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3 Opportunities in the Animal Health Space: How the “Humanization” of Pets Has Created a Booming Industry

By Neal Rosenberg, Portfolio Manager

Key Points

1. The pet industry is experiencing significant and sustainable growth
2. Pet owners increasingly view pets as members of their family and are willing to spend accordingly; demographics suggest this will continue
3. The animal health industry is structurally more attractive than the human health industry due to superior growth, less regulation, less costly R&D projects, and lack of third party payers
4. We believe IDEXX (diagnostics), Dechra (veterinary pharmaceuticals), and Covetrus (veterinary technology) are excellent investment opportunities in the animal health space

According to the American Pet Products Association, Americans are spending more on pets than ever before: \$73 billion in 2018, representing an increase of over 4% from 2017.

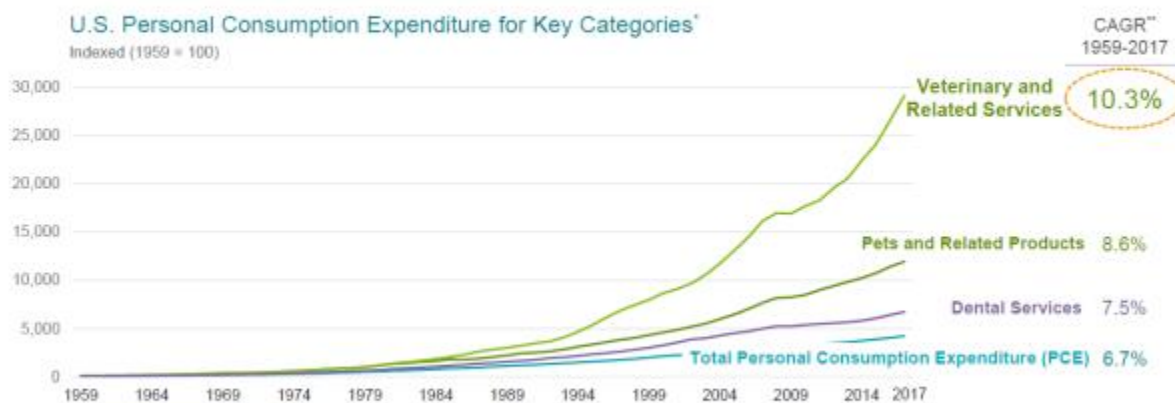
Driving much of this growth is a secular shift referred to as the “humanization of pets.” Today more than ever, pet owners view their pets as irreplaceable members of their families and lives. Over the last twenty years, pets have moved from sleeping in the backyard to the living room, to the bedroom, to our beds.

These trends are being enhanced by demographics. As millennial consumers have grown into adulthood, they have embraced the pet-owning and pet-loving lifestyles to a far greater extent than older consumers. This shift in attitude manifests itself in a willingness to pay for products and services that improve the health and well-being of their pets. While early, Gen Z is exhibiting spending and affinity trends that outpace that of millennials.

Companies are starting to take notice of the increasing numbers of pet owners prepared to invest in their pets’ health. Walmart, the nation’s largest retailer, announced earlier this month that is launching an online pet pharmacy and expanding in-store veterinary clinics.

Veterinary services is an \$18 billion subset of the U.S. pet care market. Spending on veterinary services has grown at a 10.3% CAGR from 1959 through 2017, well ahead of the broader pet industry and total personal consumption expenditures. We attribute this to growth in the overall pet population, increasing frequency of medical visits, expansion in the range of diagnostics and therapeutics that can be offered to pets, longer average pet lifespans, and consistent price increases.

U.S. Market Backdrop: Pet-related Spending Growth has Significantly Outpaced Personal Consumption



Yet, veterinary services, pets and related products together still comprise only ~1% of total consumption expenditure

* Analysis based on data from Bureau of Economic Analysis last revised on May 30, 2018. ** Compound Annual Growth Rate.

Source: Idexx Labs

The animal health industry boasts an attractive market structure. It is characterized by lower regulatory barriers, shorter and less costly R&D projects, less competition from generics, and lower third-party reimbursement risks relative to human medicine. We believe that the combination of attractive secular growth and favorable market structure is creating investment opportunities in the diagnostics, therapeutics, and veterinary technology spaces.

One company in the veterinary category we think is well positioned to benefit from this trend is **IDEXX Laboratories, Inc.** We have been investors in this company since 2005. IDEXX is the leader in developing diagnostic tests for companion animals, livestock and poultry. Since animals cannot communicate what is wrong with them to the veterinarian, a strong market exists for innovative and effective diagnostic technologies. These diagnostics are now an integral part of veterinary school curricula, creating a new generation of veterinarians that are increasingly reliant on these tests.

IDEXX spends five times more than all of its competitors combined on research and development, creating a robust pipeline of novel proprietary diagnostic tests. The company's portfolio of tests engenders significant customer loyalty, with retention rates on its market-leading platforms approaching 100%.

IDEXX is positioned for sustained double-digit revenue growth due to favorable industry trends, market share gains, and pricing power. We believe that a broader industry push around compliance and wellness plans, both of which are diagnostic-intensive, will be additive to growth. We expect strong top-line growth to lead to accelerated margin expansion and consistent free cash flow conversion over time.

Another holding that we believe has strong potential upside is **Dechra Pharmaceuticals PLC**, a U.K.-based company that develops, manufactures, and sells specialty veterinary pharmaceuticals. Dechra is the 10th largest animal pharmaceutical company in the world but has just 2% global market share. The company targets sectors that are underserved by larger pharmaceutical competitors, and is often the dominant provider in its individual therapeutic niches. We expect the company to grow revenue at consistent double-digit rates by gaining share in existing categories, launching innovative new therapeutics, and expanding into underserved geographies. The company is likely to supplement this organic growth with acquisitions. Ultimately, we view Dechra as an attractive acquisition target for its larger competitors given its unique portfolio of niche products.

We also see interesting investment opportunities in veterinary software. **Covetrus, Inc.** has created a platform to help boost the dismally low refill rates for animal medications. It has developed an integrated platform that uses data to identify gaps in care, and then contacts pet owners to improve refill compliance and enhance medication completion rates. Veterinarians that work with Covetrus can offer their customers convenient reminders, multi-channel ordering capabilities, and home delivery. Solutions such as Covetrus benefit the entire industry by enhancing pet health, improving the pet owner experience, and growing the veterinarian's practice.

As pets continue to play an integral role in our lives, their medical, dietary, grooming, and entertainment needs have come to be seen as nearly on par with the human members of the family. Though we have been invested in the sector for over a decade, we believe the durable growth characteristics of the global animal health industry is creating an expanding set of attractive investment opportunities.

Portfolio holdings as a percentage of net assets as of March 31, 2019 for securities mentioned are as follows: **IDEXX Laboratories, Inc.** – Baron Asset Fund (5.4%), Baron Growth Fund (3.8%), Baron Small Cap Fund (2.7%), Baron Partners Fund (6.9%*), Baron Health Care Fund (2.9%); **Dechra Pharmaceuticals PLC** – Baron Growth Fund (0.2%), Baron Small Cap Fund (0.9%), Baron International Growth Fund (1.5%), Baron Health Care Fund (2.3%); **Covetrus, Inc.** – Baron Small Cap Fund (0.1%), Baron Health Care Fund (1.5%).

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Risks: All investments are subject to risk and may lose value.

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

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