

VCA ANTECH INC  
Form 10-Q  
November 08, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2005

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**Commission File Number: 001-16783**

**VCA ANTECH, INC.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**95-4097995**

*(I.R.S. Employer  
Identification No.)*

**12401 West Olympic Boulevard  
Los Angeles, California 90064-1022**

*(Address of principal executive offices)*

**(310) 571-6500**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No .

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No .

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No .

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: Common stock, \$0.001 par value 82,628,370 shares as of November 4, 2005.

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****VCA ANTECH, INC. AND SUBSIDIARIES  
CONDENSED, CONSOLIDATED BALANCE SHEETS****As of September 30, 2005 and December 31, 2004****(Unaudited)****(In thousands, except par value)**

|   | <b>September<br/>30,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|---|-----------------------------------|----------------------------------|
| <b>ASSETS</b>   |                                   |                                  |
| Current assets:   |                                   |                                  |
| Cash and cash equivalents   | \$ 44,501                         | \$ 30,964                        |
| Restricted cash   |                                   | 1,250                            |
| Trade accounts receivable, less allowance for uncollectible accounts of \$8,817 and \$7,668 at September 30, 2005 and December 31, 2004, respectively     | 33,764                            | 28,936                           |
| Inventory   | 17,407                            | 10,448                           |
| Prepaid expenses and other  | 7,673                             | 6,275                            |
| Deferred income taxes   | 12,847                            | 11,472                           |
| Prepaid income taxes  | 2                                 | 10,830                           |
| Total current assets  | 116,194                           | 100,175                          |
| Property and equipment, less accumulated depreciation and amortization of \$89,956 and \$79,139 at September 30, 2005 and December 31, 2004, respectively | 146,970                           | 119,903                          |
| Other assets:   |                                   |                                  |
| Goodwill  | 579,637                           | 499,144                          |
| Other intangible assets, net  | 11,328                            | 11,660                           |
| Deferred financing costs, net   | 1,405                             | 4,052                            |
| Other   | 7,404                             | 7,166                            |
| Total assets  | \$ 862,938                        | \$ 742,100                       |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                                   |                                  |
| Current liabilities:  |                                   |                                  |
| Current portion of long-term obligations  | \$ 5,826                          | \$ 6,043                         |
| Accounts payable  | 19,294                            | 15,566                           |
| Accrued payroll and related liabilities   | 18,389                            | 19,850                           |
| Accrued interest  | 327                               | 1,578                            |
| Other accrued liabilities   | 30,350                            | 21,874                           |
| Total current liabilities   | 74,186                            | 64,911                           |
| Long-term obligations, less current portion   | 448,254                           | 390,846                          |
| Deferred income taxes   | 27,425                            | 31,514                           |
| Other liabilities   | 13,761                            | 12,915                           |
| Minority interest   | 10,257                            | 9,155                            |

Commitments and contingencies

Preferred stock, par value \$0.001, 11,000 shares authorized, none outstanding

Stockholders' equity:

Common stock, par value \$0.001, 175,000 shares authorized, 82,576 and 82,191 shares outstanding as of September 30, 2005 and December 31, 2004, respectively

|  |            |            |
|--|------------|------------|
|  | 83         | 82         |
| Additional paid-in capital                 | 255,493    | 251,412    |
| Retained earnings (deficit)                | 32,006     | (18,759)   |
| Accumulated other comprehensive income     | 1,474      | 34         |
| Notes receivable from stockholders         | (1)        | (10)       |
| <br>                                       |            |            |
| Total stockholders' equity                 | 289,055    | 232,759    |
| <br>                                       |            |            |
| Total liabilities and stockholders' equity | \$ 862,938 | \$ 742,100 |

The accompanying notes are an integral part of these condensed, consolidated financial statements.

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**CONDENSED, CONSOLIDATED INCOME STATEMENTS**  
**For the Three and Nine Months Ended September 30, 2005 and 2004**  
**(Unaudited)**  
**(In thousands, except per share amounts)**

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b> |
| Revenue  | \$ 229,242                | \$ 183,352  | \$ 622,689               | \$ 497,649  |
| Direct costs   | 166,598                   | 133,571     | 448,783                  | 358,304     |
| Gross profit   | 62,644                    | 49,781      | 173,906                  | 139,345     |
| Selling, general and administrative expense          | 18,394                    | 13,037      | 47,943                   | 33,503      |
| Loss (gain) on sale of assets                        | 115                       | (12)        | 27                       | 54          |
| Operating income                                     | 44,135                    | 36,756      | 125,936                  | 105,788     |
| Interest expense, net                                | 6,034                     | 6,629       | 18,782                   | 18,712      |
| Debt retirement costs                                |                           |             | 19,282                   | 810         |
| Other (income) expense                               | (130)                     | (9)         | 1                        | (185)       |
| Minority interest in income of subsidiaries          | 778                       | 746         | 2,309                    | 1,917       |
| Income before provision for income taxes             | 37,453                    | 29,390      | 85,562                   | 84,534      |
| Provision for income taxes                           | 15,196                    | 12,046      | 34,797                   | 34,279      |
| Net income   | \$ 22,257                 | \$ 17,344   | \$ 50,765                | \$ 50,255   |
| Basic earnings per common share                      | \$ 0.27                   | \$ 0.21     | \$ 0.62                  | \$ 0.62     |
| Diluted earnings per common share                    | \$ 0.26                   | \$ 0.21     | \$ 0.61                  | \$ 0.60     |
| Shares used for computing basic earnings per share   | 82,526                    | 81,944      | 82,364                   | 81,701      |
| Shares used for computing diluted earnings per share | 84,019                    | 83,455      | 83,818                   | 83,300      |

The accompanying notes are an integral part of these condensed, consolidated financial statements.

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Nine Months Ended September 30, 2005 and 2004**  
**(Unaudited)**  
**(In thousands)**

|   | <b>Nine Months Ended</b> |             |
|---|--------------------------|-------------|
|   | <b>September 30,</b>     |             |
|   | <b>2005</b>              | <b>2004</b> |
| Cash flows from operating activities:   |                          |             |
| Net income  | \$ 50,765                | \$ 50,255   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |             |
| Depreciation and amortization   | 13,947                   | 11,407      |
| Amortization of debt costs  | 482                      | 552         |
| Provision for uncollectible accounts  | 2,996                    | 2,190       |
| Debt retirement costs   | 19,282                   | 810         |
| Loss on sale of assets and other  | (310)                    | (296)       |
| Tax benefit from stock options exercised  | 2,333                    | 3,542       |
| Minority interest in income of subsidiaries                                       | 2,309                    | 1,917       |
| Distributions to minority interest partners                                       | (1,968)                  | (1,505)     |
| Changes in operating assets and liabilities:                                      |                          |             |
| Increase in accounts receivable   | (7,009)                  | (5,075)     |
| Increase in inventory, prepaid expenses and other assets                          | (5,796)                  | (909)       |
| Increase in accounts payable and other accrued liabilities                        | 6,311                    | 1,759       |
| Decrease in accrued payroll and related liabilities                               | (5,734)                  | (677)       |
| Increase (decrease) in accrued interest   | (1,251)                  | 4,107       |
| Decrease (increase) in prepaid income taxes                                       | 10,828                   | (1,173)     |
| Increase in deferred income tax assets  | (1,375)                  | (823)       |
| Increase in deferred income tax liabilities                                       | 5,404                    | 5,654       |
| Net cash provided by operating activities   | 91,214                   | 71,735      |
| Cash flows used in investing activities:  |                          |             |
| Business acquisitions, net of cash acquired                                       | (83,702)                 | (97,152)    |
| Real estate acquired in connection with business acquisitions                     | (2,929)                  | (5,565)     |
| Property and equipment additions  | (22,725)                 | (16,035)    |
| Proceeds from sale of assets  | 368                      | 184         |
| Other   | 3,540                    | 1,553       |
| Net cash used in investing activities   | (105,448)                | (117,015)   |
| Cash flows from financing activities:   |                          |             |
| Repayment of long-term obligations, including tender fees                         | (445,721)                | (147,691)   |
| Proceeds from the issuance of long-term obligations                               | 475,000                  | 225,000     |
| Payment of financing costs  | (3,257)                  | (794)       |
| Proceeds from issuance of common stock under stock option plans                   | 1,749                    | 2,362       |

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|  |           |           |
|--|-----------|-----------|
| Net cash provided by financing activities        | 27,771    | 78,877    |
| Increase in cash and cash equivalents            | 13,537    | 33,597    |
| Cash and cash equivalents at beginning of period | 30,964    | 17,237    |
| Cash and cash equivalents at end of period       | \$ 44,501 | \$ 50,834 |

The accompanying notes are an integral part of these condensed, consolidated financial statements.

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2005**  
**(Unaudited)**

**1. General**

The accompanying unaudited condensed, consolidated financial statements of our company, VCA Antech, Inc. and subsidiaries, have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the rules and regulations of the United States Securities and Exchange Commission. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles in the United States for annual financial statements as permitted under applicable rules and regulations. In the opinion of our management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2005 are not necessarily indicative of the results to be expected for the full year. For further information, refer to our consolidated financial statements and notes thereto included in our 2004 annual report on Form 10-K.

**2. Acquisitions**

We acquired the following animal hospitals during the nine months ended September 30, 2005 and 2004:

|   | <b>Nine Months Ended</b> |             |
|---|--------------------------|-------------|
|   | <b>September 30,</b>     |             |
|   | <b>2005</b>              | <b>2004</b> |
| Acquisitions, excluding NPC and Pet's Choice (1)(2)       | 19                       | 17          |
| Pet's Choice (1)  | 46                       |             |
| NPC (2)   |                          | 67          |
| Acquisitions relocated into our existing animal hospitals | (5)                      | (4)         |
| <b>Total</b>  | <b>60</b>                | <b>80</b>   |

(1) Pet's Choice, Inc., or Pet's Choice, was acquired on July 1, 2005.

(2) National PetCare Centers, Inc., or NPC, was acquired on June 1, 2004.

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The following table summarizes the aggregate consideration, including acquisition costs, paid by us for our acquired animal hospitals, excluding NPC and Pet s Choice, and the allocation of the purchase price (in thousands):

|   | <b>Nine Months Ended<br/>September 30,</b> |                  |
|---|--|------------------|
|   | <b>2005</b>                                | <b>2004</b>      |
| <b>Consideration:</b>                       |  |                  |
| Cash  | \$ 28,466                                  | \$ 28,063        |
| Notes payable and other liabilities assumed | 1,706                                      | 1,457            |
| <b>Total</b>                                | <b>\$ 30,172</b>                           | <b>\$ 29,520</b> |
| <b>Purchase Price Allocation:</b>           |  |                  |
| Goodwill (1)                                | \$ 27,178                                  | \$ 26,439        |
| Identifiable intangible assets              | 1,755                                      | 1,645            |
| Tangible assets                             | 1,239                                      | 1,436            |
| <b>Total</b>                                | <b>\$ 30,172</b>                           | <b>\$ 29,520</b> |

- (1) We expect that \$20.3 million of the goodwill recorded during the nine months ended September 30, 2005, will be fully deductible for income tax purposes.

***Pet s Choice, Inc.***

On July 1, 2005, we acquired Pet s Choice, which operated 46 animal hospitals located in five states as of the acquisition date. This acquisition allowed us to expand our animal hospital operations in five states, particularly Texas and Washington. Our condensed, consolidated financial statements reflect the operating results of Pet s Choice for the period of July 1, 2005 through September 30, 2005.

As of September 30, 2005, we had not finalized the purchase price accounting for the Pet s Choice acquisition, as we are awaiting final billing on due diligence fees and certain legal fees are still being incurred, and the valuation of certain tax assets and liabilities has not been finalized. In addition, Pet s Choice will refund a portion of the purchase price to us in accordance with the terms of the purchase agreement requiring Pet s Choice to maintain a certain level of working capital at July 1, 2005. All of these items will result in a change to the total purchase price.

The total consideration, excluding the potential integration costs and the working capital adjustment, as of September 30, 2005, was \$77.3 million, consisting of: \$51.5 million in cash paid to holders of Pet s Choice stock and debt; \$14.1 million in assumed debt; \$9.3 million in assumed liabilities; \$1.2 million of operating leases whose terms were in excess of market; \$810,000 paid for professional and other outside services; and \$460,000 paid as part of our plan to close the Pet s Choice corporate office and terminate certain employees. The \$77.3 million purchase price was allocated as follows: \$51.8 million to goodwill; \$266,000 to identifiable intangible assets; and \$25.2 million to

tangible assets, including real estate in the amount of \$1.2 million. We expect that \$21.8 million of the goodwill recorded will be fully deductible for income tax purposes.

***National PetCare Centers, Inc.***

On June 1, 2004, we acquired National PetCare Centers, Inc., or NPC, which operated 67 animal hospitals located in 11 states as of the merger date. This merger allowed us to expand our animal hospital operations in nine states, particularly California and Texas, and to expand into two new states, Oregon and Oklahoma.

The total consideration for this acquisition was \$89.3 million, consisting of: \$66.2 million in cash paid to holders of NPC stock and debt; \$2.5 million in assumed debt; \$11.7 million in assumed liabilities; \$4.5 million of operating leases whose terms were in excess of market; \$2.0 million paid for professional and other outside services;

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and \$2.4 million paid as part of our plan to close certain facilities and terminate certain employees. The \$89.3 million purchase price was allocated as follows: \$75.0 million to goodwill; \$1.4 million to identifiable intangible assets; and \$12.9 million to tangible assets, including real estate in the amount of \$5.0 million. We expect that \$30.0 million of the goodwill recorded will be fully deductible for income tax purposes.

