



INVESTMENT INSIGHTS

March 2021

Secular Theme: The Business of the Bonds Between People and Pets

Key Takeaways

- Recent evidence suggests that there has been a broad, global and sustainable increase in pet ownership in part due to changing attitudes towards pets, referred to as “humanization”.
- The humanization of pets is further demonstrated in a recent RestoraPet survey where over half of survey respondents said they would spend “whatever it takes” to keep their pet happy and healthy.
- The trend of pet ownership has been accelerated by the recent pandemic, as pet owners agree that their pets have given them great emotional support and comfort during the unprecedented times.
- In 2019, an APPA survey reported that \$95.7 billion was spent on pets, an increase from \$17 billion in 1994, representing a 7.2% compound annual growth rate over the past 25 years.
- IDEXX Laboratories is a leader in diagnostic tests and information systems for veterinary practices. We believe the company’s new diagnostic tests could result in increasing share gains in the veterinary market.

According to the APPA survey, pet ownership rates vary across generations: Millennials (25-40) 31%, Gen X (41-56) 26%, Baby Boomers (57-75) 29%, Gen Z (9-24) 11% and Builders (>75) 4%.² Millennials have the highest ownership rate overall as well as across every species. However, older, retired people are more frequently turning to pets for companionship after becoming empty nesters.

Number of U.S. Households that Own a Pet (millions)	
Dog	63.4
Cat	42.7
Freshwater Fish	11.5
Bird	5.7
Small Animal	5.4
Reptile	4.5
Horse	1.6
Saltwater Fish	1.6

Source: American Pet Products Association. As of December 31, 2019.

More Pets

Recent evidence suggests that there has been a broad, global and sustainable increase in pet ownership, in part due to changing attitudes toward pets, sometimes referred to as “humanization”. People increasingly allow pets to sleep in bed with them, buy presents for them on special occasions and take other steps to personify their animal companions. Based on a survey by consumer research company GfK, 57% of consumers in 22 countries owned a pet. Specifically in the U.S., an estimated 67%, or approximately 85 million homes, owned a pet. Dogs are the most prevalent species of pets with over 60 million households owning a dog, followed by cats at just over 43 million households.¹ This change in societal attitudes toward domesticated animals began some time ago and has grown as younger generations are having fewer children and later in life. This trend has also accelerated globally in recent months as pandemic-related stay-at-home orders have increased the desire for companionship as social interactions had been put on pause for much of 2020. Overall, pets are largely treated as members of the family, which generally reflects a greater sensitivity to and recognition of domesticated animals’ complexity and needs.

The American Pet Products Association (APPA) National Pet Owners survey states that roughly 67% of U.S. households, approximately 85 million homes, own a pet. Pet ownership rates rose from 56% from when the survey was first taken in 1988. This implies an average annual gain of four-tenths of one percent, which equates to roughly 500,000 new pet-owning households each year.

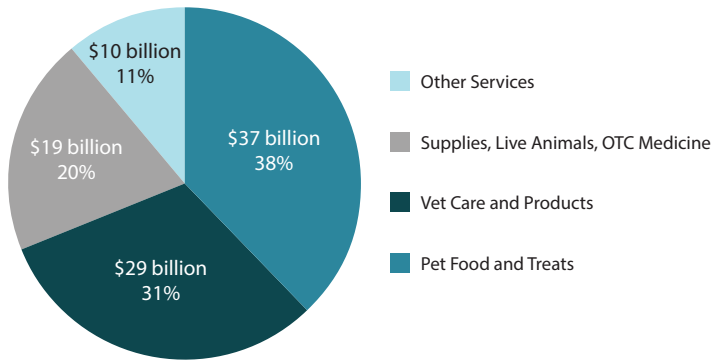
More Pampering

A recent report published by RestoraPet found that 90% of their respondents consider their pets to be a member of their family. The humanization of pets is further demonstrated by over half of the survey respondents who said they would spend “whatever it takes” to keep their pet happy and healthy.³ In addition, the bonds between humans and their pets were reinforced as a result of the COVID-19 pandemic. Pet owners largely agreed that their pets have given them great emotional comfort and support during these unprecedented times. Additionally, as many pet owners transitioned to working from home in 2020, owners have become more aware of the needs of their pet which may be a favorable trend in the industry over the next few quarters.

