

# PetMed Express, Inc.

(PETS-NASDAQ)

Current Recommendation	<b>NEUTRAL</b>
Prior Recommendation	Outperform
Date of Last Change	11/24/2013
Current Price (01/21/15)	\$16.20
Target Price	<b>\$17.00</b>

## SUMMARY

PetMed's EPS of \$0.24 in the third quarter of fiscal 2015 was up 4.3% year over year but fell short of the Zacks Consensus Estimate by \$0.01. Net sales dropped 1.6% to \$49.3 million but exceed the benchmark of \$49 million. Although we are encouraged by the company's efforts to revive the top line, lower new order and re-order sales was a drag. However, we are encouraged by the margin improvement in the quarter. The company continues to face competition which may increase further with the impending acquisition of Novartis' animal health by Eli Lilly. The dearth of any near-term catalyst might make it difficult for PetMed to overcome these challenges. Accordingly, we are Neutral on PetMed.

## SUMMARY DATA

52-Week High	\$16.20
52-Week Low	\$12.56
One-Year Return (%)	24.73
Beta	1.26
Average Daily Volume (sh)	182,265
Shares Outstanding (mil)	20
Market Capitalization (\$mil)	\$328
Short Interest Ratio (days)	43.00
Institutional Ownership (%)	65
Insider Ownership (%)	5
Annual Cash Dividend	\$0.68
Dividend Yield (%)	4.20
5-Yr. Historical Growth Rates	
Sales (%)	-0.3
Earnings Per Share (%)	-4.3
Dividend (%)	11.5
P/E using TTM EPS	17.8
P/E using 2015 Estimate	17.8
P/E using 2016 Estimate	17.8
Zacks Rank *: Short Term 1 - 3 months outlook	2 - Buy

\* Definition / Disclosure on last page

Risk Level *	Below Avg.,
Type of Stock	Small-Growth
Industry	Internet Commer
Zacks Industry Rank *	48 out of 267

## ZACKS CONSENSUS ESTIMATES

### Revenue Estimates

(In millions of \$)

	Q1 (Jun)	Q2 (Sep)	Q3 (Dec)	Q4 (Mar)	Year (Mar)
<b>2013</b>	69 A	58 A	50 A	51 A	228 A
<b>2014</b>	74 A	60 A	50 A	49 A	233 A
<b>2015</b>	73 A	58 A	49 A	49 E	229 E
<b>2016</b>	72 E	58 E	49 E	49 E	228 E

Note: Quarterly numbers may not add up to annual numbers due to rounding off

### Earnings Per Share Estimates

(EPS is operating earnings before non-recurring items, but including employee stock options expenses)

	Q1 (Jun)	Q2 (Sep)	Q3 (Dec)	Q4 (Mar)	Year (Mar)
<b>2013</b>	\$0.20 A	\$0.20 A	\$0.23 A	\$0.23 A	\$0.86 A
<b>2014</b>	\$0.23 A	\$0.21 A	\$0.23 A	\$0.23 A	\$0.90 A
<b>2015</b>	\$0.25 A	\$0.19 A	\$0.24 A	\$0.23 E	\$0.91 E
<b>2016</b>	\$0.23 E	\$0.19 E	\$0.23 E	\$0.26 E	\$0.91 E

Note: Quarterly figures may not add up to annual figures due to rounding off

**Projected EPS Growth - Next 5 Years %**

**5**

## OVERVIEW

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PetMed Express, operating as 1-800-PetMeds, is a leading nationwide pet pharmacy. The company, founded in 1996, is headquartered at Pompano Beach, FL. PetMed Express' product line contains approximately 750 SKUs catering to dogs, cats, and horses. These products include brands of medication such as Frontline Plus, K9 Advantix, Advantage, Heartgard Plus, Sentinel and Interceptor.

The company offers two types of products:

- **Non-prescription medications (over-the-counter or OTC):** These include flea and tick control, bone and joint care, vitamins, nutritional supplements, and hygiene products.
- **Prescription medications:** These include heartworm treatments, thyroid and arthritis medications and antibiotics in addition to other specialty medications as well as generic substitutes.

These two product types accounted for 59% and 40% of total sales in fiscal 2013, respectively, while 1% was derived from shipping and handling fees.

