

## Pet Valu Holdings: BUY with 29\$ Price Target

### Executive Summary

- High same-store-sales growth (~11% CAGR over the last 8 years), underpinned by secular tailwinds
- Capital light franchise model with strong economics and returns on capital (over 20% ROTC)
- Solid fundamentals: great loyalty program, increasing penetration of higher margin private label products, recurring revenue through consumables
- Track record of store growth (6% CAGR) with further room for expansion (TAM is 50% higher than current store count)

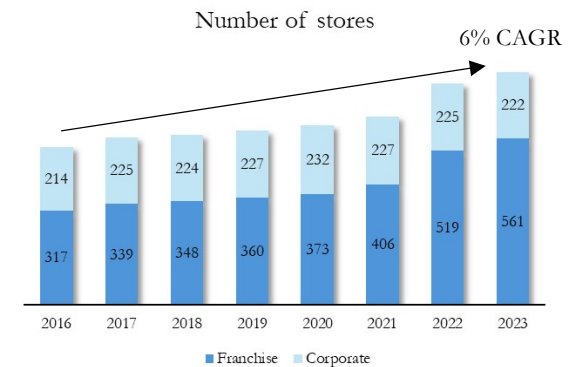
### Business Overview

Pet Valu is Canada's largest specialty pet retailer with an **18% market share**, operating 805 stores across all 10 provinces. Unlike their competitors, Pet Valu primarily carries premium pet brands (accounts for 78% of system sales) while also offering in-store services (grooming & cleaning), both contributing to consistent foot traffic for stores. **Over 80% of Pet Valu's revenues is generated by consumable sales** (food & treats) which are typically purchased on a weekly/monthly basis, creating to a steady stream of revenues. These consumable purchases tend to have high switching costs as owners are unwilling to risk the chance of their pets developing digestive issues when switching to another brand.

Pet Valu has taken note of this trend, developing their own **private label products which now accounts for 30% of sales**. Not only do these products reinforce customer loyalty, but they also allow Pet Valu to capture distributor margins as their private label products have **12% higher gross margins** than other SKUs. Pet Value's private label brand is now one of the largest and most successful pet food brands in Canada. Pet Valu also operates a very successful loyalty program with over **2.9M members which account for over 80% of system sales**. Members of Pet Valu's loyalty program are expected to spend 70%+ more per visit than traditional shoppers while visiting stores monthly, translating to well over \$1000/year.

### Impressive Unit Economics

Pet Valu has close to 600 franchised stores alongside 215 corporate owned stores. In recent years, Pet Valu has transitioned their focus to their franchise model with franchised stores growing at 7% CAGR while the corporate owned store count has remained flat. This allows Pet Valu to benefit from the attractive capital light expansion economics of the franchise model. Additionally, the franchise stores are more productive assets, carrying a mid to high teens higher AUV despite being smaller stores, leading to 30-55% higher sales per square foot.



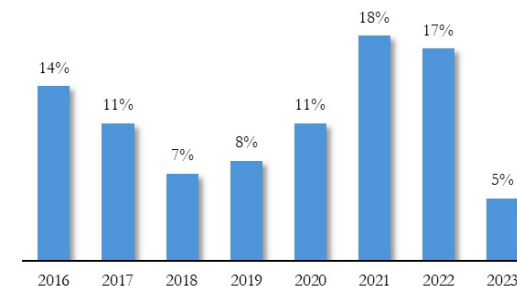
## Pet Valu Holdings (TSX: PET)

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Pet Valu's franchise base is highly fragmented with over 61% of franchisees only owning 1 store and no franchisee owning more than 7 stores. This makes sure that **Pet Valu retains favourable bargaining power over its franchisees**. The average franchisee tenure is 10 years with a 3% annual turnover which is primarily related to owner retirement. Pet Valu acts as a wholesaler for most franchisee purchases (>90% of all purchases) while collecting a 6% royalty on sales and charging a 2.5% marketing fee. Pet Valu also collects a \$40k initial franchise fee when a store is opened and a \$10k renewal fee if franchise agreements are expanded past the original 10-year agreements. These attractive economics translate to good returns on capital with **corporate stores having a 2-year payback period** (\$1.8m AUV and a 25% EBITDAM on \$500k upfront cost) while **franchisees can see a 4-year payback period** (\$2m AUV at a 12.5% EBITDAM on \$450k upfront cost).

