

VCA ANTECH INC
Form 10-Q
August 10, 2010

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

FORM 10-Q

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

For the quarterly period ended June 30, 2010

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

Commission File Number: 001-16783

VCA Antech, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

95-4097995

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

**12401 West Olympic Boulevard
Los Angeles, California 90064-1022
(Address of principal executive offices)
(310) 571-6500**

(Registrant's telephone number, including area code)

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

Yes No .

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No .

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(Do not check if a smaller
reporting company)

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

Yes No .

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: common stock, \$0.001 par value, 85,974,925 shares as of August 3, 2010.

VCA Antech, Inc. and Subsidiaries
Form 10-Q
June 30, 2010
Table of Contents

| | Page Number |
|-----------------------------------------------------------------------------------------------------|------------------------|
| Part I. Financial Information | |
| Item 1. Financial Statements (Unaudited) | |
| Condensed, Consolidated Balance Sheets as of June 30, 2010 and December 31, 2009 | 1 |
| Condensed, Consolidated Income Statements for the Three and Six Months Ended June 30, 2010 and 2009 | 2 |
| Condensed, Consolidated Statements of Equity for the Six Months Ended June 30, 2010 and 2009 | 3 |
| Condensed, Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2010 and 2009 | 4 |
| Notes to Condensed, Consolidated Financial Statements | 5 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 18 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 32 |
| Item 4. Controls and Procedures | 32 |
| Part II. Other Information | |
| Item 1. Legal Proceedings | 33 |
| Item 1A. Risk Factors | 33 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 33 |
| Item 3. Defaults Upon Senior Securities | 33 |
| Item 5. Other Information | 33 |
| Item 6. Exhibits | 33 |
| Signature | 34 |
| Exhibit Index | 35 |

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

VCA Antech, Inc. and Subsidiaries
Condensed, Consolidated Balance Sheets
(Unaudited)
(In thousands, except par value)

| | June 30, 2010 | December 31, 2009 |
|--------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------|----------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 193,757 | \$ 145,181 |
| Trade accounts receivable, less allowance for uncollectible accounts of \$12,647 and \$13,015 at June 30, 2010 and December 31, 2009, respectively | 53,407 | 49,186 |
| Inventory | 34,088 | 32,031 |
| Prepaid expenses and other | 22,299 | 27,242 |
| Deferred income taxes | 18,727 | 18,318 |
| Prepaid income taxes | 13,352 | 6,252 |
| Total current assets | 335,630 | 278,210 |
| Property and equipment, less accumulated depreciation and amortization of \$184,325 and \$167,506 at June 30, 2010 and December 31, 2009, respectively | 302,515 | 289,415 |
| Goodwill | 1,006,562 | 985,674 |
| Other intangible assets, net | 42,019 | 44,280 |
| Notes receivable, net | 5,763 | 5,153 |
| Deferred financing costs, net | 342 | 581 |
| Other | 28,026 | 24,091 |
| Total assets | \$ 1,720,857 | \$ 1,627,404 |
| Liabilities and Equity | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 508,687 | \$ 17,195 |
| Accounts payable | 28,814 | 28,326 |
| Accrued payroll and related liabilities | 46,372 | 33,539 |
| Other accrued liabilities | 51,509 | 43,298 |
| Total current liabilities | 635,382 | 122,358 |
| Long-term debt, less current portion | 23,607 | 527,860 |
| Deferred income taxes | 84,698 | 75,197 |
| Other liabilities | 16,846 | 10,651 |
| Total liabilities | 760,533 | 736,066 |
| Commitments and contingencies | | |
| Preferred stock, par value \$0.001, 11,000 shares authorized, none outstanding | | |
| VCA Antech, Inc. stockholders' equity: | | |

Edgar Filing: VCA ANTECH INC - Form 10-Q

| | | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|
| Common stock, par value \$0.001, 175,000 shares authorized, 85,976 and 85,584 shares outstanding as of June 30, 2010 and December 31, 2009, respectively | 86 | 86 |
| Additional paid-in capital | 342,339 | 335,114 |
| Accumulated earnings | 601,349 | 540,010 |
| Accumulated other comprehensive loss | (47) | (163) |
| Total VCA Antech, Inc. stockholders' equity | 943,727 | 875,047 |
| Noncontrolling interests | 16,597 | 16,291 |
| | | |
| Total equity | 960,324 | 891,338 |
| | | |
| Total liabilities and equity | \$ 1,720,857 | \$ 1,627,404 |

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

VCA Antech, Inc. and Subsidiaries
Condensed, Consolidated Income Statements
(Unaudited)
(In thousands, except per share amounts)

| | Three Months Ended | | Six Months Ended | |
|--------------------------------------------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Revenue | \$ 353,919 | \$ 344,876 | \$ 684,653 | \$ 660,726 |
| Direct costs | 260,435 | 247,528 | 508,374 | 481,209 |
| Gross profit | 93,484 | 97,348 | 176,279 | 179,517 |
| Selling, general and administrative expense | 41,045 | 22,941 | 67,185 | 45,858 |
| Net (gain) loss on sale of assets | (14) | 5,443 | 11 | 5,195 |
| Operating income | 52,453 | 68,964 | 109,083 | 128,464 |
| Interest expense, net | 2,778 | 5,726 | 5,945 | 11,844 |
| Other income | (335) | (20) | (310) | (130) |
| Income before provision for income taxes | 50,010 | 63,258 | 103,448 | 116,750 |
| Provision for income taxes | 19,493 | 24,290 | 39,999 | 44,901 |
| Net income | 30,517 | 38,968 | 63,449 | 71,849 |
| Net income attributable to noncontrolling interests | 1,113 | 1,223 | 2,110 | 2,134 |
| Net income attributable to VCA Antech, Inc | \$ 29,404 | \$ 37,745 | \$ 61,339 | \$ 69,715 |
| Basic earnings per share | \$ 0.34 | \$ 0.45 | \$ 0.71 | \$ 0.82 |
| Diluted earnings per share | \$ 0.34 | \$ 0.44 | \$ 0.70 | \$ 0.81 |
| Weighted-average shares outstanding for basic earnings per share | 86,041 | 84,825 | 85,933 | 84,753 |
| Weighted-average shares outstanding for diluted earnings per share | 87,178 | 85,937 | 87,069 | 85,629 |

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

VCA Antech, Inc. and Subsidiaries
Condensed, Consolidated Statements of Equity
(Unaudited)
(In thousands)

| | Common Stock | | Additional | Accumulated | Other | Noncontrolling | Total |
|---------------------------------------------------------------------------|--------------|--------|--------------------|-------------|-----------------------------------|----------------|------------|
| | Shares | Amount | Paid-In Capital | Earnings | Comprehensive (Loss) Income | Interests | |
| Balances, December 31, 2008 | 84,633 | \$ 85 | \$ 308,674 | \$ 408,582 | \$ (6,352) | \$ 12,846 | \$ 723,835 |
| Net income | | | | 69,715 | | 2,134 | 71,849 |
| Foreign currency translation adjustment | | | | | 177 | | 177 |
| Unrealized gain on foreign currency, net of tax | | | | | 96 | | 96 |
| Unrealized loss on hedging instruments, net of tax | | | | | (652) | | (652) |
| Losses on hedging instruments reclassified to income, net of tax | | | | | 3,637 | | 3,637 |
| Formation of noncontrolling interest | | | | | | 3,440 | 3,440 |
| Distribution to noncontrolling interest | | | | | | (1,493) | (1,493) |
| Restricted stock unit grant | | | 1,941 | | | | 1,941 |
| Share-based compensation | | | 3,920 | | | | 3,920 |
| Issuance of common stock under stock incentive plans | 239 | | 2,895 | | | | 2,895 |
| Stock repurchases | | | (549) | | | | (549) |
| Tax benefit from stock options and awards | | | 154 | | | | 154 |
| Tax shortfall and other from stock options and awards | | | (263) | | | | (263) |
| Balances, June 30, 2009 | 84,872 | 85 | 316,772 | 478,297 | (3,094) | 16,927 | 808,987 |

| | | | | | | | |
|---------------------------------------------------------------------------|--------|-------|------------|------------|----------|-----------|------------|
| Balances, December 31, 2009 | 85,584 | \$ 86 | \$ 335,114 | \$ 540,010 | \$ (163) | \$ 16,291 | \$ 891,338 |
| Net income | | | | 61,339 | | 2,110 | 63,449 |
| Foreign currency translation adjustment | | | | | (69) | | (69) |
| Unrealized loss on foreign currency, net of tax | | | | | (47) | | (47) |
| Unrealized loss on hedging instruments, net of tax | | | | | (1) | | (1) |
| Losses on hedging instruments reclassified to income, net of tax | | | | | 233 | | 233 |
| Formation of noncontrolling interest | | | | | | 450 | 450 |
| Distribution to noncontrolling interest | | | | | | (2,021) | (2,021) |
| Purchase of noncontrolling interest | | | | | | (233) | (233) |
| Share-based compensation | | | 5,855 | | | | 5,855 |
| Issuance of common stock under stock incentive plans | 392 | | 3,770 | | | | 3,770 |
| Stock repurchases | | | (2,253) | | | | (2,253) |
| Tax benefit from stock options and awards | | | 331 | | | | 331 |
| Tax shortfall and other from stock options and awards | | | (478) | | | | (478) |
| Balances, June 30, 2010 | 85,976 | \$ 86 | \$ 342,339 | \$ 601,349 | \$ (47) | \$ 16,597 | \$ 960,324 |

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

VCA Antech, Inc. and Subsidiaries
Condensed, Consolidated Statements of Cash Flows
(Unaudited)
(In thousands)

| | Six Months Ended | |
|-----------------------------------------------------------------------------------|-------------------------|-------------|
| | June 30, | |
| | 2010 | 2009 |
| Cash flows from operating activities: | | |
| Net income | \$ 63,449 | \$ 71,849 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 21,706 | 18,840 |
| Amortization of debt issue costs | 239 | 241 |
| Provision for uncollectible accounts | 3,143 | 2,936 |
| Net loss on sale and disposal of assets | 11 | 5,195 |
| Share-based compensation | 5,855 | 3,920 |
| Deferred income taxes | 6,461 | 10,944 |
| Excess tax benefit from exercise of stock options | (331) | (154) |
| Other | (225) | (218) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (7,344) | (7,989) |
| Inventory, prepaid expenses and other assets | (727) | (2,929) |
| Accounts payable and other accrued liabilities | 13,691 | 4,357 |
| Accrued payroll and related liabilities | 12,656 | 2,134 |
| Income taxes | (7,248) | 1,073 |
| Net cash provided by operating activities | 111,336 | 110,199 |
| Cash flows from investing activities: | | |
| Business acquisitions, net of cash acquired | (20,344) | (28,144) |
| Real estate acquired in connection with business acquisitions | (1,300) | (3,828) |
| Property and equipment additions | (27,925) | (25,208) |
| Proceeds from sale of assets | 9 | 108 |
| Other | (162) | (281) |
| Net cash used in investing activities | (49,722) | (57,353) |
| Cash flows from financing activities: | | |
| Repayment of debt | (12,859) | (3,899) |
| Distributions to noncontrolling interest partners | (2,021) | (1,493) |
| Proceeds from issuance of common stock under stock option plans | 3,770 | 2,895 |
| Excess tax benefit from exercise of stock options | 331 | 154 |
| Stock repurchases | (2,253) | (549) |
| Net cash used in financing activities | (13,032) | (2,892) |
| Effect of currency exchange rate changes on cash and cash equivalents | (6) | (18) |
| Increase in cash and cash equivalents | 48,576 | 49,936 |

Edgar Filing: VCA ANTECH INC - Form 10-Q

| | | |
|----------------------------------------------------------------------|------------|------------|
| Cash and cash equivalents at beginning of period | 145,181 | 88,959 |
| Cash and cash equivalents at end of period | \$ 193,757 | \$ 138,895 |
| Supplemental disclosures of cash flow information: | | |
| Interest paid | \$ 6,075 | \$ 12,316 |
| Income taxes paid | \$ 40,787 | \$ 32,884 |
| Supplemental schedule of noncash investing and financing activities: | | |
| Detail of acquisitions: | | |
| Fair value of assets acquired | \$ 22,202 | \$ 35,520 |
| Cash paid for acquisitions | (19,350) | (24,928) |
| Contingent consideration | (7) | |
| Noncash note conversion to equity interest in subsidiary | | (5,700) |
| Liabilities assumed | \$ 2,845 | \$ 4,892 |

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

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements
June 30, 2010
(Unaudited)

1. Nature of Operations

Our company, VCA Antech, Inc. (VCA) is a Delaware corporation formed in 1986 and is based in Los Angeles, California. We are an animal healthcare company with three strategic segments: animal hospitals (Animal Hospital), veterinary diagnostic laboratories (Laboratory) and veterinary medical technology (Medical Technology).

