



(PIC) Petco Health & Wellness

Important disclosures can be found in Appendix

August 24, 2023

(PIC) Petco: Lowered 2023 Profit Forecasts, Investing More In Value Priced Points - Highlights from 2Q23 Results

Bottom Line: 2Q comp growth was 3.2% vs. 5.1% last quarter. Growth was driven by strength in Services and Consumables categories, which was offset by weakness in Discretionary and Supplies. Petco indicated Consumables remain consistent, with trade down being offset by some trade up to premium and fresh products. In Supplies/Discretionary the weakness was more than management expected which, along with labor costs, impacted margins significantly. Petco lowered their EBITDA outlook for 2023 to down -18% vs. previously expecting -7%, despite reiterating sales growth of about 3% for the year.

To offset likely continued mix headwinds, management indicated they are becoming more aggressive on pricing, bringing in more value-oriented brands, optimizing vendor pricing, and reducing corporate and field leadership headcount by 25%. These actions are expected to help contribute to margins in 2024, and help offset likely continued muted discretionary demand. The company reaffirmed plans to invest in their vet clinic strategy, as well as announced expansion of their Lowe's partnership and rural store concept.

Key Points

- **2Q comparable store sales were up 3.2% vs. up 5.1% in 1Q.** Sales trends across major merchandise categories were softer in **Consumables which grew 6.8% in 2Q (11.2% in 1Q)**, while **Supplies fell -9.4% (-7.6% 1Q)**. Services & Other remained strong, growing 30.6% year/year (up 25.4% in 1Q) as vet hospitals continue to open and perform well.

	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23
Comp Store Sales	5.1%	3.8%	4.1%	5.3%	5.1%	3.2%
2 Year Stacked	33.5%	23.8%	19.1%	19.3%	10.2%	7.0%
3 Year Stacked	35.5%	34.3%	35.4%	36.3%	38.6%	27.0%
3 Year Geometric	37.6%	37.6%	39.2%	40.4%	41.8%	28.5%
Geometric vs 2019	43.2%	43.6%	44.4%	45.8%	44.7%	42.0%

Category Sales Mix	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23
Consumables	\$686	\$687	\$721	\$766	\$763	\$734
% Change	15.3%	12.3%	12.0%	12.1%	11.2%	6.8%
BPS Change	206	-1203	-931	-670	-406	-548
% of Net Sales	46.5%	46.4%	48.0%	48.5%	49.0%	48.0%
Supplies and Companion Animal	\$599	\$601	\$575	\$596	\$554	\$544
% Change	-9.0%	-9.5%	-9.4%	-7.8%	-7.6%	-9.4%
BPS Change	-4227	-1779	-1506	-1186	136	7
% of Net Sales	40.6%	40.6%	38.3%	37.8%	35.6%	35.6%



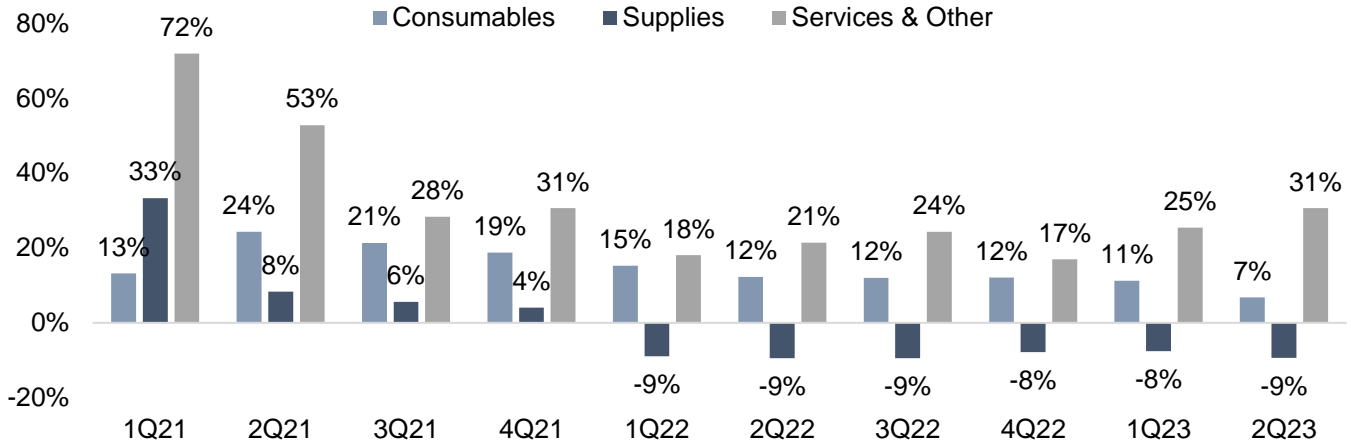
Services and Other	\$191	\$193	\$205	\$216	\$239	\$252
<i>% Change</i>	18.1%	21.4%	24.3%	17.0%	25.4%	30.6%
<i>BPS Change</i>	-5389	-3142	-396	-1360	735	922
<i>% of Net Sales</i>	12.9%	13.0%	13.7%	13.7%	15.4%	16.5%
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Net Sales	\$1,476	\$1,481	\$1,501	\$1,578	\$1,556	\$1,530
<i>% Change</i>	4.3%	3.2%	4.0%	4.2%	5.4%	3.3%

