VCA ANTECH INC
Form 10-Q
August 08, 2005

Table of Contents

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

FORM 10-Q

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

For the quarterly period ended June 30, 2005

o **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	**95-4097995**
(State or other jurisdiction of incorporation or organization)	*(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 þ No o.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Yes þ No o

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 82,503,179 shares as of August 5, 2005.

Table of Contents

VCA ANTECH, INC.
FORM 10-Q
JUNE 30, 2005
TABLE OF CONTENTS

	Page Number
Part I. Financial Information	
Item 1. Financial Statements (Unaudited)	
Condensed, Consolidated Balance Sheets as of June 30, 2005 and December 31, 2004	1
Condensed, Consolidated Income Statements for the Three and Six Months Ended June 30, 2005 and 2004	2
Condensed, Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2005 and 2004	3
Notes to Condensed, Consolidated Financial Statements	4
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3. Quantitative and Qualitative Disclosures About Market Risk	36
Item 4. Controls and Procedures	36
Part II.Other Information	
Item 1. Legal Proceedings	36
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	36
Item 3. Defaults Upon Senior Securities	37
Item 4. Submission of Matters to a Vote of Security Holders	37
Item 5. Other Information	37
Item 6. Exhibits	37
Signature	38
Exhibit Index	39
Exhibit 31.1	
Exhibit 31.2	
Exhibit 32.1	

Table of Contents

Part I. Financial Information
ITEM 1. FINANCIAL STATEMENTS

VCA ANTECH, INC. AND SUBSIDIARIES
CONDENSED, CONSOLIDATED BALANCE SHEETS
As of June 30, 2005 and December 31, 2004
(Unaudited)
(In thousands, except par value)

	June 30, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$115,515	$ 30,964
Restricted cash		1,250
Trade accounts receivable, less allowance for uncollectible accounts of $8,416 and $7,668 at June 30, 2005 and December 31, 2004, respectively	33,268	28,936
Inventory	14,676	10,448
Prepaid expenses and other	6,034	6,275
Deferred income taxes	12,190	11,472
Prepaid income taxes	11,786	10,830
Total current assets	193,469	100,175
Property and equipment, less accumulated depreciation and amortization of $86,029 and $79,139 at June 30, 2005 and December 31, 2004, respectively	127,777	119,903
Other assets:		
Goodwill	519,135	499,144
Other intangible assets, net	11,300	11,660
Deferred financing costs, net	1,496	4,052
Other	5,927	7,166
Total assets	$859,104	$742,100
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations	$ 5,538	$ 6,043
Accounts payable	16,892	15,566
Accrued payroll and related liabilities	17,951	19,850
Accrued interest	3,122	1,578
Other accrued liabilities	24,041	21,874
Total current liabilities	67,544	64,911
Long-term obligations, less current portion	471,026	390,846
Deferred income taxes	34,533	31,514
Other liabilities	12,254	12,915
Minority interest	9,892	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, 82,502 and 82,191 shares outstanding as of June 30, 2005 and December 31, 2004, respectively	83	82
Additional paid-in capital	254,294	251,412
Retained earnings (deficit)	9,749	(18,759)
Accumulated other comprehensive income (loss)	(266)	34
Notes receivable from stockholders	(5)	(10)
Total stockholders equity	263,855	232,759
Total liabilities and stockholders equity	$859,104	$742,100

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

1

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	**2004**	**2005**	**2004**
Revenue	$206,584	$169,947	$393,447	$314,297
Direct costs	145,849	119,943	282,185	224,733
Gross profit	60,735	50,004	111,262	89,564
Selling, general and administrative expense	15,417	11,765	29,549	20,466
Loss (gain) on sale of assets	(78)	4	(88)	66
Operating income	45,396	38,235	81,801	69,032
Interest expense, net	6,081	6,098	12,748	12,083
Debt retirement costs	19,282	810	19,282	810
Other (income) expense	67	(287)	131	(176)
Minority interest in income of subsidiaries	846	755	1,531	1,171
Income before provision for income taxes	19,120	30,859	48,109	55,144
Provision for income taxes	7,858	12,692	19,601	22,233
Net income	$ 11,262	$ 18,167	$ 28,508	$ 32,911
Basic earnings per common share	$ 0.14	$ 0.22	$ 0.35	$ 0.40
Diluted earnings per common share	$ 0.13	$ 0.22	$ 0.34	$ 0.40
Shares used for computing basic earnings per share	82,343	81,674	82,282	81,578
Shares used for computing diluted earnings per share	83,874	83,382	83,709	83,218