Same Store Sales Growth (SSSG)



Alongside impressive unit growth and payback economics, Pet Valu has a track record of strong SSSG (11% average), driven by increased pet adoption, the humanization of pets leading to more demand for premium products where Pet Valu specializes, and the strength of their loyalty program. The overall industry should keep growing above inflation (4-6%) as pet humanization and premiumization keep unfolding over the next few years.

## Recent Drawdown

Management has recently guided for 2024 SSSG to be flat due to weak consumer spending and overall macro, which has resulted in shares trading down to roughly **10x forward EV/EBITDA or 15x forward P/E**. I argue this has become overly cheap for a company that can consistently drive 3%+ SSSG (with potential to the upside) alongside healthy store growth of 3-5%, shown by the valuation below.

While there are no catalysts specific to the company, I argue that a general recovery in the consumer sector should help put this relatively young and small name back on analysts' radars.

## Risks

- **E-commerce could start taking market share.** This has been seen in the US, with Amazon and Chewy notably gaining a strong presence and destroying value for the rest of the industry. However, Canada hasn't seen the same e-commerce shift as the US, despite similar efforts; there's a fundamental difference in consumer behavior that favors the brick-and-mortar retailers. Other mitigating factors are Pet Valu's own online platform, and the switching costs it has set up.
- **Store saturation could happen faster than expected.** A good part of Pet Valu's growth story is store growth, which relies on building more locations without saturating the market. Management currently sees a TAM of 1200 stores in Canada (50% higher than Pet Valu's 800 stores) so there's still plenty of white space just within Canada for the company to expand.