PetMed Express markets its health products directly to consumers through national television, online, and direct mail/print advertising campaigns in order to increase the awareness of the 1-800-PetMeds brand name. These efforts are aimed at increasing traffic to its website, maximizing repeat customers and acquiring new customers. The company has been successful in increasing its sales over the Internet. During the first quarter of fiscal 2015, 80% of the sales were generated through its website compared with 79% in the year-ago period.

## REASONS TO BUY

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- **Several initiatives to improve sales:** Despite a drag in new order sales and re-order sales which led to another quarter of year-over-year sales decline, average order size increased to \$76 in the quarter from \$73 in the year-ago period on the back of favorable reaction to promotions. We are also encouraged to note that the company is working on issues like limited consumer spending and a change in product mix to lower-priced items, mainly generics. The company is asking veterinarians to prescribe additional brands.

The company is also working on improving the effectiveness of its campaigns. It has been quite successful in pushing its sales via the Internet. Approximately 80% of the company's orders were generated on the website compared with 79% in the corresponding year-ago quarter. Of late the company has started focusing on advertising efficiency to improve new order sales and shifting sales to higher margin items, including generics, while expanding its product offerings.

- **Wide portfolio to aid growth:** PetMed offers a wide range of products for dogs, cats, and horses. The company markets its products primarily under well-known brands of medication such as Frontline Plus, K9 Advantix, Advantage, Heartgard Plus, Sentinel, and Interceptor among others. We believe with improvement in economic conditions, PetMed's wide range of products will drive growth at the company's coming quarters.
- **Rewards shareholders by dividends and buybacks:** PetMed exited the quarter with cash and cash equivalents and short-term investments of \$52.6 million, up from \$33.8 million at the end of fiscal 2014. Year-to-date, cash flow from operations was \$29.5 million, compared to \$17.7 million for the same period a year ago. Further, the board declared a quarterly dividend of \$0.17 per share with

Feb 13, 2015 as the payout date. In fiscal 2015, PetMed is focusing on increasing its advertising spending to improve new order sales, and shifting sales to higher margin items while continuing to expand its product offerings. PetMed's advertising cost of acquiring a customer was approximately \$45 for the reported quarter compared to \$40 for the year-ago period.

## REASONS TO SALE

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- **Low Orders Continue to Weigh on Revenues:** PetMed's net sales in the quarter dropped 1.6% year over year to \$49.3 million negatively impacted by decrease in new order and reorder sales. According to the company, demand for flea and tick were soft. This is because spring and summer are considered peak seasons as against fall and winter which represent the off-season. A 7.5% drag in new order sales driven by increase in customer acquisition costs, and a slight decline in re-order sales, led to another quarter of year-over-year sales decline. Although the company is taking various measures to improve its top line, the sluggish quarterly numbers once again proved that the actions are not enough to nullify the pessimism of the investors.
- **Competitive environment:** PetMed operates in a highly competitive and fragmented pet medications market. The competitors include veterinarians, traditional retailers, other mail-order and online retailers of pet medications and other health products. The company has witnessed higher pricing pressure in the over-the-counter market due to increased competition. To address the increasing competition in the flea and tick segment, PetMed has adopted a more aggressive pricing strategy that has affected its gross margin.
- **Market consolidation leading to severe competitive threat:** In April Eli Lilly and Company announced its intention to acquire Novartis' animal health division which is slated to close by the end of the first quarter of 2015. The proposed acquisition is expected to throw more challenges for PetMed in the pet pharmacy industry. The deal would combine two large pet pharmacies with which Eli Lilly will move to the second position in the animal health market in terms of global revenue. We expect the acquisition to create market concentration in the entire economy, leading to an anti-competitive landscape for PetMed.

## RECENT NEWS

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### **PetMed Earnings Miss, Revenues Top Estimates in Q3**– Jan 20, 2015

PetMed reported earnings per share (EPS) of \$0.24 in the third quarter of fiscal 2015, up 4.3% year over year. However, earnings fell short of the Zacks Consensus Estimate by \$0.01.

Net sales in the quarter dropped 1.6% year over year to \$49.3 million but closely beat the Zacks Consensus Estimate of \$49 million. Year-over-year sales were negatively impacted by decreases in new order and reorder sales. According to the company, demand for flea and tick were soft. This is because spring and summer are considered peak seasons as against fall and winter which represent the off-season. Despite that, the average order size has increased to \$76 in the quarter from \$73 a year ago.