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

Table of Contents

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

	Six Months Ended June 30,	
	2005	**2004**
Cash flows from operating activities:		
Net income	$ 28,508	$ 32,911
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,785	7,435
Amortization of debt costs	351	367
Provision for uncollectible accounts	2,025	1,084
Debt retirement costs	19,282	810
Loss (gain) on sale of assets	(88)	66
Other	(377)	(92)
Tax benefit from stock options exercised	1,655	2,106
Minority interest in income of subsidiaries	1,531	1,171
Distributions to minority interest partners	(1,145)	(813)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(6,265)	(4,962)
Increase in inventory, prepaid expenses and other assets	(4,894)	(522)
Increase in accounts payable and other accrued liabilities	3,425	598
Increase in accrued payroll and related liabilities	(1,822)	(2,596)
Increase in accrued interest	1,544	10
Decrease (increase) in prepaid income taxes	(803)	1,329
Increase in deferred income tax assets	(500)	(574)
Increase in deferred income tax liabilities	3,213	3,987
Net cash provided by operating activities	54,425	42,315
Cash flows used in investing activities:		
Business acquisitions, net of cash acquired	(22,174)	(92,931)
Real estate acquired in connection with business acquisitions	(221)	(4,385)
Property and equipment additions	(14,681)	(9,027)
Proceeds from sale of assets	338	179
Other	3,039	123
Net cash used in investing activities	(33,699)	(106,041)
Cash flows from financing activities:		
Repayment of long-term obligations, including tender fees	(409,187)	(146,842)
Proceeds from the issuance of long-term obligations	475,000	225,000
Payment of financing costs	(3,216)	(794)

Proceeds from issuance of common stock under stock option plans	1,228	1,961
Net cash provided by financing activities	63,825	79,325
Increase in cash and cash equivalents	84,551	15,599
Cash and cash equivalents at beginning of period	30,964	17,237
Cash and cash equivalents at end of period	$ 115,515	$ 32,836

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

3

VCA ANTECH, INC. AND SUBSIDIARIES
NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS
June 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 footnotes 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 six months ended June 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 footnotes thereto included in our 2004 annual report on Form 10-K.

2. Acquisitions

We acquired the following animal hospitals during the six months ended June 30, 2005 and 2004:

	Six Months Ended June 30,	
	2005	**2004**
Acquisitions, excluding NPC (1)	11	15
NPC (1)		67
Acquisitions relocated into our existing animal hospitals	(2)	(3)
Total	9	79

(1) National PetCare Centers, Inc., or NPC, was acquired on June 1, 2004 and is discussed below.

Animal Hospital Acquisitions, excluding NPC

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

	Six Months Ended June 30,	
	2005	**2004**
Consideration:		
Cash	$19,621	$26,509
Obligations to sellers (1)	1,090	1,135
Notes payable and other liabilities assumed	37	151
Total	$20,748	$27,795

Purchase Price Allocation:		
Goodwill (2)	$18,593	$24,938
Identifiable intangible assets	1,237	1,523
Tangible assets	918	1,334
Total	$20,748	$27,795

Table of Contents

(1) Represents a portion of the purchase price withheld, or the holdback, as security for indemnification obligations of the sellers under the acquisition agreement.

(2) We expect that $13.8 million and $19.7 million of the goodwill recorded for these acquisitions as of June 30, 2005 and 2004, respectively, 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):

	Six Months Ended June 30,	
	2005	**2004**
Consideration:		
Cash	$ 568	$572
Notes payable and other liabilities assumed	1,202	155
Total	$1,770	$727
Goodwill recorded (1)	$ 710	$610

(1) We expect that the goodwill recorded in the

six months ended June 30, 2005 and 2004 will be fully deductible for income tax purposes.

Other Acquisition Payments

We paid $985,000 and $500,000 during the six months ended June 30, 2005 and 2004, respectively, of unused holdbacks to sellers in previously closed acquisitions.

We paid $90,000 and $75,000 during the six months ended June 30, 2005 and 2004, respectively, for earnout targets that were met and recorded goodwill in the same amount.

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 June 30, 2005 up to $2.0 million of additional purchase price if certain performance targets are met. In addition, we may incur additional fees for legal and accounting services, which will also result in additional purchase price.

