VCA ANTECH INC
Form 10-Q
November 08, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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

Commission File Number: 001-16783

VCA ANTECH, INC.
(Exact name of registrant as specified in its charter)

Delaware	**95-4097995**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

12401 West Olympic Boulevard
Los Angeles, California 90064-1022
(Address of principal executive offices)
(310) 571-6500
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

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 83,498,763 shares as of November 3, 2006.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

VCA ANTECH, INC. AND SUBSIDIARIES
CONDENSED, CONSOLIDATED BALANCE SHEETS
As of September 30, 2006 and December 31, 2005
(Unaudited)
(In thousands, except par value)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 32,821	$ 58,488
Trade accounts receivable, less allowance for uncollectible accounts of $11,100 and $9,409 at September 30, 2006 and December 31, 2005, respectively	41,091	36,104
Inventory	20,483	17,856
Prepaid expenses and other	12,315	9,867
Deferred income taxes	11,850	10,972
Prepaid income taxes	18,235	12,337
Total current assets	136,795	145,624
Property and equipment, less accumulated depreciation and amortization of $106,551 and $93,305 at September 30, 2006 and December 31, 2005, respectively	159,287	143,781
Other assets:		
Goodwill	615,784	586,444
Other intangible assets, net	15,006	10,735
Deferred financing costs, net	1,041	1,340
Other	10,459	9,149
Total assets	$ 938,372	$ 897,073
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations	$ 6,620	$ 5,884
Accounts payable	18,021	20,718
Accrued payroll and related liabilities	28,203	30,131
Accrued interest	314	306
Other accrued liabilities	28,778	23,930
Total current liabilities	81,936	80,969
Long-term obligations, less current portion	385,403	446,828
Deferred income taxes	38,267	30,803
Other liabilities	13,975	19,775

Minority interest		10,181		9,947
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, 83,460 and 82,759 shares outstanding as of September 30, 2006 and December 31, 2005, respectively		83		83
Additional paid-in capital		272,603		258,402
Retained earnings		135,246		49,057
Accumulated other comprehensive income		678		1,209
Total stockholders equity		408,610		308,751
Total liabilities and stockholders equity	$	938,372	$	897,073

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

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VCA ANTECH, INC. AND SUBSIDIARIES
CONDENSED, CONSOLIDATED INCOME STATEMENTS
For the Three and Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue	$ 251,632	$ 229,242	$ 740,962	$ 622,689
Direct costs	181,167	166,598	532,014	448,783
Gross profit	70,465	62,644	208,948	173,906
Selling, general and administrative expense	18,946	18,394	57,315	47,943
Loss (gain) on sale of assets	3	115	(200)	27
Operating income	51,516	44,135	151,833	125,936
Interest expense, net	6,084	6,034	18,323	18,782
Debt retirement costs				19,282
Other expense (income)	73	(130)	(24)	1
Minority interest in income of subsidiaries	846	778	2,520	2,309
Income before provision for income taxes	44,513	37,453	131,014	85,562
Provision for income taxes	17,536	15,196	44,825	34,797
Net income	$ 26,977	$ 22,257	$ 86,189	$ 50,765
Basic earnings per common share	$ 0.32	$ 0.27	$ 1.04	$ 0.62
Diluted earnings per common share	$ 0.32	$ 0.26	$ 1.02	$ 0.61
Shares used for computing basic earnings per share	83,339	82,526	83,092	82,364
Shares used for computing diluted earnings per share	85,187	84,019	84,864	83,818

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

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VCA ANTECH, INC. AND SUBSIDIARIES
CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(In thousands)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 86,189	$ 50,765
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,347	13,947
Amortization of debt costs	299	482
Provision for uncollectible accounts	4,174	2,996
Debt retirement costs		19,282
Loss (gain) on sale of assets	(200)	27
Share-based compensation	2,326	
Minority interest in income of subsidiaries	2,520	2,309
Distributions to minority interest partners	(2,439)	(1,968)
Deferred income taxes	7,222	4,029
Excess tax benefit from exercise of stock options	(5,774)	
Other	(750)	(337)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(8,500)	(7,009)
Increase in inventory, prepaid expenses and other assets	(6,816)	(5,796)
Increase (decrease) in accounts payable and other accrued liabilities	(2,507)	4,439
Decrease in accrued payroll and related liabilities	(1,928)	(3,862)
Increase (decrease) in accrued interest	8	(1,251)
Decrease in prepaid income taxes	567	13,161
Net cash provided by operating activities	90,738	91,214
Cash flows from investing activities:		
Business acquisitions, net of cash acquired	(37,612)	(83,702)
Real estate acquired in connection with business acquisitions	(2,872)	(2,929)
Property and equipment additions	(23,800)	(22,725)
Proceeds from sale of assets	533	368
Other	268	3,540
Net cash used in investing activities	(63,483)	(105,448)
Cash flows from financing activities:		
Repayment of long-term obligations	(64,106)	(445,721)
Proceeds from the issuance of long-term obligations		475,000
Payment of financing costs		(3,257)
Proceeds from issuance of common stock under stock option plans	5,410	1,749
Excess tax benefit from exercise of stock options	5,774	

Net cash provided by (used in) financing activities	(52,922)	27,771
Increase (decrease) in cash and cash equivalents	(25,667)	13,537
Cash and cash equivalents at beginning of period	58,488	30,964
Cash and cash equivalents at end of period	$ 32,821	$ 44,501

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

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VCA ANTECH, INC. AND SUBSIDIARIES
NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006
(Unaudited)

1. General

The accompanying unaudited, condensed, consolidated financial statements of our company, VCA Antech, Inc. and subsidiaries, have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the rules and regulations of the United States Securities and Exchange Commission. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles in the United States for annual financial statements as permitted under applicable rules and regulations. In the opinion of our management, all normal recurring adjustments considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year. For further information, refer to our consolidated financial statements and notes thereto included in our 2005 annual report on Form 10-K.

The preparation of our condensed, consolidated financial statements in accordance with generally accepted accounting principles in the United States requires our management to make estimates and assumptions that affect the amounts reported in our condensed, consolidated financial statements and notes thereto. Actual results could differ from those estimates.

2. Acquisitions

During the nine months ended September 30, 2006, we acquired 17 animal hospitals, four of which were merged into existing animal hospitals, two laboratories, one of which was merged into an existing laboratory, and a lab-related business that we will utilize in our laboratory operations. The following table summarizes the aggregate consideration, including acquisition costs, paid by us for those acquisitions that occurred during the nine months ended September 30, 2006 and the allocation of the purchase price (in thousands):

Consideration:	
Cash	$ 35,812
Notes payable and other liabilities assumed	4,844
Total	$ 40,656
Purchase Price Allocation:	
Tangible assets	$ 4,371
Identifiable intangible assets (1)	6,932
Goodwill (2)	29,353
Total	$ 40,656

(1) The acquired identifiable intangible assets have a weighted-average useful life of approximately 19 years and are comprised of

non-contractual customer relationships of $4.9 million (25-year weighted-average useful life), covenants not-to-compete of $2.0 million (five-year weighted-average useful life) and client lists of $14,000 (three-year weighted-average useful life).

