

Pet Trends Impacting M&A in 2022

The pet industry has evolved significantly over the past few years with several trends impacting the way pet product brands, manufacturers, retailers, customers and investors view the sector. In 2020, stay at home regulations driven by COVID-19 led to a step function increase in pet adoptions fueling significant growth opportunities for pet companies who had supply chain capacity to capitalize on this unexpected momentum.

As 2021 approached and pet adoptions continued to accelerate, consumers drove increased demand for pet products and services while pet businesses grappled with supply chain challenges and the complex problem of maintaining inventory to avoid out-of-stocks. As a result of the growth in the category, investors started deploying additional capital throughout the industry to acquire brands that were market leaders and / or were experiencing significant growth (including transactions Lincoln worked on with Pethonesty, Solid Gold and Manna Pro).

This year kicked off right where 2021 left off, but as inflation escalated and consumers were forced to focus their spending on essentials (e.g., gas, groceries), the pet mergers and acquisitions (M&A) market has continued to evolve as investors became wary of companies that could not demonstrate the ability to drive continued growth while maintaining margins and profitability. As we look forward, some key trends that investors are keeping front of mind as they assess opportunities are:



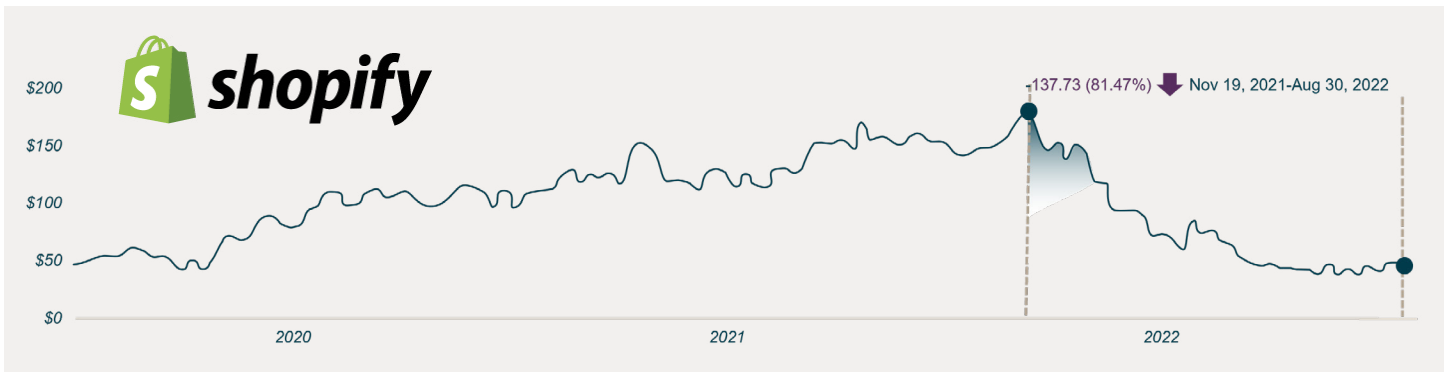
Revenue Growth vs. Profitability

In 2020 and 2021, emerging and fast-growing pet brands (particularly those selling primarily online) were commanding attractive revenue multiples with investors focused on revenue growth with the potential for future profitability, rather than significant profitability at the time of the transaction. As such, investors focused on run-rate performance and were more open to giving credit for pro-forma adjustments which showcased the potential for future profitability as the target continued to scale. As recessionary indicators began to ring in 2022, investors quickly pivoted and heightened their focus on profitability and became less likely to focus on a revenue multiple when assessing valuation.

