

November 11, 2019

## DOGNESS INTERNATIONAL CORP. (NGM: DOGZ)

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.

### COMPANY HIGHLIGHTS

- \* DOGZ: An emerging global leader in smart pet products
- \* In our view, Dogness remains well positioned to capitalize on favorable long-term global trends in the pet care industry, which historically has been insulated from recessions and economic cycle downturns.
- \* However, fiscal 2019 financial results were dampened by ongoing trade disputes and export tariffs with the United States, which began in September 2018 and increased in May 2019. Revenues in fiscal 2019 declined by 13% to \$26.2 million; encouragingly, 2H fiscal 2019 revenues stabilized and increased 5% over 1H, and Dogness was able to maintain profitability during the challenging full-year period.
- \* Amid these near-term challenges, Dogness has focused on domestic sales opportunities in China, and has made significant progress towards diversifying its global footprint by introducing its smart product portfolio into new markets such as Australia and South America. As such, we believe Dogness is well positioned to resume a growth trajectory in the coming years.
- \* During fiscal 2019, Dogness leveraged appearances at prominent global trade shows by adding new distributors, including online retailer Chewy in the U.S.; expanding its relationship with Petco, a prominent U.S. retailer with a strong online presence; and adding new international partners.
- \* Sales of the newly launched smart pet product line, which includes connected collars, harnesses, feeders, and play robots, totaled \$2.1 million in fiscal 2019. We expect the line to drive robust revenue, margin and bottom-line growth in the coming years and are encouraged by the ramping of distribution for these products among leading global retailers.

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### KEY STATISTICS

#### Key Stock Statistics

Recent price (11/11/19)	\$1.55
52 week high/low	\$1.46-\$4.25
Shares outstanding (M)	25.9
Market cap (M)	\$40.1
Dividend	Nil
Yield	Nil

#### Sector Overview

Sector	Consumer Discretionary
Sector % of S&P 500	10.1%

#### Financials (\$M)

Cash & Mkt Securities	13.7
Debt	2.9
Working Capital (\$M)	17.9
Current Ratio	3.2
Total Debt/Equity (%)	5.0%
Payout ratio	NM
Revenue (M) TTM	26.2
Net Income (M) TTM	1.4
Net Margin	5.3%

#### Risk

Beta	NA
Inst. ownership	0%

#### Valuation

P/E forward EPS	13
Price/Sales (TTM)	1.5
Price/Book (TTM)	0.7

#### Top Holders

Dimensional Advisors  
UBS Financial Services

#### Management

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

### PRICE CHART



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- \* As of June 30, 2019, Dogness had approximately \$13.7 million in cash and short-term investments on its balance sheet, which we expect to be sufficient to execute on its growth strategy through fiscal 2020.
- \* The DOGZ shares are trading at roughly 13-times our EPS estimate of \$0.12 for fiscal 2020. We do not believe that the current valuation accurately reflects above-average revenue growth expectations (42% in fiscal 2018) and expectations for resumed growth, upon addressing near-term challenges. We view the shares as having upside and a fair value of \$5.

## 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 innovation 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 as well as the United States markets, and benefits from the recession-resistant nature of the pet industry.

The company's products have been sold in about 70 markets worldwide. The geographic mix continues to evolve, as sales in China accounted for 57.5% of fiscal 2019 sales. Exports outside of China accounted for roughly 50% of fiscal 2018 sales. Although the United States remains Dogness' primary export market, fiscal 2019 exports to the U.S. accounted for 21% of revenues, down from approximately one-third of fiscal 2018 sales. In fiscal 2019, sales to Europe and Canada accounted for approximately 13% of revenues, up from 7% in fiscal 2018.

Although the United States has seen favorable growth trends for pet ownership and spending on supplies (irrespective of macro-economic trends), ongoing trade disputes and tariffs on exports has led Dogness to focus on the domestic opportunity in China and entering new markets, such as Australia and 12 countries in South America. 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.

Despite the near-term challenges, Dogness has established a 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, which collectively account for roughly half of the U.S. retail market. In addition, the company's U.S. subsidiary has recently entered into agreements with large retail chains in the U.S. and Canada for the distribution of smart pet products under the company's own brand (rather than just serving as an OEM supplier). This should help to mitigate decreased OEM sales in the United States due to the ongoing trade situation between China and the U.S.

Dogness also sells through mass brick-and-mortar and online retailers such as Walmart, Target and most recently Chewy.com, and has recently reported progress expanding distribution of its smart products

online through these vendors, as well as online leader Amazon. We think that successfully driving sales online should provide a tailwind for sustained commercial growth.

Dogness' business focuses on three primary segments: Smart Tech Products; Pet Care Products; and legacy Collar and Leash Products. Late in 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. The company also newly launched an array of feeders that suit different needs and price points for customers. Among these new products, there is a series of feeders and toys dedicated to cats and that echo the increasing population of cats. These products are still in the very early stages of their commercialization cycles, and fiscal 2019 revenues were \$2.1 million.

