

VALUE FOCUS

ANIMAL HEALTH



2014

Q1: Veterinary Services

Q2: Retail & Pet Services

Q3: Veterinary Services

Q4: Pharmacology & Biotechnology

Segment Focus

Retail & Pet Services

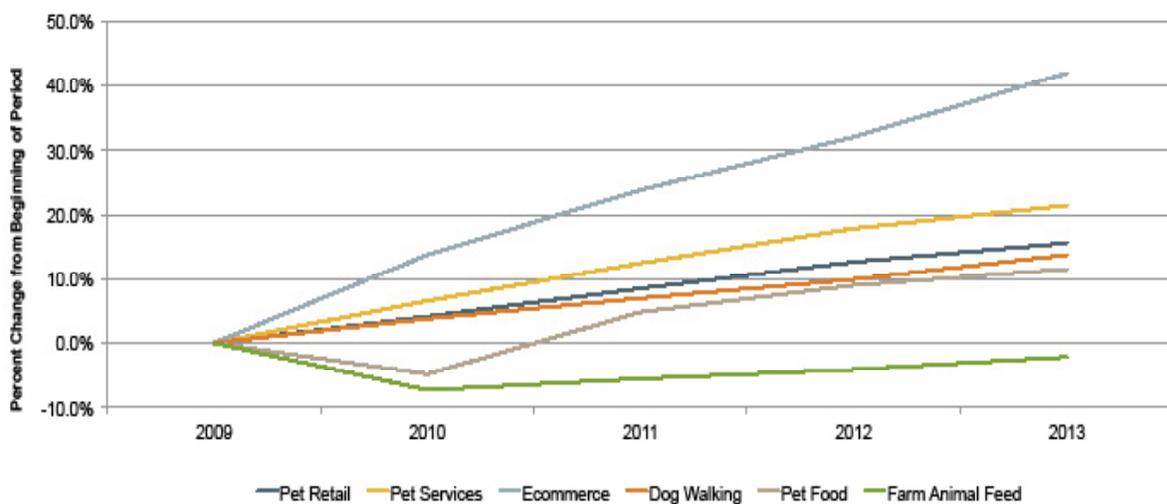
2014 Second Quarter

General Overview

The retail and pet services industry includes grooming services, pet training, boarding facilities, and specialty stores that provide pet products and food. During 2013, the pet retail and service industry generated \$21.5 billion in revenue, with retail stores generating

\$16.3 billion and boarding and grooming services generating \$5.2 billion. The Animal Pet Products Association (APPA) estimates that \$55.72 billion was spent in the United States in 2013 in the pet industry, representing a 5.2% increase relative to 2009.

Pet Retail and Services Revenue



Source: IBIS

Brick and Mortar Retail Stores

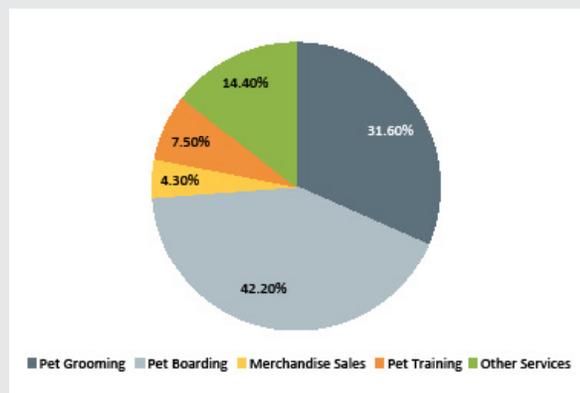
Pet food is the largest segment of the pet retail industry. Pet food production generated \$61.1 billion in 2013, increasing 2.3% from 2012. High profit margin items, such as natural and organic pet food, are expected to continue gaining popularity. The price of pet food has increased, driven by increased demand for corn. However, the pet food industry is not expected to be hurt significantly by rising corn prices.

Many retail stores have also started offering veterinary services and pet services in store. PetSmart, the largest store in the industry, had 844 in-store, full service veterinary clinics as of February 2014.

Large chain store retailers have been crowding out smaller, closely held pet stores during the past decade. Petco and PetSmart

together have accounted for approximately 45% of all store openings between 2012 and 2014 and operate over 55% of all pet stores in the U.S., enabling the chains to capture continuously larger shares of the market. While large box stores continue to dominate the retail market, mid-size specialty stores have experienced increased growth in the past two years. Specialty stores, which often focus on natural, locally-sourced, or organically-made products, seek to differentiate themselves from established chains through the quality of their offerings, while still leveraging economies of scale found in larger operations.

