By Lynn Ostrem
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Company Overview:

Everyone knows who PetSmart is...even those without pets! It's the larger of only two nationally-recognized pet supply chains in the hard line retail industry. Here are the basics:

- Opened its first store in 1987 in Phoenix, Arizona
- Opened its first Canadian store in 1996
- Went public in 1993; trades on the NASDAQ under PETM
- Operates 863 retail outlets and 9 distribution centers in the U.S. and Canada
- Each store carries 12,000 products for dogs, cats, reptiles, domestic and wild birds, and fish
- Select U.S. stores offer equine products under the State Line Tack division
- PetSmart sells companion pets: rats, guinea pigs, gerbils, hamsters, mice, fish, birds and reptiles, but has chosen not to sell dogs or cats, in an effort to stem overpopulation. Instead, they partner with more than 3,300 animal shelters and provide them with in-store adoption centers.
- 2005 net sales were $3.8 billion, making it a mid-cap as measured by sales.

The company has two operating divisions – Food & Supplies and Services:

Food & Supplies:

Food & Supplies is a defensive business because people will always feed their pets. It's a large and fragmented industry worth an estimated $35.9 billion in 2005, an increase of over 100% since 1994. Industry sales have been growing at a compounded rate of 5-6% per year. PetSmart holds 12% of the market share.

Food and treats, alone, account for $14.5 billion. PetSmart competes against Petco, as well as big box merchandisers like Target & Wal-Mart. But pet owners have been moving toward premium foods which are not currently sold through supermarkets or other mass merchandisers due to manufacturer's restrictions. That's a leg up for PetSmart.

State Line Tack was acquired in 1995. More than 20,000 total equine products are available in select U.S. stores, online at statelinetack.com, and in the State Line Tack catalog.

And PetSmart Direct was started in 1999 to offer products through the internet. This is a very small percentage of their business.

Services:

Services include training, grooming, veterinary, boarding and daycare. In 2005 this division accounted for 8% of total sales, but grew at 24.2%. PetSmart holds 9% of this market.

PetSmart stores offer pet training classes. In 2005, they trained more than 324,000 dogs.

Full-service pet grooming is offered in all PetSmart stores. More than 6 million pets came through in 2005.

Banfield, The Pet Hospital, one of the country's largest veterinary care providers, operates hospitals and wellness clinics inside about 60% of the stores. PetSmart holds a 33 percent equity position in Medical Management International, the operator of Banfield.

PetSmart Charities creates and supports programs that save the lives of homeless pets, raise awareness of companion animal welfare issues, and promote healthy relationships between people and pets. Since 1994, they have donated $42 million to pet welfare programs and through in-store adoption programs, they have saved the lives of 2.6 million pets. These adoption programs are responsible for placing approximately 1000 pets per day.

And finally, PetsHotel and Doggy Day Camp! This is the newest and most exciting (not to mention the most needed) concept of the company.

PETSMART PetsHotel®

The first PetsHotel located inside a PetSmart store opened in November 2001. The hotels average 7,000 square feet and are currently located inside of about 50 PetSmart stores.

Check this out…

- There are faux fireplaces in the lobby
- Dogs have 4x6 private rooms with poochy cots
- Cats are housed in a separate section in kitty cottages
- Bedding is laundered and bowls are sanitized daily
- The ventilation system turns the air every 6 minutes, completely eliminating smells
- Dogs can watch dog-related TV programming in the upgraded suites
- They can take phone calls from pet parents in the bone booth
- There's around-the-clock supervision from specially trained personnel
- There's video surveillance for security
- A veterinarian is on call 24 hours per day at every PetsHotel
- There's lots of supervised socialization with lactose-free ice cream and biscuits
- Daily Paw-gress reports are given to the pet parents, outlining their pets' daily activities
- Each hotel will offer Doggie Day Camp, a childcare-like offering that gives dogs a safe, fun way to socialize, exercise and play under supervision for shorter stays.
- Day rates for PetsHotel run from $12-14 for cats and $21-36 for dogs.
- Doggy Day Camp day rates are $16-23.

