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Animal Health Industry

SEGMENT FOCUS

Veterinary Care

2016

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Equity Market Overview

VCA, Inc. ("WOOF") is a major provider of veterinary laboratory services and operates 767 animal hospitals in the United States and Canada which provide general medical services, surgical services, and specialty services. VCA also has 60 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 U.S. and Canada. VCA also sells radiography and ultrasound equipment and licenses 129 Camp Bow Wow dog day care franchises. VCA's share price, which ended the second quarter at $67.61, posted total gains of 17.1% and 24.2% over the quarter and year, respectively. VCA's pricing gains were driven by ongoing acquisitions and continuing organic revenue growth. In May 2016, VCA acquired CAPNA, which operated a network of 56 animal hospitals across 18 states. Animal hospital revenue grew 19% year-over-year for the first six months of 2016. Animal hospital same location revenue increased 6.3% in the first half of 2016. In July 2015, VCA's price was boosted by larger than anticipated earnings per share, driven largely by increasing revenue growth.

Veterinary LTM Stock Performance

Source: Bloomberg

M&A Activity

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 is not often available. Additionally, specialists will often combine resources, with many specialists (either in the same specialty or across a variety of specialties) merging in order combine market bases or purchasing power. These consolidation trends are expected to continue through at least the next five years, resulting in potential cost efficiencies that may increase profits at the surviving companies.

As mentioned above, VCA acquired CAPNA in May 2016. The total consideration of the purchase was $351.1 million, and VCA acquired total assets of $439.9 million. No revenue or income information on CAPNA was available.

Trends in EBITDA Pricing Multiples

	3Q 2015	4Q 2015	1Q 2016	2Q 2016
VCA, Inc. (WOOF)	13.08	12.85	13.12	15.03
PetMed Express (PETS)	8.69	9.20	9.75	9.70
Heska, Inc. (HSKA)	17.30	19.45	13.63	16.22
Zoetis, Inc. (ZTS)	16.56	18.97	17.72	17.91
IDEXX Laboratories (IDXX)	22.56	20.35	21.31	23.37
Abaxis, Inc. (ABAX)	19.80	24.90	17.72	18.28
Phibro Animal Health (PAHC)	14.48	13.54	12.73	9.49

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

Fair Value Issues (and More) in the Veterinary Industry

How is a veterinary practice or animal hospital valued? Are the valuation concepts different for change of control versus allocation of purchase price for ASC 805 compliance? Knowing which methods to apply in the valuation of a veterinary practice and which assets to recognize in a business combination can have a material impact on the value of a company and its purchase price allocation. There are several key elements that would directly impact or concern veterinary practices and animal hospitals.

Enterprise Value

Enterprise value refers to the valuation of the entire entity, such as when contemplating a sale of the business or a transfer of a pro rata ownership interest. Enterprise value is also the basis for testing goodwill for impairment, whether on a reporting unit or company-wide basis.

There are three general approaches to determining the enterprise value of a company. These three approaches encompass a variety of different methods to determine an estimate of value. The most frequently used method under the asset approach is the net asset value method, which looks at the value of the company's tangible, operating assets net of any debt. In many cases, this approach excels at capturing the value of the tangible part of the company – the inventory, desks, and computers that underlie a business but fail to capture the ongoing operations of the company.

Other commonly used methods under the income approach are the discounted cash flow method and the capitalization of ongoing earnings method. The discounted cash flow method projects a stream of future income and converts the cash flow into a value today given expectations of inflation and risk. The capitalization of earnings method uses a point estimate of expected ongoing earnings to develop a value. Both of these methods incorporate the risks of running the company and the cash flow that produces value for the owner of a company.

Methods under the market approach include the guideline transaction method and the guideline public company method. Both methods use market data and ratios to estimate the company's value given its revenue, income, or equity. The difficulty with these approaches in the animal health industry is often the scarcity of data – the only publicly traded company focusing on animal hospitals or veterinary practices is VCA. With over 760 animal hospitals in 43 states as of June 30, 2016, it is hard to compare VCA to many single-location animal hospitals or veterinary practices and derive meaningful valuation inferences. Similarly, M&A transaction data can be difficult to verify, because many practice acquisitions are not public.