Our animal hospitals offer a full range of general medical and surgical services for companion animals. Our animal hospitals treat diseases and injuries, provide pharmaceutical products and perform a variety of pet-wellness programs, including health examinations, diagnostic testing, vaccinations, spaying, neutering and dental care. At June 30, 2010, we operated 496 animal hospitals throughout 40 states.

We operate a full-service veterinary diagnostic laboratory network serving all 50 states and certain areas in Canada. Our laboratory network provides sophisticated testing and consulting services used by veterinarians in the detection, diagnosis, evaluation, monitoring, treatment and prevention of diseases and other conditions affecting animals. At June 30, 2010, we operated 48 laboratories of various sizes located strategically throughout the United States and Canada.

Our Medical Technology segment sells digital radiography and ultrasound imaging equipment, provides education and training on the use of that equipment, provides consulting and mobile imaging services, and sells software and ancillary services to the veterinary market.

2. Basis of Presentation

Our accompanying unaudited, condensed, consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (GAAP) for interim financial information and in accordance with the rules and regulations of the United States Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and notes required by GAAP for annual financial statements as permitted under applicable rules and regulations. In the opinion of management, all normal recurring adjustments considered necessary for a fair presentation have been included. The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of the results to be expected for the full year ending December 31, 2010. For further information, refer to our consolidated financial statements and notes thereto included in our 2009 Annual Report on Form 10-K.

Certain reclassifications have been made herein to 2009 amounts to conform to the current year presentation. For the three and six months ended June 30, 2009, we reclassified certain business operations from our Medical Technology segment to our Laboratory segment to conform to the current year presentation; the reclassifications did not have a material impact on either of our segments.

The preparation of our condensed, consolidated financial statements in accordance with GAAP requires 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.

3. Multiple-Deliverable Revenue Arrangements

In October 2009, the FASB issued new accounting guidance related to multiple-deliverable revenue arrangements. The new guidance was designed to result in financial reporting that better reflects the underlying economics of multiple-deliverable transactions. We early adopted the new guidance on January 1, 2010, which resulted in the more timely recognition of revenue in our Medical Technology business segment. The early adoption resulted in the recognition of approximately \$830,000 and \$2.0 million in incremental revenue for the three and six months ended June 30, 2010, respectively, in comparison to the revenue that would have been recognized under previous accounting guidance.

VCA Antech, Inc. and Subsidiaries**Notes to Condensed, Consolidated Financial Statements (Continued)****3. Multiple-Deliverable Revenue Arrangements, continued**

Our Medical Technology business segment sells Digital Radiography (DR) imaging equipment to end users and to distributors in international markets which includes receptor plates, related computer equipment, software and additional related equipment, with one year of warranty support on the receptor plates and items related to the plates, and technical support on all software provided with the equipment. Distributors sell the DR products and warranties to the end customers and are responsible for all support provided directly to the end customer. The support that we provide to distributors is limited to the machines that are under a current support program and includes a level of warranty coordination, support and facilitation, including technical support related to the receptor plates, and receptor plate replacement during warranty repair ensuring limited down time to the end customer.

Under the new accounting guidance, sales arrangement consideration is allocated at the inception of the arrangement to all deliverables using the relative selling price method, whereby any discount in the arrangement is allocated proportionally to each deliverable on the basis of each deliverable's selling price. The selling price for each deliverable is based on vendor-specific objective evidence (VSOE) if available, third-party evidence (TPE) if VSOE is not available, or estimated selling price (ESP) if neither VSOE nor TPE is available. For elements where VSOE is available, VSOE of fair value is based on the price for those products and services when sold separately by us or the price established by management with the relevant authority. TPE of selling price is the price of our, or any of our competitor's, largely interchangeable products or services in stand-alone sales to similarly situated customers.

We do not currently have VSOE for our DR imaging equipment as units are not sold on a stand-alone basis without the related support packages. As this is also true for our competitors, TPE of selling price is also unavailable. We therefore use the ESP to allocate the arrangement consideration related to our DR imaging equipment. Our ESP was based upon the actual selling price of our DR equipment bundled with our Sound Assurance warranty. We calculated the stand-alone selling price of the DR equipment using a cost plus margin approach. The stand-alone cost in most cases was determined using manufacturer data. The margin however was based upon the amount received on the actual sale of the bundled product, which does not differ materially from the margin exclusive of the post-contract customer support (PCS). By utilizing this cost plus actual margin method we were able to incorporate both our internal pricing strategies in addition to external market conditions.

In domestic markets we have VSOE for our PCS as the support package is sold on a stand-alone basis. Our PCS agreements normally include a warranty on the receptor plate and technical support on the software elements. In foreign markets however, we do not have VSOE on the receptor plate warranties. Accordingly we use a similar cost plus margin approach to determine the ESP.

Also in international markets revenue is recognized on the DR equipment upon delivery to the distributor and distributor acceptance. After the DR equipment is delivered there may be a delay as to when the warranty and software PCS period starts as the terms of the arrangement state that the PCS period starts the earlier of the date the DR equipment is delivered to the end user or three months after the DR equipment was delivered to the distributor, as such revenue recognition for the equipment does not start until the PCS period starts. Revenue for the warranty and software PCS is recognized on a straight-line basis over the PCS period.

The changes made under the new accounting guidance did not cause any changes in the units of accounting related to our arrangements.

The new guidance resulted in a different allocation of revenue to the deliverables in the current fiscal year, which changed the pattern and timing of revenue recognition for these elements but did not change the total revenue to be recognized for the arrangement. Revenue and gross profit increased by approximately \$830,000 and \$265,000, respectively, for the three months ending June 30, 2010 and by \$2.0 million and \$545,000, respectively, for the six months ending June 30, 2010. The primary driver of the impact was the acceleration of revenue related to the delivery of the equipment in international markets, which under the previous accounting guidance was deferred over the PCS period as we were unable to establish VSOE for the undelivered elements.

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

3. Multiple-Deliverable Revenue Arrangements, continued

We are not able to reasonably estimate the effect of adopting these standards on future financial periods as the impact will vary based on the nature and volume of new or materially modified arrangements in any given period.

4. Goodwill and Other Intangible Assets**Goodwill**

Goodwill represents the excess of the aggregate of the consideration transferred, the fair value of any noncontrolling interest in the acquiree and for a business combination achieved in stages, the acquisition-date fair value of any previously held equity interest over the net of the fair value of identifiable assets acquired and liabilities assumed. The following table presents the changes in the carrying amount of our goodwill for the six months ended June 30, 2010 (in thousands):

| | Animal Hospital | Laboratory | Medical Technology | Total |
|----------------------------------------------|----------------------------|-------------------|-------------------------------|--------------|
| Balance as of December 31, 2009 | \$ 861,868 | \$ 96,285 | \$ 27,521 | \$ 985,674 |
| Goodwill acquired | 18,385 | 7 | | 18,392 |
| Goodwill related to noncontrolling interests | 33 | | | 33 |
| Other ⁽¹⁾ | (167) | 488 | 2,142 | 2,463 |
| Balance as of June 30, 2010 | \$ 880,119 | \$ 96,780 | \$ 29,663 | \$ 1,006,562 |

⁽¹⁾ Other includes purchase-price adjustments which consist primarily of an adjustment to the valuation of deferred tax assets, buy-outs, earn-out payments and foreign currency translation adjustments.

Other Intangible Assets

In addition to goodwill, we have amortizable intangible assets at June 30, 2010 and December 31, 2009 as follows (in thousands):

| | As of June 30, 2010 | | | As of December 31, 2009 | | |
|---------------------------------------|--------------------------------------|-------------------------------------|------------------------------------|--------------------------------------|-------------------------------------|------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Noncontractual customer relationships | \$ 40,178 | \$ (10,799) | \$ 29,379 | \$ 38,359 | \$ (8,077) | \$ 30,282 |
| Covenants not-to-compete | 13,828 | (7,748) | 6,080 | 14,748 | (7,785) | 6,963 |
| Favorable lease asset | 5,437 | (2,404) | 3,033 | 5,406 | (2,150) | 3,256 |

Edgar Filing: VCA ANTECH INC - Form 10-Q

| | | | | | | |
|--------------|-----------|-------------|-----------|-----------|-------------|-----------|
| Trademarks | 3,398 | (706) | 2,692 | 3,362 | (494) | 2,868 |
| Technology | 2,209 | (1,400) | 809 | 2,209 | (1,332) | 877 |
| Client lists | 37 | (11) | 26 | 60 | (26) | 34 |
| Total | \$ 65,087 | \$ (23,068) | \$ 42,019 | \$ 64,144 | \$ (19,864) | \$ 44,280 |

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

| | Three Months Ended | | Six Months Ended | |
|--------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Aggregate amortization expense | \$ 2,187 | \$ 1,823 | \$ 4,341 | \$ 3,630 |

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

4. Goodwill and Other Intangible Assets, continued

The estimated amortization expense related to intangible assets for the remainder of 2010 and each of the succeeding years thereafter as of June 30, 2010 is as follows (in thousands):

| | |
|-------------------|------------------|
| Remainder of 2010 | \$ 4,816 |
| 2011 | 8,430 |
| 2012 | 7,429 |
| 2013 | 5,308 |
| 2014 | 4,040 |
| Thereafter | 11,996 |
| Total | \$ 42,019 |

5. Other Accrued Liabilities

Other accrued liabilities consisted of the following (in thousands):

| | June 30, 2010 | December 31, 2009 |
|-----------------------------------------|--------------------------|----------------------------------|
| Deferred revenue | \$ 10,528 | \$ 12,497 |
| Accrued consulting fees | 9,064 | |
| Accrued health insurance | 4,627 | 4,484 |
| Deferred rent | 3,142 | 2,989 |
| Accrued workers' compensation insurance | 2,422 | 2,217 |
| Customer deposits | 2,648 | 3,783 |
| Other | 19,078 | 17,328 |
| | \$ 51,509 | \$ 43,298 |

6. Interest Rate Swap Agreements

In accordance with current accounting guidance, all investments in derivatives are recorded at fair value. A derivative is typically defined as an instrument whose value is derived from an underlying instrument, index or rate, has a notional amount, requires little or no initial investment and can be net settled. Our derivatives are reported as current assets and liabilities or other non-current assets or liabilities as appropriate.

