

VCA ANTECH INC  
Form 10-Q  
May 09, 2005

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

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**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 March 31, 2005

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

**Commission File Number: 001-16783**

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**VCA ANTECH, INC.**

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

**Delaware**

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

**95-4097995**

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

**12401 West Olympic Boulevard  
Los Angeles, California 90064-1022**  
*(Address of principal executive offices)*

**(310) 571-6500**

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

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

Yes 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 82,287,120 shares as of May 6, 2005.

**VCA ANTECH, INC.**  
**FORM 10-Q**  
**MARCH 31, 2005**

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

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 41,526	\$ 30,964
Restricted cash	1,250	1,250
Trade accounts receivable, less allowance for uncollectible accounts of \$8,095 and \$7,668 at March 31, 2005 and December 31, 2004, respectively	31,735	28,936
Inventory	13,169	10,448
Prepaid expenses and other	6,305	6,275
Deferred income taxes	12,220	11,472
Prepaid income taxes	1,219	10,830
Total current assets	107,424	100,175
Property and equipment, net	123,708	119,903
Other assets:		
Goodwill	513,477	499,144
Other intangible assets, net	11,629	11,660
Deferred financing costs, net	3,843	4,052
Other	6,494	7,166
Total assets	\$ 766,575	\$ 742,100

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Current liabilities:		
Current portion of long-term obligations	\$ 3,323	\$ 6,043
Accounts payable	15,883	15,566
Accrued payroll and related liabilities	21,742	19,850
Accrued interest	5,769	1,578
Other accrued liabilities	24,043	21,874
Total current liabilities	70,760	64,911
Long-term obligations, less current portion	390,152	390,846
Deferred income taxes	32,951	31,514
Other liabilities	12,699	12,915

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Minority interest	9,659	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, 82,272 and 82,191 shares outstanding as of March 31, 2005 and December 31, 2004, respectively	82	82
Additional paid-in capital	251,782	251,412
Accumulated deficit	(1,513)	(18,759)
Accumulated other comprehensive income	12	34
Notes receivable from stockholders	(9)	(10)
Total stockholders' equity	250,354	232,759
Total liabilities and stockholders' equity	\$ 766,575	\$ 742,100

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

Table of Contents**VCA ANTECH, INC. AND SUBSIDIARIES****CONDENSED, CONSOLIDATED INCOME STATEMENTS****For the Three Months Ended March 31, 2005 and 2004****(Unaudited)****(In thousands, except per share amounts)**

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Revenue	\$ 186,863	\$ 144,350
Direct costs	136,336	104,790
Gross profit	50,527	39,560
Selling, general and administrative expense	14,132	8,701
Loss (gain) on sale of assets	(10)	62
Operating income	36,405	30,797
Interest expense, net	6,667	5,985
Other expense	64	111
Minority interest in income of subsidiaries	685	416
Income before provision for income taxes	28,989	24,285
Provision for income taxes	11,743	9,541
Net income	\$ 17,246	\$ 14,744
Basic earnings per common share	\$ 0.21	\$ 0.18
Diluted earnings per common share	\$ 0.21	\$ 0.18
Shares used for computing basic earnings per share	82,220	81,482
Shares used for computing diluted earnings per share	83,511	83,020

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 Three Months Ended March 31, 2005 and 2004****(Unaudited)****(In thousands)**

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Cash flows from operating activities:		
Net income	\$ 17,246	\$ 14,744
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,342	3,616
Amortization of debt costs	209	184
Provision for uncollectible accounts	1,033	628
Loss (gain) on sale of assets	(10)	62
Other	(248)	
Tax benefit from stock options exercised	179	323
Minority interest in income of subsidiaries	685	416
Distributions to minority interest partners	(656)	(374)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(3,771)	(4,485)
Decrease (increase) in inventory, prepaid expenses and other assets	(2,429)	42
Increase in accounts payable and other accrued liabilities	2,059	473
Increase in accrued payroll and related liabilities	1,892	1,784
Increase in accrued interest	4,191	4,092
Decrease in prepaid income taxes	9,642	6,038
Increase in deferred income tax assets	(530)	(393)
Increase in deferred income tax liabilities	1,534	2,386
Net cash provided by operating activities	35,368	29,536
Cash flows used in investing activities:		
Business acquisitions, net of cash acquired	(14,322)	(14,113)
Real estate acquired in connection with business acquisitions	(221)	
Property and equipment additions, net	(7,209)	(3,465)
Proceeds from sale of assets	92	178
Other	77	95
Net cash used in investing activities	(21,583)	(17,305)
Cash flows used in financing activities:		
Repayment of long-term obligations	(3,414)	(529)
Proceeds from issuance of common stock under stock option plans	191	422
Net cash used in financing activities	(3,223)	(107)
Increase in cash and cash equivalents	10,562	12,124



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Cash and cash equivalents at beginning of period	30,964	17,237
Cash and cash equivalents at end of period	\$ 41,526	\$ 29,361

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

Table of Contents**VCA ANTECH, INC. AND SUBSIDIARIES****NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS****March 31, 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 considered necessary for a fair presentation have been included. The results of operations for the three months ended March 31, 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**

Our acquisition strategy includes the acquisition of animal hospitals. If favorable opportunities are presented we may pursue the acquisition of animal hospital chains, laboratories or related businesses. In accord with that strategy, we acquired the following:

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Animal Hospitals:</b>		
Acquisitions	8	9
Acquisitions relocated into our existing animal hospitals	(1)	(2)
Total	7	7

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

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Consideration:</b>		
Cash	\$ 13,620	\$ 13,776
Obligations to sellers (1)	900	725
Notes payable and other liabilities assumed	21	16
Total	\$ 14,541	\$ 14,517

**Purchase Price Allocation:**

Goodwill (2)	\$ 13,209	\$ 13,358
Identifiable intangible assets	774	710
Tangible assets	558	449
Total	\$ 14,541	\$ 14,517

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- (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 \$8.5 million and \$11.9 million of the goodwill recorded for these acquisitions as of March 31, 2005 and 2004, respectively, will be fully deductible for income tax purposes.

**Table of Contents*****Partnership Interests***

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

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Consideration:</b>		
Cash	\$ 500	\$ 56
Notes payable		131
<b>Total</b>	<b>\$ 500</b>	<b>\$ 187</b>
 Goodwill recorded (1)	 \$ 25	 \$ 163

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(1) We expect that the goodwill recorded in the three months ended March 31, 2004 will be fully deductible for income tax purposes.

***Other Acquisition Payments***

We paid \$575,000 and \$280,000 during the three months ended March 31, 2005 and 2004, respectively, of unused holdbacks to sellers in previously closed acquisitions.

We paid \$90,000 during the three months ended March 31, 2005 for earnout targets that were met and recorded goodwill in the same amount.

***Significant Acquisitions******STI***

On October 1, 2004, we acquired Sound Technologies Inc., STI, which is a supplier of ultrasound and digital radiography equipment and related computer hardware, software and services to the veterinary industry. As of March 31, 2005, we had not finalized the purchase price accounting for this transaction as we are still in the process of integrating STI into our operations. As part of integrating STI into our operations, we may incur additional legal and accounting fees. In addition, pursuant to the terms of the purchase agreement, we are obligated to pay an additional \$3.5 million if certain performance targets are achieved. Costs incurred in integrating STI and the payment of the \$3.5 million obligation will result in additions to the total purchase price of the transaction.

The total consideration, excluding the potential integration costs and the \$3.5 million obligation described above, as of March 31, 2005, was \$29.4 million, consisting of: \$22.4 million in cash paid to holders of STI stock; \$1.1 million in assumed debt; \$5.5 million in assumed liabilities; and \$350,000 paid for professional and other outside services. The preliminary allocation of the \$29.4 million purchase price was allocated as follows: \$19.3 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 NPC, which operated 67 animal hospitals located in 11 states as of the merger date. This merger allowed us to expand our animal hospital operations in nine states, particularly California and Texas, and to expand into two new states, Oregon and Oklahoma.

The purchase price accounting for this transaction has been finalized except our plan to close or sell certain NPC animal hospitals that do not meet our operating model. The costs to close or sell these animal hospitals, which will consist primarily of lease termination costs and employee severance, will result in additions to the purchase price.

