

November 13, 2009

Dear clients and colleagues,

We recently initiated a position in PetMed Express, the online retailer and pharmacist for pets (dogs, cats, horses, and other domestic pets). Here is a snapshot of the company:

PetMed Express (\$16.00)

Founded in 1996 by an anesthesiologist, PetMed operates under the name 1-800PetMeds. It was the first online player to enter this segment. The company sells both prescription and non-prescription medications, as well as other supplies. With Pet Health 101, PetMed offers a broad range of useful information regarding pet health. Since 2005, the company has grown its customer base by 12% annually. At this time, there are 2.5 million active customers.

Target Market Size

The size of the overall U.S. domestic pet industry is impressive. In 2008, pet retail spending reached \$43.4B, exceeding the GDP of 111 countries out of 186. We estimate the supplies & medications category, PetMed's sweet spot, account for \$5B (the American Pet Products Association estimates this segment at \$10.2B).

Investment Theme

The pet industry is far from being cyclical. Indeed, the industry is expecting 5.1% growth this year. All surveys and statistics released on the subject are unanimous: the pet industry is growing fast and pet owners are not willing to cut back on their spending. These conclusions prevail worldwide. Here are some interesting figures:

- 63% of household own a pet, and the pet population is growing at a slightly higher rate than that of households
- 84% of American pet owners regard their animal as a member of the family
- Pet owners spend an average \$1000-\$1600 on their animal
- 33% of pet owners visit the vet at least 3x annually, up from 30% three years ago

Competitive advantages

PetMed is price competitive. On average, their products sell at 15% discount from those of veterinarians and other online retailers. With their match and lower price policy, it has positioned itself as the cheapest alternative to buy supplies and medicine. The company offers a fast delivery service, with 75% of orders shipped within 24 hrs. Finally, if you watched the World Series 2009, you may have seen their TV commercials. PetMed is the only online pet retailer that relies on TV advertisement.

Growth strategy

Although online pet retailer' market share is 11%, it grows much faster than both conventional retailers and veterinarians. While veterinarians' market share lost 5% over the past 3 years, online pet retailers gained 4%. There is a huge opportunity considering veterinarians still control 72% of the market, and that 25% of their revenues are generated from medicinal products. We also think that PetMed could be an excellent takeover candidate for a larger online retailer or an international pet product manufacturer looking to expand its distribution channel in North America.

Risk

We believe the main risk associated with this stock is a lower dollar spending on TV advertising that would translate into a reduced growth profile. Other risks include competition from other online retailers.

Valuation

Based on a WACC of 8.0% and a terminal growth of 3%, our target price is \$31 for an expected return of 94%.

PetMed Express: www.1800petmeds.com

Market cap: \$365 million, P/E (TTM): 15.1x, P/E (forward): 13.6x, EV/EBITDA (forward): 6.9x, Cash: 15% of market cap, Expected sales growth: 10%-15%, Dividend yield: 2.5%.

Regards,

The Global Alpha team