In November 2018, Dogness opened its U.S. corporate headquarter in Plano, Texas, a complex which includes a science-based Pet Wellness and Health unit that will research and develop pet supplements and functional pet food, in partnership with a leading U.S. company in this arena. The companies aim to develop and manufacture in the U.S. and sell through the partners' global network, sharing the advancement of the biotechnology in the U.S. with the worldwide pet population.

Legacy products include leashes, collars, harnesses, retractable dog leashes and gift suspenders. Leashes and collars accounted for 47.5% of fiscal 2019 revenues, compared with 59.1% during the same period in fiscal 2018 due to the emergence of the smart product category. 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. Dogness has developed and made use of more than 100 patents globally, and has registered more than 160 trademarks. Through a combination of trade secret, copyright, trademark, and patent rights, Dogness appears able to protect its intellectual property and brand.

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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	1.55	4.25	1.46	40	-60	-13	-77	31.0	NA	NA
PETMED EXPRESS INC	PETS	23.33	28.38	15	470	-15	4	1	18.0	0.63	4.7
CENTRAL GARDEN AND PET CO-A	CENTA	28.7	36.92	20.51	1700	-1	8	52	16.3	-0.09	NA
CHEWY INC	CHWY	23	41.34	22.28	9164	NA	NA	NA	NA	NA	NA

## RECENT DEVELOPMENTS

Year-to-date, Dogness stock has underperformed the market, declining approximately 60% versus a 23% gain for the S&P 500. Dogness' stock has averaged volume of 60,000 over the past three months, significantly higher than the prior three-month period -- which has contributed to its recent volatility.

In October 2019, Dogness reported fiscal 2019 results that showed a 13% revenue decline to \$26.2 million, which was attributable to ongoing trade disputes and export tariffs with the United States. However, 2H revenues stabilized and showed a 5% sequential increase over 1H, as the company shifted its strategy to capitalize on expansion opportunities in China and other international markets. Gross margins were also impacted by raw material costs and lower average unit selling prices due to promotional activity, which we view as likely short-term in nature.

In October 2019, Dogness announced that its smart products had been introduced through one of Australia's leading retailers, and that additional partners (including online retailers, department stores, consumer electronics and pet retailers) were expected to launch in the near term.

In September 2019, Dogness announced that U.S. distribution of its smart products had expanded through Petco.com, expanding penetration of the U.S. market. This complements the company's smart product distribution network that is led by Chewy.com and Amazon.com.

In April 2019, Dogness announced new relationships with several international distributors, which were directly attributable to the company's attendance at major industry conferences in early 2019, including the Consumer Electronics Show (CES) in Las Vegas and Global Pet Expo (GPE) in Orlando. Dogness' products were specifically mentioned by media outlets including CNN Business, Wired, and Design Week at CES. The new distributors included U.S. online pet product retailer Chewy.com, a prominent U.S. kennel club, and a pet product distributor in Panama that provides to 12 countries in South America.

In April 2019, Dogness entered into a cooperation agreement with Canada's Corey Nutrition Pet Food, under which Dogness will be the sole distributor in China of Corey's popular food brands, and may share aggregated smart product technology data and pet food consumption, pet behavior and pet health insights with Corey.

## EARNINGS & GROWTH ANALYSIS

We expect fiscal 2020 revenues to rise by 16% to \$30.5 million, and fiscal 2021 revenues of \$38 million, which would represent 25% growth. With near-term results dampened by trade concerns with the United States, we are encouraged by Dogness' strategic shift towards domestic opportunities in China and other global markets. We expect the commercial rollout of the smart product portfolio to continue to gain traction across the year, and expect revenues to resume a growth trajectory over the coming years, based on the launch of upgraded products stemming from Dogness' commitment to R&D.

Fiscal 2019 gross margins were 36%, down from 40% in fiscal 2018, due to several items, including higher raw material costs and lower average unit selling prices as a result of promotional activity. We expect the promotional activities ultimately to drive enhanced product awareness, particularly from the nascent smart product portfolio, and for increased volumes of these higher margin products to drive the line item above 40% over the coming years.

Fiscal 2020 is also 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 products and infrastructure, including manufacturing plants and equipment to enhance long-term growth prospects.

We see EPS of \$0.12 in fiscal 2020 and EPS of \$0.21 in fiscal 2021, 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.

## FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Dogness is Medium-High. The company is funded sufficiently, in our view, with \$13.7 million in cash and short-term investments at June 30, 2019.

During fiscal 2019, net cash used in operating activities was \$1.3, compared with approximately \$3.5 million provided in fiscal 2018. Current assets were approximately \$25.9 million, and current liabilities were approximately \$8.1 million, resulting in a current ratio of 3.2:1. The company had \$2.9 million in outstanding bank loans as of June 30, 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, longer-term, with 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 & CEO. 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, 2019, Dogness had five directors, the majority of whom are independent and non-employee in status.

