

September 29, 2016

INVESTMENT LETTER

THE VETERINARIAN PROFESSION AND THE COMPANION PET BUSINESS

IDEXX LABORATORIES, INC. (NASDAQ: IDXX)

In *The Graduate*, a comedy-drama released in 1967, Mrs. Robinson (Anne Bancroft), a married woman in her mid-forties seeking fun and escape, is busy planning the seduction of twenty-one-year-old Benjamin Braddock (Dustin Hoffman).

Meanwhile Braddock, having just graduated from Williams College with a liberal arts degree and with little pragmatic preparation for any real money making career, is vigilantly pursuing any opportunity that could set him on the path to lots of money.

At a party in Beverly Hills, an affluent section of Los Angeles that he calls home, Braddock is accosted by McGuire (Walter Brooke), who, knowing that Braddock is searching for a career answer, approaches Braddock and, without any conversational prelude, offers some unsolicited advice, whispering the following into Braddock's ear: "I want to say one word to you. Just one word... **plastics**."

McGuire believed that if your company were in some kind of **plastics** business, the future was bright. McGuire's advice was, because of the then-booming business in the **plastics** industry, correct, and it was succinctly, and therefore brilliantly, memorable.

Today, like **plastics** in the 1960s, there is one word that, in the context of the business world, has its own appeal and charisma: **'consumables.'**

Gillette may have been the company that first saw the profitable magic of the **'consumables'** concept,

selling a reasonably priced razor, and then betting that the consumer would buy high margin blades for many years, blades that only worked with that one razor.

Today, **IDEXX Laboratories**, too, thrives on the production of **'consumables'**. In 2015, 84.67 percent of the company's revenue was attributed to its Companion Animal Group (CAG), a large percentage of which were **'consumables.'**

What are these **consumables**?

These **'consumables'** are large diagnostic tests, containers in which a sample of blood and urine is deposited, and then run through the VetTest Chemistry Analyzer which can determine whether critical properties are within the normal or accepted range for each property, and whether each property might pose a threat to the animal's health.

These properties include glucose, alkaline phosphate, alanine aminotransferase, albumin, calcium, creatinine, blood urea nitrogen, total protein, and many others. How important are these properties?

Let's consider creatinine. Creatinine (kree-AT-uh-nin) is a waste product that comes from the normal wear and tear on muscles of the body. If the creatinine level is too high in the animal, it warns of possible kidney failure, but **IDEXX** can detect the trouble.

<i>Amounts in thousands</i>	Years Ended	
	December 31, 2015	December 31, 2014
Net CAG Revenue		
CAG Diagnostics recurring revenue:	\$ 1,146,527	\$ 1,039,252
<i>VetLab consumables</i>	396,526	341,407
<i>VetLab service and accessories</i>	55,176	53,006
<i>Rapid assay products</i>	182,670	165,646
<i>Reference laboratory diagnostic and consulting services</i>	512,155	479,193
CAG Diagnostics capital - instruments	99,001	79,993
Customer information management and digital imaging systems	110,759	103,819
Net CAG revenue	\$ 1,356,287	\$ 1,223,064

From the IDEXX Laboratories, Inc. fourth quarter and full year 2015 earnings release dated January 29, 2016.

AMERICANS LOVE THEIR PETS AND EVERY YEAR THEY SPEND AN INCREASING AMOUNT OF MONEY TAKING CARE OF THEIR PETS

Of course it is people, animal owners, that buy the diagnostic tests that IDEXX produces. People buy these tests because they love their pets, especially their cats and dogs. People spend lots of money on their pets, often treating the pets as family members, but spending on veterinarian visits is the biggest spending chunk.

In 2004, forty-one per cent of households owning a dog reported that their dog slept with one or

more members of the household. In 2014 that figure had risen to fifty per cent. In 2004 fifty-one per cent of households with a cat said their cat (or cats) slept in their beds. That figure had risen to sixty-five per cent of all households in 2014. (One of my coworkers, Ying Qi, tells me that one of her three dogs, a miniature poodle, who is so small yet takes up so much space and is implacably insistent in his personality, would not obey her command not to sleep in the bed she shares with Ben, her husband. Deciding not to fight every battle, she traded in her Queen size bed for a King size bed to make room for her dog so he could be happy at night.)

Total U.S. Pet Industry Expenditures		According to the 2015-2016 American Pet Products Association National Pet Owners Survey, some of the basic annual expenses for dog and cat owners in dollars include:		
Year	In billions		Dogs	Cats
2016	\$62.75 Estimated			
2015	\$60.28			
2014	\$58.04			
2013	\$55.72	Surgical Vet Visits	\$551	\$398
2012	\$53.33	Routine Visits	\$235	\$196
2011	\$50.96	Food	\$269	\$246
2010	\$48.35	Food Treats	\$61	\$51
2009	\$45.53	Kennel Boarding	\$333	\$130
2008	\$43.20	Vitamins	\$62	\$33
2007	\$41.20	Groomer/Grooming Aids	\$83	\$43
2006	\$38.50	Toys	\$47	\$28



These are impressive figures. However, I am curious as to why cats seem to be gaining acceptance in human beds more rapidly than dogs. Is the explanation due to the size of the cat, or to their nocturnal behavior, their sleeping manners or something that has escaped me?

WHO IS SLEEPING IN MY BED? IS IT MY CAT OR MY DOG?

