

PETMED EXPRESS INC  
Form 10-Q  
August 02, 2011

---

---

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-28827

\_\_\_\_\_  
PETMED EXPRESS, INC.  
(Exact name of registrant as specified in its charter)

\_\_\_\_\_  
FLORIDA 65-0680967  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

1441 S.W. 29th Avenue, Pompano Beach, Florida 33069  
(Address of principal executive offices, including zip code)

(954) 979-5995  
(Registrant's telephone number, including area code)

N/A  
(Former name, former address and former fiscal year, if changed since last report)

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

Edgar Filing: PETMED EXPRESS INC - Form 10-Q

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  x  
Non-accelerated filer  Smaller reporting company  o  
(Do not check if smaller reporting company)

Indicate by check mark whether the registrant is a shell company (defined in Rule 12b-2 of the Exchange Act).  
Yes  No  x

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 21,008,033 Common Shares, \$.001 par value per share at August 1, 2011.

---

## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

PETMED EXPRESS, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands)

	June 30, 2011 (Unaudited)	March 31, 2011
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$49,413	\$49,660
Short term investments - available for sale	10,219	10,116
Accounts receivable, less allowance for doubtful accounts of \$7 and \$6, respectively	2,304	1,985
Inventories - finished goods	26,074	25,140
Prepaid expenses and other current assets	1,434	1,036
Deferred tax assets	1,177	1,003
Prepaid income taxes	-	664
Total current assets	90,621	89,604
Long term investments	4,761	12,390
Property and equipment, net	3,174	3,433
Intangible asset	860	860
Total assets	\$99,416	\$106,287
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$8,152	\$6,452
Accrued expenses and other current liabilities	2,480	2,509
Income taxes payable	2,303	-
Total current liabilities	12,935	8,961
Deferred tax liabilities	340	321
Total liabilities:	13,275	9,282
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.001 par value, 5,000 shares authorized; 3 convertible shares issued and outstanding with a liquidation preference of \$4 per share	9	9
Common stock, \$.001 par value, 40,000 shares authorized; 21,259 and 22,331 shares issued and outstanding, respectively	21	22
Retained earnings	86,159	97,115

Edgar Filing: PETMED EXPRESS INC - Form 10-Q

Accumulated other comprehensive loss	(48 )	(141 )
Total shareholders' equity	86,141	97,005
Total liabilities and shareholders' equity	\$99,416	\$106,287

See accompanying notes to condensed consolidated financial statements.

1

---

PETMED EXPRESS, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
 (In thousands, except for per share amounts)(Unaudited)

	Three Months Ended June 30,	
	2011	2010
Sales	\$73,578	\$74,369
Cost of sales	49,468	47,143
Gross profit	24,110	27,226
Operating expenses:		
General and administrative	6,104	6,208
Advertising	10,100	8,841
Depreciation	341	350
Total operating expenses	16,545	15,399
Income from operations	7,565	11,827
Other income (expense):		
Interest income, net	86	66
Other, net	(1	) 3
Total other income	85	69
Income before provision for income taxes	7,650	11,896
Provision for income taxes	2,813	4,671
Net income	\$4,837	\$7,225
Net income per common share:		
Basic	\$0.22	\$0.32
Diluted	\$0.22	\$0.32
Weighted average number of common shares outstanding:		
Basic	21,648	22,722
Diluted	21,767	22,868
Cash dividends declared per common share	\$0.125	\$0.10

See accompanying notes to condensed consolidated financial statements.

PETMED EXPRESS, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands) (Unaudited)

	Three Months Ended June 30,	
	2011	2010
Cash flows from operating activities:		
Net income	\$4,837	\$7,225
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	341	350
Share based compensation	565	523
Deferred income taxes	(155 )	376
Bad debt expense	19	7
(Increase) decrease in operating assets and increase (decrease) in liabilities:		
Accounts receivable	(338 )	(582 )
Inventories - finished goods	(934 )	13,279
Prepaid income taxes	664	330
Prepaid expenses and other current assets	(398 )	(273 )
Accounts payable	1,700	1,244
Income taxes payable	2,303	3,842
Accrued expenses and other current liabilities	(60 )	143
Net cash provided by operating activities	8,544	26,464
Cash flows from investing activities:		
Net change in investments	7,619	(10,017 )
Purchases of property and equipment	(82 )	(130 )
Net cash provided by (used in) investing activities	7,537	(10,147 )
Cash flows from financing activities:		
Dividends paid	(2,751 )	(2,278 )
Purchases of treasury stock	(13,577 )	(671 )
Proceeds from the exercise of stock options	-	252
Tax benefit related to stock options exercised	-	124
Net cash used in financing activities	(16,328 )	(2,573 )
Net (decrease) increase in cash and cash equivalents	(247 )	13,744
Cash and cash equivalents, at beginning of period	49,660	53,143
Cash and cash equivalents, at end of period	\$49,413	\$66,887
Supplemental disclosure of cash flow information:		
Dividends payable in accrued expenses	\$31	\$20

See accompanying notes to condensed consolidated financial statements.



