

VALUE FOCUS

Animal Health Industry



SEGMENT FOCUS
Veterinary Services

2014

Veterinary Services

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Animal Health Industry

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Q1: Veterinary Services

Q2: Retail & Pet Services

Q3: Veterinary Services

Q4: Pharmaceutical
& Biotechnology

SEGMENT FOCUS

Veterinary Services

2014 Third Quarter

General Overview

Veterinary services are the largest generator of revenue in the pet industry. The veterinary services sector of the animal health industry, which encompasses general pet care, emergency clinics, and specialized services, generated \$33 billion in revenue in 2013. This represents increases of 4.8% and 2.8% over 2011 and 2012, respectively. Veterinary clinics generally specialize in companion animals, large animals, or exotics, but mixed-use practices are becoming more common, especially in rural areas. Pets are increasingly being thought of as full-fledged members of the family. As the trend of “pet parenthood” continues, a larger variety of specialty services have been introduced to ensure the health and happiness of pets.

Seasonal Effect on the Industry

VCA Antech, Inc., the dominant provider of veterinary services in the industry, has reported that veterinary services revenue typically follows a cyclical pattern. Summer months, with longer days and more favorable weather, generally lead pets to spend more time outside relative to winter months. Increased time outside the house has been associated with an increase in injuries and other health problems. Summer months are also associated with increased flea, tick, and heartworm problems, increasing veterinary visits and prescription demand.

Suppliers of the veterinary services segment – largely drug manufacturers and laboratory testing service providers – see a related increase in revenue. The cycle for these companies will begin earlier in spring months as suppliers prepare for the demand from veterinary practices and consumers.

Demand Determinants

The recent recession had a strong effect on the animal health industry. Although the number of pets in the US has been increasing, a smaller percentage of pet owners take their pets to the vet, according to *Veterinary Practice News*. Additionally, increasing vaccine effectiveness has reduced the frequency of vaccine administration, reducing the number of routine visits. Better pet nutrition, reduced pet diabetes, and the rise of pet store clinics have further reduced demand for veterinary services. Recovering levels of personal income associated with continued post-recession economic recovery has helped influence expenditures on animal health in recent years.

Emergency clinics were especially hard-hit during the recession and traditional vet practices began offering emergency care in order to boost income. Vet practices and emergency clinics are both making efforts to diversify revenue sources. Some veterinary practices are continuing to expand into emergency care and are experimenting with offering boarding and other pet services, forcing some emergency clinics to expand their services to include pharmaceutical sales and laboratory testing.

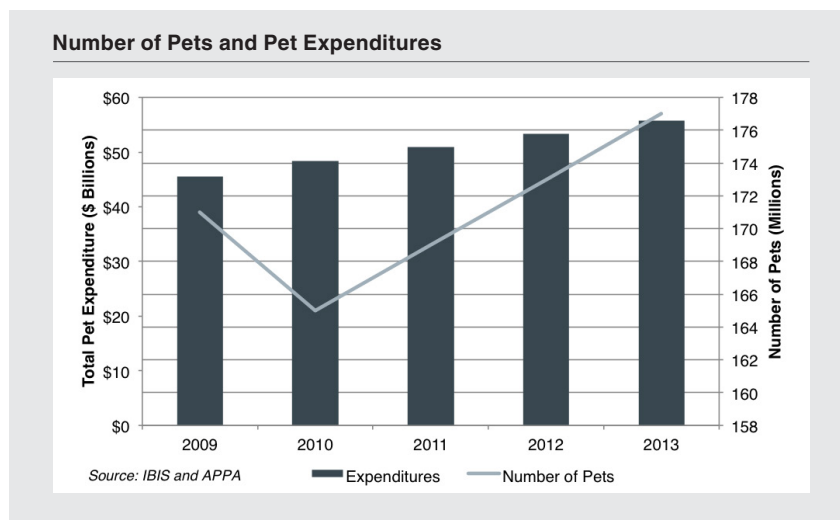
The number of pet owners with pet insurance could also affect demand for veterinary services in the future. Pet insurance increases pet owner's willingness to pay for higher cost treatments. Currently only 3% of dog owners and 1% of cat owners have pet insurance. As a larger variety of plans are being introduced, it can be expected that more pet owners will buy pet insurance. In the fourth quarter of 2013, Best Pets Insurance expanded its Best Benefits plan to cover hereditary and congenial conditions.

The number of pets in the United States increased by 2.3% from 2012 to 2013, although this has not had a significant impact on the demand for veterinary services. The lifespan of pets more directly impacts the demand for veterinary care, as increasing lifespans typically result in more vet visits, often requiring specialized end of life care.

Change in pharmaceutical manufacturing also influences the demand for veterinary care. Technological advancements in animal health have led to more sophisticated diagnostic testing, wider pharmaceutical offerings, and more vaccinations, providing an opportunity for clinics to offer new animal health programs.

