

TULLY & HOLLAND

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U.S. Pet Food Industry Update

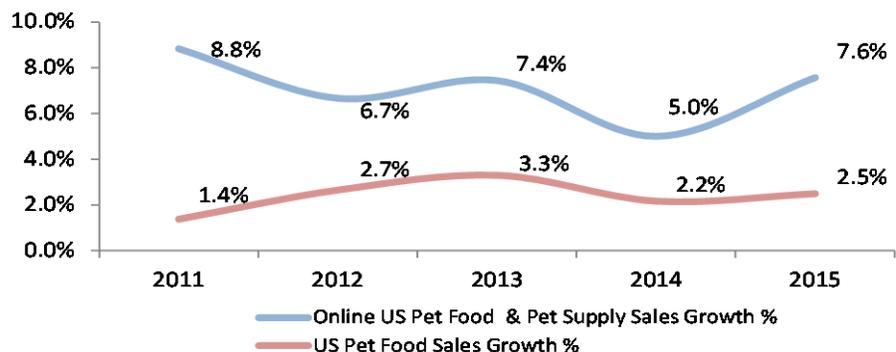
Steady growth ahead even as market matures

EXECUTIVE SUMMARY

The US pet food industry has experienced a CAGR of 2.9% as compared to 2.6% growth posted by the overall packaged food sector since 2010 backed by a long term trend of humanization of pets leading to “premiumization” of many sub-categories in the pet food world. At the same time as the premium sectors have evolved, we have seen private label emerge as a meaningful sub category. As a result, like many other food categories, there has been a bifurcation of the pet food segment into quality and value. Further, room for consolidation and continued organic growth has led both private equity and strategic buyers to show strong interest in the category over the last couple of quarters. We expect the industry to see robust M&A activity over the next 12-24 months at healthy valuations.

KEY TRENDS

- **Offline to Online shift underway:** The US online pet food and supplies segment is valued at around \$3.3 billion in sales, with pet food accounting for nearly one-third. As with most consumer subspaces, pet food consumers have become increasingly comfortable shopping online. As a result, the sales of online pet food and supplies have seen a growth rate that is consistently higher, by 300 – 400 basis points, than that of overall pet food sales. Not surprisingly, having seen its business come under competitive pressure, PetSmart has been spending considerable resources on beefing up its online presence to compete with the likes of Amazon. Further, we have also seen venture capital get active in the online pet space over the last couple of years with investments in ventures such as FetchDog, Rover.com and Bark & Co.



Source: Mintel and Ibisworld

CONTENTS

Executive Summary

Key Trends

M&A Transactions

Valuation Analysis

T&H Conclusions

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- **Consolidation among pet food distributors:** The Pet Food industry has seen heightened M&A activity over the last couple of years from both strategic and private equity buyers. The Pet Food distributors space, in particular, has been at the center of a major roll up strategy by two private equity backed pet food distributors, Animal Supply Company and Phillips Pet Food & Supplies. While this has caused some concern, especially amongst the small retailers and food manufacturers in the industry, we believe that niche regional distributors will continue to pop up as they are an essential enabler of innovation and new product introduction by entrepreneurs and small-to-medium sized pet food businesses.

List of M&A transactions by Animal Supply Company and Phillips Pet Food & Supplies:

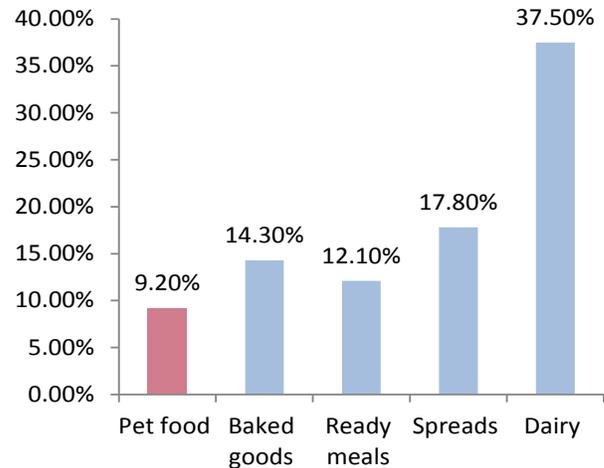
Date	Target	Buyer
15-Dec-14	Kernco Corporation	Animal Supply Company
8-Dec-14	Green Leaf Distributors, Inc.	Animal Supply Company
13-Feb-14	Wolverton	Phillips Pet Food & Supplies
2-Jan-14	Best Friend Products Corp.	Phillips Pet Food & Supplies
4-Oct-13	Elf Corporation	Animal Supply Company
19-Sep-13	RFG Distributing, Inc.	Animal Supply Company
15-Jul-13	Pet Food Wholesale, Inc.	Animal Supply Company
5-Mar-13	PFX pet supply	Phillips Pet Food & Supplies
5-Mar-13	Pet food Limited	Phillips Pet Food & Supplies
5-Mar-13	Pet Food Limited Colorado	Phillips Pet Food & Supplies
5-Mar-13	Royal Pet	Phillips Pet Food & Supplies
17-Dec-12	Zeus and Company, California Ops.	Animal Supply Company
7-Nov-12	Lone Star Pet Supply, Inc.	Animal Supply Company
22-Feb-12	Mike's feed farm wholesale	Phillips Pet Food & Supplies
7-Oct-10	Super-dog pet food	Phillips Pet Food & Supplies

Source: Capital IQ, Tully & Holland analysis

- **Heightened focus on quality:** Pet owners are increasingly concerned about the quality content of the food consumed by their pets as they are about the food consumed by themselves and their family. This growing trend has not only been fueled by humanization of the pet food category but also by events such as the Chinese melamine controversy in 2007. Pet food buyers are scrutinizing product labeling to look for terms such as 'locally grown', 'ethical supply chain' and 'natural'. According to the recent Wellness Natural Pet Food survey, 82% of pet owners look for superior features such as natural ingredients (59%), digestive benefits (42%) and no artificial colors, flavors or preservatives (40%). In fact, eight in 10 owners of dogs or cats in the US believe that their pets sometimes have healthier food than they do (Source: The 2014 Wellness Pet Parent Survey). Not surprisingly, sales of natural and organic pet food in the US have consistently grown in the low double digits as compared to low single digit increases seen in the overall pet food segment. In fact, the premium pet food segment today is larger than mid-tier and economy priced segments combined. We expect this trend to continue for the foreseeable future as pet food companies continue to introduce innovative products such as raw and higher vitamin/calcium content food in the marketplace.

➤ **Private Label – A growing opportunity:** Despite private label pet food remaining less developed relative to other private label food categories, we expect it to continue to gain popularity in the near future as consumers continue to seek ways to save money. Private label sales in many other major packaged food categories account for mid-teens or more of total market sales, suggesting that there is still plenty of room for expansion in the US market. Private label products are generally priced 20% to 30% lower than their branded equivalents and these savings can be significant especially for larger dog owners. Not only does Private Label provide higher gross margins to retailers but it also helps them create retailer differentiation. As an example, Whole Foods introduced “Whole Paws”, a line of premium pet food with no artificial flavor or animal by-products in 2013.

Private Label Penetration

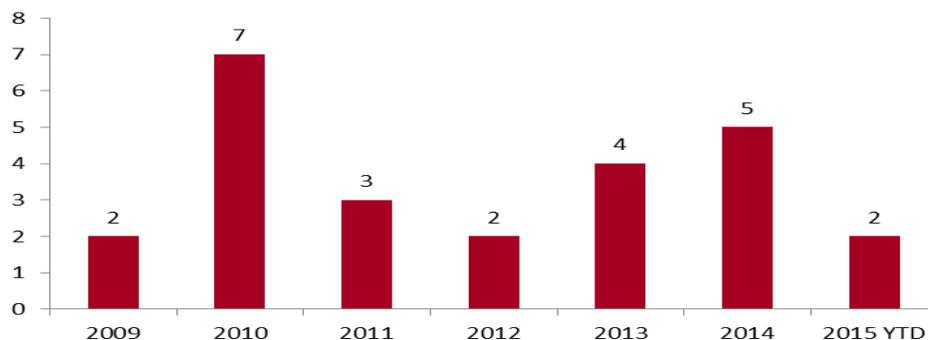


Source: Euromonitor

M&A TRANSACTIONS

The pet food industry has recorded robust M&A activity over the last couple of years fuelled by private equity interest, mainstream food companies looking to participate in this food sector and companies within the space looking to consolidate. Noteworthy was the recently announced buyout of Big Heart Pet Food brand for \$5.8 billion by The J.M. Smucker Company in an effort to gain exposure to the fast-growing pet food sector. Earlier, in 2014, Mars acquired IAMS, NATURA and EUKANUBA brands from P&G for \$2.9 billion in a bid to expand its existing pet products portfolio.