(2) We expect that $25.6 million of the goodwill recorded for these acquisitions will be fully deductible for income tax purposes.

Other Acquisition Payments

In connection with certain acquisitions, we withheld a portion of the purchase price, or the holdback, as security for indemnification obligations of the sellers under the acquisition agreement. We paid $1.7 million to sellers for the unused portion of holdbacks during the nine months ended September 30, 2006.

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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 for the nine months ended September 30, 2006 (in thousands):

	Laboratory	Animal Hospital	Medical Technology	Total
Balance as of December 31, 2005	$ 94,246	$ 473,038	$ 19,160	$ 586,444
Goodwill acquired	877	28,476		29,353
Other (1)		8		8
Goodwill related to sale of animal hospitals		(21)		(21)
Balance as of September 30, 2006	$ 95,123	$ 501,501	$ 19,160	$ 615,784

(1) Comprised of purchase price adjustments.

In addition to goodwill, we have amortizable intangible assets at September 30, 2006 and December 31, 2005 as follows (in thousands):

	September 30, 2006			December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Covenants not-to-compete	$ 12,231	$ (5,761)	$ 6,470	$ 11,145	$ (4,970)	$ 6,175
Non-contractual customer relationships	8,313	(1,346)	6,967	3,235	(701)	2,534
Technology	1,270	(504)	766	1,270	(314)	956
Trademarks	569	(113)	456	569	(70)	499
Contracts	397	(207)	190	397	(129)	268
Client lists	464	(307)	157	461	(158)	303
Total	$ 23,244	$ (8,238)	$ 15,006	$ 17,077	$ (6,342)	$ 10,735

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Aggregate amortization expense	$ 933	$ 796	$ 2,661	$ 2,393

The estimated amortization expense related to intangible assets for each of the five succeeding years and thereafter as of September 30, 2006 is as follows (in thousands):

Remainder of 2006	$ 906
2007	3,398
2008	2,777

2009	1,733
2010	997
Thereafter	5,195
Total	$ 15,006

4. Share-Based Compensation Plans

Stock Incentive Plans

At September 30, 2006, there were 5,389,377 shares of common stock issuable upon exercise of outstanding options granted under our existing stock incentive plans. We maintain three plans, the 1996 Stock Incentive Plan, or the 1996 Plan, the 2001 Stock Incentive Plan, or the 2001 Plan, and the 2006 Equity Incentive Plan, or the 2006 Plan. New options and other stock awards may only be granted under the 2006 Plan. The maximum aggregate number of shares of common stock that may be issued under the 2006 Plan to our employees, directors, consultants and those of our affiliates is (a) 6,490,412 shares of common stock; plus (b) any shares of common stock underlying prior outstanding options that expire, are forfeited, cancelled or terminate for any reason without having been exercised in full. At September 30, 2006, all of these shares were available for grant. Outstanding options granted under our plans typically vest over periods that range from two to four years and expire between seven and ten years from the date of grant.

Adoption of SFAS No. 123R

Prior to January 1, 2006, we accounted for our share-based payments 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. Accordingly, we recognized no share-based compensation expense in periods prior to January 1, 2006.

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards, or SFAS, No. 123R, *Share-Based Payment*. SFAS No. 123R requires us to measure the cost of share-based payments granted to our employees and directors, including stock options, based on the grant-date fair value and to recognize the cost over the requisite service period, which is typically the vesting period. We adopted SFAS No. 123R using the modified prospective transition method, which requires us to recognize compensation expense for share-based payments granted or modified on or after January 1, 2006. Additionally, we are required to recognize compensation expense for the fair value of unvested share-based awards at January 1, 2006 over the remaining requisite service period. Operating results from prior periods have not been restated.

The effect of adopting SFAS No. 123R on our condensed, consolidated financial statements for the three and nine months ended September 30, 2006 is as follows (in thousands, except per share amounts):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Share-based compensation:		
Laboratory direct cost	$ 172	$ 492
Laboratory selling, general and administrative expense	128	382
Animal hospital selling, general and administrative expense	376	807
Corporate selling, general and administrative expense	205	645
	881	2,326
Tax benefit	(334)	(878)
Net decrease in net income	$ 547	$ 1,448
Effect on:		
Basic earnings per common share	$ 0.01	$ 0.01
Diluted earnings per common share	$	$ 0.01

Effect on:		
Cash flows from operating activities	$	(5,774)
Cash flows from financing activities	$	5,774

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No share-based compensation was recognized during the three and nine months ended September 30, 2005, however, the following table presents net income and earnings per common share as if we had recognized share-based compensation using the fair-value-based method (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 22,257	$ 50,765
Deduct: Total share-based compensation determined under fair-value-based method for all awards, net of tax	(503)	(4,457)
Pro forma net income	$ 21,754	$ 46,308
Earnings per common share:		
Basic as reported	$ 0.27	$ 0.62
Basic pro forma	$ 0.26	$ 0.56
Diluted as reported	$ 0.26	$ 0.61
Diluted pro forma	$ 0.26	$ 0.55

Prior to the adoption of SFAS No. 123R, we reported all income tax benefits resulting from the exercise of stock options as cash provided by operating activities on our condensed, consolidated statements of cash flows. SFAS No. 123R requires the benefits of tax deductions from the exercise of options in excess of the compensation cost for those options to be classified as cash provided by financing activities. As such, the $5.8 million excess tax benefit classified as a financing activity on our condensed, consolidated statement of cash flows for the nine months ended September 30, 2006 would have been recognized as an operating activity if we had not adopted SFAS No. 123R.

Calculation of Fair Value

The fair value of our options is estimated on the date of grant using the Black-Scholes option pricing model. We amortize the fair value of our options on a straight-line basis over the requisite service period. There were 39,341 options granted during the nine months ended September 30, 2006 with a weighted-average fair value of $10.97. The weighted-average fair value of options granted during the nine months ended September 30, 2005 was $8.05. No options were granted during the three months ended September 30, 2006 and 2005. The following assumptions were used to determine the fair value of those options granted during the nine months ended September 30, 2006 and 2005:

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Expected volatility (1)	35.5%	39.1% to 39.6%
Weighted-average volatility (1)	35.5%	39.5%
Expected dividends	0.0%	0.0%
Expected term (2)	4.3 years	5 years
Risk-free rate (3)	4.99%	3.9% to 4.2%

(1) We estimate the volatility of our common stock on the date of

grant based on historical volatility.

(2) The expected term represents the period of time that we expect the options to be outstanding. We estimated the expected term based on the simplified method permitted under SEC Staff Accounting Bulletin, or SAB, No. 107.

(3) The risk-free interest rate is based on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with equivalent remaining terms.

We use historical data to estimate pre-vesting option forfeitures. We recognize share-based compensation only for those awards that we expect to vest.