Pet Services Revenue



Non Veterinary Annual Consumer Expenses

Average Expense in Dollars per Owner

	Dog Owners	Cat Owners
Food	\$239	\$203
Treats	\$65	\$36
Toys	\$41	\$23
Grooming	\$61	\$20
Kennel Boarding	\$327	\$337
Vitamins	\$64	\$77
Total Non Veterinary Expenses	\$797	\$696

Source: APPA

E-Commerce

Eighty percent of pet retail stores have websites and 30% have on-line sales. The online pet food and pet supply industry generated approximately \$3.2 billion in 2013, increasing 7.4% from the previous year and a 10.1% on an annualized basis from 2008. The recent recession had fewer repercussions for online retailers than for traditional brick and mortar stores. Increasing domestic employment, limiting pet owner's leisure time, may further spur ecommerce sales. In general, online shoppers are more price-sensitive due to the ease of comparing prices across on-line retailers. This, in turn, causes online retailers to be more price conscious.

Law currently dictates that internet companies only charge sales tax when they have physical presence in the state in which the purchase was made. However, by the end of the first quarter of 2014, twenty-four states were participating in the Sales Use and Tax Agreement by the Streamlined Sales Tax Governing Board, which charges sales tax based on the delivery address. Changes in tax law could diminish online retailer's competitive price advantage over brick and mortar stores.

Pet Services

Pet grooming and boarding revenues increased 4.9% over the past five years with \$5.2 billion generated in revenue in 2013. By offering grooming services, retail stores can double the amount of revenue per customer. Some stores offering grooming services have seen grooming revenue surpass retail revenue.

Traditional brick and mortar retailers are moving to take advantage of the rapid growth afforded by this sector of the industry; PetSmart reported that 11% of its 2013 revenue was generated by pet services, including grooming, training, daycare, and boarding. PETCO

Animal Supplies, another dominant pet product retailer, offers pet grooming in most of its 1,200 locations. Industry competition is expected to intensify further due to new pet services providers entering the market. For example, in 2006, Walmart launched a partnership with Pet Care Specialists to offer grooming and boarding services within Walmart store locations.

In order to distinguish themselves from low-cost services in private residences, formal boarding and grooming facilities are expanding luxury services, including undercoat removal and pet massage. Increasing numbers of pets are expected to provide new opportunities for pet training, which generates 7.5% of the pet services sector revenue. Dog walking franchises started emerging in the past decade and are expected to expand in the future. Revenue generated from the dog-walking market increased 3.3% to approximately \$977 million over the past 5 years.

Regulation

Companies defined as pet retail stores are regulated by the Animal and Plant Health Inspection Service (APHIS) under the Animal Welfare Act (AWA). Originally passed in 1966, AWA was intended to provide a minimum level of standards relating to the breeding, care, and sale of animals for commercial or biomedical research purposes, and allow buyers to observe animals before purchase.

On September 10, 2013, APHIS revised its definition of "retail pet store" to account for changes in the marketplace brought about by new technology. At the original passing of the AWA, the majority of breeders sold animals to pet stores, which in turn sold to individual owners. With the rise of internet sales, however, many breeders are able to sell directly to pet owners, allowing them to bypass provisions of the AWA. The definition's revision classifies any breeder not selling directly to the ultimate pet owner as a pet dealer subject to oversight, including licensing.