**Partnership Interests**

We purchased the ownership interests in certain partially-owned subsidiaries of our company from partners of these subsidiaries. The following table summarizes the consideration paid by us and the amount of goodwill recorded for these acquisitions (in thousands):

|   | <b>Nine Months Ended<br/>September 30,</b> |                 |
|---|--|-----------------|
|   | <b>2005</b>                                | <b>2004</b>     |
| <b>Consideration:</b>                       |  |                 |
| Cash  | \$ 568                                     | \$ 1,106        |
| Notes payable and other liabilities assumed | 399  | 221             |
| <b>Total</b>                                | <b>\$ 967</b>                              | <b>\$ 1,327</b> |
| <br>  |  |                 |
| Goodwill recorded (1)                       | \$ 709                                     | \$ 846          |

- (1) We expect that the goodwill recorded in the nine months ended September 30, 2005 will be fully deductible for income tax purposes.

**Other Acquisition Payments**

We paid \$1.1 million and \$864,000 to sellers for the unused portion of holdbacks during the nine months ended September 30, 2005 and 2004, respectively.

We paid \$2.0 million and \$325,000 during the nine months ended September 30, 2005 and 2004, respectively, for earnout targets that were met and recorded goodwill in the same amounts. Earnout payments are discussed under note 9, *Commitments and Contingencies*.

In June 2004, we paid \$2.3 million to settle the remaining obligation to a seller in connection with a prior year acquisition.

**Sound Technologies, Inc.**

On October 1, 2004, we acquired Sound Technologies, Inc., or STI, which is a supplier of ultrasound and digital radiography equipment and related computer hardware, software and services to the veterinary industry. Under the terms of the purchase agreement, we may be obligated to pay after September 30, 2005, up to \$2.0 million of additional purchase price if certain performance targets are met.

The total consideration, excluding the \$2.0 million contingent obligation described above, was \$30.9 million, consisting of: \$23.9 million in cash paid to holders of STI stock; \$1.1 million in assumed debt; \$5.5 million in assumed liabilities; and \$380,000 paid for professional and other outside services. The allocation of the \$30.9 million purchase price was allocated as follows: \$19.8 million to goodwill; \$4.7 million to identifiable intangible assets; and

\$6.4 million to tangible assets. We expect that \$389,000 of the goodwill recorded will be fully deductible for income tax purposes.

**3. Long-Term Obligations**

In May 2005, we entered into a new senior credit facility that provided \$475.0 million of senior term notes and a \$75.0 million revolving credit facility. The terms of the new senior credit facility are discussed below under *Senior Credit Facility*. The funds borrowed under the new senior term notes were used to retire our existing senior term notes in the principal amount of \$220.3 million and our 9.875% senior subordinated notes in the principal amount of \$170.0 million. In connection with the refinancing transactions, we wrote off deferred financing costs

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and paid financing costs, including an aggregate tender fee of \$13.8 million to purchase the 9.875% senior subordinated notes. Total debt retirement costs approximated \$19.3 million. The new senior term notes also provided the necessary financing to acquire Pet's Choice, which is discussed in note 2, *Acquisitions*. The following table summarizes our long-term obligations at September 30, 2005 and December 31, 2004 (in thousands):

|  | <b>September<br/>30,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|--|-----------------------------------|----------------------------------|
| Revolver                                 | \$                                | \$                               |
| Senior term notes (LIBOR + 1.50%)        | 437,713                           |                                  |
| Senior term notes (LIBOR + 1.75%)        |                                   | 223,313                          |
| 9.875% senior subordinated notes         |                                   | 170,000                          |
| Other debt and capital lease obligations | 16,367                            | 3,576                            |
| Total debt obligations                   | \$ 454,080                        | \$ 396,889                       |

The following table sets forth the scheduled maturities of our long-term obligations for each of the five succeeding years and thereafter as of September 30, 2005 (in thousands):

|                   |            |
|-------------------|------------|
| Remainder of 2005 | \$ 1,626   |
| 2006              | 5,650      |
| 2007              | 6,791      |
| 2008              | 5,584      |
| 2009              | 5,349      |
| Thereafter        | 429,080    |
| Total             | \$ 454,080 |

**Senior Credit Facility**

Our \$550.0 million senior credit facility is comprised of various lenders with Goldman Sachs Credit Partners, L.P. as the syndication agent and Wells Fargo Bank, N.A. as the administrative agent. The senior credit facility includes \$475.0 million of senior term notes and a \$75.0 million revolving credit facility. The revolving credit facility allows us to borrow up to an aggregate principal amount of \$75.0 million and may be used to borrow, on a same-day notice under a swing line, the lesser of \$5.0 million or the aggregate unused amount of the revolving credit facility then in effect. At September 30, 2005, we had no borrowings outstanding under our revolving credit facility.

In August 2005, we prepaid \$35.0 million of our senior term notes.

*Interest Rate.* In general, borrowings under the senior term notes and the revolving credit facility bear interest, at our option, on either:

the base rate (as defined below) plus a margin of 0.50% per annum; or

the adjusted Eurodollar rate (as defined below) plus a margin of 1.50% per annum.

Swing line borrowings bear interest at the base rate (as defined below) plus a margin of 0.50% per annum.

The base rate is the higher of Wells Fargo's prime rate or the Federal funds rate plus 0.50%. The adjusted Eurodollar rate is defined as the rate per annum obtained by dividing (1) the rate of interest offered to Wells Fargo on the London interbank market by (2) a percentage equal to 100% minus the stated maximum rate of all reserve requirements applicable to any member bank of the Federal Reserve System in respect of Eurocurrency liabilities.

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*Maturity and Principal Payments.* The senior term notes mature on May 16, 2011. Principal payments on the senior term notes are paid quarterly in the amount of \$1.1 million with the remaining balance due at maturity. The following table sets forth the remaining scheduled principal payments for our senior term notes as of September 30, 2005 (in thousands):

|                   |                |
|-------------------|----------------|
| Remainder of 2005 | \$ 1,100       |
| 2006              | 4,399          |
| 2007              | 4,399          |
| 2008              | 4,399          |
| 2009              | 4,399          |
| Thereafter        | 419,017        |
| <br>Total         | <br>\$ 437,713 |

The revolving credit facility matures on May 16, 2010. Principal payments on the revolving credit facility are made at our discretion with the entire unpaid amount due at maturity.

Starting December 31, 2005, as defined in the senior credit facility, mandatory prepayments are due on the senior term notes equal to 75% of any excess cash flow at the end of each fiscal year. Excess cash flow is defined as earnings before interest, taxes, depreciation and amortization less voluntary and scheduled debt repayments, capital expenditures, interest payable in cash, taxes payable in cash and cash paid for acquisitions. These payments reduce on a pro rata basis the remaining scheduled principal payments. All outstanding indebtedness under the senior credit facility may be voluntarily prepaid in whole or in part without premium or penalty.

*Guarantees and Security.* We and each of our wholly-owned subsidiaries guarantee the outstanding debt under the senior credit facility. These borrowings, along with the guarantees of the subsidiaries, are further secured by substantially all of our consolidated assets. In addition, these borrowings are secured by a pledge of substantially all of the capital stock, or similar equity interests, of our wholly-owned subsidiaries.

*Debt Covenants.* The senior credit facility contains certain financial covenants pertaining to fixed charge coverage and leverage ratios. In addition, the senior credit facility has restrictions pertaining to capital expenditures, acquisitions and the payment of cash dividends on all classes of stock. At September 30, 2005, we had a fixed charge coverage ratio of 1.54 to 1.00, which was in compliance with the required ratio of no less than 1.20 to 1.00, and a leverage ratio of 2.54 to 1.00, which was in compliance with the required ratio of no more than 3.25 to 1.00.

**4. Interest Rate Hedging Agreements**

We have no-fee swap agreements whereby we pay to the counterparties amounts based on fixed interest rates and set notional principal amounts in exchange for the receipt of payments from counterparties based on current LIBOR and the same set notional principal amounts. A summary of these agreements is as follows:

|                                |                |                     |                     |
|--------------------------------|----------------|---------------------|---------------------|
| Fixed interest rate            | 4.07%          | 3.98%               | 3.94%               |
| Notional principal amount      | \$50.0 million | \$50.0 million      | \$50.0 million      |
| Effective date                 | 5/26/2005      | 6/2/2005            | 6/30/2005           |
| Expiration date                | 5/26/2008      | 5/31/2008           | 6/30/2007           |
| Counterparties                 | Goldman Sachs  | Wells Fargo<br>Bank | Wells Fargo<br>Bank |
| Qualifies for hedge accounting | Yes            | Yes                 | Yes                 |

We also had two other swap agreements that expired on May 31, 2005. One agreement had a notional principal amount of \$20.0 million with a fixed interest rate of 1.72%, and the other agreement had a notional principal amount of \$20.0 million with a fixed interest rate of 1.51%.

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The following table summarizes our cash payments (receipts) and unrealized loss (gain) recognized as a result of our interest rate hedging agreements (in thousands):

|                            | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|----------------------------|---------------------------|-------------|--------------------------|-------------|
|                            | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                            | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b> |
| Cash paid (received) (1)   | \$ 190                    | \$ 90       | \$ 75                    | \$ 419      |
| Unrealized loss (gain) (2) | \$ (130)                  | \$ (9)      | \$ 1                     | \$ (185)    |

(1) These payments are included in interest expense in our condensed, consolidated income statements.

(2) These recognized losses (gains) are included in other (income) expense in our condensed, consolidated income statements.

The valuations of our swap agreements were determined by the counterparties based on fair market valuations for similar agreements. The fair market value of our swap agreements resulted in assets of \$1.6 million and \$178,000 at September 30, 2005 and December 31, 2004, respectively. These amounts are included in prepaid expenses and other in our accompanying condensed, consolidated balance sheets.

**5. Goodwill and Other Intangible Assets**

Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to identifiable assets acquired and liabilities assumed.

The following table presents the changes in the carrying amount of our goodwill by segment for the nine months ended September 30, 2005 (in thousands):

|  | <b>Laboratory</b> | <b>Animal Hospital</b> | <b>Medical Technology</b> | <b>Total</b> |
|--|-------------------|------------------------|---------------------------|--------------|
| Balance as of January 1, 2005                | \$ 93,671         | \$ 386,255             | \$ 19,218                 | \$ 499,144   |
| Goodwill acquired                            |                   | 78,974                 |                           | 78,974       |
| Other (1)                                    | 500               | (328)                  | 976                       | 1,148        |
| Goodwill related to partnership interests    |                   | 577                    |                           | 577          |
| Goodwill related to sale of animal hospitals |                   | (206)                  |                           | (206)        |
| Balance as of September 30, 2005             | \$ 94,171         | \$ 465,272             | \$ 20,194                 | \$ 579,637   |

(1) Other is the result of purchase price adjustments,

purchasing  
ownership interest  
in  
non-wholly-owned  
subsidiaries and  
earnout payments.

In addition to goodwill, we have amortizable intangible assets at September 30, 2005 and December 31, 2004 as follows (in thousands):

|  | As of September 30, 2005    |                             |                           | As of December 31, 2004     |                             |                           |
|--|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
|  | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
| Covenants-not-to-compete<br>Noncontractual-customer<br>relationships | \$ 12,020                   | \$ (5,523)                  | \$ 6,497                  | \$ 11,604                   | \$ (5,290)                  | \$ 6,314                  |
| Technology   | 3,340                       | (685)                       | 2,655                     | 3,340                       | (246)                       | 3,094                     |
| Trademarks   | 1,250                       | (250)                       | 1,000                     | 1,250                       | (62)                        | 1,188                     |
| Contracts  | 560                         | (56)                        | 504                       | 560                         | (14)                        | 546                       |
| Client lists   | 397                         | (103)                       | 294                       | 397                         | (26)                        | 371                       |
|  | 962                         | (584)                       | 378                       | 665                         | (518)                       | 147                       |
| Total  | \$ 18,529                   | \$ (7,201)                  | \$ 11,328                 | \$ 17,816                   | \$ (6,156)                  | \$ 11,660                 |

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The following table summarizes our aggregate amortization expense related to other intangible assets (in thousands):

|                                | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--------------------------------|---|-------------|--|-------------|
|                                | <b>2005</b>                                 | <b>2004</b> | <b>2005</b>                                | <b>2004</b> |
| Aggregate amortization expense | \$ 796                                      | \$ 583      | \$ 2,393                                   | \$ 1,576    |

The estimated amortization expense related to intangible assets for each of the five succeeding years and thereafter as of September 30, 2005 is as follows (in thousands):

|                   |                  |
|-------------------|------------------|
| Remainder of 2005 | \$ 816           |
| 2006              | 3,073            |
| 2007              | 2,782            |
| 2008              | 2,151            |
| 2009              | 1,107            |
| Thereafter        | 1,399            |
| <b>Total</b>      | <b>\$ 11,328</b> |

**6. Calculation of Earnings per Common Share**

Basic and diluted earnings per common share were computed as follows (in thousands, except per share amounts):

|  | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2005</b>                                 | <b>2004</b> | <b>2005</b>                                | <b>2004</b> |
| Net income                                     | \$ 22,257                                   | \$ 17,344   | \$ 50,765                                  | \$ 50,255   |
| Weighted average common shares outstanding:    |   |             |  |             |
| Basic  | 82,526                                      | 81,944      | 82,364                                     | 81,701      |
| Effect of dilutive potential common shares:    |   |             |  |             |
| Stock options                                  | 1,493                                       | 1,511       | 1,454                                      | 1,526       |
| Contracts that may be settled in stock or cash |   |             |  | 73          |
| Diluted  | 84,019                                      | 83,455      | 83,818                                     | 83,300      |
| Basic earnings per common share                | \$ 0.27                                     | \$ 0.21     | \$ 0.62                                    | \$ 0.62     |
| Diluted earnings per common share              | \$ 0.26                                     | \$ 0.21     | \$ 0.61                                    | \$ 0.60     |

**7. Lines of Business**

As of September 30, 2005, we had four reportable segments: Laboratory, Animal Hospital, Medical Technology and Corporate. These segments are strategic business units that have different products, services and/or functions. The segments are managed separately because each is a distinct and different business venture with unique challenges, rewards and risks. The Laboratory segment provides diagnostic laboratory testing services for veterinarians, both associated with our animal hospitals and those independent of us. The Animal Hospital segment provides veterinary services for companion animals and sells related retail and pharmaceutical products. The Medical Technology

segment sells ultrasound and digital radiography equipment, related computer hardware, software and ancillary services to the veterinary market. The Corporate segment provides selling, general and administrative support services for the other segments. We acquired our Medical Technology segment on October 1, 2004, and therefore do not have operating results for periods prior to that date. The accounting policies of our segments are the same as those described in the summary of significant accounting policies included in our consolidated financial statements and notes thereto included in our 2004 annual report on Form 10-K. We evaluate the performance of our segments based on gross profit. For purposes of reviewing the operating performance of the segments, all intercompany sales and purchases are accounted for as if they were transactions with independent third parties at current market prices.

