

DOGNESS INTERNATIONAL CORP.

(NGM: DOGZ)

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COMPANY HIGHLIGHTS

- * DOGZ: An Emerging Global Leader in “smart” Pet Products
- * In our view, Dogness is well positioned to capitalize on favorable trends in the pet care industry, which historically has been insulated from recessions and economic cycle downturns.
- * In December 2017, Dogness raised net proceeds of approximately \$50.2 million from an initial public offering. The company ended its fiscal year on June 30, 2018, with more than \$35 million in cash and short-term investments, which we believe will allow it to execute on its growth strategy.
- * Subsequent to the IPO, Dogness acquired a manufacturing facility in China and has launched a series of new “smart” pet products (including connected collars, harnesses, feeders, and play robots) which we expect will drive robust revenue and bottom-line growth in the coming years.
- * The DOGZ shares are trading at roughly 13-times our EPS estimate of \$0.27 for fiscal 2019. We do not believe that accurately reflects above-average revenue growth expectations (42% in fiscal 2018) and is limited by greater near-term investments and marketing spending. We view the shares as having upside and a fair value of \$9.

INVESTMENT THESIS

Dogness International, founded in 2003, is a designer and manufacturer of high-quality pet products. These include leashes, harnesses and, more recently, a suite of smart products that are designed to capitalize on the migration of consumer product trends towards connectivity and remote access. The company has established an impressive track record of product inno-

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KEY STATISTICS

Key Stock Statistics

Recent price (12/11/18)	\$3.63
52 week high/low	\$1.77-\$6.4
Shares outstanding (M)	20.8
Market cap (M)	\$75.5
Dividend	Nil
Yield	Nil

Sector Overview

Sector	Consumer Discretionary
Sector % of S&P 500	9.8%

Financials (\$M)

Cash & Mkt Securities	35.3
Debt	4.8
Working Capital (\$M)	37.4
Current Ratio	5.2
Total Debt/Equity (%)	8.0%
Payout ratio	NM
Revenue (M) TTM	30.1
Net Income (M) TTM	4.6
Net Margin	15.3%

Risk

Beta	NA
Inst. ownership	0%

Valuation

P/E forward EPS	13.4
Price/Sales (TTM)	2.5
Price/Book (TTM)	1.6

Top Holders

Hongkong Zhongking Holding Company
 Citadel Advisors
 UBS Financial Services
 Tower Research
 Millennium Management

Management

CEO	Mr. Silong Chen
CFO	Dr. Yunhao Chen
COO	Mr. Minilang Gong
Company website	www.dognesspet.com

PRICE CHART



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vation and seems well positioned for long-term growth due to its fully integrated manufacturing chain. It also has established commercial infrastructure in its core China and the United States markets, and benefits from the recession-resistant nature of the pet industry.

At the end of its fiscal year 2018 (June 30, 2018), the company's products were sold in 69 countries. Exports outside of China accounted for 50% of fiscal 2018 sales. Dogness' primary export market is the United States, which accounted for approximately one-third of fiscal 2018 sales. Both China and the United States have seen favorable growth trends for pet ownership and spending on supplies, irrespective of macro-economic trends. According to a recent industry white paper published by Goumin.com, China has approximately 74 million pet owners and has seen 15% growth in annual expenses per pet. In the U.S., approximately 79.7 million home have pets and the rate of spending on pets, as a percentage of household income, has increased over the past decade according to Dogness.

The U.S. represents a key market for continued growth, as Dogness shifts its product portfolio towards "smart" products. In our view, Dogness seems well positioned to capitalize on this market opportunity, given its established reputation for innovation and product quality, and an established commercial infrastructure — which includes a retail presence across leading pet-specialty retailers including PetSmart, Petco and Pet Valu. These chains have accounted for roughly half of the U.S. retail market, and have comprised 40%-50% of Dogness' U.S. revenues in recent years. Dogness also sells through mass retailers such as Walmart, Target and IKEA, and through more than 300 distributors and trading companies that reach smaller outlets. Lastly, the company is also exploring opportunities to drive additional online sales, as pet owners have increasingly turned to internet sites to purchase pet supplies.

Dogness' business focuses on three primary segments: Smart Tech Products, Pet Care Products and legacy Collar and Leash Products. During fiscal 2018, Dogness launched its "Smart Pet Ecosystem." This is a suite of technology-driven products that link pet owners and their pets through a single app platform that is compatible with both Android and iOS devices. We expect these products to drive compelling revenue growth and gross margins over the long term.

