Formidable

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# The Big Short Squeeze:
# Is the Juice Worth the Squeeze?

One of the books on our recent reading list was a fantastic biography on Winston Churchill. A quote of his we use often is, “You will never reach your destination if you stop and throw stones at every dog that barks.” Recently, dogs, so to speak, have been barking. By dogs, we mean seemingly *down-on-their-luck* companies that have been the target of short sellers. And by barking, we mean terrifying those who are short the stocks. The most highly shorted companies are absolutely flying of late; the following graph shows a basket of the most highly shorted names is up almost threefold from the March lows, and over 20% so far this year:


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For those who may not be overly familiar with the concept, short sellers are those who are betting on the price of a stock to decline. We'll use an example of an imaginary company to make it easy.

Let's pretend we think Sendrax, which devised a technique for televising opera back in the 1990s, is overvalued at $20 per share, given everyone knows opera is in secular decline. We decide to short Sendrax, meaning we sell the shares at $20 without owning them. In order to sell the shares, we have to borrow them from someone who owns then. This number is tracked by stock exchanges and data providers. Normally, it is viewed in terms of percentage of float, i.e., total shares of the company, or days to cover, i.e., how many days of trading volume for a stock it would take for shorts to cover their positions.

If, as expected, Sendrax declines to $10, we may decide to buy the shares for $10, having already sold them at $20, making a tidy $10 profit. Great job. But what if we are wrong?

Let's say a lot of people think Sendrax is doomed and are lined up on the short side with us. What if Sendrax surprises us with a good quarter, or involvement from an activist, or excitement on a Reddit message board. This may trigger what we know as a *short squeeze*, which is in the press lately due to the amazing story of GameStop Corp (NYSE: GME). As the price of Sendrax moves above $20, our short position starts to lose money. Unlike long positions, as the short moves against us, it becomes a larger part of our portfolio, so to manage the risk, we have to cover, i.e., buy, shares of Sendrax. Ironically, this can throw gasoline on the fire, causing the price to increase more, prompting us to buy more shares to cover; rinse, repeat. This is precisely what is happening now, with the most highly shorted names gaining momentum as short sellers are forced cover.

The downside of shorting is this unlimited risk potential. If we own a stock, the most we can lose is what we invest, i.e., it can go to zero, but no lower. Sendrax can go to infinity, theoretically. It is for these reasons we are judicious in the management of our hedge fund with regard to shorting stocks; we use advanced techniques to mitigate the risk of this "naked" shorting.

In looking through the short squeeze carnage, many already reflect the surrender of the short sellers. However, in at least on case, we have identified a company where the juice looks like it worth the squeeze, but for activist involvement.

## Time to Toss a Rock at This Barking Dog?

Part of our job as portfolio managers and analysts is to evaluate companies in terms of business models and capital allocation policies. By nature, we are critical people, and see lots of barking dogs in terms of those that are managed sub-optimally. Sometimes, we may find a flaw or two, whereas other times, there may be more reasons to be critical. We don't throw rocks very often though.

However, in the case of PetMed Express, Inc. (NASDAQ: PETS), we feel compelled to toss a rock. We find a company with attractive economics, secular tailwinds for growth, and a long, relatively stable roster of clients, products, and cash flows, yet a history of underperformance and undervaluation versus its small cap and retail peers. Moreover, we see a lack of innovation and a general comfort with a status quo that has seen the company lose share and suffer stagnation.

The following is our assessment of the company and what we think management might consider as ways to close these valuation and performance gaps. ***Formidable has recently initiated a position in the company.***

We see the following as areas where the company has an opportunity to improve, and subsequently generate returns for shareholders:

- Static Management and Board
- Inefficient Balance Sheet and Capital Return
- Antiquated Business Model

***Static Management and Board***

Continuity is great. However, new voices can help companies unlock new growth opportunities and change with the times. C-suite management has been at the helm since 2003:

| | Name | Title | Board | Age | Tenure | Start |
|---|---|---|---|---|---|---|
| 1) | Menderes Akdag | President/CEO | ✓ | 59 * | 17.5 | 07/15/2003 |
| 2) | Bruce S Rosenbloom | CFO/IR/Treasurer | | 51 * | 17.5 | 07/15/2003 |
| 3) | Alison Berges | Secretary/General Counsel | | | 16.4 | 08/06/2004 |

