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Greencross 10/12/2013 **FAT-AUS-653**

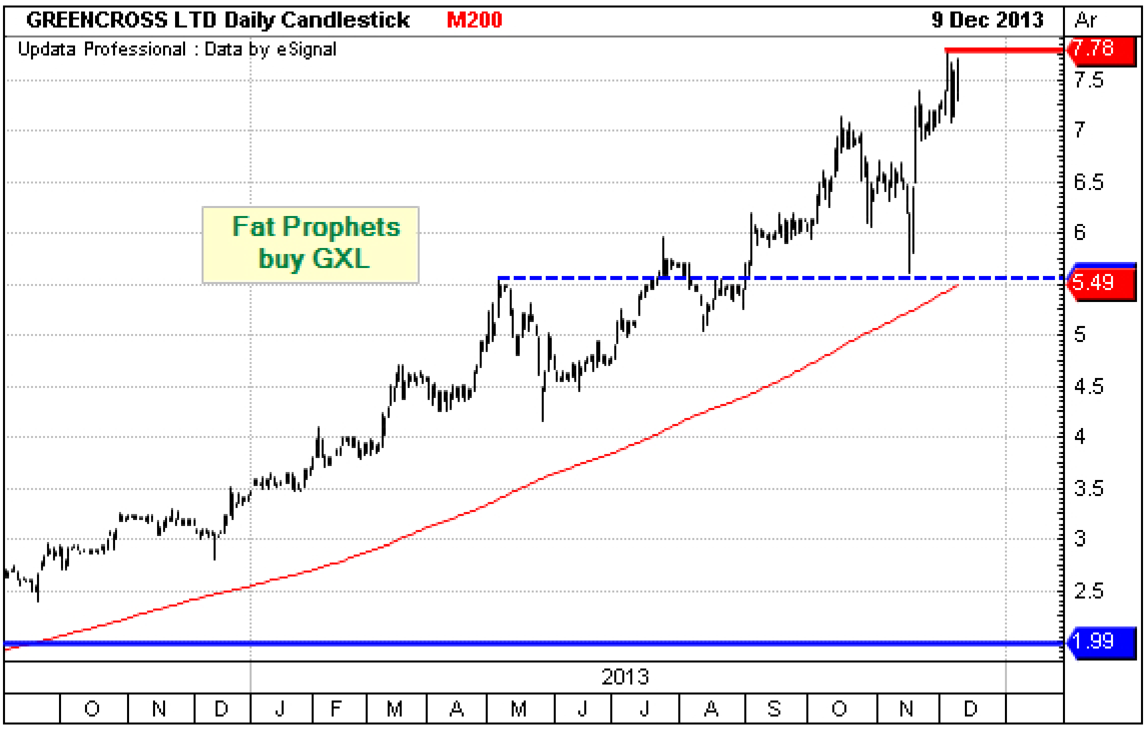
GXL AUD $7.29 Spec. **HIGH** **B**

The best of friends

Fragmented industries can create profitable opportunities for the brave, and this has certainly proven to be the case for Greencross (ASX: GXL). **The veterinary services provider has grown impressively through acquisitions in recent years, delivering compound annual growth rates in revenues and earnings of 29 percent**. However, the company's successful model of rolling up vet clinics still has plenty of room to expand, with less than 6 percent of the available revenue market share in Australia.

The company's growth profile could also be turbo-charged further by a proposed tie up with Petbarn, the largest wholesaler of pet products in Australia. Petbarn also boasts a robust revenue and earnings profile, and the merger will create strong synergies between the two businesses.

We are attracted by the growth proposition which Greencross already represents in in isolation, and believe this will be only further strengthened by the proposed combination with Petbarn. **We are therefore adding the stock to the Fat Prophets Portfolio and recommending as a buy around current levels to all Members.**



About Greencross

The creation of Greencross was enabled by deregulation of the veterinary industry which removed the limitation of business ownership to veterinary professionals. This, combined with a growing willingness by people to spend more on vet procedures to prolong the life of their pets, has underpinned the company's growth over the past five years.