We use interest rate swap agreements to mitigate our exposure to increasing interest rates as well as to maintain an appropriate mix of fixed-rate and variable-rate debt.

If we determine that contracts are effective at meeting our risk reduction and correlation criteria we account for them using hedge accounting. Under hedge accounting, we recognize the effective portion of changes in the fair value of the contracts in other comprehensive income and the ineffective portion in earnings. If we determine that contracts do not, or no longer, meet our risk reduction and correlation criteria, we account for them under a fair-value method recognizing changes in the fair value in earnings in the period of change. If we determine that a contract no longer meets our risk reduction and correlation criteria, or if the derivative expires, we recognize in earnings any accumulated balance in other comprehensive income related to the contract in the period of determination. For interest rate swap agreements accounted for under hedge accounting, we assess the effectiveness based on changes in their intrinsic value with changes in the time value portion of the contract reflected in earnings. All cash payments made or received under the contracts are recognized in interest expense.

Credit exposure associated with nonperformance by the counterparties to derivative instruments is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the consolidated balance sheets. We attempt to mitigate the risk of nonperformance by selecting counterparties with high credit ratings and monitoring their creditworthiness and by diversifying derivative amounts with multiple counterparties.

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

6. Interest Rate Swap Agreements, continued

The contractual or notional amounts for derivatives are used to calculate the exchange of contractual payments under the agreements and are not representative of the potential for gain or loss on these instruments. Interest rates affect the fair value of derivatives. The fair values generally represent the estimated amounts that we would expect to receive or pay upon termination of the contracts at the reporting date. The fair values are based upon dealer quotes when available or an estimate using values obtained from independent pricing services, costs to settle or quoted market prices of comparable instruments.

As of the quarter ended March 31, 2010, all of our interest rate swap agreements had expired and we have not entered into any new agreements during the quarter ended June 30, 2010.

The following table summarizes cash paid and ineffectiveness reported in earnings as a result of our interest rate swap agreements (in thousands):

| | Three Months Ended | | Six Months Ended | |
|-----------------------------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Cash paid ⁽¹⁾ | \$ | \$ 2,727 | \$ 382 | \$ 5,972 |
| Recognized gain from ineffectiveness ⁽²⁾ | \$ | \$ (22) | \$ | \$ (71) |

⁽¹⁾ Our interest rate swap agreements effectively converted a certain amount of our variable-rate debt under our senior credit facility to fixed-rate for purposes of hedging against the risk of increasing interests rates. The above table depicts cash payments to the counterparties on our swap agreements. These payments are offset by a corresponding decrease in interest paid on our variable-rate

debt under our senior credit facility. These amounts are included in interest expense, net in our condensed, consolidated income statements.

- (2) The recognized gain is included in other income in our condensed, consolidated income statements.

7. Fair Value Measurements

Current fair value accounting guidance includes a hierarchy that is intended to increase consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy is based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon their own market assumptions. The current guidance establishes a three-tiered fair value hierarchy which prioritizes the inputs used in measuring fair value as follows:

Level 1. Observable inputs such as quoted prices in active markets;

Level 2. Inputs, other than quoted prices, that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active; and

Level 3. Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

7. Fair Value Measurements, continued*Fair Value of Financial Instruments*

The FASB accounting guidance requires disclosure of fair value information about financial instruments, whether or not recognized in the accompanying condensed, consolidated balance sheets. Fair value as defined by the guidance is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value estimates of financial instruments are not necessarily indicative of the amounts we might pay or receive in actual market transactions. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Cash and Cash Equivalents. These balances include cash and cash equivalents with maturities of less than three months. The carrying amount approximates fair value due to the short-term maturities of these instruments.

Receivables, Less Allowance for Doubtful Accounts, Accounts Payable and Certain Other Accrued Liabilities. Due to their short-term nature, fair value approximates carrying value.

Long-Term Debt. We believe the carrying value of our variable-rate senior-term debt at June 30, 2010 is a reasonable estimate of fair value as the debt is scheduled to mature within a year of the balance sheet date. Our existing senior credit facilities are scheduled to mature in May of 2011; accordingly all remaining principal balances have been included in the current portion of long-term debt in our condensed, consolidated balance sheet for the period ended June 30, 2010. We are in the process of refinancing the remaining balances with new senior credit facilities consisting of a senior secured term loan and a senior secured revolving credit facility. We anticipate the refinance will occur during the third quarter of 2010.

We believed the carrying value of our variable-rate debt at December 31, 2009 was not a reasonable estimate of fair value due to changes in the credit market during 2009. We estimated the fair value of our variable-rate debt using discounted cash flow techniques utilizing current market rates, which incorporate our credit risk.

The following table reflects the carrying value and fair value of our long-term debt (in thousands):

| | As of June 30, 2010 | | As of December 31, 2009 | |
|------------------------------|---------------------|---------------|-------------------------|---------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Variable-rate long-term debt | \$ 505,448 | \$ 505,448 | \$ 516,889 | \$ 513,053 |

Interest Rate Swap Agreements. We use the market approach to measure fair value for our interest rate swap agreements. The market approach uses prices and other relevant information generated by market transactions involving comparable assets or liabilities.

The following table reflects the fair value of our interest rate swap agreements, which is measured on a recurring basis as defined by the FASB accounting guidance (in thousands):

| | Balance | Basis of Fair Value Measurement | | |
|---------------------------|---------|------------------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| | | Quoted Prices In Active Markets for Identical Items (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| At December 31, 2009 | | | | |
| Other accrued liabilities | \$ 380 | \$ | \$ 380 | \$ |

As of June 30, 2010, we do not have any applicable non-recurring measurements of non-financial assets and non-financial liabilities.

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

8. Share-Based Compensation***Stock Option Activity***

A summary of our stock option activity for the six months ended June 30, 2010 is as follows (in thousands):

| | Stock Options | Weighted- Average Exercise Price |
|-----------------------------------|--------------------------|-----------------------------------------------------|
| Outstanding at December 31, 2009 | 4,300 | \$ 16.72 |
| Exercised | (221) | 17.02 |
| Cancelled | (48) | 19.81 |
| Outstanding at June 30, 2010 | 4,031 | \$ 16.66 |
| Exercisable at June 30, 2010 | 3,309 | \$ 16.58 |
| Expected to vest at June 30, 2010 | 689 | \$ 17.04 |

There were no stock options granted during the six months ended June 30, 2010. The aggregate intrinsic value of our stock options exercised during the three and six months ended June 30, 2010 was \$400,000, and \$2.0 million, respectively, and the actual tax benefit realized on options exercised during these periods was \$156,000 and \$763,000, respectively.

At June 30, 2010 there was \$2.3 million of total unrecognized compensation cost related to our stock options. This cost is expected to be recognized over a weighted-average period of 1.6 years.

The compensation cost that has been charged against income for stock options for the three months ended June 30, 2010 and 2009 was \$1.4 million and \$497,000, respectively. The corresponding income tax benefit recognized was \$528,000 and \$194,000 for the three months ended June 30, 2010 and 2009, respectively.

The compensation cost that has been charged against income for stock options for the six months ended June 30, 2010 and 2009 was \$1.8 million and \$1.0 million, respectively. The corresponding income tax benefit recognized was \$711,000 and \$393,000 for the six months ended June 30, 2010 and 2009, respectively.

Nonvested Stock Activity

During the six months ended June 30, 2010 we granted 11,104 shares of nonvested common stock. These awards were granted to our non-employee directors and will vest in equal annual installments over three years from the date of grant.

Total compensation cost charged against income related to nonvested stock awards was \$2.4 million and \$1.4 million for the three months ended June 30, 2010 and 2009, respectively. The corresponding income tax benefit recognized in the income statement was \$939,000 and \$566,000 for the three months ended June 30, 2010 and 2009, respectively.

Total compensation cost charged against income related to nonvested stock awards was \$4.0 million and \$2.9 million for the six months ended June 30, 2010 and 2009, respectively. The corresponding income tax benefit recognized in the income statement was \$1.6 and \$1.1 million for the six months ended June 30, 2010 and 2009, respectively.

At June 30, 2010, there was \$6.2 million of unrecognized compensation cost related to these nonvested shares, which will be recognized over a weighted-average period of 2.1 years. A summary of our nonvested stock activity for the six months ended June 30, 2010 is as follows:

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

8. Share-Based Compensation, continued

| | Shares | Weighted-Average Fair Value Per Share |
|----------------------------------|---------------|----------------------------------------------|
| Outstanding at December 31, 2009 | 691,764 | \$ 30.54 |
| Granted | 11,104 | \$ 27.03 |
| Vested | (259,520) | \$ 31.68 |
| Forfeited/Canceled | (10,355) | \$ 30.35 |
| Outstanding at June 30, 2010 | 432,993 | \$ 29.77 |

Restricted Stock Unit Activity

Pursuant to the terms of the 2006 Equity Incentive Plan, on April 17, 2009, we awarded 84,757 restricted stock units in lieu of cash bonuses to our four senior executive officers for services performed in fiscal year 2008. Restricted stock units differ from the non-vested stock awards mentioned above in that the restricted stock units were fully vested or earned by the employee on the grant date however are restricted such that the participant will not have any right, title, or interest in, or otherwise be considered the owner of, any of the shares of common stock covered by the restricted stock units until such shares of common stock are settled. The restricted stock units will be settled upon the first to occur of the following: May 1, 2012, the date of the senior executive's separation from service, death or disability, or the date of a change in control. The restricted stock units had a grant date fair value of \$22.90 per share resulting in a total value of \$1.9 million and the grant was reported as a non-cash financing activity for the June 30, 2009 period. There were no restricted stock grants for the June 30, 2010 period.

9. Calculation of Earnings per Share

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

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Net income attributable to VCA Antech, Inc | \$ 29,404 | \$ 37,745 | \$ 61,339 | \$ 69,715 |
| Weighted-average common shares outstanding: | | | | |
| Basic | 86,041 | 84,825 | 85,933 | 84,753 |
| Effect of dilutive potential common shares: | | | | |
| Stock options | 951 | 902 | 943 | 709 |
| Nonvested shares | 186 | 210 | 193 | 167 |
| Diluted | 87,178 | 85,937 | 87,069 | 85,629 |

Edgar Filing: VCA ANTECH INC - Form 10-Q

| | | | | |
|----------------------------|---------|---------|---------|---------|
| Basic earnings per share | \$ 0.34 | \$ 0.45 | \$ 0.71 | \$ 0.82 |
| Diluted earnings per share | \$ 0.34 | \$ 0.44 | \$ 0.70 | \$ 0.81 |

For the three months ended June 30, 2010 and 2009, potential common shares of 4,200 and 8,001, respectively, were excluded from the computation of diluted earnings per share because their inclusion would have had an antidilutive effect.

