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Transcripts

Petco Health and Wellness' (WOOF) CEO Ron Coughlin on Q1 2021 Results - Earnings Call Transcript

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Petco Health and Wellness Company, Inc (NASDAQ:WOOF) Q1 2021 Earnings Conference Call May 20, 2021 8:30 AM ET

Company Participants

Kristy Moser - Vice President and Investor Relations Officer

Ron Coughlin - Chairman and Chief Executive Officer

Mike Nuzzo - Chief Operating Officer and Chief Financial Officer

Brian LaRose - Senior Vice President, Finance

Conference Call Participants

Oliver Wintermantel - Evercore ISI

Kate McShane - Goldman Sachs

John Heinbockel - Guggenheim

Michael Lasser - UBS

Steven Zaccone - Citi Research

Liz Suzuki - Bank of America

Seth Basham - Wedbush Securities

Zach Fadem - Wells Fargo

Lavesh Hemnani - Credit Suisse

Justin Kleber - Baird

Operator

Good day, ladies and gentlemen. And welcome to the Petco's First Quarter Fiscal 2021 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note that this event is being recorded.

I would now like to turn the conference over to Kristy Moser, Vice President and Investor Relations Officer. Please go ahead, Kristy.

Kristy Moser

Thanks very much and welcome everybody to Petco's first quarter fiscal 2021 earnings conference call. We are webcasting live over the internet. To access the call on the internet, please go to Petco's website at petco.com and follow the links from there.

In addition to the earnings release, there is a presentation available for download, summarizing our first quarter 2021 results and reconciling non-GAAP measures as discussed today with the most directly comparable GAAP measures as well as a financial supplement.

On the call today with me are Mr. Ron Coughlin, Petco's Chairman and Chief Executive Officer; Mr. Mike Nuzzo, Petco's Chief Operating Officer and Chief Financial Officer; and Mr. Brian LaRose, Petco's SVP of Finance. In a moment, Ron and Mike will walk you through Petco's recent financial and operating performance for the quarter.

Before we begin our remarks, I would like to remind you that in this call we will make forward-looking statements regarding our current beliefs, plans and expectations, which are not guarantees of future performance and are subject to a number of risks and uncertainties and other factors that could cause results to differ materially from results and events contemplated by such forward-looking statements.

These risks and uncertainties include those set forth in our earnings release, and our filings with the Securities and Exchange Commission. These forward-looking statements are made only as of the date hereof and except as required by law. We undertake no obligation to update or revise any of them, whether as a result of new information, future events or otherwise.

In addition, today's presentation contains references to non-GAAP financial measures. Reconciliations of these non-GAAP financial measures to the most directly comparable GAAP financial measures are included in our earnings release, and our filings with the Securities and Exchange Commission. During the question-and-answer session of today's call, please limit yourself to one question and one follow-up.

Now, let me turn it over to Ron.

Ron Coughlin

Thanks, Kristy, and good morning, everyone. Thank you for joining us today. This quarter was remarkable one for Petco. Yes, it was an all-time record for quarterly revenue with strong profit flow through, but what's truly remarkable is the customer dynamics that promote sustained growth. We added almost 1.2 million net new customers in the quarter, the strongest gain in my nearly three years at Petco. Spend per pet was up 5% and we gained market share. We drove more and more of that spend into recurring revenue programs like Repeat Delivery and Vital Care.

We launched our co-branded private label credit card this quarter, and the initial response is promising. And from a purpose standpoint, we continue to progress our mission to save pet lives, highlighted this quarter by a partnership with PetDx to launch OncoK9, a true breakthrough in pet cancer diagnostics. Cancer is the number one disease related cause of pet death and a passion topic for me, as my dog, Yummy, is a cancer survivor. Early detection will make a massive difference. This combination of purpose with performance is central to who we are as a company and guides us into the future.

Double clicking into performance. Our team got off to a great start in 2021, driving record quarterly revenue of $1.4 billion, up 27% from Q1 last year with comparable sales growth of 28%. This marks the 10th consecutive quarter of comp growth. We delivered across all of our businesses. Pet Care Centers were a particular highlight delivering growth of 26%. Make no mistake about it. A sizable number of pet parents and their pets love coming into our Pet Care Centers and now feel safe to do so.

At the same time, our digital sales exceeded expectations with 21% growth lapping very strong volume a year ago. Services and vet delivered 63% year-over-year growth. We gained share overall, particularly in the areas where we're focused. Our top line growth translated into a 45% increase in adjusted EBITDA, driven by gross margin expansion and operating leverage, even as we leaned into investments for future sustainable growth.

Last quarter, I said, we were like a unicorn as a beneficiary of both the COVID stay-at-home dynamics as well as accelerating momentum through the reopening. If I reflect on the last 18 months as chapters in Petco's performance history, pre-COVID 2020, our strategy was beginning to take off and we were growing 6%. During the heavily impacted COVID period, our business was largely open and designated as essential. In Q3 and Q4, we grew double-digits as adoptions soar and our e-commerce offers like curbside and same-day gain traction. This year, with reopening, our sales growth has accelerated to 20s with double-digit growth every month.

This performance is powered by both surge in category and the accelerated execution of our unique strategy, dynamics that we expect will generate strong growth in both the mid and long-term. That projected growth is enabled by the customer behavior we're driving through the power of our unique end-to-end ecosystem and our marketing engine. Petco is turning into a customer acquisition machine.

