

WOOF Earnings Call Transcript

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[speaker 0]: Good afternoon, and welcome to the Petco Third Quarter twenty twenty five Earnings Conference Call. All participants will be in a listen only mode. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your telephone keypad. To withdraw your question, please press star, then two. Please note, this event is being recorded. I would now like to turn the conference over to Tina Romani, Head of Investor and Treasury. Please go ahead. Good afternoon.

[speaker 1]: And thank you for joining Petco's Third Quarter twenty twenty five Earnings Conference Call. In addition to the earnings release, there is a presentation available to download on our website at ir.pepco.com. On the call with me today are Jewel Anderson, Pepco's Chief Executive Officer Sabrina Simmons, PETCO's Chief Financial Officer. Before we begin, I'd like to remind everyone that on this call, we will make certain forward looking statements which are subject to a number of risks and uncertainties that could cause actual results to differ materially from such statements. These risks and uncertainties include those set out in our earnings materials and SEC filings. In addition, on today's call, we will refer to certain non GAAP financial measures. Reconciliations of these measures can be found in our earnings release, presentation and SEC filings. With that, let me turn it over to Joel.

[speaker 0]: Thanks, Tina, and good afternoon, everyone. Thank you for joining us to discuss our third quarter results where I am pleased to share that we delivered another profitable quarter in line with our plan

[speaker 2]: We've continued to strengthen the foundation of our operating model improve retail fundamentals, and position Petco for sustainable, profitable growth over the long term. We delivered sales in line with our outlook and meaningfully improved our profitability. Increasing operating income over the last year by over 25,000,000 generating 99,000,000 in adjusted EBITDA and more than 60,000,000 in free cash flow. I want to thank our teams across the organization for their dedication, focus, and execution on our transformation initiatives that are continuing to gain traction as reflected in our improvement in profitability and cash flow in Q3 and year to date. You've heard me talk about the importance of culture, and you will continue to hear that as a key theme of our transformation. When I joined Petco, we had a strong culture centered around pets first. The passion of our 30,000 partners was one of the many things that attracted me to joining. Over the last nine months, as a collective leadership team, we've been building on that culture in two ways. First, through reinstilling retail fundamental discipline which is driving increased financial rigor and accountability. This is a testament how the organization has embraced new ways of working with strengthened operating principles and was a large contributor to our results. Second, creating a culture that is playing to win. We are fostering a culture equally focused on operating discipline and a winning mindset. Last month, I had the opportunity to spend time with our support center and store leaders at our Leadership Summit. Together, we aligned on what our go forward values will be for a reimagined Petco, and what that means for our customers and our plans to execute on our One Petco Way vision. We are squarely in phase two of our transformation. Which is centered on improving profitability and strengthening our foundation from which to grow. The success to date has fundamentally changed the way we think and work to continuously identify future areas of opportunity that will further unlock long term value. At the same time, we are now strategically shifting resources towards phase three. A return to growth Now