Smart products unveiled to date include a pet food feeder, water fountain, treat dispenser, and smart pet toys and robots. Most of the devices have a high definition camera that enables the pet owners to interact with their pet remotely. In addition, the company's H2 and C2 "smart" harness and collar products were developed in collaboration with world-class technology companies, feature SIM cards, and are expected to use T-Mobile's network in the United States. These products are still in the very early stages of their commercialization cycles, and contributed modestly to revenues in fiscal 2018.

In November 2018, Dogness launched a science-based Pet Wellness and Health unit in the U.S., which will research and develop pet supplements and functional pet food. The R&D Center for the health and wellness unit is being led by Dr. Frank Jin, who holds a PhD in animal nutrition and has rich U.S. industry experience at leading companies including Elanco/Eli Lilly, Chr. Hansen and Cargill.

Legacy products include leashes, collars, harnesses, retractable dog leashes and gift suspenders. Leashes and collars have accounted for around 60% of total sales over the past three years. Collar and harness products have been designed to withstand at least four to seven times as much force as the dogs are expected to exert. We view this commitment to product quality favorably for the launch of newer products, where product quality and consumer perceptions will be key for market adoption.

We also view Dogness' strategy to integrate vertical production as a key competitive advantage. The company manufactures much of its products internally, which promotes cost, quality, and delivery time control, while also allowing for an expanded and more-personalized product portfolio. The company estimates that it manufactures between 500 and 600 traditional products, which can be cost prohibitive when utilizing third-party vendors. Dogness' vertical integration and strong retail presence promotes greater efficiency and economies of scale, which we expect to drive superior long-term operating margins.

While products for pets may seem commoditized, Dogness has developed advanced technologies for its products. Between 2015 and 2017, Dogness had more than 120 patents approved or pending. Since its IPO in late 2017, the company won four additional international patents in the "smart" product category and has more than 20 new patents currently pending. Through a combination of trade secret, copyright, trademark, and patent rights, Dogness appears able to protect its intellectual property and brand.

RECENT DEVELOPMENTS

Dogness shares began trading on December 19, 2017, after the completion of an initial public offering that yielded net proceeds of approximately \$50.2 million. Subsequently, the stock has underperformed the market, declining 30% versus a 3.6% gain for the S&P 500. Dogness' stock is thinly traded, averaging volume of 13,263 over the past three months — which likely has contributed to its volatility.

In October 2018, Dogness reported second-half and full-fiscal-year 2018 results that were highlighted by revenue growth of 25.1% and 42.3%, respectively. Net income for the second half and full fiscal year were \$1.7 million and \$4.6 million, respectively. That represented fully diluted net income per share of \$0.09 and \$0.22, respectively. The results were lower than each year-ago period, as operating margins were negatively impacted by increased R&D and marketing investments, as well as expenses related to the IPO.

In November 2018, Dogness announced the grand opening of its U.S. corporate headquarter in Plano, Texas. The site will also serve as the R&D center for its pet health and wellness products.

In August 2018, Dogness introduced a series of new "smart" products that utilize advanced technologies to allow pet owners to remotely interact with, play and feed their pets. These products include the Dogness Smart iPet Robot; Dogness Mini Treat Robot; Dogness Smart CAM Feeder; Dogness Smart Fountain; and Dogness Smart CAM Treater.

In March 2018, Dogness purchased a 6,373 square feet office building in Dallas, Texas, for \$1.37 million, and all of the property interests in Zhangzhou Meijia Metal Product Co. Ltd for \$10.7 million. The com-

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PEER COMPARISON

Company	Ticker	Recent Price (\$)	52-Week High (\$)	52-Week Low (\$)	Mkt. Cap (\$MIL)	1-yr Price Change (%)	1-yr Rev Growth (%)	1 YR EPS Growth (%)	P/E Ratio	Beta	Yield (%)
DOGNESS INTL CORP.	DOGZ	3.60	6.40	1.77	94	-28	42	-33	16.4	NA	NA
PETMED EXPRESS INC	PETS	22.75	57.8	22.11	484	-43	10	55	11.7	0.64	4.6
CENTRAL GARDEN AND PET CO-A	CENTA	30.86	41.97	27.14	180	-25	8	52	15.8	0.93	NA

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pany plans to utilize the Dallas office for international sales and customer service, quality control and testing. It also intends to build a production facility in Zhangzhou, China, that will enable sufficient production capacity to meet anticipated customer demand. Dogness expects the facility to come online during the first half of calendar 2019.