Source: Company Reports / CRC Estimates

Category Breakout

- In **Consumables**, management indicated they are seeing strength within the premium shopper cohort while value oriented shoppers are seeing some incremental trade down
 - Premium Consumable products were up 8% in 2Q, compared to non-premium Consumables up 4%. The retailer highlighted continued strong demand leading to double digit growth in fresh/frozen food categories, up 10%, and customer growth in the segment up 12% year/year.
 - **To address the value-oriented customer, Petco is taking pricing actions across SKUs** to drive traffic and remain competitive.
 - Additionally management is going to add more value-based options.** This includes reintroducing the number one selling cat food brand **Fancy Feast** this week, as well as Diamond Naturals. Management and Pet Care Center teams are excited about potential traffic lift from adding these key brands.
- **Supplies and Companion Animals** businesses remain more pressured than anticipated, impacting overall profitability.
 - Discretionary sales were down -9% in 2Q (vs. down -8% in 1Q), with management not expecting much recovery through the rest of the year.
 - Apparel, crates and toys are seeing the largest hit as they are discretionary and can be put off
 - To stimulate additional supplies purchases, **Petco plans to lean into seasonal programs like Halloween and Holiday, and recently brought back the Popular Supplies Perks.**
- **Vet Services** continue to trend positively, driving a 26% year/year increase in total vet visits in 2Q (up 20% in 1Q).
 - Petco reaffirmed it is on track to open a total of 50-55 new hospitals in 2023, which would equate to a total of ~300 (operating 269 today)
 - Mobile vet clinic visits are up 23% year/year, with an average 1400 clinic visits per week, supporting routine wellness visits in an affordable way. The mobile clinics remain a source of talent for their full-time vets with 21% of their full-time vet recruits this year coming from our clinic pool.
 - In total, Petco added 364 vets into their company in Q2, up 59% year-over-year
 - Labor costs are stable, however, management noted they are impacting the bottom line as practices take time to scale.
 - As a result of the extreme heat, **management indicated flea and tick business was strong**, leading to Rx sales up nearly 20% year over year.
- In **Grooming**, revenue growth was strong driven by share gains and growing basket size.
 - Grooming's continued momentum has been accelerated by Clean Grooming launch earlier this year, with services and products free of parabens, phthalates, and chemical dyes, as well as a nearly 500 basis-point year-over-year improvement in groomer retention.

Petco Health And Wellness Category Growth

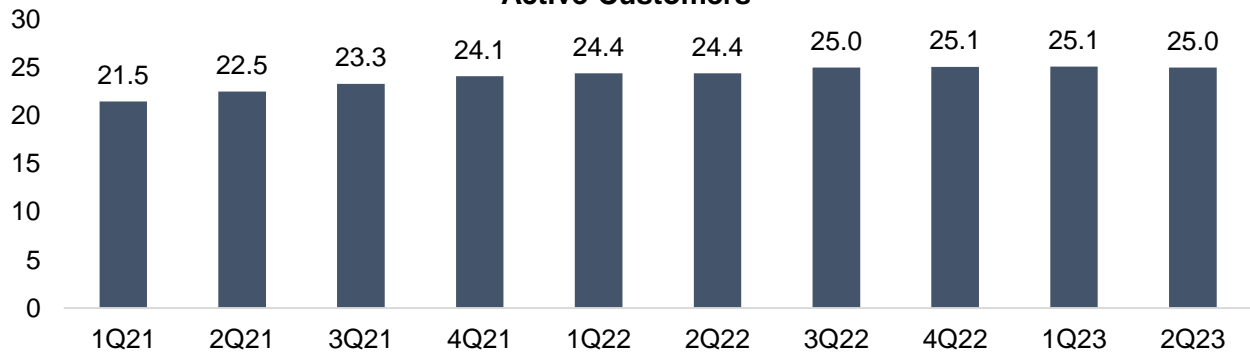


Source: Company Reports

Customer Acquisition & Strength

- Active customer growth was flat in 2Q vs. 1Q, which was a continuation growth trajectory Petco had seen. Management noted an additional 75,000 subscribers to its Vital Care Premier program, bringing total membership to 660,000.

Petco Health And Wellness Active Customers



Source: Company Reports

- The Vital Care Premier customers are considered high value Petco customers, spending 3X non-member customers on average. Today there are \$100mm recurring revenues from the program.
- Digital sales continue to grow, although have moderated, at up 9% in 2Q year/year vs up 10% in 1Q.
- Management emphasized its omnichannel strategy, noting growth in both BOPIS and repeat delivery customers.
- Brick & Mortar growth was up 2% in 2Q year/year vs 4.6% in 1Q.
 - Management emphasized its continued marketing investment in both Brick & Mortar and eCommerce platforms, looking to optimize investments across all channels tied directly to driving traffic growth.

