Capital Catalysts
By Mark Kalaygian
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Drawn by the ongoing strength of the pet care market, private-equity investors are inexorably changing the industry landscape, and providing significant opportunities and challenges to pet specialty retailers along the way.

The cat's out of the bag. The continued success of the pet care market has undeniably caught the attention and imagination of outside investors. As result, the industry is seeing an extraordinary infusion of capital up and down the supply chain. This deluge of funding has, in turn, created a variety of both positive and negative dynamics that pet specialty retailers must navigate in order to ultimately benefit from the rising tide of investment—either directly or indirectly.

As anyone who has been paying close attention over the past several years has witnessed, increased interest from the investment community is not a new phenomenon in the pet industry. In fact, that interest has been building for more than a decade. However, it has kicked into high gear since recessionary forces turned the pet segment into one of the few bright spots in the world of retailing.

"It started when investors realized that the pet industry is recession resistant," says Carol Frank, managing director at SDR Ventures, a Denver-based investment bank that counts the pet industry as one of its areas of expertise. "In 2008/2009, they looked back on the growth that the pet industry continued to have, even as the rest of the retailing and manufacturing world was not thriving, the pet industry was. So, about four or five years ago, the private-equity world really started focusing on pet."

Having first-hand experience with the interest that the pet industry is generating among prospective investors, Michael Levy, president of the 51-store Pet Food Express chain in California, agrees with Frank's timeline. "We started getting calls from private-equity people here and there around six or seven years ago," he says. "It quickly ramped up, and it continues today. We're probably contacted a couple dozen times a year [by prospective investors]."

So far, however, Pet Food Express has chosen not to take on outside investors, preferring to self-fund its steady growth.

While private-equity investors have come in at every level of the pet industry—from manufacturers to distributors to retailers—not surprisingly, manufacturers have drawn the lion's share of suitors, simply because of the scale of these operations.

"In private equity, the [strategy] is to buy what is called a 'platform company,' which is their initial investment, and those need to be pretty substantial—usually doing at least $3 million to $5 million EBITDA [earnings before interest, taxes, depreciation and amortization]—then they add on more investments in that space," says Frank, noting that demand among private-equity investors for strong manufacturing businesses currently far exceeds the supply of sellers on the market. "I can't tell you how many calls I get every week from private-equity firms asking me what deals I have to show them in pet. It's a classic case of too much money chasing too few goods, so the prices that groups are paying for good manufacturing businesses is at an all-time high."

New York-based Culbro, LLC, is one private-equity firm that was able to negotiate the unfavorable supply-demand equation to make a solid investment at the manufacturer level when it acquired a minority stake in natural treat and chew maker TDBBS, which is known for its popular Barkworthies brand. David Danziger, a partner at Culbro, says that his firm began looking closely at the pet industry as early as 2006 because of the similarities it shared with another consumer products industry in which the company already had a wealth of experience.

"We used to own a cigar business called General Cigar, which was one of the leaders in the premium-cigar industry," he explains. "When we sold that business, we wanted to find businesses that had similar characteristics. Interestingly enough, right off the bat, we felt like the pet industry had [those characteristics]—and they happen to be some of the things that attract private-equity in general."

In particular, Danziger points to a passionate, loyal consumer base and a healthy channel of small, independent retailers that are knowledge and service oriented as major similarities between the cigar and pet businesses. "You can work very nicely with these independent retailers," he says. "Relationships are important to them. If you do a good job, you have a great chance of growing your business and holding your position for a very long period of time."

Frontenac Company is another private-equity investment firm that has been looking for new investment opportunities in the pet industry. Frontenac—which has a successful record in the pet industry dating back to its involvement in PetStuff many years ago, and more recently with a leading freeze-drying co-manufacturer—has a history of working with founder- and family-owned businesses looking for a partner.

While Frontenac has yet to pull the trigger on a new investment in the pet industry, vice president Joseph R. Rondinelli says the firm is quite bullish on the category. "It's one of the industries that has seen real growth through the recession and over the past five years," he says. "We think there is a lot of opportunity [in the pet industry]. It continues to be a fairly fragmented industry where the trends toward healthy and natural, as well as convenience and service, provide a lot of different angles that investors can play."

Unlike some other private-equity firms, Frontenac is not limiting its search for investment opportunities to the manufacturer level, says managing partner Walter C. Florence. "We are open to investments across the value chain, including manufacturing, distribution, services and retail," he explains. "We're actively looking at all opportunities."   Frontenac is not alone in its broad approach to seeking pet companies with which to partner. While manufacturers may be garnering the most interest from private-equity firms, some key investments have been made at the distributor level, which has fueled a high rate of consolidation under the growing Phillips Pet Food & Supplies and Animal Supply Company umbrellas.

Pet specialty retailers are also on the radar of some private-equity investors, as evidenced by Levy's experience. In fact, there are a number of retail chains that are benefiting from the many resources that these investors bring to the table, including Pet Sense, based in Scottsdale, Ariz.; Pet Valu, which has branched out from its Canadian base to open stores in the U.S.; New England-based Pet Life; Kriser's, which operates stores in Chicago, southern California, Houston and Denver; the Farmington Hills, Mich.-based Pet Supplies "Plus" franchise; and most recently, Three Dog Bakery, which oversees 34 boutique dog bakeries internationally.