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Below is a summary of certain financial data for each of our segments (in thousands):

|  | <b>Laboratory</b> | <b>Animal<br/>Hospital</b> | <b>Medical<br/>Technology</b> | <b>Corporate</b> | <b>Intercompany<br/>Eliminations</b> | <b>Total</b> |
|--|-------------------|----------------------------|-------------------------------|------------------|--------------------------------------|--------------|
| <b>Three Months Ended September 30,<br/>2005</b> |                   |                            |                               |                  |                                      |              |
| Revenue  | \$ 56,555         | \$ 167,815                 | \$ 10,595                     | \$               | \$ (5,723)                           | \$ 229,242   |
| Direct costs                                     | 31,478            | 133,571                    | 6,881                         |                  | (5,332)                              | 166,598      |
| Gross profit                                     | 25,077            | 34,244                     | 3,714                         |                  | (391)                                | 62,644       |
| Selling, general and<br>administrative expense   | 3,636             | 4,072                      | 2,806                         | 7,880            |                                      | 18,394       |
| Gain on sale of assets                           |                   | 115                        |                               |                  |                                      | 115          |
| Operating income (loss)                          | \$ 21,441         | \$ 30,057                  | \$ 908                        | \$ (7,880)       | \$ (391)                             | \$ 44,135    |
| Depreciation and<br>amortization                 | \$ 1,025          | \$ 3,383                   | \$ 320                        | \$ 454           | \$ (20)                              | \$ 5,162     |
| Capital expenditures                             | \$ 3,080          | \$ 4,214                   | \$ 191                        | \$ 915           | \$ (356)                             | \$ 8,044     |
| <b>Three Months Ended September 30,<br/>2004</b> |                   |                            |                               |                  |                                      |              |
| Revenue  | \$ 50,685         | \$ 136,399                 | \$                            | \$               | \$ (3,732)                           | \$ 183,352   |
| Direct costs                                     | 28,470            | 108,833                    |                               |                  | (3,732)                              | 133,571      |
| Gross profit                                     | 22,215            | 27,566                     |                               |                  |                                      | 49,781       |
| Selling, general and<br>administrative expense   | 3,136             | 3,423                      |                               | 6,478            |                                      | 13,037       |
| Loss on sale of assets                           |                   | (12)                       |                               |                  |                                      | (12)         |
| Operating income (loss)                          | \$ 19,079         | \$ 24,155                  | \$                            | \$ (6,478)       | \$                                   | \$ 36,756    |
| Depreciation and<br>amortization                 | \$ 850            | \$ 2,722                   | \$                            | \$ 400           | \$                                   | \$ 3,972     |
| Capital expenditures                             | \$ 2,108          | \$ 4,451                   | \$                            | \$ 449           | \$                                   | \$ 7,008     |
| <b>Nine Months Ended September 30,<br/>2005</b>  |                   |                            |                               |                  |                                      |              |
| Revenue  | \$ 168,271        | \$ 449,128                 | \$ 20,437                     | \$               | \$ (15,147)                          | \$ 622,689   |
| Direct costs                                     | 91,947            | 357,332                    | 14,026                        |                  | (14,522)                             | 448,783      |
| Gross profit                                     | 76,324            | 91,796                     | 6,411                         |                  | (625)                                | 173,906      |
| Selling, general and<br>administrative expense   | 10,347            | 11,582                     | 6,295                         | 19,719           |                                      | 47,943       |
| Gain on sale of assets                           |                   | 27                         |                               |                  |                                      | 27           |

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|                               |           |           |        |             |          |            |
|-------------------------------|-----------|-----------|--------|-------------|----------|------------|
| Operating income (loss)       | \$ 65,977 | \$ 80,187 | \$ 116 | \$ (19,719) | \$ (625) | \$ 125,936 |
| Depreciation and amortization | \$ 2,805  | \$ 9,034  | \$ 921 | \$ 1,223    | \$ (36)  | \$ 13,947  |
| Capital expenditures          | \$ 5,941  | \$ 13,081 | \$ 436 | \$ 4,014    | \$ (747) | \$ 22,725  |

**Nine Months Ended September 30, 2004**

|   |            |            |    |             |            |            |
|---|------------|------------|----|-------------|------------|------------|
| Revenue                                     | \$ 151,818 | \$ 355,739 | \$ | \$          | \$ (9,908) | \$ 497,649 |
| Direct costs                                | 84,168     | 284,044    |    |             | (9,908)    | 358,304    |
| Gross profit                                | 67,650     | 71,695     |    |             |            | 139,345    |
| Selling, general and administrative expense | 9,499      | 9,227      |    | 14,777      |            | 33,503     |
| Loss on sale of assets                      | 1          | 53         |    |             |            | 54         |
| Operating income (loss)                     | \$ 58,150  | \$ 62,415  | \$ | \$ (14,777) | \$         | \$ 105,788 |
| Depreciation and amortization               | \$ 2,568   | \$ 7,659   | \$ | \$ 1,180    | \$         | \$ 11,407  |
| Capital expenditures                        | \$ 3,911   | \$ 10,982  | \$ | \$ 1,142    | \$         | \$ 16,035  |

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|                              | <b>Laboratory</b> | <b>Animal<br/>Hospital</b> | <b>Medical<br/>Technology</b> | <b>Corporate</b> | <b>Intercompany<br/>Eliminations</b> | <b>Total</b> |
|------------------------------|-------------------|----------------------------|-------------------------------|------------------|--------------------------------------|--------------|
| <b>At September 30, 2005</b> |                   |                            |                               |                  |                                      |              |
| Total assets                 | \$ 149,379        | \$ 609,975                 | \$ 40,446                     | \$ 65,690        | \$ (2,552)                           | \$ 862,938   |
| <b>At December 31, 2004</b>  |                   |                            |                               |                  |                                      |              |
| Total assets                 | \$ 136,810        | \$ 503,485                 | \$ 35,198                     | \$ 67,817        | \$ (1,210)                           | \$ 742,100   |

**8. Stock-Based Compensation**

We have granted stock options to various employees under multiple stock option plans and are accounting for those options under the intrinsic value method as prescribed in Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*. Under that method, when options are granted with a strike price equal to or greater than market price on date of issuance, there is no impact on earnings either on the date of grant or thereafter, absent modification to the options. This method is not a fair-value-based method of accounting as defined by Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock-Based Compensation*. Fair-value-based methods of accounting require compensation expense to be recognized based on the fair market value of the options granted over their vesting period. The following table presents net income and earnings per common share as if we accounted for our stock options under SFAS No. 123 and the fair-value-based method of accounting (in thousands, except per share amounts):

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2005</b>                                 | <b>2004</b> | <b>2005</b>                                | <b>2004</b> |
| As reported   | \$ 22,257                                   | \$ 17,344   | \$ 50,765                                  | \$ 50,255   |
| Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects | (503)                                       | (484)       | (4,457)                                    | (1,246)     |
| Pro forma net income available to common stockholders   | \$ 21,754                                   | \$ 16,860   | \$ 46,308                                  | \$ 49,009   |
| Earnings per common share:  |   |             |  |             |
| Basic as reported   | \$ 0.27                                     | \$ 0.21     | \$ 0.62                                    | \$ 0.62     |
| Basic pro forma   | \$ 0.26                                     | \$ 0.21     | \$ 0.56                                    | \$ 0.60     |
| Diluted as reported   | \$ 0.26                                     | \$ 0.21     | \$ 0.61                                    | \$ 0.60     |
| Diluted pro forma   | \$ 0.26                                     | \$ 0.20     | \$ 0.55                                    | \$ 0.59     |

In December 2004, the Financial Accounting Standards Board, or FASB, issued SFAS No. 123R, *Share-Based Payment*, which replaces SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123R will require us to measure the cost of share-based payments to employees, including stock options, based on the grant date fair value and to recognize the cost over the requisite service period. We will adopt SFAS No. 123R effective with the compliance date applicable to us, which is currently scheduled for January 1, 2006. Based on options granted on or prior to September 30, 2005, we expect that the adoption of SFAS No. 123R will result in share-based compensation of \$1.8 million, net of tax, in 2006. Any share-based payments issued subsequent to September 30, 2005, may increase our share-based compensation expense.

**9. Commitments and Contingencies**

We have certain commitments, including operating leases and supply purchase agreements, incident to the ordinary course of our business. These items are discussed in detail in our consolidated financial statements and notes thereto included in our 2004 annual report on Form 10-K. In addition to the commitments discussed in our 2004 annual report on Form 10-K, we had commitments for construction projects of approximately \$3.2 million at September 30, 2005. We also have contingencies, which are discussed below.

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*a. Earnout Payments*

We have contractual arrangements in connection with certain acquisitions, whereby additional cash may be paid to former owners of acquired companies upon attainment of specified financial criteria as set forth in the respective agreements. The amount to be paid cannot be determined until the earnout periods expire and the attainment of criteria is established. If the specified financial criteria are attained, we will be obligated to make cash payments of \$75,000 for the remainder of 2005 and \$2.3 million in 2006.

*b. Officers Compensation*

We have entered into employment agreements with three of our officers whereby payments may be required if our company terminates their employment in certain circumstances. We have entered into an agreement with another officer providing for similar benefits if we terminate his employment without cause. The amounts payable are based upon the executives' salaries and/or bonus history at the time of termination and the cost to our company of continuing to provide certain benefits. Had all of such officers been terminated as of September 30, 2005, we would have had aggregate obligations of approximately \$9.4 million plus the cost of the continuing benefits under such agreements. The employment agreements with our three executives also obligate our company to make certain payments in the event of a change in control of our company. The amounts payable by our company under these agreements upon a change in control are based on the officers' salaries and bonus history at the time of termination and the cost to our company of continuing to provide certain benefits. Had all of our officers been terminated following a change in control as of September 30, 2005, we would have aggregate obligations of approximately \$9.1 million under these agreements plus the cost of the continuing benefits. These agreements also provide for the acceleration of the vesting of certain of the stock options held by the officers in such circumstances.

*c. Other Contingencies*

We have certain contingent liabilities resulting from litigation and claims incident to the ordinary course of our business. We believe that the probable resolution of such contingencies will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

**10. Reclassifications**

Certain prior year balances have been reclassified to conform to the 2005 financial statement presentation.

**11. Subsequent Events**

From October 1, 2005 through November 4, 2005, we acquired three animal hospitals, one of which was merged into an existing VCA animal hospital, for an aggregate consideration of \$5.4 million, consisting of \$5.2 million in cash and the assumption of liabilities of \$250,000.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

|                                 | <b>Page<br/>Number</b> |
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| Executive Overview              | 15                     |
| Results of Operations           | 17                     |
| Liquidity and Capital Resources | 24                     |
| Critical Accounting Policies    | 26                     |
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| Forward-Looking Statements      | 30                     |
| Risk Factors                    | 30                     |

**Table of Contents****Introduction**

*The following discussion should be read in conjunction with our condensed, consolidated financial statements provided under Part I, Item I of this quarterly report on Form 10-Q. We have included herein statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. We generally identify forward-looking statements in this report using words like believe, intend, expect, estimate, may, plan, should plan, project, contemplate, anticipate, predict, potential, continue, or similar expressions. Some of these statements below and elsewhere in this report. These forward-looking statements are not historical facts and are inherently uncertain and outside of our control. Any or all of our forward-looking statements in this report may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in our discussion in this report will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially. Factors that may cause our plans, expectations, future financial condition and results to change include those summarized in the section of this report captioned Risk Factors.*

*The forward-looking information set forth in this quarterly report on Form 10-Q is as of November 4, 2005, and we undertake no duty to update this information. Shareholders and prospective investors can find information filed with the SEC after November 4, 2005, at our website at [www.investor.vcaantech.com](http://www.investor.vcaantech.com) or at the SEC's website at [www.sec.gov](http://www.sec.gov).*

The following Management's Discussion and Analysis of Financial Condition and Results of Operations describes the principal factors affecting the results of our operations for the three and nine months ended September 30, 2005, as well as our overall liquidity, capital resources and contractual cash obligations as of November 4, 2005. In addition, we will discuss our critical accounting policies.

We are a leading animal healthcare services company operating in the United States. We provide veterinary services and diagnostic testing to support veterinary care and we sell diagnostic imaging equipment and other medical technology products and related services to veterinarians. We have four reportable segments:

*Laboratory.* We operate the largest network of veterinary diagnostic laboratories in the nation. Our laboratories provide sophisticated testing and consulting services used by veterinarians in the detection, diagnosis, evaluation, monitoring, treatment and prevention of diseases and other conditions affecting animals. At September 30, 2005, our laboratory network consisted of 30 laboratories serving all 50 states.

