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Apr 02, 2020

## Patterson Companies (PDCO)

**$14.55** (As of 04/01/20)

Price Target (6-12 Months): **$15.00**

| | | |
|---|---|---|
| Long Term: 6-12 Months | **Zacks Recommendation:** (Since: 03/31/20) Prior Recommendation: Outperform | **Neutral** |
| Short Term: 1-3 Months | **Zacks Rank:** (1-5) | **3-Hold** |
| | Zacks Style Scores: | VGM:C |
| | Value: B \| Growth: F | Momentum: B |

## Summary

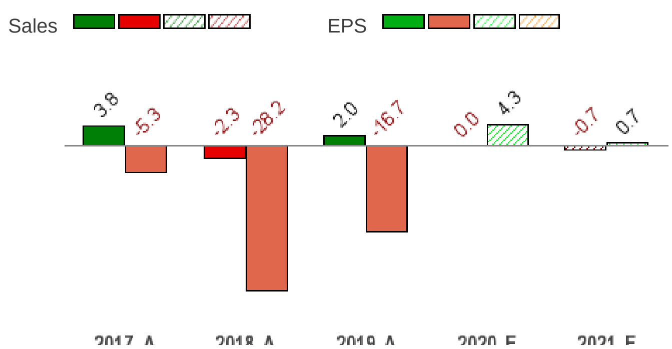
Patterson Companes' consistent efforts to drive profitability in core business were evident from its performance. A broad spectrum of products cushions it against economic downturns in the MedTech space. We believe that a diverse product portfolio, strong veterinary business prospects, accretive acquisitions and strategic partnerships are acting as the primary catalysts. On the back of strong performance, the company raised outlook for fiscal 2020, thereby instilling investor optimism in the stock. Patterson Companies ended third-quarter fiscal 2020 on a strong note,wherein both earnings and revenues beat the consensus mark. However, the company witnessed a decline in operating income in the quarter under review. Coronavirus outbreak poses another threat to the stock. Patterson Companies has underperformed the industry in a year's time.

## Price, Consensus & Surprise


## Data Overview

| | |
|---|---|
| 52 Week High-Low | **$25.70 - $12.95** |
| 20 Day Average Volume (sh) | **1,832,175** |
| Market Cap | **$1.4 B** |
| YTD Price Change | **-29.0%** |
| Beta | **1.47** |
| Dividend / Div Yld | **$1.04 / 7.1%** |
| Industry | **Medical - Dental Supplies** |
| Zacks Industry Rank | **Top 22% (55 out of 254)** |
| | |
| Last EPS Surprise | **27.0%** |
| Last Sales Surprise | **2.8%** |
| EPS F1 Est- 4 week change | **-4.5%** |
| Expected Report Date | **06/25/2020** |
| Earnings ESP | **-21.4%** |
| | |
| P/E TTM | **9.7** |
| P/E F1 | **10.0** |
| PEG F1 | **1.8** |
| P/S TTM | **0.3** |

## Sales and EPS Growth Rates (Y/Y %)




## Sales Estimates (millions of $)

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|---|---|---|---|---|---|
| 2021 | 1,245 E | 1,367 E | 1,450 E | 1,441 E | 5,535 E |
| 2020 | 1,329 A | 1,419 A | 1,456 A | 1,409 E | 5,576 E |
| 2019 | 1,336 A | 1,405 A | 1,397 A | 1,437 A | 5,575 A |

## EPS Estimates

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|---|---|---|---|---|---|
| 2021 | $0.25 E | $0.34 E | $0.40 E | $0.41 E | $1.47 E |
| 2020 | $0.27 A | $0.39 A | $0.47 A | $0.34 E | $1.46 E |
| 2019 | $0.26 A | $0.39 A | $0.38 A | $0.37 A | $1.40 A |

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 04/01/2020. The reports text is as of 04/02/2020.