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 preliminary allocation of the $30.9 million purchase price was allocated as follows: $20.8 million to goodwill; $4.7 million to identifiable intangible assets; and $5.4 million to tangible assets. We expect that $389,000 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.

Table of Contents

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; 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: $75.5 million to goodwill; $1.4 million to identifiable intangible assets; and $12.4 million to tangible assets, including real estate in the amount of $5.0 million. We expect that $28.8 million 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 in this footnote 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 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, Inc., or Pet s Choice, which is discussed in Footnote 11, *Subsequent Events*. The following table summarizes our long-term obligations at June 30, 2005 and December 31, 2004 (in thousands):

	June 30, 2005	December 31, 2004
Revolver	$	$
Senior term notes (LIBOR + 1.50%)	473,813	
Senior term notes (LIBOR + 1.75%)		223,313
9.875% senior subordinated notes		170,000
Other debt and capital lease obligations	2,751	3,576
Total debt obligations	$476,564	$396,889

The following table sets forth the scheduled maturities of our long-term obligations for each of the years indicated (in thousands):

2005 (1)	$ 2,895
2006	5,304
2007	5,410
2008	5,145
2009	4,836
Thereafter	452,974
Total	$476,564

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

Senior Credit Facility

In May 2005 we entered into a senior credit facility with various lenders for $550.0 million of senior secured credit facilities 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 June 30, 2005 we had no borrowings outstanding under our revolving credit facility.

Table of Contents

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.

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 $1.2 million with the remaining balance due at maturity. The following table sets forth the remaining scheduled principal payments for our senior term notes (in thousands):

2005	$ 2,375
2006	4,750
2007	4,750
2008	4,750
2009	4,750
Thereafter	452,438
Total	$473,813

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 if our cash and cash equivalents exceed a defined amount. 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. We believe the most restrictive covenant is the fixed charge coverage ratio. At June 30, 2005 we had a fixed charge coverage ratio of 1.49 to 1.00, which was in compliance with the required ratio of no less than 1.20 to 1.00.

Table of Contents

4. Interest Rate Hedging Agreements

We recently entered into no-fee swap agreements whereby we pay to the counterparties amounts based on fixed interest rates and set notional amounts in exchange for the receipt of payments from counterparties based on 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 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 Bank	Wells Fargo 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 amount of $20.0 million with a fixed interest rate of 1.72% and the other agreement had a notional amount of $20.0 million with a fixed interest rate of 1.51%.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	**2004**	**2005**	**2004**
Cash paid (received) (1)	$(21)	$ 166	$(115)	$ 329
Unrealized loss (gain) (2)	$ 67	$(287)	$ 131	$(176)

(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 a liability of $253,000 and an asset of $178,000 at June 30, 2005 and December 31, 2004, respectively. These amounts are included in prepaid expenses and other or other accrued liabilities on 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 six months ended June 30, 2005 (in thousands):

	Laboratory	Animal Hospital	Medical Technology	Total
Balance as of January 1, 2005	$93,671	$386,255	$19,218	$499,144
Goodwill acquired		18,593		18,593
Other (1)		(552)	1,579	1,027
Goodwill related to partnership interests		577		577
Goodwill related to sale of animal hospitals		(206)		(206)
Balance as of June 30, 2005	$93,671	$404,667	$20,797	$519,135

(1) Other is the result of purchase price adjustments, purchasing the ownership interest of partners and the payment of earnouts.

Table of Contents

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

	As of June 30, 2005			As of December 31, 2004		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Covenants-not-to-compete	$12,155	$(5,680)	$ 6,475	$11,604	$(5,290)	$ 6,314
Noncontractual-customer relationships	3,340	(539)	2,801	3,340	(246)	3,094
Technology	1,250	(187)	1,063	1,250	(62)	1,188
Trademarks	560	(42)	518	560	(14)	546
Contracts	397	(77)	320	397	(26)	371
Client lists	671	(548)	123	665	(518)	147
Total	$18,373	$(7,073)	$11,300	$17,816	$(6,156)	$11,660

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Aggregate amortization expense	$793	$553	$1,596	$993

Based on balances at June 30, 2005, estimated annual amortization expense for other intangible assets for the current year and the next four fiscal years is as follows (in thousands):

2005	$3,120
2006	$2,832
2007	$2,590
2008	$2,035
2009	$ 997

Table of Contents

6. Calculation of Earnings per Common Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income	$11,262	$18,167	$28,508	$32,911
Weighted average common shares outstanding:				
Basic	82,343	81,674	82,282	81,578
Effect of dilutive potential common shares:				
Stock options	1,531	1,628	1,427	1,530
Contracts that may be settled in stock or cash		80		110
Diluted	83,874	83,382	83,709	83,218
Basic earnings per common share	$ 0.14	$ 0.22	$ 0.35	$ 0.40
Diluted earnings per common share	$ 0.13	$ 0.22	$ 0.34	$ 0.40

7. Lines of Business

As of June 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. 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 footnotes 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.