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

9. Calculation of Earnings per Share, continued

For the six months ended June 30, 2010 and 2009, potential common shares of 12,264 and 1,273,098, respectively, were excluded from the computation of diluted earnings per share because their inclusion would have had an antidilutive effect.

10. Comprehensive Income

Total comprehensive income consists of net income and the other comprehensive income during the three and six months ended June 30, 2010 and 2009. The following table provides a summary of comprehensive income (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Net income | \$ 30,517 | \$ 38,968 | \$ 63,449 | \$ 71,849 |
| Other comprehensive income: | | | | |
| Foreign currency translation adjustments | (236) | 355 | (69) | 177 |
| Unrealized (loss) gain on foreign currency | (259) | 252 | (77) | 157 |
| Tax benefit (expense) | 101 | (98) | 30 | (61) |
| Unrealized loss on hedging instruments | | (456) | (2) | (1,070) |
| Tax benefit | | 178 | 1 | 418 |
| Losses on hedging instruments reclassified to income | | 2,727 | 382 | 5,972 |
| Tax benefit | | (1,066) | (149) | (2,335) |
| Other comprehensive (loss) income | (394) | 1,892 | 116 | 3,258 |
| Total comprehensive income | 30,123 | 40,860 | 63,565 | 75,107 |
| Comprehensive income attributable to noncontrolling interests | 1,113 | 1,223 | 2,110 | 2,134 |
| Comprehensive income attributable to VCA Antech, Inc | \$ 29,010 | \$ 39,637 | \$ 61,455 | \$ 72,973 |

11. Lines of Business

Our reportable segments are Animal Hospital, Laboratory and Medical Technology. These segments are strategic business units that have different services, products and/or functions. The segments are managed separately because each is a distinct and different business venture with unique challenges, risks and rewards. Our Animal Hospital segment provides veterinary services for companion animals and sells related retail and pharmaceutical products. Our Laboratory segment provides diagnostic laboratory testing services for veterinarians, both associated with our animal hospitals and those independent of us. Our Medical Technology segment sells digital radiography and ultrasound imaging equipment, related computer hardware, software and ancillary services to the veterinary market. We also operate a corporate office that provides general and administrative support services for our other segments.

The accounting policies of our segments are essentially the same as those described in the summary of significant accounting policies included in our 2009 Annual Report on Form 10-K. See Note 3, *Multiple-Deliverable Revenue Arrangements*, for an update on our revenue recognition policies as a result of implementing the FASB's accounting guidance on multiple-deliverable revenue arrangements. We evaluate the performance of our segments based on gross profit and operating income. For purposes of reviewing the operating performance of our segments all intercompany sales and purchases are generally accounted for as if they were transactions with independent third parties at current market prices.

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

11. Lines of Business, continued

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

| | Animal Hospital | Laboratory⁽¹⁾ | Medical Technology⁽¹⁾ | Corporate | Intercompany Eliminations | Total⁽¹⁾ |
|---------------------------------------------------|----------------------------|---------------------------------|---------------------------------------------|------------------|--------------------------------------|----------------------------|
| Three Months Ended June 30, 2010 | | | | | | |
| External revenue | \$ 267,595 | \$ 73,259 | \$ 13,065 | \$ | \$ | \$ 353,919 |
| Intercompany revenue | | 9,713 | 1,537 | | (11,250) | |
| Total revenue | 267,595 | 82,972 | 14,602 | | (11,250) | 353,919 |
| Direct costs | 218,567 | 42,416 | 10,255 | | (10,803) | 260,435 |
| Gross profit | 49,028 | 40,556 | 4,347 | | (447) | 93,484 |
| Selling, general and administrative expense | 5,673 | 6,527 | 3,404 | 25,441 | | 41,045 |
| Net (gain) loss on sale and disposal of assets | (35) | | 14 | 7 | | (14) |
| Operating income (loss) | \$ 43,390 | \$ 34,029 | \$ 929 | \$ (25,448) | \$ (447) | \$ 52,453 |
| Depreciation and amortization | \$ 7,630 | \$ 2,396 | \$ 605 | \$ 618 | \$ (250) | \$ 10,999 |
| Capital expenditures | \$ 9,849 | \$ 1,506 | \$ 124 | \$ 858 | \$ (461) | \$ 11,876 |
| Three Months Ended June 30, 2009 | | | | | | |
| External revenue | \$ 261,287 | \$ 74,562 | \$ 9,027 | \$ | \$ | \$ 344,876 |
| Intercompany revenue | | 8,614 | 1,236 | | (9,850) | |
| Total revenue | 261,287 | 83,176 | 10,263 | | (9,850) | 344,876 |
| Direct costs | 208,154 | 42,102 | 6,738 | | (9,466) | 247,528 |
| Gross profit | 53,133 | 41,074 | 3,525 | | (384) | 97,348 |
| Selling, general and administrative expense | 5,378 | 5,644 | 2,394 | 9,525 | | 22,941 |
| Net loss on sale and disposal of assets | 129 | 25 | 5 | 5,284 | | 5,443 |
| Operating income (loss) | \$ 47,626 | \$ 35,405 | \$ 1,126 | \$ (14,809) | \$ (384) | \$ 68,964 |
| Depreciation and amortization | \$ 6,560 | \$ 2,293 | \$ 367 | \$ 668 | \$ (200) | \$ 9,688 |
| Capital expenditures | \$ 9,753 | \$ 1,989 | \$ 238 | \$ 1,793 | \$ (410) | \$ 13,363 |

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

11. Lines of Business, continued

| | Animal Hospital | Laboratory⁽¹⁾ | Medical Technology⁽¹⁾ | Corporate | Intercompany Eliminations | Total⁽¹⁾ |
|---------------------------------------------------|----------------------------|---------------------------------|---------------------------------------------|------------------|--------------------------------------|----------------------------|
| Six Months Ended June 30, 2010 | | | | | | |
| External revenue | \$ 514,263 | \$ 142,659 | \$ 27,731 | \$ | \$ | \$ 684,653 |
| Intercompany revenue | | 18,493 | 2,668 | | (21,161) | |
| Total revenue | 514,263 | 161,152 | 30,399 | | (21,161) | 684,653 |
| Direct costs | 423,558 | 84,068 | 21,221 | | (20,473) | 508,374 |
| Gross profit | 90,705 | 77,084 | 9,178 | | (688) | 176,279 |
| Selling, general and administrative expense | 11,260 | 12,681 | 6,919 | 36,325 | | 67,185 |
| Net (gain) loss on sale and disposal of assets | (51) | 1 | 54 | 7 | | 11 |
| Operating income (loss) | \$ 79,496 | \$ 64,402 | \$ 2,205 | \$ (36,332) | \$ (688) | \$ 109,083 |
| Depreciation and amortization | \$ 14,982 | \$ 4,809 | \$ 1,206 | \$ 1,199 | \$ (490) | \$ 21,706 |
| Capital expenditures | \$ 22,977 | \$ 2,338 | \$ 206 | \$ 3,185 | \$ (781) | \$ 27,925 |
| Six Months Ended June 30, 2009 | | | | | | |
| External revenue | \$ 499,645 | \$ 144,275 | \$ 16,806 | \$ | \$ | \$ 660,726 |
| Intercompany revenue | | 16,763 | 2,242 | | (19,005) | |
| Total revenue | 499,645 | 161,038 | 19,048 | | (19,005) | 660,726 |
| Direct costs | 403,348 | 83,933 | 12,295 | | (18,367) | 481,209 |
| Gross profit | 96,297 | 77,105 | 6,753 | | (638) | 179,517 |
| Selling, general and administrative expense | 10,762 | 11,211 | 5,206 | 18,679 | | 45,858 |
| Net (gain) loss on sale and disposal of assets | (130) | 27 | 6 | 5,292 | | 5,195 |
| Operating income (loss) | \$ 85,665 | \$ 65,867 | \$ 1,541 | \$ (23,971) | \$ (638) | \$ 128,464 |
| Depreciation and amortization | \$ 12,859 | \$ 4,488 | \$ 724 | \$ 1,156 | \$ (387) | \$ 18,840 |
| Capital expenditures | \$ 18,876 | \$ 4,118 | \$ 318 | \$ 2,678 | \$ (782) | \$ 25,208 |

At June 30, 2010

| | | | | | | |
|--------------|--------------|------------|-----------|------------|-------------|--------------|
| Total assets | \$ 1,191,031 | \$ 212,103 | \$ 69,149 | \$ 260,651 | \$ (12,077) | \$ 1,720,857 |
|--------------|--------------|------------|-----------|------------|-------------|--------------|

At December 31, 2009

| | | | | | | |
|--------------|--------------|------------|-----------|------------|-------------|--------------|
| Total assets | \$ 1,158,891 | \$ 207,043 | \$ 71,019 | \$ 201,024 | \$ (10,573) | \$ 1,627,404 |
|--------------|--------------|------------|-----------|------------|-------------|--------------|

(1) Certain prior year amounts have been reclassified to reflect the transfer of certain business operations to the Laboratory segment from the Medical Technology segment. The reclassifications did not have a material impact on either of our segments.

VCA Antech, Inc. and Subsidiaries
Notes to Condensed, Consolidated Financial Statements (Continued)

12. Commitments and Contingencies

We have certain commitments, including operating leases and purchase agreements. These items are discussed in detail in our consolidated financial statements and notes thereto included in our 2009 Annual Report on Form 10-K. We also have contingencies as follows:

a. Earn-Out Payments

We have contractual arrangements in connection with certain acquisitions that were accounted for under previous business combinations accounting guidance, 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, at June 30, 2010, we will be obligated to pay an additional \$1.4 million. We adopted new accounting guidance regarding business combinations for acquisitions with acquisition dates of January 1, 2009 or later. Under the new guidance contingent consideration, such as earn-out liabilities, is now recognized as part of the consideration transferred on the acquisition date and a corresponding liability is recorded based on the fair value of the liability. The changes in fair value are recognized in earnings where applicable at each reporting period.

b. Supplemental Executive Retirement Program

On June 30, 2010, we executed a Supplemental Executive Retirement Program (SERP) agreement with each of the following executive officers of our company: Robert L. Antin, Arthur J. Antin, Neil Tauber and Tomas W. Fuller. The agreement provides for monthly benefit payments upon the attainment of normal retirement age, as defined in each of their agreements. The annual amount of the benefit payments will be equal to the vested percentage of final salary as of the date their employment terminates. Final salary is equal to the greater of (i) their annual base compensation paid in cash pursuant to their employment agreement immediately prior to the benefit commencement date, or (ii) the average of their annual base compensation paid in cash pursuant to their employment agreement for the three highest years during the ten year period ending on December 31st immediately preceding the benefit commencement date. Vesting percentages are in accordance with their individual SERP agreements. The payments to which the executive officers are entitled will extend for 12 years following the benefit commencement date.

