

## PET SECTOR OVERVIEW



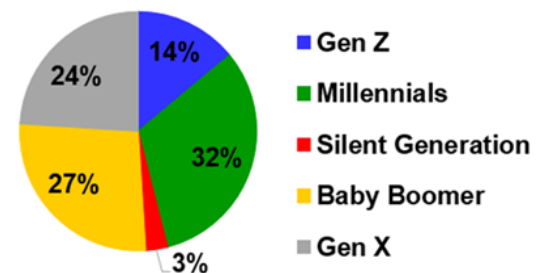
### Key Takeaways:

- Increased pet ownership, coupled with higher prices, continues to boost Pet Industry sales
- E-commerce is the most dominant source of sales growth, growing double-digits
- Recent pivot towards consumables vs. discretionary sales
- Big box pet retailers are adding more in-store services to differentiate and drive traffic
- Sector is healthier today than in pre-pandemic, though growth is expected to moderate in 2023

### Industry & Trends:

The Pet Industry continues to ride tailwinds associated with increased pet ownership, a generational shift to younger pet parents, and elevated “petflation” as we advance in 2023. A residual effect of the pandemic lockdowns is that pet ownership has increased by 20% compared to 2019, with Gen Z and Millennials now accounting for almost half of pet parents in the U.S., according to American Pet Products Association. The surge of younger owners who tend to pay more attention to their pet’s health has also led to a shift towards more premium goods and services. Pet retail operators have responded by merchandising differentiated, premium, and even sustainable products aimed at this younger generation while also investing in grooming, dog-walking, and veterinary services.

Pet Ownership by Generation (% , Current)



### E-COMMERCE UPDATE

- **Sales surged through pandemic;**
  - Now estimated at 30% of all Pet sales, up from 8% in 2015
  - 46% of consumers prefer the convenience and selection of e-commerce to B&M alone
- **Chewy’s TTM sales up 41.3% vs. FY20; Petco (2nd largest online Pet retailer) e-commerce up 140% over three-year stack**
- **Physical based (Petco / PetSmart) offering discounts on BOPIS as differentiation from Amazon / Chewy**

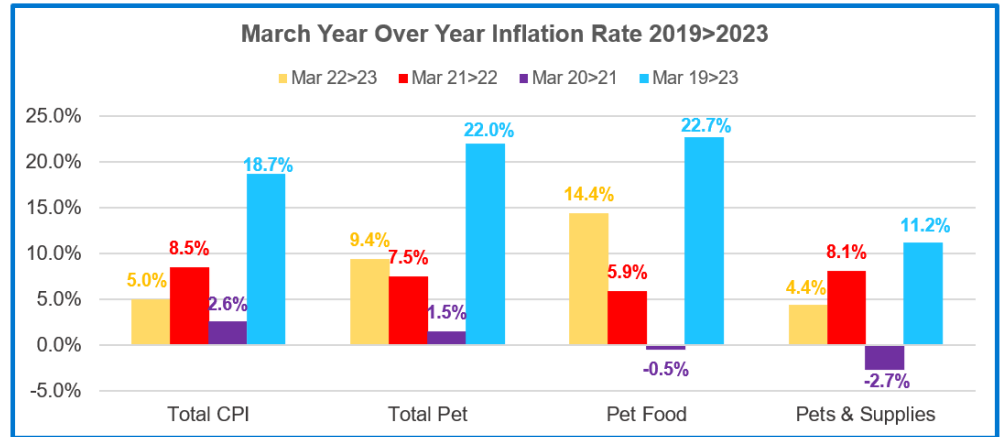
However, as consumers’ wallets are being squeezed, sector results are slowing, yet remain positive. Petco’s comps were up 5.3% in its fourth quarter, trailing inflation; however, two-year stacked comps were up 18.8% and the quarter represented the Company’s 17<sup>th</sup> consecutive quarter of comp growth. PetSmart reported an even stronger 8% comp gain through the YTD3Q timeframe. Additionally, according to Morgan Stanley, the pet category is expected to grow 134% over the next decade.