Demand Determinants

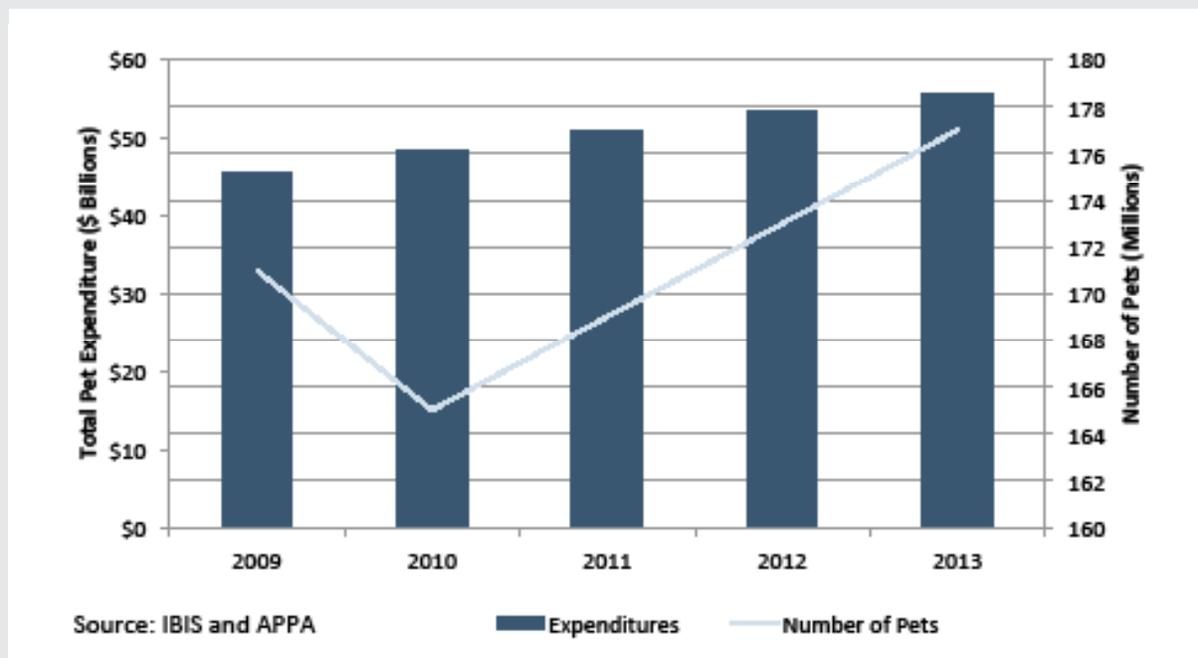
Increasing revenue in the pet retail industry is driven largely by the current economic environment and the attitude of pet owners. The trend of "pet parenthood" is continuing. "Pet parents" treat their companion animals as full-fledged members of the family, which increases their willingness to buy specialized, premium products for their pets. Additionally, the number of pet owners in the US increased by 2.3% from 2012 to 2013, translating into increased demand for pet products and food. As the lifespan of pets increases, the demand for pet products and food will rise.

The animal feed industry generated \$32.4 billion in revenue in 2013, increasing 2.1% from 2012. Although domestic demand for meat has fallen, emerging markets overseas have increased their meat consumption, resulting in increased demand for livestock products, such as animal feed. Different types of livestock operations require different feeds. High-intensity operations require high-calorie feed,

while low-intensity operations emphasize animal grazing over man-made feeds. As low-intensity farming industry gains popularity, demand for high cost livestock feed will fall. In October 2013, the FDA proposed rules governing pet and livestock feed production for the first time. The FDA's action follows numerous recalls of pet food and treats and aims to reduce diseases in pets and livestock, some of which may be transmissible to humans. The rules had not been finalized by the end of the quarter.

The national economic climate effects demand for pet services, because as unemployment falls and disposable income rises, the demand for dog walking services and doggie-day-care increases. Unemployment was relatively flat from the fourth quarter of 2013 through the first quarter of 2014, but did fall significantly throughout earlier parts of 2013.