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The total consideration, excluding the cost to close or sell certain NPC animal hospitals as described above, as of March 31, 2005, was \$90.1 million, consisting of: \$66.2 million in cash paid to holders of NPC stock and debt; \$2.5 million in assumed debt; \$12.4 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 \$2.5 million paid as part of our plan to close certain facilities and terminate certain employees. The \$90.1 million purchase price was allocated as follows: \$76.4 million to goodwill; \$1.4 million to identifiable intangible assets; and \$12.3 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. 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 three months ended March 31, 2005 (in thousands):

	<b>Laboratory</b>	<b>Animal Hospital</b>	<b>Medical Equipment</b>	<b>Total</b>
Balance as of January 1, 2005	\$ 93,671	\$ 386,255	\$ 19,218	\$ 499,144
Goodwill acquired		13,209		13,209
Other (1)		546	54	600
Goodwill related to partnership interests		577		577
Goodwill related to sale of animal hospital		(53)		(53)
Balance as of March 31, 2005	\$ 93,671	\$ 400,534	\$ 19,272	\$ 513,477

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

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

	<b>As of March 31, 2005</b>			<b>As of December 31, 2004</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>
Covenants-not-to-compete	\$ 12,370	\$ (5,816)	\$ 6,554	\$ 11,604	\$ (5,290)	\$ 6,314
Noncontractual customer relationships	3,340	(392)	2,948	3,340	(246)	3,094
Technology	1,250	(125)	1,125	1,250	(62)	1,188
Trademarks	560	(28)	532	560	(14)	546
Contracts	397	(52)	345	397	(26)	371
Client lists	672	(547)	125	665	(518)	147
Total	\$ 18,589	\$ (6,960)	\$ 11,629	\$ 17,816	\$ (6,156)	\$ 11,660

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

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Aggregate amortization expense	\$ 804	\$ 440

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Based on balances at March 31, 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	\$ 3,084
2006	\$ 2,740
2007	\$ 2,496
2008	\$ 1,942
2009	\$ 905

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

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

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Net income	\$ 17,246	\$ 14,744
Weighted average common shares outstanding:		
Basic	82,220	81,482
Effect of dilutive potential common shares:		
Stock options	1,291	1,396
Contracts that may be settled in stock or cash		142
Diluted	83,511	83,020
Basic earnings per common share	\$ 0.21	\$ 0.18
Diluted earnings per common share	\$ 0.21	\$ 0.18

**5. Lines of Business**

As of March 31, 2005, we had four reportable segments: Laboratory, Animal Hospital, Medical Technology and Corporate. We acquired our Medical Technology segment on October 1, 2004 and therefore do not have operating results for periods prior to that date. These segments are strategic business units that have different products, services and/or functions. The segments are managed separately because each is a distinct and different business venture with unique challenges, rewards and risks. The Laboratory segment provides diagnostic laboratory testing services for veterinarians, both associated with our animal hospitals and those independent of us. The Animal Hospital segment provides veterinary services for companion animals and sells related retail and pharmaceutical products. The Medical Technology segment sells ultrasound and digital radiography equipment, related computer hardware, software and ancillary services to the veterinary market. The 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.

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

	<b>Laboratory</b>	<b>Animal Hospital</b>	<b>Medical Technology</b>	<b>Corporate</b>	<b>Intercompany Eliminations</b>	<b>Total</b>
<b>Three Months Ended March 31, 2005</b>						
Revenue	\$ 53,439	\$ 133,354	\$ 4,484	\$	\$ (4,414)	\$ 186,863
Direct costs	29,570	107,619	3,445		(4,298)	136,336
Gross profit	23,869	25,735	1,039		(116)	50,527
Selling, general and administrative expense	3,365	3,703	1,567	5,497		14,132
Loss (gain) on sale of assets		(10)				(10)
Operating income (loss)	\$ 20,504	\$ 22,042	\$ (528)	\$ (5,497)	\$ (116)	\$ 36,405
Depreciation and amortization	\$ 902	\$ 2,744	\$ 299	\$ 397	\$	\$ 4,342
Capital expenditures	\$ 1,681	\$ 3,881	\$ 120	\$ 1,832	\$ (305)	\$ 7,209
<b>Three Months Ended March 31, 2004</b>						
Revenue	\$ 49,182	\$ 97,956	\$	\$	\$ (2,788)	\$ 144,350
Direct costs	27,715	79,863			(2,788)	104,790
Gross profit	21,467	18,093				39,560
Selling, general and administrative expense	3,173	2,748		2,780		8,701
Loss (gain) on sale of assets	(1)	63				62
Operating income (loss)	\$ 18,295	\$ 15,282	\$	\$ (2,780)	\$	\$ 30,797
Depreciation and amortization	\$ 821	\$ 2,401	\$	\$ 394	\$	\$ 3,616
Capital expenditures	\$ 746	\$ 2,453	\$	\$ 266	\$	\$ 3,465
<b>At March 31, 2005</b>						
Total assets	\$ 143,948	\$ 520,955	\$ 35,811	\$ 65,861	\$	\$ 766,575
<b>At December 31, 2004</b>						
Total assets	\$ 135,600	\$ 503,485	\$ 35,198	\$ 67,817	\$	\$ 742,100

**6. 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, 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):

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	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
As reported	\$ 17,246	\$ 14,744
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	(2,303)	(222)
Pro forma net income available to common stockholders	\$ 14,943	\$ 14,522
 Earnings per common share:		
Basic as reported	\$ 0.21	\$ 0.18
Basic pro forma	\$ 0.18	\$ 0.18
 Diluted as reported	\$ 0.21	\$ 0.18
Diluted pro forma	\$ 0.18	\$ 0.17

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 123R to fiscal years beginning after June 15, 2005. We plan to adopt SFAS 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.

**7. 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. Earn-out 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 earn-out 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 \$2.3 million for the remainder of 2005 and \$2.2 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 December 31, 2004, 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 of control are based on the officer's salary 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 December 31, 2004, 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.

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### *c. State Laws*

The laws of many states prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. These laws vary from state to state and are enforced by the courts and by regulatory authorities with broad discretion. At March 31, 2005, we operated 102 animal hospitals in 13 states with these laws, including 24 in New York and 26 in Texas. In two of these states, we operated a mobile imaging service. We may experience difficulty in expanding operations into other states with similar laws. Given varying and uncertain interpretations of the veterinary laws of each state, we may not be in compliance with restrictions on the corporate practice of veterinary medicine in all states. A determination that we are in violation of applicable restrictions on the practice of veterinary medicine in any state in which we operate could have a material adverse effect, particularly if we were unable to restructure its operations to comply with the requirements of that state.

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

### *d. 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.

## **8. Reclassifications**

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

## **9. Condensed, Consolidating Information**

We have a legal structure comprised of a holding company and an operating company. VCA is our holding company, or commonly referred to as our parent company. Vicar Operating, Inc., or Vicar, is our operating company and is wholly owned by VCA. Vicar owns the capital stock of all of our subsidiaries.

The borrowings under our senior credit facility are secured obligations owed by Vicar. These borrowings are guaranteed by VCA, and its wholly-owned subsidiaries. Vicar may borrow up to \$50.0 million under a revolving line of credit under the senior credit facility. Vicar's obligations under the senior credit facility are secured by the assets of VCA and its wholly-owned subsidiaries in addition to a pledge of capital stock or similar equity interests of VCA's wholly-owned subsidiaries.

The borrowings under our 9.875% senior subordinated notes are general unsecured obligations owed by Vicar. These notes are unconditionally guaranteed on a senior subordinated basis by VCA and its wholly-owned subsidiaries.

Our partnerships may elect to serve as guarantors of our obligations; however, none of our partnerships have elected to do so. The partnerships are referred to as Non-Guarantor Subsidiaries in the following financial statements.

Vicar conducts all of its business through and derives virtually all of its income from its subsidiaries. Therefore, Vicar's ability to make required payments with respect to its indebtedness and other obligations depends on the financial results and condition of its subsidiaries and its ability to receive funds from its subsidiaries.

This condensed financial information has been prepared from the books and records maintained by VCA, Vicar, the Guarantor Subsidiaries and the Non-Guarantor Subsidiaries. The condensed financial information may not necessarily be indicative of results of operations or financial position had the Guarantor Subsidiaries and the Non-Guarantor Subsidiaries operated as independent entities. The separate financial statements of the Guarantor Subsidiaries are not presented because we determined they would not be material to investors.