An aggressive acquisition strategy over the past five years has seen Greencross evolve to having 85 general practices, 9 specialist/emergency centres and 4 labs.

Location		General Practices	Specialty/ Emergency	Lab Centres
QLD	Brisbane	17	1	2
	Townsville	6	–	–
	Gold Coast	16	1	1
	Toowoomba	4	–	–
	QLD Regional	3	–	–
NSW	Sydney	6	–	–
	Central Coast	7	1	–
	Wollongong	4	–	–
	NSW Regional	2	–	–
VIC	Melbourne	18	4	1
SA	Adelaide	2	2	–
TOTAL		85	9	4

Source: Company Presentation

Financial results
Management have carried out a roll up strategy at a decent pace over the past five years, but have also done so in a disciplined and selective manner. The pay off here has been reflected in an impressive increase in key financial metrics, as borne out by the latest results.

In the year ended 30 June 2013, Greencross delivered underlying revenues of $106.7 million, up 29.6% on the prior year. Growth at the top line was eclipsed by gains at the bottom, with full year earnings (NPAT) of $6.4 million, 34.8% higher than the year before.

Financial Summary	F12 Actual	F13 Actual	Increase
	$'000	$'000	%
Revenue	82.3m	106.7m	29.6
Underlying EBITDA	11.1m	14.5m	30.7
Underlying NPAT	4.7m	6.4m	34.8
Underlying Basic EPS	15.39 cents	18.71 cents	21.6
Dividends Per Share	8.00 cents	10.00 cents	25.0
Operating Cash Flow	8.2m	10.9m	31.8

Note: Underlying figures exclude adjustments for deferred purchase payments, one-off acquisition costs and set-up costs in relation to the new Vepa Labs business.

Source: Company Presentation

Acquisitions have certainly spurred growth but management have also been able to eke out efficiencies from existing sites. Same clinic revenue and EBIT growth for the year was 5.8% and 10.3% respectively.

Helping to bolster the numbers has been the successful marketing and take-up of the company's 'Healthy Pets Plus' program. Under the plan, members pay $440 a year which allows them to have a host of consultations and a range of discounts on pet foods, medication and supplies. There are currently around 15,000 members on this plan, and management expect this to grow to 20,000 within the next 12 months.

Outlook

Greencross has clearly been able to successfully execute on the acquisition strategy to date and no surprise it is not holding back here. The company is looking to acquire between 10-20 clinics over the course of the next year with target multiples of 3.5 to 4.5 times EBIT.

Management have made six acquisitions since the middle of June. They have forecast that new acquisitions and start-ups will boost revenue and EBIT by $30.4 million and $4.2 million respectively.

Acquisitions meanwhile have not blown out the balance sheet with gearing set to remain below 65%. This is as the company has reached a scale whereby acquisitions can now be funded out of free cash flow rather than debt. A placement to fund an acquisition earlier in the year has seen cash on hand increase to around $8.8 million at year end.

Setting aside the proposed merger discussed below, management are also confident that a combination of acquisitions, plus further organic efficiencies, will see earnings grow by another 20% over the next 12 months.

Earnings gains are also being passed through to shareholders as well now with Greencross lifting the dividend to 10 cents for the full year, equating to a 54% payout ratio.

Whilst Greencross has executed admirably on an acquisition strategy to date, there is certainly more left on the table in our view. The company has just 3.5% of the locations and 5.7% of the veterinary revenue in Australia, leaving ample room to grow.

Merger

The scope for still significant growth, and possible synergies, has no doubt been central to Greencross recently agreeing to a merger with another major player in the pet industry.