As I stated earlier, we added approximately 1.2 million net new customers in Q1 on the back of roughly 1 million in both Q3 and Q4. The net new customers we've gained in the last 12 months alone contribute to incremental and meaningful growth going forward. This new customer growth is driven by the strength of our digital offering, the continued expansion of our veterinary business, expanded capacity in grooming and training and the return of brick-and-mortar customer traffic, as well as continued industry consolidation and tailwinds from a strong pet category.

Taking a closer look at the customer trends. The recovery of retail traffic is tangible with our brick-and-mortar and services new customers up over 100% and 50% respectively year-over-year. With more vet locations, more vet clinics and aggressive marketing, we almost doubled our new veterinary customers in the quarter versus prior year. These new vet customers are driving higher baskets and transactions than average.

Our digital business continues to fire on all cylinders and is serving as a customer acquisition engine, driving significant active customer growth. We spoke last quarter about multi-channel customers, customers that purchase through multiple channels like brick-and-mortar and digital or multiple categories like food and veterinary services. These customers spend much more with Petco than single channel customers. And Q1 marked our third consecutive quarter with double-digit growth in multi-channel customers. Our analytics rigor and recently built CRM muscle is a key enabler. And we have tremendous headroom here.

Impressively, our game-changing Vital Care membership program is resonating with customers and driving share while with what we believe is the industry's first comprehensive membership program that for $19 a month covers check-ups, vaccinations, grooming services and merchandise discounts.

Membership increased almost 70,000 after launching in mid-October. Early cohorts of Vital Care customers are driving 2.5 times more spend versus average customer profiles. Proving the Vital Care is providing better care for the pet and increase share of wallet for Petco. Strategically, we are driving revenue into our recurring revenue stream businesses, including Repeat Delivery, Vital Care, Insurance and PupBox.

Petco's customer base in recurring revenue programs was up over 50% year-over-year. Our unique model is supported by a phenomenal category that is large and growing. Recent industry forecast had been ratcheted up and now predicts sales growth of 9% in 2021, following stronger than expected 2020 growth of 9%. Corresponding to 2021 to 2025 CAGR is now projected to be over 7% with higher growth projections in key areas like premium nutrition, services, vet and digital, where Petco is uniquely positioned. We see four industry dynamics driving sustained outsize growth.

First, pet adoption remains strong, 2020 growth of almost 6% in pet households and about a third of pet households added more pets with continuing strength into 2021. These trends are not slowing. From a mid to long-term standpoint, a recent survey indicated 65% of 18 to 34 year olds plan to acquire a pet in the next five years. And once a cute puppy or kitten joins a family, they're going to need to be fed, groomed and vaccinated for over a decade or more. This is what we call the furry annuity.

Second, spend per pet increased from historical levels powered by humanization. It is now known that the majority of the 2020 new pets went to millennials and Gen Z-ers who have had higher than average spend levels. As they grow as a percent of pet parents, we expect this will be a tailwind per spend per pet.

Third, recent data shows a mix shift to larger breeds, larger dogs mean larger bowls, so with more food. Lastly, like human trends, pet parents are increasingly focused on their pets health and wellness. With two fifth of pet parents playing closer attention to their pets health and wellness, since the pandemic and over 15% changing the products they buy to healthier premium options. This is where a network of 27,000 passionate trained partners and a portfolio curated to maximize pet health makes a difference.

In fact, we grew our dog and cat sales within Petco’s premium focus brands by over 500 basis points in the first quarter versus last year. The pet category has clearly accelerated and we believe there’s no company better positioned to capture that growth in Petco. In the first quarter, we advanced all facets of our strategic areas of focus. In merchandising our own brands and brands exclusive to Petco, not only enhanced our gross margin, but also fortify our competitive insulation. Own brands delivered double digit growth with great results from the recent launch of WholeHearted active performance in food and the You & Me in supplies. We built strong own brand capabilities and have significant headroom here.

Fresh food is another exciting opportunity with a markets projected to quadruple into a multi-billion dollar category over the next several years. A real example of health and wellness focused translating to premiumization. Fresh food garners, a higher price point with twice the trip frequency versus average. We’re achieving high double digit growth with significant market share gains in fresh and are dedicated to being a market maker in the more humanlike, fresh refrigerated and frozen space. We’re planning to double our Just Food For Dogs footprint, which means we’re adding over 300 incremental locations in the second quarter versus our expectations coming into the year.

Another highlight is companion animals where we’ve led the market for years with a reputation for the highest quality care, knowledgeable partners and array of fish, reptiles, birds and more. Recent industry data indicates that upwards of 19% of current dog and cat owners added a companion animal during 2020. This supports our consistently strong double digit growth rates. Importantly, the companion animal customer is highly attractive with higher spending and trip frequency.

In digital, our strong growth has continued even as COVID restrictions are lifted, translating into customer acquisition, increased transactions and larger basket sizes. Our market share in digital is up by more than 50% year-on-year and more than doubled our digital share on a two year basis. As we lapped a large pandemic related growth in April of 2020, retention of these large COVID cohorts is roughly in line with previous historic cohorts demonstrating the stickiness of our model.

Our structural advantage of 1,453 micro distribution points or pet care centers is a strategic differentiator versus pure play online competitors. We can get to the customer faster for lower costs than shipping from a DC. Our offering of buy online, pickup in store, curbside and same day delivery are resonating with pet parents, including ship from store, our pet care centers now fulfill roughly 83% of petco.com orders, which is just incredible. We're actively shifting customer expectations to same day delivery. Something pure play online competitors will be challenged to replicate nationally. This is particularly strategic in categories like fresh food that are much more costly to ship from distribution centers.