PETMED EXPRESS, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1: Summary of Significant Accounting Policies

Organization

PetMed Express, Inc. and subsidiaries, d/b/a 1-800-PetMeds (the “Company”), is a leading nationwide pet pharmacy. The Company markets prescription and non-prescription pet medications and health products for dogs and cats direct to the consumer. The Company offers consumers an attractive alternative for obtaining pet medications in terms of convenience, price, and speed of delivery. The Company markets its products through national television, online, and direct mail/print advertising campaigns, which aim to increase the recognition of the “1-800-PetMeds” brand name, and “PetMeds” family of trademarks, increase traffic on its website at [www.1800petmeds.com](http://www.1800petmeds.com), acquire new customers, and maximize repeat purchases. The majority of the Company’s sales are to residents in the United States. The Company’s executive offices are located in Pompano Beach, Florida. The Company’s fiscal year end is March 31, and references herein to Fiscal 2012 or 2011 refer to the Company’s fiscal years ending March 31, 2012 and 2011, respectively.

Basis of Presentation and Consolidation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, the accompanying Condensed Consolidated Financial Statements contain all adjustments, consisting of normal recurring accruals, necessary to present fairly the financial position of the Company at June 30, 2011, the Statements of Income for the three months ended June 30, 2011 and 2010, and Cash Flows for the three months ended June 30, 2011 and 2010. The results of operations for the three months ended June 30, 2011 are not necessarily indicative of the operating results expected for the fiscal year ending March 31, 2012. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company’s annual report on Form 10-K for the fiscal year ended March 31, 2011. The Condensed Consolidated Financial Statements include the accounts of PetMed Express, Inc. and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated upon consolidation.

Use of Estimates

The preparation of Condensed Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Condensed Consolidated Financial Statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The carrying amounts of the Company’s cash and cash equivalents, short term investments, accounts receivable, and accounts payable approximate fair value due to the short-term nature of these instruments. The Company believes that the carrying amount of its long term investments approximate fair value.

Recent Accounting Pronouncements



The Company does not believe that any recently issued, but not yet effective, accounting standards, if currently adopted, will have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

4

---

## Note 2: Net Income Per Share

In accordance with the provisions of ASC Topic 260 (“Earnings Per Share”) basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per common share includes the dilutive effect of potential restricted stock and stock options exercised and the effects of the potential conversion of preferred shares, calculated using the treasury stock method. Outstanding stock options, restricted stock, and convertible preferred shares issued by the Company represent the only dilutive effect reflected in diluted weighted average shares outstanding. The following is a reconciliation of the numerators and denominators of the basic and diluted net income per share computations for the periods presented (in thousands, except for per share amounts):

	Three Months Ended June 30,	
	2011	2010
Net income (numerator):		
Net income	\$ 4,837	\$ 7,225
Shares (denominator):		
Weighted average number of common shares outstanding used in basic computation	21,648	22,722
Common shares issuable upon exercise of stock options and vesting of restricted stock	109	136
Common shares issuable upon conversion of preferred shares	10	10
Shares used in diluted computation	21,767	22,868
Net income per common share:		
Basic	\$ 0.22	\$ 0.32
Diluted	\$ 0.22	\$ 0.32

At June 30, 2011 and 2010, all common restricted stock and stock options were included in the diluted net income per common share computation. The exercise prices of the stock options were less than the average market price of the common shares for the period.

## Note 3: Accounting for Stock-Based Compensation

The Company records compensation expense associated with stock options and restricted stock in accordance with ASC Topic 718 (“Share Based Payment”). The Company adopted the modified prospective transition method provided under ASC Topic 718. The compensation expense related to all of the Company’s stock-based compensation arrangements is recorded as a component of general and administrative expenses.

