

Chewy, Inc. Stock Pitch

NYSE: CHWY

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Recommendation

I recommend **longing** Chewy, Inc. (NYSE: CHWY), the largest pure-play pet e-tailer in the United States. CHWY is currently trading at \$73.90 which undervalues it by 32.61%. I predict that its stock price will significantly increase over the next 6-12 months.

My price target and the company's intrinsic value is closer to **\$98** per share.

Chewy IPOed in June 2019 at \$22 per share and shares immediately surged 64% to \$36 per share once trading was open.¹ Over the past two years Chewy has seen immense growth (mainly due to increased pet adoption during the pandemic). The stock reached an all-time high of \$120 in February 2021. However, as Covid-19 cases continued to fall and vaccination rates rose, investors turned away from high-growth stocks toward cyclical and value stocks,² causing CHWY's price to decrease 38.42% from ATH. This cyclical change in the market presents a unique buying opportunity.

Positive catalysts that will increase the price of Chewy's shares over the next 6-12 months include technology-based product innovation, unrealized customer gains, continued humanization of pets, the launching of new programs, such as their Fresh program, and continued customer use of Chewy's Autoship program.

Key investment risks include competition from pet retailers including Amazon (NASDAQ: AMZN), Walmart (NYSE: WMT), Target (NYSE: TGT), PetCo (NASDAQ: WOOF), BarkBox (NYSE: BARK), & ZooPlus (ETR: ZO1), and continued supply issues & labor shortages.

Chewy's Industry-Leading Pet E-Tail Business

As the largest pure-play pet e-tailer in the United States, Chewy, Inc. has 19.8 million active customers and over 70,000 products from over 2,500 brands, including proprietary ones. Chewy is a high-growth company with 35%+ growth over the past four years and 20%+ projected growth over the next two years. Their strong position in the pet market is indicated by a ~40% online market share,³ and an ~11.3% total market share. To increase market share, Chewy is actively launching new programs, such as "Fresh" prepared food program, "Connect with a Vet" telehealth program, and "Compounding Pharmacy" Rx program. Chewy's Autoship subscription service accounts for ~69% of customer sales and guarantees repeat business, making them the most competitive pet e-tailer.

¹ <https://finance.yahoo.com/news/chewy-opens-for-trading-ipo-150354877.html>

² <https://www.forbes.com/sites/greatspeculations/2021/06/01/chewy-stock-down-37-from-highs-time-to-buy/?sh=4cf3322f852d>

³ J. P. Morgan - 1QFY Preview: Remain Positive & Expect Upside to Numbers; Overweight & \$98 PT

Chewy's most recent success is due to an increase in pet ownership during COVID-19. The 5.7% CAGR of pet-owning households in 2020, compared to the pre-COVID-19 CAGR of .6%, represents a ~10-year increase in pet owners packed into a single year.⁴ Skeptics of Chewy's business model may believe that continued growth is not sustainable. However, these U.S. pet-owning households are not going away. The average life expectancy of dogs is 10-13 years and cats is 13-17 years. Therefore, Chewy's customers — particularly the ~69% on Autoship — will continue to sustain their growth.

Pet Care Market Size

I calculated the size of the U.S. Pet Care Market in 2021 that is applicable to Chewy as \$78.9 billion. To make this determination, I adjusted figures provided by The American Pet Products Association (APPA) to include only those sales relevant to Chewy. APPA determined that \$109.6 billion, up from \$103.6 billion in 2020, will be spent on pets in the U.S. Market in 2021.

APPA provides four categories, one that is non-applicable and three that I used in my calculations:

- Pet Food & Treats is directly applicable to Chewy at \$44.1 billion.
- I adjusted Supplies, Live Animals, & OTC Medicine from \$23.4 billion to \$22.4 billion by removing the Live Animals category because Chewy does not sell Live Animals.
- I adjusted Vet Care & Product Sales from \$32.3 billion to \$12.3 billion by removing the Vet Care category (approximately \$20 billion)⁵ because even though Chewy has "Connect with a Vet" telehealth veterinary service, almost all veterinary services must be performed in person.