Perhaps the board is different? With one exception, again, the answer is no:

| | Name | Age | Tenure | Start |
|---|---|---|---|---|
| | Chairman | | | |
| 1) | Robert C Schweitzer "Bob" | 74 * | 14.5 | 07/2006 |
| | Board Member | | | |
| 2) | Ronald J Korn | 79 * | 17.5 | 07/15/2003 |
| 3) | Gian M Fulgoni | 72 * | 17.5 | 07/15/2003 |
| 4) | Menderes Akdag | 59 * | 17.5 | 07/15/2003 |
| 5) | Frank J Formica | 76 * | 17.4 | 08/11/2003 |
| 6) | Leslie Campbell | 62 * | 2.5 | 07/27/2018 |

To put it bluntly, management seems understaffed, lacking  diversity, entrenched, and seemingly underinvested. We think these traits lend themselves to the apparent lack of innovation that has recently plagued the company.

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| Executives | Value | Peer Avg |
|---|---|---|
| **Structure** | | |
| # Executives | 2 | 10 |
| | | |
| **Diversity** | | |
| % Women Executives | 0 | 15 |
| Average Age | 55 | -- |
| CEO Age | 59 | 51 |
| **Entrenchment** | | |
| Average Tenure (Years) | 17.58 | 7.78 |
| CEO Tenure (Years) | 17.58 | 8.81 |
| | | |
| **Ownership** | | |
| % Execs Holding Shares | 100 | 67 |
| % CEO Ownership | 1.9623 | 6.8977 |

***Inefficient Balance Sheet and Capital Return***

In an era where rates are rock bottom, as are corporate bond spreads, having a debt-free balance sheet should not be a point of pride for an established company that consistently generates free cash flow from its operations. However, that is just what PETS has. Cash is over $100M; there is no debt. From the Q3 2021 earnings call (1/19/21):

For the quarter, our advertising expenses were relatively flat at $3.2 million compared to the same quarter of the prior year. Advertising cost of acquiring a customer for the quarter was approximately $44 compared to $42 for the same quarter of the prior year. And for the nine months, it was $49 compared to $53 for the nine months of the prior year. We had $106.5 million in cash and cash equivalents and $28.2 million in inventory with no debt as of December 31, 2020. Net cash flow from operations for the nine months was relatively flat at $21.6 million compared to the nine months last year.

| In Millions of USD | 2017 Y | 2018 Y | 2019 Y | 2020 Y~ | Current/LTM |
|---|---|---|---|---|---|
| 12 Months Ending | 03/31/2017 | 03/31/2018 | 03/31/2019 | 03/31/2020 | 12/31/2020 |
| Market Capitalization | 413.4 | 860.1 | 471.0 | 580.4 | 625.8 |
| - Cash & Equivalents | 58.7 | 77.9 | 100.5 | 103.8 | 106.5 |
| + Preferred & Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| + Total Debt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Enterprise Value | 354.7 | 782.2 | 370.4 | 476.6 | 519.3 |

To its credit, the company is highly cash generative, making the continual cash stockpile inexplicable.

Part of the cash is returned to investors via dividends. While we like dividends, a more balanced approach, given the relative undervaluation of the company (not to mention its excruciatingly high short interest) may give the stock price a much-needed jolt.