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 collar and harness 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 years, by 3.7%, 2.0%, and 7.2% against the U.S. dollar in 2018, 2017 and 2016, 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 \$1.50, which represents a 13-times multiple on our \$0.12 estimate for fiscal 2020. In our view, the current valuation does not fairly reflect the 42% revenue growth Dogness achieved in fiscal 2018 and (notwithstanding challenges seen in fiscal 2019) its future growth prospects. We expect growth will be driven by a broad launch of smart products into an established retail network; and the 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 has a Smart Dog Tracker product for pets. Among publicly traded pet-centric companies, we identified PetMed Express (Nasdaq: PETS), Central Garden and Pet Company (Nasdaq: CENTA) and recently IPO'd Chewy Inc. (Nasdaq: CHWY). On a P/E-to-growth (PEG) basis, PETS and CENTA (CHWY is currently unprofitable), have been trading at an average multiple of roughly 1.3-times, using consensus analyst estimates for 2020. Applying this multiple to our projected 30% long-term growth rate for Dogness and our fiscal 2020 EPS estimate of \$0.12, we arrive at a fair value of \$5 per share.

Steve Silver

**INCOME STATEMENT**

<b>Growth Analysis (\$MIL)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020E</b>	<b>2021E</b>
Revenue	NA	NA	NA	16.1	21.2	30.1	26.2	30.5	38.1
Gross Profit	NA	NA	NA	5.6	8.3	12.1	9.4	11.9	15.8
SG&A	NA	NA	NA	1.7	2.3	5.6	8.1	8.4	9.2
R&D	NA	NA	NA	0.2	0.2	0.6	0.7	0.7	0.8
Operating Income	NA	NA	NA	3.6	5.8	5.9	0.6	3.0	5.9
Interest Expense	NA	NA	NA	0.4	0.3	0.0	0.6	0.4	0.5
Pretax Income	NA	NA	NA	4.1	5.9	5.5	1.8	3.8	6.6
Tax Rate (%)	NA	NA	NA	15	16	17	21	17	17
Net income	NA	NA	NA	3.5	4.9	4.6	1.4	3.2	5.6
Diluted Shares	NA	NA	NA	15.0	15.0	20.8	25.9	26	26.5
EPS	NA	NA	NA	0.23	0.33	0.22	0.05	0.12	0.21
Dividend	NA	NA	NA	NA	NA	NA	NA	NA	NA
<b>Growth Rates (%)</b>									
Revenue	NA	NA	NA	NA	32	42	-13	16	25
Operating Income	NA	NA	NA	NA	59	2	-90	354	104
Net Income	NA	NA	NA	NA	42	-7	-70	127	75
EPS	NA	NA	NA	NA	43	-33	-77	126	72
<b>Valuation Analysis</b>									
Price (\$): High	NA	NA	NA	NA	NA	6.40	NA	NA	NA
Price (\$):Low	NA	NA	NA	NA	NA	1.77	NA	NA	NA
PE: High	NA	NA	NA	NA	NA	29.1	NA	NA	NA
PE: Low	NA	NA	NA	NA	NA	8.0	NA	NA	NA
PS: High	NA	NA	NA	NA	NA	4.4	NA	NA	NA
PS: Low	NA	NA	NA	NA	NA	1.2	NA	NA	NA
Yield: High	NA	NA	NA	NA	NA	NA	NA	NA	NA
Yield: Low	NA	NA	NA	NA	NA	NA	NA	NA	NA
<b>Financial &amp; Risk Analysis (\$MIL)</b>									
Cash	NA	NA	NA	1.4	1.5	7.1	2.9	NA	NA
Working Capital	NA	NA	NA	-1.2	-1.5	37.4	17.9	NA	NA
Current Ratio	NA	NA	NA	0.86	0.85	5.23	3.2	NA	NA
LTDebt/Equity (%)	NA	NA	NA	NA	NA	NA	5	NA	NA
Total Debt/Equity (%)	NA	NA	NA	118	80	8	5	NA	NA
<b>Ratio Analysis</b>									
Gross Profit Margin	NA	NA	NA	34.5%	39.4%	40.3%	36%	39%	41%
Operating Margin	NA	NA	NA	22.6%	27.4%	19.7%	2%	10%	15%
Net Margin	NA	NA	NA	21.6%	23.4%	15.3%	5%	10%	15%
Return on Assets (%)	NA	NA	NA	NA	32	11	NA	NA	NA
Return on Equity (%)	NA	NA	NA	NA	80	14	NA	NA	NA
Op Inc/Int Exp	NA	NA	NA	10	17	248	1	8	12
Div Payout	NA	NA	NA	NA	NA	NA	NA	NA	NA

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