PETMED EXPRESS INC
Form 10-Q
February 01, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2009

or

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

For the transition period from _____________ to _____________

Commission file number: 000-28827

PETMED EXPRESS, INC.

(Exact name of registrant as specified in its charter)

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

1441 S.W. 29th Avenue, Pompano Beach, Florida 33069

(Address of principal executive offices, including zip code)

(954) 979-5995

(Registrant s telephone number, including area code)

N/A

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes S 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 (§ 229.405 of this chapter) during the preceeding12 months (or for such shorter period that the registrant was required to submit and post such files). Yes £ No £

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

Large accelerated filer	£	Accelerated filer	S

Non-accelerated filer	£	Smaller reporting company	£
(Do not check if smaller reporting company)			

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

Yes £ No S

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 22,856,035 Common Shares, $.001 par value per share at February 1, 2010.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

PETMED EXPRESS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

		December 31, 2009 (UNAUDITED)		March 31, 2009
ASSETS				
Current assets:				
Cash and cash equivalents	$	56,602	$	30,126
Accounts receivable, less allowance for doubtful accounts of $24 and $59, respectively		1,182		2,881
Inventories - finished goods		19,025		26,778
Prepaid expenses and other current assets		785		754
Deferred tax assets		1,150		724
Prepaid income taxes		1,802		362
Total current assets		80,546		61,625
Long term investments		12,312		14,430
Property and equipment, net		4,645		5,058
Intangible assets		850		850
Total assets	$	98,353	$	81,963

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:				
Accounts payable	$	3,478	$	4,817
Accrued expenses and other current liabilities		2,010		2,178
Total current liabilities		5,488		6,995
Deferred tax liabilities		544		-
Total liabilities		6,032		6,995
Commitments and contingencies				
Shareholders' equity:				
Preferred stock, $.001 par value, 5,000 shares authorized; 2,500 convertible shares issued and outstanding with a liquidation preference of $4 per share		9		9
Common stock, $.001 par value, 40,000 shares authorized; 22,847 and 22,687 shares issued and outstanding, respectively		23		23
Additional paid-in capital		1,958		-
Retained earnings		90,519		75,156
Accumulated other comprehensive loss		(188)		(220)
Total shareholders' equity		92,321		74,968
Total liabilities and shareholders' equity	$	98,353	$	81,963

See accompanying notes to condensed consolidated financial statements.

PETMED EXPRESS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except for per share amounts)(Unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2009	**2008**	**2009**	**2008**
Sales	$ 48,353	$ 43,406	$ 187,969	$ 171,342
Cost of sales	29,525	26,089	116,173	105,376
Gross profit	18,828	17,317	71,796	65,966
Operating expenses:				
General and administrative	4,929	5,019	17,199	16,448
Advertising	5,177	4,900	22,801	23,620
Depreciation and amortization	337	186	982	503
Total operating expenses	10,443	10,105	40,982	40,571
Income from operations	8,385	7,212	30,814	25,395
Other income:				
Interest income, net	46	297	165	959
Other, net	1	(28)	4	301
Total other income	47	269	169	1,260
Income before provision for income taxes	8,432	7,481	30,983	26,655
Provision for income taxes	2,842	2,597	11,053	9,328

Net income	$	5,590	$	4,884	$	19,930	$	17,327
Net income per common share:								
Basic	$	0.25	$	0.21	$	0.88	$	0.74
Diluted	$	0.25	$	0.21	$	0.88	$	0.73
Weighted average number of common shares outstanding:								
Basic		22,649		23,333		22,596		23,447
Diluted		22,790		23,542		22,742		23,628
Cash dividends declared per common share	$	0.10	$	-	$	0.20	$	-

See accompanying notes to condensed consolidated financial statements.

PETMED EXPRESS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)(Unaudited)

	Nine Months Ended December 31, 2009	Nine Months Ended December 31, 2008
Cash flows from operating activities:		
Net income	$ 19,930	$ 17,327
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	982	503
Share based compensation	1,158	1,090
Deferred income taxes	118	313
Bad debt expense	29	49
(Increase) decrease in operating assets and increase (decrease) in liabilities:		
Accounts receivable	1,670	(549)
Inventories - finished goods	7,753	(1,745)
Prepaid income taxes	(1,440)	(4,000)
Prepaid expenses and other current assets	(31)	30
Accounts payable	(1,055)	119
Income taxes payable	-	2,501
Accrued expenses and other current liabilities	(206)	146
Net cash provided by operating activities	28,908	15,784
Cash flows from investing activities:		
Net change in investments	2,150	(1,620)
Purchases of property and equipment	(853)	(1,748)
Purchase of intangible asset	-	(485)
Net cash provided by (used in) investing activities	1,297	(3,853)
Cash flows from financing activities:		
Dividends paid	(4,529)	-