## Inflation:

Although the CPI rate and Petflation (inflation within the pet segment) have started to slow, they both remain elevated. In March 2023, total Pet inflation was up 9.4% from the prior year, driven by Pet Food, which was up a significant 14.4% and is up 22.7% from pre-pandemic levels. Factors including supply chain complications, higher labor and input costs, and geopolitical unrest (including the war in Ukraine) are all contributing to stubbornly high inflation levels. Looking ahead, while rates seem to be softening, it is important to point out that rates remain especially elevated on a multi-year stack. Additionally, the Pet Advocacy Network noted that pet products will continue to see small increases, especially in 1H23.

Survey: Due to inflation, are you cutting back on pet care spending in any of these areas?	
Pet Toys	20%
Pet Treats	17%
Pet Grooming	14%
Pet Food	12%
Veterinary	10%
Pet Vitamins	9%
Pet Boarding	9%
Pet Day Care	8%
Pet Training	8%
Pet Product Subscription/Auto-Ship	7%
Prescription Pet Medication	6%

Source: Packaged Facts November 2022 Survey of Pet Owners



As consumers have started to tighten their budgets in the face of higher prices, the sector is seeing a mix shift in purchases as retailers have reported strength in consumables and services, which are being offset by a pullback in pet supplies and toy sales. As expected, given the mix shift to lower margin consumables, combined with higher freight, product, and labor costs, margins have suffered. Petco's YTD22 EBITDA margin dropped by approximately 40 bps even though EBITDA remained flat, boosted by sales growth.



As promotions and markdowns have returned, pet stores like Petsense by Tractor Supply and Pet Valu are focusing on services and loyalty programs to create value and drive traffic. Attempting to generate favorable margins, pet operators are also increasing investments in their private label offering. PetSmart now has 10 proprietary branded products, each of which generate over \$100 million annually.



*Note: Pet Supplies Plus was acquired by Franchise Group March 2021*

## Competitor Landscape:



Credit Rating C1

**PetSmart** is the largest player in the U.S. market, with approximately 1,660 locations across the United States, Canada, and Puerto Rico, supported by seven distribution centers. The Company has seen its top line accelerate 40% over the last four years to over \$11 billion supported by robust pandemic-driven demand. PetSmart's loyalty program also continues to accelerate and reached over 60 million members at year-end. Over the last couple of years and since its spin-off of Chewy in early 2021, the Company has been actively focusing on growing its omnichannel business. In 2022, the Company expanded partnerships with DoorDash and Shipt. The Company also offers online shopping including AutoShip and same-day delivery/pick-up to most U.S. locations, and in March 2023, the Company added Instacart services to over 150 stores located in Canada. The Company remains focused on investing in its in-store services such as vet hospitals, training, pet hotels, and grooming. Though the Company already offers hospital services in 750 stores through a long-term partnership with Banfield (subsidiary of Mars, Inc.), the Company is now also growing its own vet practice, PetSmart Veterinary Services. The vet service, introduced in June 2022, had expanded to 11 locations by the end of January 2023 and is targeting a rapid rollout nationwide. Additionally, the Company has added PetsHotels to more than 200 of its locations. Looking ahead, beyond growing in-store services, PetSmart's growth strategy includes investments in marketing and partnerships to target Gen Z pet parents who are willing to spend more on premium products and services.