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATED BALANCE SHEETS**  
**As of March 31, 2005**  
**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
Current assets:						
Cash and cash equivalents	\$	\$ 34,603	\$ 6,820	\$ 103	\$	\$ 41,526
Restricted cash		1,250				1,250
Trade accounts receivable, net		(197)	31,270	662		31,735
Inventory			12,659	510		13,169
Prepaid expenses and other		3,439	2,538	328		6,305
Deferred income taxes		12,220				12,220
Prepaid income taxes		1,219				1,219
 Total current assets		52,534	53,287	1,603		107,424
Property and equipment, net		7,499	113,751	2,458		123,708
Other assets:						
Goodwill, net			481,783	31,694		513,477
Covenants-not-to-compete, net			10,949	680		11,629
Deferred financing costs, net		3,843				3,843
Other	27	1,958	3,662	3,065	(2,218)	6,494
Investment in subsidiaries	284,050	438,805	32,261		(755,116)	
 Total assets	\$ 284,077	\$ 504,639	\$ 695,693	\$ 39,500	\$ (757,334)	\$ 766,575
 Current liabilities:						
Current portion of long-term obligations	\$	\$ 2,297	\$ 1,026	\$	\$	\$ 3,323
Accounts payable		10,374	5,509			15,883
Accrued payroll and related liabilities		13,782	7,525	435		21,742
Accrued interest		5,623	146			5,769
Other accrued liabilities		15,031	9,001	11		24,043
 Total current liabilities		47,107	23,207	446		70,760
Long-term obligations, less current portion		390,388	1,982		(2,218)	390,152
Deferred income taxes		30,880	2,071			32,951
Other liabilities		6,294	6,405			12,699
Intercompany payable/(receivable)	33,723	(254,080)	223,223	(2,866)		
Minority interest					9,659	9,659
Preferred stock						



Stockholders' equity:						
Common stock	82					82
Additional paid-in capital	251,782					251,782
Accumulated equity (deficit)	(1,513)	284,038	438,805	41,920	(764,763)	(1,513)
Accumulated other comprehensive income	12	12			(12)	12
Notes receivable from stockholders	(9)					(9)
Total stockholders' equity	250,354	284,050	438,805	41,920	(764,775)	250,354
Total liabilities and stockholders' equity	\$ 284,077	\$ 504,639	\$ 695,693	\$ 39,500	\$ (757,334)	\$ 766,575

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATED BALANCE SHEETS**  
**As of December 31, 2004**  
**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
Current assets:						
Cash and cash equivalents	\$	\$ 27,947	\$ 2,944	\$ 73	\$	\$ 30,964
Restricted cash		1,250				1,250
Trade accounts receivable, net		11	28,220	705		28,936
Inventory			9,955	493		10,448
Prepaid expenses and other		3,774	2,205	296		6,275
Deferred income taxes		11,472				11,472
Prepaid income taxes		10,830				10,830
Total current assets		55,284	43,324	1,567		100,175
Property and equipment, net		6,544	110,843	2,516		119,903
Other assets:						
Goodwill, net			467,819	31,325		499,144
Covenants-not-to-compete, net			10,979	681		11,660
Deferred financing costs, net		4,052				4,052
Other	30	1,907	3,971	2,774	(1,516)	7,166
Investment in subsidiaries	266,827	404,414	32,117		(703,358)	
Total assets	\$ 266,857	\$ 472,201	\$ 669,053	\$ 38,863	\$ (704,874)	\$ 742,100
Current liabilities:						
Current portion of long-term obligations	\$	\$ 4,896	\$ 1,147	\$ 101	\$ (101)	\$ 6,043
Accounts payable		9,644	5,922			15,566
Accrued payroll and related liabilities		12,283	7,131	436		19,850
Accrued interest		1,425	153			1,578
Other accrued liabilities		12,651	9,234	(11)		21,874
Total current liabilities		40,899	23,587	526	(101)	64,911
Long-term obligations, less current portion		390,160	2,101		(1,415)	390,846
Deferred income taxes		29,443	2,071			31,514
Other liabilities		6,263	6,652			12,915
Intercompany payable/(receivable)	34,098	(261,391)	230,228	(2,935)		
Minority interest					9,155	9,155

Preferred stock

Stockholders' equity:

Common stock	82					82
Additional paid-in capital	251,412					251,412
Accumulated equity (deficit)	(18,759)	266,793	404,414	41,272	(712,479)	(18,759)
Accumulated other comprehensive income	34	34			(34)	34
Notes receivable from stockholders	(10)					(10)
Total stockholders' equity	232,759	266,827	404,414	41,272	(712,513)	232,759
Total liabilities and stockholders' equity	\$ 266,857	\$ 472,201	\$ 669,053	\$ 38,863	\$ (704,874)	\$ 742,100

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATED INCOME STATEMENTS**  
**For the Three Months Ended March 31, 2005**  
**(In thousands)**

	<b>VCA</b>	<b>Vicar</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Elimination</b>	<b>Consolidated</b>
Revenue	\$	\$	\$ 172,796	\$ 14,504	\$ (437)	\$ 186,863
Direct costs			125,428	11,345	(437)	136,336
Gross profit			47,368	3,159		50,527
Selling, general and administrative expense		5,497	8,136	499		14,132
Gain on sale of assets			(10)			(10)
Operating income (loss)		(5,497)	39,242	2,660		36,405
Interest expense, net	(1)	6,642	75	(49)		6,667
Other expense		64				64
Minority interest in income of subsidiaries					685	685
Equity interest in income of subsidiaries	17,245	34,391	2,024		(53,660)	
Income before provision for income taxes	17,246	22,188	41,191	2,709	(54,345)	28,989
Provision for income taxes		4,943	6,800			11,743
Net income	\$ 17,246	\$ 17,245	\$ 34,391	\$ 2,709	\$ (54,345)	\$ 17,246

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATED INCOME STATEMENTS**  
**For the Three Months Ended March 31, 2004**  
**(In thousands)**

	<b>VCA</b>	<b>Vicar</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Elimination</b>	<b>Consolidated</b>
Revenue	\$	\$	\$ 133,862	\$ 10,745	\$ (257)	\$ 144,350
Direct costs			96,472	8,575	(257)	104,790
Gross profit			37,390	2,170		39,560
Selling, general and administrative expense		2,780	5,556	365		8,701
Loss on sale of assets			62			62
Operating income (loss)		(2,780)	31,772	1,805		30,797
Interest expense, net	(1)	5,983	40	(37)		5,985
Other expense		111				111
Minority interest in income of subsidiaries					416	416
Equity interest in income of subsidiaries	14,743	19,499	1,426		(35,668)	
Income before provision (benefit) for income taxes	14,744	10,625	33,158	1,842	(36,084)	24,285
Provision (benefit) for income taxes		(4,118)	13,659			9,541
Net income	\$ 14,744	\$ 14,743	\$ 19,499	\$ 1,842	\$ (36,084)	\$ 14,744

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Three Months Ended March 31, 2005**  
**(In thousands)**

	<b>VCA</b>	<b>Vicar</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Elimination</b>	<b>Consolidated</b>
Cash flows from operating activities:						
Net income	\$ 17,246	\$ 17,245	\$ 34,391	\$ 2,709	\$ (54,345)	\$ 17,246
Adjustments to reconcile net income to net cash provided by (used in) operating activities:						
Equity interest in earnings of subsidiaries	(17,245)	(34,391)	(2,024)		53,660	
Depreciation and amortization		397	3,750	195		4,342
Amortization of debt costs		209				209
Provision for uncollectible accounts			967	66		1,033
Loss on sale of assets			(10)			(10)
Other			(248)			(248)
Tax benefit from stock options exercised	179					179
Minority interest in income of subsidiaries					685	685
Distributions to minority interest partners		(656)				(656)
Decrease (increase) in accounts receivable		208	(3,956)	(23)		(3,771)
Decrease (increase) in inventory, prepaid expenses and other assets		271	(2,651)	(49)		(2,429)
Increase (decrease) in accounts payable and other accrued liabilities		3,110	(1,073)	22		2,059
Increase (decrease) in accrued payroll and related liabilities		1,499	394	(1)		1,892
Increase (decrease) in accrued interest		4,198	(7)			4,191
Decrease in prepaid income taxes		9,611	31			9,642
Increase in deferred income tax assets		(748)	218			(530)
Increase in deferred income tax liabilities		1,783	(249)			1,534
Increase in intercompany payable/(receivable)	(375)	27,599	(24,335)	(2,889)		

Net cash provided by (used in) operating activities	(195)	30,335	5,198	30	35,368
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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
**For the Three Months Ended March 31, 2005**  
**(In thousands)**

	<b>VCA</b>	<b>Vicar</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Elimination</b>	<b>Consolidated</b>
Cash flows used in investing activities:						
Business acquisitions, net of cash acquired	\$	\$ (14,322)	\$	\$	\$	\$ (14,322)
Real estate acquired in connection with business acquisitions		(221)				(221)
Property and equipment additions, net		(5,713)	(1,496)			(7,209)
Proceeds from sale of assets			92			92
Other	4	(9)	82			77
Net cash used in investing activities	4	(20,265)	(1,322)			(21,583)
Cash flows from financing activities:						
Repayment of long-term obligations		(3,414)				(3,414)
Proceeds from issuance of common stock under stock option plans	191					191
Net cash provided by (used in) financing activities	191	(3,414)				(3,223)
Increase in cash and cash equivalents		6,656	3,876	30		10,562
Cash and cash equivalents at beginning of period		27,947	2,944	73		30,964
Cash and cash equivalents at end of period	\$	\$ 34,603	\$ 6,820	\$ 103	\$	\$ 41,526



**Table of Contents****VCA ANTECH, INC. AND SUBSIDIARIES****NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)****CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Three Months Ended March 31, 2004****(In thousands)**

