



CONSUMER AND RETAIL GROUP

# PAWS FOR CONCERN: PET SPECIALTY RETAIL AT A CROSSROADS

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The COVID-19 pandemic ushered in new and accelerated old consumer trends, behaviors and demands in many product categories. Pet was one of the categories that saw a dramatic uptick in demand for pet supplies and services as approximately 23 million U.S. households adopted a new pet during pandemic times. Not only did it mean a period of rapid growth for the industry but also a flurry of investments from private equity funds to capitalize on the growth trend. As the pandemic has subsided, however, the tide has turned sharply in the last twelve months, with Pet experiencing slowing growth, declining profitability and plunging stock prices. In this article, we focus on Pet Specialty Retailers who have been the hardest hit by the downturn with stock prices plunging 80-90 percent compared to the highs of 2021.



### Stock Prices Indexed to Jan, 14 2021 - Petco IPO



**Figure 1: Stock price comparison**

Below we lay out the strong headwinds driving Pet Specialty's performance and what it should do to deal with the headwinds, set up for long-term success and reverse the valuation slide currently underway.

## Strong Headwinds for Pet Specialty

The \$147 billion pet market is primarily serviced by three types of retailers – Pet Specialty, Mass and e-commerce Pure Plays (Discount and Club are the remaining retailer types). It is commonly defined that Pet Specialty Retail<sup>1</sup> is any brick and mortar or omni retailer exclusively focused on pet products and services (e.g., Petco, Petsmart), Mass, is mass merchandisers<sup>2</sup> (e.g., Walmart or Target) and e-commerce Pure Play<sup>3</sup> as a company that concentrates on selling primarily online (e.g., Amazon and Chewy).

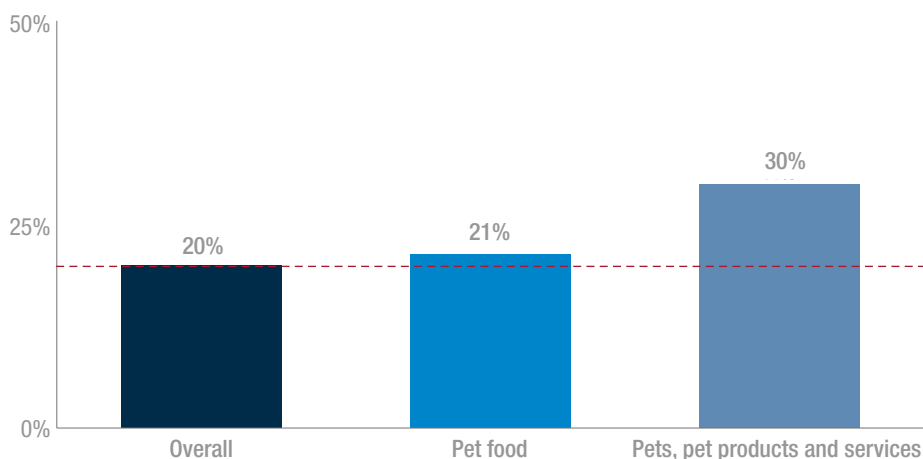
All three types of retailers are experiencing impact of industry slowdown, but the impact on Pet Specialty is significantly more than the other two driven by the following headwinds:

### 1. Overall market slowdown: double whammy of pet adoption slowdown and inflation driven trade downs even in consumables

Post pandemic boom, the number of households with pets declined by two percent year over year, a level not seen since the mid-2010s. While these levels are expected to rebound, pet ownership is only projected to grow at a nominal one percent compound annual growth rate (CAGR) over the next five years. From a sales perspective, Pet industry is projected to grow at 2.7 percent in 2024 compared with 7.6 percent in 2023.

