



Petco Health and Wellness (WOOF): Secular Tailwinds Meet Cyclical Headwinds

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Berna Barshay Substack: [@HedgeFundGirl](#)



About Me

- 23 years on the buy side as an analyst and PM
 - Goldman Sachs, Sanford Bernstein, Ingleside Investors, LaGrange Capital, Swiss Re, Buckingham Capital, Metropolitan Capital, MIG Capital, Sky Zone Capital
 - Consumer and Media sector focus with additional experience in energy, industrials, financials, and business services
 - Small cap and special situations specialist
- 2 years at Empire Financial Research (subsidiary of MKTW) writing paid investment newsletters and a free daily financial newsletter that reached >200,000 subscribers
- Additional experience as management consultant to a Fortune 100 retailer, startup advisor (seed to Series D), equity derivatives trader, Series A FinTech CFO
- Currently:
 - an active private investor
 - a research consultant at Guidepoint Insights covering Media & Entertainment, Online Sports Betting, Travel & Leisure
 - author of the Consumer/Culture/Commerce by @HedgeFundGirl Substack



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About Petco



- Pet Omnichannel Retailer with 1,500+ locations in the U.S., Mexico, and Puerto Rico
- Founded 1965
- Taken private by private equity twice
 - Leonard Green/TPG 2000, TPG 2006
- Focus on Health and Wellness + Premiumization and Humanization
- Growing Web Business and Loyalty Programs
- Merchandise Categories:
 - Consumables (Food, Litter, Treats)
 - Discretionary/Supplies (Crates, Clothes, Leashes, Toys)
 - Small Companion Animals (Birds, Rodents, Fish)
- Provides Services Including Grooming and Training
- Growing Veterinary Services Business Both On-Site and Through Mobile Clinics
- In-Store Adoption Events Have Homed Nearly 7 Million Animals

WOOF is Sick As a Dog



-64% YTD

-81% from
1/13/21
\$18 IPO
price

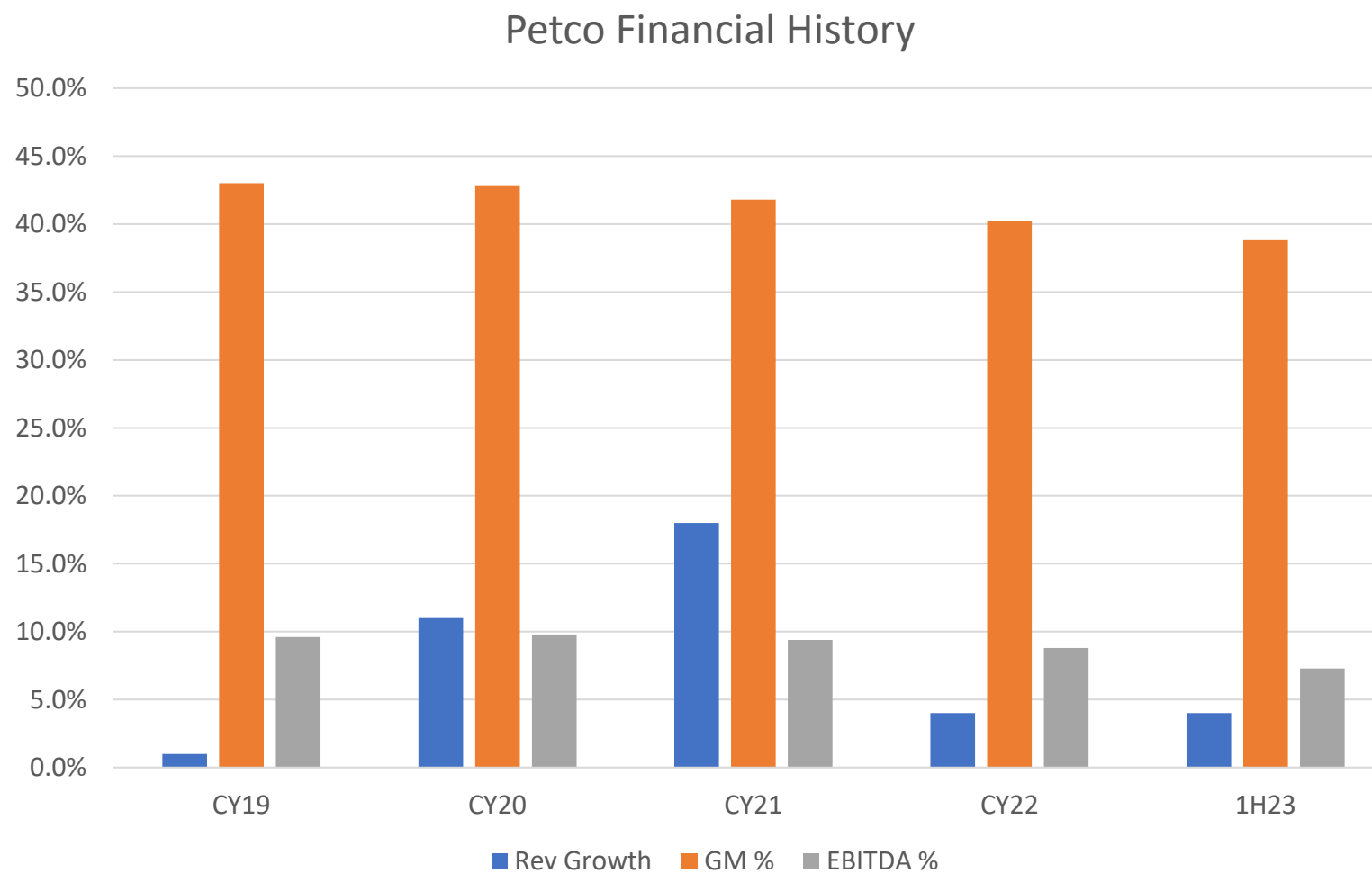
-88% from
all-time
high
\$29.40 on
1/14/21