	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23
eCom Sales (\$M)	\$214	\$214	\$206	\$236	\$236	\$233
<i>% Change</i>	10.5%	10.0%	9.8%	11.8%	10.0%	9.0%
<i>% of Total</i>	14.5%	14.4%	13.7%	15.0%	15.2%	15.2%

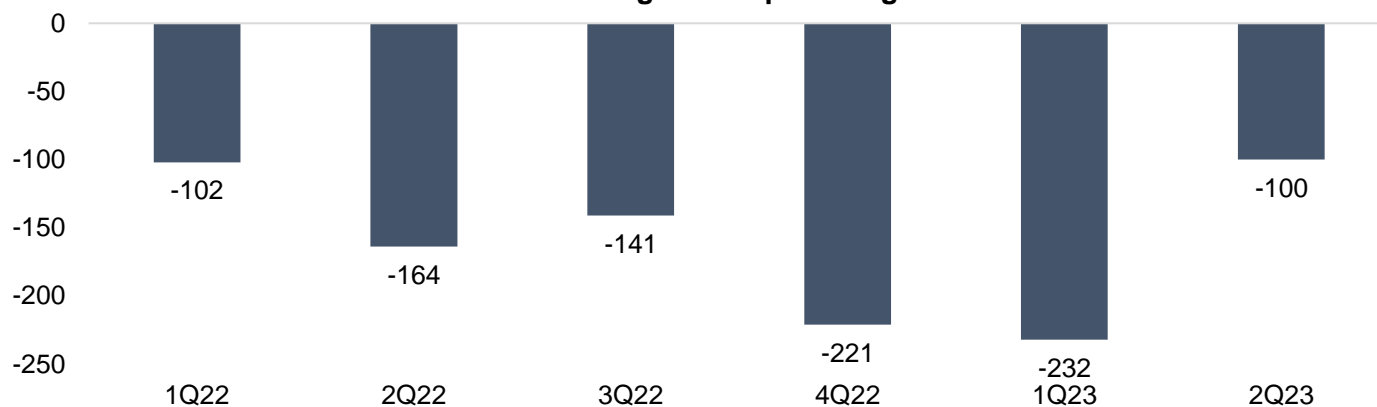
New Initiatives – Lowe’s & Rural Store

- Petco spoke positively on its partnership with Lowe’s, opening a total of 300 Petco stores within the Lowe’s footprint, 75 of which will have a Vetco clinic. These locations to date are performing ahead of expectations – bringing in new customers to the Petco ecosystem, are incremental to the topline, and require zero capital outlay from Petco.
- Petco reiterated its goal of opening 10 Pet Care Centers (PCCs) rural retail locations, within 2023, bringing the total to ~15 locations by the end of the year. Petco believes these concepts have driven 35,000 new customers to the chain.

Gross Margin & Cost Savings Efforts

- Gross margin performance remained underwhelming in 2Q, with Petco seeing a ~100 bps decline in gross margin rate due to the continued **mix impact of Consumable strength and ongoing Supplies and Companion Animal softness**.
 - Management **emphasized the continued investment in Services and Other is initially margin dilutive**, but will become gross margin accretive overtime.
 - i. According to management’s projections, the average Vet Clinic within the chain is 2 years old, when the clinic reaches its breakeven point. At year 5 the clinic will be 20% value accretive.

**Petco Health And Wellness
Gross Margin Y/Y Bps Change**



Source: Company Reports

- In efforts to optimize profits long term, amid the pressures in consumer discretionary spending, Petco has taken on various efficiency initiatives, primarily focusing on merchandising and supply chain, to drive **\$150mm of cost savings** by the end of 2025.
 - \$40mm of the \$150mm cost savings will be realized by the end of year 1, aided by the layoffs which occurred across 25% of corporate and field teams year to date, as the retailer looks to match positions with its long term strategies.
 - Further enhancements in refining supply chain, distribution automation and **merchandising efficiencies** will yield cost savings throughout 2024 – 2025. Pricing actions will also be taken, according to management, which historically have delivered customer and unit growth in year 1 with accretion thereafter.
 - Management reaffirmed investments in the vet rollout and new store concepts.
 - Offsetting some of the savings is reduced pricing, incremental advertising and promotional investments to drive traffic

2023 & 2024 Outlook

- **Petco reiterated full year 2023 sales guidance which implies ~3% net sales growth**, despite 1Q growth coming in around 5% and 2Q coming in around 3%. However, management lowered adjusted EBITDA, EPS and Capital Expenditures guidance, implying continued margin pressure for the rest of the year.
 - August has trended similar to 2Q, according to management
 - According to management, initial full-year guidance assumed a modest stabilization in discretionary spend on a dollar basis in the back half of the year, which they now don’t expect to happen



- This tapering outlook on discretionary spend pressures Gross Margin more than originally anticipated. The reduction in EBITDA is tied directly to the change in outlook for discretionary and supplies.
- Petco is putting cost actions in place to address those gaps and to try to address customer perceptions by placing more emphasis on value-oriented products.
- Additionally, Petco sees the industry **returning to pre-pandemic promotional levels**, with consumers responding to promotions as they seek out value.
- Looking to 2024, category projections are up mid-single digits with some stabilization in supplies and discretionary over the course of the year.



APPENDIX

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