Table of Contents

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

	Laboratory	Animal Hospital	Medical Technology	Corporate	Intercompany Eliminations	Total
Three Months Ended June 30, 2005						
Revenue	$ 58,277	$147,959	$5,358	$	$ (5,010)	$206,584
Direct costs	30,899	116,142	3,700		(4,892)	145,849
Gross profit	27,378	31,817	1,658		(118)	60,735
Selling, general and administrative expense	3,346	3,807	1,922	6,342		15,417
Gain on sale of assets		(78)				(78)
Operating income (loss)	$ 24,032	$ 28,088	$ (264)	$ (6,342)	$ (118)	$ 45,396
Depreciation and amortization	$ 878	$ 2,907	$ 302	$ 372	$ (16)	$ 4,443
Capital expenditures	$ 1,180	$ 4,986	$ 125	$ 1,267	$ (86)	$ 7,472
Three Months Ended June 30, 2004						
Revenue	$ 51,951	$121,384	$	$	$ (3,388)	$169,947
Direct costs	27,983	95,348			(3,388)	119,943
Gross profit	23,968	26,036				50,004
Selling, general and administrative expense	3,190	3,056		5,519		11,765
Loss on sale of assets	2	2				4
Operating income (loss)	$ 20,776	$ 22,978	$	$ (5,519)	$	$ 38,235
Depreciation and amortization	$ 897	$ 2,536	$	$ 386	$	$ 3,819
Capital expenditures	$ 1,057	$ 4,078	$	$ 427	$	$ 5,562
Six Months Ended June 30, 2005						
Revenue	$111,716	$281,313	$9,842	$	$ (9,424)	$393,447
Direct costs	60,469	223,761	7,145		(9,190)	282,185
Gross profit	51,247	57,552	2,697		(234)	111,262
Selling, general and administrative expense	6,711	7,510	3,489	11,839		29,549

Gain on sale of assets		(88)				(88)
Operating income (loss)	$ 44,536	$ 50,130	$ (792)	$(11,839)	$ (234)	$ 81,801
Depreciation and amortization	$ 1,780	$ 5,651	$ 601	$ 769	$ (16)	$ 8,785
Capital expenditures	$ 2,861	$ 8,867	$ 245	$ 3,099	$ (391)	$ 14,681
Six Months Ended June 30, 2004						
Revenue	$101,133	$219,340	$	$	$ (6,176)	$314,297
Direct costs	55,698	175,211			(6,176)	224,733
Gross profit	45,435	44,129				89,564
Selling, general and administrative expense	6,363	5,804		8,299		20,466
Loss on sale of assets	1	65				66
Operating income (loss)	$ 39,071	$ 38,260	$	$ (8,299)	$	$ 69,032
Depreciation and amortization	$ 1,718	$ 4,937	$	$ 780	$	$ 7,435
Capital expenditures	$ 1,803	$ 6,531	$	$ 693	$	$ 9,027

Table of Contents

	Laboratory	Animal Hospital	Medical Technology	Corporate	Intercompany Eliminations	Total
At June 30, 2005						
Total assets	$143,753	$528,743	$39,640	$149,078	$(2,110)	$859,104
At December 31, 2004						
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):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
As reported	$11,262	$18,167	$28,508	$32,911
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	(1,309)	(485)	(3,954)	(762)
Pro forma net income available to common stockholders	$ 9,953	$17,682	$24,554	$32,149
Earnings per common share:				
Basic as reported	$ 0.14	$ 0.22	$ 0.35	$ 0.40
Basic pro forma	$ 0.12	$ 0.22	$ 0.30	$ 0.39
Diluted as reported	$ 0.13	$ 0.22	$ 0.34	$ 0.40
Diluted pro forma	$ 0.12	$ 0.21	$ 0.29	$ 0.39

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.