Giving a personal example, when my order of Just Food For Dogs, fish and sweet potatoes comes from one of our pet care centers 2 miles from my house. It comes in a simple bag versus a pack box with cardboard, with dry ice, with foam packaging that online pure play competitors use for comparable products. Clearly, we have an advantage here. Equally exciting, Petco's highly rated app has become a hub for pet parents to manage their pets health and wellness needs, including service reminders and customized suggestions for nutrition, supplies, pet care and services.

Just last week, reminded me that I used to get yummy dental chews. We now have over 3.6 million downloads with strong engagement. Service scheduling on the app is at an all time high and the launch of our nutrition perks program or reward program for repeat purchases led to our single biggest app download week ever. This is important as app customers are spending 2.1 times more than a typical customer. That revenue almost doubled in the first quarter and we expanded our customer reach exiting the quarter at almost 1,200 pet care centers on a weekly basis between our veterinary hospitals and Vetco clinics.

We're extending our full service veterinary offering, delivering world-class affordable, compassionate and comprehensive care at a 12 vet hospitals in the quarter and projecting 72 total openings in 2021 up from the original guidance of 70. Our vet hospital performance continued to exceed our internal model in both sales and four wall hospital EBITDA, particularly newer cohorts. Also ancillary vet offerings like prescription insurance that have a combined TAM of over 11 billion are scaling nicely as we leverage our ecosystem.

I had the chance to visit a number of our great vet hospitals in Miami a few weeks ago, and saw firsthand the close connection between the hospital and the center store team. Customers appreciate the seamlessness across vet services, grooming and merchandise. I even met a companion animal specialist who's excitedly applying to our Vet Tech training programs, another example of our purpose driven performance culture.

By integrating these veterinary hospitals into existing pet care centers, we benefit from structural advantages such as lower costs acquisition and larger baskets that most competitors just don't have. And beyond that, our grooming and training services have seen a strong return of demand, not only growing over the restricted operations last year, but also over 2019. In fact, dog training delivered their highest sales quarter ever. We've continued to take share in a fragmented market as we leverage our digital and marketing capabilities. And as we annualize operational restrictions in the second quarter and third quarter, we expect grooming and training will have a favorable lap dynamic.

These results have been buoyed by the strengths of the Petco brand. Over the last year, we relaunched the brand as The Health and Wellness Company. In the first quarter, we supplemented our focus customer acquisition approach with a brand building campaign to pull away from competition as a Health and Wellness Company. Is what we want if we were pets is a campaign intended to educate pet parents about what whole health means for their pets and motivate them to take action and so thinking about their pets, health and wellness, like they would think about their own.

The response and initial impact has been overwhelmingly positive. And last, but certainly not least, we're excited to announce that our joint venture in Mexico with Grupo Gigante has now eclipsed the 100 pet care center mark and expects to add another eight pet care centers before the ending the year. We're really pleased with the performance of our business in Mexico, continuing double digit comp growth with revenue up strong double digits.

In addition to our strong financial results, our unwavering commitment to improving the lives of pets, pet parents and Petco partners is a key ingredient in our purpose-driven performance. In April, the Petco Foundation, formerly rebranded as Petco Love and rolled out Petco Love Lost a searchable database that uses facial recognition, help reunite lost pets with their families, should they ever go missing. If you've ever lost a pet, you know how nerve wracking it is and how helpless and desperate you feel. To date more than 1000 animal welfare organizations and pet industry partners across the U.S. have said, they're going to adopt the platform. And last month we launched our Pets at Work initiative to make sure all of these pets stay in their loving homes.

The good news is, in the early part of the year, rescues and shelters are seeing relinquishment down about 25% and remain down versus 2019. Like last quarter, we increased our average wage rate for our Petco partners in the field by double digits year-over-year and distributed our sixth and largest appreciation bonus yet, living up to our mantra that as the company does well, so will our partners.

We also believe environmental sustainability is fundamental to ensuring health and wellness for pets, pet parents and Petco partners. In Q1 we made a commitment to increase our assortment of standard products to 50% by the end of 2025, the only major pet retailer to make this kind of commitment. Pulling all that together, we have a category that's surging, we're gaining customers, we're growing sales and we've been building market share. That is made possible by obsessive execution by our team focused on purpose-driven performance.

We entered the quarter with momentum and with tangibly larger and more valuable customer base, delivered strong Q1 results, which should be continued into Q2. This gives us added confidence to increase our guidance for the year, including growth in the second half of the year. Mike will elaborate on this in just a moment.

And with that, let me turn it over to Mike Nuzzo.

Mike Nuzzo

Thanks, Ron. Good morning, everyone. Yes, we are certainly off to a great start in 2021 building on the strong business momentum that Ron discussed, I am pleased to share a strong financial and operational results.

We delivered record revenue of $1.4 billion in the first quarter, up 27% over Q1 2020 with comparable sales of 28% and 30% on a two-year comp basis, well ahead of our expectations with double-digit growth for each month of the quarter. We estimate that government stimulus payments contributed around seven to eight comp points of benefit in the quarter, meaning excluding stimulus, our two-year comp trend exceeded 20% an acceleration from Q3 and Q4 2020.