## Overview

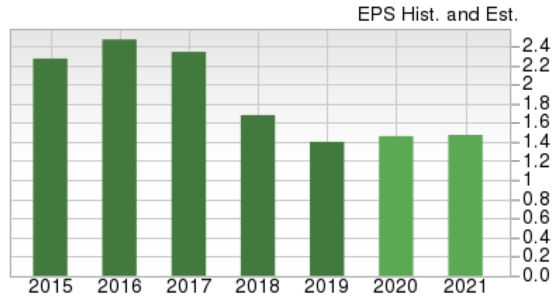
Headquartered in St. Paul, MN, Patterson Companies Inc. (PDCO) is one of the leading distributors of dental and animal health products.

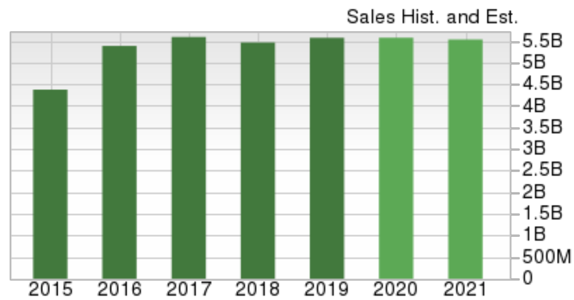
The company completed the divestiture of medical business (Patterson Medical) to private equity firm Madison Dearborn Partners (MDP) for $715 million in cash. Owing to this deal, Patterson Medical was reported as discontinued operations since the first quarter of fiscal 2016.

The company currently distributes its products through two subsidiaries — Patterson Dental and Patterson Animal Health.

**Patterson Dental:** The segment distributes consumable products (x-ray film, restorative materials, sterilization products and hand instruments); basic and advanced technology dental equipment; practice management and clinical software; patient education systems; and office forms and stationery in the U.S. and Canada.
The company's customers include dentists, dental laboratories, institutions, and other healthcare professionals. Patterson Dental is also the exclusive distributor for Sirona Dental Systems, a leading dental technologies company.

**Patterson Animal:** Notably, Patterson Animal Health is a leading distributor of veterinary supplies to companion-pet (dogs, cats and other common household pets) veterinary clinics, equine and large animal veterinary clinics, public and private institutions, and shelters across the U.S.




The acquisition of National Veterinary Services Limited (NVS) in 2013 expanded the company's footprint in the U.K. Following the acquisition of Animal Health International, this segment sells products for pets, horses, beef and dairy cattle, poultry and pigs.

**FY19 at a Glance**

Revenues were $5.57 billion in FY19.

Patterson Dental registered revenues of $2.2 billion in FY19, i.e. almost 39.3% of net revenues. Patterson Animal Health registered revenues of almost $3.4 billion in FY19, i.e. 60.2% of net revenues.

## Reasons To Buy:

> A growing diversified product portfolio, strong veterinary business prospects, accretive acquisitions and strategic partnerships are key growth catalysts, going forward

- **Broad Product Spectrum**: Patterson Companies provide a wide range of consumable supplies, equipment and software, and value-added services to its customers. The company's wide range of products hedges it from any meaningful sales shortfall during an economic downturn. Further, Patterson offers world-class service to its customers by delivering frequent, small quantity orders rapidly and reliably from its strategically located distribution centers.

  In fiscal 2019, Patterson Companies launched and integrated a new cloud-based veterinary practice management software – NaVetor – for its Animal Health segment. This software is designed to streamline and simplify workflows for veterinary practices and demonstrates Patterson Companies' commitment to providing innovative solutions to customers. In the fiscal second quarter, the company continued to boost the platform with new features and improvements that included the integration of a tool named Reputation Builder. This tool has been created to help veterinarians manage their online reputation and ratings and automate the distribution of customer surveys to strengthen their relationships and act quickly on feedback to improve their practices.

  During the fiscal first quarter, the company introduced a new private label brand named Pivotal, while continuing to add SKUs to its broader private label portfolio. Patterson Companies stands to gain from private label brands as they enable the company to serve customers with brilliant products at a reasonable price and more attractive margin profile.