On April 19, 2005 the Securities and Exchange Commission amended the compliance date for SFAS No. 123R to fiscal years beginning after June 15, 2005. We plan to adopt SFAS No. 123R effective with the compliance date applicable to us, which is currently scheduled for January 1, 2006. We are currently evaluating the method we will use to value share-based payments and the impact of this standard on our consolidated financial statements.

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 footnotes thereto included in our 2004 annual report on Form 10-K. We also have contingencies, which are discussed below.

a. Earnout Payments

In connection with certain acquisitions, we assumed certain contractual arrangements whereby additional cash may be paid to former owners of acquired companies upon attainment of specified financial criteria over periods of

one to three years, 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 $575,000 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 June 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 June 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

On July 1, 2005 we acquired Pet s Choice for $60.0 million (less assumed debt, excluding real estate and before other adjustments) in cash. Pet s Choice operates 46 animal hospitals in five states with annual revenues in fiscal year ended March 27, 2005 of $69.4 million.

In addition to the acquisition of Pet s Choice, we also acquired two animal hospitals from July 1, 2005 through August 5, 2005 for an aggregate consideration of $1.4 million, consisting of $1.3 million in cash and the assumption of liabilities of $70,000.

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

	Page Number
Introduction	15
Executive Overview	15
Results of Operations	17
Liquidity and Capital Resources	24
Critical Accounting Policies	26
New Accounting Pronouncements	29
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 August 5, 2005, and we undertake no duty to update this information. Shareholders and prospective investors can find information filed with the SEC after August 5, 2005 at our website at www.investor.vcaantech.com or at the SEC s website at 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 six months ended June 30, 2005 as well as our overall liquidity, capital resources and contractual cash obligations. 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. Our activities are divided into three 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 June 30, 2005 our laboratory network consisted of 28 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 June 30, 2005 our animal hospital network consisted of 318 animal hospitals in 37 states.

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

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 six months ended June 30, 2005 marked by continued growth in our laboratory and animal hospital segments. During the three months ended June 30, 2005, our revenue increased 21.6% compared to the comparable prior year period to $206.6 million and our diluted earnings per common share was $0.13, which includes debt retirement costs of $0.14. During the six months ended June 30, 2005, our revenue increased 25.2% compared to the comparable prior year period to $393.4 million and our diluted

earnings per common share was $0.34, which includes debt retirement costs of $0.14.

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 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 *Subsequent Event* discussion below 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 three and six months ended June 30, 2005.

Acquisitions

Our growth strategy includes the acquisition of 20 to 25 independent animal hospitals per year with aggregate annual revenues of approximately $25.0 million to $30.0 million. In addition, we also evaluate the acquisition of animal hospital chains, laboratories or related businesses if favorable opportunities are presented. The following table summarizes our laboratory and animal hospital facilities growth and animal hospital closures:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2005	**2004**	**2005**	**2004**
Laboratories:				
Beginning of period	28	23	27	23
New facilities		2	1	2
End of period	28	25	28	25
Animal hospitals:				
Beginning of period	320	247	315	241
Acquisitions, excluding NPC(1)	3	6	11	15
NPC(1)		67		67
Acquisitions relocated into hospitals operated by us	(1)	(1)	(2)	(3)
Sold or closed	(4)	(2)	(6)	(3)
End of period	318	317	318	317

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

Subsequent Event

On July 1, 2005 we acquired Pet s Choice for $60.0 million (less assumed debt, excluding real estate and before other adjustments) in cash. Pet s Choice operated 46 animal hospitals in five states with annual revenues in the fiscal year ended March 27, 2005 of $69.4 million. We paid for the acquisition using proceeds from the refinance of our senior credit facility.

We expect to incur integration expenses during the remainder of 2005 as we integrate the animal hospital operations of Pet s Choice into our existing animal hospital operations. Our integration plan includes eliminating duplicative overhead costs.