Purchases of treasury stock		-		(6,776)
Proceeds from the exercise of stock options		574		1,535
Tax benefit related to stock options exercised		226		233
Net cash used in financing activities		(3,729)		(5,008)
Net increase in cash and cash equivalents		26,476		6,923
Cash and cash equivalents, at beginning of period		30,126		20,268
Cash and cash equivalents, at end of period	$	56,602	$	27,191
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	12,149	$	10,281
Retirement of treasury stock	$	-	$	6,811
Property and equipment purchases in accounts payable	$	488	$	1,801
Dividends payable in accured expenses	$	38	$	-

See accompanying notes to condensed consolidated financial statements.

PETMED EXPRESS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: Summary of Significant Accounting Policies

Organization

PetMed Express, Inc. and subsidiaries, d/b/a 1-800-PetMeds (the Company), is a leading nationwide pet pharmacy. The Company markets prescription and non-prescription pet medications and other health products for dogs, cats, and horses direct to the consumer. The Company offers consumers an attractive alternative for obtaining pet medications in terms of convenience, price, and speed of delivery. The Company markets its products through national television, online, and direct mail/print advertising campaigns, which aim to increase the recognition of the 1-800-PetMeds brand name, and PetMeds family of trademarks, increase traffic on its website at www.1800petmeds.com, acquire new customers, and maximize repeat purchases. The majority of the Company s sales are to residents in the United States. The Company s executive offices are located in Pompano Beach, Florida. The Company s fiscal year end is March 31, and references herein to Fiscal 2010 or 2009 refer to the Company's fiscal years ending March 31, 2010 and 2009, respectively.

Basis of Presentation and Consolidation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, the accompanying Condensed Consolidated Financial Statements contain all adjustments, consisting of normal recurring accruals, necessary to present fairly the financial position of the Company at December 31, 2009 and the Statements of Income for the three and nine months ended December 31, 2009 and 2008, and Cash Flows for the nine months ended December 31, 2009 and 2008. The results of operations for the three and nine months ended December 31, 2009 are not necessarily indicative of the operating results expected for the fiscal year ending March 31, 2010. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company s annual report on Form 10-K for the fiscal year ended March 31, 2009. The Condensed Consolidated Financial Statements include the accounts of PetMed Express, Inc. and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated upon consolidation.

Use of Estimates

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

Fair Value of Financial Instruments

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

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") established the Accounting Standards Codification (the Codification or ASC). The FASB issued Accounting Standards Update (ASU) No. 2009-01, Generally Accept Accounting Principles (ASC Topic 105) which establishes the FASB Accounting Standards Codification as the official single source of authoritative U.S. generally accepted accounting principles (GAAP). All existing accounting standards are superseded and all other accounting guidance not included in the Codification will be considered non-authoritative. The Codification also includes all relevant Securities and Exchange Commission (SEC) guidance organized using the same topical structure in separate sections within the Codification.

Following the Codification, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue the ASU which will serve to update the Codification, provide background information about the guidance, and provide the basis for conclusions on the changes to the Codification. The Codification is not intended to change GAAP, but it will change the way GAAP is organized and presented. The Codification was effective for our second quarter ended September 30, 2009 financial statements and the principal impact on our financial statements is limited to disclosures as all future references to authoritative accounting literature will be referenced in accordance with the Codification. In order to ease the transition to the Codification, we are providing the Codification cross-reference alongside the references to the standards issued and adopted prior to the adoption of the Codification.

In August 2009, FASB issued ASU No. 2009-05 which amends Fair Value Measurements and Disclosures Overall (ASC Topic 820-10) to provide guidance on the fair value measurement of liabilities. This update requires clarification for circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques: 1) a valuation technique that uses either the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as an asset; or 2) another valuation technique that is consistent with the principles in ASC Topic 820 such as the income and market approach to valuation. The amendments in this update also clarify that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. This update further clarifies that if the fair value of a liability is determined by reference to a quoted price in an active market for an identical liability, that price would be considered a Level 1 measurement in the fair value hierarchy. Similarly, if the identical liability has a quoted price when traded as an asset in an active market, it is also a Level 1 fair value measurement if no adjustments to the quoted price of the asset are required. This update was effective for our third quarter ended December 31, 2009.