- **Patterson Technology Center**: Patterson Companies' solid technology support infrastructure – the Patterson Technology Center in Effingham Ill, helps it to strengthen its customer base. Per management, Patterson companies is the only company that boasts specially trained staff dedicated solely to the sale and support of technology.

  The Patterson Technology Center supports over 80,000 customers nationwide and resolves hardware, software, computer networking or digital technology issues very fast. In fact, management at Patterson confirmed the receipt of the title of technology leader by continually researching, developing and upgrading technology and support to keep pace with growing demand for greater efficiency and profitability for healthcare practices.

- **Dental Market Holds Promise**: Patterson Companies is expected advantage from the gradual recovery in the dental market and the rebounding dental equipment business (especially in North America), assisted by increased technology marketing/promotional activities. A research report by the Grand View Research suggests that the global dental equipment market is projected to grow at a CAGR 4.9% by 2020.

  Per management, the company remains optimistic about serving a strong and stable dental end market. In this fiscal second quarter, the company exhibited strong performance across all three categories of its Dental business – equipment, consumables and value-added services. Effective mix management in its Dental segment and continued focus on sales execution and customer experience drove the company in the quarter under review.

  In fact, it is encouraging to note that Patterson Companies' dental sales in fiscal third-quarter 2020 improved 8.1% year over year to approximately $626.6 million driven by strong growth in equipment sales, sustained improving trends in consumables and robust demand for value-added services. Moreover, solid revenue growth across all three categories, which resulted in internal sales growth, contributed to the improvement.

- **Solid Prospects in Animal Health Unit**: Patterson Companies' growing Animal Health unit is a key long-term growth driver. Management at Patterson Companies expects solid margin improvement in the Animal Health Unit through stronger partnerships with product manufacturers and strong sales execution.

  Patterson Companies is focused on the enterprise-wide productivity and efficiency initiatives that are essential for optimizing the company's operating model. Primarily on the back of high growth in companion pet population, the veterinary market seems to provide ample growth opportunity for the company. Moreover, the acquisition of Animal Health International is expected to double the size of Patterson Companies' existing veterinary business. It will help the company gain a strong foothold in the animal health market, complementing its existing presence in the companion pet market.

  In fiscal third-quarter 2020, the segment sales improved 1.2% on a year-over-year basis to $817.3 million. Per the fiscal second-quarter 2020 earnings call, management announced that its Animal Health business continues to remain committed toward meeting the product and service needs of customers and driving sales execution. Per the company, Animal Health business remains well poised to drive the top line and thereby margins in fiscal 2020.

- **Acquisitions Driving Growth**: Patterson Companies has been expanding its business on the back of strategic acquisitions. In recent past, Patterson Dental Supply, Inc., a business unit of Patterson Companies announced that it acquired Fitzpatrick Dental Design, a dental office design and dental equipment dealer located in Moorpark, California.

  Since 1987, the company has acquired over 30 dental products distributors in the United States and Canada, which improved its penetration in both the countries. The acquisition of Holt Dental Supply expands the company's local reach while also enhancing its Midwest domination. Patterson's past acquisition of NVS expanded its footprint in the UK veterinary market. Recently, Patterson acquired Animal Health International. We believe that the company will continue to pursue strategic acquisitions that will expand its product portfolio as well as improve its competitive position over the long term.

  In fiscal fourth quarter of 2019, the company acquired VetIT – a leading cloud-based practice management software in the U.K. – in a bid to boost international veterinary business. The buyout will enable the company to enhance service offerings and technology capabilities to lend support to more vets and build presence in a key geography.

## Reasons To Sell:

A rapidly changing healthcare environment in the U.S., unfavorable price movements, declinig dental revenues and integration risks pose significant challenges.

- **Share Price Movement**: Over the past year, shares of Patterson Companies have lost 33.7%, compared with the industry's decline of 21.6%. The company witnessed a decline in operating income in the quarter under review, while gross margin remained flat. Further, the ongoing economic volatility on account of the global coronavirus outbreak is hampering the stock.