Many veterinary clinics also offer care to food animals and livestock. Growing health consciousness increases the demand for veterinary services for food animals. Veterinary meat inspectors monitor the treatment and health of livestock. Although increased feed prices (caused by high corn prices) and water prices (caused by ongoing drought conditions in many parts of the country) caused herd sizes to fall, market participants observe that herd numbers have largely recovered. Market participants also note that even if livestock-related clients have financial difficulty, they still require veterinary services and products, although the risk of bad debt will rise.

The Veterinary Medicine Mobility Act was signed into law on August 7, 2014. The bill allows veterinarians to carry medications from their clinics to remote sites, including across state lines. In addition to expanding the territory in which rural large animal vets can operate, the bill would also effectively allow practitioners to provide pain management and end of life care for companion animals at home.



Equity Market Overview

VCA ("WOOF") operates 612 animal hospitals in the United States which provide general medical services, surgical services, and specialty services. VCA also has 59 veterinary laboratories, which provide testing and consulting for veterinarians regarding chemistry, pathology, endocrinology, and other diseases. They operate the largest network of freestanding animal hospitals and veterinary labs in the US.

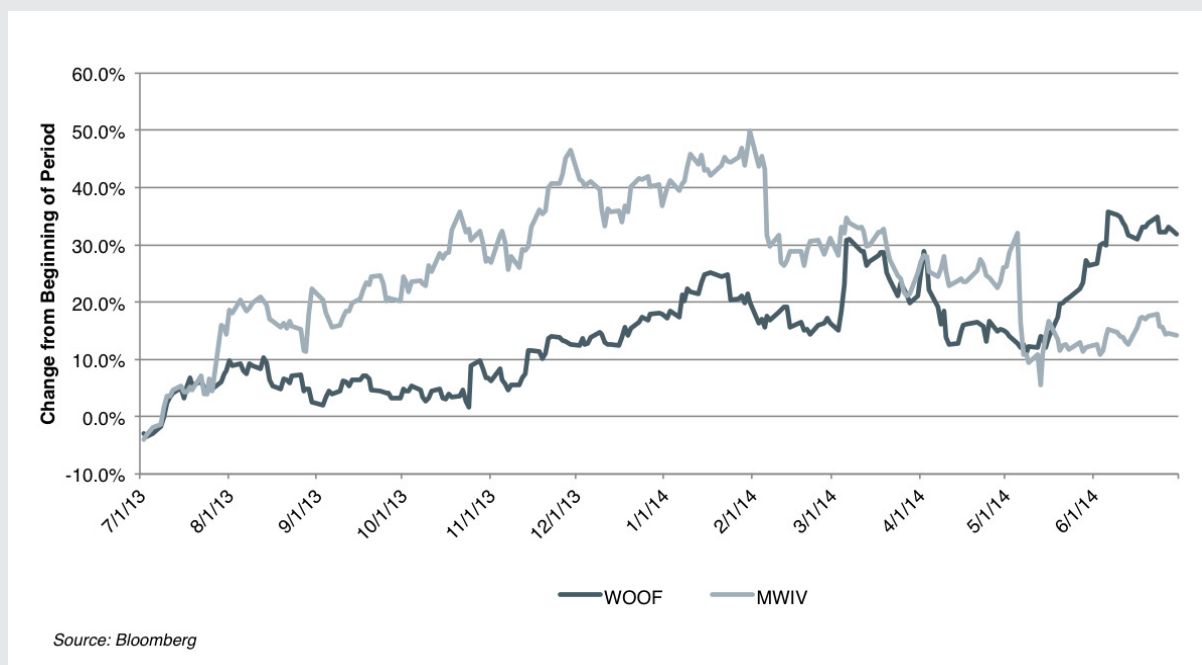
Although it does not provide veterinary services, MWI Veterinary Supply ("MWIV") provides products to animal hospitals ranging from dental x-ray equipment to vaccinations and animal food. Demand of MWI's products depends strongly on the strength of the veterinary services market.

VCA's share price, which ended the third quarter at \$35.09, posted total gains of 8.9% and 31.9% over the quarter and year, respectively. VCA's price gains were driven by revenue growth, which was itself largely driven through acquisitions (VCA acquired \$28.1 million in animal hospital revenue year to date through June 2014). Same-store revenue growth in its animal health segment grew 1.4% in the

six months ending June 30, 2014 relative to the six months ending June 30, 2013. Same-store revenue growth is attributable to 2.8% increase in average revenue per order outstripping the 1.4% decline in number of orders.