Credit Rating C2

**Petco** is the second largest pet retailer in the U.S. with more than 1,500 locations, 247 hospitals, and 25 million active users. FY22 sales rose 4% to \$6.04 billion on comp growth of 4.5%. While the Company offers pet owners a full spectrum of products, Petco's assortment is more weighted towards unique premium products catering to the ongoing humanization and premiumization trends in the market. To further differentiate from both pet specialty and outside competitors, the Company remains focused on "its health and wellness" ecosystem. The Company added 1,100 veterinarians (40% growth YOY) and 50 new full-service vet hospitals in 2022. Petco also expanded into rural markets mid 2022 with the opening of its small-format Neighborhood Farm & Pet Supply pet care centers, which caters to farm animals. By FYE22, the Company had opened five rural locations, while also expanding its shop-in-shop partnerships with Lowe's and Canadian Tire. Management recently noted Petco's shop-in-shops are expected to be available in 450 Canadian Tire stores, roughly 90% of the chain's locations, by mid-2023. The Company is expanding its Mexico footprint as well, adding 12 new stores since January 2023, and as of March had 120 locations. Lastly, the Company recently announced a new partnership with FreshPet to offer subscription meal plans to pet owners.



Credit Rating D2

The past few years have marked substantial growth for **Pet Supplies Plus**, a subsidiary of Franchise Group. Franchise Group acquired the Company in March 2021 for \$451 million and has since expanded operations to four distribution centers and 675 locations in 39 states, making it the third largest pet retailer in the country. Total revenue increased 40% to \$1.29 billion for FY22, primarily attributable to positive comp growth driven by growth in services (grooming and dog washes). Management noted Pet Supplies Plus is performing well across all channels, leading franchisees to open additional locations, representing 40% of the overall growth. The Company is also growing through acquisitions, having acquired Wag N' Wash in February 2022, a small format pet retailer with a focus on dog washing and grooming services. It also recently acquired 20 Loyal Partner stores for \$3.7 million following former competitor Independent Pet Partner's bankruptcy in February 2023; Pet Supplies Plus plans to franchise the stores to existing franchisees under Pet Supplies Plus and Wag N' Wash banners in the upcoming months. Looking ahead, management remains optimistic, noting what it believes is its upside opportunity to add between 1,500 and 2,000 locations.



Credit Rating A2

**Petsense by Tractor Supply** is a small-box pet retailer, situated in rural and mid-sized communities, that is primarily caters to farmers and ranchers, in addition to the standard pet owner. Tractor Supply acquired the 136 store Petsense business in 2016 for \$117 million and has since grown the banner to 186 locations across 23 states. During FY22, the Company rebranded Petsense to Petsense by Tractor Supply, along with remodeling its store base to average 5,500 square feet and expanding its Neighbor's Club loyalty program, which now exceeds 28 million members, representing roughly 50% of all Petsense sales. To differentiate itself, the Company focuses on maintaining a comprehensive assortment of products and services such as premium food brands and offerings like free pet washes and grooming, and veterinary services through its app "My Pet." The Company also allows pet owners to order pet medications through Tractor Supply. Management indicated plans to open between 10 to 15 new stores in 2023.



**Pet Supermarket** has followed an interesting path after being acquired by Roark Capital in 2015. First it was merged with Pet Valu (under the combined Pet Retail Brands), then in 2021, Roark unwound the merger, due to Pet Valu's soft performance in the U.S. market. Today, Pet Supermarket operates two distribution centers and approximately 220 stores across the U.S. Southeast. From 2017 to 2020, the Company exercised little to no store growth. However, store expansion is now on the rise, likely due to renewed business strength. Sales for FY22 are estimated to have been up low double digits to \$680 million with margins and profitability likely in line with industry trends. Contrary to the larger retailers, Pet Supermarket has positioned itself as "the most dependable pet retailer", focusing on its neighborhood-based small format appeal, which averages around 7,000 square feet. The Company's online platform now offers same-day delivery and curbside pickup, while in-store services include self-serve dog wash, grooming, adoptions, and VIP Petcare clinics. This year, the Company is enhancing its omnichannel offering and has announced partnerships with Bringg and RELEX to bolster delivery and optimize demand forecasts and replenishment orders. It also partnered with Better Choice's Halo's natural pet food in March targeting the younger generation who spend more on their pets. Management plans to open eight stores in 2023 and 10 to 15 stores annually in 2024 and beyond.