Direct-to-consumer (DTC) Evolution

As consumers shifted their purchasing habits online in 2020 and 2021, pet companies took advantage of the attractive digital marketing environment to achieve low customer acquisition costs (CAC) and to quickly scale their brands. With the introduction of iOS 14.5 and the increasing cost of advertising across various marketing channels, a number of DTC-focused brands were faced with rising and more volatile customer acquisition costs which drove down DTC channel profitability, combined with a lack of visibility into their digital marketing return on advertising spend (ROAS). A perfect example to the struggle of DTC platforms is Shopify's stock chart from 2020 to today. As CAC continued to trend in the wrong direction, the brands that had built strong Amazon, Chewy and brick and mortar distribution capabilities shifted additional focus to those channels. A number of digitally native brands had to push breakeven profitability timelines back and employ a more stringent focus on cash. As we progress through 2022, the brands that truly resonate with consumers and have diversified, sophisticated marketing strategies will succeed and garner the attention of investors while brands that were able to take advantage of the cheap customer acquisition costs of 2020 and 2021 but that did not necessarily diversify digital marketing strategies or distribution channels will be more out of favor with investors.

(continued on next page)



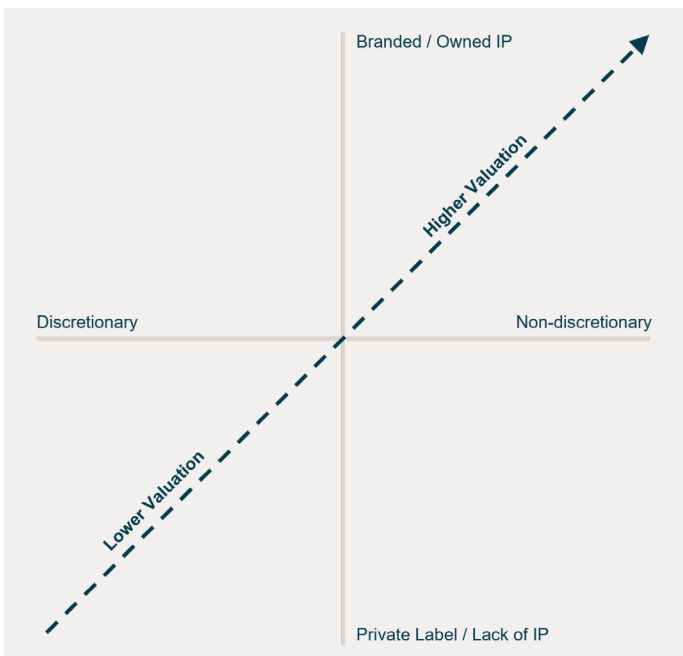
Channel Conflict Insights

For a number of years, pet specialty and independent pet retailers were sensitive to brands distributing products through other retailers and / or channels. With the emergence of Amazon and Chewy as key channels and players in the pet space and the macro consumer shift online, channel conflict has often become less of an issue. Pet specialty (e.g., Petco and PetSmart) and independent pet retailers (e.g., Pet Supplies Plus) are typically less concerned with brands distributing outside of their networks with one major caveat: food, drug and mass. This is termed The Blue Buffalo Effect (where in Blue Buffalo was acquired by General Mills and quickly expanded away from pet specialty into food, drug and mass). Today, brands need to still be cognizant of not creating channel conflicts with their pet specialty and independent pet customers by distributing the same brand to food, drug and mass customers. Brands often navigate this dynamic by creating separate brands and product sizes while being transparent with its current retailer base to ensure surprise consequences are limited.

The Pet Company Valuation Spectrum

Investors in 2022 are keenly focused on two valuation drivers: brand value with retailers / consumers and repeat purchase rates which provide revenue visibility. Pet companies that have a strong brand that resonates in the market will continue to command premium valuation multiples over those focused on creating private label offerings for retailers (appreciating that this does not apply to pet co-manufacturers). As a general rule of thumb, every 10% of sales that relate to private label, valuation can shift one turn of EBITDA down.

Additionally, investors will place additional value on companies focused on non-discretionary products that result in a stickier consumer base.



Lincoln Insights

We have broad experience across the pet sector, selling companies for premium and outlier valuations based on both revenue and EBITDA multiples. The depth of our experience over a number of years and different M&A environments provides us with unique insights on how to best position pet companies to maximize value and terms for sellers. As the pet M&A environment continues to evolve, we are excited to share our perspectives and experience with companies as they assess their strategic alternatives and the best time to explore a transaction.

[Sign up to receive email updates](#) to stay on the pulse of what is happening in the pet sector.

For other perspectives, visit us at www.lincolnternational.com/perspectives.