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Chewy, Inc. Research (7/30/19)

Description: Chewy, Inc. engages in the pure play e-commerce business in the United States. The company provides pet food, pet products, pet medications, and other pet health products for dogs, cats, fish, birds, small pets, horses, and reptiles through its chewy.com retail website, as well as its mobile applications. It offers approximately 45,000 products from 1,600 partner brands. The company was founded in 2010 and is headquartered in Dania Beach, Florida. Chewy, Inc. is a subsidiary of PetSmart, Inc.

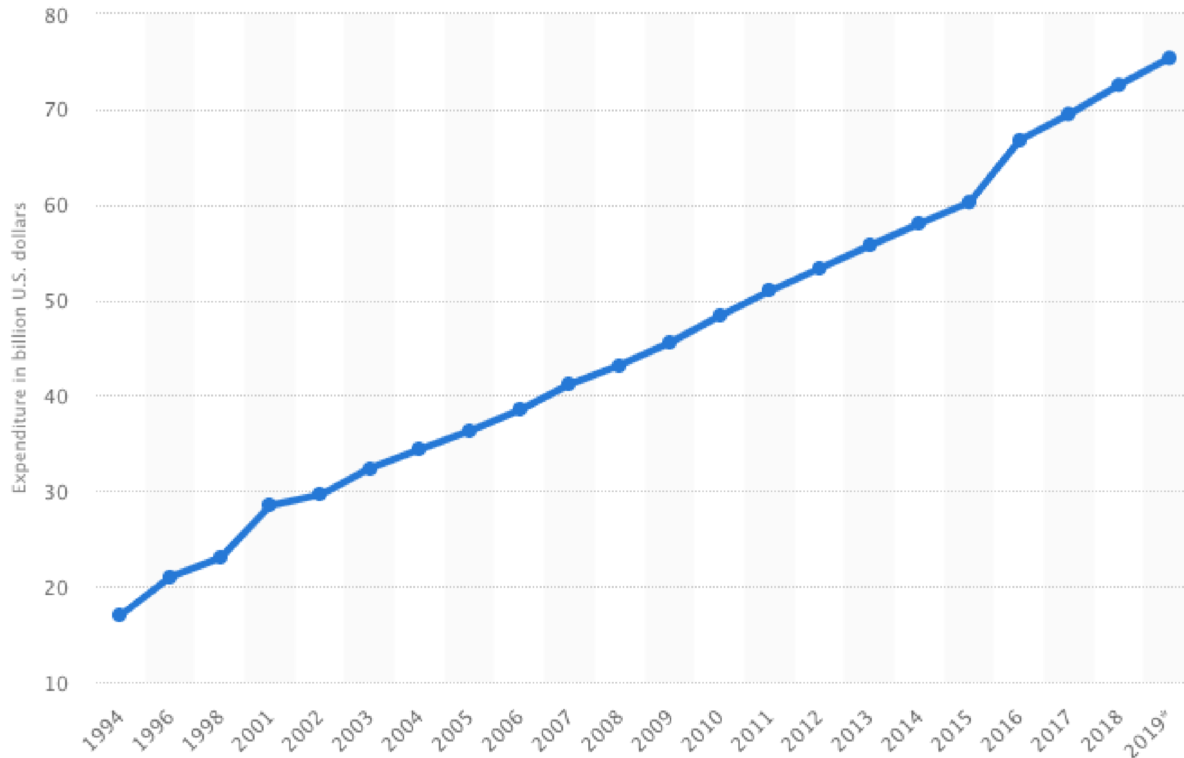
Ticker: CHWY
Price: $34.16
Market Cap: $13.6B
Performance: +54.5% since IPO at $22 per share on June 14th

Analysis

Chewy was a hot IPO right out of the gate in June but shares really haven't done anything since then. The stock made a high of $40.07 on the day it went public and has since pulled back hitting as low as $29.61 and now resting in the middle at $34.

Chewy is operating in an industry that has been growing exponentially and it is showing zero signs of slowing down.