	<b>VCA</b>	<b>Vicar</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Elimination</b>	<b>Consolidated</b>
Cash flows from operating activities:						
Net income	\$ 14,744	\$ 14,743	\$ 19,499	\$ 1,842	\$ (36,084)	\$ 14,744
Adjustments to reconcile net income to net cash provided by (used in) operating activities:						
Equity interest in earnings of subsidiaries	(14,743)	(19,499)	(1,426)		35,668	
Depreciation and amortization		394	3,061	161		3,616
Amortization of debt costs		180	4			184
Provision for uncollectible accounts			569	59		628
Loss on sale of assets			62			62
Tax benefit from options exercised		323				323
Minority interest in income of subsidiaries					416	416
Distributions to minority interest partners		(374)				(374)
Increase in accounts receivable		(1)	(4,400)	(84)		(4,485)
Decrease (increase) in inventory, prepaid expenses and other assets		145	(156)	53		42
Increase (decrease) in accounts payable and other accrued liabilities		(71)	537	7		473
Increase (decrease) in accrued payroll and related liabilities		3,242	(1,458)			1,784
Increase (decrease) in accrued interest		4,093		(1)		4,092
Decrease in prepaid income taxes		6,038				6,038
Increase in deferred income tax assets		(393)				(393)
Increase in deferred income tax liabilities		2,386				2,386
Increase in intercompany payable/(receivable)	(423)	16,764	(14,314)	(2,027)		

Net cash provided by (used in) operating activities	(422)	27,970	1,978	10	29,536
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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
**For the Three Months Ended March 31, 2004**  
**(In thousands)**

	<b>VCA</b>	<b>Vicar</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Elimination</b>	<b>Consolidated</b>
Cash flows used in investing activities:						
Business acquisitions, net of cash acquired	\$	\$ (14,113)	\$	\$	\$	\$ (14,113)
Property and equipment additions, net		(2,719)	(746)			(3,465)
Proceeds from sale of assets		178				178
Other		12	83			95
Net cash used in investing activities		(16,642)	(663)			(17,305)
Cash flows from financing activities:						
Repayment of long-term obligations		(529)				(529)
Proceeds from issuance of common stock under stock option plans	422					422
Net cash provided by (used in) financing activities	422	(529)				(107)
Increase in cash and cash equivalents		10,799	1,315	10		12,124
Cash and cash equivalents at beginning of period		14,883	2,244	110		17,237
Cash and cash equivalents at end of period	\$	\$ 25,682	\$ 3,559	\$ 120	\$	\$ 29,361

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**10. Subsequent Events**

From April 1, 2005 through May 6, 2005, we acquired two animal hospitals, one of which was merged into an existing VCA animal hospital, for an aggregate consideration of \$1.4 million, consisting of \$1.3 million in cash and the assumption of liabilities of \$90,000.

On April 19, 2005, we announced our proposal to enter into a new senior credit facility providing for up to \$425.0 million in senior term notes and a \$75.0 million revolving credit facility. If consummated, the facility will provide for up to \$475.0 million in senior term notes. The new senior credit facility is intended, among other uses, to refinance the \$220.3 million of total outstanding senior term F notes and to provide the financing for a tender offer and consent solicitation for any and all of our outstanding \$170.0 million principal amount of 9.875% senior subordinated notes due 2009. If the existing senior term F notes are refinanced and the tender offer is consummated, we expect to incur debt retirement costs in the second quarter of 2005 related to the write-off of deferred financing costs and additional charges, including tender consideration, related to expenses with respect to both the refinancing of the senior term F notes and the purchase of the senior subordinated notes. The tender offer is contingent on the satisfaction of several conditions, including the receipt of sufficient funds from the anticipated new senior credit facility. Our intention to enter into the new senior credit facility and consummate the tender offer is dependent on final pricing of the senior credit facility, which will depend on market conditions. If we do not consider the pricing to be favorable, we will not consummate these transactions.

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

	<b>Page Number</b>
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### **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 May 6, 2005, and we undertake no duty to update this information. Shareholders and prospective investors can find information filed with the SEC after May 6, 2005 at our website at [www.investor.vcaantech.com](http://www.investor.vcaantech.com) or at the SEC's website at [www.sec.gov](http://www.sec.gov).*

The following Management's Discussion and Analysis of Financial Condition and Results of Operations describes the principal factors affecting the results of our operations for the quarter ended March 31, 2005 as well as our overall liquidity, capital resources and contractual cash obligations. In addition, we will discuss our significant accounting policies and estimates.

We are a leading animal healthcare services company operating primarily in the United States. We provide veterinary care and diagnostic testing to support veterinary care and we sell diagnostic imaging equipment and other medical technology products and 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 March 31, 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 March 31, 2005 our animal hospital network consisted of 320 animal hospitals in 37 states.

*Medical technology.* We sell ultrasound and digital radiography imaging equipment, related computer hardware, software and ancillary services to veterinarians. This segment is a new segment for our company and it is considerably smaller than our other two segments.

### **Executive Overview**

We had a strong first quarter marked by continued growth in our laboratory and animal hospital segments. Consolidated revenue increased 29.5% to a first quarter record of \$186.9 million and diluted earnings per common share increased to \$0.21. Our laboratory internal revenue growth, adjusted for one less billing day, was 10.1% for the

first quarter of 2005. Our laboratory gross profit increased 11.2% to \$23.9 million and our laboratory gross profit margin increased to 44.7% from 43.6% in the first quarter of 2004. Our consolidated animal hospital revenue for the first quarter of 2005 grew 36.1%, primarily the result of animal hospital same-store revenue growth, adjusted for one less business day, of 7.3% and the additional revenue of the animal hospitals acquired from National PetCare Centers, Inc., or NPC, in June of 2004. NPC operated 67 animal hospitals in 11 states at the date of acquisition. The increase in animal hospital revenue increased animal hospital gross profit 42.2% with gross profit margin growing to 19.3% from 18.5% in the first quarter of 2004.

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The acquisition of Sound Technologies, Inc., or STI, in October 2004 allowed us to enter into the digital diagnostic imaging segment of the animal healthcare industry, which we believe is an emerging and growing segment of animal healthcare. Our medical technology revenue and gross profit for the first quarter of 2005 was \$4.5 million and \$1.0 million, respectively.

Our growth strategy includes the acquisition of animal hospitals. In accord with that strategy, we acquired eight animal hospitals, one of which was merged into an existing animal hospital, in the first quarter of 2005.

In accordance with our NPC merger plan, we closed two animal hospital facilities in the first quarter of 2005.

In the first quarter of 2005, we opened a new laboratory facility in North Carolina to better service our customers in that region.

The following table summarizes our laboratory and animal hospital facilities growth and animal hospital closures:

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Laboratories:		
Beginning of period	27	23
New facilities	1	
End of period	28	23
Animal hospitals:		
Beginning of period	315	241
Acquisitions	8	9
Relocated into hospitals operated by us	(1)	(2)
Sold or closed	(2)	(1)
End of period	320	247

Though our operating results were strong for the first quarter of 2005, there are a variety of factors that could cause our future performance to soften. Such factors include, but are not limited to, the items discussed herein in the *Risk Factors* section.

**Subsequent Event**

On April 19, 2005, we announced our proposal to enter into a new senior credit facility providing for up to \$425.0 million in senior term notes and a \$75.0 million revolving credit facility. If consummated, the facility will provide for up to \$475.0 million in senior term notes. The new senior credit facility is intended, among other uses, to refinance the \$220.3 million of total outstanding senior term F notes and to provide the financing for a tender offer and consent solicitation for any and all of our outstanding \$170.0 million principal amount of 9.875% senior subordinated notes due 2009. If the existing senior term F notes are refinanced and the tender offer is consummated, we expect to incur debt retirement costs in the second quarter of 2005 related to the write-off of deferred financing



costs and additional charges, including tender consideration, related to expenses with respect to both the refinancing of the senior term F notes and the purchase of the senior subordinated notes. The tender offer is contingent on the satisfaction of several conditions, including the receipt of sufficient funds from the anticipated new senior credit facility. Our intention to enter into the new senior credit facility and consummate the tender offer is dependent on final pricing of the senior credit facility, which will depend on market conditions. If we do not consider the pricing to be favorable, we will not consummate these transactions.