Since Chewy will have \$8.9 billion in revenue in 2021, they will cut into 11.3% of the readily available \$78.9 billion U.S. market.

Currently, Chewy only offers its services in the United States. If Chewy were to expand its services internationally, then they would more than double their market reach from \$78.9 billion in the United States to \$160.49 billion globally in 2021. (With Chewy's current services, they reach 72% of the U.S. pet care market, and in 2021 the global pet care market is expected to be \$222.93 billion).⁶ The global pet care market size is expected to reach \$325.74 billion by 2028, with a CAGR of 5.6% from 2021-2028.⁷ So, Chewy should expand its services internationally to increase their revenues and access more of the pet care market.

Positive Catalysts

I have identified the following five positive catalysts drivers of future growth in the pet care industry and for Chewy:

Technology-Based Product Innovation

Technological innovations in pet products are leading to higher sales and demand in the pet care market.

Currently, Chewy sells multiple types of smart doors, smart feeders, smart litter boxes, GPS/Activity trackers,

⁴ <https://www.fool.com/investing/2021/06/07/chewy-q1-earnings-preview-what-want-to-know/>

⁵ <https://www.veterinarypracticenews.com/americans-spent-billion-veterinary-care-2018/>

⁶ <https://www.fortunebusinessinsights.com/pet-care-market-104749>

⁷ <https://www.fortunebusinessinsights.com/pet-care-market-104749>

and pet cameras.⁸ Chewy's website reports smart pet products as a \$555 million category in 2020, up 13% from 2019.⁹ This trend can be expected to continue as technological innovation advances.

Unrealized Customer Gains

Chewy reports that over the past two years they have increased their active customer base by 8.4 million or 75%.¹⁰ The longer Chewy customers remain with the company, the more they spend. On average customers spend \$400 in their 2nd year, \$700 in their 5th year, and \$900 in their 9th year.¹¹ Since most active Chewy customers have been with Chewy for less than two years, there are significant gains to realize.

Humanization of Pets

More than 80% of U.S. pet owners identify their pets as family members instead of pets/companions or property.¹² Chewy's website features hundreds of photos & articles about "Pet Families," "Pet Parents," "Dogfathers," "Dog Moms," and pets in weddings.¹³ Because pets are increasingly seen as family members, pet owners splurge on expensive food, medicine, toys, and treatment.¹⁴

Obesity and Healthier Foods

Pet obesity rates in the U.S. have led to higher sales of healthier products, medicine, and services which are expected to outpace overall industry sales in the next few years.¹⁵ The most recent study in 2018 shows that 59.5% of cats and 55.8% of dogs are classified as overweight or obese.¹⁶ Chewy just announced in their Q1 2021 Letter to Shareholders that they have entered the fresh and prepared pet food space through their program, Fresh, and developed a proprietary fresh food brand, Tylee's, for that program.¹⁷

Lower Prices and Ease

In 2020, 71% of pet owners purchased pet supplies online due to lower prices and convenience.¹⁸ While COVID-19 explains much of this statistic, most consumers will not switch back to in-person shopping as online shopping is cheaper and easier. Chewy's sales represent this trend as 69.3% of their customer sales came from their Autoshop subscription service in Q1 2021.¹⁹

Valuation

I am using J.P. Morgan's recent \$98 price target as CHWY's target price for the next 6-12 months.²⁰ I believe that it is a fairly conservative target especially when considering comps trading multiples.

By using a ~3.75x FY22E Net Sales of \$11.1B, the price target came out to \$98. This multiple is a premium to online retailer comps trading at ~2x on average (W, AMZN, RVLV, SFIX); however, J.P. Morgan believes that

⁸ <https://be.chewy.com/pet-tech-watch-2021-smart-devices-serve-up-benefits-for-you-and-your-pets/>

⁹ <https://be.chewy.com/pet-tech-watch-2021-smart-devices-serve-up-benefits-for-you-and-your-pets/>

¹⁰ https://s23.q4cdn.com/610444331/files/doc_financials/2021/q1/Q1-2021-Shareholder-Letter.pdf

¹¹ https://s23.q4cdn.com/610444331/files/doc_financials/2021/q1/Q1-2021-Shareholder-Letter.pdf