The company began a serious rollout of the PetsHotel concept in 2005 with plans to grow it from 62 this year to 300 in 5 years. They recently revised that plan to 435 hotels in 6-7 years. This concept is responsible for raising profit margins from 7% to 12%. And management believes that the hotel will increase sales by 25-29% per store.

Financials:

PetSmart had phenomenal growth for many years, but stumbled in the 4th quarter of 2002. When it warned of slower growth in 2003, the stock was hammered. But since then, they have reassessed their future and have come up with innovations and smart acquisitions that have propelled it back to growth. The company's statistics are as follows:

- 4-year average sales growth of 11.8%
- 4-year average EPS growth of 17.9%
- 2005 sales were 11.8%
- 2005 EPS were 19%
- Same store sales were 4.2%
- Gross Margins have been in the 30% range for the last 3 years
- 2Q 2006 sales were up 13.5%
- 2Q 2006 EPS were actually up a penny, but they took a $2.9 million charge for acquisition inquiry fees (Analysts believe they originally put in a bid to buy Petco, then backed out)
- 2Q Comp sales growth 4.9%
- 2Q services sales grew 28%
- And, the board authorized a $250 Million Stock Purchase Plan
- Debt is currently at 29% of total capital

Management:

The company gets good governance ratings from most analysts. Morningstar gives them a B. They like the fact that 12 of the 13 board members are outside directors, and they regularly meet without the CEO. In the five years ending in fiscal 2005, total shareholder return exceeded 530% under the current leaders. And as a group, these leaders own 4% of the outstanding shares.

Industry Trends:

As stated earlier, the Food & Supplies segment has been growing at a 5-6% clip for several years. And the Services part of the business is quite fragmented. The industry estimates that 63% of US households own a pet and 45% own more than one. We're talking about 69 million households with 91 million cats and 74 million dogs. All analysts are expecting these segments to continue to grow through the end of the decade. If you don't think pets are important, here are some statistics:

- 80% of owners give pets holiday or birthday gifts
- 90% of senior citizens believe pets have a positive impact on their health
- 30% talk to their pets on the phone
- 94% of dog owners and 84% of cat owners characterize their relationship with their pet as "close"
- Nearly 50% of women rely more on their pets for affection than they do their spouse or children

Competition:

Other merchandisers are trying to cash in on this trend. The company is facing increasing rivalry from Target and Wal-Mart which have more than 1,300 and 3,600 domestic stores respectively. Many nontraditional competitors, like Bed Bath & Beyond, Home Depot, and Old Navy, are also seeking to cash in on this growing industry.

Target recently launched its own brand of premium pet food named LIFELong. The cheap chic retailer also offers collars, leashes, apparel, and other pet supplies from fashion designers. Wal-Mart, which already has the number-one-selling dry dog food (Ol' Roy), is also going upscale with its recent rollout premium pet food brand Natural Life.

But Petco (PETC) has always been the predominant competitor. Good news came in July when they announced they were being taken private. These private investors will be saddling Petco with $1.35 billion of debt and, as a result, the company will need to focus on paying it down, which should mean a slower pace of expansion and less investment in its stores. It is also possible that Petco will become less aggressive on pricing. (PetSmart already offers prices about 10% lower than those of Petco and other pet specialty shops).

PetSmart's stores are already 70% bigger than Petco's, allowing for a larger product offering and more space for pet services. With its bigger, recently reformatted stores, the company delivered $206 in sales per square foot in 2005, versus Petco's $185. So any other comparisons, especially now, won't be as helpful.

Right now, PetSmart is willing to sacrifice some profits in the near term to improve its competitive advantage, which analysts believe should lead to increased earnings over the long run.

Positive Influences:

The company is a big cash generator. Currently, they have over $300 million in the bank. PetsHotel should be able to generate 25-29% more revenue and nearly double the pretax income within five years' time.

Consumer spending habits are in favor of this industry as Generation Xers put off having children for their careers and, subsequently, spend more on their 4-legged family members.

Between them, PetSmart and Petco, the two largest companies in the space only have 16% of the market. This leaves a huge amount of market share to be gained.