that our bottom line has meaningfully been improved, Last quarter, I outlined the four pillars that support Petco's return to growth. First, delivering compelling product and merchandise differentiation. Second, delivering a trusted store experience. Third, winning with integrated services at scale. And finally, serving our customer with a seamless omni experience. Let me now provide you more specific color on each pillar. Starting with compelling product, and merchandise differentiation. I view this in two categories. On the consumable side, we have improved shoppability. With higher in stock availability, Our customers rely on us to have everyday go to product. Better integrated assortment planning, and merchandising teams have been created improved in store experience as well as online. On the discretionary side, we are focused on infusing a steady stream of newness in 2026 that complements our evergreen product assortment with more seasonal, and trend driven buys. Previously, there has been a set it and forget it mentality. Which is not a very aspirational shopping experience, and one that we are changing. As we look forward, we see significant opportunity to change our collective merchandise mindset from solely a needs based business to also a wants based business by overhauling our product offering, and surprising our customers with unexpected ideas for their pets. A great example with the success of our online pilot our new My Human product line was expanded into over 200 stores This is a small milestone, but exemplifies our team's focus and ability to lean into trend forward impulse purchases. Next. Moving to a trusted store experience. Joe Venizia, our chief revenue officer, who joined us just about a year ago, leads our operations and services team. Since joining, he has been focused on store simplification, standardizing processes across our fleet, and taking costs out of our operations. He is now shifting his focus to additionally include revenue driving KPIs like increasing transaction size, driving sales contests, and increasing customer interactions. With our passionate partners, strong customer engagement, and a full suite of services, we can create both a fun and convenient experience that pet parents are unable to get anywhere else. Our store partners are a unique differentiator for Petco. We benefit from having long time passionate and knowledgeable partners that serve our pets and our pet parents. Our opportunity today is around making it easier to run our stores. Freeing up our store associates to interact with customers, and use what we call their superpowers of pet knowledge. Improving these areas will make it easier for us to drive sales growth in 2026. Moving now to services at scale. Our nationwide wholly owned and operated services business continues to be our fastest growing category. And is our competitive moat given its in person nature high barriers of entry, and difficulty to replicate. The holistic ecosystem between grooming, owned hospitals, clinics, and center of store can only be found at Petco. What especially excites me here is the opportunity we have with our existing assets. I think about it in three ways. One, improving utilization through increased staffing and appointment availability. Two, improving engagement. Through enhanced digital capabilities. And three, improving integration of services and center of store. With regards to veterinarian staffing, I'm pleased to share that we are ahead of our doctor hiring goals that we set at the start of the year with record high doctor retention. During the quarter, we also promoted two of our longtime leaders to chief veterinarians. Reinforcing our commitment to growing our veterinary business. Simultaneously are fostering a culture of team development, top talent recruitment, and execution of our strategic veterinary initiatives. All of this is foundational and is critical to increasing the utilization of our hospitals. Additionally, we are increasing access to care by strategically adding hours back on peak client demand and making appointments easier to book. You're standardizing processes across our fleet to secure in store follow-up bookings. We are increasing efficiency through our refined grooming apprenticeship model freeing up both appointment availability and increasing volume. And finally, we are enhancing online appointment scheduling to ensure we have better coverage and better flexibility for our customers. Clearly, Q3 has been a busy yet productive time for our services businesses. Let me spend a moment on improving integration between services and center of store. As the opportunity here may not be well understood. Historically, Petco stores and services were run relatively siloed which was a missed opportunity. There is a tremendous value unlock when better integrating our stores, and services experience. I'll give you a simple example. Previously, our veterinarians did not have access to customer purchase data. We are in the process of fixing that. And in 2026, our veterinarians will be able to see purchase history, and make more informed diet recommendations based on overall pet health, and specific needs. Taking that a step further, the veterinarian will be able to direct the customer to the recommended product in store or rec store

associate to assist. This is a simple example, but illustrates how increased integration of services and stores create a better outcome for pets, and improved experiences for our customers. Now moving on to our fourth and final pillar, seamless omni integration. Layered on to everything I just discussed, are enhanced digital capabilities, more compelling membership offering, and a frictionless digital to store experience to customers wherever they choose to engage. I'm happy to report we are on plan with our improvements and in fact, we are starting to implement some of these changes in Q4 of this year. For example, we are transitioning the way we buy media, beginning with better targeting, and bidding strategies, which we expect to drive efficiencies in our marketing spend as we continue to strengthen Petco's reintroduction of our tagline where the pets go. I'm pleased with the progress on the membership program, and we will begin live testing and pilot the program this quarter in a small handful of districts. Our focus on these four pillars will fuel our growth which we still expect to see in 2026. In closing, as you can hear in my voice, this has been a productive quarter at Petco. And I'm pleased with the progress we continue to make on the commitments I outlined at the beginning of the As each quarter passes, we get better at celebrating amazing pet experiences executing our strategies, and delivering on our promises internally, and externally. The initiatives planned for the fourth quarter will advance the Petco transformation and I look forward to sharing updates with you in March. Ahead of the Thanksgiving holiday, I want to personally express my gratitude for our partners, who put pets first every day and boldly reflect who we are and what we stand for. Our Petco Love Foundation, has demonstrated our long standing commitment to saving lives finding loving homes for over 7,000,000 pets to improve the welfare of animals. With that, I'll hand the call over to Sabrina take you through the specifics of our third quarter results and outlook for the remainder of the year. Sabrina?