Table of Contents

Results of Operations

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

	Laboratory	Animal Hospital	Medical Technology	Corporate	Inter-company Eliminations	Total
Three Months Ended June 30, 2005						
Revenue	$ 58,277	$147,959	$5,358	$	$(5,010)	$206,584
Direct costs	30,899	116,142	3,700		(4,892)	145,849
Gross profit	27,378	31,817	1,658		(118)	60,735
Selling, general and administrative expense	3,346	3,807	1,922	6,342		15,417
Gain on sale of assets		(78)				(78)
Operating income (loss)	$ 24,032	$ 28,088	$ (264)	$ (6,342)	$ (118)	$ 45,396
Depreciation and amortization	$ 878	$ 2,907	$ 302	$ 372	$ (16)	$ 4,443
Three Months Ended June 30, 2004						
Revenue	$ 51,951	$121,384	$	$	$(3,388)	$169,947
Direct costs	27,983	95,348			(3,388)	119,943
Gross profit	23,968	26,036				50,004
Selling, general and administrative expense	3,190	3,056		5,519		11,765
Loss on sale of assets	2	2				4
Operating income (loss)	$ 20,776	$ 22,978	$	$ (5,519)	$	$ 38,235
Depreciation and amortization	$ 897	$ 2,536	$	$ 386	$	$ 3,819
Six Months Ended June 30, 2005						
Revenue	$111,716	$281,313	$9,842	$	$(9,424)	$393,447
Direct costs	60,469	223,761	7,145		(9,190)	282,185
Gross profit	51,247	57,552	2,697		(234)	111,262
Selling, general and administrative expense	6,711	7,510	3,489	11,839		29,549
Gain on sale of assets		(88)				(88)

Operating income (loss)	$ 44,536	$ 50,130	$ (792)	$(11,839)	$ (234)	$ 81,801
Depreciation and amortization	$ 1,780	$ 5,651	$ 601	$ 769	$ (16)	$ 8,785
Six Months Ended June 30, 2004						
Revenue	$101,133	$219,340	$	$	$(6,176)	$314,297
Direct costs	55,698	175,211			(6,176)	224,733
Gross profit	45,435	44,129				89,564
Selling, general and administrative expense	6,363	5,804		8,299		20,466
Loss on sale of assets	1	65				66
Operating income (loss)	$ 39,071	$ 38,260	$	$ (8,299)	$	$ 69,032
Depreciation and amortization	$ 1,718	$ 4,937	$	$ 780	$	$ 7,435

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Revenue:				
Laboratory	28.2%	30.6%	28.4%	32.2%
Animal hospital	71.6	71.4	71.5	69.8
Medical technology	2.6		2.5	
Intercompany	(2.4)	(2.0)	(2.4)	(2.0)
Total revenue	100.0	100.0	100.0	100.0
Direct costs	70.6	70.6	71.7	71.5
Gross profit	29.4	29.4	28.3	28.5
Selling, general and administrative expense	7.5	6.9	7.5	6.5
Gain on sale of assets	(0.1)			
Operating income	22.0	22.5	20.8	22.0
Interest expense, net	2.9	3.6	3.2	3.8
Debt retirement costs	9.3	0.5	4.9	0.3
Other (income) expense	0.1	(0.2)	0.1	(0.1)
Minority interest in income of subsidiaries	0.4	0.4	0.4	0.4
Income before provision for income taxes	9.3	18.2	12.2	17.6
Provision for income taxes	3.8	7.5	5.0	7.1
Net income	5.5%	10.7%	7.2%	10.5%

Revenue

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

	Three Months Ended June 30,			Six Months Ended June 30,		
	2005	2004	% Change	2005	2004	% Change
Laboratory	$ 58,277	$ 51,951	12.2%	$111,716	$101,133	10.5%
Animal hospital	147,959	121,384	21.9%	281,313	219,340	28.3%
Medical technology	5,358			9,842		
Intercompany	(5,010)	(3,388)	47.9%	(9,424)	(6,176)	52.6%
Total revenue	$206,584	$169,947	21.6%	$393,447	$314,297	25.2%

Laboratory Revenue

Laboratory revenue increased $6.3 million for the three months ended June 30, 2005 and increased $10.6 million for the six months ended June 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):

Table of Contents

	Three Months Ended June 30,			Six Months Ended June 30,		
Laboratory Revenue:	**2005**	**2004**	**% Change**	**2005**	**2004**	**% Change**
Internal growth:						
Number of requisitions (2)	2,572	2,373	8.4%	4,835	4,476	8.0%
Average revenue per requisition (1)	$ 22.66	$ 21.89	3.5%	$ 23.11	$ 22.45	2.9%
Total internal revenue (2)	$58,277	$51,951	12.2%	$111,716	$100,494	11.2%
Billing day adjustment (3)					639	
Total	$58,277	$51,951	12.2%	$111,716	$101,133	10.5%

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

(2) 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.

(3) The 2004 billing day adjustment reflects the impact of one additional billing day for the six months ended June 30, 2004 as compared to the six months ended June 30, 2005.