¹² <https://humanepro.org/page/pets-by-the-numbers>

¹³ <https://be.chewy.com/beinspired/people-x-pets/>

¹⁴ <https://www.wearwoodruff.com/blog/pets/expert-sees-us-pet-industry-growth-millennials-and-care/>

¹⁵ <https://www.wearwoodruff.com/blog/pets/expert-sees-us-pet-industry-growth-millennials-and-care/>

¹⁶ <https://petobesityprevention.org/2018>

¹⁷ https://s23.q4cdn.com/610444331/files/doc_financials/2021/q1/Q1-2021-Shareholder-Letter.pdf

¹⁸ <https://www.petfoodindustry.com/blogs/7-adventures-in-pet-food/post/9838-pet-food-e-commerce-on-steroids-in-2020-and-beyond>

¹⁹ https://s23.q4cdn.com/610444331/files/doc_financials/2021/q1/Q1-2021-Shareholder-Letter.pdf

²⁰ J. P. Morgan - 1QFY Preview: Remain Positive & Expect Upside to Numbers; Overweight & \$98 PT

Chewy merits this premium due to its high growth, high visibility, and recurring revenue.²¹ CHWY's multiple is a discount to consumer subscription comps that trade at ~9x on average (NFLX, SPOT, MTCH, CHGG) and pet comps that trade at ~4x on average (FRPT, TRUP, ZO1, PETQ, PETS).²²

Risk Factors

Chewy stated in their Q1 2021 shareholder letter that “elevated out-of-stock levels were a persistent headwind throughout the quarter and reduced [their] first quarter net sales by an estimated \$40 million.”²³ While these supply issues and nation-wide labor shortages are still persistent, Chewy states that they will subside by the second half of 2021 and especially will be minimal in the long-term. Also, Chewy is working on these issues by investing in their distribution network. They opened their 12th fulfillment center at the end of Q1 2021, and plan to open their 3rd automated fulfillment center next year. Along with investing in facilities they are also investing in their employees, by committing \$60 million of enhanced wages and benefits to employees last quarter with a likely additional \$30 million to recruiting and hiring incentives over the next two quarters.

Chewy's major competitors are Amazon (NASDAQ: AMZN), Walmart (NYSE: WMT), Target (NYSE: TGT), PetCo (NASDAQ: WOOF), BarkBox (NYSE: BARK), and ZooPlus (ETR: ZO1). PetSmart and Chewy are both majority-owned by private-equity firm BC Partners. When considering financials, PetCo emerges as Chewy's main competitor. PetCo's Adjusted EBITDA Margin in 2020 was 9.88%,²⁴ while Chewy's Adjusted EBITDA Margin in 2020 was 1.19%. Petco's almost ten-times higher Adjusted EBITDA margin is due to significantly higher gross profits. In 2020, PetCo had a gross profit of 42.8% or \$2.1 billion of their \$4.9 billion in revenue, while Chewy only had a gross profit of 25.5% or \$1.8 billion of their \$7.1 billion in revenue. However, since PetCo operates in brick-and-mortar stores, they have higher overhead, which led to their operating expenses of 37.3% or \$1.8 billion in 2020 compared to Chewy's operating expenses of 26.7% or \$1.9 billion in 2020.²⁵ If Chewy were to increase their gross profit to a similar level of PetCo's gross profits, then they would have a higher Adjusted EBITDA leading to a higher share price.

However, these risks do not pose much of a threat to Chewy because the supply issues and labor shortages will be resolved, and Chewy is expected to remain highly competitive.

²¹ J. P. Morgan - 1QFY Preview: Remain Positive & Expect Upside to Numbers; Overweight & \$98 PT

²² J. P. Morgan - 1QFY Preview: Remain Positive & Expect Upside to Numbers; Overweight & \$98 PT

²³ https://s23.q4cdn.com/610444331/files/doc_financials/2021/q1/Q1-2021-Shareholder-Letter.pdf

²⁴ <https://www.sec.gov/Archives/edgar/data/1826470/000119312521002588/d62974ds1a.htm>

²⁵ Bloomberg L.P.