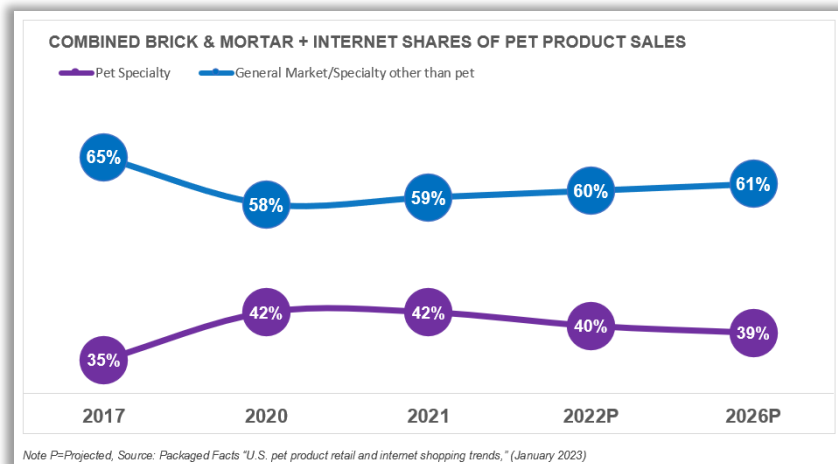
**Credit Rating A2**

**Pet Valu** is the largest pet retailer in Canada, outpacing, PetSmart, Walmart, and Amazon. Performance has remained elevated coming out of the pandemic; FY22 sales advanced 23% with comps up 17.1%. The Company now operates 744 locations (70% franchised) across all 10 provinces; footprint expansion accelerated through the acquisition of 66 unit Chico's in early 2022. In 4Q22, management noted strong growth across all categories, especially from consumables. However, bedding, crates, and travel have begun softening due to lower adoption rates and inflation. Although competitive promotional activity remains low across Canada, management is focused on creating value with its in-store services including self-service dog washes and grooming salon. In addition to store pick-up, Pet Valu rolled out a new subscription service and Autoship across all regions in Quebec in September with management noting online sales to have recently doubled by higher website traffic; 74% of Canada's population lives within three miles of a store. The Company expects to open between 40 to 50 new stores in FY23 while relocating or renovating 20 to 30.



**Credit Rating B2**

Given its leading presence, **Chewy.com** continues to gain share as more owners use online shopping, reporting double-digit top line growth and sequential improvements in margins throughout 2022. The Company ships across the U.S., operates 17 fulfillment centers, and plans to launch internationally over the next few quarters. In addition to its AutoShip (73.3% of sales), online veterinary services, and pet adoptions, Chewy expanded its CarePlus pet insurance service in Spring 2022. The insurance program had grown into over 30 states as of January, with a nationwide launch of Lemonade insurance set this spring. Chewy generated roughly \$120 million in free cash flow in FY22 following five years of neutral free cash flow. During that time, the Company nearly tripled its sales, launched six fulfillment centers, and opened three new pharmacy locations and three customer service centers, all supported by operating cash flows, which enabled a debt-free balance sheet. For FY23, management anticipates a similar double-digit sales gain while margins will compress despite recent warehouse automation as input inflation continues to be harder to pass along to consumers.