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Stock Option Activity

A summary of our stock option activity for all share-based compensation plans during the nine months ended September 30, 2006 is as follows (in thousands, except weighted-average exercise price and weighted-average remaining contractual term):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options outstanding at January 1, 2006	6,090	$ 14.58		
Granted	39	30.70		
Exercised	(701)	7.72		
Canceled	(39)	16.50		
Options outstanding at September 30, 2006	5,389	$ 15.58	5.3	$ 110,382
Options exercisable at September 30, 2006	4,372	$ 15.58	5.4	$ 89,552
Options expected to vest at September 30, 2006	991	$ 15.57	4.5	$ 20,300

The total intrinsic value of options exercised during the nine months ended September 30, 2006 was $16.5 million and the total tax benefit realized on the options exercised was $6.5 million.

At September 30, 2006, there was $4.1 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our stock incentive plans. This cost is expected to be recognized over a weighted-average period of 1.9 years.

5. Long-Term Obligations and Interest Rate Hedging Agreements

During the nine months ended September 30, 2006, we prepaid $60.0 million of our senior term notes.

In June 2006, we entered into a no-fee swap agreement with a fixed interest rate of 5.51% and a set notional amount of $50.0 million to hedge against the risk of increasing interest rates.

At September 30, 2006, we had four no-fee swap agreements with an aggregate notional amount of $200.0 million, a weighted-average fixed-interest rate of 4.4% and a fair market value of $1.4 million. At December 31, 2005, we had three no-fee swap agreements with an aggregate notional amount of $150.0 million, a weighted- average fixed-interest rate of 4.0% and a fair market value of $2.2 million. The fair market value of these no-fee swap agreements is included in prepaid expenses and other in our condensed, consolidated balance sheets. As of September 30, 2006, all four of our no-fee swap agreements qualify for hedge accounting.

6. Income Taxes

In prior periods we recognized contingent liabilities for differences between the probable tax bases and the as-filed tax bases of certain assets and liabilities. These amounts totaled $6.8 million and were recorded in other liabilities in our condensed, consolidated balance sheets at December 31, 2005. During the first quarter of 2006, we determined that these contingencies no longer existed due to the outcome of an income tax audit and recognized a tax benefit of $6.8 million.

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7. Calculation of Earnings per Common Share

Basic earnings per common share is calculated by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income by the weighted-average number of common shares outstanding after giving effect to all potentially dilutive common shares outstanding during the period. Basic and diluted earnings per common share were calculated as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Net income	$ 26,977	$ 22,257	$ 86,189	$ 50,765
Weighted-average common shares outstanding:				
Basic	83,339	82,526	83,092	82,364
Effect of dilutive potential common shares:				
Stock options	1,848	1,493	1,772	1,454
Diluted	85,187	84,019	84,864	83,818
Basic earnings per common share	$ 0.32	$ 0.27	$ 1.04	$ 0.62
Diluted earnings per common share	$ 0.32	$ 0.26	$ 1.02	$ 0.61

8. Lines of Business

We have four reportable segments: Laboratory, Animal Hospital, Medical Technology and Corporate. These segments are strategic business units that have different products, services and/or functions. The segments are managed separately because each is a distinct and different business venture with unique challenges, risks and rewards. 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 imaging equipment, related computer hardware, software and ancillary services to the veterinary market. The Corporate segment provides selling, general and administrative support services for the other segments.

The accounting policies of our segments are the same as those described in the summary of significant accounting policies included in our 2005 annual report on Form 10-K. We evaluate the performance of our segments based on gross profit and operating income. 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):

	Laboratory	Animal Hospital	Medical Technology	Corporate	Intercompany Eliminations	Total
Three Months Ended September 30, 2006						
External revenue	$ 60,261	$ 183,592	$ 7,779	$	$	$ 251,632
Intercompany revenue	5,793		1,177		(6,970)	
Total revenue	66,054	183,592	8,956		(6,970)	251,632
Direct costs	36,041	146,132	5,530		(6,536)	181,167
Gross profit	30,013	37,460	3,426		(434)	70,465
Selling, general and administrative expense	4,350	5,161	2,534	6,901		18,946
Loss (gain) on sale of assets	6	(3)				3
Operating income (loss)	$ 25,657	$ 32,302	$ 892	$ (6,901)	$ (434)	$ 51,516
Depreciation and amortization	$ 1,221	$ 3,577	$ 315	$ 424	$ (41)	$ 5,496
Capital expenditures	$ 2,388	$ 4,747	$ 404	$ 1,354	$ (160)	$ 8,733
Three Months Ended September 30, 2005						
External revenue	$ 51,600	$ 167,815	$ 9,827	$	$	$ 229,242
Intercompany revenue	4,955		768		(5,723)	
Total revenue	56,555	167,815	10,595		(5,723)	229,242
Direct costs	31,478	133,571	6,881		(5,332)	166,598
Gross profit	25,077	34,244	3,714		(391)	62,644
Selling, general and administrative expense	3,636	4,072	2,806	7,880		18,394
Loss on sale of assets		115				115
Operating income (loss)	$ 21,441	$ 30,057	$ 908	$ (7,880)	$ (391)	$ 44,135
Depreciation and amortization	$ 1,025	$ 3,383	$ 320	$ 454	$ (20)	$ 5,162
Capital expenditures	$ 3,080	$ 4,214	$ 191	$ 915	$ (356)	$ 8,044

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	Laboratory	Animal Hospital	Medical Technology	Corporate	Intercompany Eliminations	Total
Nine Months Ended September 30, 2006						
External revenue	$ 177,964	$ 540,117	$ 22,881	$	$	$ 740,962
Intercompany revenue	17,100		2,467		(19,567)	
Total revenue	195,064	540,117	25,348		(19,567)	740,962
Direct costs	103,977	430,409	16,276		(18,648)	532,014
Gross profit	91,087	109,708	9,072		(919)	208,948
Selling, general and administrative expense	12,793	15,107	7,734	21,681		57,315
Loss (gain) on sale of assets	14	(214)				(200)
Operating income (loss)	$ 78,280	$ 94,815	$ 1,338	$ (21,681)	$ (919)	$ 151,833
Depreciation and amortization	$ 3,373	$ 10,674	$ 1,089	$ 1,320	$ (109)	$ 16,347
Capital expenditures	$ 5,352	$ 16,124	$ 489	$ 2,294	$ (459)	$ 23,800
Nine Months Ended September 30, 2005						
External revenue	$ 154,532	$ 449,128	$ 19,029	$	$	$ 622,689
Intercompany revenue	13,739		1,408		(15,147)	
Total revenue	168,271	449,128	20,437		(15,147)	622,689
Direct costs	91,947	357,332	14,026		(14,522)	448,783
Gross profit	76,324	91,796	6,411		(625)	173,906
Selling, general and administrative expense	10,347	11,582	6,295	19,719		47,943
Loss on sale of assets		27				27
Operating income (loss)	$ 65,977	$ 80,187	$ 116	$ (19,719)	$ (625)	$ 125,936
Depreciation and amortization	$ 2,805	$ 9,034	$ 921	$ 1,223	$ (36)	$ 13,947
Capital expenditures	$ 5,941	$ 13,081	$ 436	$ 4,014	$ (747)	$ 22,725
At September 30, 2006						
Total assets	$ 165,740	$ 655,457	$ 47,158	$ 74,308	$ (4,291)	$ 938,372
At December 31, 2005						
Total assets	$ 146,902	$ 614,492	$ 47,114	$ 90,977	$ (2,412)	$ 897,073

9. Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board, or FASB, issued Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in tax positions. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. FIN 48 will be effective for our company on January 1, 2007. We are currently evaluating the impact of adopting FIN 48 on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The provisions of SFAS No. 157 will be effective for our company on January 1, 2008. We are currently evaluating the impact of adopting SFAS No. 157 on our consolidated financial statements.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual-approach includes both an income statement focused assessment and a balance sheet focused assessment. The guidance in SAB No. 108 must be applied to our annual consolidated financial statements for the fourth quarter of 2006. We are currently assessing

the impact of adopting SAB No. 108, however, we do not expect that it will have a material effect on our consolidated financial statements.

10. Commitments and Contingencies

We have certain commitments, including operating leases and supply purchase agreements, incidental to the ordinary course of our business. These items are discussed in detail in our consolidated financial statements and notes thereto included in our 2005 annual report on Form 10-K. We also have contingencies, which are discussed below.

a. Earn-out Payments

We have contractual arrangements in connection with certain acquisitions, whereby additional cash may be paid to former owners of acquired companies upon attainment of specified financial criteria as set forth in the respective agreements. The amount to be paid cannot be determined until the earn-out periods expire and the attainment of criteria is established. If the specified financial criteria are attained, we will be obligated to pay an additional $413,000.

b. Officers Compensation

Each of our Chief Executive Officer, Chief Operating Officer and Chief Financial Officer has entered into employment agreements with our company. The agreements provide for a base salary and annual bonuses set by our Compensation Committee of the Board of Directors.

As of any given date, unless any of those agreements are sooner terminated pursuant to their respective provisions, the Chief Executive Officer has five years remaining under the term of his employment agreement, the Chief Operating Officer has three years remaining under the term of his employment agreement, and the Chief Financial Officer has two years remaining under the term of his employment agreement. In addition, these employment agreements provide for certain payments in the event an officer s employment with our company is terminated.

In the event any of these officers employment is terminated due to death or disability, each officer, or their estate, is entitled to receive the remaining base salary during the remaining scheduled term of his employment agreement, the acceleration of the vesting of his options, which options shall remain exercisable for the full term, and the right to continue receiving specified benefits and perquisites.

In the event any of these officers terminate their employment agreements for cause, we terminate any of their employment agreements without cause or a change of control occurs (in which case such employment agreements terminate automatically), each officer is entitled to receive the remaining base salary during the remaining scheduled term of his employment agreement, a bonus based on past amounts, the acceleration of the vesting of his options, which options shall remain exercisable for the full term, and the right to continue receiving specified benefits and perquisites.

In the event of a change of control, in which case all of these employment agreements would terminate simultaneously, collective cash payments would be made to these officers. In addition, if any of the amounts payable to these officers under these provisions constitute excess parachute payments under the Internal Revenue Code, each officer is entitled to an additional payment to cover the tax consequences associated with excess parachute payments.

Pursuant to a letter agreement between our Senior Vice President and our company, in the event our Senior Vice President s employment is terminated for any reason other than cause, that officer is entitled to receive an amount equal to one year s base salary in effect at the date of termination and the right to continue receiving specified benefits and perquisites. Our Senior Vice President s base salary and annual bonus are set by our Compensation Committee of the Board of Directors.

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c. Other Contingencies

We have certain contingent liabilities resulting from litigation and claims incidental 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.

11. Reclassifications

Certain prior year balances have been reclassified to conform to the 2006 financial statement presentation.

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

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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 are described throughout this report including new factors discussed in Risk Factors, Part II, Item 1A and in our annual report on Form 10-K, particularly in Risk Factors, Part I, Item 1A of that report.

The forward-looking information set forth in this quarterly report on Form 10-Q is as of November 7, 2006, and we undertake no duty to update this information. Shareholders and prospective investors can find information filed with the SEC after November 7, 2006 at our website at www.investor.vcaantech.com or at the SEC s website at www.sec.gov.

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

Our laboratory segment operates the largest network of veterinary diagnostic laboratories in the nation. Our laboratories provide sophisticated testing and consulting services used by veterinarians in the detection, diagnosis, evaluation, monitoring, treatment and prevention of diseases and other conditions affecting animals. At September 30, 2006, our laboratory network consisted of 33 laboratories serving all 50 states.

Our animal hospital segment operates the largest network of freestanding, full-service animal hospitals in the nation. Our animal hospitals offer a full range of general medical and surgical services for companion animals. We treat diseases and injuries, offer pharmaceutical products and perform a variety of pet wellness programs, including health examinations, diagnostic testing, routine vaccinations, spaying, neutering and dental care. At September 30, 2006, our animal hospital network consisted of 376 animal hospitals in 37 states.

Our medical technology segment sells ultrasound and digital radiography imaging equipment, related computer hardware, software and ancillary services.

Our corporate segment provides selling, general and administrative support for our other segments.

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

Executive Overview

Our operating results for the three and nine months ended September 30, 2006 were marked by continued growth in our laboratory and animal hospital operating segments. During the three months ended September 30, 2006, our consolidated revenue increased 9.8% to $251.6 million, our consolidated gross profit margin was 28.0% compared to 27.3% in the same prior year quarter, and our consolidated operating income margin was 20.5% compared to 19.3% in the same prior year quarter. During the nine months ended September 30, 2006, our consolidated revenue increased 19% to $741.0 million, our consolidated gross profit margin was 28.2% compared to 27.9% in the same prior year period, and our consolidated operating income margin was 20.5% compared to 20.2% in the same prior year period. Our consolidated margins were impacted by the adoption of Statement of Financial

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Accounting Standards, or SFAS, No. 123R, *Share-Based Payment*, on January 1, 2006, which resulted in a pre-tax non-cash compensation charge of $881,000 and $2.3 million for the three and nine months ended September 30, 2006, respectively.

