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PetCo hasn't learned new tricks under TPG and Leonard Green

Despite years of private equity ownership, PetCo lags its competition

Key points:

- PetCo, a retailer of pet supplies and services controlled by private equity firms TPG Capital and Leonard Green & Partners, recently filed for IPO.
- TPG and Leonard Green's nine year hold period for PetCo far exceeds the private equity industry average.
- PetCo's EBITDA growth has slowed significantly since 2012.
- During the nine years of TPG and Leonard Green's ownership (2006-2015), PetCo has trailed its main rival, PetSmart, by several metrics.
- Since 2005, PetSmart has seen its operating and EBITDA margins expand. PetCo's operating and EBITDA margins shrunk over the same period.
- Despite continuing to trail its main peer, combined deal fees paid by PetCo during TPG and Leonard Green's two phases of ownership were at least $104 million.
- TPG and Leonard Green have loaded on additional debt to PetCo to extract dividends in a series of dividend recapitalizations. PetCo's leverage increased significantly over the period.

Introduction

PetCo, a retailer of pet supplies and services, has been under the control of private equity firms TPG Capital and Leonard Green & Partners for 12 of the past 15 years.

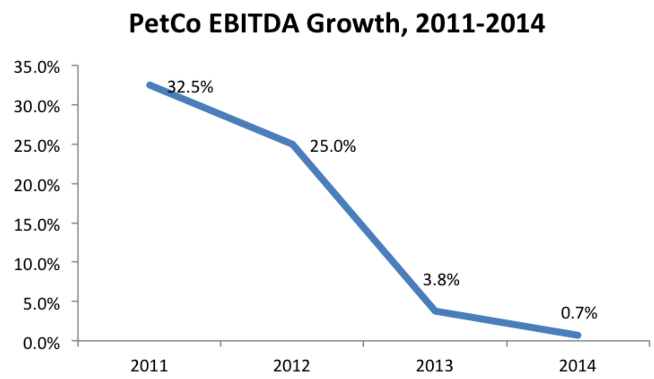
Since 2000, TPG and Leonard Green have taken the firm private twice and recently filed to take it public for a second time.

Photo: Mike Mozart (CC BY 2.0)

Over that period, TPG and Leonard Green have extracted $1.7 billion in fees and dividends from PetCo.

PetCo is aiming to go public this time with a valuation of around $4 billion. TPG and Leonard Green re-acquired PetCo nine years ago in 2006, when they took it private for $1.7 billion. [1]

Extended hold period



The hold period of nine years far exceeds the private equity industry average for portfolio companies, which in 2015 dropped to 5.5 years, according to Preqin.[2]

PetCo's holding period has exceeded more specific metrics as well. Preqin reported that consumer and retail companies had the longest hold period, with an average of 5.3 years. Large cap deals (over $1 billion) have gone from a short 3-year average in 2008 to a longer 7-year average in 2014.[3]

TPG and Leonard Green also opted to hold PetCo through the recent period of exits by their private equity peers. In 2014, Preqin recorded 1,686 exits with an aggregate value of $442 billion, both record figures.[4]

While PetCo's EBITDA has grown over the past five years, that growth has slowed significantly since 2012. Between 2011 and 2012 PetCo's EBITDA grew by 25%. It grew by just 3.8% and 0.7% in 2013 and 2014.

PetCo EBITDA[5]

Fiscal year	2010	2011	2012	2013	2014
EBITDA (in $thousands)	$237,591	$314,809	$393,564	$408,554	$411,401
Year-over-year change		32.5%	25.0%	3.8%	0.7%

PetCo's cash from operations has been volatile over the past few years, dipping by 34% in 2013.

PetCo cash from operations[6]

Fiscal Year	2010	2011	2012	2013	2014
Cash from operating activities	156,756	207,321	248,423	164,553	245,432
Year-over-year change		32.3%	19.8%	-33.8%	49.2%

Cash provided by operations decreased for fiscal 2013 primarily due to an "increase in cash used for inventory and the payment timing of accrued salaries and employee benefits and accrued expenses," according to the company.[7]

Just after PetCo's initial S-1 filing, the stock market began experiencing significant volatility, which may bode poorly for IPOs generally. Quoting a PwC analyst, CNBC reported, "Volatility is the enemy of IPOs."[8]

TPG and Leonard Green are pursuing a dual track exit strategy, while preparing for IPO they are simultaneously entertaining bids from other buyout shops, the *Wall Street Journal* reported.[9] In addition, PetCo is exploring the possibility of being acquired by PetSmart, according to *Reuters*.[10]