Negative Influences:

As a retail company, PetSmart is subject to consumer spending patterns and in fluctuations in the economy. PetSmart is considered a seasonal business with a traditional end-of-the-year holiday season.

The biggest concern would be the growing popularity of this space. Wal-Mart, for example, has annihilated the competition in every segment it set its sights on. It could make inroads here, if it wanted to. We can come up with any number of things that "could" go wrong…increased fuel prices, a weakening economy, supply chain disruptions, higher occupancy costs, etc. But this leadership team has a proven track record of dealing with such issues.

Future Drivers of Growth:

- Increased penetration in the higher-margin services business (10% of sales growing at a 20%+ clip). This is significant because, after the initial capital expense in PetsHotels, there's virtually no inventory, resulting in substantially larger profit margins.
- Increased store count – average of 100 new stores per year for the next 5 years
- Plan to open 435 PetsHotels in the next 6-7 years
- Management believes the market can support 1,400 stores
- PetSmart is on line to complete its store reformatting plans by 2008 which will add to the margins
- Expansion of the pet services business will increase cross-selling opportunities

- **PetPerks Program** Just implemented, PetPerks is a discount card any customer can obtain for free. The mechanics of the program include two-tiered pricing on 800-1,200 items in the store, with the average discount for PetPerks members in the 5-8% range. By gathering data from PetPerks loyalty cards, management is able to better understand what its customer is buying. The company can then work with its vendors to target the more-profitable merchandise categories and make these products readily available. To date, 16.7 million cards have been obtained, and 2/3 of total sales are run through the cards.

Company Guidance:

Comp sales are expected to grow in the mid-single-digit range
Gross margins are expected to be flat in the beginning, picking up steam as PetsHotels rollout
EPS (including $250M in potential share repurchases) is expected to grow at a 17-19% rate annually for the foreseeable future.

Analysts Opinions:

Morningstar is very optimistic about the fast-growing services business. Over the next five years, they forecast the company will deliver 13.0% average sales growth, driven by stepped-up store expansion and 4.5% average same-stores sales growth. Earnings are on track for 12-13% now, but accelerating to 17% in years to come. They have a buy-below of $26.20.

Wachovia likes them, too. They believe the favorable industry backdrop gives PetSmart 6-7 years of visible unit growth potential. They also like the strong underlying same-store-sales trends, prospects for improved operating margins, and a share buyback program. Their 3-5 year estimated EPS growth rate is 17.0%.

VL/Manifest doesn't paint as pretty a picture. They estimate 11.4% in sales growth, 6% in net margin, and 14.5% in estimated projected return. What's missing is the .60% dividend yield which puts it over 15% PAR, and I don't believe it's accounting for the large share buyback that is currently in progress. Still, even with a financial strength rating of 50, the Quality Rating is coming in at 66.1%...well within the "bold blue."

Yahoo shows ThomsonFN's 5-year EPS estimated growth at 17.1%
MSN shows Zack's 5-year EPS estimated growth at 16.9%

Judgments on the SSG:

Common sense would tell me that 4.5% same-store sales (that are expected to increase) coupled with a 10% annual increase in square footage would equates to 14.5% in top line growth. Manifest/Value Line is estimating 11.4%. I'm taking the middle ground by using Morningstar's estimate of 13%.

I'm using an estimated EPS of 17% for two reasons. (A) because everyone, including the company itself is using this figure, and (B) because I think the new initiatives will keep this company in the growth cycle, and 17% is in line with its 4-year historical growth rate.

I'm not recalculating the profit margins or shared outstanding (as a built-in safety factor). However, I did have to give careful consideration to the P/Es. The current P/E on 11/10/06 was 25.5. I figure that is a conservative number for the High P/E going forward. Then I chose the average 5-year Low P/E of 13.9 for my lowest figure. This stock was hammered in August, and

I don't see a lot of recovery yet. I'm betting that, as the company continues to execute, the tide will raise these values.