*Animal hospitals.* We operate the largest network of freestanding, full-service animal hospitals in the nation. Our animal hospitals offer a full range of general medical and surgical services for companion animals. We treat diseases and injuries, offer pharmaceutical products and perform a variety of pet wellness programs, including health examinations, diagnostic testing, routine vaccinations, spaying, neutering and dental care. At September 30, 2005, our animal hospital network consisted of 365 animal hospitals in 37 states.

*Medical technology.* We sell ultrasound and digital radiography imaging equipment, related computer hardware, software and ancillary services to veterinarians.

*Corporate.* We provide selling, general and administrative support for our other segments.

The practice of veterinary medicine is subject to seasonal fluctuation. In particular, demand for veterinary services is significantly higher during the warmer months because pets spend a greater amount of time outdoors, where they are more likely to be injured and are more susceptible to disease and parasites. In addition, use of veterinary services may be affected by levels of infestation of fleas, heartworm and ticks and the number of daylight hours.

**Executive Overview**

We experienced strong operating results for the three and nine months ended September 30, 2005, marked by continued growth in our laboratory and animal hospital segments. During the three months ended September 30, 2005, our revenue increased 25.0% compared to the comparable prior year period to \$229.2 million and our diluted earnings per common share increased 23.8% compared to the comparable prior year period to \$0.26. During the nine months ended September 30, 2005, our revenue increased 25.1% compared to the comparable prior year period

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to \$622.7 million and our diluted earnings per common share was \$0.61, which included debt retirement costs of \$0.13.

*Refinancing Transactions*

On May 16, 2005, we refinanced our senior credit facility. The new senior credit facility provides for \$475.0 million of senior term notes and a \$75.0 million revolving credit facility. Both the senior term notes and the revolving credit facility are priced at LIBOR plus 150 basis points, a 25 basis point reduction from our previous senior credit facility. We used the proceeds from the refinance to retire our outstanding debt under our previous senior credit facility, to purchase all of our \$170.0 million outstanding 9.875% senior subordinated notes, and to purchase Pet s Choice, Inc., or Pet s Choice (see discussion in note 2, *Acquisitions*, in our notes to the condensed, consolidated financial statements for additional details on the Pet s Choice acquisition). In conjunction with these refinancing transactions, we incurred debt retirement costs of approximately \$19.3 million, which were recognized as part of income from continuing operations in the nine months ended September 30, 2005.

*Acquisitions*

Our growth strategy includes the acquisition of 20 to 25 independent animal hospitals per year with aggregate annual revenues of approximately \$30.0 million to \$35.0 million. In addition, we also evaluate the acquisition of animal hospital chains, laboratories or related businesses if favorable opportunities are presented. On July 1, 2005, we acquired Pet s Choice, which operated 46 animal hospitals in five states as of the acquisition date. The following table summarizes our laboratory and animal hospital facilities growth and animal hospital closures:

|  | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|--|-------------|
|  | <b>2005</b>                                | <b>2004</b> |
| Laboratories:  |  |             |
| Beginning of period                                  | 27   | 23          |
| New facilities                                       | 3  | 3           |
| End of period  | 30   | 26          |
| Animal hospitals:                                    |  |             |
| Beginning of period                                  | 315  | 241         |
| Acquisitions, excluding Pet s Choice and NPC (1)(2)  | 19   | 17          |
| Pet s Choice (1)                                     | 46   |             |
| NPC (2)  |  | 67          |
| New facilities                                       |  | 1           |
| Acquisitions relocated into hospitals operated by us | (5)  | (4)         |
| Sold or closed                                       | (10)                                       | (4)         |
| End of period  | 365  | 318         |

(1) Pet s Choice was acquired on July 1, 2005.

(2) National PetCare Centers, Inc., or NPC, was

acquired on  
June 1, 2004.

**Table of Contents****Results of Operations**

The following is a summary of the operating results for each of our segments (in thousands):

|  | <b>Laboratory</b> | <b>Animal<br/>Hospital</b> | <b>Medical<br/>Technology</b> | <b>Corporate</b> | <b>Intercompany<br/>Eliminations</b> | <b>Total</b> |
|--|-------------------|----------------------------|-------------------------------|------------------|--------------------------------------|--------------|
| <b>Three Months Ended September 30,<br/>2005</b> |                   |                            |                               |                  |                                      |              |
| Revenue  | \$ 56,555         | \$ 167,815                 | \$ 10,595                     | \$               | \$ (5,723)                           | \$ 229,242   |
| Direct costs                                     | 31,478            | 133,571                    | 6,881                         |                  | (5,332)                              | 166,598      |
| Gross profit                                     | 25,077            | 34,244                     | 3,714                         |                  | (391)                                | 62,644       |
| Selling, general and<br>administrative expense   | 3,636             | 4,072                      | 2,806                         | 7,880            |                                      | 18,394       |
| Gain on sale of assets                           |                   | 115                        |                               |                  |                                      | 115          |
| Operating income (loss)                          | \$ 21,441         | \$ 30,057                  | \$ 908                        | \$ (7,880)       | \$ (391)                             | \$ 44,135    |
| Depreciation and<br>amortization                 | \$ 1,025          | \$ 3,383                   | \$ 320                        | \$ 454           | \$ (20)                              | \$ 5,162     |
| <b>Three Months Ended September 30,<br/>2004</b> |                   |                            |                               |                  |                                      |              |
| Revenue  | \$ 50,685         | \$ 136,399                 | \$                            | \$               | \$ (3,732)                           | \$ 183,352   |
| Direct costs                                     | 28,470            | 108,833                    |                               |                  | (3,732)                              | 133,571      |
| Gross profit                                     | 22,215            | 27,566                     |                               |                  |                                      | 49,781       |
| Selling, general and<br>administrative expense   | 3,136             | 3,423                      |                               | 6,478            |                                      | 13,037       |
| Loss on sale of assets                           |                   | (12)                       |                               |                  |                                      | (12)         |
| Operating income (loss)                          | \$ 19,079         | \$ 24,155                  | \$                            | \$ (6,478)       | \$                                   | \$ 36,756    |
| Depreciation and<br>amortization                 | \$ 850            | \$ 2,722                   | \$                            | \$ 400           | \$                                   | \$ 3,972     |
| <b>Nine Months Ended September 30,<br/>2005</b>  |                   |                            |                               |                  |                                      |              |
| Revenue  | \$ 168,271        | \$ 449,128                 | \$ 20,437                     | \$               | \$ (15,147)                          | \$ 622,689   |
| Direct costs                                     | 91,947            | 357,332                    | 14,026                        |                  | (14,522)                             | 448,783      |
| Gross profit                                     | 76,324            | 91,796                     | 6,411                         |                  | (625)                                | 173,906      |
| Selling, general and<br>administrative expense   | 10,347            | 11,582                     | 6,295                         | 19,719           |                                      | 47,943       |
| Gain on sale of assets                           |                   | 27                         |                               |                  |                                      | 27           |
| Operating income (loss)                          | \$ 65,977         | \$ 80,187                  | \$ 116                        | \$ (19,719)      | \$ (625)                             | \$ 125,936   |
| Depreciation and<br>amortization                 | \$ 2,805          | \$ 9,034                   | \$ 921                        | \$ 1,223         | \$ (36)                              | \$ 13,947    |

**Nine Months Ended September 30,  
2004**

|  |            |            |    |             |            |            |
|--|------------|------------|----|-------------|------------|------------|
| Revenue  | \$ 151,818 | \$ 355,739 | \$ | \$          | \$ (9,908) | \$ 497,649 |
| Direct costs                                   | 84,168     | 284,044    |    |             | (9,908)    | 358,304    |
| Gross profit                                   | 67,650     | 71,695     |    |             |            | 139,345    |
| Selling, general and<br>administrative expense | 9,499      | 9,227      |    | 14,777      |            | 33,503     |
| Loss on sale of assets                         | 1          | 53         |    |             |            | 54         |
| Operating income (loss)                        | \$ 58,150  | \$ 62,415  | \$ | \$ (14,777) | \$         | \$ 105,788 |
| Depreciation and<br>amortization               | \$ 2,568   | \$ 7,659   | \$ | \$ 1,180    | \$         | \$ 11,407  |

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The following table sets forth components of our condensed, consolidated income statements expressed as a percentage of revenue:

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2005</b>                                 | <b>2004</b> | <b>2005</b>                                | <b>2004</b> |
| Revenue:                                    |   |             |  |             |
| Laboratory                                  | 24.7%                                       | 27.6%       | 27.0%                                      | 30.5%       |
| Animal hospital                             | 73.2  | 74.4        | 72.1                                       | 71.5        |
| Medical technology                          | 4.6   |             | 3.3  |             |
| Intercompany                                | (2.5)                                       | (2.0)       | (2.4)                                      | (2.0)       |
| Total revenue                               | 100.0                                       | 100.0       | 100.0                                      | 100.0       |
| Direct costs                                | 72.7  | 72.8        | 72.1                                       | 72.0        |
| Gross profit                                | 27.3  | 27.2        | 27.9                                       | 28.0        |
| Selling, general and administrative expense | 8.0   | 7.1         | 7.7  | 6.7         |
| Gain on sale of assets                      |   | 0.1         |  |             |
| Operating income                            | 19.3  | 20.0        | 20.2                                       | 21.3        |
| Interest expense, net                       | 2.7   | 3.6         | 3.0  | 3.8         |
| Debt retirement costs                       |   |             | 3.1  | 0.2         |
| Other (income) expense                      |   |             |  | (0.1)       |
| Minority interest in income of subsidiaries | 0.3   | 0.4         | 0.4  | 0.4         |
| Income before provision for income taxes    | 16.3  | 16.0        | 13.7                                       | 17.0        |
| Provision for income taxes                  | 6.6   | 6.5         | 5.5  | 6.9         |
| Net income                                  | 9.7%  | 9.5%        | 8.2%                                       | 10.1%       |

**Revenue**

The following table summarizes our revenue (in thousands, except percentages):

|                    | <b>Three Months Ended September 30,</b> |             |                     | <b>Nine Months Ended September 30,</b> |             |                     |
|--------------------|---|-------------|---------------------|--|-------------|---------------------|
|                    | <b>2005</b>                             | <b>2004</b> | <b>%<br/>Change</b> | <b>2005</b>                            | <b>2004</b> | <b>%<br/>Change</b> |
| Laboratory         | \$ 56,555                               | \$ 50,685   | 11.6%               | \$ 168,271                             | \$ 151,818  | 10.8%               |
| Animal hospital    | 167,815                                 | 136,399     | 23.0%               | 449,128                                | 355,739     | 26.3%               |
| Medical technology | 10,595                                  |             |                     | 20,437                                 |             |                     |
| Intercompany       | (5,723)                                 | (3,732)     | 53.3%               | (15,147)                               | (9,908)     | 52.9%               |
| Total revenue      | \$ 229,242                              | \$ 183,352  | 25.0%               | \$ 622,689                             | \$ 497,649  | 25.1%               |

**Table of Contents***Laboratory Revenue*

Laboratory revenue increased \$5.9 million for the three months ended September 30, 2005, and increased \$16.5 million for the nine months ended September 30, 2005, as compared to the same periods in the prior year. The components of the increases in laboratory revenue are detailed below (in thousands, except percentages and average price per requisition):

|                                     | Three Months Ended September 30, |           |          | Nine Months Ended September 30, |            |          |
|-------------------------------------|----------------------------------|-----------|----------|---------------------------------|------------|----------|
|                                     | 2005                             | 2004      | % Change | 2005                            | 2004       | % Change |
| <b>Laboratory Revenue:</b>          |                                  |           |          |                                 |            |          |
| Internal growth:                    |                                  |           |          |                                 |            |          |
| Number of requisitions (1)          | 2,396                            | 2,137     | 12.1%    | 7,232                           | 6,613      | 9.4%     |
| Average revenue per requisition (2) | \$ 23.60                         | \$ 23.72  | (0.5)%   | \$ 23.27                        | \$ 22.86   | 1.8%     |
| Total internal revenue (1)          | \$ 56,555                        | \$ 50,685 | 11.6%    | \$ 168,271                      | \$ 151,179 | 11.3%    |
| Billing day adjustment (3)          |                                  |           |          |                                 | 639        |          |
| Total                               | \$ 56,555                        | \$ 50,685 | 11.6%    | \$ 168,271                      | \$ 151,818 | 10.8%    |

(1) Internal revenue and requisitions were calculated using laboratory operating results adjusted for the impact resulting from any differences in the number of billing days in comparable periods.

(2) Computed by dividing total internal revenue by the number of requisitions.

(3) The 2004 billing day adjustment reflects the impact of one additional billing day for the nine months ended

September 30,  
2004, as  
compared to the  
comparable  
2005 period.

The increase in requisitions from internal growth is the result of a continued trend in veterinary medicine to focus on the importance of laboratory diagnostic testing in the diagnosis, early detection and treatment of diseases. This trend is driven by an increase in the number of specialists in the veterinary industry relying on diagnostic testing, the increased focus on diagnostic testing in veterinary schools and general increased awareness through ongoing marketing and continuing education programs provided by ourselves, pharmaceutical companies and other service providers in the industry.

The change in the average revenue per requisition is attributable to price increases and changes in the mix, type and number of tests performed per requisition. The price increases for most tests ranged from 2% to 4% in both February 2005 and February 2004.