What happened?

- Negative Earnings Revisions
 - EPS Estimates down 61% since 1/5/2023 \$0.71 → \$0.28
 - EBITDA Estimates down 26% since 1/5/2023 \$605 mm → \$446 mm
 - Revenue Estimates down 1% since 1/5/2023 \$6.33 bn → \$6.26 bn
- Gross Margins down 200 bp in 2 years
 - Unfavorable Merchandise Mix Shift From Discretionary to Consumables
 - Services growing DD and drag down GM (but not EBITDA margins)
- Macro-driven trade down by some – but not all - customers
- Jitters over leveraged equities in a rising rate environment



Retail Twist: Deleverage w/o Sales Loss



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A Plan for Tackling Cyclical Challenges

- Cost cuts: \$150 mm cost cutting program (\$40 mm year one)
- Merchandising: While premiumization/humanization remain the core focus, supplement with more value-priced products
 - Add “good” to what has been a “better”/”best” assortment
 - Fancy Feast recently added to approximately half of stores
 - After 3 weeks, “strong double digit % of Fancy Feast customers are new to Petco”
 - Traffic driver w/potential for add-ons and, longer-term, customer trade up
- Pricing/Competitiveness: Broader, targeted price actions which should break even in two quarters, be accretive in four
 - High-end and exclusive products not being cut
 - More targeted at mid-level range of merchandise



Retail Turnarounds: Key Questions

Alt Title: How to Spot a Retail Value Trap!

Shrinking merchandise category?

NO

Fashion risk/fashion volatility?

NO

Unusually tough comps?

YES

Evolving bricks & mortar competition?

NO

E-commerce cannibalization?

SOME

Loss of relevance to customer?

NO

Tech obsolescence?

NO

Incompetent management?

NO

High leverage?

YES

Close-in maturities?