Acquisitions and Facilities

Our growth strategy includes the acquisition of 20 to 25 independent animal hospitals per year with aggregate annual revenues of approximately $30.0 million to $35.0 million. In addition, we also evaluate the acquisition of animal hospital chains, laboratories or related businesses if favorable opportunities are presented. In accordance with our strategy, we acquired 17 independent animal hospitals, two laboratories and a lab-related business during the nine months ended September 30, 2006. The following table summarizes the changes in the number of facilities operated by our laboratory and animal hospital segments:

Laboratories:	
Facilities at December 31, 2005	31
Acquisitions	2
Acquisitions relocated into a laboratory operated by us	(1)
New facilities	1
Facilities at September 30, 2006	33
Animal hospitals:	
Facilities at December 31, 2005	367
Acquisitions	17
Acquisitions relocated into hospitals operated by us	(4)
Sold or closed	(4)
Facilities at September 30, 2006	376

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue:				
Laboratory	26.3%	24.7%	26.3%	27.0%
Animal hospital	73.0	73.2	72.9	72.1
Medical technology	3.6	4.6	3.4	3.3
Intercompany	(2.9)	(2.5)	(2.6)	(2.4)
Total revenue	100.0	100.0	100.0	100.0
Direct costs	72.0	72.7	71.8	72.1
Gross profit	28.0	27.3	28.2	27.9
Selling, general and administrative expense	7.5	8.0	7.7	7.7
Gain on sale of assets				
Operating income	20.5	19.3	20.5	20.2
Interest expense, net	2.4	2.7	2.5	3.0
Debt retirement costs				3.1
Other expense	0.1			
Minority interest in income of subsidiairies	0.3	0.3	0.3	0.4
Income before provision for income taxes	17.7	16.3	17.7	13.7
Provision for income taxes	7.0	6.6	6.1	5.5
Net income	10.7%	9.7%	11.6%	8.2%

Revenue

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2006	2005	% Change	2006	2005	% Change
Laboratory	$ 66,054	$ 56,555	16.8%	$ 195,064	$ 168,271	15.9%
Animal hospital	183,592	167,815	9.4%	540,117	449,128	20.3%
Medical technology	8,956	10,595	(15.5)%	25,348	20,437	24.0%
Intercompany	(6,970)	(5,723)	21.8%	(19,567)	(15,147)	29.2%
Total revenue	$ 251,632	$ 229,242	9.8%	$ 740,962	$ 622,689	19.0%

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Laboratory Revenue

Laboratory revenue increased $9.5 million for the three months ended September 30, 2006 and increased $26.8 million for the nine months ended September 30, 2006 as compared to the same periods in the prior year. The components of the increase in laboratory revenue are detailed below (in thousands, except percentages and average revenue per requisition):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2006	**2005**	**% Change**	**2006**	**2005**	**% Change**
Internal growth:						
Number of requisitions (1)	2,786	2,397	16.2%	8,387	7,232	16.0%
Average revenue per requisition (2)	$ 23.39	$ 23.59	(0.8)%	$ 23.09	$ 23.27	(0.8)%
Total internal revenue (1)	$ 65,177	$ 56,555	15.2%	$ 193,674	$ 168,271	15.1%
Acquired revenue (3)	877			1,390		
Total	$ 66,054	$ 56,555	16.8%	$ 195,064	$ 168,271	15.9%

(1) Internal revenue and requisitions were calculated using laboratory operating results, adjusted to exclude the operating results of acquired laboratories for the comparable periods that we did not own them in the prior year.

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

(3) Acquired revenue represents the revenue of the laboratory

acquired on May 1, 2006 and the laboratory acquired on September 1, 2006.

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 us, pharmaceutical companies and other service providers in the industry.

The change in the average revenue per requisition is attributable to changes in the mix, type and number of tests performed per requisition and price increases. The price increases for most tests ranged from 3% to 5% in both February 2006 and February 2005.

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Animal Hospital Revenue

Animal hospital revenue increased $15.8 million for the three months ended September 30, 2006 and increased $91.0 million for the nine months ended September 30, 2006 as compared to the same periods in the prior year. The components of the increase are summarized in the following table (in thousands, except percentages and average revenue per order):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2006	2005	% Change	2006	2005	% Change
Same-store facilities:						
Orders (1)(2)	1,308	1,345	(2.8)%	3,319	3,411	(2.7)%
Average revenue per order (3)	$ 133.28	$ 123.65	7.8%	$ 130.81	$ 120.78	8.3%
Same-store revenue (1)	$ 174,297	$ 166,321	4.8%	$ 434,238	$ 411,981	5.4%
Business day adjustment (4)				1,666		
Net acquired revenue (5)	9,295	1,494		104,213	37,147	
Total	$ 183,592	$ 167,815	9.4%	$ 540,117	$ 449,128	20.3%

(1) Same-store revenue and orders were calculated using animal hospital operating results, adjusted to exclude the operating results for the newly acquired animal hospitals that we did not own a full 12 months from the beginning of the applicable period and adjusted for the impact resulting from any differences in the number of business days in the periods presented. Same-store

revenue also includes revenue generated by customers referred from our relocated or combined animal hospitals, including those merged upon acquisition.

(2) The change in orders may not calculate exactly due to rounding.

(3) Computed by dividing same-store revenue by same-store orders. The average revenue per order may not calculate exactly due to rounding.

(4) The business day adjustment reflects the impact of one additional business day for the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005.

(5) 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 comparable period, which was July 1, 2005 for the three months ended September 30, 2006, and January 1, 2005 for the nine months ended September 30, 2006. Fluctuations in net acquired revenue occur due to the volume, size and timing of acquisitions and disposals during the periods from this date through the end of the applicable period.

Over the last few years, some pet-related products 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. Our business strategy continues to place a greater emphasis on comprehensive wellness visits and advanced medical procedures, which typically generate higher-priced orders. These trends have resulted in a decrease in the number of orders and an increase in the average revenue per order.

Price increases, which approximated 5% to 6% on most services at most hospitals in February 2006 and February 2005, also contributed to the increase in the average revenue per order. Prices are reviewed on an annual basis for each hospital and adjustments are made based on market considerations, demographics and our costs.

Medical Technology Revenue

Medical technology revenue was $9.0 million and $10.6 million for the three months ended September 30, 2006 and 2005, respectively, and $25.3 million and $20.4 million for the nine months ended September 30, 2006 and 2005, respectively. Revenue for the nine months ended September 30, 2006 increased as compared to the same period in the prior year due to sales of our digital radiography imaging equipment. Although we sold more digital radiography imaging units during the three months ended September 30, 2006 as compared to the same period in the prior year,

our revenue decreased because of the increase in the number of sales where the total sales revenue was deferred and will be recognized over the support period. This increase in the number of sales deferred was the result of a change in support programs provided to certain customers.

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Sales of our ultrasound imaging equipment declined during the three and nine months ended September 30, 2006 as compared to the same periods in the prior year. This decline is attributed to the sale of our digital radiography imaging equipment, which was first introduced at the end of 2004. Our sales force has invested significant time and resources related to the introduction and rollout of our digital radiography imaging equipment, which has shifted some focus away from the sale of our ultrasound imaging equipment.

At September 30, 2006, we had deferred revenue of $11.2 million, $10.0 million of which related to sales of our digital radiography imaging equipment.