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

Note 2: Net Income Per Share

In accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings Per Share*, (ASC Topic 260) basic net income per common share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per common share includes the dilutive effect of potential stock options exercised, restricted stock, and the effects of the potential conversion of preferred shares, calculated using the treasury stock method. Outstanding stock options, restricted stock, and convertible preferred shares issued by the Company represent the only dilutive effect reflected in diluted weighted average shares outstanding. The following is a reconciliation of the numerators and denominators of the basic and diluted net income per common share computations for the periods presented:

In thousands, except for per share amounts	Three Months Ended December 31, 2009	Three Months Ended December 31, 2008	Nine Months Ended December 31, 2009	Nine Months Ended December 31, 2008
Net income (numerator):				
Net income	$ 5,590	$ 4,884	$ 19,930	$ 17,327
Shares (denominator):				
Weighted average number of common shares outstanding used in basic computation	22,649	23,333	22,596	23,447
Common shares issuable upon exercise of stock options and vesting of restricted stock	131	199	136	171
Common shares issuable upon conversion of preferred shares	10	10	10	10
Shares used in diluted computation	22,790	23,542	22,742	23,628
Net income per common share:				
Basic	$ 0.25	$ 0.21	$ 0.88	$ 0.74
Diluted	$ 0.25	$ 0.21	$ 0.88	$ 0.73

For the three and nine months ended December 31, 2009 and 2008, all common stock options were included in the diluted net income per common share computation as their exercise prices were less than the average market price of the common shares for the period.

Note 3: Accounting for Stock-Based Compensation

The Company records compensation expense associated with stock options in accordance with SFAS No. 123R, *Share Based Payment,* which is a revision of SFAS No. 123 (ASC 718). The Company adopted the modified prospective transition method provided under SFAS No. 123R (ASC 718). Under this transition method, compensation expense associated with stock options recognized in the first quarter of fiscal year 2007, and in subsequent quarters, includes expense related to the remaining unvested portion of all stock option awards granted prior to April 1, 2006, the estimated fair value of each option award granted was determined on the date of grant using the Black-Scholes option valuation model, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 (ASC Topic 260). The compensation expense related to all of the Company s stock-based compensation arrangements is recorded as a component of general and administrative expenses.

As a result of the adoption of SFAS No. 123R (ASC 718), the Company s net income for the three months ended December 31, 2009 and 2008 includes approximately $6,000 and $61,000 of stock option compensation expense, respectively, and for the nine months ended December 31, 2009 and 2008 includes approximately $18,000 and $182,000. As of December 31, 2009 and 2008, there was approximately $6,000 and $85,000, respectively, of unrecognized compensation expense related to stock option awards, which will be fully expensed at the end of Fiscal 2010. Cash received from stock options exercised for the three months ended December 31, 2009 and 2008 was $98,000 and $304,000, respectively, and for the nine months ended December 31, 2009 and 2008 cash received from stock options exercised was $574,000 and $1.5 million, respectively. The income tax benefits from stock options exercised totaled approximately $226,000 and $233,000 for the nine months ended December 31, 2009 and 2008, respectively.

The PetMed Express, Inc. 1998 Stock Option Plan (the Plan), provided for the issuance of qualified options to officers and key employees, and nonqualified options to directors, consultants, and other service providers, to purchase the Company s common stock. The Company had reserved 5.0 million shares of common stock for issuance under the Plan. The exercise prices of options issued under the Plan had to be equal to or greater than the market price of the Company's common stock as of the date of issuance. The Company had 69,000 and 195,000 options outstanding under the Plan at December 31, 2009 and 2008, respectively. Options generally vested ratably over a three-year period commencing on the first anniversary of the grant with respect to options granted to employees/directors under the Plan. No options have been issued since May 2005. The 1998 Plan expired on July 31, 2008.