Compounding this slowdown is inflation-driven trade down to value, even in consumables, which is driving down average unit prices and profitability. The cost of pet ownership has increased faster than overall inflation since 2020, as shown in the chart below. Driven by the increase in cost of ownership and reduced consumer confidence, pet owners are often turning to value and private brands even in consumables, surprising many industry experts and investors. This was emphasized on the 3Q23 Petco earnings call<sup>4</sup>, as they acknowledged that 50 percent of their services consumers were not buying their consumables (e.g., pet food or treats), due to limited value product assortment and pricing concerns. The trade-down effect is even more prevalent in hard goods (e.g., beds, toys, leashes) market, with consumers often turning to low-cost alternatives from Amazon, Walmart, or ultra-low-priced marketplaces like Temu.

### Inflation: Feb 20 vs. Feb 24 %Change



Source(s): Bureau of Labor Statistics; A&M analysis

**Figure 2: Inflation Feb 2020 vs. Feb 2024**

<sup>1</sup> Pet Stores Definition | Law Insider

<sup>2</sup> Mass Merchandiser - Definition & Meaning | Marketing Overview | MBA Skool

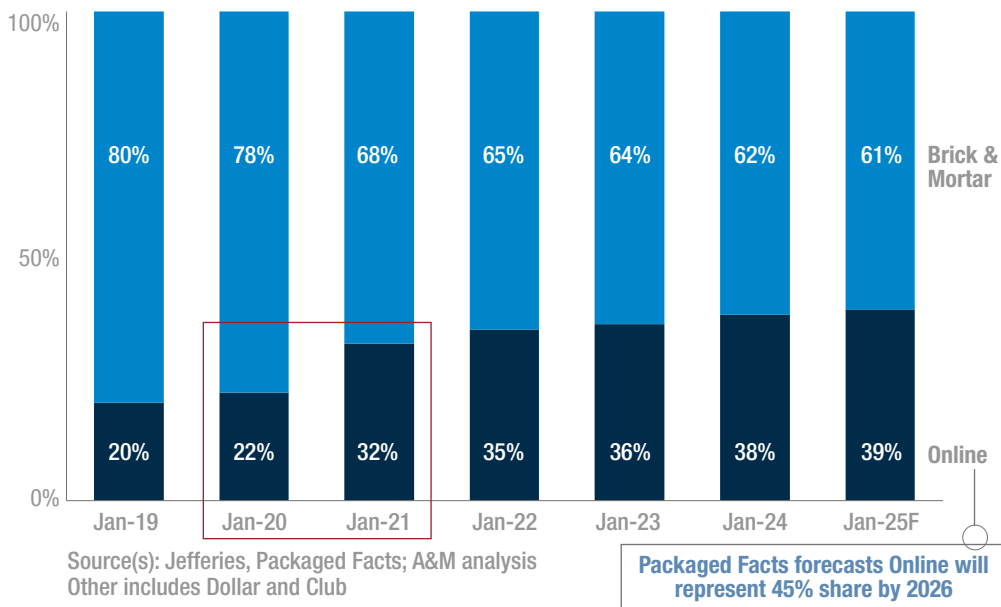
<sup>3</sup> Pure Play - Meaning, Examples (E-commerce/Retailers), What is it? (wallstreetmojo.com)

<sup>4</sup> Petco Third Quarter 2023 Earnings Call - webinar.net

## 2. E-commerce continuing its relentless market share gain

The long-term trend of growth in e-commerce market share was turbocharged by the pandemic, growing from 22 percent to 32 percent in less than two years. Even as the pandemic has subsided, e-commerce continues to outpace brick and mortar growth and is expected to grow to 40-45 percent of the pet market by 2026.

