A Perspective on Dollar Tree

By Dave Perkins, CFA

Dollar Tree operates a network of approximately 14,400 discount variety stores across the United States and Canada under the Dollar Tree, Dollar Tree Canada and Family Dollar brands. During the summer of 2015, Dollar Tree completed a transformational acquisition of competitor Family Dollar Stores for $8.8 billion and now operates under two distinct banners. The legacy Dollar Tree segment operates 6,400 stores, offering everyday basics, seasonal, closeout and promotional merchandise at a fixed $1 price point ($1.25 CAD in Canada). The Family Dollar segment operates approximately 8,000 general merchandise discount retail stores focused on providing customers basic necessities such as diapers, food and paper products as well as seasonal merchandise at prices between $1 and $10.

Value & Convenience

The dollar store model was born in the 1950s, targeting small ticket (typically less than $10), weekly "fill-in" visits between larger trips to the grocery store (and later, mass merchants like Wal-Mart). Small stores (6,000-10,000 square-feet) with a narrower selection of lower priced goods allowed dollar stores to operate economically in close proximity to customers. This combination of value and convenience resonated with lower- to middle-income American consumers, leading to a doubling in the number of dollar stores across the country since 2003. As their reach expanded, dollar stores generated sales comparable to that of grocers and mass merchants on the 7,000 items stocked, providing the opportunity to buy those same products at similar discounts. At the same time, low-cost, efficient store footprints allowed dollar stores to build local density, lowering logistics costs. As a result, dollar stores offer convenience at equal or lower prices versus their larger grocery and mass store competitors. They also match the relative ease of drug and convenience stores, but with 20-40% lower prices. These twin advantages have proven a durable niche, allowing dollar stores to generate consistent growth, attractive returns on capital and significant excess cash flow.

The Giving Tree

The legacy Dollar Tree banner is the last remaining true *dollar store* where every item is a dollar. Dollar Tree prides itself on being a *'variety store',* aiming to strike a balance between consumables such as food and toilet paper and more discretionary items such as toys, stationery, party supplies and holiday décor. Dollar Tree describes its core customer as "a woman on the go, with household income of $40,000+ balancing work, home and family". The Dollar Tree concept has proven effective in serving this core customer in communities of all sizes, with remarkably consistent and attractive financial results. Same-store sales have risen in 22 of the past 23 years with store payback periods between two and three years (pre-tax), among the most attractive in retail. Dollar Tree has intentionally shared a meaningful portion of these scale benefits with customers in the form of higher quantity and/or better quality for the customers' dollar. We believe the company should comfortably grow square footage at a 3-5% annual clip over the next 5-10 years, driving solid mid-single-digit profit growth.

Improving Family Dollar

For most of the past decade, Family Dollar's operating performance has lagged that of peers Dollar General and Dollar Tree. Much of that underperformance can be traced to two costly strategic errors. First, in response to burgeoning demand following the '08-09 financial crisis, the company embarked upon an aggressive multi-year store expansion plan by increasing density in existing markets and introducing new Family Dollar stores into middle and upper-middle class suburban markets. The expansion cannibalized its existing store base, raised costs and pressured margins. With same-store sales falling and store productivity declining, Family Dollar made its second mistake–abandoning its everyday low price (EDLP) model in favor of a 'high-low' promotional pricing strategy aimed at reigniting store traffic. Gross margins fell further, leading to unsustainable cost cuts including maintenance deferral and already thin in-store labor. Pressure to sell the company mounted, culminating in activist investor Carl Icahn purchasing a 10% stake in the company and demanding its sale.

Dollar Tree ultimately won the ensuing and well-chronicled battle for Family Dollar. A key question for Dollar Tree investors is whether the problems it inherited at Family Dollar are structural–a combination of a suboptimal real estate footprint, damaged brand and undifferentiated product offering–or the result of a series of strategic missteps that can be gradually undone. Answering this question is nuanced, but we believe Family Dollar should return to historical operating margin levels (roughly 8%) over the next several years under the Dollar Tree leadership team's care. Returning Family Dollar to an EDLP pricing model, improving its store merchandise (more private label and $1 price points) and in-stock levels, catching up on deferred maintenance, fixing in-store staffing levels and rebannering underperforming stores should lead to a gradual improvement in profitability. Longer-term, supply chain opportunities could result in Family Dollar closing the margin gap with consumable-heavy peer Dollar General.

Durable Retail?

Retailing is a notoriously difficult business. Creating lasting value requires continual reinvestment, extreme cost consciousness, painful evolution and competitive paranoia. We believe Dollar Tree demonstrates these traits. Discount retail is becoming more competitive with low-margin, hard discounters like Aldi expanding rapidly and Lidl planning a major push into the U.S. over the next five years. Amazon (which we also own in Value Fund and Research Fund) continues to invest significant sums into its already formidable fulfillment network, with an eye toward daily–even hourly–delivery. The combined Dollar Tree is unlikely to be entirely immune to competitive encroachment, but our working thesis is that the company's combination of convenience and low average ticket are underappreciated competitive weapons in serving the low- to middle-income U.S. consumer. In short, we continue to see Dollar Tree as one of the 'disruptors', with an attractive runway of store growth and self-help opportunities at Family Dollar. We believe Dollar Tree's stock provides long-term investors with a healthy margin of safety in the low $70s. Our base case estimate of intrinsic value falls between $100 and $105 per share.

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Included above is a reference to the term "margin of safety". This term refers to purchasing securities at a price that is less than our estimate of intrinsic value. A potential "margin of safety" may limit downside risk and optimize the potential for growth.

As of March 31, 2017: Dollar Tree, Inc. represented 1.6% and 2.0% of the Value and Research Funds' net assets, respectively. Dollar General Corp. represented 1.1% of Research Fund's net assets. Amazon.com, Inc. represented 1.2% and 2.3% of the Value and Research Funds' net assets, respectively.