Diving one level deeper, Q1 digital revenue was up 21% and 129% on a two-year stack. Services and Vet were up over 63% and 46% on a two-year stack and brick-and-mortar merchandise was up 26%, reflecting both the return of retail demand and our strategic initiatives. Both transactions and average basket trends were again strongly positive for the quarter. In Q1, the categories unprecedented and sustained surge in Vet merchandise demand created both added supply chain expense and vendor supply challenges.

Petco is not immune to these dynamics, but we entered this year well inventory to support our strong sales momentum and vendors have indicated that they expect gradual improvement in supply as we move through 2021. And Petco's performance highlights our ability to successfully ship customers to alternative products in out of stock situations.

In our financial outlook, we have incorporated both modest, rest of year elevated supply chain expenses, along with a level of gross profit favorability from select retail price adjustments to address input costs increases. Historically, higher product input costs have resulted in market price increases that have driven higher gross profit results.

Our Services and Vet businesses showed strong results in Q1 and are poised for continued growth as we scale that services and drive new customer acquisition and retention in both grooming and training. Our vet hospital recruiting efforts continue to produce market-leading, time to fill and vet staff retention results.

As Ron mentioned, both our hospital cohort and rest of store lift performance continued to exceed expectations. And in Q2, we expect to close on our first vet practice acquisitions to further augment our hospital expansion. This year, we have plans to do a few of these small one or two vet practice tuck-in acquisitions, where we will move them into our Pet Care Centers, gain learnings, and then determine how best to integrate this approach in the future plans.

Moving down to P&L, gross profit increased $131 million or 28% slightly ahead of the 27% revenue growth to $597 million. Gross profit as a percentage of sales improved 32 basis points over Q1 2020 to 42.2% driven by rate expansion across key business areas, offsetting modest channel and merchandise products mixed pressure and increased supply chain expenses to accommodate higher sales. While we do expect channel mix pressure over the balance of 2021 with the increased relative strength of our Digital, Services and Vet businesses, we continue to see opportunity to drive gross profit rate improvement across our business as an offset.

SG&A as a percent of revenue improved from 40.4% in Q1 2020 to 38.8% in Q1 2021, driven by leveraging Pet Care Center variable and occupancy expenses on our sales volume increase. On an absolute basis, SG&A expenses were $549 million, up $99 million or 22% from prior year driven by brand infrastructure and people investments for sustained growth. In particular, we capitalized on a great opportunity to capture more customers and more than double our marketing spend from Q1 2020 to support our brand campaign and successful digital marketing that we expect will drive additional sales growth benefit throughout the year.

Q1 adjusted EBITDA was $126 million, an increase of 45% from prior year, outpacing revenue and gross profit growth. Q1 adjusted EPS, which also excludes costs related to the refinancing of our term loan improved by $0.24 to $0.17, based on $265 million weighted average fully diluted shares as well as a normalized effective tax rate of 26%.

Turning to our Pet Care Center base, we ended Q1 with 1,453 Pet Care Centers in the United States down one from the fourth quarter. Our Mexico joint venture ended the quarter with 100 Pet Care Centers up four from year end. We continue to have strong liquidity, ending the quarter with $595 million, inclusive of $174 million in cash and cash equivalents and $421 million of availability on a revolving credit facility.

On the cash flow side, we generated strong cash from operations of $115 million, up $147 million from the prior year and had $47 million in capital expenses. We generated robust free cash flow of $68 million, our strongest cash flow for the first quarter in our history and well above expectations. As we discussed last quarter, we took significant actions in Q4 to strengthen our balance sheet driven by our IPO, related recapitalization and free cash flow generation. Our net leverage ratio reduced by 62% to 2.9 times in Q1 of 2021.

Shifting to updated guidance, we are now expecting the following for full year 2021; total revenue of $5.475 billion to $5.575 billion or an 11% to 13% increase from 2020; Adjusted EBITDA between $550 million and $560 million or a 14% to 16% increase from 2020; Adjusted EPS between $0.73 and $0.76 based on 266 million shares outstanding and an effective tax rate of 26% and capital expenditures of between $185 million and $235 million as reported in our 10-K, which includes incremental investments in supply chain capacity in response to sales growth.

Our guidance raise reflect stronger than expected Q1 performance, initial revenue trends in Q2, and a low 20%s range two-year comp assumption for the balance of 2021. Our confidence in the ongoing strength and resiliency of the pet space, the performance of our business areas, our momentum in customer engagement that drives recurring revenue and multi-channel purchase behavior and our executional excellence points to an extremely strong 2021 performance.

Ron and I will now be joined by Brian LaRose, our SVP, leading Finance to take your question.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question today will come from Oliver Wintermantel with Evercore ISI. Please go ahead.

Oliver Wintermantel

Yes, thanks very much, and good morning. I was looking at the guidance for EBITDA and it looks like – it's by the midpoint of the guide is about 10%. I was just wondering if that is, how you think about that longer term, is that a pull forward from your longer term guide or do you think your longer term guide is shifting up.

Ron Coughlin

Thanks for the question, Oliver. We're going to let Brian LaRose take that question.

Brian LaRose

Oliver thanks for the question. First let me comment a little bit on guidance overall, Oliver. So as you saw in the increased guide, we – our EBITDA flow through on the increased guide did result in what you said. So an increase of about 20 basis points at the midpoint to 10%. I'm not sure I characterize that as a pull forward, but more a characterization of what we see for the balance of the year. So if you look at our revenue guidance update, we feel confident in what we're seeing so far in Q2, which gave us the confidence to raise revenue for the full year. And as Mike reflected in his prepared remarks, if you look at the balance of revenue for the year, it implies about a low 20-ish percent two-year comp for Q2 to Q4 in terms of what that means for our EBITDA, we've got modest supply chain costs that we're working through with some modest price – product input inflation and related pricing actions. But we feel good about the EBITDA flow through that we have put in the guidance for the balance of the year. And it's more a characterization of what we see for FY2021. We're not going to comment on any further long-term guidance at this point. With that, I'll turn it over to Ron to see if he has anything to add on to that.