The Company had no stock options outstanding under the PetMed Express, Inc. 1998 Stock Option Plan (“1998 Plan”) as of June 30, 2011, and 13,332 options outstanding at June 30, 2010. Options generally vested ratably over a three-year period commencing on the first anniversary of the grant with respect to options granted to employees/directors under the 1998 Plan. No options have been issued since May 2005 and there was no unrecognized compensation expense related to vested stock option awards. The 1998 Plan expired on July 31,

2008. There were no stock option exercises for the quarter ended June 30, 2011. For the quarter ended June 30, 2010 the Company received \$252,000 upon the exercise of stock options and the income tax benefit from stock options exercised totaled approximately \$124,000 for the three months ended June 30, 2010.

The Company had 481,227 restricted common shares issued under the 2006 Employee Equity Compensation Restricted Stock Plan ("Employee Plan") and 122,000 restricted common shares issued under the 2006 Outside Director Equity Compensation Restricted Stock Plan ("Director Plan") at June 30, 2011, all shares of which were issued subject to a restriction or forfeiture period which will lapse ratably on the first, second, and third anniversaries of the date of grant, and the fair value of which is being amortized over the three-year restriction period. The Company did not issue any shares of restricted stock during the quarter. For the quarters ended June 30, 2011 and 2010, the Company recognized \$565,000 and \$523,000, respectively, of compensation expense related to the Employee and Director Plans. At June 30, 2011 and 2010, there was \$3.2 million and \$3.9 million of unrecognized compensation cost related to the non-vested restricted stock awards, respectively, which is expected to be recognized over the next three years.

## Note 4: Short and Long Term Investments

The Company's short term investment balance consists of short term bond mutual funds. The Company's long term investment portfolio consists of auction rate securities ("ARS"), which are investments with contractual maturities generally between 20 to 30 years, in the form of municipal bonds and preferred stock, whose interest rates are reset, typically every seven to twenty-eight days, through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par. Beginning in February 2008, auctions failed for the ARS held because sell orders exceeded buy orders. These failures are not believed to be a credit issue, but rather are caused by a lack of liquidity. The funds associated with these failed auctions may not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures.

As a result, these securities with failed auctions have been classified as long-term assets in the Condensed Consolidated Balance Sheet due to the fact that they were not currently trading at such date, and conditions in the general markets created uncertainty as to when successful auctions would be reestablished. These ARS are recorded at estimated fair value and have variable interest rates that are recorded as interest income. In accordance with ASC Topic 320 ("Accounting for Certain Investments in Debt and Equity Securities"), short term investments are accounted for as available for sale securities, and long term investments are classified as available for sale, with any changes in fair value to be reflected in other comprehensive income. The Company evaluates its long term investments for impairment and whether impairment is other-than-temporary, and, if other-than-temporary, then the measurement of the impairment loss is a charge to net income. Unrealized gains and losses are deemed temporary and are included in accumulated other comprehensive income. The Company recognized a temporary impairment on its ARS investments during fiscal 2011. The Company does not believe that the underlying credit quality of the assets has been impacted; however the temporary impairment is mainly due to the lack of liquidity. The Company is currently trying to liquidate all ARS. The following is a summary of our investments:

	June 30,	March 31,
Investments (In thousands)	2011	2011
Short term investments	10,219	10,116
Long term investments	4,761	12,390
Total investments	\$ 14,980	\$ 22,506

The long term investment balances consist of ARS investments. Our ARS consist of closed-end fund preferred ARS, with interest rates that reset, typically every seven to twenty-eight days. These ARS are currently rated AAA, the highest rating available by a rating agency. The fair value of our ARS investments was assessed by management with the assistance of an outside third party, which was conducted during the fourth quarter of fiscal 2011. Subsequently, during the quarter ended June 30, 2011, the Company was able to liquidate approximately \$7.7 million of its ARS investments, at par. As of June 30, 2011, the Company held \$4.8 million in ARS, at par, which were classified as long term investments and the Company recorded an unrealized recovery of \$47,000 during the quarter. As of June 30, 2011, cumulative losses of \$64,000 were recognized within the accumulated other comprehensive loss account. The \$64,000 impairment was recorded as temporary due to the fact that the Company has the intent and the ability to hold these securities until anticipated recovery or maturity, and does expect to fully recover the cost basis of the investment.