A Wealth of Resources Regardless of whether it is a manufacturer, distributor or retailer, companies that take on private-equity investors will find that such partnerships can bring important benefits. While an infusion of capital is often first and foremost among the resources offered by private-equity groups, there is a lot more to the equation. "They not only bring financial capital, they also bring intellectual capital," says Frank. "A lot of these private-equity groups have operating partners with deep industry experience and a great understanding of how to grow a consumer-focused business."

This type of intellectual capital is exactly what Culbro brings to the table when it invests in a business, says Danziger. "Usually what we are helping [business owners] do is professionalize the people who work with them," he says. "There are often some material weaknesses within the organization—finance is one of the big areas where we see this, but it can sometimes be in marketing or some other element of the business."

According to Danziger, private-equity groups can often draw from a network of people to help a business shore up weaknesses. For example, Barkworthies' vice president of marketing Bill Chilian is an ex-employee of Culbro's former General Cigar business, he notes.

Another benefit of partnering with a private-equity investor, says Danziger, is the confidence it can instill in the company's management team. "A lot of times, when you're running your own business, there is a little bit of fear about taking the next step," he explains. "Obviously, any entrepreneur is a risk taker, to some extent. But when they get to a certain scale, there can be a moment of hesitancy where they ask themselves, 'Do I have the confidence to do what I need to do to grow?' A lot of times, they just need that person on their board to help them along. And if you have the other two components of capital and connections, it really makes a difference."

Over the past year and a half, the Kriser's chain, which operates 24 stores across its four markets, has been benefiting from these types of non-monetary resources. "Our partners have a lot of experience with many different types of company models," says founder and CEO Brad Kriser. "They have been able to help us add to the infrastructure of the company, so we can support the stores we are opening. They have also helped us with the interviewing process for some of the new management team that we've brought in to work in our headquarters. And their insights on a myriad of other things have made them valuable members of our board, which meets monthly. It has definitely been a positive experience."

Impact on Retailers While it has clearly been a boon to the industry at large, all of the investment activity in the pet care market has impacted pet specialty retailers both positively and negatively. For example, while all of the private-equity-driven consolidation among pet product distributors has significantly narrowed retailers' supply chain, it has also simultaneously enhanced the capabilities and efficiencies of Phillips Pet Food & Supplies and Animal Supply Company, which are able to pass along the resulting benefits to their retailer customers.

Similar dynamics are playing out at the manufacturer level, with private-equity capital offering a mixed bag for independent pet stores. "Small, independent retailers have to be cognizant of how private equity is affecting consolidation and other changes in the industry," says Levy. "A lot of highly skilled, intelligent people have come into the industry. But private-equity groups invest money for roughly five years to grow their investment and flip it, and a lot of times that means doing things like reducing the number of SKUs a manufacturer offers or going to new markets—those things ultimately hurt the independent retailer."

Kriser also sees outside investment within the supply chain as having the potential to either help or hurt retailers, and notes that the jury is still out on which way the scales will ultimately tip. "Quite honestly, I'm still waiting to see how it is all going to play out," he says. "I've seen that there are positives and negatives with all of these investors coming in. On one side, usually, what it does is allow companies to grow and be better-run operations. But on the other hand, it also sometimes expands a company's distribution [beyond independent pet stores].

"That is probably the biggest area where the landscape has changed. Whereas some independent manufacturers that only sold to independent retailers would not have gone into certain stores in the past, they're no longer calling the shots on that. And when someone is making a large financial investment and needs to increase revenue, there are only so many ways to do that."

Despite the channel jumping that often results from private-equity groups with ambitious goals for their investments, Kriser believes that there are enough partners out there to help small pet stores thrive. "There are enough small companies out there sticking to their mantra of focusing on the independent retailers," he says.

Frank is also confident that the pet specialty channel will continue to yield a contingent of manufacturers that are focused on independents, and she notes that private-equity investment is not always a bad thing for small retailers. She cautions retailers not to equate these investments with a mass and grocery player acquiring a pet specialty brand. "[Private-equity investment] can be a wonderful thing, if they have the right partner," says Frank. "The manufacturer is just going to become more professional and more innovative."

Beyond the impact that private-equity groups are having on suppliers, retailers must also contend with the effect that these groups can have on their competitors. The already formidable pet chains that are most likely to draw interest from investors quickly become even more dangerous once they tap into such a partnership. "It is a game changer," says Frank. "The objective of most private-equity groups is to triple or quadruple their money in three to five years. They're not messing around; they're looking for big returns. And you're not going to get those big returns by opening a new store here and there. So, they're going to ramp up and look for big things to happen."

Whether it is ultimately a blessing or a curse for independent pet stores, the high level of private-equity investment in the pet industry is not expected to wane anytime soon. "Regional retailers with 10-plus stores, good margins and sustained growth will continue to be approached by certain investor groups," says Frank. "And in manufacturing, I don't see interest slowing down for at least the next three years.

"As long as the pet industry is robust, investor interest will continue."