PRIVATE EQUITY INSTITUTE

SAID BUSINESS SCHOOL

UNIVERSITY OF OXFORD

Saïd Business School cases

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Petco Animal Supplies Inc

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This Note was prepared by Tim Jenkinson and Ruediger Stucke as the basis for class discussion. Tim Jenkinson is Professor of Finance at the Saïd Business School, Oxford University. Ruediger Stucke is Research Fellow in Finance and Economics at the Saïd Business School, Oxford University.

Introduction

> *"They must have been really missing us! Marrying the same wife a second time, that must be true love…"*
>
> *"Not if you have been divorced in between…"*

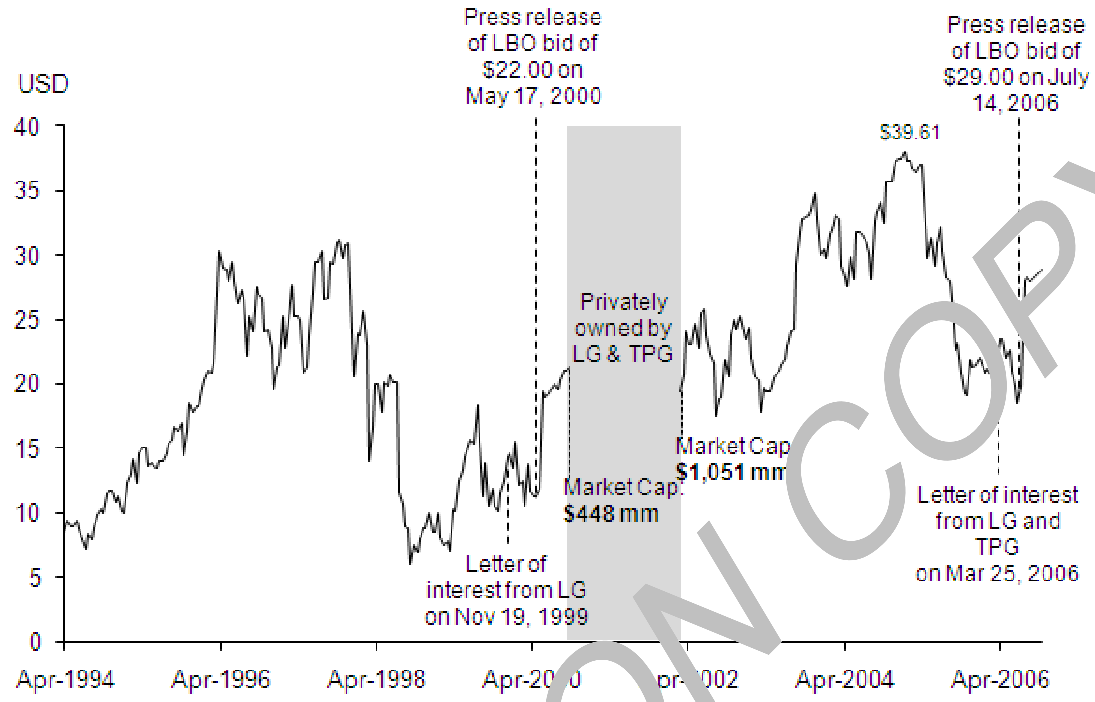
Such sentiments seemed applicable to the situation facing Petco. It was March 29, 2006 in San Diego, California, where the headquarters of Petco was located. The Board of Directors was gathering to review details of a suggested Leveraged Buyout (LBO), proposed by Leonard Green & Partners and Texas Pacific Group - the same investors who had already bought-out the company 6 years ago and subsequently taken it public again. The previous buyout had been a great success, not only for the two private equity sponsors. While supporting Petco's growth, especially through focusing on distribution channels, the sponsoring parties had quadrupled their money within just 17 months.[1] But today, the outlook was a bit different. Petco's operating cash flows had been stagnating for two consecutive years. Concerns that rising energy prices were reducing shopping trips by their customers had driven down Petco's stock price by 50 percent since early 2005 (see Exhibit 1). And competition from supermarkets and other retailers had been growing in recent years.

However, both private equity firms were experienced players in the U.S. market, and had a strong track record of successful transactions. John G. Danhakl, one of the three managing partners at Leonard Green, has been serving on Petco's Board of Directors since the first buyout was completed in October 2000 - even beyond the final exit of both private equity firms in November 2004. As a result of this ongoing cooperation, the company's business and operations were very well understood. This was also the reason why both investors considered the current concerns about the future development of pet stores, which seemed to be depressing the share price, as far too pessimistic.

After reviewing the takeover proposal, the board decided to meet up again on April 5 in order to set up the committee of independent Directors to further evaluate the offer, consult a legal and financial advisor, and start negotiations with Leonard Green and TPG.

[1] "Texas financiers anticipate windfall from Petco IPO" - Associated Press on February 20, 2002.

Exhibit 1: Stock prices of Petco Animal Supplies Inc. since its first IPO in 1994.[2]



Source: Thomson Financial Datastream, U.S. Securities and Exchange Commission.

The private equity players

Leonard Green & Partners

Before founding Leonard Green & Partners in 1989, Leonard I. Green was working at Gibbons, Green and van Amerongen Ltd., a New York-based merchant bank that he had co-founded with two partners 20 years before. "Gibbons Green", whose sole activity was management-led, non-hostile Leveraged Buyouts, had been among the earliest practitioners of this new technique, successfully applying the concept of buying companies primarily with "other people's money" in 30 Leveraged Buyouts. Among the most notable transactions during that period were the acquisitions of Budget Rent-a-Car in 1986 and Kash n' Karry Food Stores in 1988.

After the dissolution of Gibbons Green in 1989, Leonard Green started raising his own private equity fund, Green Equity Investors L.P. (see Exhibit 2). Investments in the 1990s included the acquisition of Big 5 Sporting Goods in 1992 and Rite Aid in 1999. Leonard I. Green died in October 2002, leaving the firm to be run by John G. Danhakl, Peter J. Nolan and Jonathan D. Sokoloff who had been Green's bankers at Drexel Burnham Lambert and Donaldson, Lufkin & Jenrette prior to joining the firm, and Managing Partners since then.

[2] Between taking Petco private in late 2000 and public again in spring 2002 there was a split of Petco's stock, which is the reason for a different market capitalization despite similar stock prices.

Exhibit 2: LBO funds of Leonard Green & Partners and Texas Pacific Group.

Fund	Vintage Year	Size ($mm)	Money Multiple	IRR	As at
Green Equity Investors I	1990	216	5.3	n/m	12/31/2006
Green Equity Investors II	1994	311	2.1	14.0%	12/31/2006
Green Equity Investors III	1998	1,240	2.3	22.4%	12/31/2006
Green Equity Investors IV	2003	1,850	1.1	14.5%	12/31/2006
Green Equity Investors V	2006	5,300	-	-	12/31/2006
Texas Pacific Group Partners I	1994	721	3.5	36.3%	12/31/2006
Texas Pacific Group Partners II	1997	2,500	1.6	8.8%	12/31/2006
Texas Pacific Group Partners III	2000	3,414	2.1	24.3%	12/31/2006
Texas Pacific Group Partners IV	2003	5,300	1.5	34.3%	12/31/2006
Texas Pacific Group Partners V	2006	15,000	-	-	12/31/2006

Source: Private Equity Intelligence.