[speaker 1]: Thank you, Joel. Good afternoon, everyone. In the third quarter, PEPCO once again delivered against our commitments while building a stronger foundation from which to grow. As we've discussed all year, strengthening the health of Pepco's economic model, has been our top priority. I'm pleased with our progress as demonstrated in our expanding gross margin, expense leverage, operating margin expansion. Not only in the quarter, but year to date. In line with our outlook, which reflects our decision to move away from unprofitable sales, Net sales were down 3.1% with comp sales down 2.2%. As a reminder, the difference between total sales and comp is driven by the 25 net store closures in 2024, and the additional nine net store closures year to date. We ended the quarter with thirteen eighty nine stores in The US. Gross margin expanded approximately 75 basis points to 38.9%. Similar to the first half, gross margin expansion was primarily driven by a more disciplined approach to average unit retail and average unit cost. Including stronger guardrails and more disciplined processes to effectively manage our pricing and promotional strategies. It's important to note that in this quarter, tariffs began to more meaningfully impact our cost of goods sold. Moving to SG and A. For the quarter, SG and A decreased \$32,000,000 below last year and leveraged 97 basis points. As we've discussed previously, our shift in mindset and increase in rigor around expense management is evident in our results. Savings were achieved across the board in especially in g and a areas. Notably, marketing spend was about flat year over year. Our expanded gross margin and expense leverage resulted in operating margin expansion of over a 170 basis points Adjusted EBITDA increased 21% or \$17,000,000 to 99,000,000 and adjusted EBITDA margin expanded nearly 140 basis points to 6.7% of sales. Moving to the balance sheet and cash flow. Q3 ending inventory was down 10.5% while achieving higher in stocks for our customers. We continue to manage inventory with discipline, which is one of the drivers of our improving cash profile. Free cash flow for the quarter was \$61,000,000 and year to date was 71,000,000 Both the quarter and year to date were significant above the prior year. Notably, year to date cash flow from operations has nearly doubled versus the prior year to a 161,000,000. We ended the quarter with a cash balance of \$237,000,000 and total liquidity of 733,000,000 including the availability on our undrawn revolver. And now turning to our outlook for the full year. We are once again raising our adjusted EBITDA outlook for 2025. We now expect adjusted EBITDA to be between \$3.95 and \$397,000,000. An increase of roughly 18% year over year at the midpoint. For the full year, given we are entering the last quarter, we are narrowing our range for net sales and now expect net sales to be down between two and a half percent and 2.8%. For the fourth quarter, we expect net sales to be down low single digits versus the prior year as we continue to execute on the initiatives we've outlined. We expect adjusted EBITDA to be between \$93 and

95,000,000 It's important to note that the impact of tariffs is sequentially more meaningful in Q4. Additionally, the significant progress we've made year to date against strengthening our economic model and improving our earnings profile has provided us the option to begin selectively investing behind the business where it may make sense as part of our ongoing efforts to set the stage for phase three. A return to profitable sales growth. With regard to other guidance items, for the full year, we expect depreciation, to be about 200,000,000 net interest expense of approximately a 125,000,000 about 20 net store closures and 125,000,000 to 130,000,000 of capital expenditures with a greater focus on ROIC. In closing, as Joel discussed, we're in a period of significant change and I want to extend my deepest appreciation to all of our teams for embracing that change to deliver better outcomes for all of our stakeholders. With that, we welcome your questions.

[speaker 0]: We will now begin the question and answer session. If you are using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press star then 2. In the interest of time, please limit yourself to one question and one follow-up. We will now pause momentarily to assemble our roster. The first question will come from Simeon Gutman with Morgan Stanley. Please go ahead.

[speaker 2]: Hi, guys. Hey, Joel.

[speaker 3]: Let me I was intrigued by something you talked about. Some of the wants. Can you talk about can you frame what mix of the business is wants versus needs today? And it's maybe far out there. But what's the vision? And my guess is the wants aren't truly wants. I think it's you know, given your background, there's probably some unique merchandising that's partially wants, but curious how you can frame that and maybe tease it out a little.