#### *Animal Hospital Revenue*

Animal hospital revenue increased \$31.4 million for the three months ended September 30, 2005, and increased \$93.4 million for the nine months ended September 30, 2005, as compared to the same periods in the prior year. The components of the increases are summarized in the following table (in thousands, except percentages and average price per order):

|                                 | Three Months Ended September |                   |              | Nine Months Ended September |                   |              |
|---------------------------------|------------------------------|-------------------|--------------|-----------------------------|-------------------|--------------|
|                                 | 2005                         | 2004              | %<br>Change  | 2005                        | 2004              | %<br>Change  |
| <b>Animal Hospital Revenue:</b> |                              |                   |              |                             |                   |              |
| Same-store facility:            |                              |                   |              |                             |                   |              |
| Orders (1)                      | 1,158                        | 1,178             | (1.7)%       | 2,691                       | 2,730             | (1.4)%       |
| Average revenue per order (2)   | \$ 121.81                    | \$ 112.44         | 8.3%         | \$ 120.40                   | \$ 110.76         | 8.7%         |
| Same-store revenue (1)          | \$ 141,072                   | \$ 132,421        | 6.5%         | \$ 323,992                  | \$ 302,500        | 7.1%         |
| Business day adjustment (3)     |                              | 1,730             |              |                             | 2,454             |              |
| Net acquired revenue (4)        | 26,743                       | 2,248             |              | 125,136                     | 50,785            |              |
| <b>Total</b>                    | <b>\$ 167,815</b>            | <b>\$ 136,399</b> | <b>23.0%</b> | <b>\$ 449,128</b>           | <b>\$ 355,739</b> | <b>26.3%</b> |

(1) Same-store revenue and orders were calculated using animal hospital operating results, adjusted to exclude the operating results for the newly acquired animal hospitals that we did not own for the entire period presented and adjusted for

the impact  
resulting from  
any differences  
in the number of  
business days in  
comparable  
periods.

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- (2) Computed by dividing same-store revenue by same-store orders.
- (3) The 2004 business day adjustment reflects the impact of one additional business day for the three months ended September 30, 2004, and the impact of two additional business days for the nine months ended September 30, 2004, as compared to the comparable 2005 periods.
- (4) Net acquired revenue represents the revenue from those animal hospitals acquired, net of revenue from those animal hospitals sold or closed, on or after the beginning of the comparative period, which was July 1, 2004, for the three months ended September 30,

2005, and  
January 1, 2004,  
for the nine  
months ended  
September 30,  
2005.

Fluctuations in  
net acquired  
revenue occur  
due to the  
volume, size  
and timing of  
acquisitions and  
disposals during  
the periods  
compared.

Over the last few years, some pet-related products, including medication prescriptions, traditionally sold at animal hospitals have become more widely available in retail stores and other distribution channels, and, as a result, we have fewer customers coming to our animal hospitals solely to purchase those items. In addition, there has been a decline in the number of vaccinations as some recent professional literature and research has suggested that vaccinations can be given to pets less frequently. Orders for these pet-related products and vaccinations generally generate revenue that is less than the average revenue for orders of more advanced medical procedures, which our business strategy has placed a greater emphasis on including, but not limited to, high-quality veterinary care and wellness programs that typically generate higher-priced orders. These trends have resulted in a decrease in the number of orders and an increase in the average revenue per order.

Price increases, which approximated 2.5% to 6% on services at most hospitals in February 2005, and 2.5% to 5% in February 2004, also contributed to the increase in the average revenue per order. Prices are reviewed on an annual basis for each hospital and adjustments are made based on market considerations, demographics and our costs.

#### *Medical Technology Revenue*

Medical technology revenue was \$10.6 million and \$20.4 million for the three and nine months ended September 30, 2005, respectively. For sales of our digital radiography solution, commencing in the third quarter of 2005, we recognized revenue on the digital radiography equipment, computer hardware and software at the time of customer acceptance, and recognized revenue from post-contract customer support services on a straight-line basis over the term of the support periods, which is generally one year. Prior to the third quarter of 2005, the full amount of digital radiography sales was deferred and recognized over the term of the support periods. During the three months ended September 30, 2005, we sold digital radiography solutions for a total contract amount of \$5.2 million, of which \$470,000 was deferred, and we recognized revenue of \$1.5 million for sales deferred prior to the third quarter of 2005. At September 30, 2005, we had deferred revenue of \$4.3 million related to our digital radiography solutions that will be recognized over the term of the support periods.

Due to the seasonality of the medical technology industry and the fact we deferred less revenue during the three months ended September 30, 2005 as compared to prior quarters, results for the three and nine months ended September 30, 2005, may not be indicative of results experienced in future periods.

#### *Intercompany Revenue*

Approximately 8% and 7% of our laboratory revenue in 2005 and 2004, respectively, was intercompany revenue that was generated by providing laboratory services to our animal hospitals. Approximately 7% of our medical technology revenue for the three and nine months ended September 30, 2005, was intercompany revenue that was generated by providing products and services to our animal hospitals. For purposes of reviewing the operating performance of our business segments, all intercompany transactions are accounted for as if the transaction was with an independent third party at current market prices. For financial reporting purposes, intercompany transactions are eliminated as part of our consolidation.



**Table of Contents****Gross Profit**

The following table summarizes our gross profit and our gross profit as a percentage of applicable revenue, or gross profit margin (in thousands, except percentages):

|                    | Three Months Ended September 30, |                     |           |                     |          | Nine Months Ended September 30, |                     |            |                     |          |
|--------------------|----------------------------------|---------------------|-----------|---------------------|----------|---------------------------------|---------------------|------------|---------------------|----------|
|                    | 2005                             |                     | 2004      |                     |          | 2005                            |                     | 2004       |                     |          |
|                    | \$                               | Gross Profit Margin | \$        | Gross Profit Margin | % Change | \$                              | Gross Profit Margin | \$         | Gross Profit Margin | % Change |
| Laboratory         | \$ 25,077                        | 44.3%               | \$ 22,215 | 43.8%               | 12.9%    | \$ 76,324                       | 45.4%               | \$ 67,650  | 44.6%               | 12.8%    |
| Animal hospital    | 34,244                           | 20.4%               | 27,566    | 20.2%               | 24.2%    | 91,796                          | 20.4%               | 71,695     | 20.2%               | 28.0%    |
| Medical technology | 3,714                            | 35.1%               |           |                     |          | 6,411                           | 31.4%               |            |                     |          |
| Intercompany       | (391)                            |                     |           |                     |          | (625)                           |                     |            |                     |          |
| Total gross profit | \$ 62,644                        | 27.3%               | \$ 49,781 | 27.2%               | 25.8%    | \$ 173,906                      | 27.9%               | \$ 139,345 | 28.0%               | 24.8%    |

**Laboratory Gross Profit**

Laboratory gross profit is calculated as laboratory revenue less laboratory direct costs. Laboratory direct costs are comprised of all costs of laboratory services, including but not limited to, salaries of veterinarians, specialists, technicians and other laboratory-based personnel, facilities rent, occupancy costs, depreciation and amortization and supply costs.

The increase in laboratory gross profit margin was primarily attributable to increases in laboratory revenue combined with operating leverage associated with our laboratory business. Our operating leverage comes from the incremental margins we realize on additional tests ordered by the same client, as well as when more comprehensive tests are ordered. We are able to benefit from these incremental margins due to the relative fixed cost nature of our laboratory business.

**Animal Hospital Gross Profit**

Animal hospital gross profit is calculated as animal hospital revenue less animal hospital direct costs. Animal hospital direct costs are comprised of all costs of services and products at the animal hospitals, including, but not limited to, salaries of veterinarians, technicians and all other animal hospital-based personnel, facilities rent, occupancy costs, supply costs, depreciation and amortization, certain marketing and promotional expense and costs of goods sold associated with the retail sales of pet food and pet supplies.

Over the last 24 months we have acquired 152 new animal hospitals, representing approximately 42% of the animal hospitals currently operated by us. Many of these newly acquired animal hospitals had lower gross profit margins at the time of acquisition than those previously operated by us. These lower gross profit margins were offset by improvements in animal hospital revenue, increased operating leverage and the favorable impact of our integration efforts.

**Medical Technology Gross Profit**

Medical technology gross profit is calculated as medical technology revenue less medical technology direct costs. Medical technology direct costs are comprised of all products and services costs, including, but not limited to, all costs of equipment, related products and services, salaries of technicians, support personnel, trainers, diagnostic specialists and other non-administrative personnel, facilities rent, occupancy costs, depreciation and amortization and supply costs.

Medical technology gross profit was \$3.7 million and \$6.4 million for the three and nine months ended September 30, 2005, respectively. For sales of our digital radiography solution, commencing in the third quarter of 2005, we recognized gross profit on the digital radiography equipment, computer hardware and software at the time of

customer acceptance, and recognized gross profit from post-contract customer support services on a straight-line basis over the term of the support periods, which is generally one year. Prior to the third quarter of 2005, the full amount of the gross profit related to digital radiography sales was deferred and recognized over the term of the support periods. During the three months ended September 30, 2005, we sold digital radiography solutions for a total contract amount that yielded \$2.7 million of gross profit, of which \$470,000 was deferred, and we recognized gross profit of \$670,000 for sales deferred prior to the third quarter of 2005. At September 30, 2005, we had deferred gross profit of \$1.7 million related to our digital radiography solutions that will be recognized over the term of the support periods.

Due to the seasonality of the medical technology industry and the fact we deferred less gross profit during the three months ended September 30, 2005 as compared to prior quarters, results for the three and nine months ended September 30, 2005, may not be indicative of results experienced in future periods.

**Table of Contents*****Selling, General and Administrative Expense***

The following table summarizes our selling, general and administrative expense, or SG&A, and our expense as a percentage of applicable revenue (in thousands, except percentages):

|                    | Three Months Ended September 30, |              |           | Nine Months Ended September 30, |          |           |              |           |              |          |
|--------------------|----------------------------------|--------------|-----------|---------------------------------|----------|-----------|--------------|-----------|--------------|----------|
|                    | 2005                             |              | 2004      |                                 | 2005     |           | 2004         |           |              |          |
|                    | \$                               | % of Revenue | \$        | % of Revenue                    | % Change | \$        | % of Revenue | \$        | % of Revenue | % Change |
| Laboratory         | \$ 3,636                         | 6.4%         | \$ 3,136  | 6.2%                            | 15.9%    | \$ 10,347 | 6.1%         | \$ 9,499  | 6.3%         | 8.9%     |
| Animal hospital    | 4,072                            | 2.4%         | 3,423     | 2.5%                            | 19.0%    | 11,582    | 2.6%         | 9,227     | 2.6%         | 25.5%    |
| Medical technology | 2,806                            | 26.5%        |           |                                 |          | 6,295     | 30.8%        |           |              |          |
| Corporate          | 7,880                            | 3.4%         | 6,478     | 3.5%                            | 21.6%    | 19,719    | 3.2%         | 14,777    | 3.0%         | 33.4%    |
| Total SG&A         | \$ 18,394                        | 8.0%         | \$ 13,037 | 7.1%                            | 41.1%    | \$ 47,943 | 7.7%         | \$ 33,503 | 6.7%         | 43.1%    |

***Laboratory SG&A***

Laboratory SG&A consists primarily of salaries of sales, customer support, administrative and accounting personnel, selling, marketing and promotional expense.

The increase in laboratory SG&A is primarily the result of increasing our sales force and marketing efforts.

***Animal Hospital SG&A***

Animal hospital SG&A consists primarily of salaries of field management, certain administrative and accounting personnel, recruiting and certain marketing expense.

The increase in animal hospital SG&A was primarily the result of expanding the animal hospital administrative operations to absorb the recent acquisitions, including Pet's Choice and NPC.

***Medical Technology SG&A***

Medical technology SG&A consists primarily of salaries of sales, customer support, administrative and accounting personnel, selling, marketing and promotional expense and research and development costs.

We acquired our medical technology division on October 1, 2004, and consequently do not have comparative operating results for prior periods.

***Corporate SG&A***

Corporate SG&A consists of administrative expense at our headquarters, including the salaries of corporate officers, administrative and accounting personnel, rent, accounting, finance, legal and other professional expense and occupancy costs as well as corporate depreciation.

In March 2004, we resolved an outstanding claim with our insurance company related to a legal settlement and received reimbursement of \$1.9 million. As a result of acquiring Pet's Choice and NPC we incurred integration costs. The following table reconciles corporate SG&A as reported to corporate SG&A excluding the litigation settlement and the integration costs (in thousands, except percentages):

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|  | Three Months Ended September 30, |              |          | Nine Months Ended September 30, |          |           |              |           |      |       |
|--|----------------------------------|--------------|----------|---------------------------------|----------|-----------|--------------|-----------|------|-------|
|  | 2005                             | 2004         | %        | 2005                            | 2004     | %         |              |           |      |       |
|  | \$                               | % of Revenue | \$       | % of Revenue                    | % Change | \$        | % of Revenue | % Change  |      |       |
| Corporate SG&A as reported                           | \$ 7,880                         | 3.4%         | \$ 6,478 | 3.5%                            | 21.6%    | \$ 19,719 | 3.2%         | \$ 14,777 | 3.0% | 33.4% |
| Impact of certain items:                             |                                  |              |          |                                 |          |           |              |           |      |       |
| Litigation settlement reimbursement                  |                                  |              |          |                                 |          |           |              | 1,124     |      |       |
| Legal fees reimbursement                             |                                  |              |          |                                 |          |           |              | 801       |      |       |
| Integration costs                                    | (809)                            |              | (668)    |                                 |          | (933)     |              | (1,238)   |      |       |
| Corporate SG&A excluding the impact of certain items | \$ 7,071                         | 3.1%         | \$ 5,810 | 3.2%                            | 21.7%    | \$ 18,786 | 3.0%         | \$ 15,464 | 3.1% | 21.5% |

Corporate SG&A excluding the impact of certain items increased significantly from the prior year primarily as a result of expanding the corporate operations to absorb the recent acquisitions, including Pet's Choice, STI and NPC.

