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Search for Value Criteria

Patterson Companies, Inc. (NASDAQ: PDCO) is currently trading at $21.86 USD per share and has a market capitalization of $2.02B, which is above the $1.20B U.S. market capitalization screening criterion. The company's P/E ratio is 8.46x and it has a P/B ratio of 1.37. The P/E ratio is favourable because it is below the value investing benchmark of 13x, while the P/B ratio exceeds the value investing benchmark of 1.2. The stock is currently covered by 19 analysts and has very high institutional ownership, which is undesirable from a value investing perspective. The stock is underperforming as its share price has reached a significant low compared to the 52-week range between $21.84 USD to $48.30 USD. Although some criteria are not met, the low P/E and the fact that the stock is trading at its 52-week low causes us to believe that this stock may be undervalued, and we will proceed with valuation.

Industry/Company Analysis

Industry Risk: PDCO operates as a distributor within both the dental supplies industry and the animal health supplies industry.
The dental supplies industry has **medium** risk because revenue is dependent on disposable income and the general economic cycle. However, the necessary nature of dental care and growing demand from an aging population mitigates some of these concerns.
The animal health supplies industry also has **medium** risk because it is dependent on general economic conditions as well as commodities prices of milk, grains, livestock, and poultry. However, the essential nature of health supplies to improve animal productivity and maintain food safety mitigates many of these concerns.

Business Risk: PDCO is a dominant player with significant market shares in both industries that it operates in. PDCO enjoys cost advantages from economies of scale because of its size. However, there are many substitutes to PDCO as customers have low search costs and low switching costs. In addition, manufacturers have begun to establish their own distribution centers, adding to the competitive pressure. Overall, PDCO has **medium** risk, giving it an **optimal debt/capital ratio range of 30-49%**.

Financial Risk: PDCO has been increasing its debt/capital ratio over the past few years, with an average ratio of 44.20% over the past 3 years and a ratio of 46.20% in 2018. Since the company's debt/capital ratio is within the optimal range of 30-49%, its financial risk level is **medium**.

For a company with medium business risk and medium financial risk, its credit rating is expected to be A-BBB. After calculating additional ratios, we determined PDCO bond rating to be BBB (Exhibit 1). This is also close to the company's senior unsecured note rating of BBB+. The company's cost of debt is 3.87%, and it has an equity risk premium of 5%, leading to a cost of equity of 8.87%. The company's past 3-year debt/capital ratio is 44.20% and the ratio in 2018 is 46.29%, which are both within the optimal level. As a result, we used a target debt/capital ratio of 44.20% in the WACC calculation.

PDCO's first-pass ROIC is 13.61%, which is an average over the past 2 years. This is higher than the company's WACC of 6.27% (Exhibit 2). From this comparison, we expect that EPV would be greater than NAV.

Valuation

NAV: Using the NAV approach, we obtained a valuation of $24.44 per share (Exhibit 3).
EPV: Under the EPV approach, we obtained a valuation of $30.96 per share (Exhibit 4).

PDCO's second-pass ROIC is 7.49%, which is lower than the first-pass ROIC. This is driven by the large amount of hidden assets possessed by PDCO (Exhibit 5).

Strategic Value Analysis & Franchise Value

Since the EPV per share is significantly higher than NAV per share, there is a franchise value. Government licenses do not drive the franchise because there are none. We believe that the management does not drive the franchise as there have been frequent changes to the management team in the recent years. Franchise value for PDCO is driven by barriers to entry as the size of PDCO allows them to enjoy economies of scale. However, economies of scale are not sufficient for competitive advantage as PDCO does not have customer demand advantage as there are low searching and switching costs. As a result, we estimated a low probability of sustainability of 30%.

Intrinsic Value & Recommendation

Given an intrinsic value of $27.70 per share and a margin of safety of ⅓, the suggested entry price is $18.47, which is lower than the current price of $21.86 (Exhibit 5). Therefore, our recommendation is **not to purchase PDCO shares at this point.**