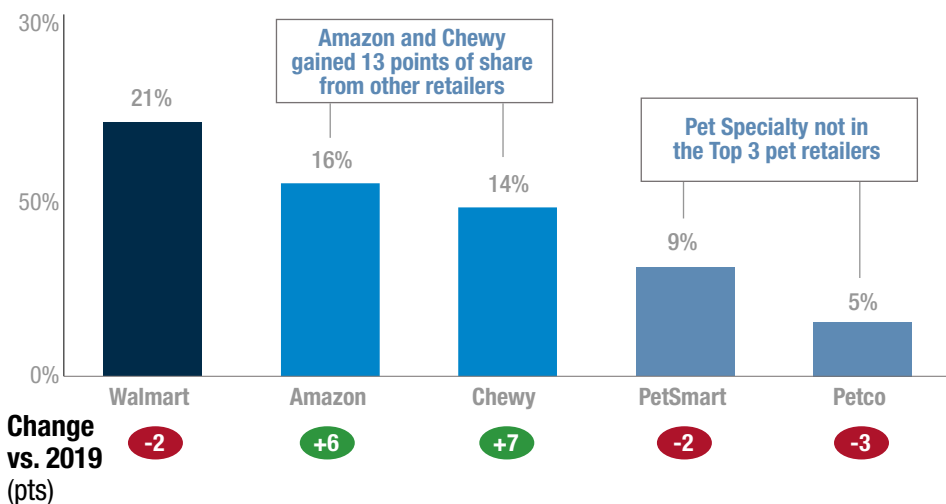
### Pet spend by channel (2019 – 2025F, %)



**Figure 3: E-commerce vs. Brick and Mortar, 2019 – 2025F**

As the above chart shows, this shift to e-commerce<sup>5</sup> has been led by e-commerce Pure Plays Amazon and Chewy who own over 80 percent of all U.S. e-commerce pet sales, having gained an additional 13 percent market share from Mass and Pet Specialty since 2019. E-commerce Pure Plays continues to grow faster than Pet Specialty, driven by better assortment, lower prices and better customer experience.

### Retailer Market Share (2023, %)



**Figure 4: Retailer market share**

<sup>5</sup> Jefferies, Packaged Facts; A&M analysis



## Amazon leading in hard goods (Dog Beds):

Based on dog bed search results (on 2/28/24)

Dog food		Petco	PetSmart	Chewy	Walmart	Amazon
Assortment	Brands	107	42	129	150+	200+
	Products	932	528	842	4,954	3,000+
	4-star+ products <small>4-star+ 3-star &amp; lower</small>	447	194	469	1,372	2,000+
Price	Pricing (Top 10 prod)	\$44.1	\$37.0	\$37.8	\$24.7	\$38.0
Customer Experience	Clicks to purchase (for members)	5	6	5	4	3
	Loyalty	Vital Care, Repeat Delivery	Treats, Autoship	Autoship	Walmart+, Subscribe	Prime, Subscribe & Save
	Delivery	Same Day	Same Day	1-3 Days	Same Day	Same Day

Source(s): Amazon, Chewy, Petco, PetSmart, Walmart web site; A&M analysis

Note: Petco, PetSmart, Walmart, and Chewy pricing based on average price of top 10 products; Amazon pricing based on proprietary ASP estimations  
Brands at Amazon, Walmart based on number of products and average products per brand (14.2 products on Amazon, estimate 200+; 33.9 products on Walmart, estimate 150+); Chewy, Petco, PetSmart based on number of brand filter options

Products at Walmart based on estimate of products per search page times number of search pages (max 25); Amazon, Chewy, Petco, PetSmart based on number of search results

### Figure 5: Hard goods, Dog Beds comparison

In dog beds, Amazon leads with a wide assortment of over 3,000 options and 67 percent 4+ star rated products, three times the offerings of Pet Specialty, with prices that are 17 percent lower on average and a more seamless shopping experience.

Amazon's third-party marketplace model allows sellers from China to directly sell to U.S. customers at extremely low prices. This is especially important in hard goods like dog beds where customers do not have a strong affinity for brands and competition is primarily on price. Amazon has invested and continues to invest in growing its marketplace by actively recruiting new sellers and driving competition and lower prices on its platform. Walmart also has a growing marketplace and new marketplaces like Temu which sell ultra-low (<\$10) price products are growing rapidly.