The applicable percentage immediately will be 50% if before or coincident with the officers separation from employment there occurs a change in control, an involuntary termination by the company without cause, a voluntary termination by the officer for good reason, or the officer's death or disability. If before the benefit commencement date, there is a change in control that qualifies as a change in control event within the meaning of Treasury Regulation section 1.409A-3(i)(5) or the officer dies or becomes disabled, then the actuarial equivalent of the monthly benefits owing to the officer must be paid in a lump sum on the date of such event. In addition, if a change in control that is also a change in control event occurs after the benefit commencement date, then the SERP agreement terminates and the actuarial equivalent of any remaining monthly benefits owing to the officer must be paid in a lump sum on the date of such change in control event.

At June 30, 2010 we have \$6.1 million recorded in the other liabilities section of the condensed, consolidated balance sheet, of which \$4.5 million was recorded as compensation expense for the three and six months ended June 30, 2010.

The costs associated with both the SERP agreements and Consulting agreements which are described below have been recognized over each executive's requisite service period assuming the service to be provided is deemed substantive.

c. Consulting Agreement

On June 30, 2010, we entered into consulting agreements with each of the following executive officers of our company: Robert L. Antin, Arthur J. Antin, Neil Tauber and Tomas W. Fuller. The agreements each provide for compensation for future consulting services following each executive's resignation. The executive will continue to be an employee of the company and qualify for SERP vesting during the term of the consulting agreement. The term of the agreement is defined in each of the executive's respective agreements. Compensation is determined by taking the

higher of: (i) the executive's annual base salary immediately before the effective date (before adjustments for elective deferrals or contributions to company-sponsored employee benefit plans), plus the highest bonus earned by the executive with respect to services rendered during the four preceding full calendar years immediately before the effective date, or (ii) the average of the executive's annual base salary plus any bonus earned (before adjustments for elective deferrals or contributions to company-sponsored employee benefit plans) with respect to services rendered during the two highest compensation years for the five-year period ending on the December 31st immediately preceding the effective date. For the three and six months ended June 30, 2010 we accrued \$10.9 million related to the estimated future compensation; the payments will be made over a period ranging from three to five years.

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.

In the fourth quarter of 2009, we received correspondence from the state of New York which included a proposed assessment of taxes payable related to our reported taxable income for the tax years from 2004 through 2006. We have evaluated the proposal and have determined that it is more likely than not that our position will be upheld.

13. Subsequent Events

On July 1, 2010, we acquired a controlling interest in Pet DRx Corporation (Pet DRx), a provider of veterinary primary care and specialized services to companion animals. The acquisition expands our presence in the California market. Under the agreement we will acquire Pet DRx in two steps for a total purchase price of \$41.3 million. We anticipate the completion of step two prior to the year end. The results of Pet DRx will be reported within our Animal Hospital segment.

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

| | Page |
|------------------------------------|-------------|
| Introduction | 19 |
| Executive Overview | 20 |
| Critical Accounting Policies | 21 |
| Consolidated Results of Operations | 22 |
| Segment Results | 24 |
| Liquidity and Capital Resources | 29 |

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 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 August 10, 2010, and we undertake no duty to update this information. Shareholders and prospective investors can find information filed with the SEC after August 10, 2010 at our website at <http://investor.vcaantech.com> or at the SEC's website www.sec.gov.

We are a leading national animal healthcare company. We provide veterinary services and diagnostic testing to support veterinary care and we sell diagnostic imaging equipment, other medical technology products and related services to veterinarians. Our reportable segments are as follows:

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 and retail products and perform a variety of pet wellness programs, including health examinations, diagnostic testing, routine vaccinations, spaying, neutering and dental care. At June 30, 2010, our animal hospital network consisted of 496 animal hospitals in 40 states.

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 June 30, 2010, our Laboratory network consisted of 48 laboratories serving all 50 states and certain areas in Canada.

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

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, heartworm and ticks, and the number of daylight hours.

Our revenue has been adversely impacted by the current economic recession. We are unable to forecast the timing or degree of any economic recovery. Further, trends in the general economy may not be reflected in our business at the same time or in the same degree as in the general economy. The timing and degree of any economic recovery, and its impact on our business, are among the important factors that could cause our actual results to differ from our forward-looking information.

Executive Overview

During the three and six months ended June 30, 2010, the economy continued to negatively impact organic revenue growth in both our Animal Hospital and Laboratory business segments. We achieved an increase in consolidated revenues primarily through animal hospital acquisitions and increased revenue from our Medical Technology business segment, which was partially offset by a decline in Animal Hospital same-store revenue. Our Animal Hospital same-store revenue growth was negative 2.0% and negative 1.8% for the three and six months ended June 30, 2010, respectively. Our overall earnings declined in comparison to the prior year due to the impact of consulting agreements and SERPs entered into with our senior executive officers during the quarter and lower gross profit margins offset by lower interest expense on our long-term debt.

Acquisitions and Facilities

Our growth strategy includes the acquisition of independent animal hospitals. Including animal hospitals acquired during the first half of 2010 and the Pet DRx acquisition on July 1, 2010, we currently anticipate that we will acquire \$110 million to \$120 million of annualized Animal Hospital revenue by the end of 2010. We also evaluate the acquisition of animal hospital chains and laboratories, or related businesses if favorable opportunities are presented. The following table summarizes the changes in the number of facilities operated by our Animal Hospital and Laboratory segments during the six months ended June 30, 2010:

Animal Hospitals:

| | |
|------------------------|-----|
| Beginning of period | 489 |
| Acquisitions | 11 |
| Sold, closed or merged | (4) |
| End of period | 496 |

Laboratories:

| | |
|-------------------------------------------------------|-----|
| Beginning of period | 47 |
| Acquisitions | |
| Acquisitions relocated into our existing laboratories | (1) |
| Created | 2 |
| End of period | 48 |

The following table summarizes the aggregate consideration for the eleven animal hospitals acquired during the six months ended June 30, 2010, and the allocation of the purchase price (in thousands):

Consideration:

| | |
|-----------------------------------------------|-----------|
| Cash ⁽¹⁾ | \$ 19,350 |
| Contingent consideration | 7 |
| Fair value of total consideration transferred | \$ 19,357 |

Allocation of the Purchase Price:

| | |
|--------------------------------|----------|
| Tangible assets | \$ 1,407 |
| Identifiable intangible assets | 2,380 |
| Goodwill ⁽²⁾ | 18,415 |
| Other liabilities assumed | (2,845) |

Total

\$ 19,357

- (1) See the *Cash Flows from Investing Activities* section in the Liquidity and Capital Resources discussion for reconciliation of cash paid for acquisitions per this schedule to the condensed, consolidated statement of cash flows.
- (2) We expect that \$8.0 million of the goodwill recorded for these acquisitions as of June 30, 2010 will be fully deductible for income tax purposes.

In addition to the purchase price listed above, we made cash payments for real estate acquired in connection with our purchase of animal hospitals totaling \$1.3 million for the six months ended June 30, 2010.

Acquisition of Eklin Medical Systems, Inc.

On July 1, 2009, we acquired Eklin, a leading seller of digital radiography and ultrasound systems in the veterinary market. We acquired Eklin for a purchase price of \$12.5 million, net of cash acquired of \$1.0 million. The following table summarizes the consideration and allocation of the purchase price (in thousands):

Consideration:

| | |
|-----------------------------------------------|-----------|
| Cash | \$ 12,504 |
| Fair value of total consideration transferred | \$ 12,504 |

Allocation of the Purchase Price:

| | |
|--------------------------------|-----------|
| Tangible assets | \$ 6,830 |
| Identifiable intangible assets | 7,351 |
| Goodwill ⁽¹⁾ | 10,875 |
| Other liabilities assumed | (12,552) |
| Total | \$ 12,504 |

⁽¹⁾ We expect that \$3.4 million of the goodwill recorded for this acquisition as of June 30, 2010 will be fully deductible for income tax purposes.

Eklin has been combined with Sound Technologies, Inc. (STI) and is reported within our Medical Technology segment.

The pro forma impacts on revenue and earnings have not been disclosed for the current or comparable prior periods as the amounts were immaterial to the financial statements as a whole.

Critical Accounting Policies

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (GAAP), which require management to make estimates and assumptions that affect reported amounts. The estimates and assumptions are based on historical experience and on other factors that management believes to be reasonable. Actual results may differ from those estimates. Critical accounting policies represent the areas where more significant judgments and estimates are used in the preparation of our consolidated financial statements. A discussion of such critical accounting policies, which include revenue recognition, valuation of goodwill and other intangible assets, income taxes, and self-insured liabilities can be found in our 2009 Annual Report on Form 10-K. During the quarter ended March 31, 2010, we implemented new accounting guidance related to multiple-deliverable revenue arrangements. Other than the changes to our revenue recognition policies there have been no other material changes to the policies noted above as of this quarterly report on Form 10-Q for the period ended June 30, 2010.

Medical Technology Revenue

We sell our digital radiography imaging equipment with multiple elements, including hardware, software, licenses and/or services. Under new accounting guidance, tangible products containing software components and nonsoftware components that function together to deliver the tangible product's essential functionality are now accounted for under the FASB's guidance pertaining to multiple-deliverable revenue arrangements. These types of arrangements were previously accounted for under software accounting guidance. Accordingly we now account for our digital radiography imaging equipment under this revised guidance.

Sales arrangement consideration is allocated at the inception of the arrangement to all deliverables using the relative selling price method, whereby any discount in the arrangement is allocated proportionally to each deliverable on the basis of each deliverable's selling price. The selling price for each deliverable is based on vendor-specific objective evidence (VSOE) if available, third-party evidence (TPE) if VSOE is not available,

or estimated selling price (ESP) if neither VSOE nor TPE is available. For elements where VSOE is available, VSOE of fair value is based on the price for those products and services when sold separately by us or the price established by management with the relevant authority. TPE of selling price is the price of our, or any of our competitor s, largely interchangeable products or services in stand-alone sales to similarly situated customers. Our ESP was based upon the actual selling price of our DR equipment bundled with our Sound Assurance warranty. We calculated the stand-alone selling price of the DR equipment using a cost plus margin approach. The stand-alone cost in most cases was determined using manufacturer data. The margin however was based upon the amount received on the actual sale of the bundled product, which does not differ materially from the margin exclusive of the post-contract customer support (PCS). By utilizing this cost plus actual margin method we were able to incorporate both our internal pricing strategies in addition to external market conditions.

We do not currently have VSOE for our digital radiography imaging equipment as units are not sold on a stand-alone basis without support packages. As this is also true for our competitors, TPE of selling price is also unavailable. We therefore use the ESP to determine the selling price of our digital radiography imaging equipment using the methodology mentioned above. See Note 3, *Multiple-Deliverable Revenue Arrangements*, in our condensed, consolidated financial statements of this quarterly report on Form 10-Q for a more detailed discussion.

We recognize revenue when the services are provided or at the time of delivery or installation and customer acceptance. Generally, at the time of delivery and installation of equipment the only undelivered item is the PCS. This obligation is contractually defined in both terms of scope and period. For the PCS, we recognize the revenue for these services on a straight-line basis over the period of support and we expense the costs of these services as they are incurred.