Below is chart displaying the amount that customers have spent in the pet industry annually in the United States.



Pet industry expenditures in the United States is estimated to reach approximately $75.38B this year. U.S. consumer expenditures has gradually increased year-on-year, growing by around 450% since 1994. The increase in the household penetration rate for pet-ownership in the U.S. could partly explain the rise in pet industry expenditure. In 2017, about 68% of American households owned one or more pets, in comparison to a 56% pet-ownership rate in 1988. As of December 31, 2016, there were almost 85 million households in the United States with at least one pet, up from nearly 73 million in 2010, according to the APPA. The growth in pet households occurred across generations, with the percentage of young adults (ages 18 to 24) that own dogs or cats growing from approximately 44% in 2010 to approximately 53% in 2017, according to Packaged Facts.

Some more stats:

- The global pet care market reached $125B in 2018, according to Euromonitor International, and 73% of that total, about $91.1B, was global pet food sales – right down Chewy's alley.
- Dry dog food is the dominant pet food segment worldwide in terms of formats, recording value sales of nearly $35B in 2018, according to Euromonitor's data. Though the segment has experienced healthy growth since 2013 of about 5% CAGR, growth was stronger for dog treats (almost 6% CAGR), dry cat food (5.5%) and, especially, cat treats, the highest growth segment at 9% CAGR.
- Global cat treat sales are relatively low, only about $2B in 2018
    - Asia-Pacific posts a unique and growing landscape as this region saw a rise of 23% CAGR from 2013-2018.
- With wet pet food and its typically higher prices, values sales growth has outpaced that of volume sales, with increases of 4-5% CAGR for both dog and cat food.
- Euromonitor projects absolute sales of dog food in Asia Pacific will increase nearly $4B through 2023, compared to $7B for the entire rest of the world.
- E-commerce has enjoyed the highest growth by a large margin at more than 25% CAGR from 2013-2018, compared to less than 5% CAGR for each of the other channels (warehouse clubs, variety stores, chemists/pharmacies, pet superstores and pet shops)
- According to third-party estimates, online spending on pet food and supplies is calculated to be $6B in 2017 and is expected to grow at a 17% CAGR from 2017 to 2022 as a result of the secular shift from offline to online spending and the expected consistent growth in overall market spending

With these stats, it's apparent that Chewy operates in a business that is growing rapidly but there were some findings in Chewy's financials that make the investment thesis difficult to size up.

The company reported Q1 GAAP EPS of -$0.08 missing estimates by $0.01 on revenue of $1.11B, in-line with estimates.

Fiscal Q1 2019 Highlights:

- Net sales grew 45.2% year-over-year to $1.1B
- Gross margin of 22.9% improved 330 basis points year-over-year
- Net loss of $29.6M improved 50.6% year-over-year
- Adjusted EBITDA loss of $15.8M improved 69.4% year-over-year
- Adjusted EBITDA margin of -1.4% improved 530 basis points year-over-year

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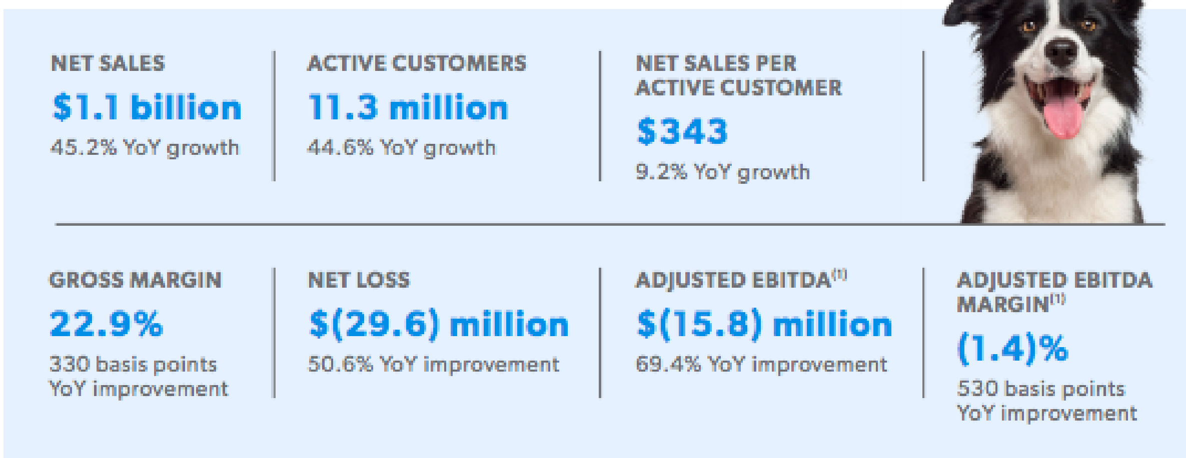