Intercompany Revenue

For the three and nine months ended September 30, 2006, $5.8 million and $17.1 million of our laboratory revenue was intercompany revenue that was generated by providing laboratory services to our animal hospitals compared to $5.0 million and $13.7 million in the same periods of the prior year. For the three and nine months ended September 30, 2006, $1.2 million and $2.5 million, respectively, of our medical technology revenue was intercompany revenue that was generated by providing products and services to our animal hospitals compared to $768,000 and $1.4 million in the same periods of the prior year. For purposes of reviewing the operating performance of our business segments, all intercompany transactions are accounted for as if they were conducted with an independent third party at current market prices. For financial reporting purposes, intercompany transactions are eliminated as part of our consolidation.

Gross Profit

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

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2006		2005			2006		2005		
	$	Gross Profit Margin	$	Gross Profit Margin	% Change	$	Gross Profit Margin	$	Gross Profit Margin	% Change
Laboratory	$ 30,013	45.4%	$ 25,077	44.3%	19.7%	$ 91,087	46.7%	$ 76,324	45.4%	19.3%
Animal hospital	37,460	20.4%	34,244	20.4%	9.4%	109,708	20.3%	91,796	20.4%	19.5%
Medical technology	3,426	38.3%	3,714	35.1%	(7.8)%	9,072	35.8%	6,411	31.4%	41.5%
Intercompany	(434)		(391)			(919)		(625)		
Total gross profit	$ 70,465	28.0%	$ 62,644	27.3%	12.5%	$ 208,948	28.2%	$ 173,906	27.9%	20.1%

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 attributed 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

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limited to, salaries of veterinarians, technicians and all other animal hospital-based personnel, facilities rent, occupancy costs, supply costs, depreciation and amortization, certain marketing and promotional expense, and costs of goods sold associated with the retail sales of pet food and pet supplies.

Over the last several years we have acquired a significant number of animal hospitals. Many of these newly acquired animal hospitals had lower gross profit margins at the time of acquisition than those previously operated by us. These lower gross profit margins, in the aggregate, have been favorably impacted subsequent to the acquisition by improvements in animal hospital revenue, increased operating leverage and our integration efforts.

Medical Technology Gross Profit

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

The increase in medical technology gross profit margin was primarily the result of a change in the mix of products and services sold. Specifically, revenue from the sale of our digital radiography imaging equipment, which has a higher gross profit margin than our other products and services, has increased as a percentage of our total medical technology revenue.

At September 30, 2006, we had deferred revenue and costs of $11.2 million and $5.2 million, respectively. Included in these amounts at September 30, 2006 was $10.0 million of deferred revenue and $5.2 million of deferred costs related to sales of our digital radiography imaging equipment.

Selling, General and Administrative Expense

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

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2006		2005			2006		2005		
	$	% of Revenue	$	% of Revenue	% Change	$	% of Revenue	$	% of Revenue	% Change
Laboratory	$ 4,350	6.6%	$ 3,636	6.4%	19.6%	$ 12,793	6.6%	$ 10,347	6.1%	23.6%
Animal hospital	5,161	2.8%	4,072	2.4%	26.7%	15,107	2.8%	11,582	2.6%	30.4%
Medical technology	2,534	28.3%	2,806	26.5%	(9.7)%	7,734	30.5%	6,295	30.8%	22.9%
Corporate	6,901	2.7%	7,880	3.4%	(12.4)%	21,681	2.9%	19,719	3.2%	9.9%
Total SG&A	$ 18,946	7.5%	$ 18,394	8.0%	3.0%	$ 57,315	7.7%	$ 47,943	7.7%	19.5%

Laboratory SG&A

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

The increase in laboratory SG&A was primarily attributed to increasing our sales force and marketing efforts, commission payments as a result of an increase in revenue, and recognizing $128,000 and $382,000 of share-based compensation for the three and nine months ended September 30, 2006, respectively, as a result of adopting SFAS No. 123R on January 1, 2006.

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.

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The increase in animal hospital SG&A was primarily attributed to expanding the animal hospital administrative operations to absorb the recent acquisitions and recognizing $376,000 and $807,000 of share-based compensation for the three and nine months ended September 30, 2006, respectively, as a result of adopting SFAS No. 123R on January 1, 2006.

Medical Technology SG&A

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

The increase in medical technology SG&A for the nine months ended September 30, 2006 as compared to the same period in the prior year was primarily attributed to increasing our sales force and administrative support, and commission payments as a result of an increase in revenue. The decrease in medical technology SG&A for the three months ended September 30, 2006 as compared to the same period in the prior year was attributed to a decrease in certain selling costs.

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, occupancy costs and corporate depreciation.

We have expanded our corporate office and will continue to do so in order to absorb recent and future acquisitions. The increase in corporate SG&A for the nine months ended September 30, 2006 as compared to the same period in the prior year was the result of such expansion. This increase was partially offset by one-time integration costs incurred during 2005 in connection with the acquisition of Pet s Choice, Inc.

The decrease in Corporate SG&A for the three months ended September 30, 2006 as compared to the same period in the prior year was attributed to the one-time integration costs described above and a decrease in legal and accounting fees.

Interest Expense, Net

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Interest expense:				
Senior term notes	$ 6,597	$ 5,847	$ 19,515	$ 12,488
9.875% senior subordinated notes				6,342
Interest rate hedging agreements	(484)	190	(1,054)	75
Capital leases and other	432	453	1,041	863
Amortization of debt costs	73	132	299	482
	6,618	6,622	19,801	20,250
Interest income	534	588	1,478	1,468
Total interest expense, net of interest income	$ 6,084	$ 6,034	$ 18,323	$ 18,782

The change in interest expense was primarily attributed to our debt refinancing transactions, which we discuss in the *Liquidity and Capital Resources* section of our 2005 annual report on Form 10-K, and changes in LIBOR.

Provision for Income Taxes

The effective tax rate for the three and nine months ended September 30, 2006 was 39.4% and 34.2%, respectively, and reflects a lower weighted-average state statutory tax rate when compared to the comparable prior

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year periods due to a favorable shift in the number of facilities that we operated in states with lower tax rates or no state income tax. The effective tax rate for the nine months ended September 30, 2006 also reflects a tax benefit in the amount of $6.8 million recognized during the first quarter of 2006 due to the outcome of an income tax audit that resulted in a change to our estimated tax liabilities. We estimate that our effective tax rate for the three months ended December 31, 2006 will approximate 39.4%.

Liquidity and Capital Resources

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

	Nine Months Ended September 30,	
	2006	**2005**
Cash provided by (used in):		
Operating activities	$ 90,738	$ 91,214
Investing activities	(63,483)	(105,448)
Financing activities	(52,922)	27,771
Increase (decrease) in cash and cash equivalents	(25,667)	13,537
Cash and cash equivalents at beginning of year	58,488	30,964
Cash and cash equivalents at end of period	$ 32,821	$ 44,501

Cash Flows from Operating Activities

Net cash provided by operating activities decreased $476,000 in the nine months ended September 30, 2006 as compared to the same period in the prior year. Although we experienced growth in our core segments through acquisitions and internal growth, cash flows from operating activities declined primarily due to an increase in taxes paid of $26.5 million and changes in working capital. Also contributing to the decline in cash flows from operating activities was a $5.8 million excess tax benefit from the exercise of stock options. SFAS No. 123R, which we adopted on January 1, 2006, requires the benefits of tax deductions from the exercise of options in excess of the compensation cost for those options to be classified as cash provided by financing activities. Excess tax benefits in periods prior to 2006 were classified as an operating activity.