- **Cutthroat Competition in the Niche Space:** The U.S. dental products distribution industry is highly competitive and consists principally of national, regional and local full-service and mail-order distributors. Patterson faces competition from another national, full-service firm, Henry Schein Dental, a unit of Henry Schein. In addition, there are at least 15 full-service distributors that operate on a regional level and hundreds of small local distributors. Patterson needs to continue to introduce newer products in the market to withstand competitive pressures. Failure to do so will dilute the company's market share.

- **Supplier Concentration Issue:** Patterson has a significant key supplier concentration. The company's top 10 supply vendor's account for more than 40% of its cost of dental products sold in a fiscal year. Loss of relationship with these vendors will disrupt the supply of raw materials, which in turn will lead to lower sales of Patterson products.

- **Integration Risks:** Patterson had been on an acquisition spree which is improving its revenue opportunities on one hand and aggravating integration risks on the other. Regular acquisitions are also a distraction for management which is likely to impact organic growth. This may limit Patterson's future expansion and worsen the company's risk profile, going forward.

- **Challenging Macroeconomic Scenario:** Pricing pressure in the United States and Europe has been a staggering issue over the past few quarters. Healthcare reform in the United States has created a degree of uncertainty for the medical devices companies and has created a less flexible pricing environment. The company also anticipates these trends to persist in the coming quarters. In fact, the company's earnings declined year over year in the fiscal third quarter.

  Moreover, the overall macro-economic uncertainty across the globe affects physician office visits, thereby impacting the company's progress. Thus, the company is treading cautiously in the markets it serves, especially Europe and the Americas, as the results from these territories might hurt margins. With growing concerns over healthcare spending taking its toll on players in the medical device space, the stock might suffer due to a sluggish market.

## Last Earnings Report

**Patterson Companies Q3 Earnings Top Estimates, Up Y/Y**

| Quarter Ending | 01/2020 |
|---|---|
| Report Date | Feb 27, 2020 |
| Sales Surprise | 2.75% |
| EPS Surprise | 27.03% |
| Quarterly EPS | 0.47 |
| Annual EPS (TTM) | 1.50 |

Patterson Companies, Inc. reported adjusted earnings per share of 47 cents in third-quarter fiscal 2020, which beat the Zacks Consensus Estimate by 27%. Moreover, the bottom line improved 23.7% from the prior-year quarter.

Net sales in the quarter were $1.46 billion, outpacing the Zacks Consensus Estimate by 2.8%. The top line also rose 4.3% year over year.

**Segmental Analysis**

The company currently distributes products through subsidiaries Patterson Dental and Patterson Animal Health.

*Dental Segment*

This segment provides a complete range of consumable dental products, equipment, software, turnkey digital solutions and value-added services to dentists, and laboratories throughout North America.

In the fiscal third quarter, dental sales improved 8.1% year over year to approximately $626.6 million.

*Dental Consumable*

Sales in the sub-segment totaled $300.4 million, up 1.9% year over year.

*Dental Equipment & Software*

Sales in the segment improved 16.2% on a year-over-year basis to $252.9 million.

*Other*

This segment comprises technical service, parts and labor, software support services and office supplies. Sales at the segment improved 8.8% on a year-over-year basis to $73.3 million.

**Animal Health Segment**

This segment is a leading distributor of veterinary supplies to clinics, public and private institutions and shelters across the United States.
In the fiscal third quarter, the segment sales improved 1.2% on a year-over-year basis to $817.3 million.

**Corporate**

Sales at the segment were $12.3 million, up 29% from $9.5 million reported in the year-ago quarter.

**Gross Margin Analysis**

Gross profit in the reported quarter was $311.8 million, up 4.1% year over year. As a percentage of revenues, gross margin of 21.4%, remaining flat on year-over-year basis.

Operating expenses in the reported quarter totaled $268 million, up 5.5% on a year-over-year basis.