NO

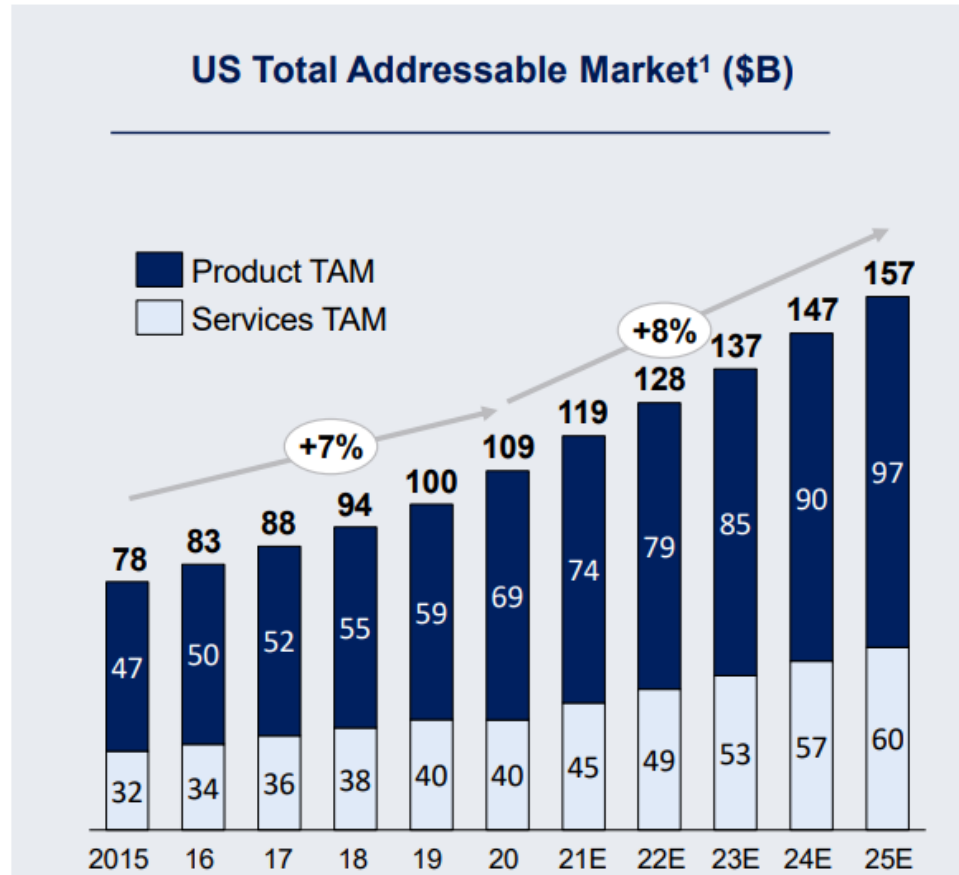
Vendor problems/concerns?

NO



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It's Not All Bad News: U.S. Pet Industry Outgrows GDP and Consumer Spending



Source: Petco 2021 AGM Presentation

Drivers:

- Growth in Pet Ownership
 - U.S. Households with dogs = 38.4% in 2016 and 44.5% in 2022
 - U.S. Households with cats = 25% in 2016 and 29% in 2022
- Higher spend per animal due to focus on wellness
- Mind shift from “pet ownership” to “pet parenting”

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Humanization is WOOF's Friend



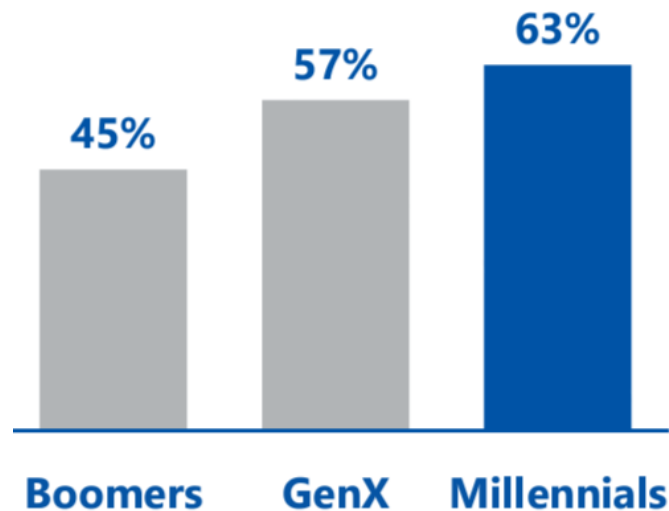
Forbes Survey of 10,000 dog owners found:

- 39% tightened budget to spend more on a dog
- 14% moved from apartment to house so dog could have a yard
- 36% said they would spend \$4000+ on vet care in an emergency

CPG All-In on Premium Pet Food

Elevating Role of Pets

% of Pet Parents Who Say They
Treat Dog or Cat Like a Child



Source: Custom Survey Aug 2022 n=1800 dog and cat parents

Source: 2023 General Mills CAGNY presentation

Recent Transactions

- 2018: General Mills buys super-premium, natural pet food maker Blue Buffalo for \$8 billion
- 2021: General Mills buys Tyson's pet treat business for \$1.2 billion
- 2022: Colgate spends \$700 million on three U.S. manufacturing facilities to drive growth at its Hill's Pet Nutrition unit

