

# **PET VALU**™

## **Better Pet Nutrition**

**PET VALU, INC.**

**Quarterly Report**

**Thirteen Weeks Ended April 1, 2006**

(prepared in accordance with Accounting Principles Generally Accepted in the United States of America)  
(in thousands of U.S. dollars)

121 McPherson Street  
Markham, Ontario  
L3R 3L3

# **Pet Valu, Inc.**

## **Content**

- 3 Management's Discussion and Analysis
- 13 Notice to Shareholders
- 14 Consolidated Balance Sheets
- 15 Consolidated Statements of Operation
- 16 Consolidated Statements of Cash Flow
- 17 Notes to Consolidated Financial Statements

# **Pet Valu, Inc.**

## **Management's Discussion & Analysis**

(prepared in accordance with Accounting Principles Generally Accepted in the United States of America)

For purposes of this discussion, "Pet Valu" or the "Company" refers to Pet Valu, Inc. and its subsidiaries.

This Management's Discussion and Analysis ("MD&A") section of the Quarterly Report contains commentary from the Company's management regarding strategy, operating results, and financial condition.

This MD&A should be read in conjunction with the Consolidated Financial Statements and Notes to the Consolidated Financial Statements for the 2005 fiscal year – the 52-week period ended December 31, 2005. The 2004 fiscal year refers to the 52-week period ended January 1, 2005. Unless otherwise indicated, all amounts are expressed in U.S. dollars. References to Canadian dollars shall be noted by using the International Monetary symbol for Canadian dollars, namely "C\$".

This MD&A is current as of May 11, 2006. Additional information relating to the Company, including the Annual Information Form of Pet Valu, Inc. and Pet Valu Canada Inc., is available on-line at [www.sedar.com](http://www.sedar.com).

### **Cautionary Statement Regarding Forward-Looking Information**

Certain information in this MD&A and in other public announcements by the Company is forward-looking and is subject to important risks and uncertainties. Forward-looking information includes information concerning the Company's future financial performance, business strategy, plans, goals, and objectives. Factors which could cause actual results or events to differ materially from current expectations include, among other things: the ability of the Company to successfully implement its strategic initiatives and whether such strategic initiatives will yield the expected benefits; competitive conditions in the businesses in which the Company participates; changes in consumer spending; the outcome of legal proceedings as they arise; general economic conditions and normal business uncertainty; customer preferences towards product offerings; adverse climate changes; the occurrence of a pandemic or other catastrophic event which could create shortages of labour, products or services required to operate the business profitably; fluctuations in foreign currency exchange rates; changes in the Company's relationship with its merchandise and service suppliers; interest rate fluctuations and other changes in borrowing costs; and changes in laws, rules and regulations applicable to the Company or the markets in which the Company operates.

While the Company believes that its forecasts and assumptions are reasonable, results or events predicted in this forward-looking information may differ materially from actual results or events.

### **Overview**

The Company's principal business is that of a specialty retailer and wholesaler of food and supplies for dogs, cats, birds, fish, reptiles, and small animals and a franchisor of pet food and pet-related supply outlets. The PET VALU business was founded in 1976 with the opening of its first retail outlet in Ontario, Canada. Canadian operations have grown through "greenfield" store development and through the acquisition of smaller chains. In 1995, the Company entered the U.S. market by opening its first retail outlet in the state of Maryland. At April 1, 2006, there were 283 stores in operation in Canada and 67 stores operating in the U.S. Of the 283 Canadian stores, 210 stores were franchised and 73 were company-owned. In the U.S., 63 of the 67 stores were company-owned and four were franchised. PET VALU stores are located in Ontario, Manitoba, Pennsylvania, Delaware, New Jersey, Maryland and Virginia.

The Company classifies its operations into two geographical operating segments, Canadian operations and U.S. operations. Canadian stores are operated by, or franchised through, Pet Valu Canada Inc. or one of Pet Valu Canada Inc.'s Ontario subsidiaries, Paulmac's Pet Food Inc. ("Paulmac's"). U.S. stores are operated by, or franchised through, Pet Valu, Inc.'s U.S. operating subsidiary, Pet Valu International Inc.