## Note 5: Fair Value

Effective April 1, 2008, the Company adopted ASC Topic 820 (“Fair Value Measurements”), except as it applies to non-financial assets and non-financial liabilities subject to ASC Topic 320. ASC Topic 320 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. ASC Topic 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 - Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company's cash equivalents are classified within Level 1, with the exception of the investments in ARS. The Company's investments in ARS are classified within Level 3 because they are valued using a discounted cash flow model. Some of the inputs to this model are unobservable in the market and are significant. Assets and liabilities measured at fair value are summarized below:

(In thousands)	June 30, 2011	Fair Value Measurement at June 30, 2011 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and cash equivalents - money market funds	\$49,413	\$49,413	\$-	\$ -
Short term investments - bond mutual funds	10,219	10,219	-	-
Long term investments - auction rate securities	4,761	-	-	4,761
	\$64,393	\$59,632	\$-	\$ 4,761

The following table is a reconciliation of financial assets measured at fair value using unobservable inputs (Level 3) during the quarter ended June 30, 2011:

(In thousands)	Auction Rate Securities Quarter Ended June 30, 2011
Balance, beginning of period	\$ 12,390
Redemption of securities	(7,676 )
Recovery of valuation	47
Balance, end of period	\$ 4,761

Long term investments measured at fair value using Level 3 inputs are comprised of ARS. Although ARS would typically be measured using Level 2 inputs, the recent failure of auctions and the lack of market activity and liquidity required that these securities be measured using Level 3 inputs. The Company's ARS consist of closed-end fund preferred ARS, with interest rates that reset, typically every seven to twenty-eight days. The fair value of our ARS investments was assessed by management with the assistance of an outside third party appraisal firm, which was conducted during the fourth quarter of fiscal 2011. The fair value was calculated using a discounted cash flow valuation model. The three inputs used in determining the fair values of the ARS were:

(1) Forecasted interest payments cash flows - In failed ARS auctions, interest rates are set by the terms of the prospectus. For almost all of the securities the terms are a combination of two components: the determination of a base rate that is based on the maximum of two indexes, or a single index as defined in the prospectus. Base rates are adjusted through either a multiplication factor or an addition of a spread factor as defined in the prospectus, which is dependent on the credit rating of the security. Our ARS are currently rated AAA, the highest rating available by a rating agency.

(2) Discount rate calculation - The discount rates were calculated from the applicable forward curve plus a credit risk/liquidity spread. The credit risk spread was estimated via the credit spreads for 1-3 year term, AAA rated, debt over US Treasury notes and bonds which were determined to be 50 basis points (0.50%). To address the continued illiquidity of the Company's ARS portfolio, an additional spread of 0.30% was added to the credit risk spread. This spread is based on the required yield attributable to liquidity for AAA rated debt, as determined by empirical studies. Specifically, research on municipal bond yields indicate that for AAA rated securities, the liquidity component represents approximately 7-10% of the required yield. In total, a credit risk/liquidity spread of 0.80% was utilized.

(3) A present value calculation was performed utilizing the cash flow of the forecasted interest payments combined with the discount rate determined above.

As of June 30, 2011, the Company held \$4.8 million in ARS, at par, which were classified as long term investments and the Company recorded an unrealized recovery of \$47,000 for the quarter then ended. As of June 30, 2011, cumulative losses of \$64,000 were recognized within the accumulated other comprehensive loss account, based upon an assessment by the outside third party appraisal firm. The \$64,000 impairment was recorded as temporary due to the fact that the Company has the intent and the ability to hold these securities until anticipated recovery or maturity, and does expect to fully recover the cost basis of the investment.

#### Note 6: Commitments and Contingencies

In October 2009, the Company was notified that it was named as a defendant in a multi-defendant lawsuit, filed in the United States District Court for the Eastern District of Texas, Marshall Division, seeking declaratory, injunctive, and monetary relief styled Charles E. Hill & Associates, Inc. v. ABT Electronics, Inc., et al, Cause No. 2:09-CV-313. The lawsuit alleges that the Company is infringing on patents related to electronic catalog systems. From the outset, the vendor that provides the Company with the Internet software had been defending and indemnifying the Company. However, effective February 15, 2011, the company that acquired this vendor declined to provide any further indemnification of the Company. The Company is continuing to defend itself, and at this stage, it is difficult to assess any possible outcome or estimate any potential loss in the event of an adverse outcome.

The Company has settled complaints that had been filed with various states' pharmacy boards in the past. There can be no assurances made that other states will not attempt to take similar actions against the Company in the future. The Company initiates litigation to protect its trade or service marks. There can be no assurance that the Company will be successful in protecting its trade or service marks. Legal costs related to the above matters are expensed as incurred.