Number of M&A Transactions in US Pet Food Industry



Source: Capital IQ, Tully & Holland analysis

The chart below summarizes select pet food M&A transactions over the last three years.

Date	Target	Transaction Value (\$ mm)	Buyers	EV/Revenues	EV/EBITDA
02/03/2015	Big Heart Pet Brands	5,781.8	The J. M. Smucker Company	2.53x	19.32x
01/20/2015	Salix LLC	-	United Pet Group, Inc.	-	-
01/19/2015	Manna Pro Products, LLC	-	Broad Sky Partners	-	-
07/18/2014	Nature's Variety, Inc.	-	Agrolimen SA	-	-
06/03/2014	C.J. Foods, Inc.	-	J.H. Whitney & Co., LLC	-	-
04/09/2014	P&G, Pet Food Brands	2,900.0	Mars Petcare US, Inc.	-	-
03/26/2014	The Scotts Miracle-Gro Company, U.S. Wild Bird Food Business	5.1	Global Harvest Foods, Ltd.	-	-
02/10/2014	Pet Carousel Inc.	-	Cargill, Incorporated	-	-
01/15/2014	Performance Pet Nutrition, LLC	-	Nestlé Purina PetCare Company	-	-
11/06/2013	PetAg, Inc.	-	PBI-Gordon Corporation	-	-
05/22/2013	Natural Balance Pet Foods, Inc.	341.4	Big Heart Pet Brands	-	-
01/11/2013	Phelps Industries, LLC	-	Wafra Partners LLC	-	-
11/28/2012	Stockade Brands, Inc.	5.73	Ridley USA Inc.	-	-
04/16/2012	Pet Appeal, Inc.	-	Merrick Pet Care, Inc.	-	-
02/15/2012	Emporia Pet Food Products, Pet Food Plant in Emporia	-	Cargill, Incorporated	-	-

Source: Capital IQ

VALUATION ANALYSIS

Over the past few years we have seen a growing number of precedent transactions within the pet food industry. The majority of valuation metrics have not been publicized, as most of these deals have been private. The latest indicator of valuation trends in this space is the recently announced acquisition of Big Heart Pet Brands by JM Smucker at slightly under 20 times LTM EBITDA and 13 times 2015 EBITDA. Interestingly, in its earlier form as Del Monte Foods, Big Heart Pet Brands got bought out by KKR for just under 9 times EBITDA.

On the public market side, there are very few comparables that purely operate in the pet food arena. One such company is Freshpet, Inc., a pet food company focused on healthy alternatives, trading at slightly under 8 times revenue on a trailing twelve months basis.

T&H CONCLUSIONS

With stable disposable income backed by an improving jobs market, humanization of pets and product innovation is likely to lead to a sustained period of above average growth in the pet food industry. Roughly 82.5 million households or 68% of total households own a pet in the US. Not only do we expect this number to inch up over the next five years but we also expect spending per pet to grow over the same period. The secular nature of growth will provide expansion opportunities for firms via both organic growth as well as through mergers and acquisitions.

ABOUT TULLY & HOLLAND

INVESTMENT BANKING SOLUTIONS FOR CONSUMER PRODUCT COMPANIES

Founded in 1992, Tully & Holland, Inc. is a leading US investment bank that provides merger & acquisition advisory services and private placements to consumer companies with special emphasis on food companies, multi-channel marketers, consumer product manufacturers/distributors, and retailers. Tully & Holland's Managing Directors have a combination of deep industry knowledge and sophisticated financial experience enabling them to craft innovative solutions for each client's needs.

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