Ron Coughlin

Yes. The only thing I'd say is, we have confidence in the guide. The first thing that gives us confidence is what's happening with our customers, right? We added 1.2 million in the quarter on the back of nearly a million in the prior two quarters each and there are spend per customer is up, our retention is up and that's going to power us through Q2 in the back of the year and into 2022. So we feel confident in the guide.

Oliver Wintermantel

Thanks, Ron. And just to follow-up on what you just said about the acquisition of customers. There's some articles out there saying that people returning their pets to the shelter now that the economy is opening up again. But I think in your prepared remarks, you mentioned that that's not a trend that you're seeing, just wondering what the details are there.

Ron Coughlin

Yes. We were alarmed by that information as well, and I would characterize it as misinformation, through Petco Love, our foundation, we work with all the majority 4,000 shelters and rescues around the country and the data from a tracking service that works with all of those shows that they're actually down 25% from comparable months, year-over-year and down versus 2019. So the good news is because we're in the business of eliminating euthanasia, the good news is the relinquishments are actually down. We want to make sure it stays that way. So we actually launched the, bring your pet to work initiative. We're working with employers on making pet friendly offices, which we have here. My dog Yummy comes to work with me and people joke that she's the Chief Dog Officer that goes so. It's down and we want to make sure it stays that way. Thanks for the question, Oliver.

Oliver Wintermantel

Thanks very much and good luck.

Operator

And our next question will come from Kate McShane with Goldman Sachs. Please go ahead.

Kate McShane

Good morning. Thanks for taking my question. I have wondered about your same day fulfillment option through DoorDash. Can you just confirm that's rolled out to all stores? And can you tell us how much it is as a part of the mix at this point digital mix? And then finally, in the same vein, just how much of your merchandise is being offered through DoorDash at this time and how will it be rolled out over time?

Ron Coughlin

Yes. So, Kate, thanks for the question. So same day is offered through all of our locations, which implicitly highlights the competitive advantage that it provides, our same day offer gets to the customer faster and lower costs than DC shipped product. You think about a DC-shipped bag of 40-ton bag of dog food going across from UPS or FedEx versus it going in the back of a DoorDash over the same cost as a tennis ball. It is an absolute competitive advantage. We're pleased with what percent of our business it is. And actually 30% of customers are saying they prefer same day. We are actively trying to ship, shift the expectation towards same day because our online competitors would have a difficult time replicating that on a national basis. And as we go forward, one of the categories that we are super excited about is fresh food via same day delivery. I cited that on the call and you think about the dynamics of fresh food same day, it is perfect for that. And that gives us another competitive advantage in the fastest growing part of the food – pet food industry.

And sorry, I didn't cover your assortment question. Basically nearly all the assortment goes through - is available via same day. The only stuff that wouldn't would be some of the long-tail type offers that aren't stocked in stores, but I would say 97% of volume SKUs would be available through same day.

Kate McShane

Thank you. And then my follow-up question. So just on gross margins in the back half of the year, I know in Mike's prepared comments, you still flagged the next pressure, but that you're working on some offsets. Could you maybe walk through those as we get through the rest of the year?

Brian LaRose

Yes. Kate, it's Brian, I'll take this one. So I'm not going to get into quarterly guidance on gross margin and but I'll reiterate some of what Mike said that, we did see in Q1 slightly better brick-and-mortar mix than we anticipated, which helped gross margin in Q1. We expect that mix to flip in the Q2 to Q4, as we have relative strength in our Digital, Vet and Services businesses. Now we do expect to continue to work on great gross margin improvements across multiple variables in the business, things like own brands and premium offerings, driving higher AOV through customer engagement, strategies, productivity enhancements. So while we expect some modest mixed pressure Q2 to Q4, we do have vehicles to help mitigate that mixed pressure. That's about as deep as I can go, Kate, I don't want to get into quarterly gross margin dynamics.

Kate McShane

Got it. Thank you. That's helpful.

Operator

And our next question will come from John Heinbockel with Guggenheim. Please go ahead.

John Heinbockel

So Ron, I wanted to start Just Food for Dogs, right? Just remind us frequency of purchase for that customer, maybe relative to a non-customer and an overall spend. And then going from 300 – I saw the 300 to 600, right in one quarter, ultimately, where does – it cannot be in every or the vast majority of the Pet Care Centers and how quickly?

Ron Coughlin

Yes. So let me – at the macro level fresh food is roughly $1 billion now, we see it going to $3 billion to $4 billion the next few years. So a rocket ship of a sub-category, super premium prices, highest price in the Pet Care Center. And the frequency of purchase is significantly higher than your normal kibble. Not only does that mean they're buying that more, but they're also means that we're getting ancillary basket items on those trips. So we love Just Food for Dogs. We also love it, the e-commerce because we think it's a competitive advantage because we do have this distributed inventory through our micro distribution strategy. We are accelerating it and just to be clear, we accelerated it from what we talked about on the Q1 call. We accelerated from what we talked about on our road show.