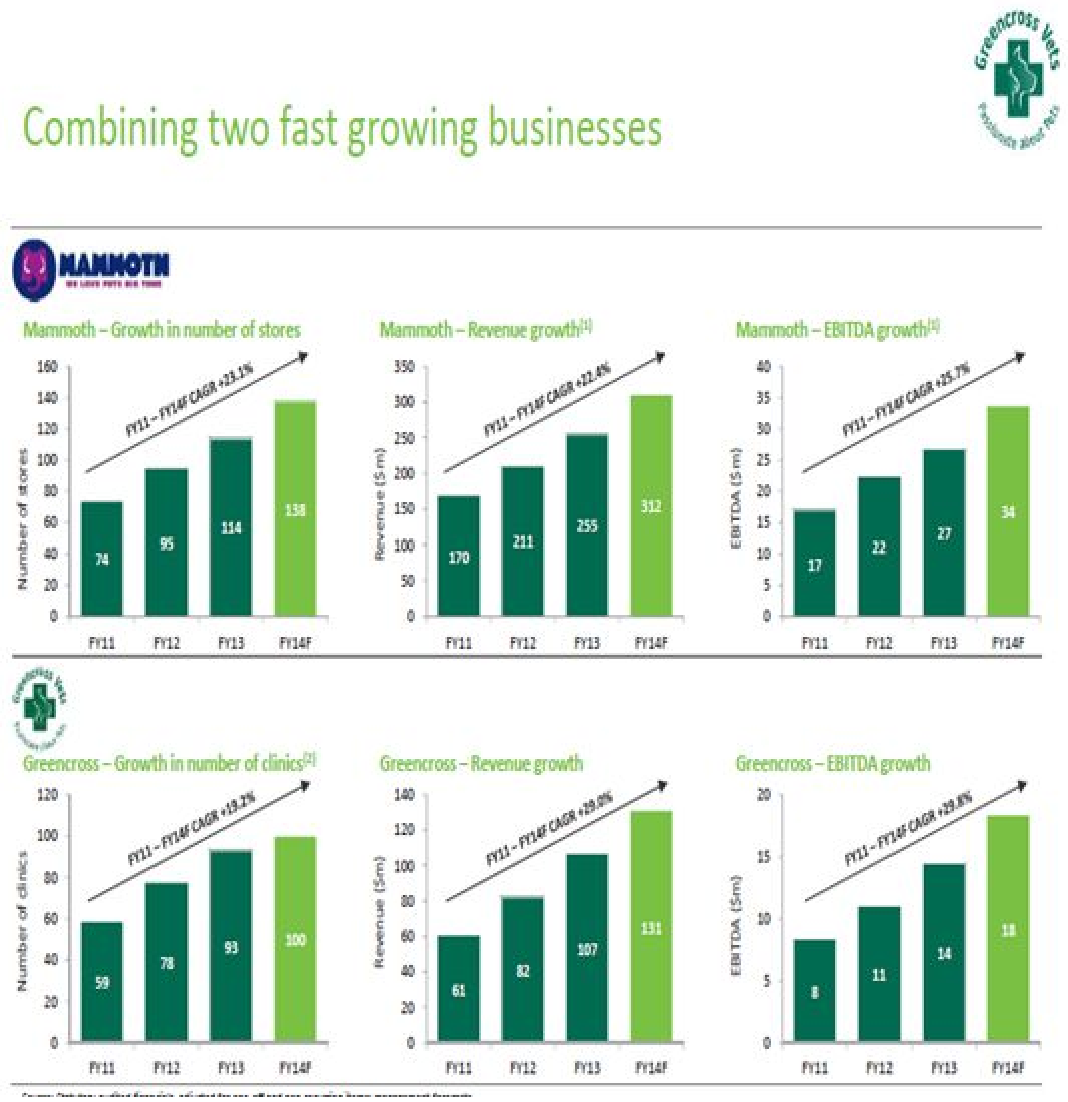
Management have announced an agreement to merge with Mammoth Pet Holdings, acquiring 100% of the company in exchange for 52.6 million shares (or 58.2% of the merged company's issued securities) in Greencross.

Mammoth operates pet shops under the Petbarn brand in Australia and Animates in New Zealand. The company's beginnings go back to the first Petbarn store in Sydney 30 years ago. The company now has 100 Petbarn stores in Australia and 24 in New Zealand under the Animates banner.

