

The US Veterinary Health Market



Source: <http://www.allposters.com> - Real Pals

Companies Highlighted

Petmed Express, Inc.	(NASDAQ: PETS - \$4.28)
Heska Corp.	(NASDAQ: HSKA - \$1.35)
Idexx Laboratories, Inc.	(NASDAQ: IDXX - \$49.64)
Neogen Corp.	(NASDAQ: NEOG - \$18.70)

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INTRODUCTION

The United States population is experiencing several demographic/ lifestyle trends that are projected to continue over the next two decades, including the aging demographics and the obesity trend. Both of these factors are causing healthcare costs to increase annually. Another trend that is gaining increased awareness is healthcare spending not on humans, but on companion pets. In this report, we lay out some statistics on the overall pet market in the US and more specifically, the pet healthcare market, and finally, highlight a few stocks that stand to benefit from these trends.

The growth in the dog and cat population has increased at a higher rate than the growth rate of US households as shown below:

(millions)	1996	2001	CAGR
Total US Households	99.6	108.2	1.7%
Total Dogs	52.9	61.6	3.1%
Total Dog Owners	31.3	37.9	3.9%
% of US Household	31.6%	36.1%	
Vet Spend Per HH – Dogs	\$187	\$261	6.9%
Total Cats	59.1	70.8	3.7%
Total Cat Owners	27.0	33.2	4.2%
% of US Household	27.3%	31.6%	
Vet Spend Per HH - Cats	\$147	\$160	1.7%

Source: American Veterinary Medical Association

The US Companion Pet Market

According to the American Pet Products Manufacturers Association, 62% of US households own a pet and 46% of all households own more than one pet. US pet spending is estimated at \$34.3 billion in 2004, doubled from the \$17 billion spent in 1994. The breakout in spending is as follows:

Category	Sales (\$bil)
Food	\$14.3
Vet Care	8.3
Supplies/ Medicine	7.9
Live animal purchases	1.6
Pet services: grooming & boarding	2.2
Total	\$34.3



Source: American Pet Products Manufacturers Association, Inc.

The food category leads overall pet spending, followed by veterinary care and supplies/ medicine. However, the greatest expense for pet owners over a 12-month period is veterinary care services. Americans are willing to spend on healthcare services so their pets can have a better quality of life. This has resulted in the purchase of pet health insurance by many owners.

Rationale for Pet Spending

Americans are spending more on their pets these days because many pets are treated as members of the family. Pets provide companionship for many owners such as single, busy urbanites, families with small children and empty nesters. The following survey, conducted by the American Pet Association, notes the primary reasons why Americans have either a dog or a cat:

Reasons for Ownership	Dogs	Cats
Someone to play with	90%	93%
Companionship	83	84
Help Children learn	82	78
Someone to communicate with	57	62
Security	79	51

Source: 1998-2001 American Pet Association Polls

In addition, recent studies have shown that pets are good for one's health. According to a study by the State University of New York at Buffalo, people with hypertension had lower blood pressure readings in stressful situations when they have a pet. Another study showed that pets also prevent heart disease since they provide their owners with greater psychological stability. Finally, pets help ward off depression and loneliness, especially among seniors, as they provide seniors with comfort and meaning in their lives.

As such, pet spending is expected to increase for the foreseeable future. Some specific examples of pet spending are as follows:

- Approx. 1 million US dog and cat owners have purchased health insurance for their pets.
- The pet hospitality services industry is gaining momentum as companies such as Norwalk-based Best Friends Pet CarePet is opening up its 40th store, and retailers such as Petsmart (NASDAQ: PETM) and Petco Animal Supplies (NASDAQ: PETC) are entering into this premium pet lodging market. A one-week stay for dogs can cost between \$200 to \$250.
- Companies such as Paul Mitchell, Omaha Steaks, Harley Davidson and Old Navy are now offering lines of pet products ranging from dog shampoo, pet attire and name-brand toys to gourmet treats and foods.

The US Veterinary Health Market

According to the American Pet Products Manufacturers Association, Americans will spend \$8.3 billion on veterinary services in 2004. The majority of this spending is for services provided by approx. 62,000 veterinarians in the US. Approximately 75% of the US veterinarians are focused on small animals. According to a KPMG study sponsored by three veterinary associations, demand for veterinary services is projected to grow at 5% through 2015. Of the total spent on veterinarian services, approximately 30% or \$2.5 billion is allocated to drugs/ medical supplies, pet food and other feed, laboratory and radiology fees. Combined with the estimated \$7.9 billion spent by consumers, total pet supplies and medicine spending is over \$10 billion.