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

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

	<b>Laboratory</b>	<b>Animal Hospital</b>	<b>Medical Technology</b>	<b>Corporate</b>	<b>Inter- company Eliminations</b>	<b>Total</b>
<b>Three Months Ended March 31, 2005</b>						
Revenue	\$ 53,439	\$ 133,354	\$ 4,484	\$	\$ (4,414)	\$ 186,863
Direct costs	29,570	107,619	3,445		(4,298)	136,336
Gross profit	23,869	25,735	1,039		(116)	50,527
Selling, general and administrative expense	3,365	3,703	1,567	5,497		14,132
Loss (gain) on sale of assets		(10)				(10)
Operating income (loss)	\$ 20,504	\$ 22,042	\$ (528)	\$ (5,497)	\$ (116)	\$ 36,405
Depreciation and amortization	\$ 902	\$ 2,744	\$ 299	\$ 397	\$	\$ 4,342
<b>Three Months Ended March 31, 2004</b>						
Revenue	\$ 49,182	\$ 97,956	\$	\$	\$ (2,788)	\$ 144,350
Direct costs	27,715	79,863			(2,788)	104,790
Gross profit	21,467	18,093				39,560
Selling, general and administrative expense	3,173	2,748		2,780		8,701
Loss (gain) on sale of assets	(1)	63				62
Operating income (loss)	\$ 18,295	\$ 15,282	\$	\$ (2,780)	\$	\$ 30,797
Depreciation and amortization	\$ 821	\$ 2,401	\$	\$ 394	\$	\$ 3,616

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

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Revenue:		
Laboratory	28.6%	34.1%
Animal hospital	71.4	67.9
Medical technology	2.4	
Intercompany	(2.4)	(2.0)
Total revenue	100.0	100.0
Direct costs	73.0	72.6
Gross profit	27.0	27.4
Selling, general and administrative expense	7.5	6.0
Loss (gain) on sale of assets		0.1
Operating income	19.5	21.3
Interest expense, net	3.6	4.1
Other expense		0.1
Minority interest in income of subsidiaries	0.4	0.3
Income before provision for income taxes	15.5	16.8
Provision for income taxes	6.3	6.6
Net income	9.2%	10.2%

***Revenue***

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

	<b>Three Months Ended March 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>% Change</b>
Laboratory	\$ 53,439	\$ 49,182	8.7%
Animal hospital	133,354	97,956	36.1%
Medical technology	4,484		
Intercompany	(4,414)	(2,788)	
Total revenue	\$ 186,863	\$ 144,350	29.5%

**Table of Contents***Laboratory Revenue*

Laboratory revenue increased \$4.3 million for the three months ended March 31, 2005 as compared to the same period in the prior year. The components of the increase in laboratory revenue are detailed below (in thousands, except percentages and average price per requisition):

<b>Laboratory Revenue:</b>	<b>Three Months Ended March 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>% Change</b>
Internal growth:			
Number of requisitions (2)	2,263	2,103	7.6%
Average revenue per requisition (1)	\$ 23.61	\$ 23.08	2.3%
Total internal revenue (2)	\$ 53,439	\$ 48,543	10.1%
Billing day adjustment (3)		639	
Total	\$ 53,439	\$ 49,182	8.7%

- 
- (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 three months ended March 31, 2004 as compared to the three months ended March 31, 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. In addition, we continue to see the impact from the recent migration of diagnostic testing from the human healthcare industry and the advent of medicine in the veterinary industry that requires diagnostic assessment and monitoring.

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.

**Table of Contents***Animal Hospital Revenue*

Animal hospital revenue increased \$35.4 million for the three months ended March 31, 2005 as compared to the same period in the prior year. The components of the increase are summarized in the following table (in thousands, except percentages and average price per order):

	Three Months Ended March 31,		
	2005	2004	% Change
<b>Animal Hospital Revenue:</b>			
Same-store facility:			
Orders (2)	855	863	(0.9)%
Average revenue per order (1)	\$ 119.15	\$ 109.91	8.4%
Same-store revenue (2)	\$ 101,837	\$ 94,945	7.3%
Business day adjustment (3)		1,073	
Net acquired revenue	31,517	1,938	
Total	\$ 133,354	\$ 97,956	36.1%

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- (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 three months ended March 31, 2004 as compared to the three months ended March 31, 2005.

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 other orders. In addition, our business strategy has placed greater emphasis on 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 also contributed to the increase in the average revenue per order, which approximated 2.5% to 6% on services at most hospitals in February 2005 and 2.5% to 5% in February 2004. Prices are reviewed on an annual basis for each hospital and adjustments are made based on market considerations, demographics and our costs.

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 January 1, 2004 for the three months ended March 31, 2005. Fluctuations in net acquired revenue occur due to the volume, size, and timing of acquisitions and disposals during the periods compared.

**Table of Contents***Medical Technology Revenue*

The components of revenue for our medical technology segment for the three months ended March 31, 2005 are summarized in the following table (in thousands):

	<b>Three Months Ended March 31, 2005</b>
<b>Medical Technology Revenue:</b>	
Ultrasound equipment	\$ 2,209
Digital radiography	865
Education and installation services	482
Consulting and mobile imaging services	928
 Total revenue	 \$ 4,484

We acquired our medical technology business on October 1, 2004 and consequently do not have comparative operating results for prior periods. At March 31, 2005, we had not fully integrated our medical technology division into our operations. As we complete the integration of this business we may make changes to its operations and the terms on which we sell the equipment, software and services that we offer. As a result of our integration plan and the seasonality of the medical technology industry, results for the three months ended March 31, 2005 may not be indicative of results experienced in future periods.

*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):

	<b>2005</b>		<b>Three Months Ended March 31, 2004</b>		
	<b>\$</b>	<b>Gross Profit Margin</b>	<b>\$</b>	<b>Gross Profit Margin</b>	<b>% Change</b>
Laboratory	\$ 23,869	44.7%	\$ 21,467	43.6%	11.2%
Animal hospital	25,735	19.3%	18,093	18.5%	42.2%
Medical technology	1,039	23.2%			
Intercompany	(116)				
 Total gross profit	 \$ 50,527	 27.0%	 \$ 39,560	 27.4%	 27.7%

*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,

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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.

The increase in animal hospital gross profit margin was primarily attributable to increases in animal hospital revenue combined with operating leverage associated with our laboratory business.

*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. At March 31, 2005, we had not fully integrated our medical technology division into our operations. As we complete the integration of this division we may make changes to operations and the terms on which we sell the equipment, software and services that we offer. Consequently, our gross profit margins for the three months ended March 31, 2005 may not be indicative of results experienced in future periods.

*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):

	<b>Three Months Ended March 31,</b>		<b>2004</b>		
	<b>2005</b>	<b>% of</b>		<b>% of</b>	<b>%</b>
	<b>\$</b>	<b>Revenue</b>	<b>\$</b>	<b>Revenue</b>	<b>Change</b>
Laboratory	\$ 3,365	6.3%	\$ 3,173	6.5%	6.1%
Animal hospital	3,703	2.8%	2,748	2.8%	34.8%
Medical technology	1,567	34.9%		0.0%	
Corporate	5,497	2.9%	2,780	1.9%	97.7%
Total SG&A	\$ 14,132	7.6%	\$ 8,701	6.0%	62.4%

*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.

*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. At March 31, 2005, we had not fully integrated our medical technology division into our operations. As we complete the integration of this division we may make changes to operations and the

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terms on which we sell the equipment, software and services that we offer. Consequently, results for the three months ended March 31, 2005 (including selling, general and administrative expense as a percentage of revenue) for the medical technology division may not be indicative of results experienced in future 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.

During the three months ended March 31, 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 excluding the partial reimbursement (in thousands, except percentages):

	<b>Three Months Ended March 31,</b>				
	<b>2005</b>		<b>2004</b>		
	<b>\$</b>	<b>% of Revenue</b>	<b>\$</b>	<b>% of Revenue</b>	<b>% Change</b>
Corporate SG&A as reported	\$ 5,497	2.9%	\$ 2,780	1.9%	97.7%
Impact of certain items:					
Litigation settlement reimbursement			(1,124)		
Legal fees reimbursement			(801)		
Corporate SG&A excluding the impact of certain items:	\$ 5,497	2.9%	\$ 4,705	3.3%	16.8%

Corporate SG&A, excluding the impact of certain items, as a percentage of total revenue decreased primarily as a result of an increase in total revenue combined with operating leverage.

*Interest Expense, Net*

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

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Interest expense:		
Senior term notes	\$ 2,420	\$ 1,342
9.875% senior subordinated notes	4,197	4,197
Interest rate hedging agreements	(94)	164
Amortization of deferred financing costs and debt discount	209	184
Secured and unsecured seller notes	61	33
Capital leases and other	148	155
	6,941	6,075
Interest income	274	90

Total interest expense, net of interest income	\$ 6,667	\$ 5,985
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The increase in interest expense related to our senior term notes was attributable to \$79.7 million in additional borrowings used to fund the NPC acquisition on June 1, 2004 and an increase in LIBOR.

***Provision for Income Taxes***

Our effective tax rate was 40.5% and 39.3% for the three months ended March 31, 2005 and 2004, respectively. The effective tax rate for the three months ended March 31, 2004 is slightly lower than our statutory rate primarily due to a litigation settlement reimbursement in the amount of \$1.1 million, which we discuss above in the *Corporate*

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SG&A section, which had no related tax expense. The effective tax rate for the three months ended March 31, 2005 approximates the statutory rate.