After digging through the 10Q and S1 here are some other things CUBE has found on Chewy:

- From fiscal year 2012 to fiscal year 2018, our net sales per active customer grew from $223 to $334. In Q1 2019, it rose to $343.
- Autoship customer sales have grown from $115M in fiscal year 2014 to $2.3B in fiscal year 2018. Autoship customer sales grew 55.8% to $743.9M in the first quarter of 2019, compared to $477.4M in the first quarter of 2018
- Active customers increased by 3.5M, or 44.6% , in the thirteen weeks ended May 5, 2019 compared to the thirteen weeks ended April 29, 2018
- Net cash used in operating activities was $51.1M for the thirteen weeks ended May 5, 2019. Total free cash flow came in at -$63.4M for the quarter

(in thousands, except net sales per active customer and percentages)	13 Weeks Ended May 5, 2019	13 Weeks Ended April 29, 2018	% Change
Financial and Operating Data			
Net sales	$ 1,108,872	$ 763,462	45.2 %
Net loss	$ (29,554)	$ (59,815)	50.6 %
Adjusted EBITDA [1]	$ (15,766)	$ (51,509)	69.4 %
Adjusted EBITDA margin [1]	*(1.4)%*	*(6.7)%*	
Net cash used in operating activities	$ (51,141)	$ (45,273)	(13.0)%
Free cash flow [1]	$ (63,363)	$ (58,734)	(7.9)%
Active customers	11,321	7,830	44.6 %
Net sales per active customer	$ 343	$ 314	9.2 %
Autoship customer sales	$ 743,853	$ 477,449	55.8 %
Autoship customer sales as a percentage of net sales	67.1 %	62.5 %	

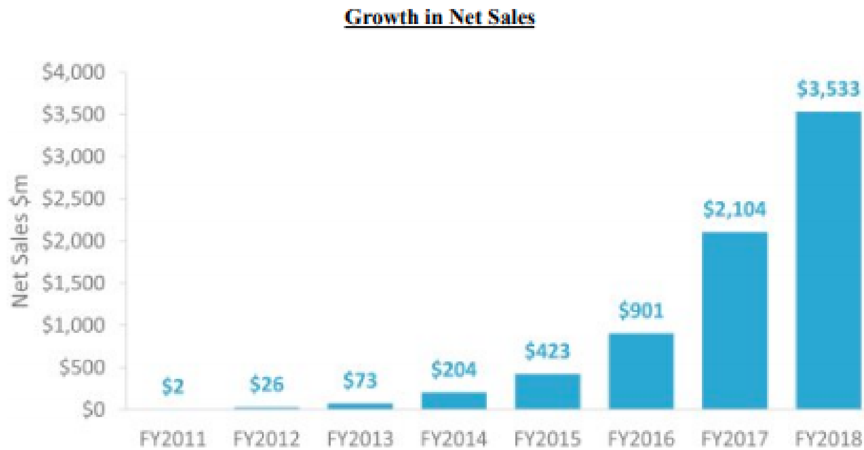
[1] Adjusted EBITDA, adjusted EBITDA margin and free cash flow are non-GAAP financial measures.