The main manufacturers of pet medication are Merial, Pfizer Animal Health, Bayer, and Novartis. The two primary medications that pet owners have to buy are flea and tick treatment for dogs and cats and heartworm disease prevention medication.

- ***Fleas and Ticks:*** Fleas and ticks rest on dogs and cats and multiply, causing irritation, illness and diseases. Flea and tick control products keep all stages of fleas from developing and kills major ticks. Effective medications include Frontline Plus, Advantage, Advantix, and Program.
- ***Heartworm:*** Heartworm is the result of parasites transmitted by mosquitoes that can potentially be fatal to dogs or cats. If the pet is infected, the adult heartworm clog up the heart and major arteries, leading to malfunctions of the heart and various other organs. Heartworm preventatives include Heartgard Plus, Interceptor, Sentinel, Filaribits Plus and Revolution.

Other medication and supplies that pet owners buy for their dogs and cats include the following:

- Allergy/ anxiety drugs – cough relief, anxiety relief, nose relief
- Dental care products – rise, chews, toothpaste, dental care kit, breath spray, toothwipes
- Digestive care – laxatives, hairball remedy, fiber capsules, pet digestive upsets
- Ear care – ear clear, ear powder, ear mite treatment, ear cleaning solution
- Eye care – eye clear, puralube ointment, tear clear
- Grooming – coat shed reducer, grooming kit, pooch scents
- Skin care – cream, location, salve, spray, skin & itch relief, skin & wound cleanser
- Vitamins/ supplements – pet tabs, calorie/ vitamin supplements

Pet/ Veterinary Plays

The following companies all participate in the pet health market by either selling products directly to pet owners or selling to veterinarians. These companies are poised to grow along with the growth in the pet/ veterinary market.

Table 1: Capitalization and Valuation Statistics

(\$ in millions, except per share data)	PetMed Express, Inc. PETS - NASD	Heska Corp. HСКА - NASD	Idexx Labs, Inc. IDXX - NASD	Neogen Corp. NEOG - NASD
FYE	30-Mar	31-Dec	31-Dec	31-May
Diluted Shares O/S	23.74	49.00	36.42	8.01
Current Stock Price (8/3/2004)	\$4.28	\$1.35	\$49.64	\$18.70
Equity Market Capitalization	101.61	66.15	1,808.04	149.77
Plus: Long Term Debt	0.07	10.06	-	3.90
Less: Cash & Investments	(3.28)	(4.88)	(233.86)	(1.70)
Total Enterprise Value	98.40	71.33	1,574.17	151.97
Price to 2004 Earnings	13.9	N/A	24.2	27.2
Price to 2005 Earnings	11.0	N/A	22.3	24.3
TEV to 2004 EBITDA	8.2	N/A	12.8	14.2
TEV to 2005 EBITDA	6.5	N/A	11.6	12.3

Source: Company data and Gabelli & Company, Inc. estimates.



PetMed Express, Inc. (PETS - \$4.28 – NASD)

Headquartered in Pompano Beach, FL, PetMed Express is a national online pet pharmacy, providing prescription and non-prescription medication and health and nutritional supplements for dogs and cats direct to the consumer. The company was founded in 1996. It markets its products through national television, online and direct mail ad campaigns with its “1-800-PetMeds” brand name. The main benefits to consumers include convenience, price and speed of delivery.

- \$94 million in sales during FYE 3/31/2004
 - Non-prescription medications accounted for 69% of total sales and prescription medications accounted for 30% of sales
 - Sales have almost tripled in the past two years from \$32 million in FYE March 2002 to \$94 million in FYE March 2004
 - Seasonality of business (the fall and winter months have slower sales) – 23% of total sales occurred in March quarter, 32% in June quarter, 27% in Sept. quarter and 18% during Dec. quarter
 - Margins have improved from 2.9% operating margin in FYE March 2002 to 9.8% in FYE March 2004
- Its strategy is to grow the business; it would consider acquisitions or enter into other pet related markets
- Competition: PetMed estimates that it has a 3% market share of the pet medication market which is dominated by veterinarians with 80% market share followed by retailers with 15% market share
- Tricon Holdings, LLC, a non-related entity, owns 31.4% of the shares outstanding
- Caveats:
 - Generates minimal cash flow due to increasing inventory carrying costs
 - Buys supplies and medications from various third party distributors, not directly from pharmaceutical manufacturers

Heska Corp. (HSKA - \$1.35 – NASD)

Headquartered in Fort Collins, CO, Heska is a manufacturer of veterinary products for companion pets and other larger animals. Heska sell its products to veterinarians through a direct sales force and independent third party distributors. The company was founded in 1988 as Paravax, Inc. and changed its name to Heska Corp. in 1995. Its main products are diagnostic test kits and vaccines and pharmaceuticals for companion pets, and private label vaccine and pharmaceutical production for cattle.