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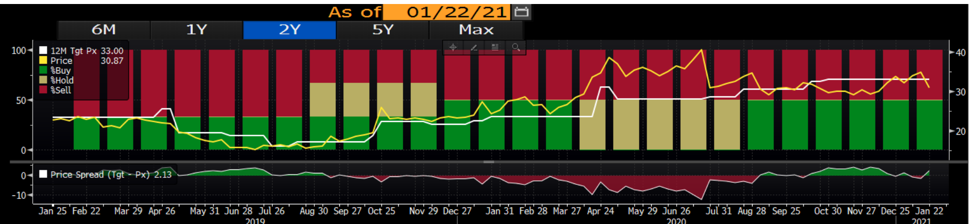
| | | | | | | |
|---|---|---|---|---|---|---|
| Cash from Financing Activities | | | | | | |
| + Dividends Paid | -14.7 | -15.5 | -17.5 | -21.9 | -21.8 | -22.4 |
| + Cash From (Repayment) Debt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| + Cash From (Repay) ST Debt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| + Cash From LT Debt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| + Repayments of LT Debt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| + Cash (Repurchase) of Equity | 0.1 | 0.0 | 0.0 | 0.0 | -11.5 | 0.0 |
| + Increase in Capital Stock | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| + Decrease in Capital Stock | 0.0 | 0.0 | 0.0 | 0.0 | -11.5 | 0.0 |
| + Other Financing Activities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| + Net Cash From Disc Ops | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Cash from Financing Activities | -14.5 | -15.5 | -17.5 | -21.9 | -33.3 | -22.4 |

This lack of capital markets activity limits sell-side coverage on the stock, which, though unfair, also limits its ability to attract institutional investors, many of whom are unwilling to do the deep, fundamental research we conduct. There were three (3) analysts on the company's most recent earnings call:

| | | |
|---|---|---|
| PetMed Express Inc | | |
| Consensus Rating | | 3.00 |
| Buys | 50.0% | 1 |
| Holds | 0.0% | 0 |
| Sells | 50.0% | 1 |
| 12M Tgt Px | 2/3 | 33.00 |
| Last Price | | 30.87 |
| Pricing Currency | | USD |
| Return Potential | | 6.9% |
| LTM Return | | 32.2% |

As of 01/22/21

6M 1Y 2Y 5Y Max




Showing 3 of 3 sources

| | Firm | Analyst | Recommendation | Tgt Px | Date | 1 Yr Rtn | BARR | Rank |
|---|---|---|---|---|---|---|---|---|
| 1) | Credit Suisse | Erin E Wilson Wright | underperform | 25 | 01/19/21 | -22.65% | 2 | 1 |
| 2) | Sidoti & Company L... | Anthony C Lebiedzin... | buy | 41 | 01/19/21 | 18.77% | 1 | 2 |
| 3) | ISS-EVA | Anthony Campagna | buy | | 07/21/20 | -37.69% | 3 | |

Accordingly, the majority of the largest holders are passive index and sector funds.

***Antiquated Business Model***

Entrenched management is seemingly dogmatic in its approach (no pun intended). For example, the company's logo (just updated) still includes its 1-800 number.

**Our Previous Logo:**

**Our New Logo:**

Ancillary (hopefully high margin) cross sells and monetization tools would seem to be a high priority for a company in PETS position. We will let you know is the response:

**Q - Erin Wright** {BIO 16550188 <GO>}
Okay. And then, one last question, have you started contemplated around services beyond pharmacy like telehealth, platforms or other services that you could kind of link or co-market across your platforms?

**A - Menderes Akdag** {BIO 3419918 <GO>}
Yes. We are exploring them. We will be focused on the next fiscal year and we will give you more information in the later part of the year.

Call us crazy, but a 2% sales lift from a website refresh does not seem material or aimed at making the structural changes the company desperately needs. Perhaps capital is better allocated to the aforementioned new verticals, new endeavors, or to other branded products beyond medication? In a world where successful retailers are looking at myriad of ways to capture data, insource margin, and create stickier customer relationships, it does not seem like management is adapting the way their more innovative competitors are. For example, competitor Chewy (NASDAQ: CHWY) spends significantly more to acquire customers (around $150 versus approximately $40 for PETS).[1]

[1] Kalaygian, Mark: *A Closer Look At Chewy' Latest Earnings Report*; Information accessed on January 25, 2021 via URL: https://www.petbusiness.com/blogs/a-closer-look-at-chewys-latest-earnings-report/article_8e6a693d-d8e7-5cce-9cd5-6bd7eedd62ee.html#:~:text=Expensive%20Customer%20Acquisition&text=In%20fact%2C%20Chewy%20went%20from,about%20%24148%20per%20new%20customer

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**Operator**

(Operator Instructions) Our next question is from Ben Rose with Battle Road Research. Your line is open.