On July 28, 2006, the Company received shareholder approval for the adoption of the 2006 Employee Equity Compensation Restricted Stock Plan (the Employee Plan) and the 2006 Outside Director Equity Compensation Restricted Stock Plan (the Director Plan). The purpose of the plans is to promote the interests of the Company by securing and retaining both employees and outside directors. The Company had reserved 1.0 million shares of common stock for issuance under the Employee Plan. The Company had reserved 200,000 shares of common stock for issuance under the Director Plan. The value of the restricted stock is determined based on the market value of the stock at the issuance date. The restriction period or forfeiture period is determined by the Company s Board and is to be no less than one year and no more than ten years. During the quarter no restricted shares were issues to the employees and outside directors of the Company. The Company had 304,643 restricted common shares issued under the Employee Plan and 92,000 restricted common shares issued under the Director Plan at December 31, 2009, all shares of which were issued subject to a restriction or forfeiture period which will lapse ratably on the first, second, and third anniversaries of the date of grant, and the fair value of which is being amortized over the three-year restriction period. For the three months ended December 31, 2009 and 2008, the Company recognized $430,000 and $349,000, respectively, and for the nine months ended December 31, 2009 and 2008 the Company recognized $1.1 million and $907,000, respectively, of restricted stock compensation expense related to the Employee and Director Plans. At December 31, 2009 and 2008, there was $2.1 million and $2.2 million of unrecognized compensation cost related to the non-vested restricted stock awards, respectively, which is expected to be recognized over the next three years.

Note 4: Long Term Investments

The Company s investment portfolio consists of auction rate securities (ARS), which are investments with contractual maturities generally between 20 to 30 years, in the form of municipal bonds and preferred stock, with interest rates that reset, typically every seven to twenty-eight days, through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par. Beginning in February 2008, auctions failed for the ARS held because sell orders exceeded buy orders. These failures are not believed to be a credit issue, but rather are caused by a lack of liquidity. The funds associated with these failed auctions may not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures. As a result, these securities with failed auctions have been reclassified as long-term assets in the Condensed Consolidated Balance Sheet due to the fact that they were not currently trading at such date, and conditions in the general markets created uncertainty as to when successful auctions would be reestablished. These ARS are recorded at estimated fair value and have variable interest rates that are recorded as interest income. In accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (ASC Topic 320), temporary investments are accounted for as trading securities. Trading securities are securities that are bought and held principally for the purpose of selling in the near term. In Fiscal 2008, the Company reclassified the majority of its ARS from temporary investments to long term investments due to the widespread auction failures occurring in February 2008, as it was unknown if the Company would be able to liquidate these securities within one year. Long term investments are classified as available-for-sale, with any changes in fair value to be reflected in other comprehensive income. The Company evaluates its long term investments for impairment and whether impairment is other-than-temporary, and measurement of an impairment loss as a charge to net income. Unrealized gains and losses are deemed temporary and are included in accumulated other comprehensive income. The Company recognized a temporary impairment on its ARS investments during Fiscal 2009. The Company does not believe that the underlying credit quality of the assets has been impacted; however the temporary impairment is mainly due to the lack of liquidity. The Company is currently trying to liquidate all ARS and is holding all excess cash in money market accounts. The following is a summary of our investments:

Investments (In thousands)	December 31, 2009	March 31, 2009
Long term investments	$ 12,312	$ 14,430
Total investments	$ 12,312	$ 14,430

The long term investment balances consist of ARS investments. Our ARS consist of closed-end fund preferred ARS, with interest rates that reset, typically every seven to twenty-eight days. These ARS are currently rated AAA, the highest rating available by a rating agency.

The fair value of our ARS investments was assessed by management with the assistance of an outside third party, which was conducted during the third quarter of Fiscal 2010. During the quarter ended September 30, 2009, the Company was able to liquidate approximately $2.2 million of its ARS investments, at par. As of December 31, 2009, the Company held $12.5 million in ARS, at par, which were classified as long term investments and the Company recorded an unrealized impairment loss of $187,500, within accumulated other comprehensive loss based upon an assessment by an outside third party. The $187,500 impairment was recorded as temporary due to the fact that the Company has the intent to sell the security, the intent to hold these securities until anticipated recovery or maturity, and does expect to fully recover the cost basis of the investment.

Note 5: Fair Value

Effective April 1, 2008, the Company adopted SFAS 157 (ASC Topic 820), except as it applies to nonfinancial assets and nonfinancial liabilities subject to Staff Position SFAS 157-2 (ASC Topic 820). SFAS 157 (ASC Topic 820) clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability.

