

May 17, 2019

**Dear clients and colleagues,**

At Global Alpha, our preference is to invest in large and growing markets. As part of the investment process, it is important to understand the drivers behind growth, as they often vary by theme – such as demographics, innovation, and environment.

For example, we have invested in the animal health industry because of the massive rise in pet ownership among baby boomers and millennials (two incredibly powerful demographics in terms of purchasing power).

### **How big is the animal health market?**

Animal health is a \$150+ billion market, and includes a wide range of players, such as veterinarians, producers, ranchers, groomers, and pet owners. Also important to this industry is its diversity by species and region, making it more resilient than expected during economic crises.

### **What about the companion animal (pets) market?**

The companion animal industry is divided into therapeutics (medicines and vaccines), diagnostics, pet food and supplies. More and more people regard their pets as family members, driving demand beyond vaccination to specialty products, like treatment for allergies, dermatology, and organic, fresh food.

### **What is driving this growth?**

The biggest driver of the animal industry has been the ‘humanization’ of pets, and their move from the yard to the home. People who own pets take their responsibilities as pet parents very seriously. According to the American Animal Hospital Association (AAPA), Americans spent \$72.5 billion in 2018 on their pets. Back in 1996 that number was just \$21 billion. Not surprisingly pet food accounts for approximately 42% of the total.

There are also proven health benefits to owning a pet, which has spurred growth in the sector. According to American Heart Association, 74% of pet owners reported mental health improvements from pet ownership.

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### **How diverse is the consumer base?**

During the past decade, the majority of pet owners in the United States (US) were middle aged. As the baby boomer generation ages, they are taking more interest in pets for companionship and health benefits. According to a 2017 report by Packaged Facts, the number of pet owners in the 70-plus age group rose to about 40 percent.

However in recent years, pet ownership in the US has begun to trend younger. In the US, 41% of pet owning adults are under the age of 40. Over the past decade Gen Z (18 to 24 year olds) and Millennials (25 to 39 year olds) accounted for more than half of the growth in pet owner population.

It should come as no surprise that Gen Z and Millennial pet owners are influencing the pet industry in very different ways than their parents and grandparents.

### **How is the market different globally?**

From a global perspective, the US has the highest population of dogs and cats, followed by Brazil, China, and Russia. However, when it comes to actual dollars spent, the US is the clear leader.

### **We are also anticipating growth in emerging markets, where we expect to see similar pet ownership trends in the coming decades.**

At the moment, Brazil is the second largest pet food market worldwide. In Brazil, small dog breeds are growing in popularity, and the dog food category has seen smaller pack sizes increase in popularity as well.

China is the third largest pet food market. According to GfK, pet food sales in China were at \$2.2 billion in 2018, representing a 21% growth from 2017. E-commerce is the preferred option for Chinese consumers, with 51.8% of the sales coming from online purchases.

In India, the opening of a luxury dog hotel called Criteratti, reflects another growing niche in the pet industry. This does not come as a surprise when considering premium dog food sales in India have been growing very strong since 2016. According to Euromonitor, India's pet food market is expected to grow annually by 9.1% (CAGR 2019–23) from the current amount of US\$388 million.

According to the latest numbers from Statista, Mexico will continue to see pet food market growth in 2019. The market is expected to grow annually at 6.2% (CAGR 2019-2023).

Looking at innovative diagnostics, the Global Market is worth about \$4.2 billion with strong secular growth trends. While the US currently represents the largest chunk at 62% of the market, this may change in the near future.

There are over 2.5 times the number of veterinary practices internationally, compared to the US. If the same standard of care was applied, the international market could be 4 times the size of the US market over the next few decades. There are approximately 170 million cats and dogs in the US, giving it a total addressable market of \$2.6 billion vs 400 million cats and dogs internationally, which can grow the market from its current total addressable market of \$1.6 billion to \$6.1 billion.

### **How have our holdings performed in this industry?**

Since inception in 2008, we have continuously maintained exposure to the animal health industry. Below are a few highlights.

#### **VCA Antech:** Profiled in our February 28, 2012 weekly

- Founded in 1986, it is a leading animal healthcare services company
- VCA Antech provides lab testing for over 17,000 animal hospitals with over 30,000 veterinarians
- Provided exposure to animal hospitals, and pet diagnostics
- Exited in Q2, 2016 as the market cap crossed the upper limit of the benchmark – It was finally acquired by Mars in September 2017

#### **Heska:** Highlighted in our September 23, 2016 weekly

- HSKA is a veterinary diagnostic company
- It has 162 US patents and 139 foreign issued patents
- Provided exposure to veterinary diagnostics
- Exited in Q1, 2017 as it had reached our fair value

#### **Greencross:** Highlighted in our June 3, 2016 weekly

- Australian pet health company, founded in 1994
- Number one pet care specialist in Australia, providing both retail and veterinary services

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- Provided exposure to the animal clinics and pet retail stores
- Exited in Q1, 2019 as it was acquired by private equity group TPG Capital

### **What is our current exposure?**

We are currently invested in an UK pet health company called CVS Group. Founded in 1999, the company went public in October of 2007.

CVS Group plc (CVS LN - £6.64)  
[www.cvsukltd.co.uk](http://www.cvsukltd.co.uk)

### ***Business overview***

Headquartered in Norfolk, CVS is one of the leading veterinary services provide in the UK with about 12% market share. They have 491 surgeries, four laboratories, seven pet crematoriums and an online dispensary. Approximately 90% of sales is from veterinary practices, which they own and operate.

### ***Target market***

The total addressable market in the UK for veterinary products and services is £1.1 billion. The market is fragmented with 4,470 vet practises and over thirteen thousand vet surgeons. The category in which CVS operates accounts for 54% of the total (2,399 surgeries), with the top six operators having approximately 17% of the UK small animal surgeries.

### ***Competitive advantages***

Largest and most comprehensive provider of vet services in the UK, meeting all customers' needs

Scale – has developed shared facilities and opportunities to cross sell its products, like lab testing, generic medicines, loyalty schemes, specialist surgeries and pet cremation

### ***Growth strategy***

- ✓ Consolidate large-animal vet practices (delivering equine & livestock care), which is more fragmented
- ✓ Their laboratory diagnostic business could enter the farm animal diagnostics market
- ✓ International expansion – CVS has entered Republic of Ireland and the Netherlands

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### *Management*

Simon Innes became CEO in January 2004. Previously he ran Vision Express, where he built the business up to £220 million turnover and 205 practices, and reversed a loss-making position to create one of the most profitable corporate optical operators in the UK. The growth strategy that was successful at Vision Express is now being implemented in the veterinary industry by CVS.

### *Risks*

- ✓ Economy (business model has a high fixed cost)
- ✓ Acquisition multiples may increase as consolidation continues
- ✓ Competitors could start a price war to gain/maintain market share

### **What's next?**

We have our eyes on a few interesting companies operating in the animal health space, ranging from pet insurance and fresh pet food, to a diagnostics company. Our ability to be highly selective and nimble in our portfolio holdings leaves us well-positioned to add some exposure to the animal health industry at attractive valuations.

Have a great weekend.

The Global Alpha Team

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