Looking ahead, Q2 is seen as coming in strong with the outlook of $1.12-1.14B in revenues vs. the $1.12B consensus. Unfortunately, and quite concerning, FY19 guidance sees revenue of $4.675-4.750B vs. consensus of $4.882B with the adjusted EBITDA margin improving 400-450bps Y/Y.

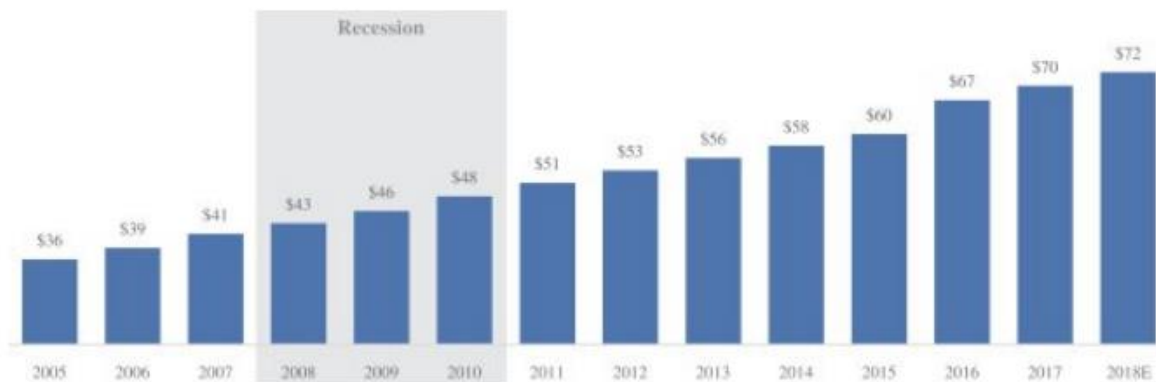
Pros

Chewy is still growing at a solid pace. Revenues came in at over 45% growth Y/Y, margins have improved, average revenue per user continues to track higher which helps greatly with margins alongside strong growth in new customers, auto shipping has grown faster than the overall revs at nearly 56% which also helps with better inventory management, more consistent revenues and better margins as well.

Growth in Net Sales



U.S. Pet Industry Grew During the Recession of 2008 to 2010
(market size, $ in billions)



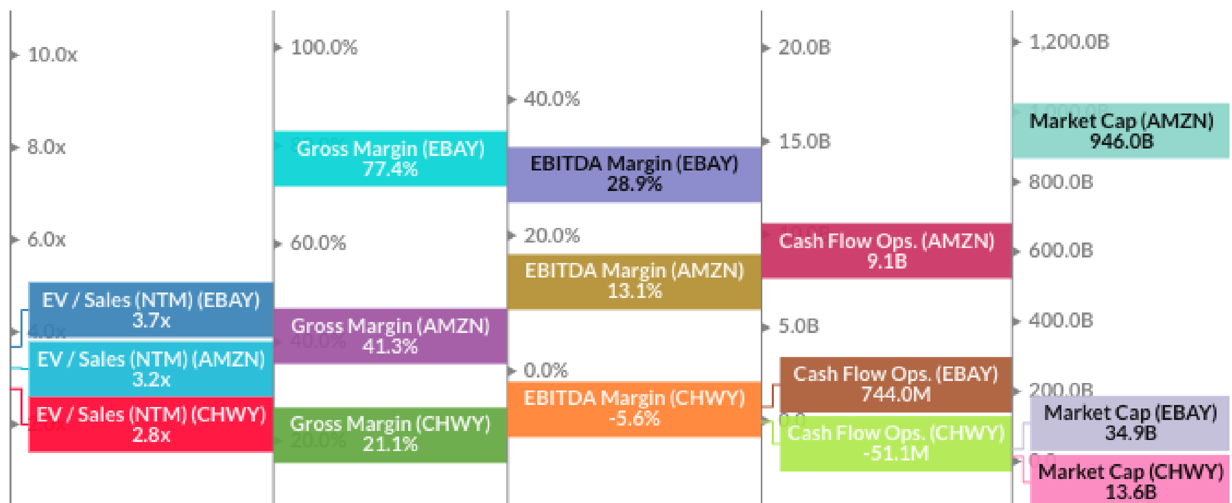
Something a lot of people don't talk about is how recession proof this business is. It is virtually exposed to zero seasonality and economic risks – or at least that's what history teaches us. As seen during the financial crisis, spending in the pet industry actually grew from $48B to $46B to $48B from 2008-2010, all while other businesses were tanking. This speaks volumes and is something investors should keep in mind as CHWY operates in an industry where their customers view their pets as part of their families and will be sure to cut other costs from their budget before looking to cut their pet expenditures.