Texas Pacific Group

By March 2006, Texas Pacific Group (TPG) had become one of the world's largest Private Equity firms, having raised about $14 billion in four Buyout funds since its inception in 1992. At this time, TPG was just about to close its fifth fund at a record level of $15 billion of committed capital, almost tripling the size of its predecessor, and was ready to exploit new investment opportunities.

TPG, named after a railway company in the late 19th century, had a track record of strong returns and a high reputation within the industry. Founded by David Bonderman, James Coulter and William S. Price III in 1992, TPG operated from a dozen offices around the globe, with its headquarters in Fort Worth, Texas, and San Francisco, California. Bonderman and his co-founders initially became famous in the mid 1990s after turning around financially distressed Continental Airlines, earning about 10 times their initial equity investment from the deal when exiting after 6 years. TPG focuses primarily on buying financially troubled corporations with brand-name recognition in order to restructure and improve their operations and provide new strategic directions.

Petco Animal Supplies - "where the pets go" [3]

Company profile

> *"At Petco, our vision is to create a fun and exciting shopping experience, online and in stores, for our customers and their pets by offering a complete selection of pet-related products and pet services, including grooming, canine education, vaccination clinics, and photography at competitive prices with superior customer service at convenient locations. We understand that our customers are pet lovers, not just pet owners. They view their pets as members of the family and believe they deserve the same level of care and comfort. We invite our customers to shop our stores with their pets. This makes purchasing the right product easier and a lot more fun! We also realize that in today's world, our customers' lives are filled with competing demands for their time. To help make caring for their pets a little easier, our stores are conveniently located in the community. Next to the local grocery store, bookstore, video store or on the way home from work, Petco is in your neighborhood. We also offer the convenience of online shopping. Your favorite pet products are available here on our web site and are conveniently delivered to your door."*[4]

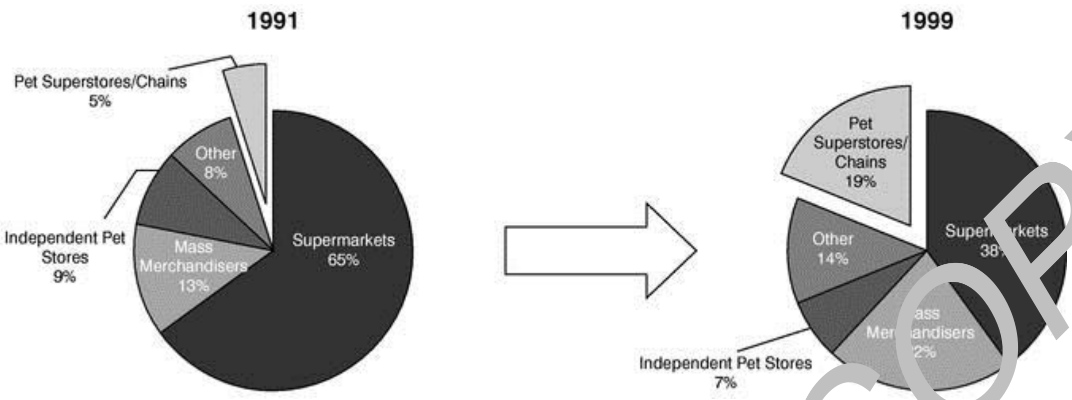
Advent of the Petco superstore

Petco had been operating as a retailer of pet food and supplies for nearly 30 years before the company launched its bid to become the dominant national player in its industry. Founded in 1965, the company competed during its first decades as one of the hundreds of regional pet merchandisers scattered across the country who found it difficult to operate under the shadow of the all-powerful supermarkets. In the battle to lure pet owners into their stores, the supermarkets prevailed comfortably, accounting for 95 percent of all the pet food sold in the U.S. Their dominance came at the expense of specialized retailers like Petco, but beginning in the mid-1980s the grip maintained by the supermarkets started to weaken. The cause for the change was part of a pervasive transformation of the retail industry as whole, a trend that saw massive "warehouse" discount stores and "superstores" secure a substantial foothold in the retail sector. Along with the growing prominence of these new retail formats, the diversity of pet products - particularly food - increased, providing a lucrative niche for the specialized retailers to exploit. Supermarkets had held sway by stocking their shelves with popular brands such as Alpo, Kal Kan, and Purina. But beginning in the mid-1980s new premium brands of pet food were introduced into the market, such as IAMS, Science Diet, and Nutro, that offered higher levels of nutrition than the supermarket brands. These became increasingly popular among pet owners, and specialized pet products stores were the only retailers to carry such brands. The changing dynamics of the pet products industry worked against the supermarkets and contributed to the growing prominence of retailers like Petco.

3 This section draws on information from the International Directory of Company Histories, Vol. 29, St. James Press, 1999.

4 From http://www.petco.com/petco_Page_PC_companyinfo_Nav_142.aspx, accessed February 25, 2009.

Exhibit 3: Shift in market share in the pet food and supplies industry.



Source: 1991 data based on Petco's management estimates, 1999 data based on Package facts reports.

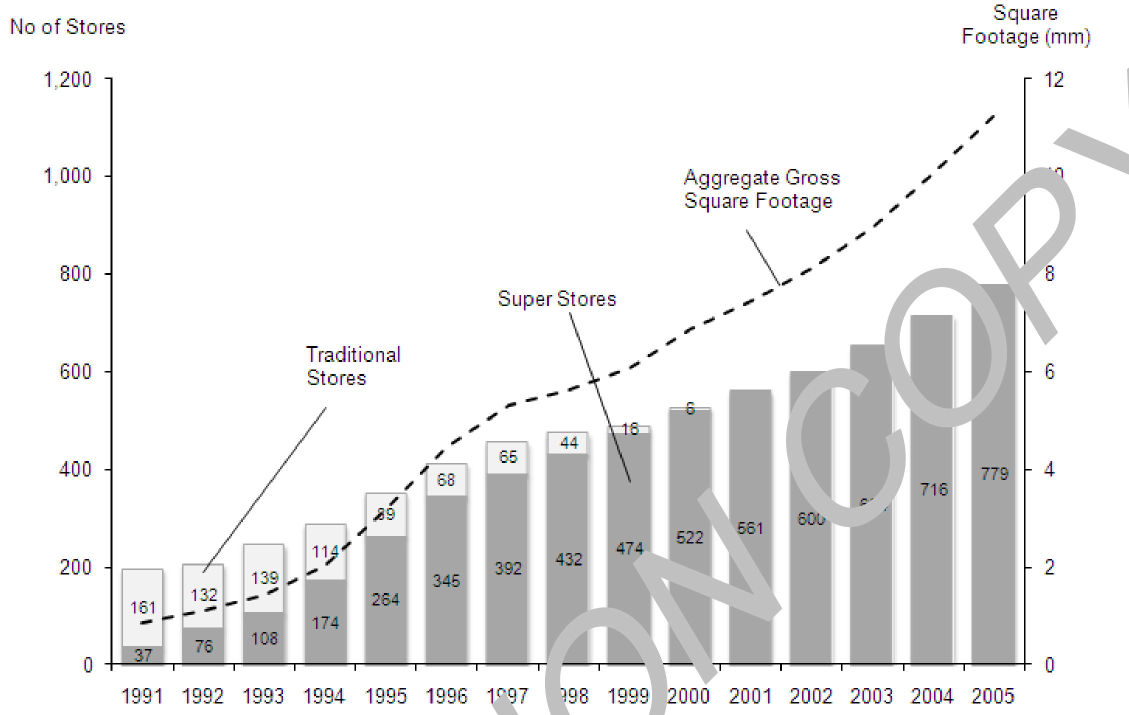
Between the mid-1980s and the mid-1990s, the percentage of pet food sold in supermarkets slipped from 95 percent to 50 percent, with specialized pet products retailers, warehouse clubs, and mass merchandisers accounting for the change. The conditions were perfect for Petco's growth and expansion into a national chain. In the reshaping of the pet products industry, the nearly 30-year-old regional retailer played a leading role (see Exhibit 3).