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 increase 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 prices of most tests were increased 2% to 4% in February 2005 and in February 2004.

Animal Hospital Revenue

Animal hospital revenue increased $26.6 million for the three months ended June 30, 2005 and increased $62.0 million for the six months ended June 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 June 30,			**Six Months Ended June 30,**		
Animal Hospital Revenue:	**2005**	**2004**	**% Change**	**2005**	**2004**	**% Change**
Same-store facility:						
Orders (2)	953	978	(2.5)%	1,774	1,803	(1.6)%
Average revenue per order (1)	$ 121.73	$ 111.58	9.1%	$ 120.55	$ 110.92	8.7%
Same-store revenue (2)	$116,030	$109,100	6.4%	$213,814	$200,047	6.9%
Business day adjustment (3)					1,073	
Net acquired revenue (4)	31,929	12,284		67,499	18,220	
Total	$147,959	$121,384	21.9%	$281,313	$219,340	28.3%

(1) Computed by dividing same-store revenue by same-store orders.

(2) 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.

(3) The 2004 business day adjustment reflects the impact of one additional business day for the six months ended June 30, 2004 as compared to the six months ended June 30, 2005.

(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 April 1, 2004

Table of Contents

for the three months ended June 30, 2005, and January 1, 2004 for the six months ended June 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, which 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

The components of revenue for our medical technology segment for the three and six months ended June 30, 2005 are summarized in the following table (in thousands):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Medical Technology Revenue:		
Ultrasound equipment	$ 2,698	$ 4,907
Digital radiography	1,320	2,331
Education and installation services	465	800
Consulting and mobile imaging services	875	1,804
Total revenue	$ 5,358	$ 9,842

We acquired our medical technology business on October 1, 2004 and consequently do not have comparative operating results for prior periods. Due to the seasonality of the medical technology industry, results for the three and six months ended June 30, 2005 may not be indicative of results experienced in future periods.

Intercompany Revenue

Approximately 8% of our laboratory revenue for the three and six months ended June 30, 2005 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 six months ended June 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 revenue is accounted for as if the transaction was with an independent third party at current market prices. For financial reporting purposes, intercompany revenue is eliminated as part of our consolidation.

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):

Table of Contents

	Three Months Ended June 30,					Six Months Ended June 30,				
	2005		2004			2005		2004		
	$	Gross Profit Margin	$	Gross Profit Margin	% Change	$	Gross Profit Margin	$	Gross Profit Margin	% Change
Laboratory	$27,378	47.0%	$23,968	46.1%	14.2%	$ 51,247	45.9%	$45,435	44.9%	12.8%
Animal hospital	31,817	21.5%	26,036	21.4%	22.2%	57,552	20.5%	44,129	20.1%	30.4%
Medical technology	1,658	30.9%				2,697	27.4%			
Intercompany	(118)					(234)				
Total gross profit	$60,735	29.4%	$50,004	29.4%	21.5%	$111,262	28.3%	$89,564	28.5%	24.2%

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 100 new animal hospitals, representing approximately 31% 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.

We acquired our medical technology division on October 1, 2004 and consequently do not have comparative operating results for prior periods. Due to the seasonality of the medical technology industry, results for the three and six months ended June 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 June 30,					Six Months Ended June 30,				
	2005		2004			2005		2004		
	$	% of Revenue	$	% of Revenue	% Change	$	% of Revenue	$	% of Revenue	% Change
Laboratory	$ 3,346	5.7%	$ 3,190	6.1%	4.9%	$ 6,711	6.0%	$ 6,363	6.3%	5.5%
Animal hospital	3,807	2.6%	3,056	2.5%	24.6%	7,510	2.7%	5,804	2.6%	29.4%
Medical technology	1,922	35.9%				3,489	35.5%			
Corporate	6,342	3.1%	5,519	3.2%	14.9%	11,839	3.0%	8,299	2.6%	42.7%
Total SG&A	$15,417	7.5%	$11,765	6.9%	31.0%	$29,549	7.5%	$20,466	6.5%	44.4%

Laboratory SG&A

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

The decrease in laboratory SG&A as a percentage of laboratory revenue was primarily attributable to an increase in laboratory revenue combined with operating leverage associated with our laboratory business.

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 is primarily the result of expanding the animal hospital administrative operations to absorb the recent acquisitions, including NPC and Pet s Choice.

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. The following table reconciles corporate SG&A as reported to corporate SG&A ex