Significant increases in interest rates may materially impact our operating cash flows in future periods because of the variable-rate nature of our senior term notes.

Cash Flows from Investing Activities

Net cash used in investing activities primarily consisted of cash used for acquisitions 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 for a total purchase price of approximately $30.0 million to $35.0 million. In addition, we also evaluate the acquisition of animal hospital chains, laboratories or related businesses if favorable opportunities are presented. In accordance with that strategy, we acquired 17 hospitals, two laboratories and a lab-related business in 2006 for total cash consideration of $35.8 million. We intend to primarily use cash in our acquisitions but, depending on the timing and amount of our acquisitions, we may use stock or debt. For the remaining three months of 2006, we intend to spend approximately $10.0 million for animal hospital acquisitions and $10.0 million to $15.0 million for property and equipment.

Cash Flows from Financing Activities

Net cash used in financing activities during the nine months ended September 30, 2006 consisted primarily of cash used to repay our long-term obligations, including $60.0 million to prepay a portion of our senior term notes. This use of cash was partially offset by a $5.8 million excess tax benefit from the exercise of stock options. SFAS No. 123R, which we adopted on January 1, 2006, requires the benefits of tax deductions from the exercise of options in excess of the compensation cost for those options to be classified as cash provided by financing activities. Excess

tax benefits in periods prior to 2006 were classified as an operating activity. Our financing activities during the nine months ended September 30, 2005 reflects $475.0 million in borrowings used to retire our existing senior term notes and 9.875% senior subordinated notes aggregating $404.1 million, and to fund the acquisition of Pet s Choice, Inc. on July 1, 2005. In addition, we used $35.0 million to prepay a portion of our senior term notes in August 2005.

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):

	Total	2006 (1)	2007	2008	2009	2010	Thereafter
Long-term debt	$ 376,544	$ 1,282	$ 5,377	$ 4,181	$ 3,879	$ 3,880	$ 357,945
Capital lease obligations	15,479	255	1,039	1,070	1,144	1,283	10,688
Operating leases	500,500	7,685	30,650	30,543	30,297	28,850	372,475
Fixed cash interest expense	6,917	351	1,257	1,329	1,069	767	2,144
Variable cash interest expense (2)	122,651	6,632	26,265	26,457	26,547	26,630	10,120
Swap agreements (2)	(3,476)	(613)	(1,994)	(795)	(74)		
Purchase obligations	54,548	7,718	13,759	8,383	8,942	9,744	6,002
Other long-term liabilities (3)	46,761		65	65	65		46,566
Earn-out payments (4)	413		363	50			
	$ 1,120,337	$ 23,310	$ 76,781	$ 71,283	$ 71,869	$ 71,154	$ 805,940

(1) Consists of the period from October 1, 2006 through December 31, 2006.

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

that the interest rate on our variable-rate debt (including the fixed-rate portion) will be 7.1%, 7.1%, 7.2%, 7.3%, 7.4% and 7.5% for years 2006 through thereafter, respectively. These estimates are based on interest rate projections used to price our interest rate swap agreements. Our consolidated financial statements included in our 2005 annual report on Form 10-K discuss these variable-rate notes in more detail.

(3) Includes deferred income taxes of $38.3 million.

(4) Represents contractual arrangements whereby additional cash may be paid to former owners of acquired businesses upon attainment of specified performance targets.

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

Debt Related Covenants

Our senior credit facility contains certain financial covenants pertaining to fixed-charge coverage and leverage ratios. In addition, the senior credit facility has restrictions pertaining to capital expenditures, acquisitions and the payment of cash dividends. As of September 30, 2006, we were in compliance with these covenants, including the two covenant ratios, the fixed-charge coverage ratio and the leverage ratio.

The senior credit facility defines the fixed-charge coverage ratio as that ratio 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. Pro forma earnings before interest, taxes, depreciation and amortization include 12 months of operating results for businesses acquired during the period. Fixed charges are defined as cash interest expense, scheduled principal payments on debt obligations, capital expenditures, and provision for income taxes. At September 30, 2006, we had a fixed-charge coverage ratio of 1.85 to 1.00, which was in compliance with the required ratio of no less than 1.20 to 1.00.

The senior credit facility defines the leverage ratio as that ratio which is calculated as total debt divided by pro forma earnings before interest, taxes, depreciation and amortization, as defined by the agreement. At September 30, 2006, we had a leverage ratio of 1.86 to 1.00, which was in compliance with the required ratio of no more than 3.00 to 1.00.

Interest Rate Hedging Agreements

We have swap agreements whereby we pay counterparties amounts based on fixed interest rates and set notional principal amounts in exchange for the receipt of payments from the counterparties based on London Interbank Offer Rates, or LIBOR, and the same set notional principal amounts. We entered into these swap agreements to hedge against the risk of increasing interest rates. The contracts effectively convert a certain amount of our variable-rate debt under our senior credit facility to fixed-rate debt for purposes of controlling cash paid for interest. That amount is equal to the notional principal amount of the swap agreements, and the fixed-rate conversion period is equal to the terms of the contract. The impact of these swap agreements has been factored into our future contractual cash requirements table above. A summary of the swap agreements existing at September 30, 2006 is as follows:

Fixed interest rate	4.07%	3.98%	3.94%	5.51%
Notional amount	$50.0 million	$50.0 million	$50.0 million	$50.0 million
Effective date	5/26/2005	6/2/2005	6/30/2005	6/20/2006
Expiration date	5/26/2008	5/31/2008	6/30/2007	6/30/2009
Counterparties	Goldman Sachs	Wells Fargo	Wells Fargo	Goldman Sachs
Qualifies for hedge accounting	Yes	Yes	Yes	Yes

In the future, we may enter into additional interest rate strategies. We have not yet determined what those strategies will be or their possible impact.

Description of Indebtedness

Senior Credit Facility

At September 30, 2006, we had $373.6 million principal amount outstanding under our senior term notes and no borrowings outstanding under our revolving credit facility.

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

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

Other Debt

At September 30, 2006, we had seller notes secured by assets of certain animal hospitals, unsecured debt and capital leases that totaled $18.4 million.

Critical Accounting Policies

We believe that the application of the following accounting policies, which are important to our financial position and results of operations, requires significant judgments and estimates on the part of our management. For a summary of all our accounting policies, including the accounting policies discussed below, see our consolidated financial statements included in our 2005 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:

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there exists adequate evidence of the transaction;

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

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

Medical Technology Revenue

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

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

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

Delivery: We consider delivery to have occurred when the ultrasound imaging equipment is delivered. We consider delivery to have occurred when the digital radiography imaging equipment is either accepted by the customer if installation is required, or delivered. We consider delivery to have occurred with respect to professional services when those services are provided or on a straight-line basis over the service contract term, based on the nature of the service or the terms of the contract.