During the quarter under review, PetMed acquired 96,000 new customers, down from 114,000 in the third quarter of fiscal 2014. Roughly 80% of all orders were generated from its website (versus 79% in the prior-year quarter).

Gross margin expanded 100 basis points (bps) year over year to 34.7% due to a shift in sales to higher margin items. General and administrative expenses declined 3.1% year over year to \$4.9 million while there was a 4.2% drop in advertising expenses to \$4.3 million. This led to a 3.7% reduction in adjusted

operating expenses (without depreciation and discontinued project costs), which amounted to \$9.3 million. Adjusted operating margin in the quarter expanded 138 bps to 15.9%.

PetMed exited the quarter with cash and cash equivalents and short-term investments of \$52.6 million compared with \$33.8 million at the end of fiscal 2014.

## VALUATION

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PetMed reported a mixed performance in the third quarter of fiscal 2015 with earnings missing the Zacks Consensus Estimate but revenues beating the mark. However, the top line fell short of the year-ago number. Sales were negatively impacted by lower new order and reorder sales. However, we are impressed with the fact that PetMed is striving to expand its portfolio to drive the top line. These strategies include focus on advertising efficiency to improve new order sales and shifting sales to higher margin items.

We are also encouraged by the fact that after a series of disappointing quarterly operating margin numbers, the company showed a turnaround in the reported quarter. This was mainly because of the company's ongoing cost reduction initiatives. Meanwhile, the company continues to face competitive pressure in the competitive and fragmented pet medications market. We expect the impending acquisition of Novartis' animal health division by Eli Lilly to create market concentration in the entire economy, leading to an anti-competitive landscape for PetMed. Accordingly, we reiterate the stock at Neutral with a target price of \$17.00.

PetMed Express' current trailing 12-month earnings multiple is 17.8, compared to Industry Average of 55.0 and 18.6 for the S&P 500. Over the last five years, the company's shares have traded in a range of 11.2x to 19.1x trailing 12-month earnings. Our target price is based on 18.7x our 2015 EPS estimate of \$0.91.