The early 1990s and Petco's first Initial Public Offering

Petco did not begin to transform into a national force until after its 1994 initial public offering, but the individual who spearheaded the mid 1990s expansion arrived as the decade began. Brian K. Devine joined Petco in August 1990, bringing with him 20 years of retail experience. Prior to his arrival at Petco, Devine had served as president for Krause's Sofa Factory, a furniture retailer and manufacturer, but the bulk of his professional experience came from his association with Toys 'R' Us, a retailer of children's toys. From 1970 to 1988 Devine served in various capacities for the specialty retailer, including as senior vice-president in charge of growth, development, and operations and as the chain's director of stores.

His background in specialty retailing contributed to the personality of Petco as a national retailer, distinguishing it from its main rival, but the company did not take on this personality until it fully embraced the superstore concept. The transition from operating traditional stores to superstores had begun by the early 1990s, when there were nearly 200 Petco stores of various sizes in operation. The majority of the stores consisted of Petco's traditional units, which measured roughly 3,500 square feet. The company had discovered, however, that it could achieve greater customer traffic, sales volume, and profitability with a larger format: Petco's prototype superstore.

Exhibit 4: Development of Petco's stores and sales area.



Source: Data compiled from the U.S. Securities and Exchange Commission; store numbers before 1997 are adjusted by those resulting from the acquisition of PetCare in 1997.

Petco's superstores were five times larger than the company's traditional units, stocking a full range of pet food and supplies, as well as fish aquarium systems, reptiles, and other small animal selections generally not available at the traditional stores. By the end of 1991, the company had established 37 superstores, recording sufficient success with the new format to convince executives to direct expansion efforts in this direction.

Although Petco officials had not abandoned the traditional concept and would continue to operate smaller units that were profitable, the first half of the 1990s would see an increasing number of Petco superstores and a decline in the number of traditional stores (see Exhibit 4).

To expand at a greater rate and to take advantage of market conditions primed for a company with Petco's characteristics, Devine, who was named chairman of the corporation in January 1994, decided to take the company public. Petco's IPO was completed in March 1994, giving the company the financial resources to step up its expansion, something Devine intended to do through acquisitions of smaller pet merchandise chains.

Petco's mid-1990s expansion

Over the course of the ensuing year-and-a-half, Petco completed 12 acquisitions representing 100 stores located in 16 states, converting the purchased units to its superstore format. Petco's superstores carried a merchandise assortment of more than 10,000 items, which was far more than the 400 items generally stocked by supermarkets. Inside the stores, the shelves were stocked with premium cat and dog food, grooming products, toys, and a broad assortment of pet-related items whose diversity was intended to stimulate impulse purchases. Confronted with crab-and-tuna-flavored cat treats, peanut butter-flavored dog biscuits, orthopedic dog beds, bird beak conditioners, pet greeting cards, and numerous other pet-related items, customers responded by generally buying more than they originally intended.

It was a marketing strategy one Petco employee summarized by saying,

> *"They'll come in to just buy dog food and end up buying toys and treats."*

Petco customers admitted as much, their buying habits typified by one customer who explained,

> *"I usually pick up something that I didn't intend to buy. I even look at the dog stuff and I don't have a dog."*

Aside from tantalizing its customers with a vast array of pet products, Petco paid particular attention to the presentation of products. One of the signature traits of the chain was its practice of incorporating the merchandising ideas of other retailers, including those outside the pet products industry. For example, the idea for a brochure wall that began appearing in Petco superstores was first seen by a Petco executive in a hardware store in Europe. The inspiration for a pet bar stocked with pet treats similar to a salad bar for humans was taken from a chain of pet stores in Boston. The result was the adoption of market-proven merchandising techniques and the elimination through assimilation of merchandising advantages held by competitors.

The rewards for capturing the spending dollars of pet owners were vast, estimated at $20 billion by the mid-1990s. Vying for a share of the annual, pet owner expenditures were legions of small, independent pet shops, supermarkets, mass merchandisers, and convenience stores. Petco was in competition with all such pet products retailers, but the most obvious rival was the only other publicly held, national pet merchandise chain, Phoenix-based PETsMART Inc.

Industry pundits preferred to view the two sprawling chains as waging a battle against one another for national supremacy, but Petco officials emphasized the distinctions separating the two companies and downplayed the drama of two industry heavyweights competing head to head.

> *"There is a giant difference," Devine explained. "They [PETsMART] are catering more toward the grocery store user and the mass-market customer. We're catering more to the specialty retail customer. We both sort of picked our niches."*

The niches occupied by the two companies were reflective of the different professional backgrounds of the leaders who controlled each company. Devine's years at Toys 'R' Us influenced his decision to position Petco as a specialty retailer, whereas PETsMART's president and chief executive officer, Mark Hansen, used his experience as a grocery store veteran to pattern PETsMART after the supermarket model of high turnover and lower profitability. Accordingly, PETsMART focused on stocking less expensive merchandise in larger, 26,000-square-foot stores. Petco, on the other hand, based its strategy on retailing more expensive merchandise in smaller, 15,000-square-foot stores.

The contrasting philosophies of PETsMART and Petco also affected each company's real estate strategy, which was part of the reason Devine did not perceive the success of Petco as being dependent on the demise of PETsMART. Generally, the two chains were not side-by-side competitors; instead, each moved into distinct areas, pursuing different demographics. Typically, PETsMART located its superstores in what were referred to as "power centers" alongside other superstores and warehouse stores like Home Depot, Costco, and Staples, hoping to draw customers from outside their immediate neighborhoods. Petco, in contrast, established its stores within neighborhoods, positioning its premium outlets in local shopping centers anchored by supermarkets, where the company's target customer - accounting for 70 percent of its customer base - frequented.