**Q - Ben Rose** {BIO 1507640 <GO>}

Yes, good morning. A few questions to begin with Menderes, in terms of the rollout of the website enhancements, is that relatively complete at this stage? And what is your assessment of the improvement?

**A - Menderes Akdag** {BIO 3419918 <GO>}

It is not complete yet. We anticipate it will be completed by June. But it will be substantially probably completed by end of March, but I would say full completion by June. We did some AB testing -- ABCD testing, I should say, comparing the new design with the whole design. And we are predicting some sales lift, approximately a 2% sales lift.

**Q - Ben Rose** {BIO 1507640 <GO>}

Okay. And another question is, is there -- PetMeds does have a very well established brand, as I understand it, as in, as a function of its Net Promoter Score or the Net Promoter Score reflecting that. Have you given any thought to developing branded merchandise for PetMeds that is to say, non-medication pet-oriented merchandise with the PetMed brand?

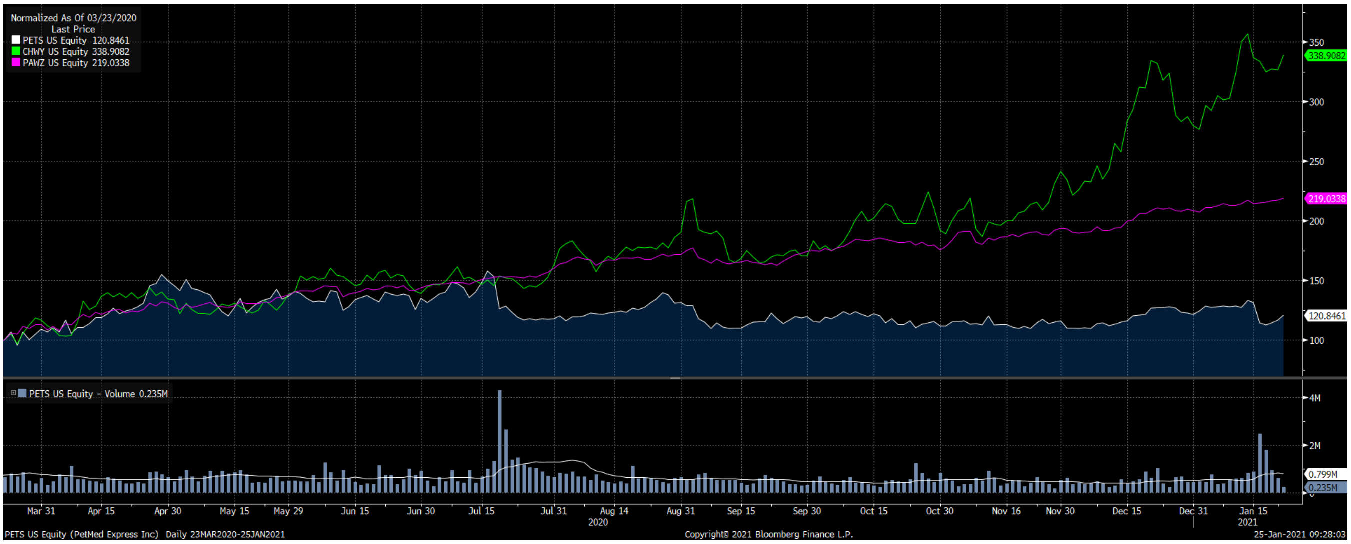
**A - Menderes Akdag** {BIO 3419918 <GO>}

Yeah. We do have OTC medications under our brand. We did not think about beyond medications at the stock.