SFAS 157 (ASC Topic 820) establishes a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

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

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

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

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

		Fair Value Measurement at December 31, 2009 Using		
(In thousands)	**December 31, 2009**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:				
Cash and money market funds	$ 56,602	$ 56,602	$ -	$ -
Auction rate securities	12,312	-	-	12,312
	$ 68,914	$ 56,602	$ -	$ 12,312

The following table is a reconciliation of financial assets measured at fair value using unobservable inputs (Level 3) during the year ended December 31, 2009:

(In thousands)	**Auction Rate Securities Quarter Ended December 31,**

		2009
Balance, beginning of period, March 31, 2009	$	14,430
Redemptions of Level 3 securities		(2,150)
Net change in unrealized loss on long term investments		32
Balance, end of period, December 31, 2009	$	12,312

Marketable securities measured at fair value using Level 3 inputs are comprised of auction rate securities. Although ARS would typically be measured using Level 2 inputs, the recent failure of auctions and the lack of market activity and liquidity required that these securities be measured using Level 3 inputs. The discount rates that were applied to the pricing model were based on market conditions and rates for comparable or similar term asset-backed securities as well as other fixed income securities.

Note 6: Changes in Stockholders Equity and Comprehensive Income:

Changes in stockholders equity for the nine months ended December 31, 2009 is summarized below (in thousands):

		Additional Paid-In Capital		Retained Earnings		Accumulated Other Comprehensive Income
Beginning balance at April 1, 2009:	$	-	$	75,156	$	(220)
Proceeds from the exercise of stock options		574		-		-
Share based compensation		1,158		-		-
Tax benefit related to stock options exercised		226		-		-
Dividends declared		-		(4,567)		-
Net Income		-		19,930		-
Net change in unrealized loss on long term investments		-		-		32
Ending balance at December 31, 2009:	$	1,958	$	90,519	$	(188)

Total comprehensive income for the three and nine months ended December 31, 2009 and 2008 is summarized below (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2009	2008	2009	2008
Net income	$ 5,590	$ 4,884	$ 19,930	$ 17,327
Net change in unrealized loss on long term investments	32	-	32	-
Comprehensive income	$ 5,622	$ 4,884	$ 19,962	$ 17,327

Note 7: Commitments and Contingencies

In October 2009, the Company was notified that it was named as a defendant in a multi-defendant lawsuit, filed in the United States District Court for the Eastern District of Texas, Marshall Division, seeking declaratory, injunctive, and monetary relief styled Charles E. Hill & Associates, Inc. v. ABT Electronics, Inc., et al, Cause No. 2:09-CV-313. The lawsuit alleges that the Company is infringing on patents related to electronic catalog systems. The Company notified the vendor that provides it with Internet software that it was seeking indemnification, and at this time, the vendor is supplying legal counsel at their expense. However, at this early stage it is difficult to assess the outcome or estimate any potential loss in the event of an adverse outcome.

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

Note 8: Subsequent Events

On January 29, 2010, the Company signed a sixth addendum to its existing lease extending the terms of the lease until May 31, 2015. This addendum also includes a one-year option that expires on January 29, 2011, which will allow the

Company to extend the lease until May 31, 2016. The future minimum annual lease payments are as follows: $723,000 for fiscal 2011, $745,000 for fiscal 2012, $767,000 for fiscal 2013, $784,000 for fiscal 2014, $794,000 for fiscal 2015, and $133,000 for fiscal 2016.

On February 1, 2010 our Board of Directors declared a $0.10 per share dividend. The Board established a February 12, 2010 record date and a February 26, 2010 payment date. Based on the outstanding share balance as of January 31, 2010 the Company estimates the dividend payable to be approximately $2.3 million.

The Company evaluated subsequent events as of February 1, 2010, the date the financial statements were issued.

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

Executive Summary

PetMed Express was incorporated in the state of Florida in January 1996. The Company s common stock is traded on the NASDAQ Global Select Market (NASDAQ) under the symbol PETS. The Company began selling pet medications and other pet health products in September 1996. Presently, the Company s product line includes approximately 750 of the most popular pet medications and other health products for dogs, cats, and horses.

The Company markets its products through national television, online, and direct mail/print advertising campaigns which aim to increase the recognition of the 1-800-PetMeds brand name, and PetMeds family of trademarks, increase traffic on its website at www.1800petmeds.com, acquire new customers, and maximize repeat purchases. The Company s sales consist of products sold mainly to retail consumers. The Company s sales returns average was approximately 1.4% for the quarters ended on December 31, 2009 and 2008. The three-month average retail purchase was approximately $78 per order for the quarters ended December 31, 2009 and 2008. The nine-month average retail purchase was approximately $80 per order for the nine months ended December 31, 2009, compared to $82 per order for the nine months ended December 31, 2008. The decrease in the average order for the nine months ended December 31, 2009 was due to some customers buying smaller quantities, for example, three packs rather than six packs, which may be attributed to a more frugal consumer due to the current economic environment.