Operating income was $43.8 million, down 3.4% from the year-ago quarter.

**Fiscal 2020 Guidance Raised**

For fiscal 2020, Patterson Companies now expects adjusted earnings per share in the range of $1.50 to $1.55 (up from the prior range of $1.36-$1.46). The mid-point of the guidance of $1.53 is above the Zacks Consensus Estimate of $1.42 per share.

## Valuation

Patterson Companies' shares are down 28.9% and 33.7% in the year-to-date period and the trailing 12-month periods, respectively. Stocks in both the Zacks sub-industry and Zacks Medical Market are down 16.1% and 13.3% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are down 21.6% and 12.6%, respectively.

The S&P 500 index is down 19.7% in the year-to-date period and 10.2% in the past year.

The stock is currently trading at 9X Forward 12-months earnings, which compares to 14.7X for the Zacks sub-industry, 18.2X for the Zacks sector and 15.9X for the S&P 500 index.

Over the past five years, the stock has traded as high as 20.5X and as low as 9X, with a 5-year median 16.3X.

Our Neutral recommendation indicates that the stock will perform in line with the market. Our $15 price target reflects 9.5X forward 12-months earnings.

The table below shows summary valuation data for PDCO.

**Valuation Multiples - PDCO**

| | | Stock | Sub-Industry | Sector | S&P 500 |
|---|---|---|---|---|---|
| P/E F12M | Current | 9.01 | 14.73 | 18.19 | 15.99 |
| | 5-Year High | 20.45 | 19.08 | 21.09 | 19.34 |
| | 5-Year Low | 9.01 | 13.70 | 15.81 | 15.18 |
| | 5-Year Median | 16.25 | 16.55 | 18.70 | 17.44 |
| P/S F12M | Current | 2.81 | 0.29 | 2.43 | 2.81 |
| | 5-Year High | 3.43 | 0.36 | 3.84 | 3.43 |
| | 5-Year Low | 2.54 | 0.23 | 2.43 | 2.54 |
| | 5-Year Median | 3.00 | 0.28 | 2.96 | 3.00 |
| P/B TTM | Current | 0.95 | 3.66 | 3.34 | 3.48 |
| | 5-Year High | 3.69 | 4.72 | 5.05 | 4.55 |
| | 5-Year Low | 0.95 | 2.53 | 2.84 | 2.85 |
| | 5-Year Median | 2.62 | 3.44 | 4.30 | 3.63 |

As of 04/1/2020

## Industry Analysis **Zacks Industry Rank:** Top 22% (55 out of 254)


## Top Peers

| | |
|---|---|
| AmerisourceBergen Corporation **(ABC)** | Neutral |
| Align Technology, Inc. **(ALGN)** | Neutral |
| Danaher Corporation **(DHR)** | Neutral |
| Henry Schein, Inc. **(HSIC)** | Neutral |
| Integra LifeSciences Holdings Corporation **(IART)** | Neutral |
| IDEXX Laboratories, Inc. **(IDXX)** | Neutral |
| DENTSPLY SIRONA Inc. **(XRAY)** | Neutral |
| Zimmer Biomet Holdings, Inc. **(ZBH)** | Neutral |