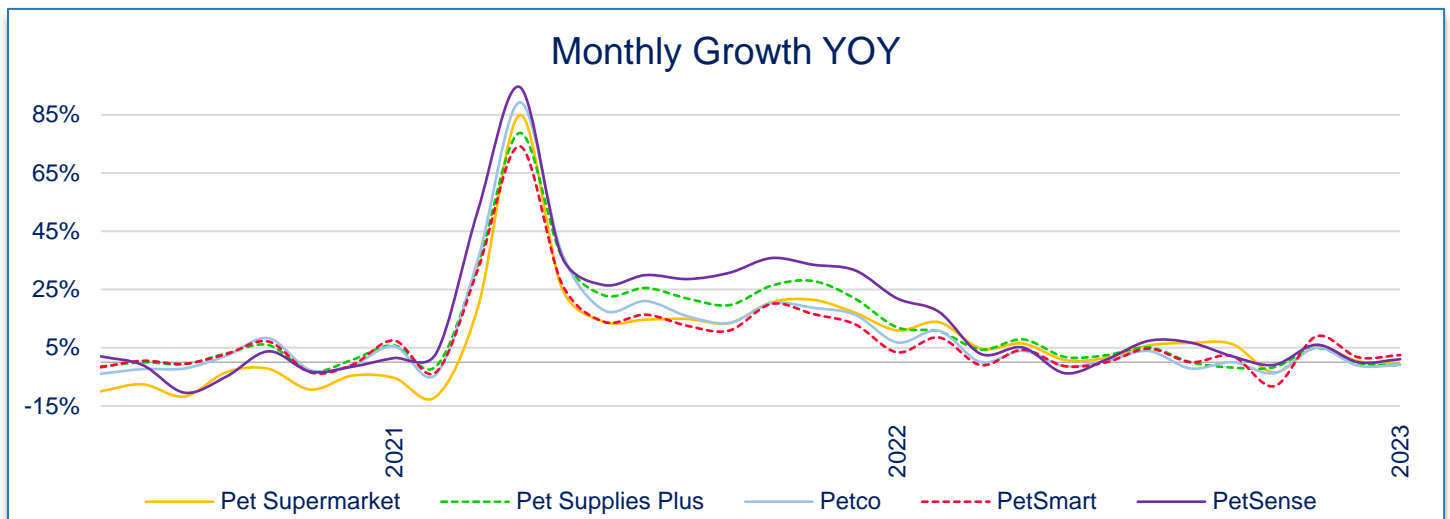


**Other Outside Competition:** Although sales have started to soften, consecutive years of record growth and robust demand in premium products has resulted in a proliferation of competition from other retailers looking to grab a share of the pet market. Packaged Facts projects that non ‘Pet Specialty’ competitors (e.g. grocery, mass merchandisers) will capture 61% of market share by 2026, up from 59% in 2021, leading to pet specialty’s market share contracting from 42% to 39%. Grocers have been especially quick to jump into the space; in October 2022, **Albertsons** said its pharmacies would begin to carry a variety of pet medications along with offering a Pet Health Savings Card. The Company is also piloting two pet health service programs in Texas and California and offers Freshpet, a refrigerated pet food brand which goes head-to-head with Petco’s WholeHearted and PetSmart’s Nom Nom brands. Meanwhile, **Hy-Vee** founded ShopPetship.com in late December 2021, which offers pet supplies, food, and subscription services. The grocer also hosted its first annual Pet Products Vendor Summit in May 2022. Big box retailer Walmart is also chasing market share in the pet category, targeting owners who are price conscious. In September 2022, **Walmart** announced it would provide pet insurance and expand its online presence through its new collaboration with The Dodo, which offers a subscription box, dog apparel, toys, and accessories, and other products at low prices. Management added that Pet products were a strong contributor to the Company reporting double digit comps in 3Q22. Similarly, **Target** also reported recent strength in the pet category, offering its own pet food brand, Kindfull, launched in 2021, targeting owners who are searching for high-quality food at a lower cost.

Direct-to-Consumer (DTC) food brands like **The Farmer’s Dog**, **Oma’s Pride**, and **Smalls** also represent a disruption to the Pet retail scene especially given the growing use of digital shopping coming out of the pandemic. The primarily boutique services offer a plethora of premium products and are growing at a rapid clip; the DTC pet food market is now estimated to reach \$8.20 billion by 2028. As an example, **The Farmer’s Dog**, a premium subscription service which opened in 2014, noted it is now delivering millions of meals a month and recently raised over \$103 million in Series C funding. The Company differentiates itself by offering customized dog food plans and heavily invests in social media marketing including Facebook.

**Store Traffic:**

Like other retail sectors, as lockdowns began to ease following the pandemic, Pet specific retailers enjoyed elevated foot traffic throughout 2021. According to Creditintell’s foot traffic data, traffic growth slowed during 2022 and has remained relatively flat in 2023.