Increases in Pet Spending

The rise in pet ownership and the closer bonds have led to increased amounts of spending on pets and pet-related services. In 2019, the APPA survey reported that \$95.7 billion was spent on pets, with \$37 billion spent on pet food and treats, \$29 billion on veterinary care, \$19 billion on pet supplies and medicine, and \$10 billion on other services such as pet sitting and walking. The total has grown from \$17 billion in 1994, representing 7.2% compound annual growth over the 25-year period. Some of the basic annual costs of owning a dog or cat total \$1,466 and \$908 respectively.⁴ Pet spending for 2019 breaks down as follows:

U.S. Pet Expenditure Breakdown \$96B in 2019



Source: American Pet Products Association. As of December 31, 2019.

The APPA figures are supported by longer-term government data from the Bureau of Economic Analysis (BEA). The BEA found that pets and related product expenditures has grown at a compound annual growth rate of 6.5% since 1980. The BEA also found that veterinary and related services spending has grown 8.9% over the same time period. Both categories outpaced overall growth in total personal consumption, which grew 5.7%, over the time frame.⁵ Further validating our belief that pet spending growth will be robust and sustainable is the fact that better medical treatment is resulting in longer life expectancies for pets. In addition, the Insurance Information Institute states that pet insurance, which started over a century ago in Sweden and was first sold in the United States in 1982, experienced significant growth in 2018, with a 17% increase in gross written premiums over 2017.⁶ Another qualitative change in pet spending habits is that pet owners are buying better quality food for their pets, known as premiumization.

Investing in Pet Spending – IDEXX Laboratories

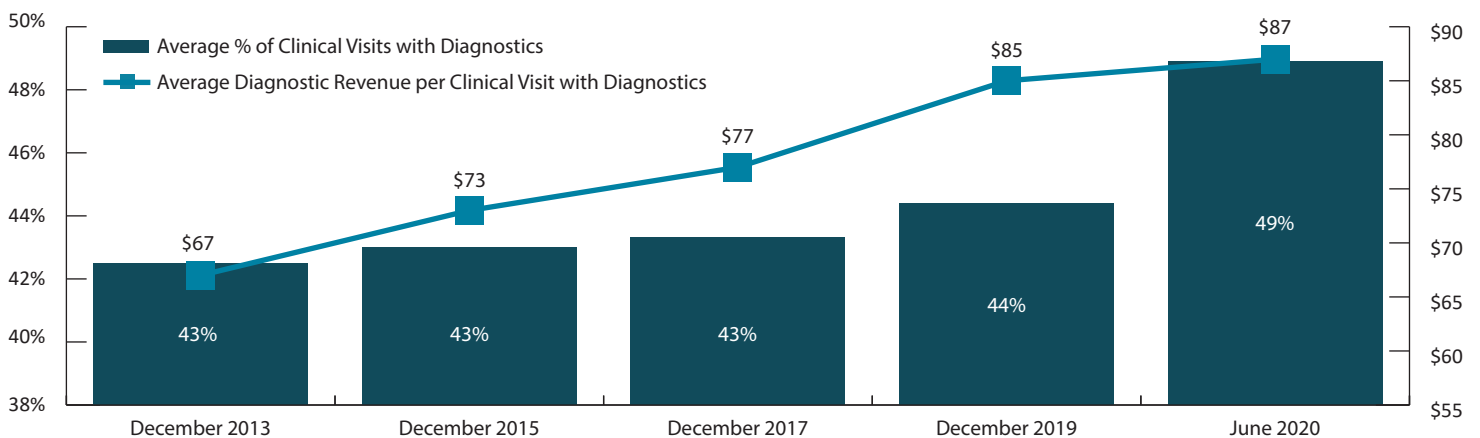
Based on our positive secular outlook for pet spending, we seek to find companies that we believe are poised to benefit from this spending trend and that offer specialized products with high barriers to entry. We currently own IDEXX Laboratories, Inc. (IDEXX), the leader in diagnostic tests and information systems for veterinary practices.