> *"The educated woman is our best customer," explained Devine. "She is the best premium food customer. We try to place our stores where they shop on a regular basis. We try to go with the upscale grocer if possible."*

Difficulties in the late 1990s

With Petco and PETsMART occupying separate turf and together controlling only five percent of a $20 billion market, there was substantial room for expansion as the two companies faced the late 1990s. Devine foresaw the expansion of Petco to 1,[illegible]50 stores, roughly four times the size of the chain by the end of 1996, but as the company pursued its ambitious goal it faltered, sparking criticism that it had been over-zealous in its growth plans. Problems surfaced after the company registered an aggressive year of expansion in 1997. 104 stores were added to the chain, with the majority of the new units coming from the acquisition of the 81-store PetCare chain, which operated in nine mid-western and southern states. The process of efficiently incorporating the new stores into the company's fold and continuing to transform from a 3,000-square-foot format to a superstore format proved to be difficult. As a result of the acquisitions, which increased the company's store count to more than 430 units and extended its presence into 31 states, sizeable financial losses were incurred. During the first half of 1998, Petco racked up more than $[illegible] million in net losses. The company's stock, which had swelled to more than $30 per share in 19[illegible], plunged to around $5 per share.

One stock analyst offered his opinion, explaining,

> *"The company has had problems because, frankly, they expanded their business too much, too fast. The company's costs got a little out of line of what they should have been."*

To make matters worse, the company also faced three class action shareholder lawsuits charging management with securities violations and fraud. The acquisition of nearly 20 retail chains since the 1994 IPO caused considerable strain on the once vibrant chain, but the late 1990s witnessed the recovery of the company that touted itself as the "premier specialty retailer of pet food and supplies in the United States."

By the early months of 1999, Petco began to display signs of vitality. The company had eased back on its acquisition campaign and focused on invigorating the profitability of its existing stores. The stores acquired in 1997 that had precipitated the company's downfall were expected to begin producing as well as the other units by the end of 1999. Analysts, who previously had warily distanced themselves from the company, began to view Petco's prospects more positively. The cause for their more sanguine outlook derived from the company's emphasis on producing returns to shareholders and its new growth strategy. Petco operated 476 stores in 37 states and planned to add to its store count, but expansion in the years ahead was expected to come from the construction of new stores rather than through acquisitions, thereby avoiding the pitfalls of converting stores to the Petco format. In 1999 the company planned to build 40 new stores. As Petco pushed ahead with its plans, its future success depended on producing consistent earnings growth, something that eluded the company during the 1990s. A perennially growing market and a tighter control on profitability, however, engendered optimism for the 21st century.

The first leveraged buyout of Petco in 2000

Leonard Green and TPG acquired Petco in autumn 2000. During the due diligence process they had focused sharply on issues where the operations and the performance of Petco could be improved in the near future. Unexploited potential to integrate and control the large number of mainly independent operating stores, as well as improvements in the entire supply chain management, were of particular interest. Identified issues were thoroughly elaborated and agreed with Petco's management and individual project plans were created to put these ideas into action. From the first day after the completion of the LBO, executives of Leonard Green and TPG, through their positions as the new Directors of the company (see Exhibit 5), were focusing on the progress and pushing the timely implementation of these changes. Of special interest were the creation of up-to-date information and reporting systems and the establishment of an e-commerce platform as an additional distribution channel:

> *"We have invested significant resources in establishing a comprehensive integrated information system infrastructure to replace and upgrade our existing information systems. We have integrated all key functional areas that provide management with timely information on sales trends, inventory tracking and operational data at the individual store level. The new system empowers regional, district and store managers to increase sales, to improve operational efficiency, to control inventory and to enhance customer satisfaction. Our new in-store point-of-sale system tracks all sales by stockkeeping unit using bar codes and allows us to compare the current performance against historical performance and current year's budget on a daily basis. The information gathered by this system supports automatic replenishment of in-store inventory from our regional and central distribution centers and is integrated into product buying decisions. Store labor planning and visual presentation levels are supported by sales management information systems.*

Exhibit 5: Composition of Executive Officers and Directors before and after the LBO.

EXECUTIVE OFFICERS AND DIRECTORS PRIOR TO THE LBO IN 2000

Executive Officers		Joined Petco in	Position since	Stock Options
Brian K. Devine	CEO and Chairman of the Board	1990	1994	477,616
James M. Myers	CFO and Director	1990	1998	35,027
Bruce C. Hall	COO	1997	1997	122,500
Janet D. Mitchell		1989	1998	21,366
William M. Woodard		1991	1999	111,182

Directors		Joined Petco in	Position since
Brian K. Devine	Chairman of the Board and CEO	1990	1994
James M. Myers	Director and CFO	1990	1998
Andrew G. Galef	Director		198[illegible]
Richard J. Lynch, Jr.	Director		1997
James F. McCann	Director		1997
Peter M. Starrett	Director		1994

EXECUTIVE OFFICERS AND DIRECTORS AFTER THE LBO IN 2000

Executive Officers		Joined Petco in	Position since	Common Stock	Fraction of new CS
Brian K. Devine	CEO and Chairman of the Board	1990	1994	87,976	9.1%
James M. Myers	CFO and Director	1990	1998	17,595	1.8%
Bruce C. Hall	COO	1997	1997	17,595	1.8%
Robert E. Brann		2000	2000	n/a	n/a
Janet D. Mitchell		1989	1998	8,798	0.9%
William M. Woodard		1991	1999	8,798	0.9%

Directors		Joined Petco in	Position since
Brian K. Devine	Chairman of the Board and CEO	1990	1994
James M. Myers	Director and CFO	1990	1998
John M. Baumer	*(Partner at LG)*		2000
Jonathan Coslet	*(Executive at TPG)*		2000
John G. Danhakl	*(Partner at LG)*		2000
Julian C. Day			2000
William S. Price III	*(Co-Founder of TPG)*		2000

Source: U.S. Securities and Exchange Commission.

We use Electronic Data Interchange with selected suppliers for efficient transmittal of purchase orders, shipping notices and invoices. Management believes that the systems we have developed provide the ability to continue to improve customer service, operational efficiency and their ability to monitor critical performance indicators. We continue to invest in supply chain technologies, human resources management, financial planning tools and continued improvement to the point-of-sale systems located in all stores."[5]

[5] Company report filed with the U.S. Securities and Exchange Commission.

On December 4, 2000, Petco acquired Petopia.com, a comprehensive pet commerce Internet destination that launched in the summer of 1999, for a payment of approximately $2.5 million to Petopia.com and $2.0 million in additional payments to third parties. Formerly, Petco had a strategic alliance with, and owned an equity interest of approximately 17.4% in, Petopia.com. The operations of Petopia.com had been rationalized and fully integrated with Petco's existing Internet operations since then.