So this is an acceleration based upon the trends that we're seeing in those locations, where we've been there for more than one to two years. In many of those locations is now our number one selling food, which is just incredible at that price point. But the best news is, in our view, it's one of the healthiest products you could give to the pet. We can see it across our Pet Care Centers. It would take different forms. In some locations like our Union Square, you'll see a gorgeous kitchen where we're actually preparing the food in front of customers. In others, we have what we call pantries, which are not smaller and others, we have a run, which is a much smaller from that. And then we have cooler execution. So we'll customize the execution based upon the throughput of the location.

John Heinbockel

Okay, thanks. So then there is the second non-related right. So the service – with the vet lift, right to comp or attachment rate, right. So that was like 631, right, first three years? In any sense of, is it modestly better than that? Or so for you saying, is it materially better than that?

Ron Coughlin

Mike, you want to handle that one.

Mike Nuzzo

Yes. John, good morning. Yes, the lift is consistent. And what we're seeing in our own vet models is that it's a little better. And again, you can attribute that to everything that we're talking about in terms of that synergy between the Pet Care Center team and the vet hospital, it's strong across the board. It gets a little stronger with the own vet model.

John Heinbockel

Okay. Thank you.

Ron Coughlin

Yes. Just to clarify, one thing on Just Food for Dogs, actually the trip frequency is 2X kibble, so very attractive.

John Heinbockel

Thank you.

Operator

And our next question will come from Michael Lasser with UBS. Please go ahead.

Michael Lasser

Good morning. Thanks a lot for taking my question. What drove into the 5% increase in spending per pet in the quarter? Was it more items in the basket, trading up and inflation benefit, how do you break that down?

Ron Coughlin

Yes and yes on the first two items that you suggested. Our basket is increasing and has been increasing. The premiumization is a trend that's been going on in this category for years. Whether it's premiumization of food, we've moved our premium mix by about 10 points over the last three years. And we see significant headroom to move that further as evidenced by the conversation on Just Food for Dogs or even Honest Kitchen, which is a super premium human grade food that we rolled out towards the end of last year, that's doing well.

So we see both of those as factors on the spend per pet. The other piece that we had is the comeback of our services. They were impinged upon due to COVID regulations. We actually had to shut down our group training as we said on the call, our training had the best quarter it's ever had. Our grooming response and there's more demand than supply, which we're addressing right now, the addition of our vets. So we're seeing basket trend, we're seeing AOV increase and we see those as long-term.

The other longer term dynamic is looking back on the 11 million. I said, 11 million or over 10 million pets in 2020. The majority of those went to millennials and Gen Zers. Millennials and Gen Zers spend more per pet. So that is another tailwind on the spend per pet at the category level.

Michael Lasser

Got it. My follow-up question is it was helpful that Mike quantified the impact from stimulus spending of seven to eight points during the quarter. Presumably, a lot of that went into hard goods. So how did it unfold between hard good and consumables? And then as an unrelated follow-up, how are you using these period of strength as an opportunity to double down on some of your advertising, which presumably will help customer acquisition and continue to drive the funnel that seems to be influencing the business?

Mike Nuzzo

Hey, Michael, I'll take the first part of your question on stimulus. As far as the composition of the spend, it was really across the board. So we had strong trends in all of our categories, for all the reasons that we're talking about. We also feel good about the estimate of the seven to eight comp points. It's not an exact science, but I think our teams did a really good job, really looking at our daily and weekly trend changes associated with the precise timing of stimulus payments really as they've landed at household. So we feel good about the estimate. Again, it was really across the board a reflection of all the strong trends that we had in the quarter. And I'll turn it over to Ron for the…

Ron Coughlin

Actually, yes. So one of the things on your advertising question, that's been just so phenomenal for the business. As we started pulling out of the initial lockdown, probably around Q3 of last year, we really started getting the growth flywheel going and getting into this virtuous cycle of increased marketing investment, increased marketing return, and the business kept accelerating. We've had that flywheel going now since probably September of last year. I'll let Brian elaborate.

Brian LaRose

Yes. On advertising, so in Mike's prepared remarks, he mentioned that in the quarter, we more than doubled year-over-year our advertising investment. We continue to like the ROI we're getting there. On our advertising spend, we took the opportunity in the first quarter to lean into that advertising to fuel that flywheel. Even with those incremental investments in SG&A, we got 160 basis points of leverage in terms of SG&A as a percentage of revenue while continuing to fuel that advertising vehicle for future growth. And that ROI by the way is 2x industry benchmarks on that ad spend.

Michael Lasser

Great. Thank you so much.

Operator

And our next question will come from Steven Zaccone with Citi Research. Please go ahead.

Steven Zaccone

Great. Good morning, guys. Thanks for taking my question. I actually wanted to follow-up on the advertising. And I was curious, how do you feel about your broader brand awareness in light of this increased advertising spend? Is there more work to be done and I guess, specifically you cited strong adoption trend among younger demographics like millennials and Gen Z. How do you feel about your positioning with that younger demographic?

Ron Coughlin

Yes. Hi, Steven, thanks for the question. Our advertising spend, if I look at the chapters, we really focus on customer acquisition and performance marketing got really good at that and you see the customer acquisition trends. So that was working. What we supplemented within Q1 is our new ad campaign, which is all about treating your pet. As you treat yourself, we're getting phenomenal feedback and initial results are very positive on that amongst both older demos, as well as younger demos.