On average a person moves in his or her bed forty-two times during the night. Do cats and dogs also move frequently during the night and do dogs tend to move more than cats? Do cats hold the same sleeping position longer than dogs and hence create less disturbance from moving pet body parts and inadvertent encroachment on owners' territory and fewer unintentional collisions than do dogs? Or maybe the explanation is more simple. Cats are generally more reserved than dogs, and tend to be happy with less contact with their owners than dogs are. Cats will pick a portion of the bed and quietly but firmly signal that portion as their territory, but they rarely

venture outside of their territory or province during the night.

A STORY ABOUT A MAN'S LOYALTY TO OKLAHOMA FOOTBALL AND TO HIS DOG

September 16, 2016, Tulsa, Oklahoma, 2:30 AM

It is two-thirty in the morning on Monday, and a supremely loyal University of Oklahoma football fan, a chief executive officer at a privately held oil and gas company, an affluent businessman, a 1980 graduate of the University of Oklahoma, and a generous contributor to the school's annual alumni drive, is sleeping, finally able to rest, able to dispel the feelings of frustration that he had experienced two nights ago when, driving one hundred and thirty miles each way between Tulsa and Norman, the home of the University of Oklahoma, he had watched the Sooners succumb to the artistry and raw power of the Ohio State football team, falling 45-24.

Our hero, like millions of Americans, loves his dog so much that he willingly shares his bed with the animal. An outsider might wonder, observing the dog, who is curled up against his owner, whether the dog is insecure, lonely, and even if the dog suffers from an attachment disorder.

Our hero has had a difficult night, repeating in his mind the fumbles, the missed opportunities, and what he deemed to be the incorrect strategy of the Oklahoma coach, Bob Stoops, an idol to Sooner fans when he wins, and a traitor to the Oklahoma football tradition when the team loses. He's exhausted. However, maybe forty-five minutes or so after he has fallen into the Rapid-Eye Movement (REM) range of his sleep, he feels a gentle but firm force pushing on his leg.

The dog must relieve himself and if the owner wants to avoid a messy situation, he must let him outside. The love for the dog, the innate unspoken self-assumed responsibility for the dog's happiness, the dog's welfare, is paramount in the owner's psyche. So he takes a deep breath and he gets up from his bed, careful not to disturb his spouse, puts on his bathrobe, lets the dog out, and patiently waits for his dog to return to the house, with the dog's mission accomplished.

Every night this scene repeats itself. Is the dog owner irritated that his sleep is interrupted? Yes. But he puts up with the dog's habit, and other behaviors that may produce annoyance, because the dog owner's love for his pet is unconditional: no matter what the dog does, the owner will love him. (Notwithstanding the definition of 'unconditional,' certain canine behaviors, such as barking all night if the owner refused to let the pet sleep in the owner's bed, may cross the line, and could evoke a nasty face, a loud rebuke, and possibly severe punishment, such as limiting Frisbee chasing time during the week, or holding back a dog treat.) The owner understands that a dog—or a cat in millions of households—has undivided loyalty to him, and to all members of

his household. The dog, the owner knows, has the utmost loyalty to his owner, and would sacrifice his life to save his owner. The owner knows this, wants to reciprocate, takes care of his dog, and keeps his dog happy and physically healthy, because he knows that his dog may be his best friend. The owner will spend lots of money on his dog to demonstrate his love for him, as the table of expenditures on companion animals or pets over the last ten years shows on Page Two.

Our hero, like millions of pet owners, may sometimes get impatient with his dog, but he never forgets the loyalty of his companion animal and will continue to spent money at the vet's office to pay for tests run on his animal, always appreciating the fact that time means money, so that the veterinarian can confer with the owner on the pet's health without keeping the owner waiting for a long time in the vet's office, thanks to **IDEXX** who provides tests that make a fast, accurate diagnosis every time.

TO BE CONTINUED

Sincerely,



Fredric E. Russell
Fredric E. Russell Investment Management Co.
918.743.5959
www.ferimc.com

Fredric E. Russell has a B.A. from **Swarthmore College** in Swarthmore, PA and an M.B.A and an M.A. from **Washington University** in St. Louis,

MO. He also holds the CPA certificate and, in his previous life, he taught accounting and finance at three universities, as well as history and literature at one university. He believes that his love for writing and his usually correct grammar come from spending four years learning the English language at [Deerfield Academy](#) in Deerfield, MA, and from spending countless hours in the [Swarthmore College](#) library on Saturday afternoon studying great writers in history and philosophy while wishing he were at a big university, such as [the University of Oklahoma](#), watching a football game on Saturday afternoon with women who enjoyed partying as well as studying, a dual dynamic missing at [Swarthmore](#). He likes to read anything well written that he can find. He does not enjoy fiddling with an iPhone but prefers to use his work and spare time studying and collaborating with his driven, sharp colleagues to produce letters that are informative and easy to read. BUT MOST IMPORTANTLY OUR JOB IS TO MAKE MONEY WITH LITTLE RISK AS POSSIBLE FOR OUR CLIENTS. We are appreciative of a wonderful client base and I am appreciative of being able to come to work each

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day and be with highly intelligent and pleasant coworkers.

For further information: contact [Ying Qi, Qian Zhang](#), or [Christopher Reavis](#) at their respective email addresses: yqi@ferimc.com, qzhang@ferimc.com, or clr@ferimc.com; or our office: 918-743-5959.

Our web site: www.ferimc.com has loads of information about the firm including an archive of Investment Letters. Clients and employees (through taxable accounts and through the Fredric E. Russell Investment Management Co. 401(k) Plan) own, as of September 28, 2016, **12,425 shares** of **IDEXX Laboratories, Inc.** (Nasdaq: **IDXX**). We may liquidate, decrease, or increase our position in **IDEXX Laboratories, Inc.** at any time, without notice before or after we do so. This letter is not a recommendation of purchase or other action.

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