[speaker 2]: Yeah. Hey. Thanks, Simeon. It's a great question. And yeah, if you think about it in the traditional sense, you know, consumables is traditionally a needs business, and you know, is the overwhelming majority of our business. Even that business, Simeon, I think has some elements to it that can be more of a wants in in principle. And and what I mean by that, and and I alluded to it in my prepared remarks, we've just had this, you know, set it and forget it mentality for our entire business. And if I just focus on consumables for a second, for example, in 2025,

[speaker 1]: we

[speaker 2]: our dog food business was largely all surrounded around one big episodic reset in the middle of the year. And we're really gonna change that in '25 And as as our big vendor partners come out with innovation, newness, different types of product, new flavors, cat extensions. We're we're gonna roll that out on on in line with their timing, not our timing. So that's gonna make more of a perception of wants rather than just needs in the sense that somebody walks in and and is a a sense of discovery. We just haven't been good at that in the past, Simeon. So think the whole business has an opportunity to create more of a exploration throughout our store, not just our supplies business, which is traditionally by the way you were thinking. There's an element to it in consumables as well.

[speaker 0]: And certainly, when we get on the call in in March, we'll

[speaker 2]: we'll go through that in more detail. I cut you off, Simeon.

[speaker 3]: No. I cut you off. My my follow-up, it's related. You talked about integrating store functions. You talked about wants versus need. And then there was a little bit of maybe forward investing, I think Sabrina just mentioned. So if you and and by the way, the business itself is getting close to lapping like, whatever tough compares. It seems like it's naturally getting back to positive territory. So what what kinda clicks or what's the priority among the things we heard where the top line start to move, or is it something we haven't heard yet?

[speaker 2]: No. I don't think it's something you heard. I I think look, we're gonna approach twenty twenty six from the top line the same way we approach 2025 from the bottom line. In 2024, we came out with the strategies that would fix the bottom line. And then we executed them in 2026. And 2025. We're doing the same thing for top line growth. I outlined four pillars, We backed it up with building blocks, which I talked about many of them today. And then we're gonna execute against those with the same rigor and discipline And so it's not just to cross your fingers and hope. We've got plans around four pillars with a lot of building blocks for each one of them. And I'm I'm really excited about all four of them. I alluded to some of them that we're already testing here in Q4. But all of them are making traction, and some just take longer to implement than others. But teams are all focused, and we got a

good plan.

[speaker 3]: Okay. Happy happy Thanksgiving. Take care. Thanks, Simeon. Happy bet.

[speaker 0]: Next question will come from Oliver Wintermantel with Evercore ISI. Please go ahead.

[speaker 3]: Yeah. Thanks. Joel, what is the realistic

[speaker 4]: timeline for comp stabilization? And which categories or customer behaviors would represent the biggest swing factors there?

[speaker 2]: Yeah. Look. I'm not gonna get into 2026 today on this call and and the the timing of it. But certainly, what you should expect from me in March is to not only give you guidance for Q1, but we'll give you an outlook on on the full year. But, specifically, I can tell you, all four of the pillars I went through today are getting traction. And, know, so I would expect all four of them to contribute towards comp in in 2026. And then we'll just outline the timing for you on the March call.

[speaker 4]: Got it. That makes sense. And then just on the free cash flow side, strong improvements there year to date and in the quarter. But how much of the Q3 working capital improvement is sustainable? What financial or operational levels continue to support the cash generation for next year? Yeah. I mean, I think

[speaker 1]: we view cash flow and all of its levers as continuous improvement. We certainly are focused on continuing on the

[speaker 5]: path of generate generating strong free cash. The principal lever, of course, Oliver, is net earnings. So we're gonna continue to focus on our bottom line and growing net earnings We'll continue to focus on inventory discipline, We're not done. We've made huge strides this year. and reducing In terms of rationalizing our SKUs our inventory compared to our sales, which is fantastic. But I wouldn't say we're best in class interns yet. We still have a lot of opportunity. We'll be looking at that lever as well as all of our other levers to continue delivering on strong cash generation.

[speaker 4]: Excellent. Good luck, happy Thanksgiving. Thank you.

[speaker 1]: Thank you.

[speaker 0]: Question will come from Michael Lasser with UBS. Please go ahead.