Petco is a strong brand. It was dormant two, three years ago, we really reactivated it. And I think the addition, the combination of performance marketing plus this broader brand building campaign is going to be very powerful and the results speak for themselves. April was a very strong month. And as we said, that momentum continues into May and that's when the campaign launched in end of March. So thanks for the question.

Steven Zaccone

Great. Thanks very much.

Operator

And our next question will come from Liz Suzuki with Bank of America. Please go ahead.

Liz Suzuki

Great. Thank you. On new customer acquisition, do you have any data you can share about where your new customers are coming from? Are they mostly new pet owners or people who already had pets are choosing Petco over other retailers?

Ron Coughlin

Thanks for the question, Liz. We were really pleased with those acquisition trends and what's nice is these customers are shopping across channels. 39% of customers want to be omni-channel customers. And that's where we believe our value proposition is most powerful. In 2020, as I said earlier, the industry game more than 10 million new pets with continued adoptions. As I said, forecast continued to go up in terms of number of new pets, backlogs at breeders, et cetera. And we're getting more than our fair share.

In terms of sources, first, there's a lot of new pets coming to the category. Second, we're seeing industry consolidation, for example, pet value closed in December, and we've seen significant customer acquisition in their former geographies. And anywhere we put a new vet, which is what Mike talked about. That's a new customer for Petco.

From a marketing standpoint, we talked about the campaign. We're also deploying enhanced CRM, analytics, segmentation and as Brian said, marketing ROIs are double the industry benchmark. So we have that marketing flywheel going. With the story within the story that I really like, and it's nascent, but it's impactful is the Vital Care and recurring revenue story.

We increased our recurring revenue customers by 50% in Q1 year-over-year, 50% increase in recurring revenue. And that's behind programs like our Vital Care membership program, our PupBox, our Insurance, and needless to say, our Repeat Delivery. So that gives us stickiness of revenues from Q2 through the second half of the year.

Liz Suzuki

Great. Thank you.

Operator

And our next question will come from Seth Basham with Wedbush Securities. Please go ahead.

Seth Basham

Thanks a lot and good morning. My questions around the vet hospital business and your tuck-in acquisitions there, that's a little bit different strategy you used in the past. If I'm not mistaken, can you give us some more color as to why you're going out and acquiring vets rather than going fully organic with the growth?

Ron Coughlin

Let me just – I'll start and then turn it over to Mike. It's not that we're not organically building. That is our primary strategy. The acquisition is a supplemental strategy, but I'll let Mike elaborate.

Mike Nuzzo

Yes, Seth, thanks for the question. We like this opportunity. I would tell you, we're going to give you a lot more updates as we go along with this. And we're in sort of a test and learn with this, but as we looked at the market, there is still many, many small one, two vet practices out there that typically don't get consolidated. And those are actually a perfect fit for our model. So, as Ron said, the primary focus is recruiting. We're seeing a lot of success for that, but we like the idea of this taking an existing vet practice, moving it into our Pet Care Center hospital. You start with a mature vet hospital, and it gives you a way to accelerate the model.

So again, we'll give more updates on it. We liked the opportunity. We think the financials will be really attractive on it, and that's how we're measuring each potential acquisition. But again, it is a supplement to what has been a really strong recruiting part of the business.

Seth Basham

Understood. Thank you. And as a follow-up question, in the quarter, you guys reported $9.3 million of non-recurring costs. I think you had guide to zero for that. What should we be expecting going forward and what was in that non-recurring cost for the quarter?

Brian LaRose

Yes. Hey Seth, it's Brian. I can take that one. So the vast majority of that line item was a legal settlement this quarter. Going forward, I would stick with what we said in the past, which those will be small and modest amounts, but this quarter we did have a singular item that took up the vast majority of that line.

Seth Basham

Thank you.

Ron Coughlin

Thanks Seth.

Operator

And our next question will come from Zach Fadem with Wells Fargo. Please go ahead.

Zach Fadem

Good morning, guys. Can you talk about your spend per customer and how an in-store only customer compares to a digital or a multi-channel customer? Given that your total spend per customer is roughly half of that of your online pure play competitor. How should we think about new customer adds versus spend per customer trajectory as they move through the year and into the future?

Ron Coughlin

Yes. Thanks for the question, Zach. So as I said, we gained 1.2 million customers in Q1, nearly, 1 million – nearly 1 million in Q4, nearly 1 million in Q3. We've been focused on performance marketing to drive that. Our customer acquisition costs in Q1 and into May are down versus Q4. So we see it as a favorable market to acquire customers. And we're seeing a lot of traction. Now we tend to focus only on digital, where we believe our customer acquisition costs are either lower or are competitive with our main online competitor. But one of the other important parts is on our services business, where we compete with mom and pop. So if you think about a trainer, if you think about a groom or think about a vet the customer acquisition costs because we have traffic in those locations is a fraction of our competitive set.

So not only we're competitive on the digital side, not only is our customer acquisition costs lower, and we're adding marketing at our high ROI, but our customer acquisition in our services end of our business is a fraction of our competitors. If you think about things like Google Local, a mom and pop rumor isn't going to be deploying tools like that. So we have the traffic advantage from the pet care center, plus we have the performance marketing advantages. And overall what's enabling the flywheel is growth in our LTV. So it's a good story on both sides, customer acquisition and LTV.

Zach Fadem

Got it. And then on the impact of inflation, what was the contribution to average ticket and comps in the quarter? And you mentioned some select price increases in response. Maybe you could update us on price competitiveness versus peers and how you expect that to trend?