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

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

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

value of one or more undelivered elements does not exist, the revenue is deferred and recognized when delivery of those elements occurs. 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.

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Ultrasound Imaging Equipment

We sell our ultrasound imaging equipment with and without related computer hardware and software. We account for the sale of ultrasound imaging equipment on a stand-alone basis under the requirements of SAB No. 104, and recognize revenue upon delivery. We account for the sale of ultrasound imaging equipment with related computer hardware and software by bifurcating the transaction into separate elements. We account for the ultrasound imaging equipment under the requirements of SAB No. 104, as the software is not deemed to be essential to the functionality of the equipment, and account for the computer hardware and software under the requirements of SOP No. 97-2, as amended. For those sales of our ultrasound imaging equipment that include computer hardware and software, we recognize revenue on the ultrasound imaging equipment, computer hardware and software upon delivery, which occurs simultaneously.

Digital Radiography Equipment

We sell our digital radiography imaging 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 digital radiography imaging equipment sales under SOP No. 97-2.

In the third quarter of 2005, we established vendor-specific objective evidence of the fair value of post-contract customer support services by including renewal rates in the sales contracts. As a result, we began recognizing revenue on the sales of digital radiography imaging equipment, computer hardware and software at the time of customer acceptance if installation is required, or delivery, and revenue from post-contract customer support services on a straight-line basis over the term of the support period. Prior to the third quarter of 2005, we recognized revenue on all elements in these arrangements ratably over the period of the post-contract customer support services, which was generally one year.

Valuation of Goodwill

Our goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to identifiable assets acquired and liabilities assumed. The total amount of our goodwill at September 30, 2006 was $615.8 million, consisting of $95.1 million for our laboratory segment, $501.5 million for our animal hospital segment and $19.2 million for our medical technology segment.

Annually, and upon material changes in our operating environment, we test our goodwill for impairment by comparing the fair market value of our reporting units, laboratory, animal hospital and medical technology, to their respective net book value. At December 31, 2005, the estimated fair market value of each of our reporting units exceeded their respective net book value, resulting in a conclusion that our goodwill was not impaired. In addition, we have not tested our goodwill for impairment since December 31, 2005 due to our assessment that there were no material changes in our operating environment.

Income Taxes

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

We make judgments in assessing our ability to realize future benefits from our deferred tax assets, which include operating and capital loss carryforwards. As such, we have a valuation allowance to reduce our deferred tax assets for the portion we believe will not be realized.

We also assess differences between our probable tax bases and the as-filed tax bases of certain assets and liabilities. At December 31, 2005, we had contingent liabilities of $6.8 million recorded in other liabilities in our condensed, consolidated balance sheet related to such differences. During the first quarter of 2006, we determined that these contingencies no longer existed due to the outcome of an income tax audit and recognized a tax benefit of $6.8 million.

Effective January 1, 2007, we will be required to assess any uncertain tax positions using the recognition threshold and measurement attribute prescribed by the Financial Accounting Standards Board, or FASB, Interpretation No. 48, or FIN 48. See discussion of FIN 48 below under *Recent Accounting Pronouncements.*

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Recent Accounting Pronouncements

Effective January 1, 2006, we adopted SFAS No. 123R, *Share-Based Payment.* SFAS No. 123R requires 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, which is typically the vesting period. Although the cost recognized as a result of adopting SFAS No. 123R is non-cash, our operating results, including our margins, net income, earnings per common share and operating cash flows, will be negatively impacted in future periods. See Note 4, *Share-Based Compensation Plans,* of our condensed, consolidated financial statements for a detailed discussion of our adoption of SFAS No. 123R.

In June 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in tax positions. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. FIN 48 will be effective for our company on January 1, 2007. We are currently evaluating the impact of adopting FIN 48 on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The provisions of SFAS No. 157 will be effective for our company on January 1, 2008. We are currently evaluating the impact of adopting SFAS No. 157 on our consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin, or SAB, No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual-approach includes both an income statement focused assessment and a balance sheet focused assessment. The guidance in SAB No. 108 must be applied to our annual consolidated financial statements for the fourth quarter of 2006. We are currently assessing the impact of adopting SAB No. 108, however we do not expect that it will have a material effect on our consolidated financial statements.

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, shou project, contemplate, anticipate, predict, potential, continue, or similar expressions. You may find some of th statements 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 are described throughout this report and in our annual report on Form 10-K, particularly in *Risk Factors*, Part I, Item 1A of that report.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At September 30, 2006, we had borrowings of $373.6 million under our senior credit facility with fluctuating interest rates based on market benchmarks such as LIBOR. For our variable-rate debt, changes in interest rates generally do not affect the fair market value, but do impact earnings and cash flow. To reduce the risk of increasing interest rates, we entered into the following interest rate swap agreements:

Fixed interest rate	4.07%	3.98%	3.94%	5.51%
Notional amount	$50.0 million	$50.0 million	$50.0 million	$50.0 million
Effective date	5/26/2005	6/2/2005	6/30/2005	6/20/2006
Expiration date	5/26/2008	5/31/2008	6/30/2007	6/30/2009
Counterparties	Goldman Sachs	Wells Fargo	Wells Fargo	Goldman Sachs
Qualifies for hedge accounting	Yes	Yes	Yes	Yes

These swap agreements have the effect of reducing the amount of our debt exposed to variable interest rates. For the 12-month period ending September 30, 2007, for every 1.0% increase in LIBOR we will pay an additional $2.0 million in interest expense and for every 1.0% decrease in LIBOR we will save $2.0 million in interest expense.

We may consider entering into additional interest rate strategies. We have not yet determined what those strategies will 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 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 filed with the SEC.

During our most recent fiscal quarter, there were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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

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 1A. RISK FACTORS

There have been no material changes in our risk factors from those disclosed in our 2005 annual report on Form 10-K except for the risk factors described below.

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We may have to write-off certain capitalized software development costs

We are currently in the process of internally developing software that will be used in our animal hospitals. Costs related directly to the software design, coding, testing and installation will be capitalized and amortized over the expected life of the software when it is deployed. To the extent that we are unable to realize the benefits of this software, we may have to write-off a portion or all of the capitalized costs, which may have an adverse effect on our operating results.

Failure to receive products and/or supplies in a timely manner will have a negative impact on our operating results

Our operations depend, in some cases, on the ability of single source suppliers or a limited number of suppliers, to deliver products and supplies on a timely basis. We have in the past experienced, and may in the future experience, shortages of or difficulties in acquiring products and/or supplies in the quantities and of the quality needed. Shortages in the availability of products and/or supplies for an extended period of time will have a negative impact on our operating results.

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

None

ITEM 6. EXHIBITS

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

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

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

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on November 7, 2006.

Date: November 7, 2006

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

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EXHIBIT INDEX

Exhibit No.	Description
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.