**Liquidity and Capital Resources**

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

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Cash provided by (used in):		
Operating activities	\$ 35,368	\$ 29,536
Investing activities	(21,583)	(17,305)
Financing activities	(3,223)	(107)
Increase in cash and cash equivalents	10,562	12,124
Cash and cash equivalents at beginning of year	30,964	17,237
Cash and cash equivalents at end of year	\$ 41,526	\$ 29,361

***Cash Flows from Operating Activities***

Net cash provided by operating activities increased \$5.8 million in the three months ended March 31, 2005 as compared to the comparable period in the prior year primarily due to improved operating performance and acquisitions. Our cash flows from operating activities for the three months ended March 31, 2005 as compared to the comparable period in the prior year were negatively impacted by an increase in interest paid of \$742,000 and a litigation settlement reimbursement received during the three months ended March 31, 2004.

On a prospective basis, we anticipate cash flow from operating activities to continue growing in line with increases in operating income resulting from improved operating performance and acquisitions. However, we also anticipate that operating cash flow may be negatively impacted by an increase in cash paid for interest as a result of interest rates rising. Interest rates have been at historical lows and are projected to increase over the next several years. Significant increases in interest rates may materially impact our operating cash flows because of the variable rate nature of our senior credit facility. In addition, our cash interest payments will change if we are successful in refinancing our existing senior credit facility and are able to pay off our outstanding \$170.0 million principal amount of 9.875% senior subordinated notes due 2009 as discussed further in *Subsequent Event* under Item 2 of this quarterly report.

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

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

Depending upon the attractiveness of the candidates and the strategic fit with our existing operations, we intend to acquire approximately 20 to 25 independent animal hospitals per year with aggregate annual revenues of approximately \$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. For example, in 2004 we acquired 85

animal hospitals, 67 of which were part of a chain operated by NPC, which we acquired in June 2004. We intend to primarily use cash in our acquisitions but, depending on the timing and amount of our acquisitions, we may use stock or debt. In 2005, we also intend to spend approximately \$25.0 million for property and equipment.

***Cash Flows from Financing Activities***

Net cash used in financing activities primarily consisted of cash used to repay our long-term obligations.

**Table of Contents*****Future Cash Requirements***

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

	<b>Total</b>	<b>2005 (1)</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Thereafter</b>
Long-term debt	\$ 393,142	\$ 2,536	\$ 29,214	\$ 109,056	\$ 81,714	\$ 170,086	\$ 536
Capital lease obligations	333	114	129	64	26		
Operating leases	360,840	17,345	23,036	22,943	22,720	22,243	252,553
Fixed cash interest expense	85,347	17,240	17,250	16,913	17,049	16,840	55
Variable cash interest expense (2)	33,938	8,759	13,065	9,470	2,644		
Swap agreements (2)	(99)	(99)					
Purchase obligations	12,912	8,189	4,008	330	330	55	
Other long-term liabilities	41,344						41,344
	<b>\$ 927,757</b>	<b>\$ 54,084</b>	<b>\$ 86,702</b>	<b>\$ 158,776</b>	<b>\$ 124,483</b>	<b>\$ 209,224</b>	<b>\$ 294,488</b>

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

(2) We have both fixed-rate and variable-rate debt. The interest payments on our variable-rate debt are based on a variable rate component plus a fixed 1.75%. Including the fixed 1.75%, we estimate that the interest rate on our variable rate debt will be 3.28%, 4.25%, 4.60% and 4.75% for years 2005 through 2008, respectively. These estimates are based on interest rate projections used to price our interest rate swap agreements. Our consolidated financial statements included in our 2004 annual report on Form 10-K discuss these variable-rate notes in more detail.

Our future cash commitments will change if we are successful in refinancing our existing senior credit facility and are able to pay off our outstanding \$170.0 million principal amount of 9.875% senior subordinated notes due 2009, as discussed further in *Subsequent Event* under Item 2 of this quarterly report.

The table above excludes certain contractual arrangements whereby additional cash may be paid to former owners of acquired companies, including STI, upon attainment of specified performance targets. We may be required to pay up to \$4.5 million in future periods if these performance targets are achieved.

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

***Debt Related Covenants***

Our senior credit facility contains certain financial covenants pertaining to interest coverage, fixed charge coverage and leverage ratios. In addition, the senior credit facility has restrictions pertaining to capital expenditures, acquisitions and the payment of cash dividends. In particular, the covenants limit our acquisition spending, without a waiver, to \$50.0 million per year plus up to \$5.0 million of any unused amount from the previous year. As of March 31, 2005, we were in compliance with these covenants. We currently believe the most restrictive covenant is

the fixed charge coverage ratio. The senior credit facility defines the fixed charge coverage ratio as that ratio which is calculated on a last 12-month basis by dividing pro forma earnings before interest, taxes, depreciation and amortization, as defined by the agreement, by fixed charges. Fixed charges are defined as cash interest expense, scheduled principal payments on debt obligations, capital expenditures, and provision for income taxes. At March 31, 2005, we had a fixed charge coverage ratio of 1.43 to 1.00, which was in compliance with the required ratio of no less than 1.10 to 1.00.

***Interest Rate Hedging Agreements***

We entered into certain no-fee swap agreements whereby we pay to counterparties amounts based on fixed interest rates and set notional principal amounts in exchange for the receipt of payments from the counterparties

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based on London interbank offer rates, LIBOR, and the same set notional principal amounts. A summary of these agreements is as follows:

	<b>Swap Agreements</b>	
Fixed interest rate	1.72 %	1.51 %
Notional amount	\$20.0 million	\$20.0 million
Effective date	5/30/2003	5/30/2003
Expiration date	5/31/2005	5/31/2005
Counter party	Wells Fargo Bank	Goldman Sachs

We entered into these swap agreements to hedge against the risk of increasing interest rates. The contracts effectively convert a certain amount of our variable rate debt under our senior credit facility to fixed rate debt for purposes of controlling cash paid for interest. That amount is equal to the notional amount of the swap agreements and the fixed rate conversion period is equal to the terms of the contract. The impact of these swap agreements has been factored into our future contractual cash requirements table above.

In the future, we may enter into additional interest rate strategies to take advantage of favorable current rate environments. We have not yet determined what those strategies will be or their possible impact. In addition, if we are successful in refinancing our existing senior credit facility as discussed in *Subsequent Event* under Item 2 of this quarterly report, we may be required by the new senior credit facility to hedge a certain amount of our variable rate debt.

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

At March 31, 2005, we had \$220.3 million principal amount outstanding under our senior term F notes and no borrowings outstanding under our revolving credit facility.

We pay interest on our senior term F notes and our revolving credit facility based on the interest rate offered to our administrative agent on the London interbank market, or LIBOR, plus an applicable margin. For our senior term F notes, that margin is 1.75% per annum and for our revolving credit facility that margin ranges from 2.00% to 3.25% per annum.

The senior term F notes mature in September 2008 and the revolving credit facility matures in September 2006.



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### *9.875% Senior Subordinated Notes*

On November 27, 2001, Vicar Operating, Inc., our wholly-owned subsidiary, issued \$170.0 million in principal amount of senior subordinated notes due December 1, 2009, which were exchanged on June 13, 2002 for substantially similar securities that are registered under the Securities Act. Interest on these senior subordinated notes is 9.875% per annum, payable semi-annually in arrears in cash. At March 31, 2005, the outstanding principal balance of these senior subordinated notes was \$170.0 million. We and each existing wholly-owned subsidiary of Vicar have jointly and severally, fully and unconditionally guaranteed these notes. These guarantees are unsecured and subordinated in right of payment to all existing and future indebtedness outstanding under the senior credit facility and any other indebtedness permitted to be incurred by Vicar under the terms of the indenture agreement governing these notes.

Beginning December 1, 2005, we can redeem all of our 9.875% senior subordinated notes at 104.9% of the principal amount. Pursuant to the terms of the indenture agreement, the redemption price decreases to 103.3% on December 1, 2006, 101.6% on December 1, 2007 and 100.0% on December 1, 2008.

If we are successful in refinancing our existing senior credit facility, we expect to use a portion of those proceeds to purchase our outstanding \$170.0 million principal amount of 9.875% senior subordinated notes due 2009, as discussed further in *Subsequent Event* under Item 2 of this quarterly report, at a purchase price of approximately 108.1%.

### *Other Debt*

At March 31, 2005, we had seller notes secured by assets of animal hospitals, unsecured debt and capital leases that totaled \$3.2 million.