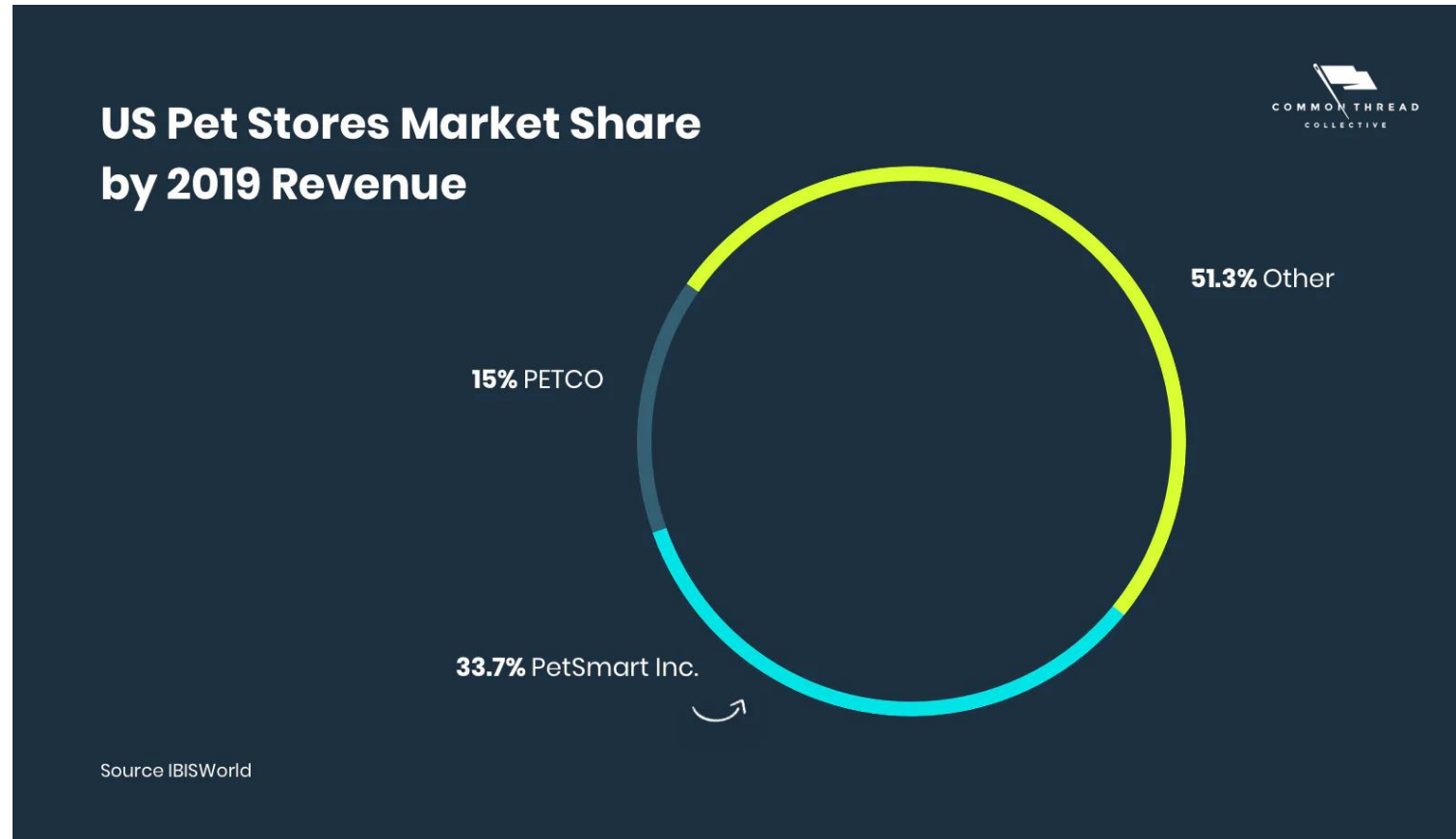
Premiumization

- 61% of U.S. pet owners say they will pay more for foods targeted to their pets' dietary needs
- 69% of Millennials opt for natural or organic pet food
- 43% of dog owners and 41% of cat owners buy premium food

Source: [Petfoodindustry.com](https://www.petfoodindustry.com)

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Brick & Mortar Competition



- #2 Player in physical pet retail
- High and growing subsector concentration
- Petco been taking share from PetSmart
- WMT, TGT, and Grocery are big players but at lower-end of food market

Increasing Category E-Commerce Penetration

Pet Products Sold Online in 2015 8%

Pet Products Sold Online in 2022 30%

Pet Products Expected to be Sold Online in 2024 35%

Leading Online Pet Retailers Annual Sales



Source: Packaged Facts, CommonThread/Digital Commerce 360

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Key Elements of Petco's Strategy



What?