Both methods under the income approach require the appraiser to make an estimate of the company's risk. For veterinary practices, these risks can include geographic risk (which reflects the dependency of a practice on the economic health of one city or suburb), key man risk (if the majority of relationships or revenue lie with a single vet), and size risk (if the business is particularly small). Other risk factors specific to the company may also be considered. For example, if the expected growth of a practice is due to the future hiring of additional staff or an expansion of the facilities, the appraiser needs to incorporate the risk of these processes taking longer than expected or not having the expected return.

Intangible Assets

When a practice or animal hospital is sold, intangible assets may need to be valued through a purchase price allocation. This process allows for intangible assets that have been created through the operations of the company to be recorded as assets on the company's balance sheet. Key intangible assets in the animal health industry include non-compete agreements, trade names, and goodwill. Customer relationships can also be an important asset in a general veterinary practice; however, the different nature of animal hospitals and specialty practices reduces the relevance of this asset and may result in a referral partnership asset instead. The chart below shows the preliminary purchase price allocation for VCA's May 1, 2016 acquisition of Companion Animal Practices (CAPNA). CAPNA operates a network of 56 free-standing animal hospitals in 18 states. The identifiable intangible assets category includes customer relationships, tradenames, and non-compete agreements.

VCA Purchase of CAPNA

Asset	Value	% of Assets
Tangible Assets	$13,548	3.1%
Identifiable Intangible Assets	147,500	33.5%
Goodwill	281,311	64.0%
Assumed Liabilities	(2,572)	-0.6%
Fair Value of Assets and Liabilities	$439,787	100.0%
Noncontrolling Interest	(88,638)	
Total Consideration	$351,149	

Source: From VCA's (Ticker: WOOF) 10-q for the quarter ended June 30, dated August 1, 2016

Customer Relationships

Beyond the client data contained in the company's files, relationships exist based on the trust fostered between customers and the company. These relationships, in turn, give rise to an expectation that a significant number of customers will continue their relationship with the company. In general, the values of customer relationships depend on the revenue and income generated by the existing customer base and some expectation of customer loss. While recurring relationships are common and expected in general veterinary practices, such a relationship is less predictable when the company is an emergency hospital or a specialist. For example, someone ceasing to visit an animal oncologist is not necessarily a sign of a degrading relationship, but could rather be due to the resolution of the underlying health issue.

Referral Partnership Networks

Referral partnerships can be key assets in some practices for hospitals or specialty practices. A referral partnership network occurs when general practice veterinarians maintain relationships with a particular specialty practice as the main practice to send clients with particular needs. If a group of veterinarians or specialists only recommends one emergency hospital, that hospital would experience a boost in revenue that it would not have otherwise received without the intangible asset.

Non-compete Agreements

Non-compete agreements can prevent the loss of key employees, customers, and suppliers. In the animal health industry, non-compete agreements typically prevent a key vet or the seller of the company from starting a new practice shortly after the sale of the old company. The value of a non-compete agreement is dependent on the income generated by the covered party and how likely the covered party is to compete with the company absent the non-compete agreement.

Trade Names

Valuable trademarks identify premier services in the relevant marketplace, and thus allow a company to enjoy higher prices paid for its products or services. Furthermore, securing the rights to use a given trademark in an acquisition is a valuable component of the ownership transition process because of the perception of continuity from the perspective of existing customers. The value of trade name can be reduced if the trade name is only recognized in a limited geographic area. If the acquirer does not intend to use the company's trade name, the trade name does not have value and should therefore not be included in the purchase price allocation.

Goodwill

Goodwill can only arise through the acquisition of a company, and it is effectively the difference between the value of the company's assets (including identifiable intangible assets) and the price that was paid. Some business combinations are driven by prospective synergies, which may include vendor discounts or a reduction in administrative costs. Business combinations can also allow access to new geographic markets, such as new parts of cities or expansion into new states. Additionally, a large portion of the company's business may be driven by the quality of its staff. All these items would result in significant allocations of value to goodwill.