## **Significant Accounting Policies**

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

### ***Revenue***

#### *Laboratory and Animal Hospital Revenue*

We recognize laboratory and animal hospital revenue only after the following criteria are met:

there exists adequate evidence of the transaction;

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

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

Approximately 8% of laboratory revenue for the three months ended March 31, 2005 was intercompany revenue that was generated by providing laboratory services to our animal hospitals. For purposes of reviewing the operating performance of the 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.

Our laboratories give discounts, such as those for prompt payment, to clients in periods subsequent to the period the related revenue was recognized, however, we report the related revenue net of those discounts. In order to net the discounts against the related revenue, we estimate the discounts based on historical experience. We do not expect that revisions to these discounts would have a material effect on our condensed, consolidated financial statements.

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### *Medical Technology Revenue*

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

While accounting for the sale of equipment is substantially governed by the requirements of Staff Accounting Bulletin, SAB, No. 104, *Revenue Recognition*, as amended, and the sale of software licenses and related items is governed by Statement of Position, SOP, No. 97-2, *Software Revenue Recognition*, as amended, the determination of the amount of software license, maintenance and professional service revenue to be recognized in each accounting period requires us to exercise judgment and use estimates.

We sell our ultrasound imaging equipment with and without related computer hardware and software. We account for the sale of ultrasound imaging equipment on a stand-alone basis under requirements of SAB No. 104. We account for the sale of ultrasound imaging equipment with related computer hardware and software by bifurcating the transaction and accounting for the ultrasound imaging equipment under SAB No. 104 and the computer hardware and software under SOP No. 97-2. The consensus reached by Emerging Issues Task Force, EITF, No. 03-5, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*, requires that arrangements that include software that is more than incidental to the products or services as a whole are to be accounted for under SOP 97-2. We have concluded that our software is incidental to the ultrasound imaging equipment because that equipment is manufactured as an out-of-the-box solution and many of our customers purchase it as such. We have also concluded that the software is more than incidental to the computer hardware we sell and therefore account for that portion of the sale under SOP 97-2.

We sell our digital radiography equipment with related computer hardware and software. The digital radiography equipment requires the computer hardware and software to function. As a result, we account for the digital radiography sales under SOP 97-2.

Under the residual method prescribed by SOP 97-2, revenue is recognized when vendor-specific objective evidence of fair value exists for all of the undelivered elements in the arrangement (i.e. maintenance and professional services), but does not exist for one or more of the delivered elements in the arrangement (i.e. the equipment, computer hardware or the software product). Each transaction requires careful analysis to ensure that all of the individual elements in the license transaction have been identified, along with the fair value of each element.

We allocate revenue to each undelivered element based on its fair value, with the fair value determined by the price charged when that element is sold separately. We are recognizing the revenue on the computer hardware and software we sell with our ultrasound equipment when the computer hardware is delivered, as there are no undelivered elements associated with the sale at that point in time. We recognize the revenue on the sale of ultrasound imaging equipment upon delivery as well as there are not undelivered elements associated with the sale. We are recognizing the revenue on computer hardware and software we sell with our digital radiography equipment over the period we are providing maintenance, ranging from one to four years. We are recognizing the revenue for the sale of the digital radiography equipment over that same period because the software and computer hardware we sell with this equipment is essential to its functionality.

In determining whether or not to recognize revenue, we evaluate each of these criteria:

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

Delivery: We consider delivery to have occurred when the ultrasound imaging equipment is delivered and the digital radiography equipment is installed. We recognize revenue for professional services when that

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service is provided or on a straight-line basis over the service contract term, based on the nature of the service or the terms of the contract.

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

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

Our software is ready to use by the customer upon receipt, and there is no significant customization of the underlying software code required to meet the individual needs of customers. We provide warranties for our software guaranteeing its performance for a defined period of time. Historically, the costs to satisfy these warranties have been nominal and we expect this to be the case in the future. Accordingly, we expense these costs as incurred.

Approximately 6% of our medical technology revenue for the three months ended March 31, 2005 was intercompany that was generated by providing products and services to our animal hospitals.

### ***Valuation of Goodwill***

Our goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to identifiable assets acquired and liabilities assumed. The total amount of our goodwill at March 31, 2005 was \$513.5 million, consisting of \$93.7 million for our laboratory segment, \$400.5 million for our animal hospital segment and \$19.3 million for our medical technology segment.

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

### ***Income Taxes***

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

We made judgments in assessing our ability to realize future benefits from our deferred tax assets. As such, we record a valuation allowance to reduce our deferred tax assets for the portion we believe will not be realized. At March 31, 2005 and 2004, we used valuation allowances to offset net operating loss and capital loss carryforwards and investment related expenditures where the realization of this deduction is uncertain.

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

estimates resulting in an increase in our future tax provision. In addition, there are certain tax contingencies that represent a possible future payment but not a probable one. While we have not recognized a liability for these possible future payments, they may result in future cash payments and increase our tax provision.

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### **New Accounting Pronouncements**

#### ***Share-Based Compensation***

In December 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or 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 123R to fiscal years beginning after June 15, 2005. We intend to adopt SFAS 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.

#### ***Inventory Costs***

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – An Amendment of ARB No. 43, Chapter 4*, effective for fiscal years beginning after June 15, 2005, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material or spoilage that may be incurred. Among other things, SFAS No. 151 requires that these items be recognized as charges to expense in the periods incurred and clarifies that fixed production overhead costs be allocated to inventory based on normal production capacity. Unallocated overhead costs associated with abnormally low or high production in a given period should be charged to expense in that period. SFAS No. 151 is effective for our company on January 1, 2006 and we do not expect it to have a material impact on our consolidated financial statements or the way we conduct our operations.

#### ***Accounting for Preexisting Relationships between the Parties to a Business Combination***

In October 2004, the FASB ratified the Emerging Issues Task Force, or EITF, consensus on Issue No. 04-1, *Accounting for Preexisting Relationships between the Parties to a Business Combination*. This consensus will require parties in a business combination that had a preexisting relationship to evaluate whether or not the acquisition resulted in the settlement of an existing contract, thus requiring accounting treatment separate from the business combination.

The consensus of EITF No. 04-1 must be applied as appropriate for our company beginning on January 1, 2005. We generally do not have preexisting contracts with the parties we acquire, and therefore, we do not expect that the application of EITF No. 04-1 will have a material impact on our consolidated financial statements or the way we conduct our operations.

### **Forward-Looking Statements**

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties, as well as assumptions that, if they materialize or prove incorrect, could cause our results and the results of our consolidated subsidiaries to differ materially from those expressed or implied by these forward-looking statements. We generally identify forward-looking statements in this report using words like believe, intend, expect, estimate, may, plan, should, project, contemplate, anticipate, predict, potential, continue, or similar expressions. You may find some of the statements below and elsewhere in this report. These forward-looking statements are not historical facts and are inherently uncertain and outside of our control. Any or all of our forward-looking statements in this report may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and

uncertainties. Many factors mentioned in our discussion in this report will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially. Factors that may cause our plans, expectations, future financial condition and results to change include those summarized in the section of this report captioned *Risk Factors*.

## **Risk Factors**

Because of the factors set forth below, and the other cautionary language contained above and in other sections of this quarterly report, investors in our common stock should not assume that the forward-looking statements



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contained in this quarterly report will prove to be a reliable indicator of future performance, and investors should not use these forward-looking statements to anticipate results or trends in future periods.

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

Our success depends in part on our ability to build on our position as a leading animal healthcare services company through a balanced program of internal growth initiatives and selective acquisitions of established animal hospitals, laboratories and related businesses. If we cannot implement or effectively execute these initiatives and acquisitions, our results of operations will be adversely affected. Even if we effectively implement our growth strategy, we may not achieve the economies of scale that we have experienced in the past or that we anticipate having in the future. For example, the animal hospitals we acquired as part of the acquisition of NPC have not achieved the same gross profit margin as our animal hospitals that existed at the time we acquired NPC. In addition, our medical technology division, acquired in October 2004, operates at lower gross profit margins than the combined gross profit margins for our laboratory and animal hospital divisions. Our internal growth rate may decline and could become negative. Our laboratory internal revenue growth has fluctuated between 9.8% and 14.1% for each fiscal year from 2002 through 2004. For the three months ended March 31, 2005, our laboratory internal revenue growth, adjusted for one less billing day, was 10.1%. Similarly, our animal hospital same-store revenue growth rate has fluctuated between 3.6% and 4.9% over the same fiscal years. For the three months ended March 31, 2005, our animal hospital same-store revenue growth, adjusted for one less business day, was 7.3%. Our internal growth may continue to fluctuate and may be below our historical rates. Any reductions in the rate of our internal growth may cause our revenues and margins to decrease. Investors should not assume that our historical growth rates and margins are reliable indicators of results in future periods.

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

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

Significantly more than a majority of our expense in 2004, particularly rent and personnel costs, are fixed costs and are based in part on expectations of revenue. We may be unable to reduce spending in a timely manner to compensate for any significant fluctuations in our revenue. Accordingly, shortfalls in revenue may adversely affect our operating income.