The combination with Petbarn would create the leading integrated retail pet care company in Australia, and would open up a host of substantial synergies in our view. The new entity would have 124 stores and 100 vet clinics across Australia and New Zealand. **The deal will give the company pole position in the pet care industry in Australia, which is estimated to be worth around $7 billion.**

We believe the merger makes sense on a myriad of levels, not least because both businesses are growing at robust rates, have a history of strong financial performance, and have successfully executed on acquisitions and store rollouts.

Mammoth has achieved average annual growth rates in revenue and earnings over the last three years of 22.6% and 25.4% respectively. Like for like sales growth at Petbarn was also strong last year at 8.5%. Mammoth is forecasting revenues this coming year of $312 million and EBITDA of $34 million.



Source: Company Presentation

There is also significant scope for Petbarn to grow. The company has around 4 percent of the pet care and pet services market (excluding veterinary services) and is looking to grow this to 20 percent over the longer term.

The merger should also translate into significant market share gains for the combined entity, and much more so than if either were to go it alone. The merged company will be able to provide an 'integrated retail and services offering' to customers. Whilst this would be a first for Australia, such a model has proven highly successful in other markets such as the UK (an example being Pets at Home) and the US (as evidenced by PetSmart).

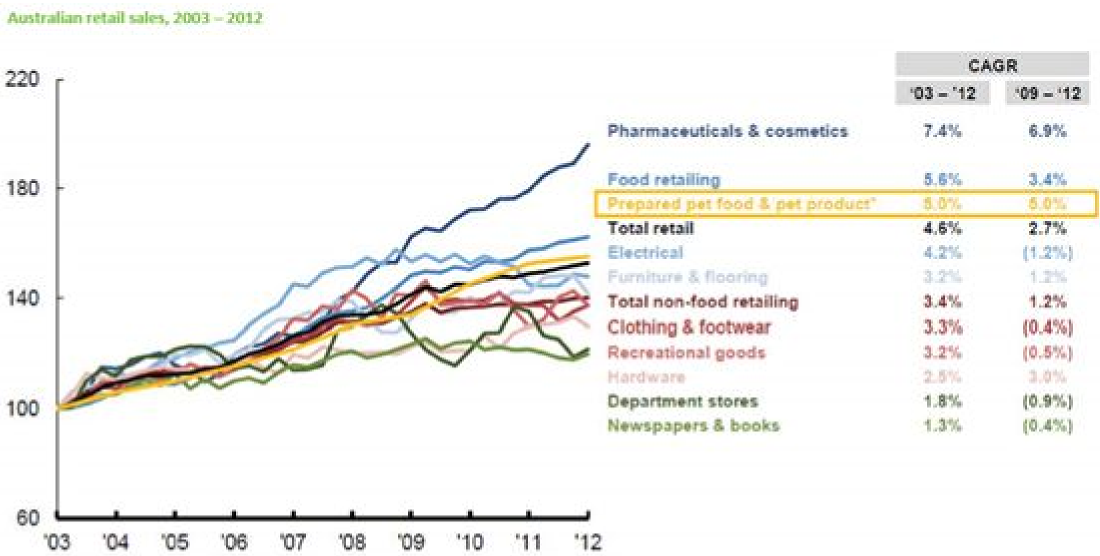
The deal will also significantly bolster the distribution reach for Greencross. Petbarn's own membership program 'Friends for Life' has around 1.1 million members.

The combination will also generate significant efficiencies, and bolster cross selling opportunities in a fragmented market. **Management also unsurprisingly expect material synergies to be extracted from the merger**. Expectations are that it will be earnings accretive in the first year (with $1.5 million in annualised cost synergies), and will deliver 'double digit EPS accretion' in the 2015 financial year.

The deal will significantly increase the geographical footprint of both businesses which will foster market share gains. In additional to cross selling initiatives, the plans include co-locating Greencross clinics in existing and new Petbarn stores.

Source: Company Presentation

The added benefit is that the companies are in a segment which is also growing strongly. As the chart below shows the pet specialty retail sector has outperformed most other retail categories over the past decade.