Based on the November 10th price of $31.05, my calculations give me a 2.6:1 upside ratio, with a relative value of 114.3, PAR of 11.5% and Total Return of 17.3%. Per the SSG, my recommendation is a buy below $29.78 which is required to attain a 3:1 upside and a 15% Total Return.

One thing to consider is this: The stock price hasn't moved much in the last 2 years. If management can continue to generate double digit top line growth, and balance the capital expenditures to also generate double digit bottom line growth, the price will be forced to move. It would be nice if we can catch a ride.

Sources of Information for this report:

I ordered an investor's packet, but only received the 2005 annual report, which incorporated the 10K. The rest of my research was on the company's website, Value Line, Wachovia Research, Morningstar, Barron's, and online financial resources. I'm including with this report the article from Barron's that originally triggered my interest in the stock, the Value Line Report, and the SSG.

(To close the presentation for the club meeting, I'll play the video clip of a PetSmart commercial):

PetSmart's TV ad campaign resonates with consumers, with USA Today ranking one PetSmart TV ad among the top ten most likeable and effective TV commercials of 2005.

How many of you recognize Buddy and his loofah toy, Bo-Bo? Would anyone care to guess how many Bo-Bo toys were sold because of this advertising campaign?

The above video clip can be found at:
http://phx.corporate-ir.net/phoenix.zhtml?c=196265&p=imageGalleryTVAds
It's SO cute!

BEFORE YOU ASK:
3Q earnings came in two days after this report was presented. PLUS…the SSG is using OPS data, not StockCentral data. The numbers will vary depending on your source.

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Stock Selection Guide ®

The most widely used aid to good investment judgment

Company Petsmart, Inc. Date 11/10/06

Prepared by Hemscott Data taken from StkCntrl

Where traded NASDAQ Major product/service Specialty R

CAPITALIZATION --- Outstanding Amounts Reference

Preferred ($M)	0.0	% Insiders	% Institution
Common (M Shares)	140.2	1.5	88.5
Debt ($M) 15.4	% to Tot.Cap. 1.6	% Potential Dil.	None