- \$65 million of revenues during 2003 which includes \$1.4 million of R&D revenues
 - Two segments: companion animal health (74% of total product sales) and diamond animal health (26% of total product sales)
 - Companion animal health segment: diagnostic and monitoring instruments and supplies (42% of product sales), and single use diagnostic tests, vaccines and pharmaceuticals (32% of product sales)
 - Diamond animal health segment: private label vaccine and pharmaceutical production, primarily for cattle, sold by third parties under their labels
- The company generated net losses in each of the past five years ending 2003 and expects to generate losses in the first half of 2004
- Competitors in point of care diagnostics: Idexx Laboratories, Abaxis and Synbiotics
- Competitors in vaccines and pharmaceuticals: Bayer, Intervet International (unit of Akzo Nobel), Merial, Novartis, Pfizer, Schering-Plough and Wyeth
- Other:
 - Owns a 168,000 SF production facility on 34 acres of land in Des Moines, Iowa
 - Owns a 175 acre farm in Carlisle, Iowa
 - Has \$165.7 million of NOLs as of 12/31/2003
 - Exclusive agreement with AgriLabs to distribute Heska’s bovine vaccines until Dec. 2013 with certain annual minimums

Idexx Laboratories, Inc. (IDXX - \$49.64 – NASD)

Headquartered in Westbrook, Maine, Idexx Labs is a manufacturer of products and services for the veterinary market, water quality products and products and services for production animal health and dairy quality. The company was incorporated in 1983. It has three segments: Companion Animal Group (81% of total sales), Water (10%), and Food Diagnostics Group (9% of total sales). Idexx has exclusive relationships with the nation’s top veterinary distributors. International sales accounted for 30% of total sales in 2003.

- \$476 million of revenues in 2003, up from \$367 million in 2000
 - Companion Animal segment (81% of total sales): consists of instruments and consumables (46%), laboratory services (24%), rapid assays (22%) and other (8%)
 - Water segment (10% of total sales): customers are primarily water utilities
 - Food Diagnostic Group (9% of total sales): broad range of tests for various poultry, cattle, and swine diseases and conditions and dairy testing business



companion
animal

- In March 2004, Idexx received approval from the USDA for its Herdchek® BSE Antigen test kit, which is a rapid test kit for testing of mad cow disease.
- Other recent product launches:
 - May 2004: Two unique tests for equine practitioners to detect and confirm Streptococcus equi (strangles) infection
 - May 2004: Topical anti-inflammatory cream for treatment of horses with pain and lameness due to osteoarthritis
 - March 2004: LaserCyte Hematology analyzer now available to equine veterinarians for complete blood count
- Its operating margin has improved steadily from 14.5% in 2000 to 18.4% in 2003

Neogen, Corp. (NEOG - \$18.70 – NASD)

Headquartered in Lansing, MI, Neogen is a manufacturer of products dedicated to food safety and animal safety. The company was founded in 1981. Its food safety products are marketed to food producers and processors to detect dangerous and/ or unintended substances in food and animal feed. Its animal safety products are marketed to veterinarians. The company has made six small acquisitions to complement its food and animal safety product lines since 2000. International sales accounted for 21% of total sales.



Source: Neogen, Corp.

- \$55.5 million of revenues for FYE May 2004
 - Food safety products (50% of total sales): diagnostic test kits and complementary products marketed to food producers and processors to detect foodborne pathogens, natural toxins, food allergens and general sanitation concerns; sold direct to end users
 - Animal safety products (50% of total sales): pharmaceuticals, vaccines, veterinary instruments, topical and diagnostic tests to the professional animal care market
- Neogen has increased sales from \$22.2 million in FYE May 1999 to \$55.5 million in FYE May 2004.
- Its operating margin has improved from 11.5% to 13.6% during the past five years
- Other: Owns six buildings in Lansing, Michigan totaling 65,500 SF

INVESTMENT SUMMARY

Given the positive trend toward spending for pet care that will continue over the next decade, we believe that veterinary products companies represent good investment opportunities for investors with a long-term two to five year investment horizon. Over time, if these companies continue to execute well and generate solid sales growth, they should benefit from leveraging off their existing infrastructure and deliver improved earnings growth.

I, Jennie Tsai, the Research Analyst who prepared this report, hereby certify that the views expressed in this report accurately reflect the analyst’s personal views about the subject companies and their securities. The Research Analyst has not been, is not and will not be receiving direct or indirect compensation for expressing the specific recommendation or view in this report.

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