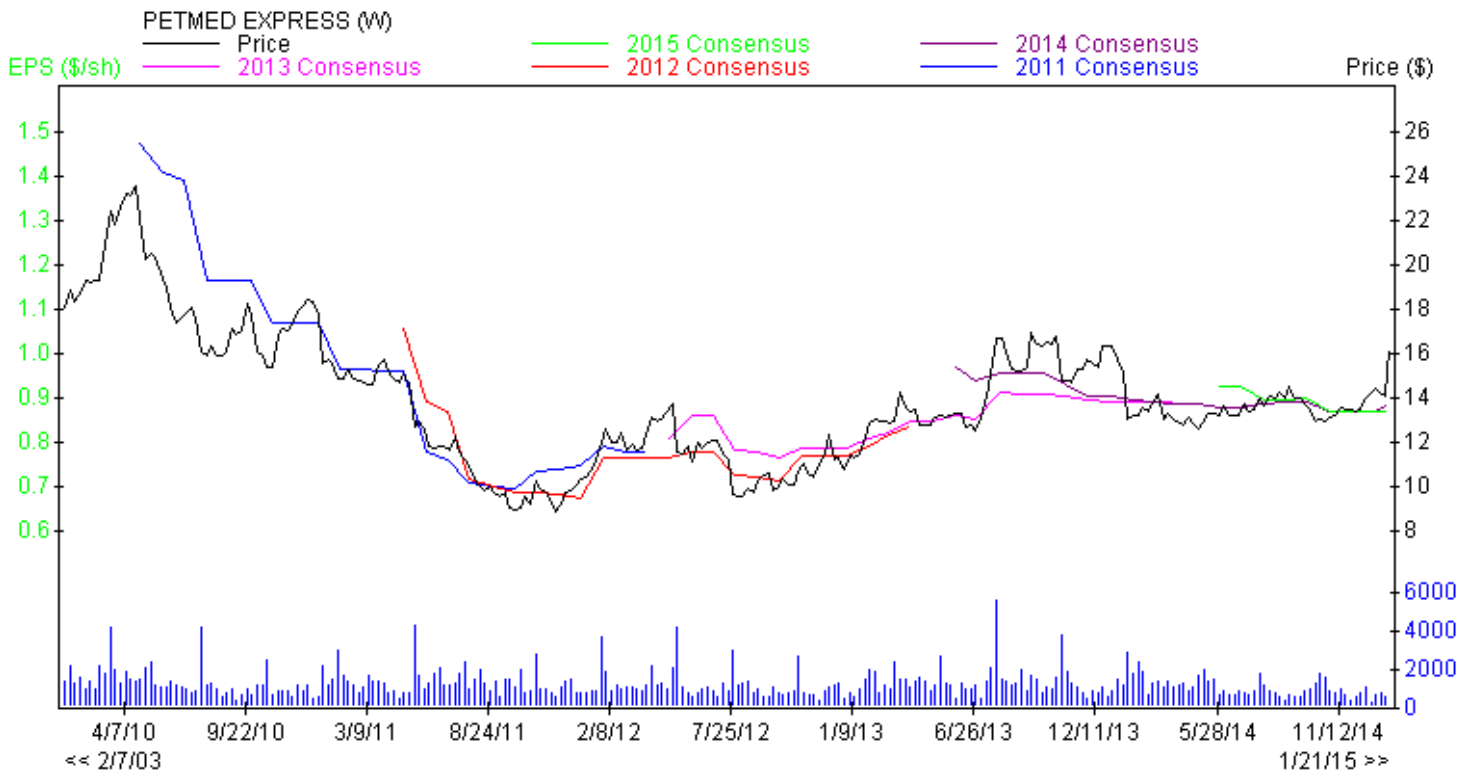
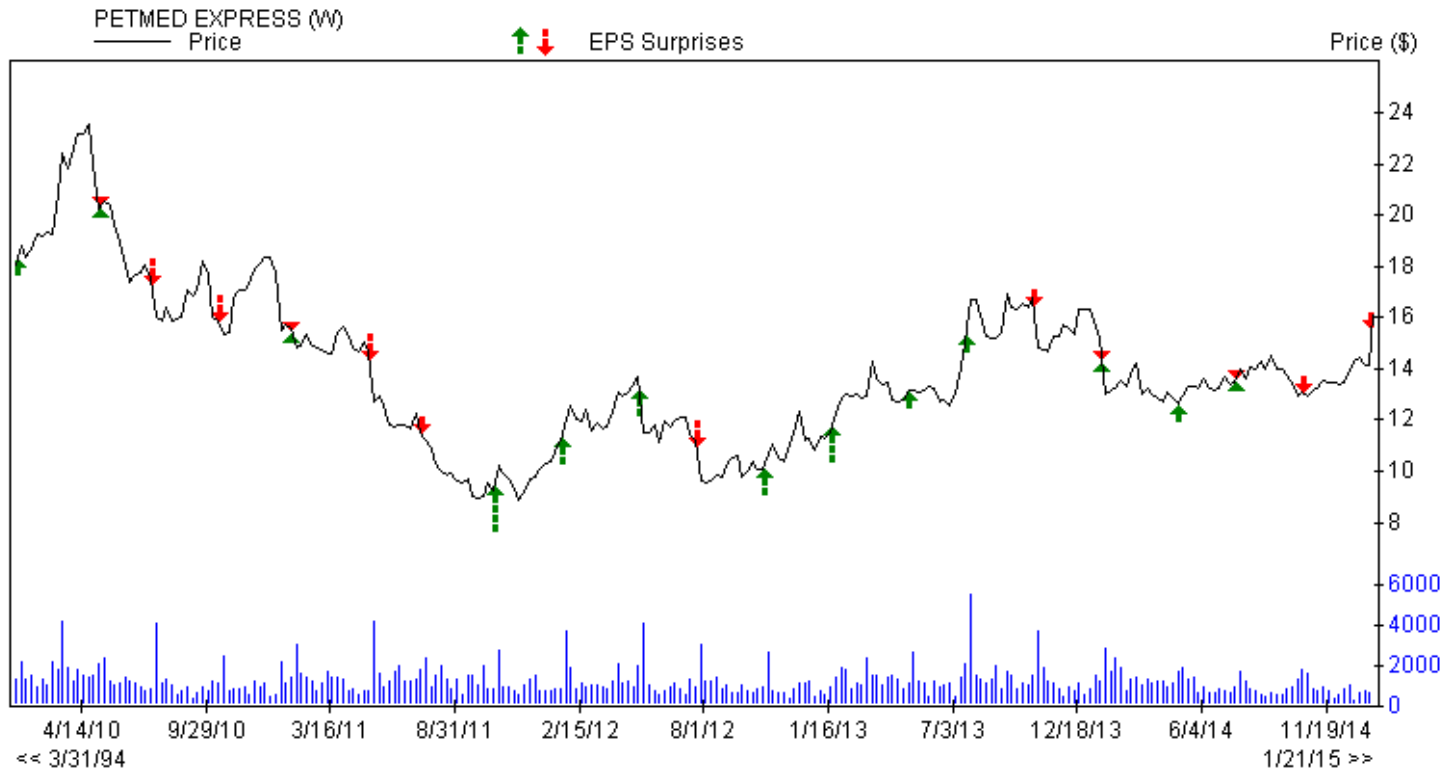
## Key Indicators