## Chewy leading in consumables (Dog Food):

Based on dog food search results (on 2/28/24)

Dog food		Petco	PetSmart	Chewy	Walmart	Amazon
Assortment	Brands	90	50	268	210	250+
	Products	2,246	1,716	4,412	2,700	7,000+
	4-star+ products	 1,831	 1,484	 3,491	 1,372	 4,000+
	4-star+ 3-star & lower					
Price	Pricing (Top 10 prod)	\$50.6	\$44.6	\$41.2	\$31.1	\$42.7
Customer Experience	Clicks to purchase (for members)	5	6	5	4	3
	Loyalty	Vital Care, Repeat Delivery	Treats, Autoship	Autoship	Walmart+	Prime, Subscribe & Save
	Delivery	Same Day	Same Day	1-3 Days	Same Day	Same Day

Source(s): Amazon, Chewy, Petco, PetSmart, Walmart web site; A&M analysis

Note: Petco, PetSmart, Walmart, and Chewy pricing based on average price of top 10 products; Amazon pricing based on proprietary ASP estimations. Brands at Amazon, Walmart based on number of products and average products per brand (27.8 products on Amazon, estimate 250+; 12.9 products on Walmart, estimate 210+); Chewy, Petco, PetSmart based on number of brand filter options; Products at Walmart based on estimate of products per search page times number of search pages (max 25); Amazon, Chewy, Petco, PetSmart based on number of search results

### Figure 6. Consumables, Dog food comparison

Chewy leads with a wide assortment of 268 brands compared with 90 in Pet Specialty and serves all segments from value to super premium. It has over 3,400 4+ star rated products (twice the amount of Pet Specialty) and, on average, 23 percent lower prices along with seamless customer experience. Amazon is prioritizing pet consumables and investing in growing its assortment and incentivizing customers to sign up for Subscribe & Save (the equivalent to Chewy's Autoship). We anticipate increased competitive intensity from e-commerce Pure Plays in consumables.

As e-commerce share has grown from 20 percent in 2019 to 36 percent in 2023, Pet Specialty physical store count has stayed largely constant which currently stands at 6,000+ across top 25 Pet Specialty retailers.<sup>6</sup> The omni-channel Pet Specialty retailers have leveraged their store network to service e-commerce demand, but their e-commerce sales penetration is estimated to be 15-20 percent of total which is much lower than total market penetration of 36 percent and store traffic in every quarter over the last two years has declined year-over-year.<sup>7</sup> Hence, the continued market share gain of e-commerce Pure Plays, hurts Pet Specialty even more as the existing store asset base becomes less productive.

<sup>6</sup> Top 25 Pet Retailers in North America (petbusiness.com)



### 3. Heavy investments by mass market to drive growth

While e-commerce continues to take market share, Pet Specialty Retail is also being beaten at their own brick and mortar game by mass market retailers like Walmart and Target. Walmart, the largest pet retailer in the U.S. with a 21 percent market share, has responded to the e-commerce challenge by not only focusing on growing its online marketplace but also investing in in-store and omni experiences to build a moat against e-commerce Pure Plays.

Walmart has invested over \$8 billion in the last two years to automate segments of its supply chain, improve store and warehouse inventory accuracy and management, reduce e-commerce order fulfillment steps and geofence stores for a seamless Buy Online, Pick Up in Store (BOPIS) experience. In 2023, Walmart completed a successful remodel pilot, with state-of-the-art store displays, digital touchpoints and streamlined checkout process that transforms the in-store experience. Walmart will invest \$9 billion in 2024 to remodel 1,400 U.S. stores.<sup>8</sup> Other mass merchandisers are following suit – Kohl's has launched niche pet assortment, Target has initiatives for supporting pet brands e.g., Target Takeoff – marketing and analytics support for newer pet brands.<sup>9</sup> Pet Specialty's ability to respond to these investments and initiatives are likely constrained by capital.