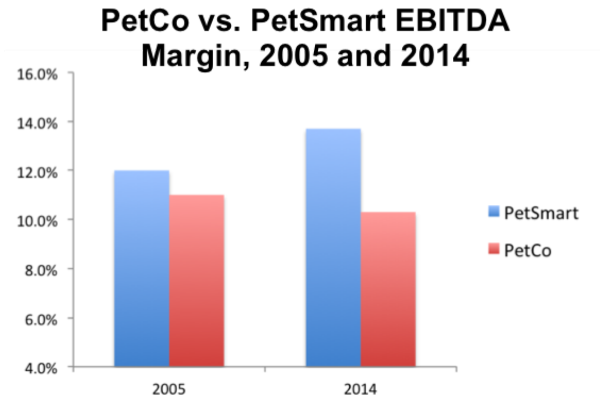
Questions:

- Has the market volatility put a dent in potential IPO pricing?
- Has that, in turn, put a dent in the valuation on the secondary market?

Competitive marketplace

PetCo reports it is the largest chain pet retail store, with 16% of the market share based on the number of locations. That compares to 14% for its largest competitor, PetSmart (63% of the market share is held by independent stores).[11]

Both chains have grown since 2005. They have both benefited from increasing household spending on pets, which persisted through the recession.[12] During most of the period from 2005 to present, PetCo was privately held while PetSmart was traded publicly. PetSmart was taken private in late 2014 in that year's largest LBO, an $8.2 billion deal.[13]



During the nine years of TPG and Leonard Green's ownership, PetCo has been nipping at PetSmart's heels, but has not pulled ahead by several metrics. Despite Leonard Green's expertise in retail, the sales and operations figures for PetCo show that the firm hasn't gained much ground on its rival during its years of private equity ownership. Indeed, PetCo has seen some key margins slip during the period.

The two companies have a similar number of stores, with PetSmart operating 1,387 stores and PetCo operating 1,409 stores. A comparison of the two companies in 2005 and 2014 shows that PetSmart has maintained a significant edge over PetCo in sales and profitability.

A comparison of PetCo's 2014 sales data to PetSmart's numbers from the last full reported (twelve months ending November 2014) show that despite a similar number of stores, PetSmart's total sales of $7 billion were about 40% greater than PetCo's total sales of $4 billion.

PetSmart also generated a higher operating margin (9.12%) than PetCo (7.02%).

	FY 2005			52 wks ended 11/2/14	FY ended 1/31/15
	PetSmart[14]	**PetCo**[15]		**PetSmart**[16]	**PetCo**[17]
Stores	826	779		1,387	1,383
Square feet (Mil)	19.0	11.3		29.2	18.4
Sales (Mil)	$3,760.00	$1,996.00		$7,003.00	$3,995.37
Net sales per square foot	$206.00	$175.09		$240.08	$217.00
Op Income (Mil)	$311.38	$141.50		$638.60	$280.50
Op Income as % of sales	8.28%	7.09%		9.12%	7.02%
Op Income per store	$0.38	$0.18		$0.46	$0.20
EBITDA (Mil)	$451.01	219.32		$959.67	$411.40
EBITDA margin	12.0%	11.0%		13.7%	10.3%

Over the period since 2005, PetSmart has seen both its operating and EBITDA margins expand. PetSmart's EBITDA margin grew from 12% in 2005 to 13.7% in the twelve months ended November 2, 2015. PetSmart's operating margin grew from 8.28% to 9.12% over the same period.[18]

At PetCo meanwhile, despite the expertise of its private equity owners, the firm saw its operating and EBITA margins shrink slightly. PetCo's EBITDA margin shrunk from 11% in 2005 to 10.3% in fiscal 2014. PetCo's operating margin shrunk from 7.09% in 2005 to 7.02% in fiscal 2014.[19]

In other words, PetCo has fallen behind PetSmart in terms of operating and EBITDA margins during the period that PetCo has been owned by TPG Capital and Leonard Green & Partners.

Sales and EBITDA per square foot

PetCo and PetSmart, while similar in many ways, have historically had a slightly different retail format, with PetSmart offering larger (20,000 SF+ on average) stores versus 13,000-14,000 square foot stores on average for PetCo.[20]

Photo: Virginia Hill (CC BY-ND 2.0)

Despite the larger stores, though, PetSmart has used its space more efficiently to generate sales and cash than PetCo has.

