

VALUE FOCUS

Animal Health Industry



SEGMENT FOCUS

Veterinary Services

2015

Veterinary Services

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Animal Health Industry

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Special Supplement

Fairness Opinions: Evaluating a Buyer's Shares from the Seller's Perspective

SEGMENT FOCUS

Veterinary Services

2015 First Quarter

General Overview

As of December 2013, an estimated 64,000 veterinarians were involved in private practice in the United States. Demand for veterinary services has been spurred by growing numbers of households with companion animals, aging pets, and the growing trend of “pet parenthood.” Advances in animal healthcare have allowed specialty practices to expand over the last several decades.

Equity Market Overview

VCA Antech, Inc (“WOOF”) is a major provider of veterinary services and operates 622 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. VCA's share price, which ended the fourth quarter at \$48.77, posted total gains of 24.0% and 55.5% over the quarter and year, respectively. VCA's price gains were driven by ongoing acquisitions and continuing revenue growth, which increased 5% in the year-to-date period relative to the same period in the prior year. Animal hospital same store revenue increased 2.3% in the YTD September 2014 period.

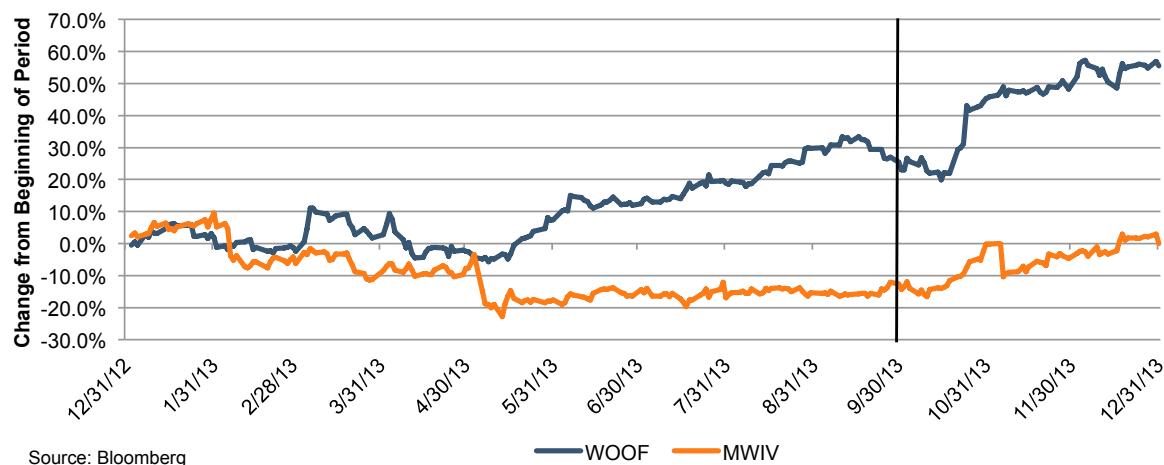
Equity Market Overview (cont.)

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. MWI also experienced strong share price growth during the last quarter of 2014. MWI's share price fell steeply in April 2014 due to lower earnings outlooks. The share price struggled to recover and ultimately ended 2014 just about where it began. Overall, MWI's share price increased 14.5% over the fourth quarter.

Subsequent to the end of the quarter, MWI was purchased by a drug wholesaler. We discuss this transaction in the M&A Activity section of this newsletter.

VCA has experienced a trend of increasing EBITDA multiple during the last four quarters. VCA's improved profitability contributed to its multiple expansion. MWI's expanded EBITDA multiple is largely a factor of its share price (and thus its market capitalization) recovering to its original levels following the April price drop.

Veterinary LTM Stock Performance



Source: Bloomberg

Trends in EBITDA Pricing Multiples

	Q1 2014	Q2 2014	Q3 2014	Q4 2014
VCA, Inc. (WOOF)	10.24	10.67	11.36	13.42
MWI Vet Supply (MWIV)	10.67	11.36	13.42	17.03
Pet Smart (PETM)	7.42	6.55	7.53	8.63
PetMed Express (PETS)	7.70	8.19	7.82	8.39
Heska, Inc. (HSKA)	nm	40.12	14.17	17.37
Zoetis, Inc. (ZTS)	13.90	14.97	16.55	18.15
IDEXX Laboratories (IDXX)	19.92	21.31	18.34	21.82
Phibro Animal Health (PAHC)	nm	nm	13.08	15.47
Abaxis, Inc. (ABAX)	24.36	31.60	33.08	33.77
Aratana Therapeutics (PETX)	nm	nm	nm	nm
Parnell Pharmaceuticals (PARN)	nm	nm	nm	nm

Source: Capital IQ

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 a trend toward consolidation. 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 profitability) 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.