Consolidated Results of Operations

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

| | Three Months Ended | | Six Months Ended | |
|-----------------------------------------------------|--------------------|-------|------------------|-------|
| | June 30, | | June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Revenue: | | | | |
| Animal Hospital | 75.6% | 75.8% | 75.1% | 75.6% |
| Laboratory | 23.4 | 24.1 | 23.5 | 24.4 |
| Medical Technology | 4.1 | 3.0 | 4.4 | 2.9 |
| Intercompany | (3.1) | (2.9) | (3.0) | (2.9) |
| Total revenue | 100.0 | 100.0 | 100.0 | 100.0 |
| Direct costs | 73.6 | 71.8 | 74.3 | 72.8 |
| Gross profit | 26.4 | 28.2 | 25.7 | 27.2 |
| Selling, general and administrative expense | 11.6 | 6.7 | 9.8 | 6.9 |
| Net loss on sale and disposal of assets | | 1.5 | | 0.9 |
| Operating income | 14.8 | 20.0 | 15.9 | 19.4 |
| Interest expense, net | 0.8 | 1.7 | 0.8 | 1.7 |
| Other income, net | (0.1) | | | |
| Income before provision for income taxes | 14.1 | 18.3 | 15.1 | 17.7 |
| Provision for income taxes | 5.5 | 7.0 | 5.8 | 6.8 |
| Net income | 8.6 | 11.3 | 9.3 | 10.9 |
| Net income attributable to noncontrolling interests | 0.3 | 0.4 | 0.3 | 0.3 |

| | | | | |
|--------------------------------------------|------|-------|------|-------|
| Net income attributable to VCA Antech, Inc | 8.3% | 10.9% | 9.0% | 10.6% |
|--------------------------------------------|------|-------|------|-------|

Revenue

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

| | Three Months Ended June 30, | | | | | Six Months Ended June 30, | | | | |
|---------------------------|-----------------------------|------------|------------|------------|----------|---------------------------|------------|------------|------------|----------|
| | 2010 | | 2009 | | % Change | 2010 | | 2009 | | % Change |
| | \$ | % of Total | \$ | % of Total | | \$ | % of Total | \$ | % of Total | |
| Animal | | | | | | | | | | |
| Hospital | \$ 267,595 | 75.6% | \$ 261,287 | 75.8% | 2.4% | \$ 514,263 | 75.1% | \$ 499,645 | 75.6% | 2.9% |
| Laboratory ⁽¹⁾ | 82,972 | 23.4% | 83,176 | 24.1% | (0.2)% | 161,152 | 23.5% | 161,038 | 24.4% | 0.1% |
| Medical | | | | | | | | | | |
| Technology ⁽¹⁾ | 14,602 | 4.1% | 10,263 | 3.0% | 42.3% | 30,399 | 4.4% | 19,048 | 2.9% | 59.6% |
| Intercompany | (11,250) | (3.1)% | (9,850) | (2.9)% | 14.2% | (21,161) | (3.0)% | (19,005) | (2.9)% | 11.3% |
| Total revenue | \$ 353,919 | 100.0% | \$ 344,876 | 100.0% | 2.6% | \$ 684,653 | 100.0% | \$ 660,726 | 100.0% | 3.6% |

(1) Prior year amounts have been adjusted to reflect the reclassification of certain business operations from our Medical Technology segment to our Laboratory segment, (see Note 11, *Lines of Business*). The reclassifications did not have a material impact on either segment.

Consolidated revenue increased \$9.0 million for the three months ended June 30, 2010 and \$23.9 million for the six months ended June 30, 2010 as compared to the same periods in the prior year. The increase was primarily attributable to revenue from acquired animal hospitals and increased revenue from our Medical Technology business segment, in part due to our ability to integrate the Eklin product line. The increase was partially offset by a decline in Animal Hospital same-store revenue. Our Animal Hospital same-store growth was negative 2.0% and negative 1.8% for the three and six months ended June 30, 2010, respectively. The decline in our same-store growth rates is attributable to the economic environment mentioned previously.

Gross Profit

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

| | Three Months Ended June 30, | | | | | Six Months Ended June 30, | | | | |
|---------------------------|-----------------------------|--------------|-----------|--------------|--------|---------------------------|--------------|------------|--------------|--------|
| | 2010 | | 2009 | | % | 2010 | | 2009 | | % |
| | \$ | Gross Margin | \$ | Gross Margin | | \$ | Gross Margin | \$ | Gross Margin | |
| Animal | | | | | | | | | | |
| Hospital | \$ 49,028 | 18.3% | \$ 53,133 | 20.3% | (7.7)% | \$ 90,705 | 17.6% | \$ 96,297 | 19.3% | (5.8)% |
| Laboratory ⁽¹⁾ | 40,556 | 48.9% | 41,074 | 49.4% | (1.3)% | 77,084 | 47.8% | 77,105 | 47.9% | 0.0% |
| Medical | | | | | | | | | | |
| Technology ⁽¹⁾ | 4,347 | 29.8% | 3,525 | 34.3% | 23.3% | 9,178 | 30.2% | 6,753 | 35.5% | 35.9% |
| Intercompany | (447) | | (384) | | | (688) | | (638) | | |
| Total gross profit | \$ 93,484 | 26.4% | \$ 97,348 | 28.2% | (4.0)% | \$ 176,279 | 25.7% | \$ 179,517 | 27.2% | (1.8)% |

(1) Prior year amounts have been adjusted to reflect the reclassification of certain business operations from our Medical Technology segment to our Laboratory segment, (see Note 11, *Lines of Business*). The reclassifications did not have a material impact on either segment.

Consolidated gross profit decreased \$3.9 million for the three months ended June 30, 2010 and \$3.2 million for the six months ended June 30, 2010 as compared to the same periods in the prior year. The decrease was primarily due to a decline in Animal Hospital same-store revenues and a decline in both acquired and same-store Animal Hospital gross margins. The decrease was partially offset by increased sales in our Medical Technology segment of digital radiography equipment and customer service revenue partially offset by declines in the gross profit margins due to product mix in that segment.

Segment Results***Animal Hospital Segment***

The following table summarizes revenue, gross profit and gross margin for our Animal Hospital segment (in thousands, except percentages):

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--------------|------------------------------------|-------------|-----------------|----------------------------------|-------------|---------------|
| | 2010 | 2009 | % Change | 2010 | 2009 | Change |
| Revenue | \$ 267,595 | \$ 261,287 | 2.4% | \$ 514,263 | \$ 499,645 | 2.9% |
| Gross profit | \$ 49,028 | \$ 53,133 | (7.7)% | \$ 90,705 | \$ 96,297 | (5.8)% |
| Gross margin | 18.3% | 20.3% | | 17.6% | 19.3% | |

Animal Hospital revenue increased \$6.3 million for the three months ended June 30, 2010 and \$14.6 million for the six months ended June 30, 2010 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 June 30, | | | Six Months Ended June 30, | | |
|------------------------------------------|------------------------------------|-------------|-----------------|----------------------------------|-------------|-----------------|
| | 2010 | 2009 | % Change | 2010 | 2009 | % Change |
| Same-store facilities: | | | | | | |
| Orders ⁽¹⁾ | 1,605 | 1,681 | (4.5)% | 3,036 | 3,179 | (4.5)% |
| Average revenue per order ⁽²⁾ | \$ 158.61 | \$ 154.54 | 2.6% | \$ 157.34 | \$ 153.04 | 2.8% |
| Same-store revenue ⁽¹⁾ | \$ 254,566 | \$ 259,735 | (2.0)% | \$ 477,673 | \$ 486,442 | (1.8)% |
| Net acquired revenue ⁽³⁾ | 13,029 | 1,552 | | 36,590 | 13,203 | |
| Total | \$ 267,595 | \$ 261,287 | 2.4% | \$ 514,263 | \$ 499,645 | 2.9% |

(1) Same-store revenue and orders were calculated using Animal Hospital operating results, adjusted to exclude the operating results for newly acquired animal hospitals that we did not own as of the beginning of the comparable period in the prior year. Same-store revenue also includes revenue

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

- (2) Computed by dividing same-store revenue by same-store orders. The average revenue per order may not calculate exactly due to rounding.
- (3) 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 April 1, 2009 for the three month analysis and January 1, 2009 for the six month analysis. Fluctuations in net acquired revenue occur due to the volume, size, and timing of

acquisitions and
dispositions
during the
periods from
this date
through the end
of the applicable
period.

We believe that factors contributing to the continued decline in our volume of same-store orders during the three and six months ended June 30, 2010 include the continued impact of the current economic environment and the wide availability of many pet-related products traditionally sold in our animal hospitals in retail stores and other distribution channels such as the Internet.

In addition, our business strategy is to place a greater emphasis on comprehensive wellness visits and advanced medical procedures, which typically generate higher priced orders. The migration of lower priced orders from our animal hospitals to other distribution channels mentioned above and our emphasis on comprehensive wellness visits has over the past several years resulted in a decrease in lower priced orders and an increase in higher priced orders. However, this trend was not continued during the three and six months ended June 30, 2010 when we experienced a decrease in the number of both lower and higher priced orders, which we believe is primarily a consequence of the continued depressed economic conditions in the United States, and to a lesser extent the impact of changes in our overall business environment on the mix of tests performed.

Price increases also contributed to the increase in the average revenue per order. Prices at each of our animal hospitals are reviewed regularly and adjustments are made based on market considerations, demographics and our

costs. These adjustments historically have approximated 3% to 6% on most services at the majority of our animal hospitals and are typically implemented in February of each year; however, during the quarter ended March 31, 2010 price adjustments were in the 2-3% range.

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

Our combined Animal Hospital gross margin decreased to 18.3% for the three months ended June 30, 2010 and to 17.6% for the six months ended June 30, 2010 as compared to 20.3% and 19.3% in the prior year periods. Our same-store gross margin decreased to 18.6% for the three months ended June 30, 2010 and to 18.2% for the six months ended June 30, 2010 as compared to 20.4% and 19.5% for the comparable prior year periods.

The decrease in same-store gross margin for the three months ended June 30, 2010 was primarily due to the decline in same-store revenue compounded by increases in medical supply costs, laboratory expenses and overall increases in office and administration and depreciation and amortization expenses. The combined Animal Hospital gross margin was further impacted by the lower gross margins from our acquired animal hospitals. The same-store margin for the six months ended June 30, 2010 was also impacted by the increases in the aforementioned costs partially offset by a decrease in labor costs due to our cost control measures.

Over the last several years we have acquired a significant number of animal hospitals. Many of these newly acquired animal hospitals had lower gross margins at the time of acquisition than those previously operated by us. We have improved these lower gross margins, in the aggregate, subsequent to the acquisition by improving animal hospital revenue, reducing costs and/or increasing operating leverage.