**Interest Expense, Net**

The following table summarizes our interest expense, net of interest income (in thousands):

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2005 | September 30, 2004 | September 30, 2005 | September 30, 2004 |
| Interest expense:                              |                    |                    |                    |                    |
| Senior term notes                              | \$ 5,847           | \$ 2,166           | \$ 12,488          | \$ 5,035           |
| 9.875% senior subordinated notes               |                    | 4,197              | 6,342              | 12,591             |
| Interest rate hedging agreements               | 190                | 90                 | 75                 | 419                |
| Amortization of debt costs                     | 132                | 185                | 482                | 552                |
| Capital leases and other                       | 453                | 214                | 863                | 595                |
|  | 6,622              | 6,852              | 20,250             | 19,192             |
| Interest income.                               | 588                | 223                | 1,468              | 480                |
| Total interest expense, net of interest income | \$ 6,034           | \$ 6,629           | \$ 18,782          | \$ 18,712          |

The changes in interest expense were primarily attributable to changes in our debt structure, which we discuss below in *Liquidity and Capital Resources*, and changes in LIBOR.

**Debt Retirement Costs**

In connection with debt refinancing transactions, we incurred debt retirement costs of \$19.3 million and \$810,000 during the nine months ended September 30, 2005 and 2004, respectively. These transactions are discussed below in the *Liquidity and Capital Resources* section.

**Provision for Income Taxes**

Our effective tax rate for the three and nine months ended September 30, 2005, approximated our statutory rate.

We recognized a litigation settlement reimbursement of \$1.1 million during the first quarter of 2004, which we discuss above in *Corporate SG&A*. This reimbursement had no related tax expense and reduced our effective tax rate to 40.6% for the nine months ended September 30, 2004. This reimbursement did not impact our effective tax rate for individual quarters ending subsequent to March 31, 2004. Our effective tax rate for the three months ended September 30, 2004, approximated our statutory rate.

**Table of Contents****Liquidity and Capital Resources**

The following table summarizes our cash flows (in thousands):

|  | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|--|-------------|
|  | <b>2005</b>                                | <b>2004</b> |
| Cash provided by (used in):                    |  |             |
| Operating activities                           | \$ 91,214                                  | \$ 71,735   |
| Investing activities                           | (105,448)                                  | (117,015)   |
| Financing activities                           | 27,771                                     | 78,877      |
| Increase in cash and cash equivalents          | 13,537                                     | 33,597      |
| Cash and cash equivalents at beginning of year | 30,964                                     | 17,237      |
| Cash and cash equivalents at end of year       | \$ 44,501                                  | \$ 50,834   |

***Cash Flows from Operating Activities***

Net cash provided by operating activities increased \$19.5 million in the nine months ended September 30, 2005, as compared to the comparable period in the prior year primarily due to improved operating performance, acquisitions and a \$9.7 million decrease in taxes paid. Our cash flows from operating activities for the nine months ended September 30, 2005, as compared to the comparable period in the prior year were negatively impacted by changes in working capital, a \$6.5 million increase in interest paid and a litigation settlement reimbursement received during the nine months ended September 30, 2004.

On a prospective basis, we anticipate cash flow from operating activities to continue growing in line with increases in operating income resulting from improved operating performance and acquisitions. However, we also anticipate that operating cash flow may be negatively impacted by an increase in cash paid for interest as a result of possible future increases in interest rates. Interest rates have been at historical lows and are projected to increase over the next several years. Significant increases in interest rates may materially impact our operating cash flows because of the variable-rate nature of our senior credit facility.

***Cash Flows used in Investing Activities***

Net cash used in investing activities primarily consisted of cash used for the acquisition of animal hospitals and expenditures for property and equipment.

Depending upon the attractiveness of the candidates and the strategic fit with our existing operations, we intend to acquire approximately 20 to 25 independent animal hospitals per year with aggregate annual revenues of approximately \$30.0 million to \$35.0 million. In addition, we also evaluate the acquisition of animal hospital chains, laboratories or related businesses if favorable opportunities are presented. In accord with that strategy, we acquired Pet's Choice, which operated 46 animal hospitals, on July 1, 2005. We funded the acquisition of Pet's Choice with cash received from our new senior credit facility entered into in May 2005. We intend to primarily use cash in our acquisitions but, depending on the timing and amount of our acquisitions, we may use stock or debt. For the remaining three months of 2005, we also intend to spend approximately \$6.0 million for property and equipment.

***Cash Flows from Financing Activities***

In May 2005, we entered into a new senior credit facility that provided \$475.0 million of senior term notes and a \$75.0 million revolving credit facility. The funds borrowed under the new senior term notes were used to retire our existing senior term notes in the principal amount of \$220.3 million and repurchase our 9.875% senior subordinated notes in the principal amount of \$170.0 million. The new senior term notes also provided the necessary financing to acquire Pet's Choice, which we discuss in note 2, *Acquisitions*, in our notes to the condensed, consolidated financial statements. In connection with the refinancing transactions, we paid financing costs of approximately \$3.2 million and paid an aggregate tender fee of \$13.8 million to purchase the 9.875% senior subordinated notes.



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In August 2005, we voluntarily repaid \$35.0 million of our senior term notes.

In June 2004, we amended and restated our senior credit facility to replace the existing senior term notes in the principal amount of \$145.3 million with an interest rate margin of 2.50% with new senior term notes in the principal amount of \$225.0 million with an interest rate margin of 2.25%. The additional borrowings were used to fund the NPC merger. In connection with this refinancing transaction, we paid financing costs of \$794,000.

**Future Cash Requirements**

The following table sets forth the scheduled principal, interest and other contractual cash obligations due by us for each of the years indicated (in thousands):

|                                      | <b>Total</b>        | <b>2005 (1)</b>  | <b>2006</b>      | <b>2007</b>      | <b>2008</b>      | <b>2009</b>      | <b>Thereafter</b> |
|--------------------------------------|---------------------|------------------|------------------|------------------|------------------|------------------|-------------------|
| Long-term debt                       | \$ 441,094          | \$ 1,445         | \$ 4,850         | \$ 5,986         | \$ 4,768         | \$ 4,485         | \$ 419,560        |
| Capital lease obligations            | 12,986              | 181              | 800              | 805              | 816              | 864              | 9,520             |
| Operating leases                     | 366,882             | 6,816            | 27,018           | 26,458           | 25,924           | 25,235           | 255,431           |
| Purchase Obligations                 | 8,732               | 3,759            | 4,258            | 330              | 330              | 55               |                   |
| Fixed cash interest expense (1)      | 7,026               | 301              | 1,155            | 1,066            | 1,163            | 914              | 2,427             |
| Variable cash interest expense (2)   | 166,716             | 6,675            | 28,924           | 29,709           | 29,832           | 29,945           | 41,631            |
| Swap agreements (1)                  | (4,311)             | (226)            | (1,730)          | (1,740)          | (615)            |                  |                   |
| Other long-term liabilities(3)       | 36,748              | 65               | 65               | 65               | 65               |                  | 36,488            |
| <b>Total Contractual Obligations</b> | <b>\$ 1,035,873</b> | <b>\$ 19,016</b> | <b>\$ 65,340</b> | <b>\$ 62,679</b> | <b>\$ 62,283</b> | <b>\$ 61,498</b> | <b>\$ 765,057</b> |

(1) Consists of the period October 1 through December 31, 2005.

(2) We have variable-rate debt. The interest payments on our variable-rate debt are based on a variable-rate component plus a fixed 1.50%. For purposes of this computation, we have assumed that the interest rate on our variable-rate debt (including the fixed rate portion) will be

6.10%, 6.65%,  
6.90%, 7.00%,  
7.10% and  
7.25% for years  
2005 through  
thereafter,  
respectively.

These  
assumptions are  
based on  
interest rate  
projections used  
to price our  
interest rate  
swap  
agreements. Our  
condensed,  
consolidated  
financial  
statements  
included in this  
quarterly report  
on Form 10-Q  
discuss these  
variable-rate  
notes in more  
detail.

- (3) Includes  
deferred income  
taxes of  
\$27.4 million.

The table above excludes certain contractual arrangements whereby additional cash may be paid to former owners of acquired businesses upon attainment of specified performance targets. We may be required to pay up to \$2.3 million in future periods if these performance targets are achieved.

We anticipate that our cash on-hand, net cash provided by operations and, if needed, our revolving credit facility will provide sufficient cash resources to fund our operations for more than the next 12 months. If we consummate one or more significant acquisitions during this period we may need to seek additional debt or equity financing.

#### ***Debt Related Covenants***

Our senior credit facility contains certain financial covenants pertaining to fixed charge coverage and leverage ratios. In addition, the senior credit facility has restrictions pertaining to capital expenditures, acquisitions and the payment of cash dividends. In particular, the covenants limit our acquisition spending, without a waiver, to \$110.0 million for the period from May 16, 2005 to December 31, 2005, and \$50.0 million per year thereafter plus up to \$10.0 million of any unused amount from the previous year. As of September 30, 2005, we were in compliance with these covenants, including the two covenant ratios, the fixed charge coverage ratio and the leverage ratio.

The senior credit facility defines the fixed charge coverage ratio as that ratio that is calculated on a last 12-month basis by dividing pro forma earnings before interest, taxes, depreciation and amortization, as defined by the agreement, by fixed charges. Pro forma earnings before interest, taxes, depreciation and amortization include 12 months of operating results for businesses acquired during the period. Fixed charges are defined as cash interest expense, scheduled principal payments on debt obligations, capital expenditures, and provision for income taxes. At September 30, 2005, we had a fixed charge coverage ratio of 1.54 to 1.00, which was in compliance with the required ratio of no less than 1.20 to 1.00.



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The senior credit facility defines the leverage ratio as that ratio which is calculated as total debt divided by pro forma earnings before interest, taxes, depreciation and amortization, as defined by the agreement. At September 30, 2005, we had a leverage ratio of 2.54 to 1.00, which was in compliance with the required ratio of no more than 3.25 to 1.00.

**Interest Rate Hedging Agreements**

We have no-fee swap agreements whereby we pay counterparties amounts based on fixed interest rates and set notional principal amounts in exchange for the receipt of payments from the counterparties based on London interbank offer rates, or LIBOR, and the same set notional principal amounts. A summary of these agreements is as follows:

|                                |                |                     |                     |
|--------------------------------|----------------|---------------------|---------------------|
| Fixed interest rate            | 4.07%          | 3.98%               | 3.94%               |
| Notional principal amount      | \$50.0 million | \$50.0 million      | \$50.0 million      |
| Effective date                 | 5/26/2005      | 6/2/2005            | 6/30/2005           |
| Expiration date                | 5/26/2008      | 5/31/2008           | 6/30/2007           |
| Counterparties                 | Goldman Sachs  | Wells Fargo<br>Bank | Wells Fargo<br>Bank |
| Qualifies for hedge accounting | Yes            | Yes                 | Yes                 |

We entered into these swap agreements to hedge against the risk of increasing interest rates. The contracts effectively convert a certain amount of our variable-rate debt under our senior credit facility to fixed rate debt for purposes of controlling cash paid for interest. That amount is equal to the notional principal amount of the swap agreements, and the fixed rate conversion period is equal to the terms of the contract. The impact of these swap agreements has been factored into our future contractual cash requirements table above. At November 4, 2005, the one-month LIBOR was approximately 4.1%.

In the future, we may enter into additional interest rate strategies to take advantage of favorable current rate environments. We have not yet determined what those strategies will be or their possible impact.

**Description of Indebtedness***Senior Credit Facility*

At September 30, 2005, we had \$437.7 million principal amount outstanding under our senior term notes and no borrowings outstanding under our revolving credit facility.

We pay interest on our senior term notes and our revolving credit facility based on the interest rate offered to our administrative agent on LIBOR plus a margin of 1.50% per annum.

The senior term notes mature in May 2011 and the revolving credit facility matures in May 2010.

*Other Debt*

At September 30, 2005, we had seller notes secured by assets of certain animal hospitals, unsecured debt and capital leases that totaled \$16.4 million.

**Critical Accounting Policies**

We believe that the application of the following accounting policies, which are important to our financial position and results of operations, requires significant judgments and estimates on the part of management. For a summary of all our accounting policies, including the accounting policies discussed below, see our consolidated financial statements included in our 2004 annual report on Form 10-K.

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### ***Revenue***

#### ***Laboratory and Animal Hospital Revenue***

We recognize laboratory and animal hospital revenue only after the following criteria are met:  
there exists adequate evidence of the transaction;

delivery of goods has occurred or services have been rendered; and

the price is not contingent on future activity and collectibility is reasonably assured.

#### ***Medical Technology Revenue***

The majority of our medical technology revenue is derived from the sale of ultrasound imaging equipment and digital radiography equipment. We also derive revenue from: (i) licensing our software; (ii) providing technical support and product updates related to our software, otherwise known as maintenance; and (iii) providing professional services related to our equipment and software, including installations, on-site training and education services. We frequently sell equipment and license our software in multiple element arrangements in which the customer may choose a combination of one or more of the following elements: (i) ultrasound imaging equipment; (ii) digital radiography equipment; (iii) software products; (iv) computer hardware; (v) maintenance; and (vi) professional services.

The accounting for the sale of equipment is substantially governed by the requirements of Staff Accounting Bulletin, SAB, No. 104, *Revenue Recognition*, as amended, and the sale of software licenses and related items is governed by Statement of Position, SOP, No. 97-2, *Software Revenue Recognition*, as amended. The determination of the amount of software license, maintenance and professional service revenue to be recognized in each accounting period requires us to exercise judgment and use estimates. In determining whether or not to recognize revenue, we evaluate each of these criteria:

**Evidence of an arrangement:** We consider a non-cancelable agreement signed by the customer and us to be evidence of an arrangement.

**Delivery:** We consider delivery to have occurred when the ultrasound imaging equipment is delivered and the digital radiography equipment is installed. We recognize revenue for professional services when those services are provided or on a straight-line basis over the service contract term, based on the nature of the service or the terms of the contract.

**Fixed or determinable fee:** We assess whether fees are fixed or determinable at the time of sale and recognize revenue if all other revenue recognition requirements are met. We generally consider payments that are due within six months to be fixed or determinable based upon our successful collection history. We only consider fees to be fixed or determinable if they are not subject to refund or adjustment.