Business Summary

Offering its products and services globally, IDEXX provides diagnostic, detection and information systems for veterinary, food and water-testing applications. Veterinarians use the company’s VetTest analyzers for blood and urine chemistry and its SNAP in-office test kits to detect heartworms, feline leukemia and other diseases. The company provides lab-testing services and practice management software as well as operating an international network of veterinary reference laboratories. In addition, IDEXX makes diagnostic products to detect livestock and poultry diseases and to test for contaminants in water and milk. IDEXX’s Livestock and Poultry Diagnostics business includes products to test for Bovine Spongiform Encephalopathy (BSE or “mad cow” disease) as well as porcine illnesses and poultry diseases. IDEXX’s water-testing segment produces tests to detect E. coli, Enterococci and Cryptosporidium. The company’s dairy testing unit produces a SNAP test to measure antibiotic residues in milk, which are highly regulated in markets outside of the United States. IDEXX also sells OPTI Medical Systems, which measure human electrolyte, blood gases and glucose levels. The systems and consumables are sold to hospitals and clinics.

Companion Animal Group (CAG)

The vet and related services category in which IDEXX participates has grown at 12% compound annual growth rate from 2015 to 2019. IDEXX expects 9% to 13% growth in their domestic CAG and 12% to 16% growth in international CAG. Most of CAG’s revenue comes from diagnostic products and services, including chemistry analyzers, rapid test kits and laboratory services. The company offers a network of reference labs to which veterinarians can send patient samples for testing as well as a full line of in-office diagnostic equipment and related consumables. Diagnostic revenues, while growing, still accounts for only 15% of veterinary practice revenue. IDEXX has several new diagnostic tests, the most important being Symmetric Dimethylarginine (SDMA) for kidney disease, which we believe will result in increasing share gains in the veterinary market. As more impactful tests and easier testing methodologies are introduced, we see the potential for greater adoption of diagnostic testing in vet practices.



Source: IDEXX Practice Intelligence based on 7,750 practices weighted to represent the market based on practice size and region.

Conclusion

As of the end of 2020, IDEXX's long term financial model calls for greater than 10% annual revenue growth, 50-100 bps of margin expansion, 1-2% incremental EPS growth from capital allocation, which equates to 15-20% of annual EPS growth for the company. We believe the considerable opportunity for global adoption of animal diagnostic testing offers another tailwind for growth. Also, IDEXX is outspending peers on research and development, which we believe will result in a higher value-added portfolio of test of earnings. Overall, we appreciate the secular tailwinds supporting the projected revenue growth rates and the high barriers to entry. IDEXX's strong moat of innovation and market leadership should allow them to continue to gain market share and grow at rates above what we believe are already attractive market growth rates.

Disclosures:

^{1,4,5}Source: https://www.americanpetproducts.org/press_industrytrends.asp; Note: As of December 31, 2019.

²Source: <https://www.petfoodprocessing.net/articles/13709-appa-provides-generational-insight-into-pet-product-purchasing>; Note: As of December 31, 2019.

³Source: https://www.prweb.com/releases/restorapet_survey_shows_61_percent_of_pet_owners_spend_the_same_or_more_on_their_pets_wellness_vs_their_own/prweb17369382.htm; Note: As of September 30, 2020.

⁶Source: <https://www.iii.org/fact-statistic/facts-statistics-pet-statistics>; Note: As of December 31, 2018.

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