#### Note 7: Changes in Stockholders' Equity and Comprehensive Income:

Changes in stockholders' equity for the three months ended June 30, 2011 is summarized below (in thousands):

	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss
Beginning balance at March 31, 2011:	\$-	\$97,115	\$ (141 )
Share based compensation	565	-	-
Repurchased and retired shares	(13,577 )	-	-
Allocation of retirement of repurchased shares of additional paid in capital and retained earnings	13,012	(13,012 )	-
Dividends declared	-	(2,781 )	-
Net Income	-	4,837	-
Net change in unrealized gain on short term investments	-	-	46
Net change in unrealized gain on redemptions of long term investments	-	-	47
Ending balance at June 30, 2011:	\$-	\$86,159	\$ (48 )

Shares of treasury stock purchased in the period ended June 30, 2011 totaling 1,071,607 were retired and cancelled, and shares of treasury stock purchased in the period ended June 30, 2010 totaling 37,795 were retired, and 195 shares remained as treasury stock outstanding as of June 30, 2010.





Total comprehensive income for the three months ended June 30, 2011 and 2010 is summarized below (in thousands):

	Three Months Ended	
	2011	2010
Net income	\$ 4,837	\$ 7,225
Net change in unrealized gain on short term investments	46	8
Net change in unrealized gain on redemptions of long term investments	47	-
Comprehensive income	\$ 4,930	\$ 7,233

#### Note 8: Income Taxes

For the quarters ended June 30, 2011 and 2010, the Company recorded an income tax provision for approximately \$2.8 million and \$4.7 million, respectively. The effective tax rate for the quarters ended June 30, 2011 and 2010 were 36.8% and 39.3%, respectively. The effective tax rate decrease was due to a one time tax adjustment to reconcile the remaining net operating loss carryforward (“NOL”) in June 2010. The Company’s reconciliation of this NOL resulted in a one time tax charge of approximately \$280,000, which was recognized in June 2010.

#### Note 9: Subsequent Events

In July 2011, the Company repurchased approximately 342,000 of its own shares for approximately \$3.8 million. On July 29, 2011 the Board of Directors approved the issuance of approximately 91,000 restricted shares to certain employees and the outside directors of the Company. All shares which were issued are subject to a restriction or forfeiture period which will lapse ratably on the first, second, and third anniversaries of the date of the grant, and the fair value is being amortized over the the three-year restriction period.

On August 1, 2011 our Board of Directors declared a quarterly dividend of \$0.125 per share. The Board established an August 12, 2011 record date and an August 26, 2011 payment date. Based on the outstanding share balance as of August 1, 2011 the Company estimates the dividend payable to be approximately \$2.6 million. The Board of Directors also approved a fourth share repurchase program of up to \$20.0 million, effective immediately. This program is intended to be implemented through purchases made from time to time, in either the open market or through private transactions at the Company's discretion, subject to market conditions conditions and other factors, in accordance with Securities and Exchange Commission requirements. The Company still has approximately \$299,000 remaining from its third \$20.0 million repurchase plan, under which the Company has already repurchased approximately 1.6 million shares for approximately \$19.7 million, an average of \$12.54 per share.

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

### Executive Summary

PetMed Express was incorporated in the state of Florida in January 1996. The Company's common stock is traded on the NASDAQ Global Select Market under the symbol "PETS." The Company began selling pet medications and other pet health products in September 1996. Presently, the Company's product line includes approximately 1,200 of the most popular pet medications, health products, and supplies for dogs and cats. In March 2010 the Company started offering for sale additional pet supplies on its website, and these items are drop shipped to customers by third parties.

The Company markets its products through national television, online, and direct mail/print advertising campaigns which aim to increase the recognition of the "1-800-PetMeds" brand name, and "PetMeds" family of trademarks, increase traffic on its website at [www.1800petmeds.com](http://www.1800petmeds.com), acquire new customers, and maximize repeat purchases. Approximately 73% of all sales were generated via the Internet for the three months ended June 30, 2011, compared to 70% for the quarter ending June 30, 2010. The Company's sales consist of products sold mainly to retail consumers. The Company's sales returns average was approximately 1.5% and 1.6% of sales for the quarters ended on June 30, 2011 and 2010, respectively. The three-month average purchase was approximately \$80 and \$82 per order for the quarters ended on June 30, 2011 and 2010, respectively.