**Collection is deemed probable:** We conduct a credit review for all significant transactions at the time of the arrangement to determine the credit worthiness of the customer. Collection is deemed probable if we expect that the customer will be able to pay amounts under the arrangement as payments become due. If we determine that collection is not probable, we defer the revenue and recognize the revenue upon cash collection.

Under the residual method prescribed by SOP No. 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, in multiple element arrangements involving software, revenue is recognized when vendor-specific objective evidence of fair value exists for all of the undelivered elements in the arrangement (i.e., maintenance and professional services), but does not exist for one or more of the delivered elements in the arrangement (i.e., the equipment, computer hardware or the software product). Vendor-specific objective evidence of fair value is based on the price for those products and services when sold separately by us and customer renewal rates for post-contract customer support services. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. If evidence of the fair value of one or more undelivered elements does not exist, the revenue is deferred and recognized when delivery of those

elements occurs or when fair value can be established. Each transaction requires

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careful analysis to ensure that all of the individual elements in the license transaction have been identified, along with the fair value of each element.

*Ultrasound Imaging Solution*

We sell our ultrasound imaging equipment with and without related computer hardware and software. We account for the sale of ultrasound imaging equipment on a stand-alone basis under the requirements of SAB No. 104, and recognize revenue upon delivery. We account for the sale of ultrasound imaging equipment with related computer hardware and software by bifurcating the transaction into separate elements. We account for the equipment under the requirements of SAB No. 104, as the software is not deemed to be essential to the functionality of the equipment, and account for the computer hardware and software under the requirements of SOP No. 97-2, as amended. For the later arrangements, we recognize revenue on the ultrasound imaging equipment, computer hardware and software upon delivery, which occurs simultaneously, and we recognize revenue from future services on a straight-line basis over the term of the service or as delivered, depending on the nature of the service.

*Digital Radiography Solution*

We sell our digital radiography equipment with related computer hardware and software. The digital radiography equipment requires the computer hardware and software to function. As a result, we account for the digital radiography sales under SOP No. 97-2.

For sales of our digital radiography solution, commencing in the third quarter of 2005, we recognize revenue on the digital radiography equipment, computer hardware and software at the time of customer acceptance, and recognize revenue from post-contract customer support services on a straight-line basis over the term of the support period. In the third quarter of 2005, we established vendor-specific objective evidence of the fair value of post-contract customer support services by including renewal rates in the sales contracts. Prior to the third quarter of 2005, we recognized revenue on all elements in these arrangements ratably over the period of the post-contract customer support services.

*Valuation of Goodwill*

Our goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to identifiable assets acquired and liabilities assumed. The total amount of our goodwill at September 30, 2005, was \$579.6 million, consisting of \$94.1 million for our laboratory segment, \$465.3 million for our animal hospital segment and \$20.2 million for our medical technology segment.

Annually, and upon material changes in our operating environment, we test our goodwill for impairment by comparing the fair market value of our reporting units, laboratory, animal hospital and medical technology, to their respective net book value. At December 31, 2004 and 2003, the estimated fair market value of each of our reporting units exceeded their respective net book value, resulting in a conclusion that our goodwill was not impaired.

*Income Taxes*

We account for income taxes under Statement of Financial Accounting Standards, or SFAS No. 109, *Accounting for Income Taxes*. In accordance with SFAS No. 109, we record deferred tax liabilities and deferred tax assets, which represent taxes to be recovered or settled in the future. We adjust our deferred tax assets and deferred tax liabilities to reflect changes in tax rates or other statutory tax provisions. Changes in tax rates or other statutory provisions are recognized in the period the change occurs.

We made judgments in assessing our ability to realize future benefits from our deferred tax assets. As such, we record a valuation allowance to reduce our deferred tax assets for the portion we believe will not be realized. At September 30, 2005, we used valuation allowances to offset net operating loss and capital loss carryforwards and investment related expenditures where the realization of this deduction is uncertain.

We also have a liability for differences between the probable tax bases and the as-filed tax bases of certain assets and liabilities recorded in other liabilities on our condensed, consolidated balance sheets. This liability relates to losses that to our best judgment are probable. Changes in facts and circumstances may cause us to: (1) lower our estimates or determine that payments are no longer probable resulting in a reduction of our future tax provision; or (2) increase our estimates resulting in an increase in our future tax provision. In addition, there are certain tax

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contingencies that represent a possible future payment but not a probable one. While we have not recognized a liability for these possible future payments, they may result in future cash payments and increase our tax provision.

**New Accounting Pronouncements*****Accounting for Rental Costs Incurred During a Construction Period***

On October 6, 2005, the Financial Accounting Standards Board, FASB, issued FASB Staff Position, FSP, No. 13-1, *Accounting for Rental Costs Incurred During a Construction Period*. In FSP No. 13-1, the FASB clarified that rental costs incurred during construction are not to be capitalized as a cost of construction but rather to be recognized as rental expense during that period consistent with SFAS No. 13, *Accounting for Leases*. FSP No. 13-1 is effective for periods starting after December 15, 2005. We do not expect FSP No. 13-1 to have a material impact on our consolidated financial statements.

***Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections***

In May 2005, the Financial Accounting Standards Board, FASB, issued SFAS No. 154, *Accounting Changes and Error Corrections*, defining and changing the way companies account for changes in accounting principles, accounting estimates and reporting entities, as well as corrections of errors. Among other things, SFAS No. 154 prohibits companies from changing accounting principles or the methodology of applying accounting principles unless directed to do so by new accounting principles or unless the new principle or application is acceptable and superior. Entities changing accounting principles outside of specific guidance are required to retroactively apply the change to all prior periods unless it is impracticable to do so. To the extent that it is impracticable to do so, entities are required to make an adjustment to retained earnings in the year of change.

We do not anticipate that SFAS No. 154 will have a material impact on our future operations; however, its application could result in a change in historically reported financial statements if in the future we either adopt a new accounting principle where no specific application guidance is provided or if we change current accounting principles or the method of their application.

SFAS No. 154 is effective for fiscal years beginning after December 15, 2005.

***Share-Based Compensation***

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*, which replaces SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123R will require us to measure the cost of share-based payments to employees, including stock options, based on the grant date fair value and to recognize the cost over the requisite service period. We will adopt SFAS No. 123R effective with the compliance date applicable to us, which is currently scheduled for January 1, 2006. Based on options granted on or prior to September 30, 2005, we expect that the adoption of SFAS No. 123R will result in share-based compensation of \$1.8 million, net of tax, in 2006. Any share-based payments issued subsequent to September 30, 2005, may increase our share-based compensation expense.

***Inventory Costs***

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs - An Amendment of ARB No. 43, Chapter 4*, effective for fiscal years beginning after June 15, 2005, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material or spoilage that may be incurred. We do not expect that the application of SFAS No. 151 will have a material impact on our consolidated financial statements or the way we conduct our operations.

**Table of Contents****Forward-Looking Statements**

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties, as well as assumptions that, if they materialize or prove incorrect, could cause our results and the results of our consolidated subsidiaries to differ materially from those expressed or implied by these forward-looking statements. We generally identify forward-looking statements in this report using words like believe, intend, expect, estimate, may, plan, show, project, contemplate, anticipate, predict, potential, continue, or similar expressions. You may find some of the statements below and elsewhere in this report. These forward-looking statements are not historical facts and are inherently uncertain and outside of our control. Any or all of our forward-looking statements in this report may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in our discussion in this report will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially. Factors that may cause our plans, expectations, future financial condition and results to change include those summarized in the section of this report captioned *Risk Factors*.

**Risk Factors**

Because of the factors set forth below, and the other cautionary language contained above and in other sections of this quarterly report, investors in our common stock should not assume that the forward-looking statements contained in this quarterly report will prove to be a reliable indicator of future performance, and investors should not use these forward-looking statements to anticipate results or trends in future periods.

***If we are unable to effectively execute our growth strategy, we may not achieve our desired economies of scale and our margins and profitability may decline.***

Our success depends in part on our ability to build on our position as a leading animal healthcare services company through a balanced program of internal growth initiatives and selective acquisitions of established animal hospitals, laboratories and related businesses. If we cannot implement or effectively execute these initiatives and acquisitions, our results of operations will be adversely affected. Even if we effectively implement our growth strategy, we may not achieve the economies of scale that we have experienced in the past or that we anticipate having in the future. For example, the animal hospitals we recently acquired, including those from the acquisition of NPC and Pet's Choice, had lower gross profit margins than our same-store gross profit margins. In addition, our medical technology division, acquired in October 2004, operates at lower gross profit margins than the combined gross profit margins for our laboratory and animal hospital divisions. Our internal growth rate may decline and could become negative. Our laboratory internal revenue growth, adjusted for differences in billing days, has fluctuated between 9.8% and 14.1% for each fiscal year from 2002 through 2004. For the three and nine months ended September 30, 2005, our laboratory internal revenue growth, adjusted for differences in billing days, was 11.6% and 11.3%, respectively. Similarly, our animal hospital same-store revenue growth, adjusted for differences in business days, has fluctuated between 3.6% and 4.9% over the same fiscal years. For the three and nine months ended September 30, 2005, our animal hospital same-store revenue growth, adjusted for differences in business days, was 6.5% and 7.1%, respectively. Our internal growth may continue to fluctuate and may be below our historical rates. Any reductions in the rate of our internal growth may cause our revenues and margins to decrease. Investors should not assume that our historical growth rates and margins are reliable indicators of results in future periods.

***Demand for certain products and services could decline.***

Demand for certain products could decline as their product life cycle matures and the products become available in other channels of distribution such as retail-oriented locations and through the Internet. This cycle could affect the frequency of veterinary visits and may result in a reduction in revenue. Demand for vaccinations may also be impacted in the future as protocols for vaccinations change. Vaccinations have been recommended by some in the profession to be given less frequently. This may result in fewer visits and potentially less revenue. Vaccine protocols for our company are currently established by our veterinarians. Some of our veterinarians have changed their protocols and others may change their protocol in light of recent literature.

**Table of Contents*****Due to the fixed cost nature of our business, fluctuations in our revenue could adversely affect our operating income.***

Significantly more than a majority of our expense, particularly rent and personnel costs, are fixed costs and are based in part on expectations of revenue. We may be unable to reduce spending in a timely manner to compensate for any significant fluctuations in our revenue. Accordingly, shortfalls in revenue may adversely affect our operating income.

***Difficulties integrating new acquisitions may impose substantial costs and cause other problems for us.***

Our success depends on our ability to timely and cost-effectively acquire, and integrate into our business, additional animal hospitals, laboratories and related businesses. In 2004, we acquired 85 animal hospitals, 67 in a single acquisition of NPC, and a new medical technology division, a new business segment for us. During the nine months ended September 30, 2005, we acquired 65 animal hospitals, including 46 animal hospitals in the acquisition of Pet's Choice on July 1, 2005. We expect to continue our acquisition program in all segments of our business. Any difficulties in the integration process may result in increased expense, loss of customers and a decline in profitability. In some cases, we have experienced delays and increased costs in integrating acquired businesses, particularly where we acquire a large number of animal hospitals in a single region at or about the same time. Further, the expansion into new territories and new business segments result in risks to successful integration of the acquired businesses that are new to our operations. As a consequence, our field management may spend a greater amount of time integrating these new businesses and less time managing our existing businesses. During these periods, there may be less attention directed to marketing efforts or staffing issues. We also may experience delays in converting the systems of acquired businesses into our systems, which could result in increased payroll expense to collect our results and delays in reporting our results, both for a particular region and on a consolidated basis. Further, the legal and business environment prevalent in new territories and with respect to new businesses may pose risks that we do not anticipate and adversely impact our ability to integrate newly acquired operations. For all of these reasons, our historical success in integrating acquired businesses is not a reliable indicator of our ability to do so in the future. If we are not successful in timely and cost-effectively integrating future acquisitions, it could result in decreased revenue, increased costs and lower margins.

We continue to face risks in connection with our acquisitions including:

negative effects on our operating results;

impairments of goodwill and other intangible assets;

dependence on retention, hiring and training of key personnel, including specialists; and

contingent and latent risks associated with the past operations of, and other unanticipated problems arising in, an acquired business.

The process of integration may require a disproportionate amount of the time and attention of our management, which may distract management's attention from its day-to-day responsibilities. In addition, any interruption or deterioration in service resulting from an acquisition may result in a customer's decision to stop using us. For these reasons, we may not realize the anticipated benefits of an acquisition, either at all or in a timely manner. If that happens and we incur significant costs, it could have a material adverse impact on our business.

***We face numerous risks associated with our acquisition of our medical technology division.***

In October 2004, we acquired STI, which we now operate as our medical technology division. This acquisition poses numerous risks, in addition to the risks discussed in the immediately preceding paragraphs. STI sells medical imaging equipment and related software and services. At the time of the acquisition, our existing management had no experience in this industry and consequently may not be as effective in managing and overseeing these operations as in the case of business segments where they have significant operating experience. Advanced medical imaging equipment has not been widely adopted in the veterinary market and no clear market leader has emerged. As advanced medical imaging equipment becomes more common in the veterinary industry and generates more significant aggregate revenues, the competition may increase, along with greater price pressures and demands for research and

development and market differentiation.

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Our medical technology division does not manufacture the principal products it distributes, and therefore its future business is dependent upon distribution agreements with the manufacturers of the equipment, the ability of those manufactures to produce desirable equipment and the overall rate of new development within the industry. If the distribution agreements terminate and are not renewed, if the manufacturers breach their covenants under these agreements, if the equipment manufactured by these manufacturers becomes less competitive or if there is a general decrease in the rate of new development within the industry, demand for our products and services would decrease. In addition, because the products represent a significant capital investment for our customers, an adverse change in the economy or the current tax law could also negatively impact the demand for our products and services. Any reduction in demand could lead to fewer customer orders, reduced revenues, pricing pressures, reduced margins, reduced levels of profitability and loss of market share.