### **Products and Services**

PET VALU and PAULMAC'S stores offer a wide range of pet food and pet-related supply products. In addition to national and premium brands of pet food and supplies, they carry a broad selection of private label dog, cat and other pet foods marketed under trademarks owned by either Pet Valu Canada Inc. or Paulmac's. All company-owned and franchise stores also offer customers a large variety of non-food products, such as rawhide products, collars, leashes, flea and tick products, pet cages and carriers, dog and cat toys, and other pet-related accessories. These products include both brand name and private label brands. Additional pet food and pet-related supply products, not regularly carried by stores, are available by special order.

In Canada, some PET VALU and most PAULMAC'S stores sell fish, birds, reptiles, and/or small animals and some offer grooming services. All stores in Canada and the U.S. carry a range of wild bird products and none sell dogs or cats.

## **Pet Valu, Inc.**

The Company has ongoing programs to identify higher quality, differentiated merchandise brands as well as private label offerings. Among the private label food products developed and introduced in recent years are the Company's PERFORMATRIN ULTRA line of products. These products take a wellness-focused approach to pet nutrition by using fresh, whole food and other functionally beneficial ingredients, such as anti-oxidants, probiotics and prebiotics. In addition to private label branded products, the Company has also introduced in recent years into its stores third party brands of specialized natural and wellness-focused products, which are not typically offered for sale by mass merchandisers and grocery retailers. Through the introduction of these private label and specialty food offerings as well as unique pet-related supply products, reflecting higher tiers of product quality, the Company seeks to differentiate itself from many of its principal competitors in the sale of pet food and supplies.

### **Warehousing and Distribution**

The Company purchases, warehouses, and distributes pet food and pet-related supplies for and to all company-owned and franchise stores in Canada and the U.S. There are eight leased and two owned distribution facilities in Canada and two leased distribution facilities in the U.S. Total space under lease in these facilities is approximately 484,000 square feet. Most of these facilities are located regionally to support local small box store delivery logistics. Distribution services in both countries are provided by a fleet of company-owned and leased vehicles and supplemented by outside carriers and short-term rentals. Distribution services include delivery of merchandise to company-owned and franchise stores, as well as pick up of merchandise from some vendors to improve the utilization of the fleet.

### **Franchising**

In Canada, Company revenues in relation to franchise operations are generated from fees and gains on the sale of franchises, from ongoing merchandise sales to franchisees, and from royalty and other income from franchise operations. Franchisees purchase the majority of their inventory requirements from the Company. In Canada, PET VALU franchises are sold on a turnkey basis and the price of a franchise includes leasehold improvements, equipment, merchandise inventory, goodwill where applicable, franchise fees, and a site development fee. Franchisees pay a royalty as a percentage of gross sales or imputed gross sales and percentage rent equal to the amount by which a fixed percentage of gross sales or imputed gross sales exceeds the base rent payable by the franchisee under the sublease. They are also responsible, generally, for the costs of operating the business, including rent, employee wages and benefits, and other costs. Transfer fees are charged on the sale of existing franchises to new franchisees. The purchase price of a PAULMAC's franchise includes similar items. PAULMAC's franchisees pay a weekly royalty as a percentage of gross sales and are responsible, generally, for the costs of operating the business, including rent, employee wages and benefits, and other costs. PET VALU franchisees in Canada and PAULMAC's franchisees sign a franchise agreement and, generally, a lease or sublease.

Under the U.S. franchising system, as distinct from the Canadian franchise program, the Company retains ownership of all inventories and records as revenue the full amount of store sales at the retail level. As well, the franchisee does not sublet the premises; instead, Pet Valu International Inc. pays the rent and normal operating expenses. U.S. franchisees purchase the store equipment and are responsible for certain store operating costs, including labour, for which they receive an allowance from the Company. In addition, U.S. franchisees are paid a royalty based on merchandise sales and compliance with operational standards. Royalties and store operating cost allowances paid by the Company to U.S. franchisees are recorded by the Company as store operating expenses. The Company is not currently offering new PET VALU franchises in the U.S. nor PAULMAC'S franchises in Canada.

### **Key Accomplishments**

During fiscal 2005 and the first quarter of fiscal 2006, the Company pursued key priorities intended to improve results from operations, liquidity, capital resources and cash flow.

#### **Reniching project**

During the last nine fiscal quarters, the Company continued to pursue a long-term objective of shifting its product offering to higher-margin, high-quality pet products, which include pet specialty brands and private label products featuring a wellness focused approach to pet nutrition. During the first quarter of fiscal 2006 the Company introduced several new high-quality products including Performatrin Ultra Slim Care, Performatrin Ultra Cat food, Mewsprint, or Homepath. This component of our reniching is expected to improve operating profits and enhance the image of the Company as a specialty retailer. The other key component of the Company's reniching project involves the development of revised or new store location and store image strategies reflecting changes in consumer traffic patterns, shopping centre developments, and competitive dynamics between mass merchandisers and specialty stores. This resulted in certain store closures in Canada and certain store openings in the U.S. during the first quarter of fiscal 2006.