1 VISUAL ANALYSIS of Sales, Earnings and Price

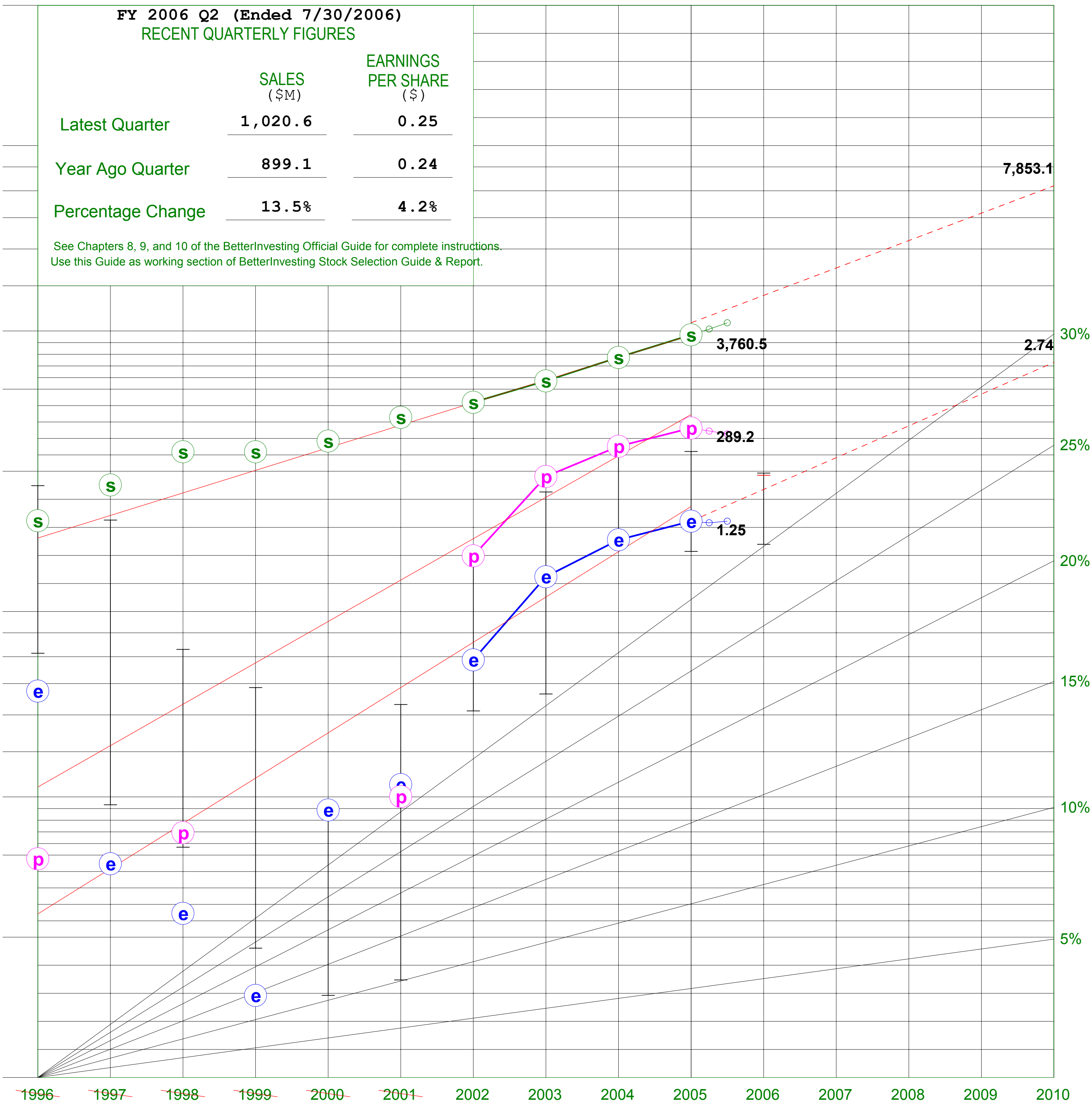
PETM

FY 2006 Q2 (Ended 7/30/2006)

RECENT QUARTERLY FIGURES

	SALES ($M)	EARNINGS PER SHARE ($)
Latest Quarter	1,020.6	0.25
Year Ago Quarter	899.1	0.24
Percentage Change	13.5%	4.2%

See Chapters 8, 9, and 10 of the BetterInvesting Official Guide for complete instructions.
Use this Guide as working section of BetterInvesting Stock Selection Guide & Report.



(1) Historical Sales Growth 11.8 %

(2) Estimated Future Sales Growth 14.5 %

(3) Historical Earnings Per Share Growth 25.1 %

(4) Estimated Future Earnings Per Share Growth 17.0 %

Printed: 11/16/06 06:54 PM Prepared by: Hemscott Using The Investor's Toolkit

2 EVALUATING MANAGEMENT

Company Petsmart, Inc. (PETM) 11/10/06

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A	% Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)	2.3	-1.8	1.9	-1.5	-1.5	1.9	5.7	7.6	7.9	7.7	6.1	UP	
B	% Earned on Equity (E/S ÷ Book Value)	17.0	8.0	5.8	4.5	11.9	11.8	12.9	16.2	17.4	18.5	15.4	UP	

3 PRICE-EARNINGS HISTORY as an indicator of the future

This shows how stock prices have fluctuated with earnings and dividends. It is a building block for translating earnings into future stock prices.

PRESENT PRICE 31.050 HIGH THIS YEAR 31.380 LOW THIS YEAR 22.070

	Year	A PRICE HIGH	B PRICE LOW	C Earnings Per Share	D Price Earnings Ratio HIGH A ÷ C	E Price Earnings Ratio LOW B ÷ C	F Dividend Per Share	G % Payout F ÷ C X 100	H % High Yield F ÷ B X 100
1	2001	10.0	2.6	0.34	29.4	7.6	0.000	0.0	0.0
2	2002	20.9	9.7	0.63	33.2	15.4	0.000	0.0	0.0
3	2003	28.6	10.5	0.95	30.1	11.1	0.020	2.1	0.2
4	2004	35.9	23.4	1.14	31.5	20.5	0.110	9.6	0.5
5	2005	34.9	21.3	1.25	27.9	17.0	0.120	9.6	0.6
6	TOTAL		67.5		152.1	71.6		21.3	
7	AVERAGE		13.5		30.4	14.3		7.1	
8	AVERAGE PRICE EARNINGS RATIO	22.3		9	CURRENT PRICE EARNINGS RATIO		24.8		