Laboratory Segment

The following table summarizes revenue and gross profit for our Laboratory segment (in thousands, except percentages):

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--------------|-----------------------------|-----------|----------|---------------------------|------------|----------|
| | 2010 | 2009 | % Change | 2010 | 2009 | % Change |
| Revenue | \$ 82,972 | \$ 83,176 | (0.2)% | \$ 161,152 | \$ 161,038 | 0.1% |
| Gross profit | \$ 40,556 | \$ 41,074 | (1.3)% | \$ 77,084 | \$ 77,105 | 0.0% |
| Gross margin | 48.9% | 49.4% | | 47.8% | 47.9% | |

Laboratory revenue decreased \$204,000 for the three months ended June 30, 2010 and increased \$114,000 for the six months ended June 30, 2010 as compared to the same periods in the prior year. The components of the changes in Laboratory revenue are detailed below (in thousands, except percentages and average revenue per requisition):

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|------------------------------------------------|-----------------------------|-----------|----------|---------------------------|------------|----------|
| | 2010 | 2009 | % Change | 2010 | 2009 | % Change |
| Internal growth: | | | | | | |
| Number of requisitions ⁽¹⁾ | 3,563 | 3,664 | (2.8)% | 6,769 | 6,939 | (2.4)% |
| Average revenue per requisition ⁽²⁾ | \$ 23.22 | \$ 22.70 | 2.3% | \$ 23.75 | \$ 23.21 | 2.3% |
| Total internal revenue ⁽¹⁾ | \$ 82,735 | \$ 83,176 | (0.5)% | \$ 160,728 | \$ 161,038 | (0.2)% |
| Acquired revenue ⁽³⁾ | 237 | | | 424 | | |
| Total | \$ 82,972 | \$ 83,176 | (0.2)% | \$ 161,152 | \$ 161,038 | 0.1% |

(1)

Internal revenue and requisitions were calculated using Laboratory operating results, adjusted to exclude the operating results of acquired laboratories that we did not own as of the beginning of the comparable period in the prior year, and adjusted for the impact resulting from any differences in the number of billing days in comparable periods, if applicable.

- (2) Computed by dividing internal revenue by the number of requisitions.
- (3) Acquired revenue represents the current year period revenue recognized from our acquired laboratories that we did not own as of the beginning of the comparable period in the prior year.

The decrease in Laboratory revenue for the three months ended June 30, 2010 was due to a decrease in internal revenue attributable to a decline in volume mostly offset by increases in average revenue per requisition. The decrease in volume is associated with overall increased competition and the aforementioned economic conditions. The Laboratory revenue for the six months ended June 30, 2010 showed marginal improvement as acquired laboratory revenues more than offset the internal revenue decline.

Requisitions from internal growth have been driven by an ongoing trend in veterinary medicine to focus on the importance of laboratory diagnostic testing in the diagnosis, early detection and treatment of diseases, and the migration of certain tests to outside laboratories that have historically been performed in animal hospitals. While these factors historically have resulted in significant increases in internal requisitions, increased competition and the economic environment continue to impact requisitions.

The average revenue per requisition increased slightly for the three and six months ended June 30, 2010 as compared to prior year periods due to price increases which ranged from 3% to 4% in both February 2010 and February 2009. The price increases were largely offset by other factors including changes in the mix, performing lower-priced tests historically performed at the animal hospitals, and a decrease in higher-priced tests as a result of the current economic environment.

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, transportation and delivery costs, facilities rent, occupancy costs, depreciation and amortization and supply costs.

Our Laboratory gross margin decreased slightly to 48.9% and 47.8% for the three and six months ended June 30, 2010, respectively, as compared to 49.4% and 47.9% in the prior year comparable periods. The gross margin decreased comparable to the prior year periods as decreases in labor costs and other laboratory operating costs were more than offset by increases in transportation costs.

Medical Technology Segment

The following table summarizes revenue and gross profit for our Medical Technology segment (in thousands, except percentages):

| Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|------------------------------------|-------------|-----------------|----------------------------------|-------------|-----------------|
| 2010 | 2009 | % Change | 2010 | 2009 | % Change |

Edgar Filing: VCA ANTECH INC - Form 10-Q

| | | | | | | |
|--------------|-----------|-----------|-------|-----------|-----------|-------|
| Revenue | \$ 14,602 | \$ 10,263 | 42.3% | \$ 30,399 | \$ 19,048 | 59.6% |
| Gross profit | \$ 4,347 | \$ 3,525 | 23.3% | \$ 9,178 | \$ 6,753 | 35.9% |
| Gross margin | 29.8% | 34.3% | | 30.2% | 35.5% | |

Medical Technology revenue increased \$4.3 million for the three months ended June 30, 2010 and \$11.4 million for the six months ended June 30, 2010 as compared to the prior year comparable periods. The increases were due to increases in the unit sales of each of our digital radiography equipment product lines partially due to our ability to integrate the Eklin product line. In addition, we experienced an overall increase in revenue per unit due to a shift in product mix. Customer service revenue and ultrasound sales also increased during the three and six months ended June 30, 2010. Medical Technology revenue also benefited from a change in our revenue recognition policy due to the implementation of new accounting guidance. See Note 3, *Multiple-Deliverable Revenue Arrangements*.

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.

Medical Technology gross profit increased \$822,000 for the three months ended June 30, 2010 and \$2.4 million for the six months ended June 30, 2010 as compared to the prior year comparable periods. Gross margin decreased to 29.8% and 30.2% for the three and six months ended June 30, 2010, respectively, as compared to 34.3% and 35.5% in the prior year comparable periods. The increase in gross profit is attributable to the increase in revenue as discussed above. The decline in gross margin was due to an increase in ultrasound equipment sales and the integration of the Eklin product line, which carry lower margins.

Intercompany Revenue

Laboratory revenue for the three and six months ended June 30, 2010 included intercompany revenue of \$9.7 million and \$18.5 million, respectively, that was generated by providing laboratory services to our animal hospitals. Medical Technology revenue for the three and six months ended June 30, 2010 included intercompany revenue of \$1.5 million and \$2.7 million, respectively, that was generated by providing products and services to our animal hospitals and laboratories. For purposes of reviewing the operating performance of our business segments, all intercompany transactions are accounted for as if the transaction was with an independent third party at current market prices. For financial reporting purposes, intercompany transactions are eliminated as part of our consolidation.

Selling, General and Administrative Expense

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

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---------------------------|-----------------------------|--------------|-----------|---------------------------|--------------|----------|
| | 2010 | 2009 | % | 2010 | 2009 | % |
| | \$ | % of Revenue | \$ | \$ | % of Revenue | % Change |
| Animal | | | | | | |
| Hospital | \$ 5,673 | 2.1% | \$ 5,378 | \$ 11,260 | 2.2% | 4.6% |
| Laboratory | 6,527 | 7.9% | 5,644 | 12,681 | 7.9% | 13.1% |
| Medical | | | | | | |
| Technology ⁽¹⁾ | 3,404 | 23.3% | 2,394 | 6,919 | 22.8% | 32.9% |
| Corporate | 25,441 | 7.2% | 9,525 | 36,325 | 5.3% | 94.5% |
| Total SG&A | | | | | | |
| ⁽¹⁾ | \$ 41,045 | 11.6% | \$ 22,941 | \$ 67,185 | 9.8% | 46.5% |

⁽¹⁾ Prior year amounts have been reclassified to conform to the current year's presentation.

Consolidated SG&A increased \$18.1 million for the three months ended June 30, 2010 and \$21.3 million for the six months ended June 30, 2010 primarily due to the accrual of \$14.5 million in estimated future consulting and SERP expenses to be incurred in accordance with consulting and SERP agreements entered into on June 30, 2010, see Note 12, Commitment and Contingencies, in our condensed, consolidated financial statements of this quarterly report on Form 10-Q and due to \$872,000 in acquisition transaction costs related to Pet DRx Corporation and increases in other legal costs, higher research and development costs in our Laboratory segment and additional costs incurred as a result

of the continuing integration of Eklin in our Medical Technology segment.

Operating Income

The following table summarizes our operating income in both dollars and as a percentage of applicable revenue (in thousands, except percentages):

| | Three Months Ended June 30, | | | | | Six Months Ended June 30, | | | | |
|---------------------------|-----------------------------|--------------|-----------|--------------|---------|---------------------------|--------------|------------|--------------|---------|
| | 2010 | | 2009 | | % | 2010 | | 2009 | | % |
| | \$ | % of Revenue | \$ | % of Revenue | | \$ | % of Revenue | \$ | % of Revenue | |
| Animal | | | | | | | | | | |
| Hospital | \$ 43,390 | 16.2% | \$ 47,626 | 18.2% | (8.9)% | \$ 79,496 | 15.5% | \$ 85,665 | 17.1% | (7.2)% |
| Laboratory ⁽¹⁾ | 34,029 | 41.0% | 35,405 | 42.6% | (3.9)% | 64,402 | 40.0% | 65,867 | 40.9% | (2.2)% |
| Medical | | | | | | | | | | |
| Technology ⁽¹⁾ | 929 | 6.4% | 1,126 | 11.0% | (17.5)% | 2,205 | 7.3% | 1,541 | 8.1% | 43.1% |
| Corporate | (25,448) | | (14,809) | | 71.8% | (36,332) | | (23,971) | | 51.6% |
| Intercompany | (447) | | (384) | | 16.4% | (688) | | (638) | | 7.8% |
| Total operating income | \$ 52,453 | 14.8% | \$ 68,964 | 20.0% | (23.9)% | \$ 109,083 | 15.9% | \$ 128,464 | 19.4% | (15.1)% |

(1) Prior year amounts have been adjusted to reflect the reclassification of certain business operations from our Medical Technology segment to our Laboratory segment, (see Note 11, *Lines of Business*). The reclassifications did not have a material impact on either segment.

The decrease in our consolidated operating income during the three and six months ended June 30, 2010 was primarily due to the SG&A increases discussed above as well as the aforementioned decline in our Animal Hospital and Medical Technology gross profit.

Interest Expense, Net

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

Three Months Ended Six Months Ended

| | June 30, | | June 30, | |
|------------------------------------------------|-----------------|-------------|-----------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Interest expense: | | | | |
| Senior term notes | \$ 2,326 | \$ 2,573 | \$ 4,575 | \$ 5,160 |
| Interest rate hedging agreements | | 2,727 | 382 | 5,972 |
| Capital leases and other | 559 | 569 | 1,123 | 1,149 |
| Amortization of debt costs | 107 | 121 | 239 | 241 |
| | 2,992 | 5,990 | 6,319 | 12,522 |
| Interest income | (214) | (264) | (374) | (678) |
| Total interest expense, net of interest income | \$ 2,778 | \$ 5,726 | \$ 5,945 | \$ 11,844 |

The decrease in net interest expense for the three and six months ended June 30, 2010 was attributable to a decrease in the overall weighted average interest rate primarily due to the gradual expiration of all of our higher cost fixed-rate swap agreements during the last twelve months.

Liquidity and Capital Resources

Introduction

We generate cash primarily from payments made by customers for our veterinary services, payments from animal hospitals and other clients for our laboratory services, and from proceeds received from the sale of our imaging equipment and other related services. Our business historically has experienced strong liquidity, as fees for services provided in our animal hospitals are due at the time of service and fees for laboratory services are collected under standard industry terms. Our cash disbursements are primarily for payments related to the compensation of our employees, supplies and inventory purchases for our operating segments, occupancy and other administrative costs, interest expense, payments on long-term borrowings, capital expenditures and animal hospital acquisitions. Cash outflows fluctuate with the amount and timing of the settlement of these transactions.

We manage our cash, investments and capital structure so we are able to meet the short-term and long-term obligations of our business while maintaining financial flexibility and liquidity. We forecast, analyze and monitor our cash flows to enable investment and financing within the overall constraints of our financial strategy.

At June 30, 2010, our consolidated cash and cash equivalents totaled \$193.8 million, representing an increase of \$48.6 million as compared to December 31, 2009. Cash flows generated from operating activities totaled \$111.3 million in the six months ended June 30, 2010, representing an increase of \$1.1 million as compared to the six months ended June 30, 2009.