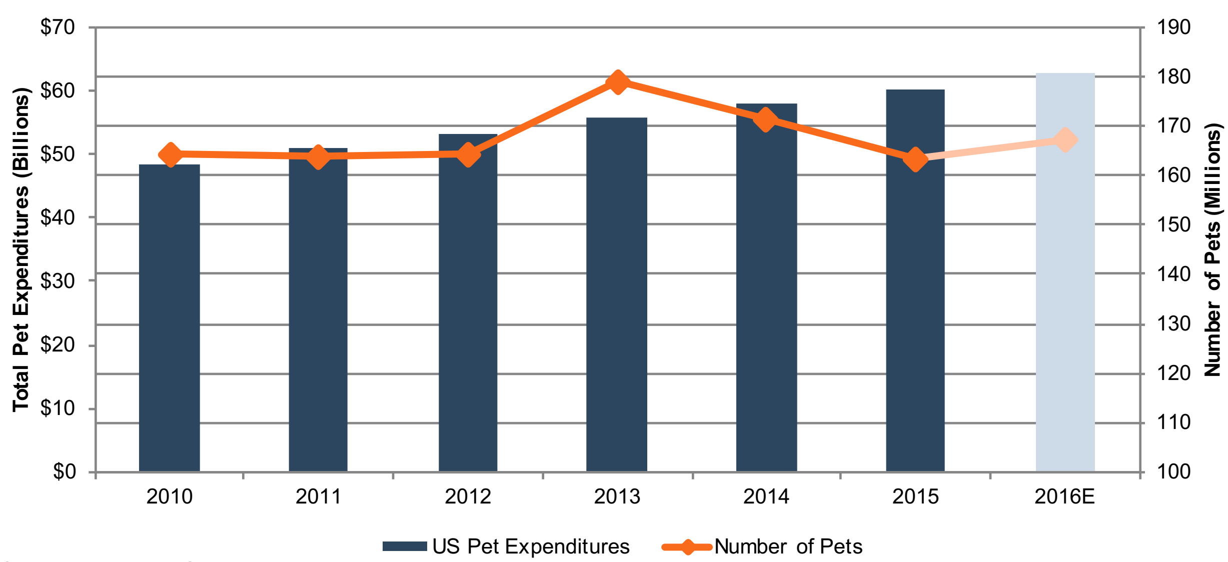
As an aside, for tax purposes, goodwill can sometimes be separated into personal and corporate components. While corporate goodwill is attributable to the business itself, personal goodwill is attributable to the professionals or owners of a company. While the classification of goodwill between the corporate and personal categories does not impact the financial statements from a financial reporting perspective, the sellers of a company may face more favorable tax treatment depending on the type of goodwill recognized in the transaction. The classification of goodwill as personal or corporate may also be complicated by the existence of a non-compete agreement.

Segment Outlook

The traditional care veterinary industry faces competition from retail stores such as PetSmart, which are increasingly offering full-service veterinary hospitals in existing storefronts. As traditional vets expand their practices to compete with in store clinics, emergency and specialty vets face increasing competition. While increasing specialization should drive margins higher, competition is expected to provide downward margin pressure. Although 2016 is expected to end higher than previously anticipated, estimates of pet and revenue growth in later years have been revised downward. Despite this, increased pet insurance coverage could increase demand for high-cost procedures. Based on industry reports, veterinary services revenue is expected to grow at an annualized rate of 1.8% over the five year period ending in 2021.

Innovations in commercial animal health continue as well. The application of GMO practices to animals will result in new areas of application for animal pharmaceuticals and biotechnology. Increasing use of human equipment and medicine for pet treatment will also expand the reaches of the animal pharmaceutical and biotechnology industry. Advances in MRI and ultrasound imaging will allow improve diagnostic abilities. The use of linear accelerators for animal cancer treatment has enabled the treatment of new cancers. Advancements in 3-D printers allow for the manufacture of custom bone, blood vessel, muscle, and organ implants, in addition to the manufacture of animal prosthetics.