Cons

Chewy is still operating at a loss, free cash flow burn has gotten worse, cash on hand even after the IPO is still pretty low, gross margins are still very weak, competition is growing fierce with Amazon and Walmart and other smaller players, and guidance for FY19 calls for a pretty big fall in their revenue growth rate to 32-34% Y/Y vs. FY18 (analysts were expecting 38% growth). For better reference, FY18 vs. FY17 saw 68% Y/Y growth. Even with the law of larger numbers, that is pretty substantial. In addition, the company also only had $29M in cash as of the end of Q1 plus the $111M raised from the IPO putting their cash balance around $140M. With a free cash flow burn of around $64M in Q1, we expect CHWY to either tap into their $300M line of credit or do a secondary offering later in the year unless the company can turn things around in time.

Valuation

Chewy is a difficult company to value because the company still does not generate any EBITDA, net income, or cash flow therefore many ratios and valuation methods like EV/EBITDA, P/E, PEG, DCF analysis, can't really be used effectively. From a forward EV/Sales ratio, as you'll see below, CHWY trades at a pretty fair level but the problem is CHWY has pretty awful margins right now and none of the revenue makes its way successfully to the bottom of the income statement.



A simple comparison to other ecommerce companies like eBay and Amazon, shows us a few things. Yes, CHWY trades at 2.8x forward EV (Enterprise Value)/Sales which is cheaper than AMZN at 3.2x and EBAY at 3.7x but we notice quickly that revenue doesn't tell the whole story.

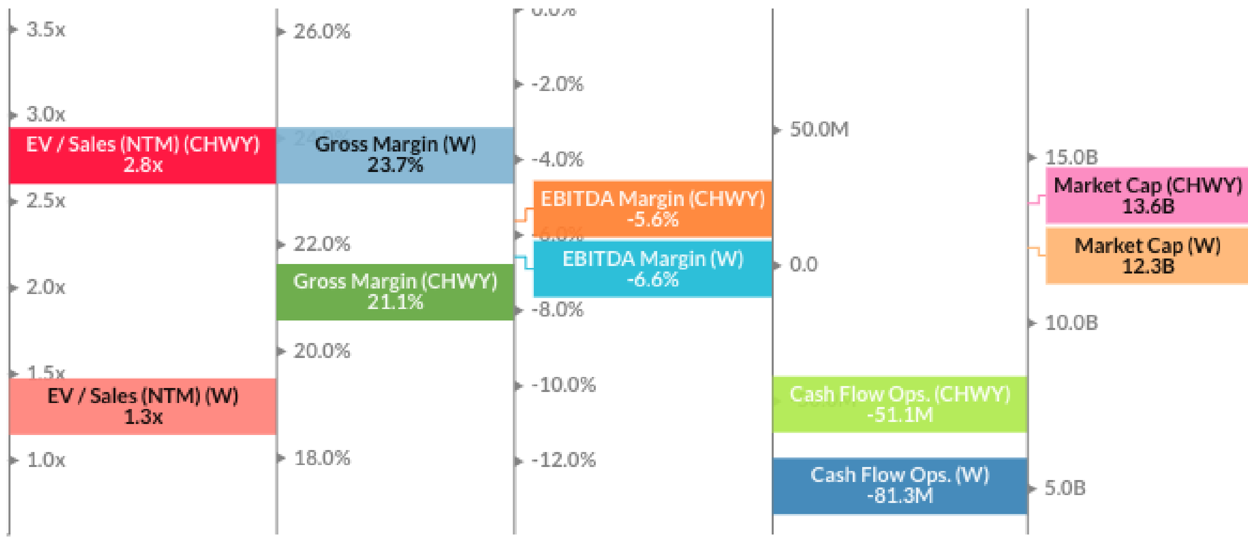
CUBE gets it. CHWY is in growth mode and needs to be spending their money on sales, general, and admin, along with marketing and promos to keep gaining market share. That's completely understandable and why we don't have a problem that they are not cash flow positive, profitable, or even draw in EBITDA (even though they should be). What concerns us is how gross margins only stand at 22.9% (from most recent quarter).