Though the last year was challenging, retailers focused on ecommerce (or, in this case, phone commerce), i.e., PETS, should have had a significant tailwind. CHWY grew its revenues over 37% during the pandemic. However, revenue for PETS was only flat versus significant increases for peers, while earnings showed the sharpest decline within the peer group. All this while having the smallest base, which should make it easier to grow, given a smaller base. The median for its pet-oriented peer group is 27%; PETS is flat from a revenue perspective.

| Name | Mkt Cap (USD) | Rev - 1 Yr Gr:Y | EPS - 1 Yr Gr:Y | Net Sale... T12M |
|---|---|---|---|---|
| Median | 2.96B | 27.23% | 7.44% | 770.18M |
| PETMED EXPRESS INC | 625.77M | 0.25% | -29.89% | 311.82M |
| CHEWY INC - CLASS A | 43.36B | 37.19% | 7.44% | 6.46B |
| PETIQ INC | 992.62M | 34.21% | -26.73% | 770.18M |
| FRESHPET INC | 6.04B | 27.23% | 82.89% | 300.02M |
| PETS AT HOME GROUP... | 2.96B | 10.17% | 26.51% | 1.39B |

This criticism may come across as harsh, but PETS is seemingly missing a great opportunity in a channel with tremendous secular and cyclical growth (think of the recent spike in pet ownership). How has the market responded to PETS lack of innovation and growth? Unfavorably, to put it mildly. Since the market bottomed in March, PETS has lagged peers (PAWZ is the ProShares Pet Care Equity ETF) and CHWY by huge margins:




As just one example, Chewy launched an online pharmacy in July 2018 that generated over $500 million in 2020 sales). PETS, well, they have a 1.800 number and a new logo…

***Valuation***

While valuations for equities, as a whole, are at all-time highs, given massive fiscal stimulus (aimed at consumers, i.e., pet owners) and monetary stimulus, PETS is valued only in-line with its longer-term metrics, i.e., its multiple has compressed in relative terms:

| Metric | Current | Hist Avg | Diff | # SD | 3M Trend | Low | Range | High | Hist Avg | Price (USD) |
|---|---|---|---|---|---|---|---|---|---|---|
| Current Price | | | | | | | Current Hist Avg | | | 30.87 |
| BF P/E | 17.9x | 18.4x | -3% | -0.1 | | 9.2x | | 34.0x | 18.4x | 31.67 |
| BF EV/EBITDA | 11.6x | 11.6x | 0% | 0.0 | | 4.4x | | 20.6x | 11.6x | 30.89 |
| BF EV/EBIT | 12.2x | 12.1x | 1% | 0.0 | | 4.8x | | 21.8x | 12.1x | 30.66 |
| BF EV/Rev | 1.6x | 1.8x | -9% | -0.3 | | 0.7x | | 3.6x | 1.8x | 33.42 |
| LF P/BV | 4.5x | 5.3x | -15% | -0.4 | | 2.3x | | 10.5x | 5.3x | 36.13 |

Versus peers, it is excruciatingly cheap:

| Current vs 5Y Average Historical Premium | | | | | | 5Y Historical Premium Range | | | Implied @ Hist Avg | |
|---|---|---|---|---|---|---|---|---|---|---|
| Metric | Current | Hist Avg | Diff | # SD | 3M Trend | Low | Range | High | Multiple | Price (USD) |
| Current Price | | | | | | | Current Hist Avg | | | 30.87 |
| 1) BF P/E | -19% | 11% | -30% | -1.9 | | -23% | | 49% | 24.5x | 42.34 |
| 2) BF EV/EBITDA | -13% | 30% | -43% | -1.0 | | -45% | | 169% | 17.3x | 43.45 |
| 3) BF EV/EBIT | -47% | -4% | -43% | -1.3 | | -60% | | 111% | 22.1x | 51.49 |
| 4) BF EV/Rev | -73% | -28% | -44% | -1.5 | | -74% | | 32% | 4.3x | 72.71 |
| 5) LF P/BV | 32% | 60% | -28% | -1.9 | | 32% | | 84% | 5.5x | 37.40 |

Historically, the company has traded at a premium to peers based on the more relevant metrics (forward P/E, EV/EBITDA, and EV/Revenue). The reason? As much as we have beaten up on the company, it does generate very high returns on assets and invested capital, given it is a capital-light business with modest capex. However, the market has become disenchanted, given the lack of recent growth.