Number of Pets and Pet Expenditures

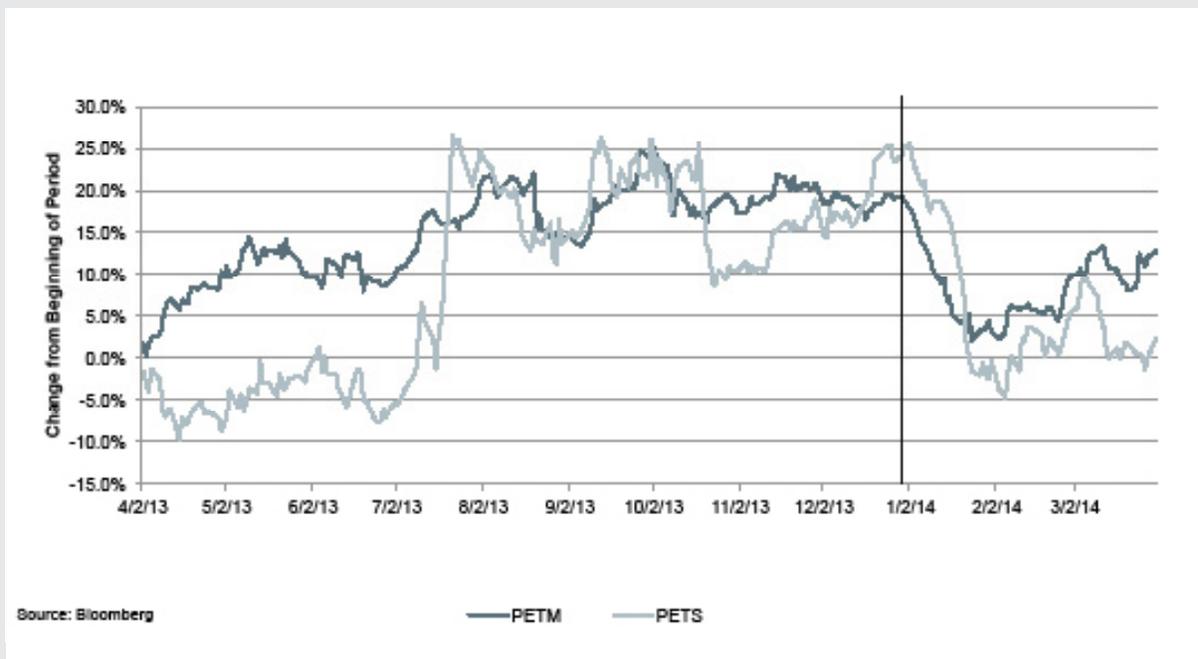


Equity Market Overview

PetSmart (PETM) and PetMed Express (PETS) are major publicly-traded players in the pet retail industry. PetSmart's share price ended at \$68.71, falling 5.0% through the first quarter, but increasing 12.8% from twelve months ago. PetSmart's falling share price was caused primarily by its announcement of weaker than expected fourth-quarter sales and increased competition from online retailers. PetSmart's EBITDA multiples decreased relative to the previous quarter and over the last twelve months, largely driven by changes in stock price.

PetMed Express, which sells companion animal pharmaceuticals directly to customers, likewise suffered during the first quarter. PetMed Express's share price fell 18.3% during the quarter, but increased 2.4% over the last twelve months. PetMed Express's rapid drop in price is attributed to its relatively flat revenue and earnings, despite strong order placement growth. PetMed Express's EBITDA multiple decreased relative to the prior quarter and increased over the year, largely driven by these changes in price.

Retail LTM Historic Stock Prices



Trends in EBITDA

	2Q 2013	3Q 2013	4Q 2013	1Q 2014
VCA Inc (WOOF)	9.52	9.12	10.03	10.12
MWI Vet Supply (MWIV)	15.81	17.49	20.13	17.96
PetMED Express (PETS)	7.82	9.40	10.05	8.15
Heska (HSKA)	15.50	-	59.84	37.29
Zoetis (ZTS)	19.74	20.85	19.36	16.97
Pet Smart (PETM)	7.97	8.85	8.32	7.57
Philbro Animal Health Co. (PAHC)	14.40	na	na	na
IDEXX Laboratories (IDXX)	15.44	16.58	17.64	19.49

Source: Bloomberg

M&A Activity

PETCO and PetSmart generate more than half the industry's total revenue and are expected to continue growing their share of the industry as other pet retail stores face tougher competition from supermarkets and online retailers. Mergers and acquisition activity included diversifications of pet services and private equity investment over the last twelve months.