[speaker 2]: Can you size the magnitude of the potential investments that you would make and what forms those are gonna come in, whether it's

[speaker 5]: labor

[speaker 3]: marketing,

[speaker 0]: or promotions, And are those

[speaker 4]: investments

[speaker 6]: necessary as you look to 2026 in order to drive top line growth?

[speaker 5]: Well, maybe I'll just start, Michael, with the framework, and then Joel can chime in on how he feels. You know, he's looking at each one. What we've tried to do, and we're really pleased that we banked so much profit improvement through Q3. And this is afforded us as I said, the option and it's only an option to consider investing in areas that we think can drive improvements both in Q4, but also for our future. So everything you mentioned is on our plate of options. Certainly, marketing certainly looking at labor, And, sure, we'll always continue to look at promos to see if we can do them effectively. In a way that brings value to our customer. But also in a way that's very responsible as we continue to manage our margin expansion.

[speaker 1]: Joel, do you wanna Yeah. I yeah. Sabrina, I think you

[speaker 2]: you nailed that pretty good. And when Michael, I look at the four pillars we outlined, I don't think any of them as it relates to 2026 require any, you know, substantial step change from what we're doing today in terms of you know, cash investment or change in OpEx investment or something. It's it's really you know, you take merchandise. Like, we're selling through our existing merchandise, and we're buying into new. So that's really just a a steady flow change. And you know, really don't see any episodic change in in 2026. From an investment standpoint. From from the runway we're already on today. I I guess the question in the

[speaker 6]: and and the critical point is Yeah. Can Petco experience the same magnitude of the improvement in the profitability while reversing what seems like some market share losses this year and beyond that path next year.

[speaker 5]: Yeah. If I'm hearing you, Michael, and I and I might want you to repeat the question, but

we, for sure, believe that investments are going to be necessary. Our whole focus and what I talked about all year long in terms of the economic model we're pursuing is delivering leverage. On expenses. But as you know, if sales improve, you increase operating expenses and still deliver leverage. So we're very aware that we need to make some investments That's why we're talking about in Q4 We may make some of those investments in advance. Of entering the new year because we've been able to bank so much profitability and leverage. And we will measure our success in meeting our goals and expanding margin and delivering expense leverage on a full year basis. That's another thing we always said. We never said every single quarter in the same way. It's on a full year basis. So that's why we've given ourselves the option because we know that the next phase will require investment we are prepared to stand behind that in a responsible way that still delivers on our full year goal to deliver the model.

[speaker 6]: Hey, Sabrina. Could I could I just clarify? You know, if we look at what the embedded EBITDA margin is in the fourth quarter versus what Petco's experienced over the last couple of quarters. It looks like the pace of improvement is gonna moderate. Should we think about the magnitude of the potential investment, the option for investing would be the difference between what Petco has achieved over the last couple of quarters and what's implied in in the fourth quarter? Is that how we should think about quantifying that potential investment?

[speaker 5]: I think that's a fair framework, Michael. I would add to that as we look to Q4, as I stated, remember, when we think about gross margin, there's more there's more tariff impact. That's just one factor. It's not enormous as we've said all year. It's it's we're pleased that we're in a retail sector that doesn't have mountains of tariff. It is an impact. So that's one factor. The second impact is that investment that we're talking about. And how much we will choose to do and how we'll manage through that in the fourth quarter. So, yes, I think your statement, broadly speaking, is fair.

[speaker 6]: Okay. Thank you very much, and good luck with the holiday.

[speaker 1]: Thank you.

[speaker 0]: Next question will come from Kendall Toscano Bank of America Global Research.

[speaker 4]: Please go ahead.

[speaker 5]: Thanks for taking my question. Hopefully, you can hear me okay.

[speaker 1]: I was just wondering if you could talk more about the impact of tariffs during the quarter I know you mentioned they became more meaningful in 3Q, but maybe not as much as you're expecting for the fourth quarter. But just curious what you saw in terms of COGS impact, if any? And then in maybe some categories where there was tariff impact on price? What did you see in terms of consumer elasticity? Thanks.