> *"We believe the Internet offers opportunities to complement our 'bricks-and-mortar' stores and to increase our retail commerce and consumer brand awareness of our products. We now operate the popular e-commerce site www.petco.com, which provides our customers with pet-related content, commerce and community via the Internet"*[6]

Leonard Green and TPG had financed the overall acquisition price with almost 70 percent of debt that was moved onto Petco's balance sheet after the acquisition was completed and debt interest and principal had to be served by Petco itself (see Exhibit 6). This high level of debt resulted in a sharp focus on cashflow and the maximization of Petco's EBITDA. The amount of interest expenses that Petco had to pay was highest right after the LBO had taken place. The first year's interest payments equaled approximately 50 percent of Petco's $95 million EBITDA in the last twelve months before the acquisition was completed. On top came another $10 million of mandatory amortization payments on the Senior Loans. Only the remaining cash and drawings on the unused part of Petco's Revolving Credit Facility could then be used to invest in setting up new stores, to reinvest, or to implement all the suggested changes to the existing business operations. As a result of dealing with these constraints, in October 2001, Leonard Green and TPG arranged on behalf of Petco the issuance of another $200 million of 10.75 percent Senior Subordinated Notes. $120 million of these proceeds were then used to repay the maturing Bridge Loan, with the remaining $80 million being invested in new stores. However, the result was an additional $8.6 million in interest payments per year. Fortunately, interest on the Series A and B Preferred Stock could, at the discretion of management, be either paid in cash or in kind. An additional $23.6 million in cash payments would have created considerable financial strain (see Exhibit 7).

The initial public offering in 2002

Just 16 months after the first LBO, which resulted in the delisting of Petco's shares from NASDAQ, the company went public again in February 2002.

Petco issued 14.5 million new common stock at a price of $19.00, raising $275.5 million of fresh capital. The proceeds were then used to redeem all outstanding shares of Petco's Series A Preferred Stock, valued at approximately $142 million, as well as all of Petco's Series B Preferred Stock, valued at approximately $98 million. The remaining $35.5 million was used for general corporate purposes. As a result of this IPO, Leonard Green and TPG received $240 million for their Preferred Stock plus a fee of $12.5 million for arranging the transaction, or 1.3 times their initial equity investment. The previously existing common stock, which was still held by the two private equity sponsors, as well as certain members of Petco's management, was

[6] Company report filed with the U.S. Securities and Exchange Commission.

diluted to 73.8 percent after the IPO, valuing the remaining common stock of Leonard Green and TPG at approximately $600 million. Between March 2002 and November 2004 the two private equity sponsors subsequently sold their remaining interest in Petco at even higher stock prices, realizing a very high multiple on their initial investment within a few years.

Exhibit 6: Financial structure of the first LBO.

Sources of Funds		Uses of Funds	
Revolving Credit Facility	43.7	Purchase of all Shares and Options	486.9
Term Loan A Facility	70.0	Retirement of Debt	113.0
Term Loan B Facility	200.0	Fees & Expenses	32.0
Senior Subordinated Bridge Loan	120.0		
Equity from LG and TPG	195.0		
Retained Equity from Management	3.2		
Total	631.9	Total	631.9

Sources of Equity Contributions		Uses of Equity Contributions	
Green Equity Investors III L.P.	97.5	Series A Preferred Stock	105.0
TPG Partners III L.P.	97.5	Series B Preferred Stock	74.0
Retained Equity from Management	3.2	Common Stock	19.2
Total	198.2	Total	198.2

Source: U.S. Securities and Exchange Commission, own calculations.

Exhibit 7: Costs and details of the new capital structure after the first LBO.

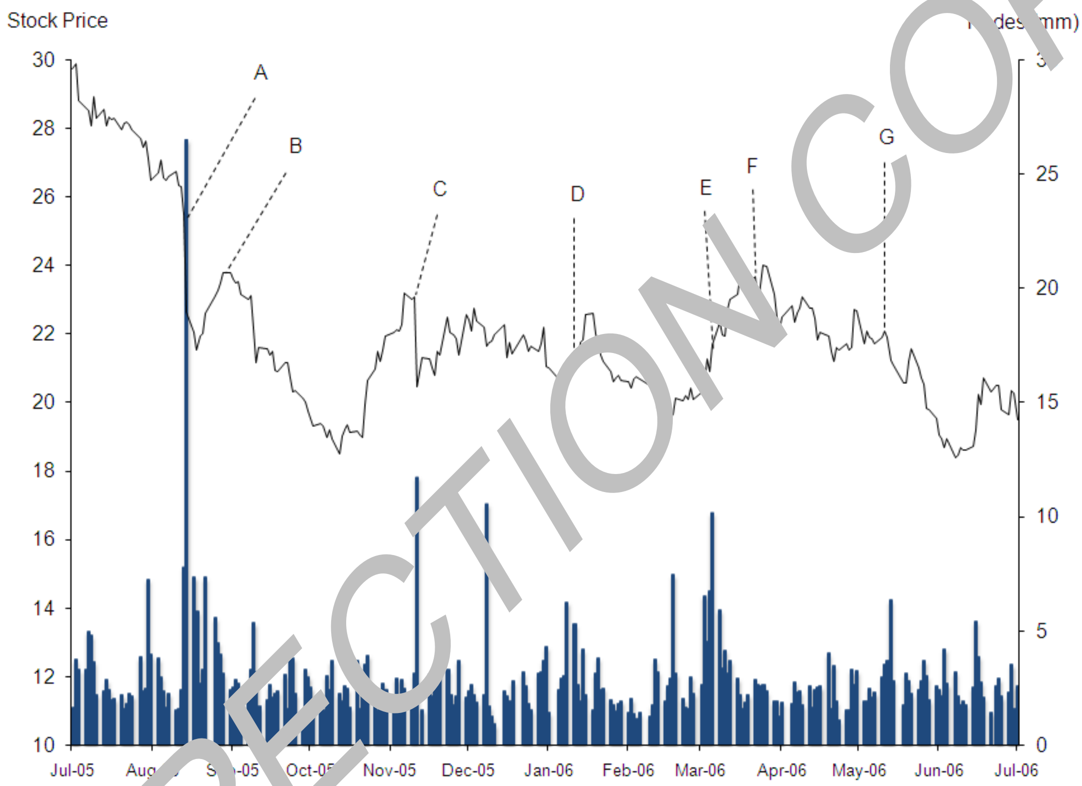
	Amount	EBITDA Mult.	Fraction	Term	Interest	Comm. Fee	LIBOR	Y1 Interest
Revolving Credit Facility ($80m)	43.7	0.46	6.9%	6	325	50	608	4.3
Term Loan A Facility	70.0	0.74	11.1%	6	325		608	6.5
Term Loan B Facility	200.0	2.11	31.7%	8	400		608	20.2
Total Senior Debt	*313.7*	*3.31*	49.6%					*30.9*
Senior Subordinated Bridge Loan	120.0	1.27	19.0%	10	1075			12.9
Total Subordinated Debt	*120.0*	*1.27*	19.0%					*12.9*
Total Debt	*433.7*	*4.57*	68.6%					*43.8*
Series B Preferred Stock	74.0	0.78	11.7%	12	1200			8.9
Series A Preferred Stock	105.0	1.11	16.6%	12	1400			14.7
Common Stock	19.2	0.20	3.0%					
Total Equity	*198.2*	*2.09*	31.4%					*23.6*

Source: U.S. Securities and Exchange Commission, own calculations.