MWI's share price declined 8.7% over the quarter but increased 14.3% over the last year. MWI's acquisition of IVESCO (a distributor and retailer of animal health products and services) boosted its price well into the first quarter. MWI paid \$78.7 million for \$154.3 million in assets. Following the first quarter, MWI has experienced increasing revenues and a modest decrease in both gross and net margins. Increasing price pressure from competitors and the success of lower-margin INVSECO products has impacted MWI's margins. MWI was also severely impacted by severe weather conditions in the first quarter of 2014. Overall, however, MWI's earnings per share increased in the last nine months, relative to the nine month period ending June 30, 2013. A negative revision and lower consensus outlooks led to a steep decline in the stock price in early May, although the price has been largely recovering throughout the second and third quarters.

Veterinary LTM Historic Stock Prices



Equity Market Overview (cont.)

VCA has experienced a trend of increasing EBITDA multiple during the last four quarters, although MWIV's EBITDA multiple has declined since the start of 2014. VCA's improved profitability (VCA's net income margin increased to 8.7% in the first six months of 2014

from 8.0% in the same period in 2013) contributed to its improving multiple. MWI's falling EBITDA multiple is largely a factor of slower revenue growth impacting the value of the company.

Trends in EBITDA Pricing Multiples

	3Q 2013	4Q 2013	1Q 2014	2Q 2014
VCA Inc (WOOF)	9.12	10.03	10.36	10.80
MWI Vet Supply (MWIV)	17.49	20.13	17.99	15.31
PetMed Express (PETS)	9.40	10.05	9.31	9.28
Heska (HSKA)	nm	59.84	33.11	33.75
Zoetis (ZTS)	20.85	19.36	17.46	18.47
Pet Smart (PETM)	8.85	8.32	8.03	6.92
IDEXX Laboratories (IDXX)	16.58	17.64	20.27	20.98
Abaxis, Inc. (ABAX)	27.12	27.92	27.21	35.09

Source: Bloomberg

Presented pricing multiples represent enterprise value relative to EBITDA from the prior twelve months
EBITDA: Earnings before interest, taxes, depreciation, and amortization

M&A Activity

Recently the veterinary services sector has seen trends of consolidation. VCA estimates that there are over 26,000 companion animal hospitals, with most operating with a sole-practitioner. The industry is changing with the workforce and technology. As technology improves, the appeal of state-of-the-art facilities is attracting veterinarians to multi-doctor practices which can afford the new technology.

The majority of M&A activity in the veterinary services industry revolves around the consolidation of smaller veterinary practices. Information concerning pricing and multiples for these transactions are not often available. The recovering economy and changing technology will contribute to continued M&A activity in the veterinary services sector of the animal health industry. The most attractive targets offer consistent work hours and an increased client base. No-lo practices (vet practices with no or low revenues) can enable buyers to expand practice size despite the low margins of the acquired office. Many buyers become the main practitioner of the consolidated practice.

It was reported in February 2014 that National Veterinary Associates (NVA), the largest privately-held system of veterinary hospitals in the US, was sold to Ares Management LP, a California-based private equity firm. According to Reuters, NVA, which owns 240 animal hospitals in 39 states, reported EBITDA of approximately \$60 million in 2013 and was purchased for approximately \$800 million, implying an EBITDA multiple of about 13.3x. This multiple assumes a baseline market multiple in line with VCA (approximately 10x) with a significant additional strategic or synergistic premium.

On August 1, 2014, VCA entered an agreement to acquire D.O.G. Development, LLC, a franchise dog boarding and daycare service. This reflects the overall trend of diversification of services offered by veterinary services and illustrates the growing importance of specialty pet services in the animal health industry. (No valuation or revenue information was available as of publication.)

Sector Outlook

The veterinary industry faces competition from retail stores such as Pet Smart, which operated full service veterinary hospitals in 856 of its 1,352 storefronts as of August 2014. Similarly, some pet stores are offering in store vaccinations. As traditional vets expand their practices to compete with in store clinics, emergency vets will face increased competition, since increasing use of preventative measures should decrease demand for emergency care.

IDEXX, a diagnostic and testing laboratory for animal health related services, announced during the second quarter that it was moving to a direct sales and distribution model beginning in January 2015. This shift will negatively affect companies like MWI, which previously