On August 1, 2014, **VCA** entered an agreement to acquire **D.O.G. Development, LLC**, an operator and franchiser of dog boarding and daycare services. As of September 30, 2014, D.O.G. operated

125 Camp Bow Wow locations in 37 states and Canada. D.O.G. generated revenue of \$6.8 million in 2013. Total consideration paid for D.O.G. totaled \$18.8 million, implying a revenue multiple of 2.8x revenue. The acquisition of D.O.G. by an operator of animal hospitals reflects the overall trend of diversification of services offered by veterinary practices and illustrates the growing importance of specialty pet services in the animal health industry.

Consolidation has occurred not only within in the industry, but also through business combinations with companies in adjacent industries. On January 12, 2015, **AmeriSourceBergen Corp.** (ABC) agreed to purchase **MWI**. ABC offered \$190 per share (a 7% premium to the previous day's closing price), resulting in a total purchase price of \$2.5 billion. This purchase price implies a revenue multiple of 0.8x revenue and an EBITDA multiple of 18.5x EBITDA. ABC cited the growing animal health market as a key influence in its decision to purchase MWI. ABC will also likely experience revenue- and cost-saving-synergies generated by streamlined distribution models and improved purchasing power with suppliers. The deal closed February 23, 2015, earlier than the March close expected by analysts.

Trigger Events and Goodwill Impairment

In its September 2014 10-Q, VCA recorded a \$130 million impairment charge related to its Vetstreet marketing and communications reporting unit. VCA usually tests for goodwill impairment on October 31 of each year, however, VCA felt that the conditions of the Vetstreet unit triggered an interim goodwill impairment test.

Typically, goodwill impairment testing is an annual process. Companies can opt for either the standard Step 1 or the more qualitative Step 0 processes, both of which require more in-depth testing if impairment is suspected. However, in addition to the annual tests required by accounting standards, companies may also need to perform interim goodwill tests as a result of certain “trigger” events. Although a significant decline in stock price is the most common triggering event, other triggers include changes in the macroeconomic environment, changes in the overall industry, significant sup-

ply changes, poor financial performance, or continuous but small decreases in stock price. The loss of a key member of management, unexpected and significant litigations, and changing regulations can also trigger impairment tests. A trigger event does not imply goodwill impairment – it merely acknowledges the possibility of impairment having occurred.

VCA noted that Vetstreet was in the process of an operational overhaul designed to make the reporting unit more competitive. Several of the changes to the reporting unit were not deployed on the schedule initially planned. Due to the changes in the overhaul and increased competition, Vetstreet was unable to meet several of its performance targets and had difficulty bringing new products to clients. Accordingly, VCA felt that this particular set of conditions comprised a triggering event.

Sector Outlook

The veterinary industry faces competition from retail stores such as Pet Smart, which are increasingly offering full-service veterinary hospitals in existing storefronts. Additionally, some pet stores are offering in-store vaccinations. As traditional vets expand their practices to compete with in-store clinics, emergency and specialty vets will face increased competition. However, the improving economy

will increase households' demand for services. In December 2014, the unemployment rate dropped to pre-recession levels. Although income growth remains weak, improved economic conditions may spur increased spending on pet products and services. *The Wall Street Journal* estimates that veterinary spending on pets has grown at a 6% annual rate during the past seven years.