The current takeover bid

Petco's management was facing tough times these days. Since early 2005 its stock price was down by about 50 percent (see Exhibit 8) despite strong increases in turnover in previous years. Public markets were concerned about the stagnating operating cash flows over the previous two years and the future outlook for the pet food and supplies industry. At this point, the prospect of life under the ownership of another private equity investor was not unattractive.

Exhibit 8: Stock price performance in the year before the final bid.



A	08/[illegible]5/200[illegible]	Petco reports Q2 revenues of $482.7mm, a 10% year-over-year increase; net income in Q2 falls
B	[illegible]9/08/2005	$1.3mm
C	11/22/2005	Petco reports expected Q3 EPS of $0.25 to $0.28
D	01/[illegible]	Petco reports that Q3 earnings are down to $0.23 per share from $0.36 a year earlier
E	[illegible]3/16/200[illegible]	Petco appoints Dave Bolen as Chief Merchandising Officer
F	03/30/20[illegible]6	Petco announces $100mm share buyback
G	05/[illegible]006	TPG & LG submit initial indication of interest letter to Boar of Directors
		Petco reports Q1 revenues of $521.0mm, a 8.5% year-over-year increase; net income in Q2 falls
		$6.2mm

Source: Thomson Financial Datastream, U.S. Securities and Exchange Commission, UBS.

The takeover process

March 25, 2006: John G. Danhakl, a Board member of Petco since the first LBO in 2000 and Managing Partner at Leonard Green, indicated to Brian K. Devine, Petco's CEO and one of the two inside Directors, that he was interested in presenting to the Board an acquisition proposal. A meeting of the Board was called for March 29, 2006.

March 29: Mr. Danhakl, on behalf of Leonard Green and TPG, delivered a written proposal to the Board members to acquire all of Petco's outstanding common stock for a price of $26.50 per share in cash.

April 5: The Board met up to form a committee of independent Directors beyond Mr. Danhakl and Petco's two inside Directors. The Independent Committee (IC) engaged its own legal advisor and UBS as its financial advisor.

April 18 - May 4: IC met four times to review and consider the proposal, to receive from, and to discuss with, UBS updates on due diligence and valuation work, and to review draft financial projections provided by Petco's management with respect to the ongoing operation of the business as a stand-alone entity.[7]

May 5: IC held meetings with its advisors to review draft projected financial information prepared by management. Representatives of UBS gave presentations which included the key economic terms of the proposal, a comparison of current and recent market valuations, as well as an analysis of the relative benefits to stockholders that could be achieved pursuant to the proposal and compared with the conduct of the business on a stand-alone basis or following a share buyback through a leveraged recapitalization. IC decided not to put Petco into a broader auction at this time.

May 8: IC considered certain prospects following the required initial filing by Leonard Green and TPG under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. IC decided to make appropriate due diligence materials available following the execution of an acceptable confidentiality agreement.

May 10: Leonard Green and TPG submitted initial operations due diligence requests, and a group from the management began assembling responses.

May 22: Petco entered into confidentiality agreements with affiliates of Leonard Green and TPG in respect of due diligence activities.

May 31: Members of Petco's senior management gave a due diligence presentation to representatives of Leonard Green and TPG, representatives of several potential sources of debt financing for the LBO, and advisors to those parties. This presentation included information on Petco's operations, recent performance, business plan and future prospects as well as an opportunity to engage in a question and answer session.

June, 2006: Leonard Green and TPG engaged in due diligence activities throughout the month.

June 1[illegible]: IC provided projected financial information to Leonard Green and TPG.

June 23: Leonard Green and TPG delivered a merger proposal, indicating that they were still willing to execute the acquisition of Petco at a price of $26.50 per share, together with equity and debt financing commitment letters.

[7] On April 17, 2006, a member of the Independent Committee received an unsolicited written proposal from another retail company competing in the pet food and supplies industry, which proposed an acquisition of all outstanding shares for a price of $30.00 to $32.00 per share in cash. The process of negotiations and due diligence with the industry party ran in parallel to the offer of LG and TPG. On July 12, 2006, IC decided that a material increase in LG and TPG's offer price of $27.00 per share would represent the better deal for Petco's shareholders on a risk/delay-adjusted basis with respect to likely difficulties in negotiations with the industry party and in the light of certain antitrust issues.

June 27: IC required Leonard Green and TPG to increase the offer price and to agree on a termination fee in case they fail to meet their obligations.
June 29: Leonard Green and TPG reported their unwillingness to raise the proposed price, but offered to pay a termination fee of $40m in the event that they did not complete an agreed offer, in return for a break-up fee of $40m, payable by Petco, if they did not complete, or if they chose an alternative bidder. Leonard Green and TPG proposed that Petco should only continue searching for superior proposals from other parties until July 7.
June 29: IC reiterated their demand of a higher offer price, as well as requested improved deal terms including a lower break-up fee and additional time to search for superior offers.
June 30: Leonard Green and TPG indicated their willingness to increase the offer price to $27.00 per share, to lower Petco's break-up fee to $30m in return for an equal reduction in their termination fee, and granted three weeks following the execution of a merger agreement to search for superior offers at a reduced break-up fee of $20m.
July 5: Leonard Green and TPG delivered a draft merger agreement to IC and continued their due diligence process.
July 12: IC reported to Leonard Green and TPG that a material increase in the offer price would result in an immediate recommendation of IC to Petco's Board of Directors to enter into a merger agreement.
July 13: Leonard Green and TPG indicated their willingness to increase the offer price to $29.00 per share, but requested a higher break-up fee of $50m.
July 13: IC considered the latest offer as being fair with respect to Petco's current shareholders and recommended the Board of Directors to enter into a merger agreement. After the Board of Directors agreed to the proposed merger agreement, Leonard Green and TPG delivered definitive equity and debt financing letters.
July 14: Petco issued a press release announcing the intended transaction.
July 14: UBS began contacting certain potential acquirers that they had identified. UBS contacted a total of 56 parties, including 11 strategic parties and 45 financial parties. During the following 20 days, none of the parties expressed an interest in receiving access to confidential due diligence materials or pursuing discussions regarding a potential transaction with Petco.

Facing a Choice

For Petco's shareholders the final bid price was certainly an interesting opportunity. With respect to Petco's stock price when Leonard Green and TPG made their original offer to the Board, the final bid represented a premium of almost 25%. Compared to the stock price one day before the official announcement that a takeover was under discussion the final bid represented a premium of around 50%. But would the employees and other stakeholders appreciate another period of ownership under a Private Equity investor as well as another couple of years of being highly leveraged? The proposed financing structure was quite tough (see Exhibit 9). First year's interest expenses following the buyout equaled 50 percent of Petco's last twelve month's EBITDA - still without borrowing under the new revolving facilities. And having enough cash at hand was crucial these days to focus on further growth. Of course, if Petco achieved the financial projections that management had prepared for Leonard Green and TPG, the new debt would be relatively easy to handle (see Exhibit 10).

However, perhaps some of the numbers were a bit optimistic, in order to dress up the bride for the wedding?

Exhibit 9: Proposed financing structure of the new LBO.