PetSmart's sales per square foot rose from $206 in 2005 to $240 in the twelve months ended November 2, 2015.[21]

While PetCo was able to increase sale per square foot from $175 to $217 over the period, the company lagged PetSmart over the period.[22]

As one would expect from its expanding EBITDA margin, PetSmart was able to grow its EBITDA per square foot from by 38% since 2005.[23] PetCo grew its EBITDA per square by just 15%, less than half its main competitor.[24]

Sales growth

PetCo also lags by a key retail measure, comparable sales growth year to year for stores open at least 12 months. A comparison of data for the period 2001-2005 and 2012-2014 show that for those eight years, PetCo's comparable sales grew more slowly than PetSmart's in all but two years.

Comparable Sales Growth			
	PetSmart FY 2005 (%)	PetCo FY 2005 (%)	PetCo compared to PetSmart (%)
2014	2.7	1.8	-0.9
2013	6.3	4.9	-1.4
2012	5.4	7.6	2.2
2005	4.2	2.7	-1.5
2004	6.3	6.2	-0.1
2003	7.0	5.6	-1.4
2002	9.6	8.0	-1.6
2001	6.5	8.6	2.1

Store closings

PetCo's lagging margins might be due in part to poor decisions on store locations. For example, in fiscal 2014 PetCo closed twenty-four stores, or 1.8% of the 1,314 stores it had at the beginning of the year. PetSmart, by comparison, closed just seven stores in the twelve months ended November 2, 2015, or 0.5% of the 1,278 stores it operated a year prior.[25]

Photo: Nicholas Eckhart (CC BY 2.0)

Questions:

- Why have PetCo's operating and EBITDA margins shrunk while PetSmart's have expanded since 2005?
- What value have TPG and Leonard Green added to PetCo, given that it has and continues to trail its main competitor by several metrics?

Rover[26] returns, draws fees

The first time PetCo was acquired by Leonard Green & TPG was in 2000 for around $600 million, $464 million in equity plus $125 million in debt.[27] TPG and Leonard Green reportedly invested about $200 million in the acquisition.[28]

Year	Fee	Amount
2000	Transaction Fee	$8 million
2001	Monitoring Fee	$3.1 million
2002	Accelerated monitoring fees (10 yrs)	$12.5 million
	Subtotal	**$23.6 million**
2006	Aggregate Structuring Fee	$25 million
2007	Monitoring Fee	$7 million
2008	Monitoring Fee	$7 million
2009	Monitoring Fee	$7 million
2010	Monitoring Fee	$7 million
2011	Monitoring Fee	$7 million
2012	Monitoring Fee	$6.9 million
2013	Monitoring Fee	$6.1 million
2014	Monitoring Fee	$6.1 million
2015	Accelerated monitoring fees	?
	Subtotal	**$79.1 million**

The sponsors paid a premium on the trading price to take PetCo private. However, the *Wall Street Journal* reported that, "That acquisition occurred as the company's share price was depressed despite strong earnings, at a time when sharp declines in dot-com and telecommunications stocks were taking the rest of the market down."[29]

The private equity firms collected an $8 million transaction fee for taking over PetCo in October 2000.[30]

TPG and Leonard Green were entitled to annual monitoring fees of $3.1 million in the management agreement, which was written with a 10-year duration, through 2010.

When PetCo held an IPO in February 2002, as per the management agreement, TPG & Leonard Green collected accelerated monitoring fees of $12.5 million.[31]

In other words, TPG and Leonard Green collected nearly $24 million in fees from PetCo over a period of about 17 months.

The IPO raised $275.5 million.[32] The prospectus reported that "All of the net proceeds from the sale of our common stock by this prospectus will go to the selling stockholders. We (PetCo) will not receive any part of the proceeds from the sale of these securities."[33]

The private equity sponsors retained control after the IPO, with their ownership share dropping to 55.8% from 80%.[34] After the IPO, TPG and Leonard Green each held 27.9%, but over the ensuing years, sold off their majority stake. By 2004, Leonard Green held 5.8% but retained two seats on the board of directors and TPG held less than 9% but held one director seat.[35]

In 2006, Leonard Green and TPG took PetCo private again in a $1.8 billion deal, paying a 49% premium to the stock price.[36]

TPG and Leonard Green collected a transaction fee of $25 million, called an "aggregate structuring fee."[37] This time, the management services agreement also included annual monitoring fees of $7 million. In 2012, TPG and Leonard Green sold a portion of their ownership stake to another investor, but retained majority control. However, their pro-rata ownership dropped resulting in a corresponding reduction in the monitoring fee.[38]

In the 2015 IPO filing, PetCo reports having paid $6.1 million in 2014, $6.1 million in 2013 and $6.9 million in 2012,[39] for a total of $19.1 million over that period.