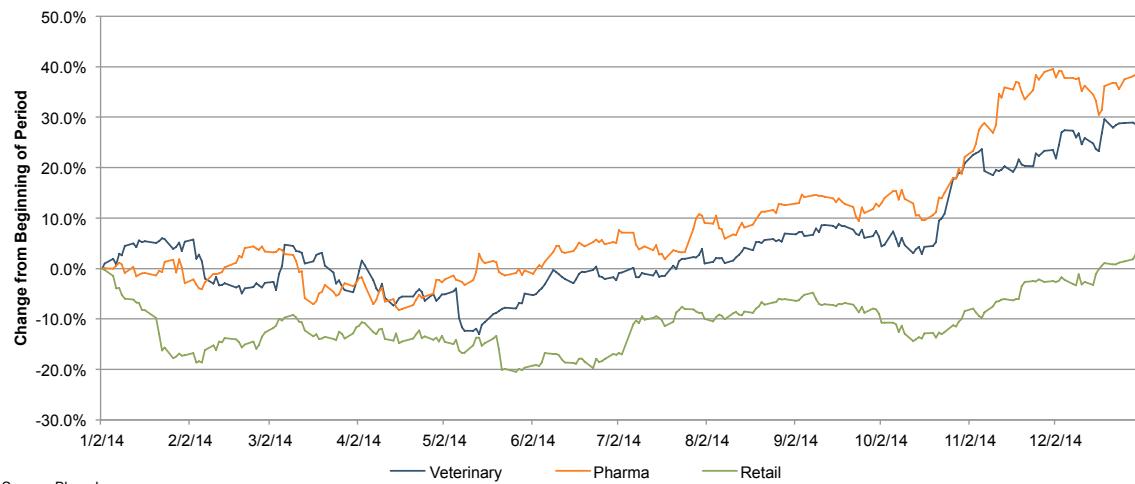
Publicly Traded Animal Health Companies

Company Name	Ticker	31-Dec 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	48.77	55.5%	85.29	8,602.51	13.7%	17.1%	15.07	12.62	32.95
MWI Veterinary Supply, inc.	MWIV	169.91	0.0%	12.91	4,820.10	3.4%	4.3%	17.53	16.02	30.07
Median-Veterinary Services		109.34	27.7%	49.10	6,711.31	8.6%	10.7%	16.30	14.32	31.51
Pet Retail										
PetSmart Inc	PETM	81.30	13.0%	7,003.05	8,602.51	6.1%	13.39%	9.18	8.94	19.26
PetMed Express Inc	PETS	14.37	-9.1%	228.84	291.26	0.0%	11.81%	10.78	10.34	16.91
Median-Pet Retail		47.83	2.0%	3,615.94	4,446.89	3.0%	12.6%	9.98	9.64	18.09
Animal Pharmaceuticals and Biotech										
Heska Corp	HSKA	18.13	107.9%	89.02	108.23	2.1%	8.19%	14.85	11.27	37.77
Zoetis Inc	ZTS	43.03	nm	4,719.00	25,218.45	14.5%	23.99%	22.28	17.27	38.42
IDEXX Laboratories Inc	IDXX	148.27	39.4%	1,487.92	7,881.70	9.2%	23.11%	22.92	19.68	38.61
Abaxis Inc	ABAX	56.83	42.9%	184.27	1,280.51	0.0%	19.18%	36.23	31.21	74.78
Aratana Therapeutics Inc	PARN	4.15	nm	6.90	30.16	92.5%	nm	nm	nm	nm
PetMed Express Inc	PETS	14.37	-9.1%	228.84	291.26	0.0%	11.81%	10.78	10.34	16.91
Parnell Pharmaceuticals Holdings Ltd	PARN	\$4.15	nm	6.90	30.16	92.5%	nm	nm	nm	nm
Median- Animal Pharm & Biotech		18.13	41.2%	184.27	291.26	9.2%	19.2%	22.28	17.27	38.42

Source: Bloomberg

Note: Aratana's and Parnell's recent IPOs have resulted in nonmeaningful multiples and ratios in the short term.

Median Percent Change in LTM Stock Prices by Industry Segment



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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Fairness Opinions

Evaluating a Buyer's Shares from the Seller's Perspective

M&A activity in the U.S. (and globally) has accelerated in 2014 after years of gradual improvement following the financial crisis. According to Dealogic, M&A volume where the target was a U.S. company totaled \$1.4 trillion YTD through November 10, the highest YTD volume on record and up 43% from the same period last year. Excluding cross-border acquisitions, domestic-only M&A was \$1.1 trillion, which represented the second highest YTD volume since 1999 and up 27% from last year. Healthcare and telecommunications were the first and second most targeted sectors.

The improvement has taken a long time even though corporate cash is high, financing costs are very low and organic revenue growth in most industries has been sluggish. Aside from improving confidence, another key foundation for increased M&A activity fell into place in 2013 when equity markets staged a strong rally as the S&P 500 rose 30% (32% with dividends) and the Russell 2000 increased 37% (39%). The absence of a meaningful pullback in 2014 and a 12% advance in the S&P 500 and 2% in the Russell 2000 have further supported activity.

The rally in equities, like low borrowing rates, has reduced the cost to finance acquisitions because the majority of stocks experienced multiple expansion rather than material growth in EPS. It is easier for a buyer to issue shares to finance an acquisition if the shares trade at rich valuation than issuing "cheap" shares. As of November 24, the S&P 500's P/E based upon trailing earnings (as reported) was 20.0x compared to 18.2x at year-end 2013, 17.0x at year-end 2012 and 14.9x at year-end 2011. The long-term average P/E since 1871 is 15.5x (Source: <http://www.multpl.com>).