	Amount	EBITDA Multiple	Debt & Equity %	Term	Interest	Comm. Fee	LIBOR	Y1 Interest
Revolving Credit Facility I ($180m)	0	0.00	0.0%	6	150	50	538	0.9
Revolving Credit Facility II ($20m)	0	0.00	0.0%	6	250	50	538	0.1
Term Loan B Facility	700	3.34	35.6%	7	250		538	[illegible]5.2
Total Senior Debt	700	3.34	35.6%					56.2
Senior Subordinated Notes	500	2.39	25.4%	10	925			46.3
Total Subordinated Debt	500	2.39	25.4%					46.3
Total Debt	1200	5.73	61.1%					102.4
Equity by Leonard Green	350	1.67	17.8%					
Equity by TPG	415	1.98	21.1%					
Total Equity	765	3.65	38.9%					

Source: U.S. Securities and Exchange Commission, Reuters Loan Pricing Corporation.

Exhibit 10: Selected actual and projected financial information.

	Actuals			Estimated	Forecast				
In USD millions	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Net Sales	1,610.4	1,812.1	[illegible]	[illegible]	2,410.5	2,626.4	2,850.3	3,073.7	3,302.3
% Growth	9.1%	12.5%	10.2%	10.7%	9.1%	9.0%	8.5%	7.8%	7.4%
EBITDA	194.6	227.2	224.3	226.9	255.7	297.9	334.5	369.6	406.4
% Margin	12.1%	12.5%	11.2%	10.3%	10.6%	11.3%	11.7%	12.0%	12.3%
EBIT	138.1	163.6	[illegible]	138.2	154.7	181.6	206.0	229.6	254.8
% Margin	8.6%	9.0%	7.3%	6.3%	6.4%	6.9%	7.2%	7.5%	7.7%
Depr.& Amort	[illegible]	[illegible]	77.8	88.7	101.0	116.3	128.5	140.0	151.6
% Margin	[illegible]	3.5%	3.9%	4.0%	4.2%	4.4%	4.5%	4.6%	4.6%

Source: U.S. Securities and Exchange Commission.

Exhibit 11: Balance Sheet of Petco Animal Supplies Inc.

For the Fiscal Period Ending	01/29/00	02/03/01	02/02/02	02/01/03	01/31/04	01/28/05	01/28/06	07/29/06
ASSETS								
Cash And Equivalents	36.1	18.0	36.2	108.9	62.2	36.8	39.5	23.4
Accounts Receivable	8.7	8.3	9.7	14.3	12.5	17.9	20.4	20.0
Inventory	116.9	122.2	129.0	138.4	139.5	167.0	183.3	195.9
Deferred Tax Assets, Curr.	18.7	14.1	26.3	14.5	12.0	17.7	16.7	18.1
Other Current Assets	4.8	7.8	8.2	7.5	12.9	10.9	13.9	[illegible]
Total Current Assets	**185.2**	**170.5**	**209.4**	**283.6**	**239.2**	**250.3**	**273.9**	**276.0**
Gross Property, Plant & Equipment	293.7	337.9	386.6	437.7	520.5	636.3	[illegible]	791.0
Accumulated Depreciation	(101.3)	(138.9)	(175.4)	(219.3)	(264.2)	(303.0)	[illegible]	(409.7)
Net Property, Plant & Equipment	**192.4**	**199.1**	**211.1**	**218.4**	**256.3**	**333.3**	[illegible]	**381.3**
Long-term Investments	26.4	19.4						
Goodwill	36.4	45.9	40.9	40.6	40.3	[illegible]	[illegible]	41.9
Deferred Charges, LT	1.9	8.8	6.1	5.7				
Other Long-Term Assets	11.6	10.6	6.0	6.4	[illegible]	[illegible]	[illegible]	20.2
Total Assets	**453.9**	**454.3**	**473.6**	**554.9**	[illegible]	**640.5**	**709.7**	**719.4**
LIABILITIES								
Accounts Payable	49.1	45.5	52.2	[illegible]	63.8	[illegible]	90.8	88.5
Accrued Exp.	50.2	74.0	82.2	96.1	117.7	140.5	146.8	165.2
Curr. Port. of LT Debt	9.1	5.3	2.0	2.0	1.9	0.4	1.8	
Curr. Port. of Cap. Leases	7.9	6.2	4.6	[illegible]				
Curr. Income Taxes Payable				[illegible]	[illegible]	0.5	11.8	
Total Current Liabilities	**116.3**	**131.0**	[illegible]	[illegible]	**190.2**	**223.5**	**251.3**	**253.7**
Long-Term Debt	89.1	373.6	392.5	[illegible]	259.4	189.0	149.3	144.3
Capital Leases	12.4	[illegible]	2.1	2.6				
Def. Tax Liability, Non-Curr.	7.1	[illegible]	6.2	13.3	26.9	32.2	22.6	16.9
Other Non-Current Liabilities	23.1	17.3	[illegible]	19.0	22.3	58.5	69.7	75.2
Total Liabilities	**248.0**	[illegible]	**560.0**	**565.9**	**498.7**	**503.2**	**492.8**	**490.1**
Pref. Stock, Redeemable		[illegible]	219.3					
Common Stock	[illegible]	[illegible]	0.0	0.1	0.1	0.1	0.1	0.1
Additional Paid In Capital	270.7			65.2	66.1	68.4	72.8	83.4
Retained Earnings	(65.3)	(85.7)	(108.5)	(76.3)	(13.0)	68.8	144.0	145.7
Treasury Stock								
Comprehensive Inc. and Other		(182.8)	(197.3)					
Total Common Equity	[illegible]	**(268.4)**	**(305.7)**	**(11.1)**	**53.1**	**137.3**	**216.8**	**229.2**
Total Equity	**205.9**	**(76.9)**	**(86.4)**	**(11.1)**	**53.1**	**137.3**	**216.8**	**229.2**
Total Liabilities And Equity	**453.9**	**454.3**	**473.6**	**554.9**	**551.9**	**640.5**	**709.7**	**719.4**

Source: U.S. Securities and Exchange Commission.

Exhibit 12: Income Statement of Petco Animal Supplies Inc.