## Industry Comparison Industry: Medical - Dental Supplies

Industry Peers

| | PDCO Neutral | X Industry | S&P 500 | ABC Neutral | HSIC Neutral | IDXX Neutral |
|---|---|---|---|---|---|---|
| **VGM Score** | C | - | - | A | B | B |
| Market Cap | 1.39 B | 1.39 B | 16.87 B | 17.75 B | 6.96 B | 19.68 B |
| # of Analysts | 8 | 5 | 13 | 7 | 9 | 4 |
| Dividend Yield | 7.15% | 0.00% | 2.53% | 1.95% | 0.00% | 0.00% |
| **Value Score** | B | - | - | B | B | D |
| Cash/Price | 0.07 | 0.08 | 0.06 | 0.19 | 0.01 | 0.00 |
| EV/EBITDA | 8.43 | 10.81 | 10.63 | 11.19 | 8.36 | 31.75 |
| PEG Ratio | 1.83 | 1.53 | 1.69 | 1.51 | 2.26 | NA |
| Price/Book (P/B) | 0.95 | 3.52 | 2.30 | 5.78 | 1.96 | 111.27 |
| Price/Cash Flow (P/CF) | 6.48 | 10.54 | 9.07 | 8.92 | 10.06 | 38.37 |
| P/E (F1) | 10.16 | 17.34 | 14.38 | 11.21 | 14.52 | 43.34 |
| Price/Sales (P/S) | 0.25 | 1.50 | 1.80 | 0.10 | 0.70 | 8.18 |
| Earnings Yield | 10.03% | 5.25% | 6.90% | 8.92% | 6.90% | 2.31% |
| Debt/Equity | 0.44 | 0.32 | 0.70 | 1.18 | 0.22 | 4.31 |
| Cash Flow ($/share) | 2.24 | 1.35 | 7.01 | 9.67 | 4.83 | 6.01 |
| **Growth Score** | F | - | - | A | B | A |
| Hist. EPS Growth (3-5 yrs) | -13.46% | 8.88% | 10.92% | 8.88% | 7.51% | 23.57% |
| Proj. EPS Growth (F1/F0) | 4.29% | 9.07% | 1.52% | 8.52% | -4.68% | 8.84% |
| Curr. Cash Flow Growth | -11.19% | 4.59% | 5.98% | -0.05% | -9.03% | 12.06% |
| Hist. Cash Flow Growth (3-5 yrs) | -3.58% | 12.65% | 8.55% | 12.37% | 2.76% | 14.54% |
| Current Ratio | 1.41 | 1.65 | 1.24 | 0.95 | 1.58 | 0.94 |
| Debt/Capital | 30.33% | 27.56% | 42.33% | 54.23% | 23.03% | 81.17% |
| Net Margin | 0.85% | 3.00% | 11.67% | 0.36% | 6.96% | 17.77% |
| Return on Equity | 9.57% | 15.19% | 16.70% | 49.95% | 15.01% | 283.27% |
| Sales/Assets | 1.66 | 1.02 | 0.54 | 4.65 | 1.40 | 1.38 |
| Proj. Sales Growth (F1/F0) | 0.02% | 2.47% | 1.75% | 6.14% | -2.24% | 8.52% |
| **Momentum Score** | B | - | - | C | F | B |
| Daily Price Chg | -4.84% | -2.57% | -5.14% | -2.57% | -3.86% | -4.78% |
| 1 Week Price Chg | -2.15% | 7.98% | 12.29% | 1.45% | 11.09% | 26.44% |
| 4 Week Price Chg | -41.78% | -20.24% | -25.58% | -4.59% | -21.19% | -12.31% |
| 12 Week Price Chg | -33.10% | -15.68% | -29.13% | 0.91% | -28.50% | -15.10% |
| 52 Week Price Chg | -33.68% | -19.80% | -23.44% | 14.90% | -19.80% | 1.35% |
| 20 Day Average Volume | 1,832,175 | 495,982 | 4,261,481 | 2,652,509 | 3,084,144 | 1,074,901 |
| (F1) EPS Est 1 week change | -1.77% | 0.00% | -0.18% | 0.01% | -3.21% | 0.00% |
| (F1) EPS Est 4 week change | -4.49% | -1.14% | -3.95% | 0.01% | -9.55% | -3.05% |
| (F1) EPS Est 12 week change | 2.82% | -5.04% | -5.28% | 2.07% | -9.77% | -1.75% |
| (Q1) EPS Est Mthly Chg | -18.29% | -1.44% | -5.80% | 0.30% | -21.12% | -2.59% |

## Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

| | |
|---|---|
| Value Score | B |
| Growth Score | F |
| Momentum Score | B |
| VGM Score | C |

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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