High multiple stocks can be viewed as strong acquisition currencies for acquisitive companies because fewer shares have to be issued

to achieve a targeted dollar value. As such, it is no surprise that the extended rally in equities has supported deal activity this year. However, high multiple stocks may represent an under-appreciated risk to sellers who receive the shares as consideration. Accepting the buyer's stock raises a number of questions, most which fall into the genre of: what are the investment merits of the buyer's shares? The answer may not be as obvious as it seems, even when the buyer's shares are actively traded.

Our experience is that some, if not most, members of a board weighing an acquisition proposal do not have the background to thoroughly evaluate the buyer's shares. Even when financial advisors are involved there still may not be a thorough vetting of the buyer's shares because there is too much focus on "price" instead of, or in addition to, "value."

A fairness opinion is more than a three or four page letter that opines as to the fairness from a financial point of a contemplated transaction; it should be backed by a robust analysis of all of the relevant factors considered in rendering the opinion, including an evaluation of the shares to be issued to the selling company's shareholders. The intent is not to express an opinion about where the shares may trade in the future, but rather to evaluate the investment merits of the shares before and after a transaction is consummated.

Key questions to ask about the buyer's shares include the following:

- **Liquidity of the Shares.** What is the capacity to sell the shares issued in the merger? SEC registration and even NASDAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently. Generally, the higher the institutional ownership, the better the liquidity. Also, liquidity may improve

with an acquisition if the number of shares outstanding and shareholders increase sufficiently.

- **Profitability and Revenue Trends.** The analysis should consider the buyer's historical growth and projected growth in revenues, and operating earnings, (usually EBITDA or EBITDA less capital expenditures) in addition to EPS. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.
- **Pro Forma Impact.** The analysis should consider the impact of a proposed transaction on revenues, EBITDA, margins, EPS and capital structure. The per share accretion and dilution analysis of such metrics as earnings, EBITDA and dividends should consider both the buyer's and seller's perspectives.
- **Dividends.** In a yield starved world, dividend paying stocks have greater attraction than in past years. Sellers should not be overly swayed by the pick-up in dividends from swapping into the buyer's shares; however, multiple studies have demonstrated that a sizable portion of an investor's return comes from dividends over long periods of time. If the dividend yield is notably above the peer average, the seller should ask why? Is it payout related, or are the shares depressed? Worse would be if the market expected a dividend cut. These same questions should also be asked in the context of the prospects for further increases.
- **Capital Structure.** Does the acquirer operate with an appropriate capital structure given industry norms, cyclicalities of the business and investment needs to sustain operations? Will the proposed acquisition result in an over-leveraged company, which in turn may lead to pressure on the buyer's shares and/or a rating downgrade if the buyer has rated debt?
- **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the buyer's balance sheet that examines such areas as liquidity, access to bank credit, and the carrying value of assets such as deferred tax assets.
- **Ability to Raise Cash to Close.** What is the source of funds for the buyer to fund the cash portion of consideration? If the buyer has to go to market to issue equity and/or debt, what is the contingency plan if unfavorable market conditions preclude floating an issue?

- **Consensus Analyst Estimates.** If the buyer is publicly traded and has analyst coverage, consideration should be given to Street expectations vs. what the diligence process determines. If Street expectations are too high, then the shares may be vulnerable once investors reassess their earnings and growth expectations.
- **Valuation.** Like profitability, valuation of the buyer's shares should be judged relative to its history and a peer group presently as well as relative to a peer group through time to examine how investors' views of the shares may have evolved through market and profit cycles.
- **Share Performance.** Sellers should understand the source of the buyer's shares performance over several multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.
- **Strategic Position.** Assuming an acquisition is material for the buyer, directors of the selling board should consider the strategic position of the buyer, asking such questions about the attractiveness of the pro forma company to other acquirers.
- **Contingent Liabilities.** Contingent liabilities are a standard item on the due diligence punch list for a buyer. Sellers should evaluate contingent liabilities too.

The list does not encompass every question that should be asked as part of the fairness analysis, but it does illustrate that a liquid market for a buyer's shares does not necessarily answer questions about value, growth potential and risk profile.

We at Mercer Capital have extensive experience in valuing and evaluating the shares (and debt) of financial and non-financial service companies garnered from over three decades of business. Feel free to contact us to discuss your situation in confidence.



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