EARNINGS & GROWTH ANALYSIS

We expect fiscal 2019 revenues to rise by 20% to \$36 million (at the high end of the company's 10%-20% growth outlook) as the commercial rollout of the "smart" product portfolio gains traction over the course of the year. We expect revenue growth to remain robust over the coming years, based on the launch of upgraded products stemming from Dogness' commitment to R&D.

We are encouraged by Dogness' ability to expand revenues (through volume increases) and its ability to command higher selling prices (due to enhanced product designs and technology and material improvements). In fiscal 2018, the total quantity of product sold increased by 44%, with pet leashes and pet collars representing the two largest product segments. Among newer products, pet harness sales rose 230% to nearly \$5 million in fiscal year 2018. This was due to increased sales volumes of 143% to 1.5 million units sold and, to a lesser extent, a higher average unit-selling price of 36% (due to improved technical design and functionality and new materials). Retractable dog leashes were launched in fiscal 2015 and saw 57% higher revenues — to approximately \$2.7 million. The higher selling prices across the portfolio resulted in a higher gross margin in fiscal 2018, to 40.3%, from 39.4%.

Fiscal 2019 is likely to be a year marked by significant investment. We expect both R&D expenses and SG&A expenses to continue to increase, as Dogness invests in future growth initiatives for both products and infrastructure. We are encouraged that the company has guided for expansion of net income for fiscal 2019 after experiencing an EPS decline in fiscal 2018.

We see EPS of \$0.27 in fiscal 2019, representing the high end of Dogness' 10%-20% net income growth guidance. We expect EPS of \$0.36 in fiscal 2020, reflecting enhanced economies of scale from the integration of the new production facility in China and the expansion of the commercial portfolio to include more "smart products" (which are likely to garner higher selling prices and, thus, higher gross margins).

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Dogness is Medium-High. The company is well funded, in our view, with \$35.3 million in cash and short-term investments at June 30, 2018. The company raised net proceeds of \$50.2 million in its December 2017 initial public offering.

Net cash provided by operating activities was approximately \$3.5 million in fiscal 2018, including net income of \$4.6 million, adjusted for non-cash items for approximately \$0.9 million. Current assets were approximately \$46 million, and current liabilities were approximately \$8.8 million, resulting in a current ratio of 5.3:1. The company has \$4.8 million in outstanding bank loans as of June 30, 2018, with \$1.8 million due in January 2019 and the balance maturing in August 2019. In the past, company debts have been guaranteed by related parties, including CEO Silong Chen and his family. We expect that Dogness will be able to repay these loans with cash on hand and positive operating cash flow.

Dogness does not pay a dividend, and we do not expect one to be initiated in the near-term, as the newly public company focused on launching new products and investing in long-term growth initiatives — including manufacturing and building infrastructure to support its vertically integrated model.

MANAGEMENT & RISKS

Mr. Silong Chen serves as Chairman & Chief Executive Officer. Mr. Chen founded the Chinese subsidiary in 2003 and has more than 14 years of experience in the pet products industry. He created the Dogness brand in 2008. As the sole holder of Class B Common Shares, which hold a three-to-one voting ratio over Class A Common Shares, Mr. Chen controls a majority of the combined voting power. Overall, the company's directors, executive officers, and their affiliates, hold in aggregate approximately 62% of the voting power of the capital stock.

As of June 30, 2018, Dogness had five directors, the majority of which are independent and non-employee in status. This compares favorably to the prior two years, when the company had one director (Chairman & CEO Mr. Silong Chen).

Risks related to an investment in Dogness include the competitive nature of the pet wearable industry. Although we view Dogness' reputation for innovative technology products and robust sales distribution network favorably, its products are not as well known as competing products from the dozen-plus competitors to its "smart" C2 and H2 products. The competitors include well-known brands such as Whistle GPS Pet Tracker and Garmin's Delta Smart Dog Tracker. We also expect the company to face intense competition over the long-term for its home-based "smart" products, as market trends shift towards products becoming more connected.

Lastly, the company's functional currency is the RMB. But the global sale of its products, half of which occur outside of China, subject the company to financial currency risk which can impact the results in its financial statements that are presented in U.S. dollars. The RMB has depreciated each of the past three fiscal years, by 2.0%, 7.2% and 0.8% against the U.S. dollar in fiscal year 2017, 2016 and 2015, respectively.