[speaker 5]: Thanks. Yeah. Thanks, Kendall. Just to go back to our statement, So the first time we saw a tariff impact flow through our p and l, through cost of goods sold in any meaningful way is the third quarter. Because the second quarter had, like, let's call it, de minimis. Amounts of that. We had it on our balance sheet. We had it in inventory buys, but it wasn't flowing through COGS yet. The third quarter is the first quarter of that And my only point was in the fourth quarter, it becomes a bit more meaningful. So it's just a reminder that sequentially, the tariff headwind's a bit more meaningful. But, again, in the broad spectrum of things, it's a very manageable number, which we've managed all year and have been revising guidance upward in the face of it. So you know, I think that hopefully helps frame it up. We we also know that it's mostly in the private label supplies area. As we've said in the past. So, hopefully, that helps frame it up too. Got it. That's helpful.

[speaker 1]: And then my other question was just in terms of some self inflicted headwinds in the services segment. As you've deprioritized that program ahead of the planned relaunch. Just curious as you're now getting closer to relaunching that in 2026, and it it sounds like maybe starting to pilot it in the fourth quarter What kind of tailwind would you expect to see on same store sales growth or I guess just service services growth?

[speaker 5]: I I think you mean our membership program. That's Yes. That's what I meant. Yeah. That's what's combined with services in the way we report. Services and other. So I probably, Joel, if you wanna start with the membership program and

[speaker 2]: Yeah. Because our our our paid membership rolls into there. But, you know, I think the more important thing to take away from that is and and I alluded to it in my prepared remarks that we

are on track with our new membership program. And in fact, here in the fourth quarter, we have begun live end to end testing in several markets, and so, we really haven't seen any major glitches. In fact, minor at best. And so that's a really good sign for us. We'll then take that to a few more markets and and do, roll out the new attached to it. And are still on track then for a rollout sometime in 2026 with with the, the rest of the fleet. But membership so far has, really come together nicely. And it it's a really important element to our growth that's gonna begin in 2026.

[speaker 5]: Yeah. And since you raised it, Kendall, on the services piece, I think you can see that that continues to be not only a strategically important area for us, but it's also an area of nice growth and continues to be.

[speaker 2]: Thank you.

[speaker 0]: Next question will come from Kate McShane with Goldman Sachs. Please go ahead.

[speaker 1]: We wanted to ask, a little bit more of a higher level

[speaker 5]: question, just your view on where you think the industry is now from a digestion standpoint, where you think the industry can grow, in in 2026 if if we do return to growth in '26 for the industry. And just what you may have been seeing out of the competitive set,

[speaker 1]: this most recent quarter as, you know, some of these higher tariff costs and and prices have come through?

[speaker 2]: Yeah. Thanks, Kate. Look. Overall, the the competitive set really hasn't changed much from the the last quarter. You know, I would say, you know, the what's changed is the consumer has been a little probably a little bit more cautious You know I mean? Obviously, with, you know, tariffs and political tensions and interest rates still high, you know, that's really been you know, bogging down their outlook on the economy a little bit. But as far as the pet industry goes, it it's been pretty stable. You know, flattish in terms of growth. I think the progress we've made on our digital side has really been promising, and and that'll be very important to us as we turn to growth next year. But overall, we're positioned nicely. Our services business is Sabrina just talked about, is already growing, and that is an area of growth in the pet industry. We'll and then we'll layer in you know, the focus we've made and the progress we've made on our our digital improvements. But overall, it's pretty stable.

[speaker 5]: Yeah.

[speaker 2]: Thanks, Kate.

[speaker 0]: Question will come from Chris Bottiglieri with BNP Paribas. Please go ahead.

[speaker 4]: Hey. Thanks for taking the question.

[speaker 0]: Yeah. The first one I had was just hoping to now the cash

[speaker 2]: free cash flow profile has improved.

[speaker 6]: How do you think about prioritizing the usage of cash? Is it continued debt pay down? Do you think about reaccelerating the veterinary practices?