Critical Accounting Policies

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

Revenue recognition

The Company generates revenue by selling pet medication products mainly to retail consumers and minimally to wholesale customers. The Company s policy is to recognize revenue from product sales upon shipment, when the rights of ownership and risk of loss have passed to the consumer. Outbound shipping and handling fees are included in sales and are billed upon shipment. Shipping expenses are included in cost of sales.

The majority of the Company s sales are paid by credit cards and the Company usually receives the cash settlement in two to three banking days. Credit card sales minimize accounts receivable balances relative to sales. The Company maintains an allowance for doubtful accounts for losses that the Company estimates will arise from customers inability to make required payments, arising from either credit card charge-backs or insufficient funds checks. The Company determines its estimates of the uncollectibility of accounts receivable by analyzing historical bad debts and current economic trends. At December 31, 2009 and 2008 the allowance for doubtful accounts was approximately $24,000 and $42,000, respectively.

Valuation of inventory

Inventories consist of prescription and non-prescription pet medications and pet supplies that are available for sale and are priced at the lower of cost or market value using a weighted average cost method. The Company writes down its inventory for estimated obsolescence. At December 31, 2009 and 2008, the inventory reserve was approximately $144,000 and $149,000, respectively.

Advertising

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

Accounting for income taxes

The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes* (ASC Topic 740), which generally requires the recognition of deferred tax assets and liabilities for the expected future tax benefits or consequences of events that have been included in the Condensed Consolidated Financial Statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting carrying values and the tax bases of assets and liabilities, and are measured by applying enacted tax rates and laws for the taxable years in which those differences are expected to reverse.

Results of Operations

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

	Three Months Ended December 31,		**Nine Months Ended December 31,**	
	2009	**2008**	**2009**	**2008**
Sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of sales	61.1	60.1	61.8	61.5
Gross profit	38.9	39.9	38.2	38.5
Operating expenses:				
General and administrative	10.2	11.6	9.2	9.6
Advertising	10.7	11.3	12.1	13.8
Depreciation and amortization	0.7	0.4	0.5	0.3
Total operating expenses	21.6	23.3	21.8	23.7
Income from operations	17.3	16.6	16.4	14.8

Total other income	0.1	0.6	0.1	0.7
Income before provision for income taxes	17.4	17.2	16.5	15.5
Provision for income taxes	5.9	5.9	5.9	5.4
Net income	11.5 %	11.3 %	10.6 %	10.1 %

Three Months Ended December 31, 2009 Compared With Three Months Ended December 31, 2008, and Nine Months Ended December 31, 2009 Compared With Nine Months Ended December 31, 2008

Sales

Sales increased by approximately $5.0 million, or 11.4%, to approximately $48.4 million for the quarter ended December 31, 2009, from approximately $43.4 million for the quarter ended December 31, 2008. For the nine months ended December 31, 2009, sales increased by approximately $16.7 million, or 9.7%, to approximately $188.0 million compared to $171.3 million for the nine months ended December 31, 2008.

The increase in sales for the three and nine months ended December 31, 2009 was primarily due to increased reorder sales offset by a decrease in new order sales. The decrease in new order sales may be attributed to a reduction in advertising spending for the nine months. The Company has committed certain dollar amounts specifically designated towards television, direct mail/print, and online advertising to stimulate sales, create brand awareness, and acquire new customers. There can be no assurances that this growth trend will continue due to increasing competition and a reduction in the average order size. The Company acquired approximately 151,000 new customers for the quarter ended December 31, 2009, compared to approximately 154,000 new customers for the same period the prior year. For the nine months ended December 31, 2009, the Company acquired approximately 681,000 new customers, compared to approximately 660,000 new customers for the same period the prior year.

The following chart illustrates sales by various sales classifications:

	Three Months Ended December 30,							
Sales (In thousands)		**2009**	**%**		**2008**	**%**	**$ Variance**	**% Variance**
Reorder Sales	$	37,631	77.8%	$	32,195	74.2%	$ 5,436	16.9%
New Order Sales		10,722	22.2%		11,211	25.8%	(489)	-4.4%
Total Net Sales	$	48,353	100.0%	$	43,406	100.0%	$ 4,947	