Number of Pets and Pet Expenditures



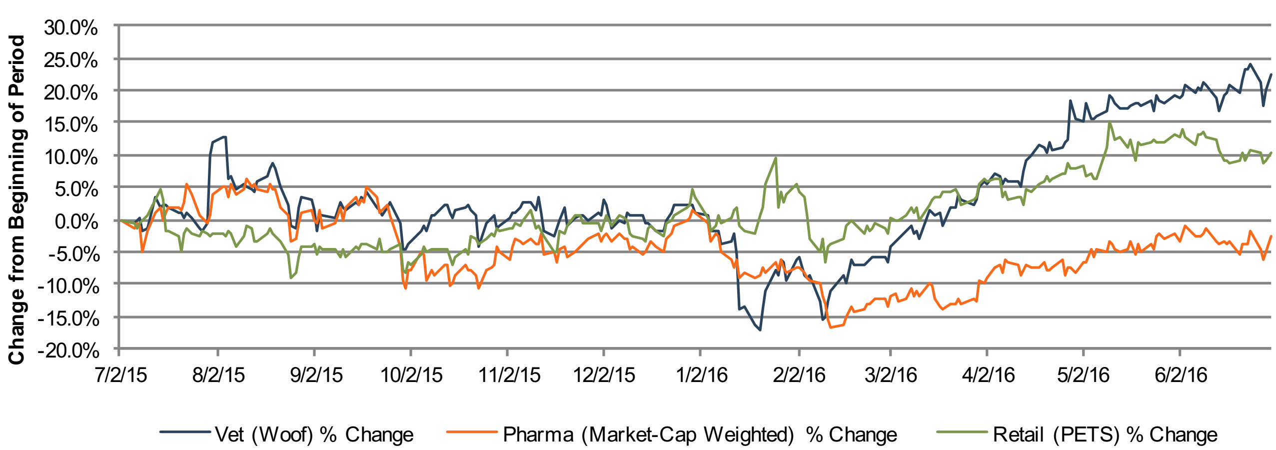
Source: APPA and IBIS

Publicly Traded Animal Health Companies

Company Name	Ticker	6/30/16 Price ($)	52 Wk Perform (%)	Sales ($)	Enterprise Value ($M)	Debt/ Mart. Cap	EBITDA Margin	EV/ EBITDA (x)	EV / Next Yr EBITDA (x)	P/E (x)
Veterinary Services										
VCA Inc.	WOOF	67.61	24.3%	80.80	6,415.52	14.8%	19.6%	14.92	12.36	28.88
Pet Retail										
PetMed Express Inc	PETS	18.76	13.3%	234.68	383.60	0.0%	14.13%	11.57	11.12	18.37
Animal Pharmaceuticals and Biotech										
Heska Corp	HSKA	37.17	25.2%	108.85	247.66	0.4%	12.66%	17.97	11.84	45.33
Zoetis Inc	ZTS	47.46	-0.6%	4,825.00	28,027.94	15.9%	21.66%	26.82	14.37	28.74
IDEXX Laboratories Inc	IDXX	92.86	44.8%	1,636.97	9,537.26	12.8%	22.74%	25.62	22.24	43.44
Abaxis Inc	ABAX	47.23	-7.3%	218.90	1,058.71	0.0%	24.77%	19.52	19.99	34.66
Aratana Therapeutics Inc	PETX	$6.32	-58.2%	0.69	259.14	15.4%	nm	nm	-7.11	nm
PetMed Express Inc	PETS	18.76	13.3%	234.68	383.60	0.0%	14.13%	11.57	11.12	18.37
Parnell Pharmaceuticals Holdings Ltd	PARN	1.63	-67.1%	9.91	nm	nm	nm	nm	nm	nm
Phibro Animal Health Corp	PAHC	18.66	-51.4%	747.30	1,101.68	33.3%	14.58%	10.11	9.16	9.89
Jaguar Animal Health Inc	JAGX	1.84	nm	0.23	24.56	24.0%	nm	nm	nm	nm
Kindred Biosciences Inc	KIN	3.54	-48.1%	0.00	70.22	0.0%	nm	nm	-2.98	nm
Median- Animal Pharm & Biotech		**18.71**	**-7.3%**	**163.88**	**383.60**	**12.8%**	**18.1%**	**18.75**	**11.48**	**31.70**

Source: Bloomberg
Note: Aratana, Parnell, Jaguar, and Kindred current income results in nonmeaningful multiples.
Note: PetSmart and MWI Veterinary no longer included due to acquisitions in the first quarter of 2015.

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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