[speaker 0]: Like, just curious how you think about that. Over the next few years. Yeah. Our first priority would always

[speaker 5]: be to invest in our business. To sustain growth going forward. So that's definitely the priority. That said, we go back to our statement that we have a lot of assets on our book already. That really are ramping up now, vet hospitals predominantly the number one on the list, that are already on our books that we are ramping up for better returns. So we don't have to make big capital investments in those. And we, in fact, you'll hear us talk about more in the Q4 call, Chris, We have a set of those that where we're gonna focus on bringing utilization up 2026 as well, without any large capital investments. So I view this as really great news because it provides a nice path for return improvement while not having to invest a lot of capital in it. So, of course, though, we'll be looking at pockets and areas as we move forward, and we finalize what kind of remodel prototype we wanna land on. How we'll start to bring those into our system, But there's no huge big capital spend necessary in the horizon, likely to increase some in '26, but no big enormous dramatic change overall in profile because we have these assets in our books where we're increasing utilization. Now beyond that beyond that priority to first invest in our business, The second, of course, is we are always looking, as I stated, you know, on the first call when I talked to you guys, we want to bring down our leverage on an absolute basis. We also wanna bring down our ratio. We're doing a terrific job with the growth and profitability of bringing down the ratio. So it's quite remarkable. We started the year at over four times debt to EBITDA

And if we hit the midpoint of our new guidance, we should be below three and a half times. Net debt to EBITDA. So quite a bit of progress indeed, we'll look to opportunities to even potentially do some opportunistic pay debt pay down.

[speaker 4]: Gotcha. That that's really helpful. And then

[speaker 0]: your gross margins were, I think, down 20 basis points on the product line.

[speaker 6]: Is that primarily that tariff had been referring to? Or

[speaker 3]: is it also somehow in is or is, like, is the

[speaker 6]: elasticity offsetting the ticket increase, and there's also a headwind on comps? Just curious by

[speaker 3]: like,

[speaker 0]: tariff headwinds are you referring to there? Where it's manifesting?

[speaker 5]: I have our merch margins expanded both in our products and services.

[speaker 3]: Sorry. I meant quarter on quarter, not not year on year.

[speaker 5]: Oh, quarter on quarter. Sure. Yeah. I would say that is primarily a little bit of tariff headwind coming in. Year on year, though, we are we are up in both products and services.

[speaker 2]: Gotcha.

[speaker 4]: Okay.

[speaker 0]: Thank you.

[speaker 1]: Next question will

[speaker 0]: come from Steve Forbes with Guggenheim Securities. Please go ahead.

[speaker 4]: Good afternoon, Joel, Sabrina.

[speaker 0]: Joel, you you spoke about services in stores coming together. And and I guess my my question is is can you help us frame up

[speaker 6]: sort of how you guys see that opportunity internally, whether it be how spending per customer sort of evolves as they engage in services, if they're a store only customer or vice versa?

[speaker 4]: Like, any way that is sort of

[speaker 0]: talk about how

[speaker 6]: how, like, the net sales per customer evolves as they broaden their engagement across store?

[speaker 2]: Yeah. Look. Look. I I think any you know, great bricks and mortar retailer has to define their moat, has to define what differentiates them from anybody else. And services is definitely one of our moats. Right? It's one of our key elements that, is really hard for any other pet retailer to replicate in the way we

[speaker 4]: built out

[speaker 2]: grooming, hospitals, vet clinics, dog dog walking, all or dog training. All those elements. And so that's obviously an area there for we've leaned in the most. And we've made incredible progress with our existing assets. You know, utilizations, we've improved. Engagement, we improved. And then what you're getting at is the integration with the center of store with product. And so what what's key to all that, Steve, is I look to 26. Is is layering that in with a membership program that really helps us better understand the profile of each one of our customers how many are using services, how many use services and merchandise, how many are buying, in store and online, and you put all those elements together, it starts to create profiles of different customers. And we we really see honestly, the better we get at services, the the halo effect that has on the overall business just gets stronger. Because it's something that's hard for anyone else to replicate. So service is probably the area that we made the most amount of progress. Pleased with the results we're seeing there. And, you'll continue to see us talk about that and but that gives you a little color on how I see it playing out. Turning into 2026.

[speaker 6]: And then maybe if I just do a quick follow-up on that, like, there is there any way to set the baseline here on just sort of you know, what percentage of your customers today actually you know, buy services or or any sort of baseline KPI that we could sort of begin to track as we think about your progression in the business?