COMPANY DESCRIPTION

Dogness was born in 2003 from the belief that pet dogs and cats are important, well-loved family members. Through its smart products, hygiene products, health and wellness products, and leash products, Dogness is able to simplify pet lifestyles, make them more scientific, and enhance the relationship between pets and pet caregivers. The company ensures industry-leading quality through its fully integrated vertical supply chain and world-class research and development capabilities. This has resulted in over 100 patents and patents pending. Dogness products reach families worldwide through global chain stores and distributors.

VALUATION

The DOGZ shares have recently traded around \$3.50, which represents a 16-times multiple on its fiscal 2018 EPS of \$0.22, and 13-times our \$0.27 estimate for fiscal 2019. In our view, the current valuation does not fairly reflect the 42% revenue growth Dogness achieved in fiscal 2018; its future growth prospects — which we expect to be driven by a broad launch of smart products into an established retail network; and its vertically integrated manufacturing platform, which can drive enhanced economies of scale and superior long-term operating margins.

The pet care industry is extremely fragmented, with many private companies or operating units of much larger companies. Indeed, Garmin (NYSE: GRMN) is a global leader in health-focused technology wearables for people, but also a Smart Dog Tracker product for pets. Among publicly traded pet-centric companies, we identified PetMed Express (Nasdaq: PETS) and Central Garden and Pet Company (Nasdaq: CENTA). On a P/E-to-growth (PEG) basis, these companies are currently trading at an average multiple of roughly 1.3-times, using consensus analyst estimates for 2019. Applying a comparable PEG multiple to our projected 25% long-term growth rate for Dogness and our fiscal 2019 EPS estimate of \$0.27, we arrive at a fair value of \$9 per share. (Steven Silver)

INCOME STATEMENT

Growth Analysis (\$MIL)	2013	2014	2015	2016	2017	2018
Revenue	NA	NA	NA	16.1	21.2	30.1
Gross Profit	NA	NA	NA	5.6	8.3	12.1
SG&A	NA	NA	NA	1.7	2.3	5.6
R&D	NA	NA	NA	0.2	0.2	0.6
Operating Income	NA	NA	NA	3.6	5.8	5.9
Interest Expense	NA	NA	NA	0.4	0.3	0.0
Pretax Income	NA	NA	NA	4.1	5.9	5.5
Tax Rate (%)	NA	NA	NA	15	16	17
Net income	NA	NA	NA	3.5	4.9	4.6
Diluted Shares	NA	NA	NA	15.0	15.0	20.8
EPS	NA	NA	NA	0.23	0.33	0.22
Dividend	NA	NA	NA	NA	NA	NA
Growth Rates (%)						
Revenue	NA	NA	NA	NA	32	42
Operating Income	NA	NA	NA	NA	59	2
Net Income	NA	NA	NA	NA	42	-7
EPS	NA	NA	NA	NA	43	-33
Valuation Analysis						
Price (\$): High	NA	NA	NA	NA	NA	6.40
Price (\$):Low	NA	NA	NA	NA	NA	1.77
PE: High	NA	NA	NA	NA	NA	29.1
PE: Low	NA	NA	NA	NA	NA	8.0
PS: High	NA	NA	NA	NA	NA	4.4
PS: Low	NA	NA	NA	NA	NA	1.2
Yield: High	NA	NA	NA	NA	NA	NA
Yield: Low	NA	NA	NA	NA	NA	NA
Financial & Risk Analysis (\$MIL)						
Cash	NA	NA	NA	1.4	1.5	7.1
Working Capital	NA	NA	NA	-1.2	-1.5	37.4
Current Ratio	NA	NA	NA	0.86	0.85	5.23
LTDebt/Equity (%)	NA	NA	NA	NA	NA	NA
Total Debt/Equity (%)	NA	NA	NA	118	80	8
Ratio Analysis						
Gross Profit Margin	NA	NA	NA	34.5%	39.4%	40.3%
Operating Margin	NA	NA	NA	22.6%	27.4%	19.7%
Net Margin	NA	NA	NA	21.6%	23.4%	15.3%
Return on Assets (%)	NA	NA	NA	NA	32	11
Return on Equity (%)	NA	NA	NA	NA	80	14
Op Inc/Int Exp	NA	NA	NA	10	17	248
Div Payout	NA	NA	NA	NA	NA	NA

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