the capital cycle of expansion and consolidation. A greater understanding of this we think may help our conviction on this stock a great deal.

### Under-earning and undervalued great companies = Lollapollaza

- A company with high market share, that is very focused on customer value and having a credible and provable reputation for delivering the same has a good chance of growing sustainably.
- 3% store growth and 2% LFL sales growth combined with no operational leverage but some medium term buy back could still easily produce EPS growth rates of 10% p.a. (Dollar Tree 1998-2014 EPS growth was a 17% cagr).
- Such a modest sustainable growth rate will likely in time lead to Mr Market re-appraising such a company. A re-rating from 10x owner earnings today (see Fig.16) to say 17x might be a reasonable outcome.

Fig.16: a cheap share indeed

Dollar Tree	Jan-18	Jan-19	
adj EBITDA	2,725	2,807	+3%
less interest	-301	-264	
less 20% tax	-346	-365	on Q2 18 debt levels
less Working Capital	-451	-100	normalised
less Maintenance Capex	-190	-200	30% of total capex
Owner Earnings	1,438	1,878	
Headline adj earnings	1,156		
Q2 18 shares	237.9		
Headline adj P/E	16.7x		
P/OE	13.4x	10.3x	

Source: Dollar Tree, Holland Advisors

The above scenarios (10% EPS growth) and the highlighted share re-rating over 5 years could result in an investor IRR of 18% pa to a shareholder buying today. Whilst such IRR's excite us, we think even that scenario might not consider the full potential of this business. Any recovery in margins and/or sales at Family Dollar will boost profits and cashflow growth by a meaningful amount. The knock on effects of which could well justify use of the term lollapalooza. We have more work to do on this but we recommend it to you all most highly.

**Buy Dollar Tree.**

**Andrew & Mark**

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