Note: Calendar periods, not fiscal periods  
 Source: [Creditintell](#)

Due to e-commerce and grocery stores encroaching on pet territory, pet retailers are increasing their focus and dedicating retail spaces to specialty pet services like grooming, training, and boarding to help drive greater customer engagement and foot traffic. As an example, Petco bought the remaining interest in Thrive, its in-store vet hospital network, last May. The Company looks to significantly accelerate roll-outs of its full-service veterinary hospital to more stores in the coming years. Similarly, with many pet owners returning to in-office settings, the largest pet stores are now offering dog walking and doggy day care. Additionally, bigger, and well capitalized operators are creating an even larger empire by adding insurance and near-end-of-life services. PetSmart offers pet insurance through MetLife and Banfield, and in October 2022, Petco announced a partnership with Nationwide, the largest pet insurer in the country.

	Pet Smart	Petco	Petvalu	Pet Supermarket	Petsense	Pet Supplies Plus
Grooming	X	X	X	X	X	X
Self-Service Dog Wash	X	X	X	X		X
Vet Services	X	X		X	X	X
Insurance	X	X				
Online Purchases	X	X	X	X	X	X
AutoShip	X	X	X	X		X
Same Day Delivery	X	X		X		X
Curbside Pickup	X	X	X	X	X	X
Adoption	X	X	X	X	X	X
Training	X	X			X	
Boarding	X	X			X	
Day Care	X	X			X	
Dog Walking		X			X	

Updated 2022

Petco: Training, Boarding, Daycare, and Dog walks offered though Rover Partnership

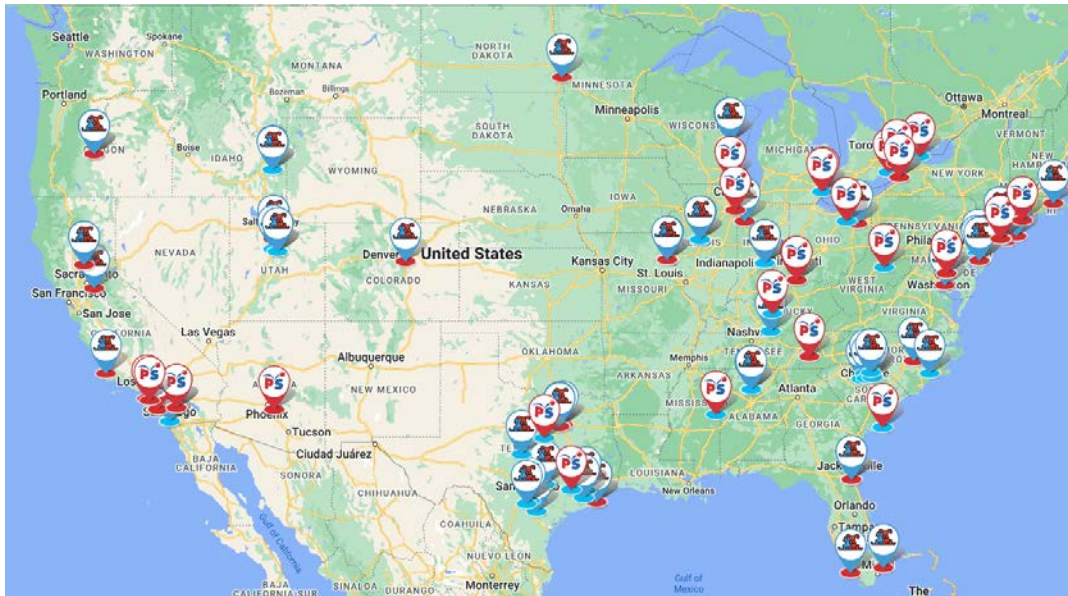
Pet Supermarket: Vet service clinic through VIP Pet

Petsense by Tractor Supply: Training, Boarding, Daycare, and Dog Walks offered through WAG Partnership