A reversion to prior averages would put the stock price in the low 40s. A CHWY-like multiple on revenue would be a more than double on the name (PETS is at 2x versus CHWY at 5x).

*What could unlock the value?*

Formidable is not an activist. It is not in our DNA. However, we generally understand how most institutional investors think, and believe PETS taking some of the following steps may increase investor appetite for the company:

- Balance sheet restructuring – Rates ***and*** spreads are at historic lows. Take on a little debt to provide for flexibility to…
- Buy back shares – Given relative valuation, management should be repurchasing shares. Additionally, proceeds of debt could be used to…
- Innovate – Migrate beyond the 1.800 era and begin to better monetize the established customer base. If customer acquisition costs increase in the interim, that's fine, as the market has been rewarding growth (and punishing the lack thereof).

The playbook we would recommend is that employed by Bed, Bath, and Beyond, Inc. (NASDAQ: BBBY; disclosure: we are long BBBY). Hire top-flight management, pivot the company more toward ecommerce, divest flagging assets, eliminate the dividend, and use cash to buy back shares.

Here is what BBBY's new management team looks like:

| Name | Title | Board | Age | Tenure | Start |
|---|---|---|---|---|---|
| 1) Mark J Tritton | President/CEO | ✓ | 56 * | 1.2 | 11/04/2019 |
| 2) Scott Lindblom | Chief Technology Officer | | | 0.3 | 09/28/2020 |
| 3) Anuradha Gupta "Anu" | Chief Strategy & Transforma… | | 51 * | 0.3 | 10/05/2020 |
| 4) Gustavo Arnal | Exec VP/CFO/Treasurer | | 50 * | 0.7 | 05/04/2020 |
| 5) John R Hartmann | Exec VP/COO | | 56 * | 0.7 | 05/18/2020 |
| 6) Cindy Davis | Exec VP/Chief Brand Officer/… | | | 0.7 | 05/26/2020 |
| 7) Joseph G Hartsig "Joe" | Exec VP/Chief Merchandising… | | 57 * | 0.8 | 03/04/2020 |
| 8) Arlene Hong | Exec VP/Chief Legal Ofcr/Se… | | | 0.7 | 05/18/2020 |
| 9) Lynda Markoe | Exec VP/Chief People & Cult… | | 53 * | 0.3 | 09/01/2020 |
| 10) Rafeh Masood | Exec VP/Chief Digital Officer | | 41 * | 0.7 | 05/11/2020 |
| 11) Gregg A Melnick | Exec VP/Chief Stores Officer | | 50 * | 0.7 | 05/11/2020 |
| 12) Juan Guerrero | Senior VP/Chief Supply Chai… | | | 0.3 | 09/14/2020 |
| 13) Mara Sirhal | Sr VP/Gen Mgr:Harmon Healt… | | | 0.0 | 01/20/2021 |
| 14) Patty Wu | Sr VP & Gen Mgr:buybuy BABY | | | 0.0 | 01/18/2021 |
| 15) Janet M Barth | VP:Investor Relations | | | 7.0 | 2014 |
| 16) Rick Wilkins | VP:West Region | | | 0.3 | 09/08/2020 |

*Approximate Age

And here is the board:

81) Executives | 82) Board | 83) Committees | 84) Changes | 85) Cross Boarding | 86) Summary