### Critical Accounting Policies

Our discussion and analysis of our financial condition and the results of our operations are based upon our Consolidated Financial Statements and the data used to prepare them. The Company's Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America. On an ongoing basis we re-evaluate our judgments and estimates including those related to product returns, bad debts, inventories, long term investments, and income taxes. We base our estimates and judgments on our historical experience, knowledge of current conditions, and our beliefs of what could occur in the future considering available information. Actual results may differ from these estimates under different assumptions or conditions. Our estimates are guided by observing the following critical accounting policies.

### Revenue recognition

The Company generates revenue by selling pet medication products and pet supplies primarily to retail consumers. The Company's policy is to recognize revenue from product sales upon shipment, when the rights of ownership and risk of loss have passed to the customer. Outbound shipping and handling fees are included in sales and are billed upon shipment. Shipping expenses are included in cost of sales. The majority of the Company's sales are paid by credit cards and the Company usually receives the cash settlement in two to three banking days. Credit card sales minimize accounts receivable balances relative to sales. The Company maintains an allowance for doubtful accounts for losses that the Company estimates will arise from customers' inability to make required payments, arising from either credit card charge-backs or insufficient funds checks. The Company determines its estimates of the uncollectibility of accounts receivable by analyzing historical bad debts and current economic trends. The allowance for doubtful accounts was approximately \$7,000 for both the quarters ended June 30, 2011 and 2010.

### Valuation of inventory

Inventories consist of prescription and non-prescription pet medications and pet supplies that are available for sale and are priced at the lower of cost or market value using a weighted average cost method. The Company writes down its inventory for estimated obsolescence. The inventory reserve was approximately \$65,000 and \$40,000 for the quarters

ended June 30, 2011 and 2010, respectively.

#### Advertising

The Company's advertising expense consists primarily of television advertising, Internet marketing, and direct mail/print advertising. Television advertising costs are expensed as the advertisements are televised. Internet costs are expensed in the month incurred and direct mail/print advertising costs are expensed when the related catalogs, brochures, and postcards are produced, distributed, or superseded.

## Accounting for income taxes

The Company accounts for income taxes under the provisions of ASC Topic 740 (“Accounting for Income Taxes”), which generally requires recognition of deferred tax assets and liabilities for the expected future tax benefits or consequences of events that have been included in the Consolidated Financial Statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting carrying values and the tax bases of assets and liabilities, and are measured by applying enacted tax rates and laws for the taxable years in which those differences are expected to reverse.

## Results of Operations

The following should be read in conjunction with the Company’s Condensed Consolidated Financial Statements and the related notes thereto included elsewhere herein. The following table sets forth, as a percentage of sales, certain operating data appearing in the Company’s Condensed Consolidated Statements of Income:

	Three Months Ended	
	June 30,	
	2011	2010
Sales	100.0 %	100.0 %
Cost of sales	67.2	63.4
Gross profit	32.8	36.6
Operating expenses:		
General and administrative	8.3	8.3
Advertising	13.7	11.9
Depreciation	0.5	0.5
Total operating expenses	22.5	20.7
Income from operations	10.3	15.9
Total other income	0.1	0.1
Income before provision for income taxes	10.4	16.0
Provision for income taxes	3.8	6.3
Net income	6.6 %	9.7 %

Three Months Ended June 30, 2011 Compared With Three Months Ended June 30, 2010

Sales

Sales decreased by approximately \$791,000, or 1.1%, to approximately \$73.6 million for the quarter ended June 30, 2011, from approximately \$74.4 million for the quarter ended June 30, 2010. The decrease in sales for the three months ended June 30, 2011 was primarily due to decreased reorder sales, offset by increased new order sales. The decrease in reorder sales may be attributed to a reduction in the average order size, due to a more aggressive flea and tick product pricing strategy and increased competition. The Company acquired approximately 226,000 new customers for the quarter ended June 30, 2011, compared to approximately 220,000 new customers for the same period the prior year. The following chart illustrates sales by various sales classifications:

Sales (In thousands)	Three Months Ended June 30,				\$ Variance	% Variance
	2011	%	2010	%		
Reorder Sales	\$56,619	77.0	% \$57,622	77.5	% \$(1,003 )	-1.7 %
New Order Sales	\$16,959	23.0	% \$16,747	22.5	% \$212	1.3 %
Total Net Sales	\$73,578	100.0	% \$74,369	100.0	% \$(791 )	-1.1 %
Internet Sales	\$54,062	73.5	% \$52,298	70.3	% \$1,764	3.4 %
Contact Center Sales	\$19,516	26.5	% \$22,071	29.7	% \$(2,555 )	-11.6 %
Total Net Sales	\$					