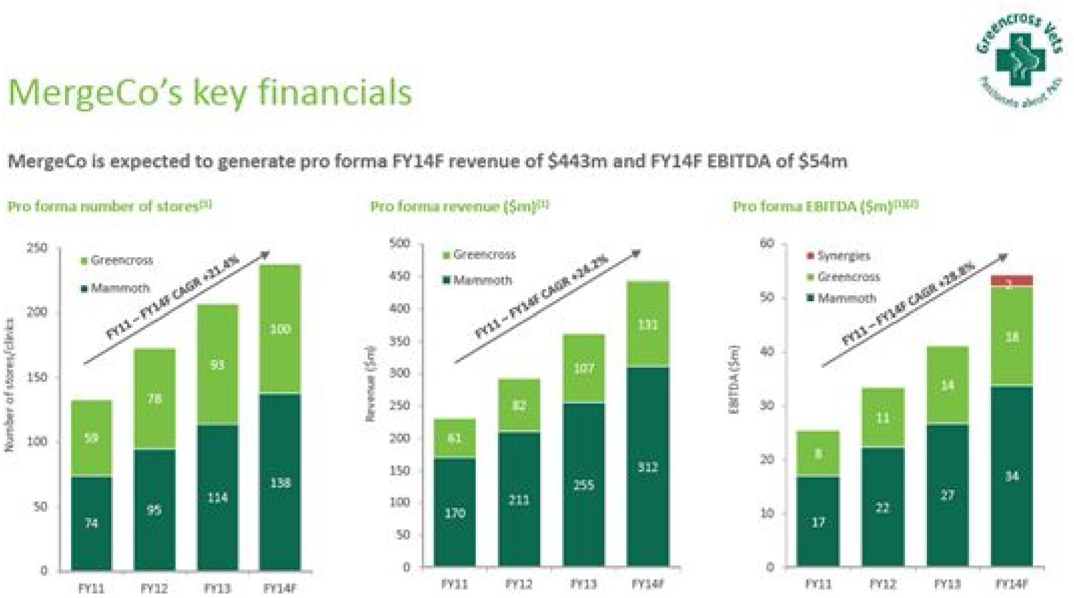


Source: Company Presentation

This is as Australia has one of the highest rates of pet ownership in the world with 63% of households owing a pet, and the average spend per year is increasing. Other trends at work include the increasing humanisation of pets, and growing awareness of the importance of pet nutrition and health.

Meanwhile, a highly fragmented market landscape (both companies have less than 6% of their respective markets) offers up significant opportunities for the combined company, especially with respect to market share gains. Interestingly, comparative leading entities in the US and UK have 18% and 11% of their markets, respectively.

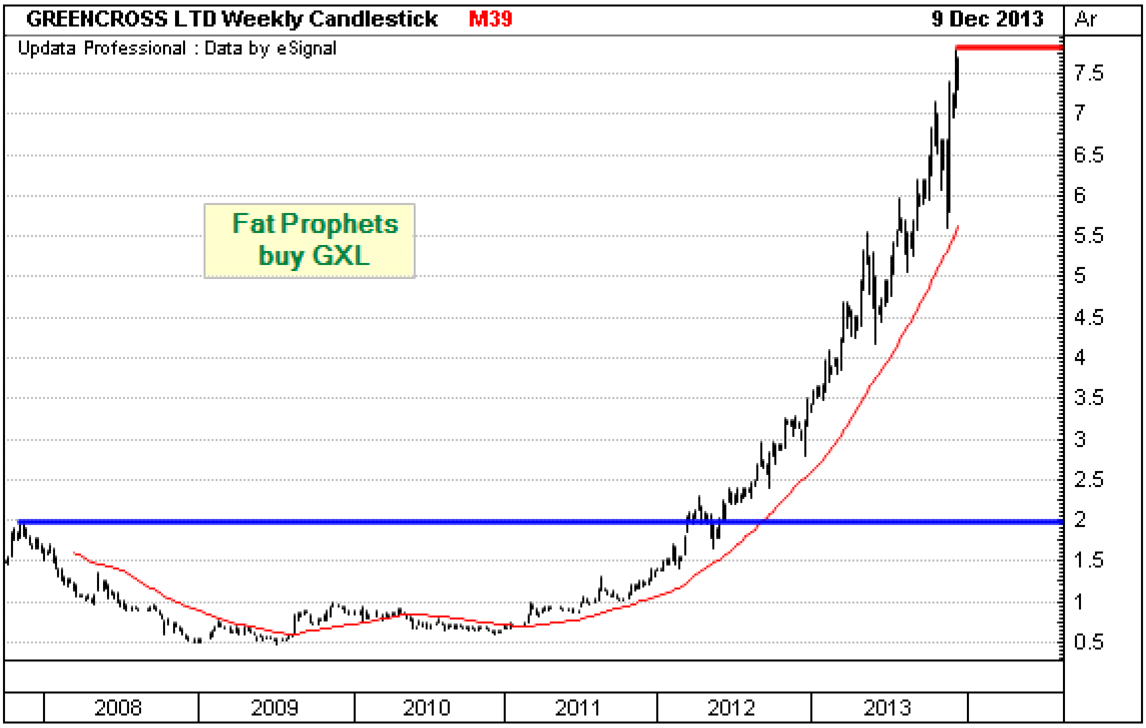
From a financial perspective, the combined entity would have revenues of around $440 million and EBIT of around $40 million. Assuming an end market cap of $600 million, the combined entity would be valued on a forward earnings multiple of around 27 times. On the face of it, this would not seem overly cheap but the fact that both businesses look to be comfortably delivering earnings growth of 20 percent or greater bolsters the appeal greatly. This is also before factoring in the significant cross selling and market share gains as a result of the combination.