We have historically funded our working capital requirements, capital expenditures and investment in individual acquisitions from internally generated cash flows and we expect to continue to do so in the future. During the quarter ended June 30, 2010, our \$75.0 million revolving credit facility expired and we have not entered into any new agreements. The remaining principal payments on our senior-term notes are payable within one year of the June 30, 2010 balance sheet date; accordingly all remaining senior-term note balances are included in the current portion of long-term debt in our condensed, consolidated balance sheet. We are currently in discussions regarding new senior credit facilities consisting of a senior secured term loan and a senior secured revolving credit facility, the proceeds of which will be used, among other things, to refinance our existing senior-term notes. We anticipate the refinance will occur during the third quarter of 2010. However, the availability of financing in the form of debt or equity is influenced by many factors including our profitability, operating cash flows, debt levels, debt ratings, contractual restrictions and market conditions. A material adverse change in market conditions or our operations could result in a decision to defer the closing of the refinancing or could have an adverse impact on the availability of such financing on favorable terms.

Future Cash Flows

Short-Term

Other than our acquisitions of animal hospital chains, we historically have funded our working capital requirements, capital expenditures and investments in animal hospital acquisitions from internally generated cash flows. We anticipate that our cash on hand and net cash provided by operations will be sufficient to meet our anticipated cash requirements for the next 12 months. If we consummate one or more significant acquisitions of animal hospital chains during this period, we may seek additional debt or equity financing.

For the year ended December 31, 2010, we expect to spend \$110 million to \$120 million, excluding real estate, related to the acquisition of independent animal hospitals. The ultimate number of acquisitions and cash used is largely dependent upon the attractiveness of the candidates and the strategic fit within our operations and as a consequence, our actual number of acquisitions and cash expenditures may be more or less than amounts currently estimated. From January 1, 2010 through June 30, 2010, we spent \$19.4 million in connection with the acquisition of eleven animal hospitals, as well as \$1.3 million for the related real estate. Also, at June 30, 2010 we were under contract to purchase Pet DRx for \$41.3 million. In addition, we expect to spend approximately \$65.0 million in 2010 for both property and equipment additions and capital costs necessary to maintain our existing facilities, of which approximately \$28.0 million had been expended at June 30, 2010.

Long-Term

Our long-term liquidity needs, other than those related to the day-to-day operations of our business, including commitments for operating leases, generally are comprised of scheduled principal and interest payments for our

outstanding long-term indebtedness, capital expenditures related to the expansion of our business, and acquisitions in accordance with our growth strategy. In addition to the scheduled payments on our senior-term notes, we are required to make mandatory prepayments in the event we have excess cash flow. Pursuant to the terms of our senior credit facility, mandatory prepayments are due on our senior-term notes equal to 75% of any excess cash flow at the end of 2010 and 2011. During the quarter ended March 31, 2010 we paid approximately \$8.8 million related to 2009 excess cash flows. Excess cash flow is defined as earnings before interest, taxes, depreciation and amortization, less voluntary and scheduled debt repayments, capital expenditures, interest payable in cash, taxes payable in cash and cash paid for acquisitions. These payments reduce on a pro rata basis the remaining scheduled principal payments.

We expect that our long-term cash flow from operations will not be sufficient to repay our long-term debt when it comes due in May 2011; we currently anticipate refinancing our senior-term debt during the third quarter of 2010. See Note 7, *Fair Value Measurements*, in our condensed, consolidated financial statements of this quarterly report on Form 10-Q for a more detailed discussion.

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 June 30, 2010, we were in compliance with these covenants, including the two covenant ratios, the fixed-charge coverage ratio and the leverage ratio.

At June 30, 2010, we had a fixed-charge coverage ratio of 1.63 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 fixed-charge coverage ratio as that ratio that is calculated on a last 12-month basis by dividing pro forma earnings before interest, taxes, depreciation and amortization, as defined by the senior credit facility (pro forma earnings), by fixed charges. Fixed charges are defined as cash interest expense, scheduled principal payments on debt obligations, capital expenditures, and provision for income taxes. Pro forma earnings include 12 months of operating results for businesses acquired during the period.

At June 30, 2010, we had a leverage ratio of 1.95 to 1.00, which was in compliance with the required ratio of no more than 2.75 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.

Historical Cash Flows

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

| | Six Months Ended June 30, | |
|-----------------------------------------------------------------------|--------------------------------------|-------------|
| | 2010 | 2009 |
| Cash provided by (used in): | | |
| Operating activities | \$ 111,336 | \$ 110,199 |
| Investing activities | (49,722) | (57,353) |
| Financing activities | (13,032) | (2,892) |
| Effect of currency exchange rate changes on cash and cash equivalents | (6) | (18) |
| Increase in cash and cash equivalents | 48,576 | 49,936 |
| Cash and cash equivalents at beginning of period | 145,181 | 88,959 |
| Cash and cash equivalents at end of period | \$ 193,757 | \$ 138,895 |

Cash Flows from Operating Activities

Net cash provided by operating activities increased \$1.1 million in the six months ended June 30, 2010 as compared to the prior year comparable period. This increase was primarily due to positive changes in working capital as compared to the comparable prior year period, in addition to decreases in cash paid for interest due to the expiration of our interest-rate swap agreements, partially offset by an increase in cash paid for taxes.

Cash Flows from Investing Activities

The table below presents the components of the changes in investing cash flows (in thousands):

| | Six Months Ended | | Variance |
|--------------------------------------------------------------|-------------------------|-------------|-------------------------|
| | June 30, | | |
| | 2010 | 2009 | |
| Investing Cash Flows: | | | |
| Acquisition of independent animal hospitals and laboratories | \$ (19,350) | \$ (24,928) | \$ 5,578 ⁽¹⁾ |
| Other | (994) | (3,216) | 2,222 ⁽²⁾ |
| Total cash used for acquisitions | (20,344) | (28,144) | 7,800 |
| Property and equipment additions | (27,925) | (25,208) | (2,717) ⁽³⁾ |
| Real estate acquired with acquisitions | (1,300) | (3,828) | 2,528 ⁽⁴⁾ |
| Proceeds from sale of assets | 9 | 108 | (99) |
| Other | (162) | (281) | 119 |
| Net cash used in investing activities | \$ (49,722) | \$ (57,353) | \$ 7,631 |

(1) The number of acquisitions will vary from year to year based upon the available pool of suitable candidates. A discussion of our acquisitions is provided above in our *Executive Overview*.

(2) The decrease in cash used for acquisitions other relates to timing differences in pay-outs of holdbacks.

(3) The increase in cash used to acquire property and equipment was related to increased maintenance and expansion of our animal hospitals

and laboratory facilities.

- (4) Due to the lower return on investment realized on acquired real estate we are highly selective in our decision to acquire real estate. The decrease in cash used to acquire real estate is due to a decrease in the number of opportunities that met our selective criteria.

Cash Flows from Financing Activities

The table below presents the components of the changes in financing cash flows (in thousands):

| | Six Months Ended June 30, | | |
|---------------------------------------------------|--------------------------------------|-------------|---------------------------|
| | 2010 | 2009 | Variance |
| Financing Cash Flows: | | | |
| Repayment of debt | \$ (12,859) | \$ (3,899) | \$ (8,960) ⁽¹⁾ |
| Distributions to noncontrolling interest partners | (2,021) | (1,493) | (528) ⁽²⁾ |
| Proceeds from stock options exercises | 3,770 | 2,895 | 875 ⁽³⁾ |
| Excess tax benefits from stock options | 331 | 154 | 177 |
| Stock repurchases | (2,253) | (549) | (1,704) ⁽⁴⁾ |
| Net cash used in financing activities | \$ (13,032) | \$ (2,892) | \$ (10,140) |

- (1) The cash used for repayment of debt increased \$9.0 million due primarily to the payment of excess cash flows. See discussion above under *Future Cash Flows*.

- (2) The distributions to noncontrolling interest partners represent cash payments to noncontrolling interest partners for their portion of the partnerships excess cash.
- (3) The number of stock option exercises has increased in comparison to the prior year related to the increase in the market price of our stock during the six months ended June 30, 2010 and the expiration of certain stock options in the near term.
- (4) The stock repurchases for the six months ended June 30, 2010 and June 30, 2009 represents employee stock delivered at vesting to pay for income taxes owed by the employee.

Off-Balance-Sheet Arrangements

Other than operating leases, as of June 30, 2010 we do not have any off-balance-sheet financing arrangements.

Interest Rate Swap Agreements

As of March 31, 2010, all of our interest rate swap agreements had expired. We did not enter into any new agreements during the quarter ended June 30, 2010.

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

Description of Indebtedness

Senior Credit Facility

At June 30, 2010, we had \$505.4 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 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 expired in May 2010. We did not renew our revolving credit facility; however, we currently anticipate refinancing our senior-term debt during the third quarter of 2010. See Note 7, *Fair Value Measurements*, in our condensed consolidated financial statements of this quarterly report on Form 10-Q for a more detailed discussion.

Other Debt and Capital Lease Obligations

At June 30, 2010, we had seller notes secured by assets of certain animal hospitals, unsecured debt and capital leases that totaled \$26.8 million.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At June 30, 2010, we had borrowings of \$505.4 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. There has been no change in our assessment of the impact of changes on interest expense for fluctuation in LIBOR since the year ended December 31, 2009.

In the future, we may enter into interest rate strategies to mitigate our exposure to increasing interest rates as well as to maintain an appropriate mix of fixed-rate and variable-rate debt. However, we have not yet determined what those strategies may be or their possible impact.

ITEM 4. CONTROLS AND PROCEDURES

We carried out an evaluation required by the Exchange Act, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the Exchange Act, as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were not effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure. Our principal executive officer and principal financial officer have concluded that, as of June 30, 2010, our disclosure controls and procedures were not effective due to a material weakness in our internal control over financial reporting relating to significant, material non-routine transactions. Our controls over such transactions require an analysis and review of any such transaction. We did not consistently perform such an analysis and review as required by our policy prior to finalizing our June 30th financial statements. Specifically, the executive consulting agreements were not analyzed and reviewed as required by our policy. As a result, a material adjustment to compensation expense was made to the condensed, consolidated financial statements prior to filing this Quarterly Report on Form 10-Q. Also, prior to filing this Quarterly Report on Form 10-Q, we completed the accounting analysis and review set forth in this control to ensure that our financial statements as of and for the quarter ended June 30, 2010 are fairly presented in all material respects in accordance with generally accepted accounting principles.

During our most recent fiscal quarter, there were no changes except for the material weakness described above 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 disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives as specified above. Management does not expect, however, that our disclosure controls and procedures will prevent or detect all error and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur, or that all control issues and instances of fraud, if any, within the company have been 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 2009 Annual Report on Form 10-K.

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

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

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. |
| 101.INS | XBRL Instance Document* |
| 101.SCH | XBRL Taxonomy Extension Schema Document* |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase* |
| 101.DEF | XBRL Taxonomy Definition Linkbase* |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase* |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase* |

* Furnished, not filed.

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 August 10, 2010.

Date: August 10, 2010

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

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. |