Mike Nuzzo

Yes. Zach, thanks for the question. Not much of an impact in Q1. We at the end of Q1 obviously had some cost increases that we pushed through retails. Today, we haven't seen any slowdown in demand. I think the team's doing a really good job managing the whole input cost situation. As we've said, historically, input cost inflation in food and consumables has been passed along in higher retails, which has generated net better margin. I would highlight on the supply side, we got ahead of this last year. We anticipated and we're starting to see some higher import and freight costs and we built those into the margin structure on our scaled own brands portfolio, which as you know, you've got to get out in front of a little bit. So that's been a positive for us. And then obviously having a strong own brand infrastructure helps with product availability and flow. So it's a good thing. And so I think we feel pretty good about our ability to manage the margin aspect of the whole product input cost situation.

Zach Fadem

Got it. Appreciate the time.

Ron Coughlin

Thanks, Zach.

Operator

And our next question will come from Lavesh Hemnani with Credit Suisse. Please go ahead.

Lavesh Hemnani

Hi, everyone. Thank you for squeezing me in here. So two quick follow-ups on the margin. So firstly on gross margin, I guess is the message that despite the pressure that you are seeing through the year, you have enough offset in the P&L where pricing actions and other stuff on the cost improvement side, you should be able to offset that. And secondly, on the SG&A side, given that you had significant COVID expenses in 2021, what is the outlook for that and the balance of the year? I believe you guys prepaid like an appreciation bonus in Q1. Thank you.

Ron Coughlin

All right, I think Brian will take that one.

Brian LaRose

Yes. Lavesh, let me reiterate a couple of things. As I mentioned in the gross – earlier gross margin question, we do expect some mixed dynamics in revenue Q2 to Q4, and we have vehicles to help offset that. I'll couple your question on SG&A with the guidance reminder on the balance of the year, our incremental EBITDA guide relative to the incremental revenue guide showed very strong EBITDA flow through Q2 to Q4, which we feel good about. I know you mentioned COVID costs for the balance of the year. I'd also remind you that particularly in March, April last year, and then into Q2, we also had some significant meaningful COVID savings from some of the way we navigated through the early part of the pandemic, which a lot of retailers and other companies also did. So there are lots of dynamics at play. I'd sort of point you to the EBITDA flow through on the incremental revenue and the confidence that we've given in the guide.

Ron Coughlin

Thanks, Lavesh.

Lavesh Hemnani

Got it. Thank you.

Operator

And our last question will come from Peter Benedict with Baird. Please go ahead.

Justin Kleber

Hey guys, thank you. It's Justin Kleber on for Pete. Ron, I wanted to follow-up on one of your comments about the 39% of customers that want to be omni-channel. You guys mentioned in the script double digit growth in the multi-channel customers. Just curious what percentage of your active customers today are multi-channel? Can you give a sense how that penetration has changed versus last year and how much runway you think you guys have to drive that penetration higher?

Ron Coughlin

Yes. So just reiterating, just to reground everybody. Thanks for the question. Reground everyone. We said double digit growth in multi-channel customers, which is our third consecutive double digit growth in multichannel. Why does that matter? Because multi-channel customers have an exponential spend, these are customers that might shop at a pet care center, as well as e-commerce, who might buy food as well as grooming. So that double digit growth is strategic and generates more revenue. The good news is, there's two pieces of good news. One is we're growing and the second is what just under 4 million out of our 22 million-ish customers who are multi-channel customers. So we have a lot of headroom to continue to drive that. And we're proving that we can do that.

I would just highlight, we just started this view in Q2 – of 2020, so we're just getting started and we continue to have momentum in driving that. And a great example of this is vital care, right? We went from zero to 70,000 members of vital care where you get your check-ups, vaccinations discounts on food, grooming, et cetera. And we're up to 70,000 of the vital care customers roughly 19% of them are new to food and over 30% are new to services. So the strategy was to gain share of wallet amongst these customers, and it is working. Our vital care customers are spending 2.5 times more than our average customer. So it's just an example of the multichannel embodied in an initiative. So very strategic for us. Thanks for the question, Justin.

Operator

And this will conclude the question-and-answer session. I'd like to turn the conference back over to Ron Coughlin for any closing remarks.

Ron Coughlin

So thank you for your questions. Our results in revised guidance are a testament to the strength of our team and our unique health and wellness ecosystem that continues to set Petco apart. Our customer acquisition engine is in high gear, while we spend some loyalty, gain share and delivered a differentiated offering of premium products and services all with a great customer experience and a digital platform with competitive advantages. And as we're demonstrating, Petco is striving to be a different kind of company, one grounded and purpose-driven performance. Saving and improving pet lives every single day, and improving our pack of partners lives, all while executing to the highest degree of excellence, elements which come together to create long-term value for our stakeholders. We know your time is valuable and we appreciate you sharing it with us today. Thank you very much.

Kristy Moser

That concludes Petco's first quarter 2021 earnings conference call. Investor relations will be available after the call if you have any follow-up questions.

Operator

And ladies and gentlemen, this concludes today's conference call. Thank you all for attending today's presentation. And you may now disconnect.

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I hereby certify that on Thursday, January 11, 2024, I provided a true and correct copy of the evidence - exhibit 2 to the following:

PETCO ANIMAL SUPPLIES STORES, INC., represented by Amanda Costa, served via ESERVICE at amanda.costa@petco.com

Signed: /s/ Sabrina Giardina