Keep brick & mortar relevant
Differentiate from general retail
Cater to premium customers
Build loyalty
Invest in omnichannel
Pursue underserved markets

How?

Services: Grooming, training, vet/health
Humanization/premiumization, private label
Focus on wellness, wide assortment incl. fresh/frozen
Free & premium loyalty programs (>\$100 mm ARR)
Auto-ship, BOPIS investments, in-stocks
Partnership w/LOW, new rural farm/companion stores

Recent Progress in Focus Areas

- 19 consecutive quarters of positive comps
- 13 straight quarters of bricks & mortar growth
- Taking share from PetSmart
- 75,000 Vital Care Premier members added in second quarter at \$25/month
- Vets employed up 59% year over year despite constrained labor market
- Digital sales outperform overall sales at +9% in 2Q23, +19% two-year stack
- Services growth +31% one year/52% two year
- Improvements in free cash flow, paid down \$75 mm in debt in August YTD



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Underappreciated Opportunity #1: Last Mile Delivery

- Pet food is heavy and low margin, expensive to ship
- CHWY margin hovering just over 2%, trading at all-time low, still 19x EBITDA to WOOF's <6x
- Ship-from-store costs 20% of ship-from-DC, food only orders can be profitable
- Daily carrier pick-ups supplemented by store worker deliveries
- Can address immediate needs while lowering shipping/packaging costs



Underappreciated Opportunity #2: Vet Business Rollout

The Business Today

- 268 vet hospitals + >1000 vet clinics
- Preferred employer in tight labor market for vets

The Business Model

- Vet Hospitals are dilutive Year 1, breakeven Year 2
- Year 5: 20% four-wall margin with 4%-5% center store lift
- Traffic driver/loyalty builder for retail

Why This Matters

- Immature, currently dilutive business that will eventually be margin accretive
- PE has been extremely active in pet hospitals, at 20x or more
 - Catterton paid \$800 mm for Alliance Animal Health (\$39 mm EBITDA) in late 2021
- Assuming just 15% EBITDA margin and 15x, Vetco is worth \$1+ bn v. \$2.3 bn EV



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Valuation: Scenario Analysis

Scenario Base



Assumptions

3% Annual Topline Growth
Stable Margins at CY23 level
\$500 mm EBITDA CY25 (7.5%)
7x EBITDA (historical 7-12x)

2025 Target

\$8.35
+141%

Bear



Interest rates up another 2 pts
Margins down another 200 bp
Interest Coverage from 3.3x to 2.3x
Risk of financial distress rises

\$1.73
-50%

Bull



3% Y1/5% Y2 Topline Growth
Partial margin recovery (100 bp)
\$600 mm EBITDA CY25 (9.0%)
10x EBITDA (2015 PE to PE multiple)