Pet Supplies Plus: Vet service clinic through VIP Pet

## Openings & Closings:

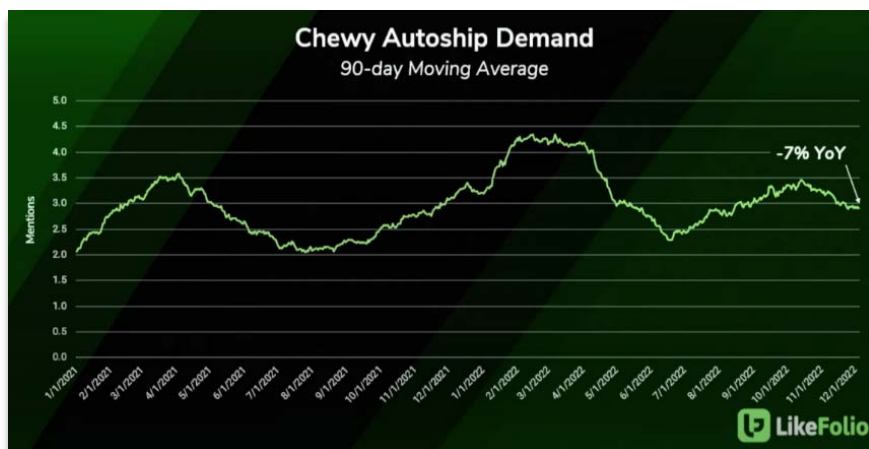
According to [CreditIntell's Store Overlap Analysis Tool](#), both Pet Smart and Petco have closed more stores than opened over the last few years, with Petco closing about 25 compared to only a dozen openings and Pet Smart closing about the same compared with only 20 openings. Recently, Petco launched a new store concept that it expects to rapidly roll out across the country, with management noting between 100 to 200 potential locations. The new concept, "Neighborhood Farm & Pet Supply", is targeted for small towns and rural communities and seems like a natural evolution for the retailer. As stated earlier, Tractor Supply's Pet Sense already operates in this space and is consistently seeing double-digit comp growth in every category. That said, competition in overlapping areas including Texas, Kentucky, and North Carolina will be significant as both Petco and Tractor Supply appear in growth mode.



Openings/Closings in past two years  
Source: CreditIntell

## Industry Outlook:

Overall, due to the sales boost over the last few years, the industry is in better shape than prior to the pandemic. Similarly, many pet retailers are now operating with improved credit profiles (with PetSmart sitting at C1 and Petco at C2). However, as consumers return to pre-pandemic norms, we expect tailwinds will subside and the industry will continue to normalize throughout 2023 and 2024. Competition from mass merchandisers, grocers, and online-only options like Amazon could create increased challenges for Pet specialty retailers especially if consumers respond to macro challenges and inflation by trading down to more traditional brands and products favoring these channels. Similarly, Chewy recently referenced increased membership cancelations and weakened demand in its AutoShip program, citing the impacts of inflation and a drop in discretionary sales.



In response to these headwinds, we expect physical based pet operators will continue to increase their focus on higher margin and foot traffic driving services including grooming, walking and pet health. Further, both PetSmart and Petco have recently offered sizeable discounts on online orders picked up at the store as a means of differentiating from Chewy / Amazon, driving traffic, avoiding delivery costs, as well as building their recurring online consumables business.

Overall, while growth initiatives, such as partnerships and additional services, are likely to be beneficial to larger pet retailers, smaller independent stores are likely to remain disadvantaged, especially as tailwinds subside, since they generally lack the scale for margins on recurring/consumables. **Pet Partners** already used the courts to liquidate earlier this year, and although none of the major operators seem to be in any type of near-term trouble, we will undoubtedly see challenges with the smaller / independent pet retailers in the future. Regardless, the pet industry is expected to remain somewhat resilient in 2023 given its larger concentration of non-discretionary sales and the overall inflated number of pets today vs. pre-pandemic.

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