### 4. Pet Health and Wellness, a stronghold of Pet Specialty, is starting to become the new battleground

Pet health and wellness is a high margin business which has attracted competition from both Mass and e-commerce Pure Plays. While Pet Specialty Retailers have first-mover advantage (Petco has 250+<sup>10</sup> in-sourced veterinarian clinics, PetSmart has 700+), entrants like Walmart and Chewy are putting significant focus and resources to grow in this category.<sup>11</sup>

In 2023, Walmart opened a pet clinic staffed by PetIQ (a pet health and wellness provider) in Duluth, Georgia.<sup>12</sup> While expansion plans are not confirmed, a successful pilot will likely lead to it. During its 2023 Investor Day, Chewy laid out plans to open four to eight clinics in the next year with an in-sourced staffing model.<sup>13</sup>

Chewy has broader ambitions in health and wellness – it aspires to become a vertically integrated healthcare payer and provider. Chewy offers its own insurance, provides telehealth services, operates a pharmacy marketplace and an integrated software-as-a-service practice management system. With vet clinics, it can offer end-to-end pet health and wellness.<sup>14</sup>

Pet Specialty Retail faces stiff headwinds in this segment, and its vantage position is under threat as the competition intensifies.

<sup>7</sup> Placer AI

<sup>8</sup> Walmart 2022, 2023 Annual Reports (walmart.com)

<sup>9</sup> Target Accelerators (target.com)

<sup>10</sup> Petco discussions

<sup>11</sup> PetSmart launches new veterinary service model (chainstoreage.com)

<sup>12</sup> Walmart opens pet center with veterinary care and grooming (cnbc.com)

<sup>13</sup> PowerPoint Presentation (q4cdn.com)

<sup>14</sup> Pet Food, Products, Supplies at Low Prices - Free Shipping | Chewy.com

## What should Pet Specialty do?

With the slowdown in the market, changing customer preferences, continued growth of e-commerce and intense competition in all segments from competitors with deep pockets, Pet Specialty and investors find themselves at a crossroad with tough choices to make. The magnitude of the challenge requires a holistic review of the business strategy that sets in motion a transformational program for long-term success.

More specifically, Pet Specialty should focus the holistic review and transformation program in the following three areas:

### 1. Rapid actions to address growth decline in short-term:

As e-commerce Pure Plays gain share and consumers trade down, immediate action is needed to stop the decline. For example – ensuring the right assortment mix is available in-stores and online. For consumables, ensuring the right mix of super premium, premium and value is important. For hard goods, completely rethinking the assortment as low-priced marketplace sellers will continue disrupting this space (e.g., hence increasing private label penetration and introducing lower priced items), and lastly, identifying opportunities to expand current state e-commerce capabilities to increase sales and slow the decline.

### 2. Envision the desired future state and invest in it:

Given the market dynamics, Pet Specialty must define a clear vision of the future state of omnichannel Pet Specialty retailer and invest in it. Defining the future state in the following seven areas and investing in it will help the sector prepare for its next phase of growth: (1) future state omnichannel customer experience along with targeted e-commerce penetration and profitability, (2) the store of the future and in-store customer experience for products and services, (3) future state store network in light of e-commerce growth, (4) value proposition of the loyalty program of the future, (5) operating model for pet health and wellness (e.g., in-source vs. outsource), (6) new revenue streams (e.g., advertising to monetize online and in-store traffic) and (7) corporate operating model.

### 3. Fund the investment in future state:

To fund the investment in future state, Pet Specialty must take a hard look at its cost structure and aggressively pursue optimization opportunities; select examples include redesign of contra programs with vendors, cost of goods sold (COGS) sourcing optimization for private label products and deep review of all areas of selling, general, and administrative expenses (SG&A) to identify and execute cost savings initiatives.

We have deep expertise in driving holistic review and end-to-end transformations for retailers including Pet Specialty and can help Pet Specialty retailers start their transformation journey rapidly.

**Please email [Abhinav Chandra \(achandra@alvarezandmarsal.com\)](mailto:achandra@alvarezandmarsal.com) with any questions.**

In the next article to be published in May 2024, we will provide our perspective on pet food and supplies manufacturing.





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