\$17.75
+413%

Assessing the Current Valuation

Private Equity Transactions

2016 PE to PE:

10x EBITDA → \$11.38, 0.85x Sales → \$14.60

2006 TPG Buyout:

8.6x EBITDA → \$9.04, 0.88x Sales → \$15.30

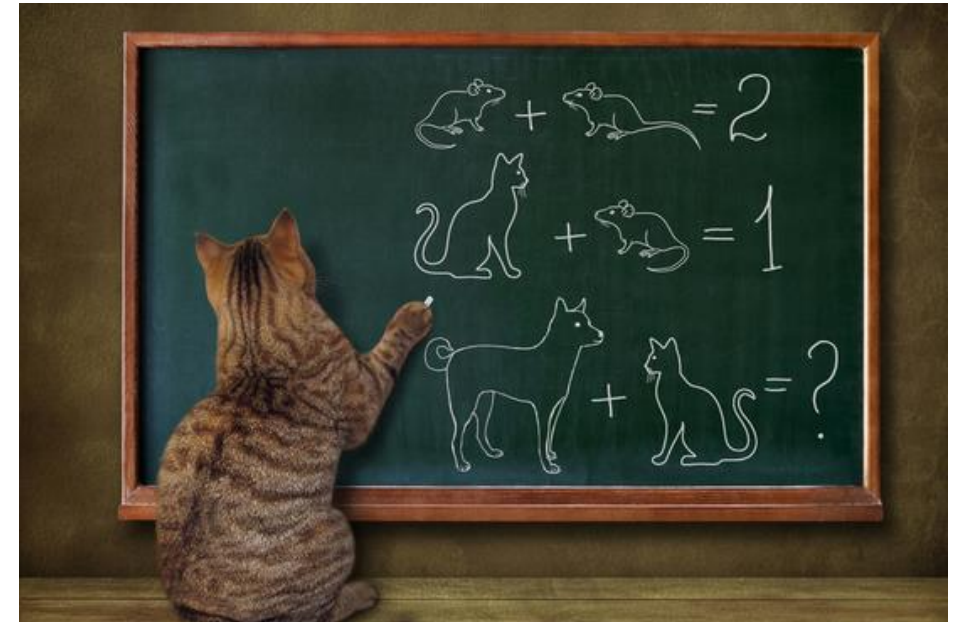
Valuation Backing Out the Vet Business

Comps = 20x EBITDA

Estimated \$500 mm Vetco Revenue, Loss-Making

Guided four-wall margin at maturity = 20%

- At 15x EBITDA/15% margin, Vetco = \$1.1 bn, retail and non-Vetco services at 2.7x EBITDA and 0.2x EV/Sales



You Can't Keep a Good Dog Down



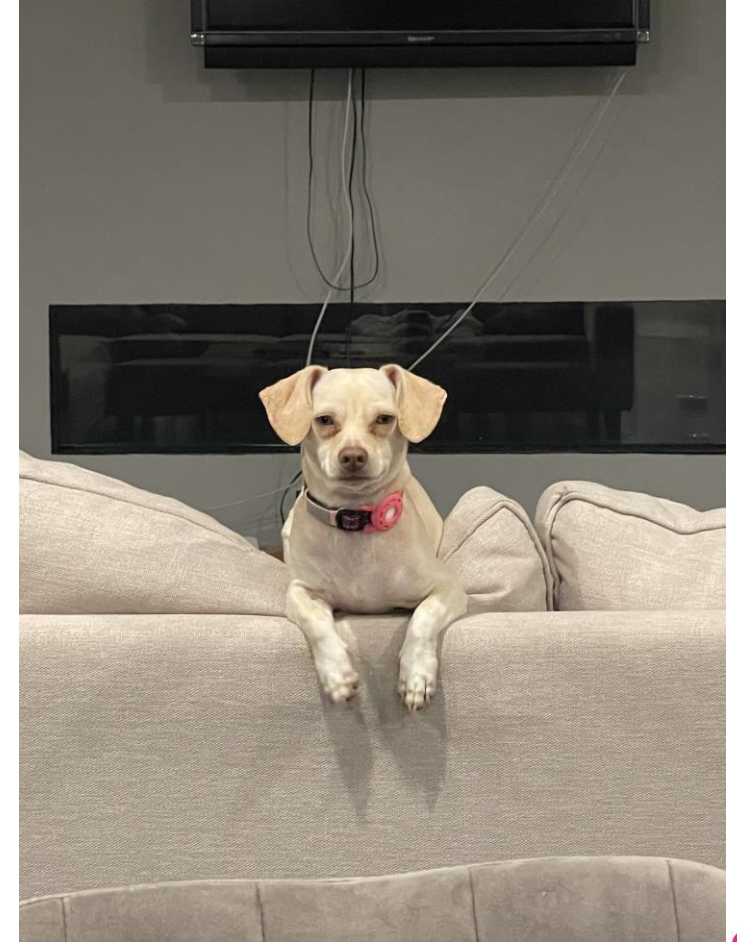
- Industry Tailwinds are Well-Established
- Well-Positioned for Omnichannel World
 - Leading player in Brick & Mortar with ability to meet immediate needs and provide convenient services
 - Already competitive in eCommerce: 1500 store footprint provides a logistics cost and speed advantage, especially in the large bag and fast-growing fresh/frozen food categories
- Increased VC Discipline/Tighter Funding Environment a Positive → Reduced Probability of Irrational Competitors Emerging
- Margin Problems, Not Revenue Problems
- Veterinary Business: Margin Accretive Over Time + Traffic Lift to Retail

Possible Petco Catalysts

- Margin recovery opportunities
 - Easier comps on discretionary goods over time
 - Cost cutting program
- Continued debt paydown
- Maturation of early vet hospital cohorts, helping margins and highlighting a hidden asset
- Better disclosures around Vetco



Thanks for Listening!



Berna Barshay Substack: @HedgeFundGirl