

Zooplus: Disruptive, Winner-Take-All Business Model

This post by Jake Rosser has been excerpted from a letter of [Coho Capital](#).

"The big money's been made in the high-quality businesses. Over the long-term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for 40 years, you're not going to make much more than a 6% return – even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result." –Charlie Munger

We are big fans of companies focused on widening their moat over the next decade rather than trying to top analyst estimates for the next quarter. Amazon is the poster child of such an approach, almost completely ignoring Wall Street while summarily increasing the sustainability of its competitive advantages. These types of companies often don't screen well on valuation metrics as reinvestment soaks up capital obscuring short-term economics. For those with longer time horizons, however, such companies can represent a bargain hiding in plain sight. Zooplus, Europe's largest online seller of pet food is such a company.

I know what you are thinking, what about the sock-puppet from Pets.com. Unlike the ill-fated Pets.com, Zooplus is profitable, earns high returns on capital (pre-tax ROIC of 25%), and has been growing its top line by over 30% a year over the last seven years. Zooplus possesses a 50% market share of the European online pet food market. It is the only European pet product vendor with scale, serving 30 countries. Growth prospects remain attractive with online penetration of pet food sales at 7%. Pet food is a natural candidate for online distribution as consumers save the inconvenience of lugging heavy, bulky bags of food from the store. This is particularly true in Europe where driving to big box stores is less prevalent than in the US.

When one considers the value proposition for Zooplus customers, the company's market share ascendancy seems inevitable. Consider that Zooplus customers on average pay 15-20% less than at Amazon and other online/offline competitors. Not only do Zooplus customers pay the lowest prices, they also have a vastly larger selection of product with Zooplus carrying over 8,000 SKUs (European supermarkets carry 150-200 pet SKUs). As we have seen with Amazon, the greatest selection, coupled with the lowest prices, is a tough combination to beat. This is reflected in Zooplus' customer retention rate of over 94%. High customer loyalty compounds Zooplus' advantage over time due to the recurring nature of pet-food sales.

Zooplus' disruptive business model has the hallmarks of a winner-take-all business. Similar to Amazon or Costco, Zooplus chooses to reinvest its profits into lower prices for its customers. Fund manager Nick Sleep referred to this concept as "Scale Economics Shared." Scale economics shared business models are self-reinforcing, with lower prices driving customer traffic enabling still lower prices. Zooplus' margins are illustrative: while gross margins have dropped ten percentage points since 2011, EBIT margins have advanced 5%. This is evidence of a moat that widens over time. Perhaps this explains why Zooplus has been able to keep Amazon at bay. We tend to stay away from companies in Amazon's competitive path but we are hopeful that in this case it is Zooplus that has Amazoned Amazon.

At 5x the scale of Amazon, we think Zooplus is well-positioned to exploit its leadership position. While

Amazon could engage in a multi-year price war to gain share, a more sensible approach would be to buy Zooplus outright. Historically, Amazon has shown a willingness to acquire niche e-commerce businesses such as Diapers.com and Zappos.

Given Zooplus' first-mover advantage and widening moat, the company's strategic value is self-evident. We believe the company's take-out value will lend a floor to the stock. The recent acquisition of Zooplus' US focused competitor, Chewy.com, offers insight into the potential value of Zooplus. Chewy.com and Zooplus demonstrate similar sales trajectories with Chewy.com slightly ahead with 2016 sales of \$901 million and projected sales of \$1.5 billion in 2017. This compares to Zooplus at €952 million in revenue for 2016 and projected 2017 revenue of €1.2 billion. Both companies have over 50% market share with Chewy.com at 51% and Zooplus at 50%. Notably, Zooplus is far more dominant with Amazon a distant number two with 10% share in the European market compared to a strong market position in the US of 35%. Given their similarities, Chewy.com is an excellent comp for Zooplus. We should mention, however, that there is one important distinction between the two companies; Zooplus has been profitable since 2013 and expanding margins every year while Chewy.com has not yet achieved profitability.

PetSmart acquired Chewy.com for \$3.35 billion in April. PetSmart's purchase price equates to a forward price/sales multiple of 2x. Applying the same multiple to Zooplus' anticipated sales of €1.4 billion in 2018 would result in an acquisition price of €394, 156% higher than current prices. A buyout may crystalize value more quickly but is not part of our investment thesis. As the economics of Zooplus' business begin to shine through we think the company will compound value at 15%+ a year. We always like situations where our companies do the compounding for us.