***The carrying value of our goodwill could be subject to impairment write-down.***

At September 30, 2005, our balance sheet reflected \$579.6 million of goodwill, which was a substantial portion of our total assets of \$862.9 million at that date. We expect that the aggregate amount of goodwill on our balance sheet will increase as a result of future acquisitions. We continually evaluate whether events or circumstances have occurred that suggest that the fair market value of each of our reporting units is below their carrying values. The determination that the fair market value of one of our reporting units is less than its carrying value may result in an impairment write-down of the goodwill for that reporting unit. The impairment write-down would be reflected as expense and could have a material adverse effect on our results of operations during the period in which we recognize the expense. At December 31, 2004, we concluded that the fair value of our reporting units exceeded their carrying value and accordingly, as of that date, our goodwill was not impaired in our consolidated financial statements. However, in the future we may incur impairment charges related to the goodwill already recorded or arising out of future acquisitions.

***We require a significant amount of cash to service our debt and expand our business as planned.***

We have, and will continue to have, a substantial amount of debt. Our substantial amount of debt requires us to dedicate a significant portion of our cash flow from operations to pay down our indebtedness and related interest, thereby reducing the funds available to use for working capital, capital expenditures, acquisitions and general corporate purposes.

At September 30, 2005, our debt consisted of:

\$437.7 million in principal amount outstanding under our senior term notes; and

\$16.4 million in principal amount outstanding under our other debt.

Our ability to make payments on our debt, and to fund acquisitions, will depend upon our ability to generate cash in the future. Insufficient cash flow could place us at risk of default under our debt agreements or could prevent us from expanding our business as planned. Our ability to generate cash is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. Our business may not generate sufficient cash flow from operations, our strategy to increase operating efficiencies may not be realized and future borrowings may not be available to us under our senior credit facility in an amount sufficient to enable us to service our debt or to fund our other liquidity needs. In order to meet our debt obligations, we may need to refinance all or a portion of our debt. We may not be able to refinance any of our debt on commercially reasonable terms or at all.

***Our debt instruments may adversely affect our ability to run our business.***

Our substantial amount of debt, as well as the guarantees of our subsidiaries and the security interests in our assets and those of our subsidiaries, could impair our ability to operate our business effectively and may limit our ability to take advantage of business opportunities. For example, our senior credit facility may:

limit our ability to borrow additional funds or to obtain other financing in the future for working capital, capital expenditures, acquisitions, investments and general corporate purposes;

limit our ability to dispose of our assets, create liens on our assets or to extend credit;

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make us more vulnerable to economic downturns and reduce our flexibility in responding to changing business and economic conditions;

limit our flexibility in planning for, or reacting to, changes in our business or industry;

place us at a competitive disadvantage to our competitors with less debt; and

restrict our ability to pay dividends, repurchase or redeem our capital stock or debt, or merge or consolidate with another entity.

The terms of our senior credit facility allow us, under specified conditions, to incur further indebtedness, which would heighten the foregoing risks. If compliance with our debt obligations materially hinders our ability to operate our business and adapt to changing industry conditions, we may lose market share, our revenue may decline and our operating results may suffer.

***Our failure to satisfy covenants in our debt instruments will cause a default under those instruments.***

In addition to imposing restrictions on our business and operations, our debt instruments include a number of covenants relating to financial ratios and tests. Our ability to comply with these covenants may be affected by events beyond our control, including prevailing economic, financial and industry conditions. The breach of any of these covenants would result in a default under these instruments. An event of default would permit our lenders and other debtholders to declare all amounts borrowed from them to be due and payable, together with accrued and unpaid interest. Moreover, these lenders and other debtholders would have the option to terminate any obligation to make further extensions of credit under these instruments. If we are unable to repay debt to our senior lenders, these lenders and other debtholders could proceed against our assets.

***The significant competition in the companion animal healthcare services industry could cause us to reduce prices or lose market share.***

The companion animal healthcare services industry is highly competitive with few barriers to entry. To compete successfully, we may be required to reduce prices, increase our operating costs or take other measures that could have an adverse effect on our financial condition, results of operations, margins and cash flow. If we are unable to compete successfully, we may lose market share.

There are many clinical laboratory companies that provide a broad range of laboratory testing services in the same markets we service. Our largest competitor for outsourced laboratory testing services is Idexx Laboratories, Inc., or Idexx. Idexx currently competes in the same markets in which we operate. In this regard, Idexx has recently acquired additional laboratories in the markets in which we operate and has announced plans to continue this expansion and aggressively bundles all of their products and services to compete with us. Increased competition may lead to pressures on the revenues and margins of our laboratory operations. Also, Idexx and several other national companies provide on-site diagnostic equipment that allows veterinarians to perform their own laboratory tests.

Our primary competitors for our animal hospitals in most markets are individual practitioners or small, regional, multi-clinic practices. Also, regional pet care companies and some national companies, including operators of super-stores, are developing multi-regional networks of animal hospitals in markets in which we operate. Historically, when a competing animal hospital opens in proximity to one of our hospitals, we have reduced prices, expanded our facility, retained additional qualified personnel, increased our marketing efforts or taken other actions designed to retain and expand our client base. As a result, our revenue may decline and our costs may increase.

Our medical technology division is a relatively new entrant in the market for medical imaging equipment in the animal healthcare industry. Our primary competitors are companies that are much larger than us and have substantially greater capital, manufacturing, marketing and research and development resources than we do, including companies such as Siemens Medical Systems, Philips Medical Systems and Canon Medical Systems. The success of our medical technology division, in part, is due to its focus on the veterinary market, which allows it to differentiate its products and services to meet the unique needs of this market. If this market receives more focused attention from these larger competitors, we may find it difficult to compete and as a result our revenues and operating margins could decline. If we fail to compete successfully in this market, the demand for our products and



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services would decrease. Any reduction in demand could lead to fewer customer orders, reduced revenues, pricing pressures, reduced margins, reduced levels of profitability and loss of market share. These competitive pressures could adversely affect our business and operating results.

***We may experience difficulties hiring skilled veterinarians due to shortages that could disrupt our business.***

As the pet population continues to grow, the need for skilled veterinarians continues to increase. If we are unable to retain an adequate number of skilled veterinarians, we may lose customers, our revenue may decline and we may need to sell or close animal hospitals. At September 30, 2005, there were 28 veterinary schools in the country accredited by the American Veterinary Medical Association. These schools graduate approximately 2,100 veterinarians per year. There is a shortage of skilled veterinarians in some regional markets in which we operate animal hospitals. During shortages in these regions, we may be unable to hire enough qualified veterinarians to adequately staff our animal hospitals, in which event we may lose market share and our revenues and profitability may decline.

***If we fail to comply with governmental regulations applicable to our business, various governmental agencies may impose fines, institute litigation or preclude us from operating in certain states.***

The laws of many states prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. These laws vary from state to state and are enforced by the courts and by regulatory authorities with broad discretion. At September 30, 2005, we operated 140 animal hospitals in 13 states with these laws, including 43 in Texas, 32 in Washington and 24 in New York. In addition, our mobile imaging service also operates in states with these laws. We may experience difficulty in expanding our operations into other states with similar laws. Given varying and uncertain interpretations of the veterinary laws of each state, we may not be in compliance with restrictions on the corporate practice of veterinary medicine in all states. A determination that we are in violation of applicable restrictions on the practice of veterinary medicine in any state in which we operate could have a material adverse effect on us, particularly if we were unable to restructure our operations to comply with the requirements of that state.

All of the states in which we operate impose various registration requirements. To fulfill these requirements, we have registered each of our facilities with appropriate governmental agencies and, where required, have appointed a licensed veterinarian to act on behalf of each facility. All veterinarians practicing in our clinics are required to maintain valid state licenses to practice.

***Any failure in our information technology systems, disruption in our transportation network (including disruption resulting from terrorist activities) or failure to receive products could significantly increase testing turn-around time, reduce our production capacity and otherwise disrupt our operations.***

Our laboratory operations depend, in part, on the continued and uninterrupted performance of our information technology systems and transportation network. Our growth has necessitated continued expansion and upgrade of our information technology systems and transportation network. Sustained system failures or interruption in our transportation network or in one or more of our laboratory operations could disrupt our ability to process laboratory requisitions, perform testing, provide test results in a timely manner and/or bill the appropriate party. We could lose customers and revenue as a result of a system or transportation network failure.

Our computer systems are vulnerable to damage or interruption from a variety of sources, including telecommunications failures, electricity brownouts or blackouts, malicious human acts and natural disasters. Moreover, despite network security measures, some of our servers are potentially vulnerable to physical or electrical break-ins, computer viruses and similar disruptive problems. Despite the precautions we have taken, unanticipated problems affecting our systems could cause interruptions in our information technology systems. Our insurance policies may not adequately compensate us for any losses that may occur due to any failures in our systems.

In addition, over time we have significantly customized the computer systems in our laboratory business. We rely on a limited number of employees to upgrade and maintain these systems. If we were to lose the services of some or all of these employees, it may be time-consuming for new employees to become familiar with our systems, and we may experience disruptions in service during these periods.

Any substantial reduction in the number of available flights or delays in the departure of flights, whether as a result of severe weather conditions, a terrorist attack or any other type of disruption, will disrupt our transportation



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network and our ability to provide test results in a timely manner. Any change in government regulation related to transporting samples or specimens could also have an impact on our business. In addition, our Test Express service, which services customers outside of major metropolitan areas, is dependent on flight services in and out of Memphis and the transportation network of Federal Express. Any sustained interruption in either flight services in Memphis or the transportation network of Federal Express would result in increased turn-around time for the reporting of test results to customers serviced by our Test Express service.

Our laboratory operations also depend, in some cases, on the ability of single source suppliers to deliver products on a timely basis. Any significant reduction in the availability of lab supplies will disrupt our ability to provide test results in a timely manner.

***Our use of a self-insurance program and a large-deductible insurance program to cover certain claims for losses suffered and costs or expenses incurred could negatively impact our business upon the occurrence of an uninsured and/or significant event.***

We have adopted a program of self-insurance with regard to certain risks such as earthquakes and other natural disasters. In addition, our other insurance programs including, but not limited to, hurricanes, floods, health benefits and workers' compensation include large deductible provisions. We self-insure and use large-deductible insurance programs when the lack of availability and/or high cost of commercially available insurance products do not make the transfer of this risk a reasonable approach. In the event that the frequency of losses experienced by us increased unexpectedly, the aggregate of such losses could materially increase our liability and adversely affect our financial condition, liquidity, cash flows and results of operations. In addition, while the insurance market continues to limit the availability of certain insurance products while increasing the costs of such products, we will continue to evaluate the levels of claims we include in our self-insurance program and large-deductible insurance program. Any increases to these programs increase our risk of exposure and therefore increases the risk of a possible material adverse effect on our financial condition, liquidity, cash flows and results of operations. In addition, we have made certain judgments as to the limits on our existing insurance coverage that we believe are in line with industry standards, as well as in light of economic and availability considerations. Unforeseen catastrophic loss scenarios could prove our limits to be inadequate, and losses incurred in connection with the known claims we self-insure could be substantial. Either of these circumstances could materially adversely affect our financial and business condition.

***The loss of Mr. Robert Antin, our Chairman, President and Chief Executive Officer, could materially and adversely affect our business.***

We are dependent upon the management and leadership of our Chairman, President and Chief Executive Officer, Robert Antin. We have an employment contract with Mr. Antin that may be terminated at the option of Mr. Antin. We do not maintain any key man life insurance coverage for Mr. Antin. The loss of Mr. Antin could materially adversely affect our business.

**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

At September 30, 2005, we had borrowings of \$437.7 million under our senior credit facility with fluctuating interest rates based on market benchmarks such as LIBOR. For our variable-rate debt, changes in interest rates generally do not affect the fair market value, but do impact earnings and cash flow. To reduce the risk of increasing interest rates, we enter into no-fee interest rate swap agreements. Currently, we are engaged in the following no-fee interest rate swap agreements:

|                                |                |                     |                     |
|--------------------------------|----------------|---------------------|---------------------|
| Fixed interest rate            | 4.07%          | 3.98%               | 3.94%               |
| Notional amount                | \$50.0 million | \$50.0 million      | \$50.0 million      |
| Effective date                 | 5/26/2005      | 6/2/2005            | 6/30/2005           |
| Expiration date                | 5/26/2008      | 5/31/2008           | 6/30/2007           |
| Counterparties                 | Goldman Sachs  | Wells Fargo<br>Bank | Wells Fargo<br>Bank |
| Qualifies for hedge accounting | Yes            | Yes                 | Yes                 |

These swap agreements have the effect of reducing the amount of our debt exposed to variable interest rates. For the 12-month period ending September 30, 2006, for every 1.0% increase in LIBOR we will pay an additional \$2.9 million in interest expense and for every 1.0% decrease in LIBOR we will save \$2.9 million in interest expense.

We may consider entering into additional interest rate strategies to take advantage of the current rate environment. We have not yet determined what those strategies may be or their possible impact.

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, we have carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic reports with the SEC.

In accordance with the requirements of the SEC, our Chief Executive Officer and Chief Financial Officer note that, since the date of the most recent evaluation of our disclosure controls and procedures to the date of this quarterly report on Form 10-Q, there have been no significant changes in our internal control over financial reporting or in other factors that could significantly affect internal control over financial reporting.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are subject to ordinary routine litigation incidental to the conduct of our business.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

(a) None.

(b) None.

**ITEM 6. EXHIBITS**

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on November 7, 2005.

Date: November 7, 2005

By: /s/ TOMAS W. FULLER  
Tomas W. Fuller  
Chief Financial Officer  
Principal Financial Officer

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 31.1               | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                             |
| 31.2               | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                             |
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