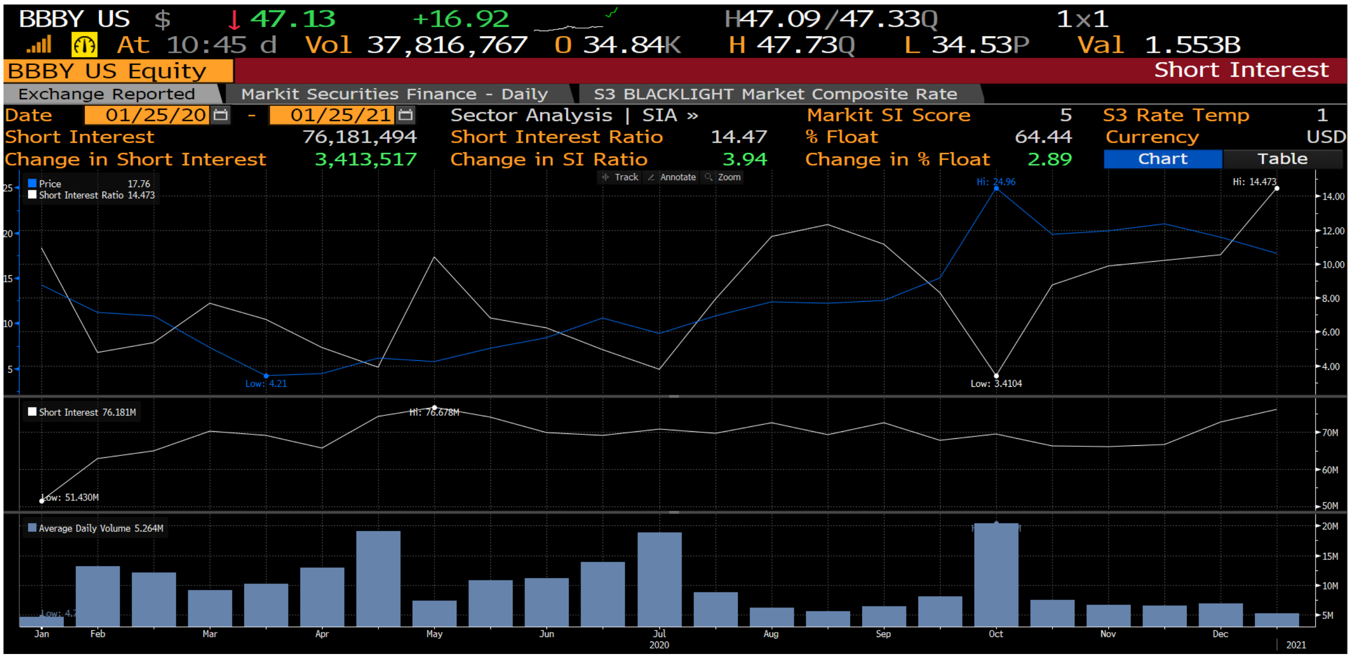
Bed Bath & Beyond Inc — 88) Compensation

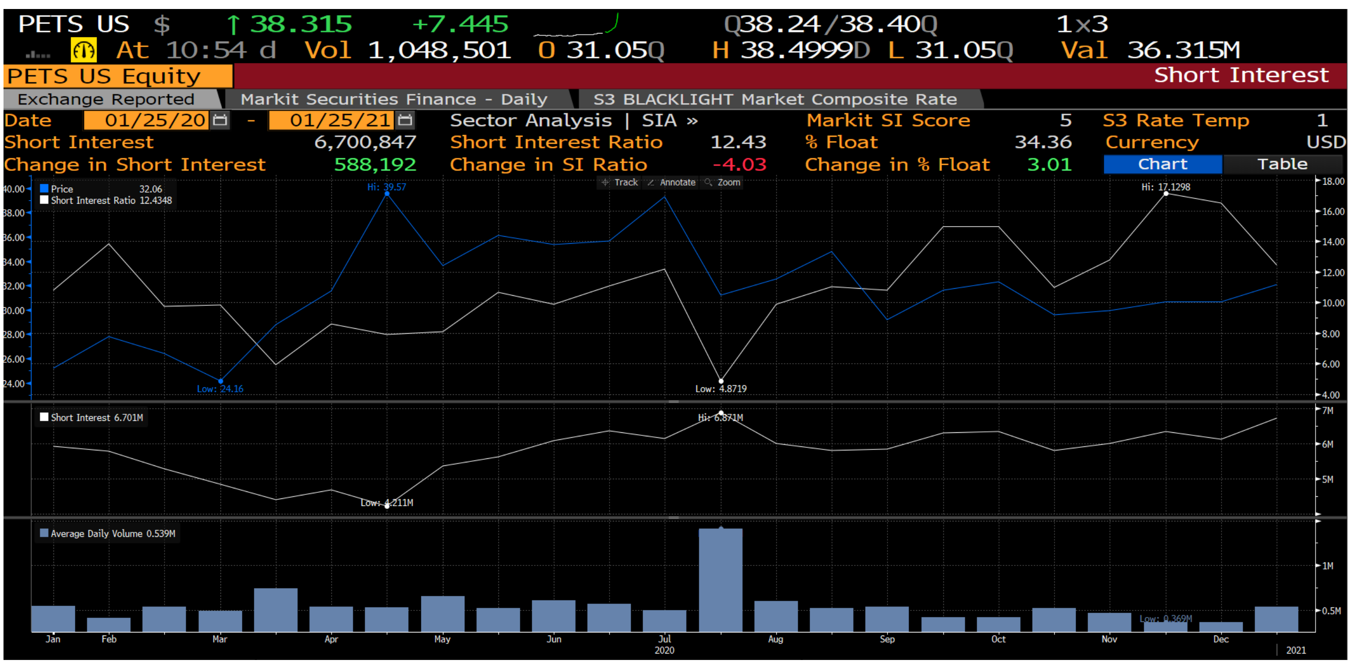
Main · Show Career Histories · Show Performance Data · Show Board History