Assuming PetCo paid the $7 million annual monitoring fee for the preceding 5 years, or $35 million, in total PetCo would have paid $79.1 million in monitoring and transaction fees to TPG and Leonard Green & Partners over the past nine years.

The management agreement had a designated term of 10 years, with a provision for accelerated monitoring fees upon exit. The initial IPO filing filed in August 2015 does not specify the amount.[40]

The fees are split among TPG and Leonard Green investment vehicles, including co-investors:[41]

TPG Partners IV 40.3%
Green Equity Investors IV 63.2%

TPG Partners V 40.6%
Leonard Green Co-Investors 36.8%
TPG Co-Investors 19.1%

Combined fees paid by PetCo during TPG and Leonard Green's two phases of ownership were at least $103 million.

Photo: Virginia Hill (CC BY-ND 2.0)

Questions:

- Given that PetCo has continued to trail its rival PetSmart, how do TPG and Leonard Green justify the $103 million in advisory and transaction fees?
- How have the fees impacted PetCo?
- How much have any deal fees not shared with limited partners depressed PetCo's potential value at sale or IPO?

Loads of Debt

TPG and Leonard Green have loaded on additional debt to PetCo in the past nine years, which totaled nearly $2.3 billion as of August 1, 2015.[42] Its leverage has grown in the last few years as PetCo took on additional debt that was used to pay out dividends.

"Calling it a 'dividend' is just plain deceitful, since dividends are supposed to come from legitimate earnings."

—Dan Primack, Fortune, on dividend recaps generally, March 2012

Dividend recapitalizations have been under fire for several years as a private equity practice. Dan Primack at *Fortune* described them in 2012 as "a noxious financial strategy that perverts the industry's mission and threatens its future ability to raise capital." He also said, "calling it a 'dividend' is just plain deceitful, since dividends are supposed to come from legitimate earnings."[4]

At the time of the 2006 takeover of PetCo, the $1.8 billion transaction included $120 million in debt. Standard & Poor's credit analyst Robert Lichtenstein said in a statement that PetCo's debt ratings could drop because the transaction would probably substantially increase the company's debt levels.[44]

In 2006 when TPG and Leonard Green took PetCo private, the leverage was 5.25x. The original deal included $765 million in equity, of which TPG contributed $415 million and Leonard Green contributed $350 million.[45]

In 2010, PetCo issued $1.7 billion in debt, including a $1.1 billion term loan and $625 million in junior debt.[46]

The transaction was used to refinance debt and fund a $700 million dividend to Leonard Green and TPG. It brought the leverage ratio to 5.5x.[47]

Through the dividend, TPG and Leonard Green recovered over 90% of the equity invested in the company at the time of the buyout.[48]

Moody's downgraded PetCo's credit rating, saying "the change in outlook to negative from stable was triggered by PetCo's plans to undertake a refinancing, increase debt, and pay up to a $700 million dividend to its owners. The net result of this transaction will be to increase leverage and weaken overall credit metrics."[49]

In 2012, PetCo issued an additional $550 million in senior notes that would be used to fund a $603 million distribution to shareholders (including cash drawn from PetCo), Moody's said. The move raised the debt/EBITDA ratio to 6.75x over 6.0x.[50]

Between 2011 and 2012, PetCo's debt grew by 32% to $2.2 billion.[51]

"The change in outlook to negative from stable was triggered by PetCo's plans to undertake a refinancing, increase debt, and pay up to a $700 million dividend to its owners. The net result of this transaction will be to increase leverage and weaken overall credit metrics."

—Moody's, November 2010

While TPG and Leonard Green have utilized debt to provide cash for dividends, PetCo's interest payments on its debt have grown considerably. In 2010, annual interest expenses were $97 million. By 2014, they increased to $159 million, growth of 64%.[52]

In total, interest expenses in the five years from 2010 to 2014 were $653 million. Over the same period, PetCo's net income was $345 million.[53]

Questions:

- How will PetCo's debt burden impact its valuation?
- Is TPG's and Leonard Green's extensive use of dividend recapitalizations at PetCo in effect a vote of no confidence in Petco management?
- Will TPG's and Leonard Green's utilization dividend recapitalizations at PetCo depress sale or IPO pricing by an amount greater that the cash that was previously returned?
- Will investors be harmed by the debt?

Endnotes

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