Sector Outlook

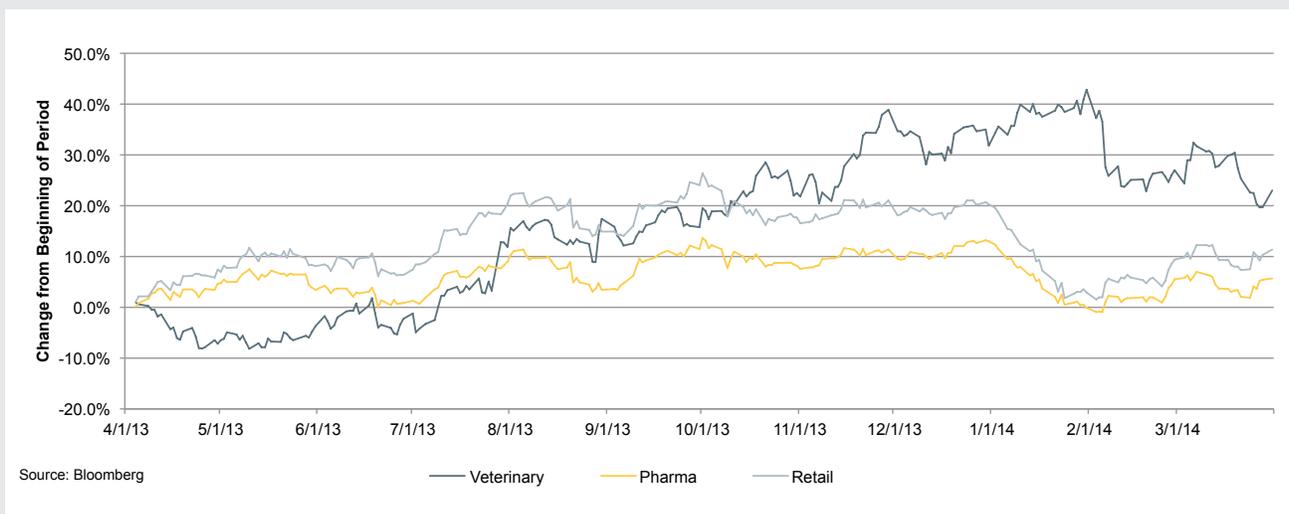
During the recession supermarkets and online retailers lured customers away from specialty pet stores with low prices and convenient shopping. Pet retail stores are expected to continue consolidating due to this increased competition, but they can find a competitive edge with specialty products that cannot be sold at supermarkets. Niche pet food and treat producers selling homemade, organic, or other specialty items have grown in popularity, typically selling higher cost, higher margin products.

Publicly Traded Animal Health Companies

Company Name	Ticker	Mar. 30 Price (\$)	52 Wk Perf (%)	Sales (\$)	Enterprise Value (\$M)	Debt/Equity	EBITDA Margin	EV/EBITDA (x)	EV / Next Yr EBITDA (x)	P/E (x)
Veterinary Services										
VCA Inc.	WOOF	32.23	37.8%	88.29	7,454.83	17.6%	18.4%	10.36	9.25	20.53
MWI Veterinary Supply, inc.	MWIV	155.62	17.1%	12.86	3,451.95	5.3%	4.5%	17.99	14.53	29.87
Median-Veterinary Services		93.93	27.5%	50.57	5,453.39	11.4%	11.4%	14.17	11.89	25.20
Pet Retail										
PetSmart Inc	PETM	68.91	11.6%	6,916.63	7,454.83	7.0%	13.43%	8.03	7.87	17.10
PetMed Express Inc	PETS	13.41	-2.3%	233.39	270.76	0.0%	12.46%	9.31	9.10	15.59
Median-Pet Retail		41.16	4.7%	3,575.01	3,862.79	3.5%	12.9%	8.67	8.49	16.35
Animal Pharmaceuticals and Biotech										
Heska Corp	HSKA	10.54	15.2%	80.15	63.01	2.2%	2.37%	33.11	6.38	nm
Zoetis Inc	ZTS	28.94	nm	4,568.00	18,156.94	20.1%	22.77%	17.46	12.12	27.83
IDEXX Laboratories Inc	IDXX	121.40	33.7%	1,405.16	6,692.75	7.0%	23.49%	20.27	17.07	34.10
Abaxis Inc	ABAX	38.88	-17.3%	171.87	867.92	0.1%	18.56%	27.21	22.10	61.71
Aratana Therapeutics Inc	PETX	18.56	nm	0.30	548.68	2.7%	nm	nm	nm	nm
PetMed Express Inc	PETS	13.41	-2.3%	233.39	270.76	0.0%	12.46%	9.31	9.10	15.59
Median-Animal		23.75	6.5%	202.63	708.30	2.5%	18.6%	20.27	12.12	30.96

Source: Bloomberg

Median Percent Change in LTM Stock Prices by Industry Segment (Price Weighted Indices)



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Contact a Mercer Capital professional to discuss your needs in confidence.

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