Gross profit is the profit a company makes after deducting the costs associated with making and selling its products, or the costs associated with providing its services. So before we even get to those costs mentioned above that CHWY is spending a lot on to grow the business, they are already losing out nearly 80 cents on the dollar just from their costs of goods sold. For FY19, CHWY gave guidance that said expect adjusted EBITDA margins to grow 4-4.5% but that's not saying too much as right now their adjusted EBITDA margins are -1.4% so by year end it should be closer to 3-3.5%.

CUBE's thing is, how about the gross margins? These costs are much harder to cut because they are associated directly with cost of the goods themselves. To put it another way, if CHWY said in their board meeting that they are going to stop marketing and fire every single person in the office and just run the company bare bones it still wouldn't bring home better margins than EBAY. What this makes us wonder is, when revenues eventually do slowdown how will CHWY sustain themselves? How good can profits actually get? What about when new competitors enter the business because CHWY certainly does not have a moat around their business? Will they ever be able to pay a dividend or start a share buyback program? These are things CUBE thinks about as we naturally look at investments in the long-term.

Before we wrap up there is one connection we want to make that is very similar to CHWY. There is a very strong possibility that CHWY is the next Wayfair (W) but with much less room to run.

Why make this connection? Wayfair is another low margin ecommerce company that sells home goods and has been growing revenues pretty consistently over the last 5 years and has seen its stock rise from $20 to as high as $173.



If you look above, the companies have virtually identical numbers. While not on the graph, Wayfair actually does $7B in revenue vs. CHWY's $3.9B. The problem here is that when Wayfair went public they were a $2-3B company which has allowed the stock to 6x without becoming too large of a corporation for people to shake their head at. If CHWY were to 6x from here in the next 5 years they would be an $81B company which is highly unlikely.

The point that's being made here is that CHWY can continue its run up but doesn't provide the same potential as Wayfair as they are already trading at a much steeper valuation right out of the IPO gate.

In order for the company to get into the $45+ range they MUST keep their revenues growing above the magical 30% mark that Wall Street has grown to love and hold firm on. If come end of year, CHWY gives a guidance for FY20 that's below 30% this could spell trouble and the issue is that it looks likely given the fact that guidance for this year is already down to 32-34%.

All in all, this is not an investment CUBE will be making. We love the what the company does and may even be a customer at some point, but the abysmal gross margins, growing competition, cash burn, and worry that revenues are going to slow to sub 30% have me on the sidelines as the upside doesn't look like enough to outweigh the risk. If CHWY can get some margin expansion and tap into the growing emerging markets to take growth to the next level then we might have something but the counter to that is that the Street might be pricing that in at a near $14B valuation already.

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Technical Analysis

CHWY stock is looking strong from the bottom it made last week in the high $20's. Short-term the stock is facing a tough wall of resistance as this level has been rejected twice now plus it's pressing hard against the upper Bollinger band channel and is overbought on RSI and W%R. I think it gets sold down to retest the trend line which would be around $32.75. At that point, if the stock does break below that trend line it could revisit the $30 mark. If it holds, it will most likely try again for the wall at $34.20-34.50.

Long-term, CUBE always believes the fundamentals prevail and will therefore depend solely on CHWY's ability to keep revenues growing above 30% as well as expand margins.