| Name | Age | Tenure | Start |
|---|---|---|---|
| **Chairman** | | | |
| 1) Harriet Edelman | 64 * | 0.7 | 05/29/2020 |
| **Board Member** | | | |
| 2) Virginia P Ruesterholz | 58 * | 3.6 | 06/29/2017 |
| 3) Johnathan B Osborne "Jb" | 39 * | 2.8 | 04/03/2018 |
| 4) Andrea M Weiss | 65 * | 1.7 | 05/01/2019 |
| 5) Ann Yerger | 58 * | 1.7 | 05/01/2019 |
| 6) Mary A Winston | 58 * | 1.7 | 05/01/2019 |
| 7) Harsha Ramalingam | 61 * | 1.7 | 05/01/2019 |
| 8) Sue E Gove | 61 * | 1.7 | 05/29/2019 |
| 9) Joshua E Schechter "Josh" | 47 | 1.7 | 05/29/2019 |
| 10) John E Fleming | 63 * | 1.7 | 05/29/2019 |
| 11) Jeffrey A Kirwan | 53 * | 1.7 | 05/29/2019 |
| 12) Mark J Tritton | 56 * | 1.2 | 11/04/2019 |

Here is what BBBY has done coming out of the COVID-crisis market bottom versus PETS:


By the way, the backdrop for BBBY has been one where the stock is highly shorted, providing a coiled spring for the efficacy of buybacks. While BBBY's short as a percent of float is much higher than PETS (64% versus 34% for PETS), its days to cover (which we believe is a better metric of the power of a squeeze) is 12 days versus 14 days to cover for BBBY, i.e., a sizable buyback program could trigger a similarly effective squeeze.



### *In Conclusion*

The high short PETS provides considerable lift opportunity, if only the match would light. One need look no further than the recent mania in GameStop, Corp. (NYSE: GME) for what can happen when activism and price appreciation start to take hold of a highly shorted stock. Additionally, very little in board initiative would not only be welcome but disruptive to the coddled ecosystem the board apparently, currently enjoys, at the shareholders' expense.

We believe the upside in the stock is easily re-priced if the company committed more cash to a shareholder repurchase program; it could even borrow money, at very low rates, to enhance its price and shareholder return proposition. This company seems ripe for an activist, and it does not seem like it would take much to move the needle right off the page. Innovation is a longer-term endeavor, but has the potential to retrofit a successful, but somnambulant, good company into an industry leader.

It bears repeating, the significant downside of shorting is this *unlimited* risk potential. While riding along through the current short squeeze wave—it is incumbent on investors to remember there are individuals on each side of trades. Right now, some are gaining momentum, while others are just getting squeezed.

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