Proj. P/E [21.23] Based on Next 4 qtr. EPS [1.46] Current P/E Based on Last 4 qtr. EPS [1.25] PEG=125

4 EVALUATING RISK and REWARD over the next 5 years

Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the stock might sell. The upside-downside ratio is the key to evaluating risk and reward.

A HIGH PRICE -- NEXT 5 YEARS

Avg. High P/E ~~30.4~~ 25.5 (3D7 as adj.) X Estimate High Earnings/Share 2.74 = Forecast High Price $ 69.9 (4A1)

B LOW PRICE -- NEXT 5 YEARS

(a) Avg. Low P/E ~~14.3~~ 13.9 (3E7 as adj.) X Estimated Low Earnings/Share 1.25 = $ 17.4

(b) Avg. Low Price of Last 5 Years = 13.5 (3B7)

(c) Recent Severe Market Low Price = 21.3

(d) Price Dividend Will Support $\frac{\text{Present Divd.}}{\text{High Yield (H)}}$ = $\frac{0.120}{0.006}$ = 21.3

Selected Estimate Low Price = $ 17.4 (4B1)

C ZONING

69.9 (4A1) High Forecast Price Minus 17.4 (4B1) Low Forecast Price Equals 52.5 (C) Range. 1/3 of Range = 13.1 (4CD)

(4C2) Lower 1/3 = (4B1) 17.4 to 30.5 (Buy) Note: Ranges changed to 25%/50%/25%

(4C3) Middle 1/3 = 30.5 to 56.8 (Maybe)

(4C4) Upper 1/3 = 56.8 to 69.9 (4A1) (Sell)

Present Market Price of 31.050 is in the Hold (4C5) Range

D UP-SIDE DOWN-SIDE RATIO (Potential Gain vs. Risk of Loss)

$\frac{\text{High Price (4A1) } 69.9 \text{ Minus Present Price } 31.050}{\text{Present Price } 31.050 \text{ Minus Low Price (4B1) } 17.4}$ = $\frac{38.9}{13.7}$ = 2.8 (4D) To 1

E PRICE TARGET (Note: This shows the potential market price appreciation over the next five years in simple interest terms.)

$\frac{\text{High Price (4A1) } 69.9}{\text{Present Market Price } 31.050}$ = (2.251) X 100 = (225.1) - 100 = 125.1 (4E) % Appreciation

Relative Value: 111.2% Proj. Relative Value: 95.2%

5 5-YEAR POTENTIAL

This combines price appreciation with dividend yield to get an estimate of total return. It provides a standard for comparing income and growth stocks.

Note: Results are expressed as a simple rate; use the table below to convert to a compound rate.

A $\frac{\text{Present Full Year's Dividend \$ } 0.120}{\text{Present Price of Stock \$ } 31.050}$ = 0.004 X 100 = 0.4 (5A) Present Yield or % Returned on Purchase Price

B AVERAGE YIELD OVER NEXT 5 YEARS

Avg. Earnings Per Share Next 5 Years 2.00 X Avg. % Payout (3G7) 7.1 = $\frac{14.2}{\text{Present Price \$ } 31.050}$ = 0.5 (5B) %

C ESTIMATED AVERAGE ANNUAL RETURN OVER NEXT FIVE YEARS

$\frac{\text{5 Year Appreciation Potential (4E) } 125.1}{5}$ 25.0 %

Average Yield (5B) 0.5 %

Average Total Annual Return Over the Next 5 Years (5C) 25.5 %

	P.A.R.	Tot. Ret.
Average Yield	0.4%	0.3%
Annual Appreciation	11.7%	17.6%
% Compd Ann Rate of Ret	12.1%	17.9%