[speaker 2]: Yeah. Look, I I I think at this point in time, I'm not gonna get into the the specifics on it at that level of detail. Mean, I think the the you know, baseline KPI to you know, track you know, as we we look into the future will be transactions overall. And and then let us manage it at the at the different

elements we have, the serve up to the customer. But services will definitely be key component to it, Steve, as we keep growing.

[speaker 6]: Thank you.

[speaker 3]: Yep. You bet.

[speaker 2]: Thank you.

[speaker 0]: Last question will come from Zach Fadem with Wells Fargo. Please go ahead.

[speaker 3]: Hi. Good afternoon. Is there a way to quantify the impact of moving away from less profitable sales and deemphasizing the member program in Q3? As it seems like

[speaker 6]: you expect your Q4 comp to step down a bit more, I

[speaker 3]: I'm curious to what extent you're expecting those items to also impact Q4.

[speaker 5]: Yeah. I mean, it's I'll I'll just start by it's it's a pretty broad range. Zach, the implied Q4. So, you know, we can land anywhere in that range. Clearly, what we've stated all year very consistently is our primary focus this year was around expanding our margins walking those unprofitable sales and building this very strong foundation upon which to start sales growth. In 2026. But, Joel, I'll let you take it from there if you wanna Yeah. I I think

[speaker 2]: Sabrina, I think you nailed it, and I I think I'd add to that. Like, you asked what's the impact? Well, the impact you're seeing quite clearly is you know, we're growing pet EBITDA market share. And so while sales are down, EBITDA is up. So clearly, we I I think we've done a really nice job of identifying which sales are really one time transactions and our empty calorie as I call them versus which customers we wanna grow lifetime value and and be with us for the long term. And so you've seen that play out quarter after quarter for us. As, you know, sales have been down, you know, consistently low single digits. But bottom line has continued to improve. So as each quarter goes by, we get better at identifying those largely or getting them out of our base. And you layer in a membership program. More strategic media buying, aspect, and all that'll start to lead towards improvement in the top line with the bottom line as well.

[speaker 6]: Thanks, Joel. And then just to

[speaker 3]: level set as we look ahead

[speaker 6]: to to 2026. I mean, the expectation is to return to sales growth I'm curious how generally

[speaker 3]: you would frame broader category performance in dog and cat food, supplies, services, etcetera. And then how you would layer in the the impact of both your initiatives and then net store opening and closings to kind of get to that

[speaker 7]: total sales growth?

[speaker 2]: Yeah. Look. I I think it's too early now to to spell that out specifically for 2026. I mean, clearly, if you

[speaker 6]: look at what we've

[speaker 2]: published, you can see the consumables and you know, supplies are are negative this year, and and we're getting growth in in services. We we expect to return to growth in in consumables and supplies going forward. What I've gotta just outline for you or translate for you is what I laid out today in terms of four pillars. How does that translate into growth at what time and what period next year? But lot what what you guys can't see is all the progress we're making here internally. And then we just gotta put the pieces together for you so you help you think about your model. But, you know, we haven't I think I answered on a few questions before. We're approaching 26. The same way we approach 25. Outline the strategies, and then execute. And, the the team is just getting better at that as every passing quarter goes by.

[speaker 5]: Yeah. And, Zach, just to emphasize what Joel's saying, for sure, I think your thinking is in line with ours where you always look at what's you know, your base sales bill then we layer on all the many initiatives which Joel has been outlining. And we'll continue to get more granular as we go 26. But we have all of those building blocks on top of that base, and they layer on throughout the year. So what you can count on is it's a gradual ramp. And then the last thing I'll say as a little bit of a preview is we would expect fewer net closures in 2026 than we had in 2025. And, again, the 2025 expectation is about 20 net store closures.

[speaker 7]: Thanks so much for the time.

[speaker 2]: Thank Zach.

[speaker 0]: This concludes our question and answer session. I would like turn the conference back over to Tina Romani for any closing remarks.

[speaker 1]: Perfect. Thanks so much, Joel and Sabrina. Thanks, everyone, for your time. That concludes our call, and we hope everyone a wonderful holiday.

[speaker 0]: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.