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

Our success depends on our ability to timely and cost-effectively acquire, and integrate into our business, additional animal hospitals, laboratories and related businesses. In 2004, we acquired 85 animal hospitals, 67 in a single acquisition of NPC, and a new medical technology division, a new business segment for us. We expect to continue our acquisition program in all segments of our business. If we acquire additional animal hospital chains in future periods, we will likely acquire a number of animal hospitals in that fiscal year greater than the 20 to 25 animal hospitals that has been our goal in recent years. In addition, we may acquire animal hospitals or laboratories in geographic territories where we do not have existing operations. Further, we may consider acquisitions of related

businesses, such as the medical technology division we acquired in 2004, in future periods. Any difficulties in the integration process may result in increased expense, loss of customers and a decline in profitability. In some cases, we have experienced delays and increased costs in integrating acquired businesses, particularly where we acquire a large number of animal hospitals in a single region at or about the same time. Further, the expansion into new territories and new business segments result in risks to successful integration of the acquired businesses that are new to our operations. As a consequence, our field management may spend a greater amount of time integrating these new businesses and less time managing our existing businesses. During these periods, there may be less attention directed to marketing efforts or staffing issues. We also may experience delays in converting the systems of acquired businesses into our systems, which could result in increased payroll expense to collect our results and

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delays in reporting our results, both for a particular region and on a consolidated basis. Further, the legal and business environment prevalent in new territories and with respect to new businesses may pose risks that we do not anticipate and adversely impact our ability to integrate newly acquired operations. For all of these reasons, our historical success in integrating acquired businesses is not a reliable indicator of our ability to do so in the future. If we are not successful in timely and cost-effectively integrating future acquisitions, it could result in decreased revenue, increased costs and lower margins.

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

negative effects on our operating results;

impairments of goodwill and other intangible assets;

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

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

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

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

In October 2004 we acquired STI, which we now operate as our medical technology division. This acquisition poses numerous risks, in addition to the risks discussed in the immediately preceding paragraphs. STI sells medical imaging equipment and related software and services. At the time of the acquisition, our existing management had no experience in this industry and consequently may not be as effective in managing and overseeing these operations as in the case of business segments where they have significant operating experience. Advanced medical imaging equipment has not been widely adopted in the veterinary market and no clear market leader has emerged. As advanced medical imaging equipment becomes more common in the veterinary industry and generates more significant aggregate revenues, the competition may increase, along with greater price pressures and demands for research and development and market differentiation. Our medical technology division does not manufacture the principal products it distributes and is dependent upon distribution agreements with the manufacturers of the equipment for its future business. If these distribution agreements terminate and are not renewed, or if the manufacturers breach their covenants under these agreements, or the equipment manufactured by these manufacturers becomes less competitive, the demand for our products and services would decrease. Any reduction in demand could lead to fewer customer orders, reduced revenues, pricing pressures, reduced margins, reduced levels of profitability and loss of market share. STI was a relatively young company at the time of our acquisition and lacked the financial and operating infrastructure and controls which we have in our other operations. As part of the integration of STI into our operations, we will be required to expand its financial and operating infrastructure and strengthen its control environment to meet the standards that prevail in the remainder of our operations. The failure to timely integrate this operation and achieve these objectives could result in an adverse impact on our revenues, margins and profitability.

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

At March 31, 2005, our balance sheet reflected \$513.5 million of goodwill, which was a substantial portion of our total assets of \$766.6 million at that date. We expect that the aggregate amount of goodwill on our balance sheet will

increase as a result of future acquisitions. We continually evaluate whether events or circumstances have occurred that suggest that the fair market value of each of our reporting units is below their carrying values. If we determine that the fair market value of one of our reporting units is less than its carrying value, this may result in an impairment write-down of the goodwill for that reporting unit. The impairment write-down would be reflected as expense and could have a material adverse effect on our results of operations during the period in which we recognize the expense. At December 31, 2004, we concluded that the fair value of our reporting units exceeded their carrying value and accordingly, as of that date, our goodwill was not impaired in our consolidated financial

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statements. However, in the future we may incur impairment charges related to the goodwill already recorded or arising out of future acquisitions.

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

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

At March 31, 2005, our debt consisted of:

\$220.3 million in principal amount outstanding under our senior term F notes;

\$170.0 million in principal amount outstanding under our 9.875% senior subordinated notes; and

\$3.2 million in principal amount outstanding under our other debt.

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

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

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

limit our funds available to repay the 9.875% senior subordinated notes;

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

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

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

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

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

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

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

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

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

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

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

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

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

Our medical technology division is a relatively new entrant in the market for medical imaging equipment in the animal healthcare industry. Our primary competitors are companies that are much larger than us and have substantially greater capital, manufacturing, marketing and research and development resources than we do, including companies such as Siemens, Phillips and Canon. The success of our medical technology division, in part, is due to its focus on the veterinary market, which allows it to differentiate its products and services to meet the unique needs of this market. If this market receives more focused attention from these larger competitors, we may find it difficult to compete and as a result our revenues and operating margins could decline. If we fail to compete successfully in this market, the demand for our products and services would decrease. Any reduction in demand could lead to fewer customer orders, reduced revenues, pricing pressures, reduced margins, reduced levels of profitability and loss of market share. These competitive pressures could adversely affect our business and operating results.

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

As the pet population continues to grow, the need for skilled veterinarians continues to increase. If we are unable to retain an adequate number of skilled veterinarians, we may lose customers, our revenue may decline and we may need to sell or close animal hospitals. As of March 31, 2005, there were 28 veterinary schools in the country accredited by the American Veterinary Medical Association. These schools graduate approximately 2,100 veterinarians per year. There is a shortage of skilled veterinarians in some regional markets in which we operate animal hospitals. During shortages in these regions, we may be unable to hire enough qualified veterinarians to adequately staff our animal hospitals, in which event we may lose market share and our revenues and profitability may decline.



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

The laws of many states prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. These laws vary from state to state and are enforced by the courts and by regulatory authorities with broad discretion. As of March 31, 2005, we operated 102 animal hospitals in 13 states with these laws, including 24 in New York and 26 in Texas. In addition, our mobile imaging service also operates in states with these laws. We may experience difficulty in expanding our operations into other states with similar laws. Given varying and uncertain interpretations of the veterinary laws of each state, we may not be in compliance with restrictions on the corporate practice of veterinary medicine in all states. A determination that we are in violation of applicable restrictions on the practice of veterinary medicine in any state in which we operate could have a material adverse effect on us, particularly if we were unable to restructure our operations to comply with the requirements of that state.

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

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

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

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

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

Any substantial reduction in the number of available flights or delays in the departure of flights, whether as a result of severe weather conditions, a terrorist attack or any other type of disruption, will disrupt our transportation network and our ability to provide test results in a timely manner. Any change in government regulation related to transporting samples or specimens could also have an impact on our business. In addition, our Test Express service, which services customers outside of major metropolitan areas, is dependent on flight services in and out of Memphis and the transportation network of Federal Express. Any sustained interruption in either flight services in Memphis or the transportation network of Federal Express would result in increased turn-around time for the reporting of test results to

customers serviced by our Test Express service.

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

We have adopted a program of self-insurance with regard to certain risks such as earthquakes and other natural disasters. In addition, our other insurance programs including, but not limited to, hurricanes, floods, health benefits and workers' compensation include large deductible provisions. We self-insure and use large-deductible insurance

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

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

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

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As of March 31, 2005, we had borrowings of \$220.3 million under our senior credit facility with fluctuating interest rates based on market benchmarks such as LIBOR. To reduce the risk of increasing interest rates, we enter into no-fee interest rate swap agreements. Currently, we are engaged in two agreements, both agreements are for \$20.0 million and commenced on May 30, 2003 and expire on May 31, 2005. These swap agreements have the effect of reducing the amount of our debt exposed to variable interest rates. Accordingly, for the 12-month period ending March 31, 2006, for every 1.0% increase in LIBOR we will pay an additional \$2.1 million in interest expense and for every 1.0% decrease in LIBOR we will save \$2.1 million in interest expense.

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

## **ITEM 4. CONTROLS AND PROCEDURES**

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

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

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

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management override of the controls. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are not subject to any legal proceedings other than ordinarily routine litigation incidental to the conduct of our business.

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

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

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

None

**ITEM 5. OTHER INFORMATION**

(a) On April 15, 2005, Dawn Olsen, our Principal Accounting Officer, was awarded a discretionary bonus of \$60,000 for services performed during 2004

(b) None

**ITEM 6. EXHIBITS**

(a) Exhibits:

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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

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**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on May 6, 2005.

Date: May 6, 2005

By: /s/ Tomas W. Fuller  
Tomas W. Fuller  
Chief Financial Officer

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**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.