For the Fiscal Period Ending	01/30/99	01/29/00	02/03/01	02/02/02	02/01/03	01/31/04	01/28/05	01/28/06	LTM 07/29/06
Revenues	839.6	990.3	1,151.2	1,300.9	1,476.6	1,610.4	1,812.1	1,996.1	2,085.9
Cost Of Goods Sold	624.8	720.7	817.1	908.1	1,017.5	1,060.5	1,175.7	1,325.1	1,400.2
Gross Profit	**214.8**	**269.6**	**334.1**	**392.9**	**459.1**	**549.9**	**636.4**	**671.0**	**685.7**
Selling General & Admin Exp.	187.9	220.8	264.8	308.1	356.5	411.8	472.8	524.6	558.2
Stock-Based Compensation				14.4	7.0				
Other Operating Expense/(Income)				0.4					
Other Operating Expenses	**187.9**	**220.8**	**264.8**	**322.9**	**363.5**	**411.8**	**472.8**	**524.6**	**558.2**
Operating Income	**26.9**	**48.8**	**69.3**	**70.0**	**95.6**	**138.1**	**163.6**	[illegible]	**127.5**
Interest Expenses	(6.9)	(9.8)	(24.5)	(41.4)	(33.5)	(27.5)	(20.3)	[illegible]	(15.3)
Interest and Invest. Income	0.2	0.9	1.6	0.6	0.8	1.4	0.9	[illegible]	0.4
Net Interest Expenses	**(6.7)**	**(8.9)**	**(23.0)**	**(40.8)**	**(32.7)**	**(26.1)**	**(19.3**	**(15.0)**	**(14.9)**
Income/(Loss) from Affiliates		(1.3)	(4.5)	(3.1)					
Unusual Items	(23.0)		(57.2)	(59.0)	(7.0)	(12.6)	[illegible]	[illegible]	(9.7)
EBT	**(2.8)**	**38.6**	**(15.4)**	**(32.9)**	**56.0**	[illegible]	**131.9**	[illegible]	**102.8**
Income Tax Expense	(0.4)	16.8	5.0	(10.1)	23.8	[illegible]	49.5	48.9	42.0
Net Income	**(2.4)**	**21.8**	**(20.3)**	**(22.8)**	**32.1**	[illegible]	[illegible]	**75.2**	**60.8**
Basic EPS	($0.003)	$0.023	($0.046)	($1.315)	$0.208	$1.127	$1.432	$1.3	$1.056
Weighted Avg. Basic Shares Out.	927.2	928.1	632.2	38.4	56.1	57.4	57.5	57.8	57.6
EBITDA	**57.2**	**88.1**	**116.1**	[illegible]	[illegible]	[illegible]	**227.2**	**224.3**	**209.5**
EBITA	26.9	48.8	69.3	70.0	[illegible]	138.1	163.6	146.5	127.5
EBIT	26.9	48.8	69.3	70.0	[illegible]	138.1	163.6	146.5	127.5
EBITDAR	136.9	177.4	219.8	235.4	[illegible]	338.9	391.8	408.8	NA

Source: U.S. Securities and Exchange Commission.

Exhibit 13: Cash Flow Statement of Petco Animal Supplies Inc.

For the Fiscal Period Ending	01/30/99	01/29/00	02/03/01	02/02/02	02/01/03	01/31/04	01/28/05	01/28/06	LTM 07/29/06
Net Income	**(2.4)**	**21.8**	**(20.3)**	**(22.8)**	**32.1**	**64.7**	**82.4**	**75.2**	**60.8**
Depreciation & Amort.	30.4	39.3	46.8	49.4	50.1	56.6	63.6	77.8	82.0
Other Amortization			3.4	14.7	1.6	3.3	5.1	0.3	0.3
(Gain) Loss From Sale Of Assets	1.7	0.0							
(Gain) Loss On Sale Of Invest.			10.2	26.1					
Asset Writedown & Restructuring Costs	(1.1)	(1.5)			0.4	2.2	2.0	2.1	1.7
(Income) Loss on Equity Invest.		1.3	4.5	3.1					
Stock-Based Compensation	0.0			17.4	8.7				7.6
Other Operating Activities	2.6	16.7	0.7	(11.0)	18.3	16.7	1.2	(7.3)	(8.1)
Change in Acc. Receivable	3.2	(1.1)	(1.4)	(1.4)	(4.6)	1.8	(5.4)	[illegible]	1.4
Change In Inventories	(7.9)	(12.0)	(2.8)	(6.8)	(9.4)	(1.1)	(27.5)	[illegible]	(14.3)
Change in Acc. Payable	(0.7)	0.7	(3.6)	6.7	9.1	2.5	18.4	8.7	(3.7)
Change in Other Net Operating Assets	2.0	13.6	18.5	4.3	27.2	10.4	32.9	[illegible]	15.2
Cash from Operations	**27.9**	**78.8**	**55.9**	**79.8**	**133.5**	**156.9**	[illegible]	[illegible]	**143.0**
Capital Expenditure	(51.7)	(40.1)	(46.5)	(56.2)	(56.2)	(95.9)	[illegible]	(123.5)	(100.0)
Cash Acquisitions	(1.8)	(2.9)	(16.4)			(3.1)	[illegible]	(0.7)	(4.6)
Divestitures									
Invest. in Marketable & Equity Securt.	(4.9)	(18.5)	(9.5)	(9.7)					
Net (Inc.) Dec. in Loans Originated/Sold									
Other Investing Activities	(3.9)	(0.8)	(0.2)	5.6	0.2	[illegible]	[illegible]		
Cash from Investing	**(62.3)**	**(62.3)**	**(72.6)**	**(60.3)**	**(56.0)**	[illegible]	[illegible]	**(124.2)**	**(104.6)**
Short Term Debt Issued									
Long-Term Debt Issued	43.3	32.4	397.5	215.7			85.0	131.7	
Total Debt Issued	**43.3**	**32.4**	**397.5**	**215.7**			**85.0**	**131.7**	**362.9**
Short Term Debt Repaid									
Long-Term Debt Repaid	(10.1)	(13.8)	(125.1)	(215.8)	(36.7)	[illegible]	(157.3)	(171.8)	
Total Debt Repaid	**(10.1)**	**(13.8)**	**(125.1)**	[illegible]	[illegible]	**(102.1)**	**(157.3)**	**(171.8)**	**(394.8)**
Issuance of Common Stock	0.1	0.3	17.0	0.1	[illegible]	0.1	0.2	3.0	3.1
Repurchase of Common Stock			(463.4)		(0.0)				(19.2)
Issuance of Pref. Stock			[illegible]						
Repurchase of Preferred Stock					(239.8)				
Total Dividends Paid									
Special Dividend Paid									
Other Financing Activities		(1.7)	(10.3)	(1.2)	(1.5)	(2.9)	(1.5)		(0.4)
Cash from Financing	[illegible]	**17.2**	**(1.3)**	**(1.3)**	**(4.8)**	**(105.0)**	**(73.6)**	**(37.1)**	**(48.3)**
Net Change in Cash	[illegible]	**33.7**	**(18.0)**	**18.2**	**72.7**	**(46.7)**	**(25.4)**	**2.7**	**(10.0)**
Supplemental Items									
Cash Interest Paid	[illegible]	[illegible]	13.7	43.0	32.9	27.3	19.9	15.0	15.0
Cash Taxes Paid	[illegible]	1.1	6.1	2.7	1.4	21.9	58.1	43.4	43.4
Levered Free Cash Flow	NA	NA	48.6	19.9	66.6	50.8	36.9	42.0	44.6
Unlevered Free Cash Flow	[illegible]	NA	63.9	45.8	87.5	68.0	49.6	51.6	54.2
Change in Net Working Capital	[illegible]	NA	(16.9)	5.8	(32.2)	(17.8)	1.6	(5.5)	7.8
Net Debt Issued	33.2	18.6	272.4	(0.2)	(36.7)	(102.1)	(72.3)	(40.1)	(31.9)

Source: U.S. Securities and Exchange Commission.