Source: Company Presentation

The enlarged company's share price should also benefit from additional institutional support and a wider market following post the merger.

The deal is subject to shareholder approval in late January and we believe the merger will prove highly successful if it goes through.



From a technical perspective, Greencross remains in an overall uptrend. The shares have notably continued their ascent after successfully taking out May's highs, finding support at the previous break out level of $5.49. With little resistance above, we believe there is a strong possibility that upward momentum will continue.

Summary

We are attracted by the growth proposition which Greencross already represents in isolation. We believe this will be only further strengthened by the proposed combination with Petbarn.

The integrated nature of the new business will be a first for Australia but has successful form in other countries such as the UK and US. The combined entity will benefit from a significantly expanded geographical footprint, operational synergies and cross selling opportunities.

Meanwhile, we do not regard the valuation of Greencross (either in isolation, or following the merger) as demanding given the company's enviable track record of earnings growth, and the prospective market share gains on the table.

We are therefore adding Greencross to the Fat Prophets Portfolio and recommending it as a buy around current levels to all Members.

Disclosure: Greencross is held within the Fat Prophets Concentrated Australian Share and Australian Small & Mid Cap Models.

STV Group, Sylvania Platinum, Tata Motors, Tencent, Tertiary Minerals, Teva Pharamaceutical, Toyota Motor, Tullow Oil, Unilever, Vedanta Resources, Vodafone, Walt Disney, Zillow.

Snapshot GXL

Greencross

Latest Closing Price: $7.29

Greencross (GXL) is a veterinary service provider which has grown impressively through acquisition in recent years, delivering compound annual growth rates in revenues and earnings of 29 percent. Meanwhile the company's successful roll up model of vet clinics has plenty of room to expand, with less than 6 percent of the available revenue market share in Australia.

The creation of Greencross was enabled by deregulation of veterinary industry which removed the limitation of business ownership to veterinary professionals. This, combined with a growing willingness by people to spend more on vet procedures to prolong the life of their pets, has underpinned the company's growth over the past five years.

The company's growth profile could also be turbo-charged further by a proposed tie up with Petbarn, the largest wholesaler of pet products in Australia. Petbarn also boasts a robust revenue and earnings profile, and the merger will create strong synergies between the two businesses.

Market Capitalisation:$277m

	FY1	FY2
Price to Earnings	28.0	23.2
Dividend Yield (%)	1.9	2.1
Price to Book	11.4	10.0
Return on Equity (%)	4.7	9.6
EV/EBITDA	6.76	4.11