Pet Sector M&A Insights and the Implications of COVID-19

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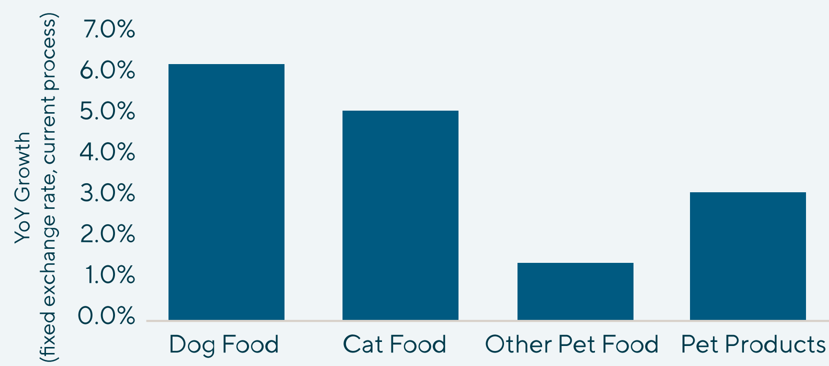
In times of market volatility and economic downturns, investors gravitate to certain recession-resistant sectors. Generally, the pet care category grew through the Great Recession when compared to the broader economy, making the industry highly appealing to strategic and financial investors.

2008 - 2009 Global Pet Care Growth by Category



(Euromonitor International)

Lincoln believes pet sector M&A will continue during these uncertain times. Pet food and products are a global industry. A rising middle class and increasing pet ownership are driving strong industry growth in international markets and emerging economies. Some countries and economies (e.g., China) have begun to emerge from the global pandemic and have (arguably) a clearer economic outlook. Countries that are further ahead on addressing the pandemic and therefore, their recovery, offer export opportunities for U.S. brands that can navigate the complexities of regulation and distribution in these attractive emerging markets. For some brands, this opportunity is exponential.

In the U.S., although it is still too early to know the long-term impact of the pandemic on the economy, during the early days of COVID-19 the pet food sector was positively impacted by its classification as an essential business. During March and April 2020, pet food sales spiked as supply chains (especially those focused on North America) remained robust and consumers stockpiled food for their pets. Below we consider the impact of COVID-19 on the pet industry in terms of channel mix and supply chains and provide insights as to how this might impact buyers pursuing pet assets going forward.

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CHANNEL SHIFT

Ecommerce is the fastest growing channel in the pet sector and represents the second largest consumer packaged goods market in the U.S. in terms of ecommerce sales. While Amazon was the original driving force behind this channel shift, Chewy, a one-stop-shop for all pet food and products with an intense focus on customer service, continues to capture market share. According to Chewy in 2019, ecommerce was expected to increase its share of the pet food and supplies market from 14% in 2017 to 25% by 2022. COVID-19 is expected to drive a short-term step change in online penetration fueled in part by the following:

67% of households in the U.S. owning one or more pets in 2019 ***(Statista)***

+

Adoption rates spiking significantly as a result of stay at home orders related to COVID-19

+

The lockdown environment forcing consumers to embrace social distancing and focus solely on ecommerce

A key driver in the historic online growth has been free delivery. As consumers have accelerated the shift from brick and mortar to ecommerce, alternatives such as "click and collect" provide those retailers without a full online-delivery ecosystem the ability to take advantage of the macro-trend and operate their traditional brick-and-mortar stores as fulfilment centers.

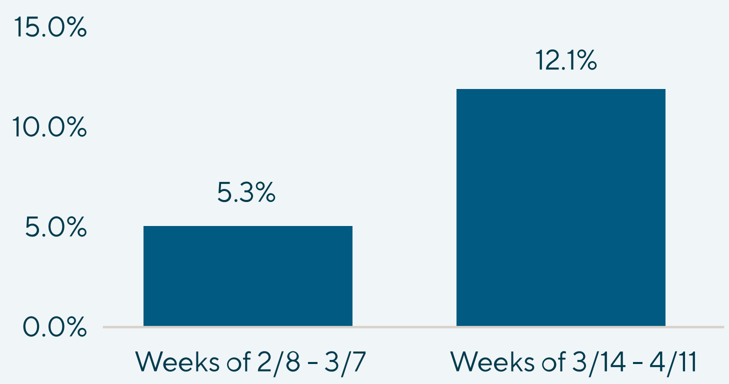
The question going forward is, how much of this step change will remain once the U.S. arrives at a new "normal" post COVID-19, which will largely be driven by customer experience. Given the uncertainty around the recovery timeline in addition to Amazon and Chewy's customer service-oriented approach and track record for driving customer loyalty, we anticipate the majority of the step change will remain, with ecommerce well placed to continue to take share from other channels.

SUPPLY CHAINS

A key focus for pet-related companies has been on their supply chains, amid a backdrop of ensuring personnel safety. With consumers stockpiling pet products, manufacturers are pressured to fulfil a significant uptick in demand during a time of increased uncertainty in international trade. For example, Vietnam halted rice exports in March while Russia suspended exports of processed grains. In addition, international trade faces significant slowdowns driven by labor limitations as certain countries implement border procedures that materially reduce the pace of import / export inspections.

The challenges manufacturers face were recently apparent in Western Europe. As cross-border trade experienced increased disruption, and online demand for pet food surged, online out-of-stocks spiked from an average of 5.3% in the week of February 8 through the week of March 7 to an average of 12.1% in the week of March 14 through the week of April 11 (and as high as 22%+ in the U.K. during the same period). This demand / supply imbalance resulted in a significant spike in prices for consumers, as well as a reduction in marketing spend and promotional activity by pet food brands.

Western Europe Dog Food Online Out-of-Stocks



Euromonitor; countries include Belgium, France, Germany, Italy and the U.K.

Those companies that have robust supply chains (e.g., low-to-no sole-sourcing, proven and reliable partners, etc.) that have been strategically developed and tested over a sustained period of time remain well-placed to fulfill demand, grow sales, fuel customer loyalty and ultimately take market share.

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Impact to M&A

Given the performance of the pet industry during the Great Recession, we expect a quick bounce back to pre-COVID-19 levels of M&A activity. Companies and brands with the following characteristics will remain attractive targets and likely generate interest from strategic and financial buyers:

Strong online growth and well positioned for continued expansion in this channel.

Proven ability to penetrate key international markets, in particular China.

Track record of successfully fulfilling rapid spikes in demand without experiencing supply chain disruption during COVID-19.

As a key diligence item, investors will seek to understand the sustainability of the increase in demand. Is it just pantry piling or has the target company / brand been able to win and retain new customers (e.g., via new pet ownership as a result of the increase in adoption rates or customer switching driven by a competitor's supply chain challenges)? To maximize investor interest and valuation, it will be important for brands to support the increase in demand during COVID-19 with continued strong performance for the remainder of 2020, demonstrating sustainability and strong customer loyalty from new patrons.

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