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Discounted Cash Flow Analysis							Projections									
(In \$ Millions)	2018A	2019A	Actuals				2024E	2025E	2026E	2027E	2028E	2029E	2030E	2031E	2032E	2033E
Retail	241	261	296	347	403	422	397	428	458	486	510	536	557	579	615	
% Growth		8.3%	13.4%	17.2%	16.1%	4.7%	(6.0%)	8.0%	7.0%	6.0%	5.0%	5.0%	4.0%	4.0%	3.0%	
Franchise & Other	289	313	353	429	549	634	666	712	755	800	840	882	918	954	1012	
% Growth		8.3%	12.8%	21.5%	28.0%	15.5%	5.0%	7.0%	6.0%	6.0%	5.0%	5.0%	4.0%	4.0%	3.0%	
<b>Total Revenue</b>	<b>530</b>	<b>574</b>	<b>649</b>	<b>776</b>	<b>952</b>	<b>1,056</b>	<b>1,062</b>	<b>1,141</b>	<b>1,213</b>	<b>1,286</b>	<b>1,351</b>	<b>1,418</b>	<b>1,475</b>	<b>1,534</b>	<b>1,580</b>	<b>1,627</b>
Cost of Goods Sold	(339)	(367)	(418)	(489)	(599)	(691)	(722)	(764)	(801)	(836)	(878)	(915)	(951)	(982)	(1011)	(1041)
% of Revenue	64.0%	63.9%	64.4%	63.0%	62.9%	65.4%	68.0%	67.0%	66.0%	65.0%	65.0%	64.5%	64.5%	64.0%	64.0%	64.0%
<b>Gross Profit</b>	<b>191</b>	<b>207</b>	<b>231.0</b>	<b>287</b>	<b>353</b>	<b>365</b>	<b>340</b>	<b>376</b>	<b>413</b>	<b>450</b>	<b>473</b>	<b>503</b>	<b>524</b>	<b>552</b>	<b>569</b>	<b>586</b>
Gross Profit Margin	36.0%	36.1%	35.6%	37.0%	37.1%	34.6%	32.0%	33.0%	34.0%	35.0%	35.0%	35.5%	35.5%	36.0%	36.0%	36.0%
SG&A	(100)	(106)	(128)	(158)	(192)	(204)	(205)	(220)	(234)	(248)	(261)	(274)	(285)	(296)	(305)	(314)
% of Revenue	18.9%	18.5%	19.7%	20.4%	20.2%	19.3%	19.3%	19.3%	19.3%	19.3%	19.3%	19.3%	19.3%	19.3%	19.3%	19.3%
<b>Operating Income (EBIT)</b>	<b>91</b>	<b>101</b>	<b>103</b>	<b>129</b>	<b>161</b>	<b>161</b>	<b>135</b>	<b>156</b>	<b>178</b>	<b>202</b>	<b>212</b>	<b>229</b>	<b>239</b>	<b>256</b>	<b>264</b>	<b>271</b>
EBIT Margin	17.2%	17.6%	15.9%	16.6%	16.9%	15.2%	12.7%	13.7%	14.7%	15.7%	15.7%	16.2%	16.2%	16.7%	16.7%	16.7%
Income Tax	(\$6)	(\$9)	(\$11)	(\$26)	(\$38)	(\$36)	(\$30)	(\$35)	(\$40)	(\$45)	(\$47)	(\$51)	(\$53)	(\$57)	(\$59)	(\$61)
Tax Rate	7%	9%	11%	20%	24%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%
<b>NOPAT</b>	<b>85</b>	<b>92</b>	<b>92</b>	<b>103</b>	<b>123</b>	<b>125</b>	<b>105</b>	<b>121</b>	<b>138</b>	<b>157</b>	<b>164</b>	<b>178</b>	<b>185</b>	<b>199</b>	<b>205</b>	<b>211</b>
Plus D&A	35	34	32	34	38	51	53	54	55	58	61	64	66	69	71	73
% of Revenue	6.6%	5.9%	4.9%	4.4%	4.0%	4.8%	5.0%	4.7%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Less: CapEx	(\$5)	(\$10)	(\$13)	(\$19)	(\$35)	(\$50)	(\$56)	(\$57)	(\$58)	(\$61)	(\$64)	(\$67)	(\$70)	(\$73)	(\$75)	(\$77)
% of Revenue	1%	1.7%	2.0%	2.4%	3.7%	4.7%	5.3%	5.0%	4.8%	4.8%	4.8%	4.8%	4.8%	4.8%	4.8%	4.8%
Add / (Less): Change in NWC	(4)	(7)	26	(29)	(30)	(22)	15	(6)	(6)	(6)	(4)	(5)	(4)	(5)	(3)	(3)
<b>Unlevered Free Cash Flow</b>	<b>111</b>	<b>109</b>	<b>137</b>	<b>89</b>	<b>96</b>	<b>104</b>	<b>117</b>	<b>112</b>	<b>129</b>	<b>147</b>	<b>157</b>	<b>169</b>	<b>178</b>	<b>190</b>	<b>198</b>	<b>204</b>
<b>PV of Unlevered Free Cash Flow</b>							<b>117</b>	<b>103</b>	<b>111</b>	<b>117</b>	<b>115</b>	<b>115</b>	<b>112</b>	<b>111</b>	<b>107</b>	<b>102</b>

Perpetuity Growth Method	
Cumulative PV of FCF	1,023
Discount Rate	8%
Final Year UFCF	204
Perpetuity Growth Rate	2.0%
Terminal Value	3,460
PV of Terminal Value	1,731
<b>Total Enterprise Value</b>	<b>2,754</b>
Cash & Securities	35
Debt	735
<b>Total Equity Value</b>	<b>2,055</b>
Diluted Shares Outstanding	71.2
<b>Implied Share Price</b>	<b>28.86</b>
Current Share Price	25.19
<b>Implied Margin of Safety</b>	<b>14.6%</b>

Exit Multiple Method	
Cumulative PV of FCF	1,046
Discount Rate	8%
Final Year EBITDA	354
Exit EBITDA Multiple	10x
Terminal Value	3,539
PV of Terminal Value	1,770
<b>Total Enterprise Value</b>	<b>2,816</b>
Cash & Securities	35
Debt	735
<b>Total Equity Value</b>	<b>2,117</b>
Diluted Shares Outstanding	71.2
<b>Implied Share Price</b>	<b>29.73</b>
Current Share Price	25.19
<b>Implied Margin of Safety</b>	<b>18.0%</b>