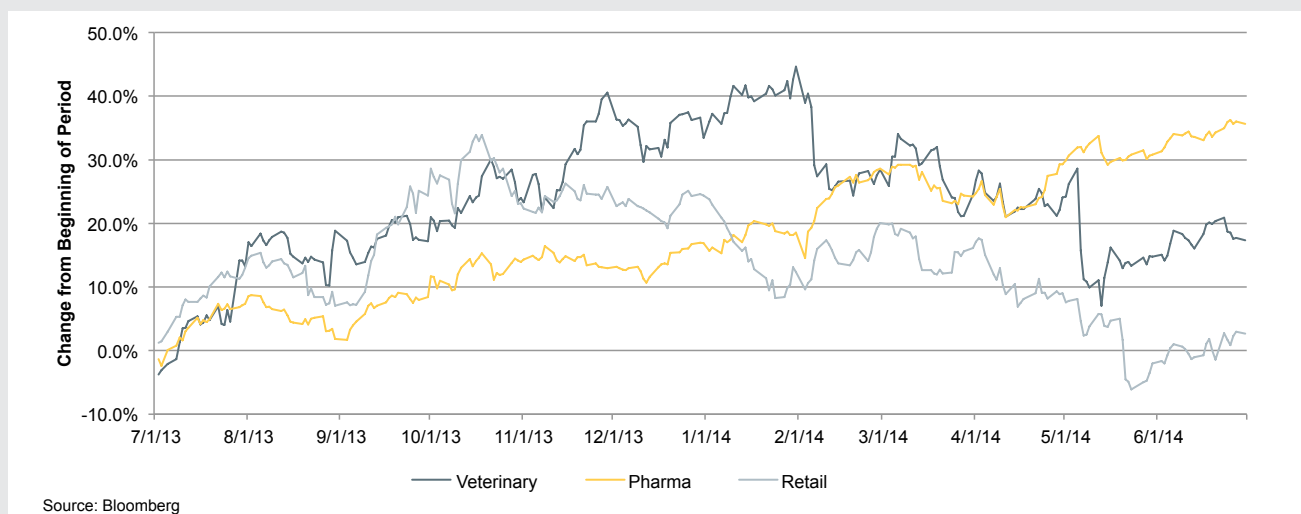
marketed and sold IDEXX's services. IDEXX's structural change will does not affect MWI's 2014 outlook, though it will result in a loss of about 3.4% of sales. MWI is already moving to develop and sell its own products associated with its laboratory setting, so it is likely that MWI will be able to recover some of the otherwise lost revenue. MWI also anticipated that the INVESCO integration will ultimately be more profitable than anticipated, as the company is retaining a larger portion of INVESCO's revenue than it previously projected.

Publicly Traded Animal Health Companies

Company Name	Ticker	30-Jun Price (\$)	52 Wk Perform (%)	Sales (\$)	Enterprise Value (\$M)	Debt/Equity	EBITDA Margin	EV/EBITDA (x)	EV / Next Yr EBITDA (x)	P/E (x)
Veterinary Services										
VCA Inc.	WOOF	35.09	31.9%	8741	6,451.68	16.2%	18.4%	10.80	9.82	21.66
MWI Veterinary Supply, inc.	MWIV	141.99	14.3%	12.85	3,661.14	2.9%	4.4%	15.31	12.92	26.25
Median-Veterinary Services		88.54	23.1%	50.13	5,056.41	9.6%	11.4%	13.06	11.37	23.95
Pet Retail										
PetSmart Inc	PETM	59.80	-11.5%	6,935.16	6,451.68	8.1%	13.44%	6.92	6.81	14.62
PetMed Express Inc	PETS	13.48	4.9%	231.74	272.16	0.0%	12.66%	9.28	9.15	14.65
Median-Pet Retail		36.64	-3.3%	3,583.45	3,361.92	4.0%	13.0%	8.10	7.98	14.64
Animal Pharmaceuticals and Biotech										
Heska Corp	HSKA	10.75	56.9%	84.81	64.23	2.2%	2.24%	33.75	6.51	24.43
Zoetis Inc	ZTS	32.27	nm	4,612.00	19,822.49	18.4%	23.27%	18.47	13.23	30.73
IDEXX Laboratories Inc	IDXX	133.57	47.2%	1,442.70	7,264.46	7.4%	23.25%	21.66	18.53	36.40
Abaxis Inc	ABAX	44.31	-8.4%	176.18	996.56	0.1%	nm	nm	25.37	63.30
Aratana Therapeutics Inc	PETX	15.61	nm	0.60	475.05	3.2%	nm	nm	nm	nm
PetMed Express Inc	PETS	13.48	4.9%	231.74	272.16	0.0%	12.66%	9.28	9.15	14.65
Median- Animal		23.94	26.1%	203.96	735.80	2.7%	18.0%	20.07	13.23	30.73

Source: Bloomberg

Median Percent Change in LTM Stock Prices by Industry Segment



Source: Bloomberg

Mercer Capital

Animal Health Industry Services

Mercer Capital has expertise providing business valuation and financial advisory services to companies in the animal health industry.

Industry Segments

Mercer Capital serves the following industry segments:

- General, Specialty, and Emergency Care
- Pharmaceutical & Biotechnology
- Retail and Pet Services

Services Provided

- Valuation of animal health companies and veterinary practices
- Transaction advisory for mergers and acquisitions
- Valuations for purchase accounting and impairment testing
- Fairness and solvency opinions
- Litigation support for economic damages and valuation and shareholder disputes

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

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