	P/E F1	P/E F2	Est. 5-Yr EPS Gr%	P/CF (TTM)	P/E (TTM)	P/E 5-Yr High (TTM)	P/E 5-Yr Low (TTM)
<b>PetMed Express, Inc. (PETS)</b>	<b>17.8</b>	<b>17.8</b>	<b>5.0</b>	<b>16.9</b>	<b>17.8</b>	<b>19.1</b>	<b>11.2</b>
Industry Average	N/M	N/M	19.9	38.5	55.0	N/M	45.9
S&P 500	16.1	15.1	10.7	15.9	18.6	19.4	12.0
Gaiam Inc. (GAIA)	22.7		15.0			N/M	32.1
Blue Nile Inc. (NILE).	33.5		19.8	33.2	42.9	N/M	32.6

TTM is trailing 12 months; F1 is 2015 and F2 is 2016, CF is operating cash flow

	P/B Last Qtr.	P/B 5-Yr High	P/B 5-Yr Low	ROE (TTM)	D/E Last Qtr.	Div Yield Last Qtr.	EV/EBITDA (TTM)
<b>PetMed Express, Inc. (PETS)</b>	<b>4.1</b>	<b>5.2</b>	<b>2.4</b>	<b>25.2</b>	<b>0.0</b>	<b>4.7</b>	<b>9.2</b>
Industry Average	7.8	7.8	7.8	7.4	0.0	0.3	17.4
S&P 500	5.1	9.8	3.2	24.8		2.0	

# Earnings Surprise and Estimate Revision History



## DISCLOSURES & DEFINITIONS

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**The analysts contributing to this report do not hold any shares of PETS. The EPS and revenue forecasts are the Zacks Consensus estimates.** Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts' personal views as to the subject securities and issuers. Zacks certifies that no part of the analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report. Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Because of individual objectives, the report should not be construed as advice designed to meet the particular investment needs of any investor. Any opinions expressed herein are subject to change. This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. Zacks or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. Zacks uses the following rating system for the securities it covers. **Outperform**- Zacks expects that the subject company will outperform the broader U.S. equity market over the next six to twelve months. **Neutral**- Zacks expects that the company will perform in line with the broader U.S. equity market over the next six to twelve months. **Underperform**- Zacks expects the company will under perform the broader U.S. Equity market over the next six to twelve months. The current distribution of Zacks Ratings is as follows on the 1054 companies covered: Outperform - 16.2%, Neutral - 76.1%, Underperform – 5.9%. Data is as of midnight on the business day immediately prior to this publication.

Our recommendation for each stock is closely linked to the **Zacks Rank**, which results from a proprietary quantitative model using trends in earnings estimate revisions. This model is proven most effective for judging the timeliness of a stock over the next 1 to 3 months. The model assigns each stock a rank from 1 through 5. Zacks Rank 1 = Strong Buy. Zacks Rank 2 = Buy. Zacks Rank 3 = Hold. Zacks Rank 4 = Sell. Zacks Rank 5 = Strong Sell. We also provide a **Zacks Industry Rank** for each company which provides an idea of the near-term attractiveness of a company's industry group. We have 264 industry groups in total. Thus, the Zacks Industry Rank is a number between 1 and 264. In terms of investment attractiveness, the higher the rank the better. Historically, the top half of the industries has outperformed the general market. In determining **Risk Level**, we rely on a proprietary quantitative model that divides the entire universe of stocks into five groups, based on each stock's historical price volatility. The first group has stocks with the lowest values and are deemed **Low Risk**, while the 5<sup>th</sup> group has the highest values and are designated **High Risk**. Designations of **Below-Average Risk**, **Average Risk**, and **Above-Average Risk** correspond to the second, third, and fourth groups of stocks, respectively.