During the first quarter of fiscal 2006, the Company continued its rebranding efforts with its new PET VALU BETTER PET NUTRITION trademark, now used in addition to the PET VALU trademark and name. This new mark, together with the expected gradual elimination of the "discount" image in association with the PET VALU business, highlight efforts to transform the Company's image from discount retailer to purveyor of higher quality products.

# Pet Valu, Inc.

## U.S. Expansion

During the first quarter of fiscal 2006, the Company continued to pursue profitable expansion in the U.S. markets in which it operates, resulting in the opening of two new stores in the state of Pennsylvania. The Company will continue to pursue a modest level of expansion in fiscal 2006.

## Overall Performance

Net income for the first quarter of fiscal 2006 was \$0.9 million as compared to net income of \$0.8 million in the first quarter of fiscal 2005. The increase in net income was primarily due to increased sales and revenues and improvements in blended gross profit margins. Increases in comparable store sales in both the U.S. and Canada contributed to increased sales and revenues. Increased retail sales at corporate stores exceeded the reduction in the wholesale revenue and other revenue received from franchisees which was due to the reduction in the number of franchisees. Blended gross profit margins increased as a result of a shift to higher margin products, and a strengthening of the Canadian dollar which increased margins on products purchased in U.S. dollars for sale in the Canadian operations in Canadian dollars. For a more in depth discussion of revenues, gross profit and expenses, please refer to the section of this MD&A entitled "Results of Operations".

Cash flow from current operations was sufficient to meet all of the Company's debt obligations during the quarter. There were no acquisitions during the first quarter of fiscal 2006 that required funding. Acquisitions of certain property and equipment were funded through vendor leasing programs. In Canada, as part of regular operations, franchisees were repurchased and sold on an on-going basis. Cash flow required to support the cost of repurchasing franchise store assets was partially offset by cash received from the sale of Company-owned store assets to new franchisees. Store expansion in the U.S. resulted in the opening of two new stores during the quarter. As the typical size of a store in the U.S. is 2,500 square feet, the amount of funding required to set up equipment and stock the store with inventory is not significant.

The Company's financial condition improved in the first quarter of fiscal 2006 due to positive cash flow from operations. The Company's capital structure remained similar to the end of the prior year. There was no additional debt issued other than capital leases for capital asset additions.

In general terms, competition in pet food and pet-related supply retailing continued to increase in the first quarter of fiscal 2006. Pet product superstores and pet food specialty stores continued to expand the number of retail outlets. The Company expects continued increases in competition and plans to address these challenges by employing strategies focused on its key competitive strengths in customer service, convenience, and expanded private label, specialty and wellness focused products, focusing on front line staff training to enhance its customer service, and increasing its efforts to source and develop new products.

## Summary of Quarterly Results

### Eight quarter summary

(expressed in thousands of U.S. dollars except for per share amounts)

	Fiscal 2004			Fiscal 2005				Fiscal 2006
	2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	1 <sup>st</sup>	2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	1 <sup>st</sup>
	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter
System-wide sales *	\$ 37,387	\$ 40,309	\$ 45,994	\$ 40,793	\$ 40,026	\$ 42,350	\$ 48,582	\$ 43,354
Sales and revenue	29,582	32,276	35,934	31,917	31,619	33,307	37,563	34,081
Gross profit	7,010	8,328	9,937	8,099	8,442	9,041	11,754	9,223
Net income	140	1,180	2,364	808	1,013	1,420	4,013	922
Net income before non-comparable items **	325	1,072	2,009	808	1,013	1,420	3,175	922
Net income per share – basic	0.02	0.16	0.32	0.11	0.14	0.19	0.54	0.12
Net income per share – diluted	0.02	0.14	0.28	0.10	0.12	0.16	0.46	0.11
Non comparable items								
Promotion fund allowance	-	-	-	-	-	-	582	-
(Gain) loss on foreign exchange	57	(417)	(3)	-	-	-	-	-
Litigation costs	200	278	(46)	-	-	-	-	-
Loss on debt extinguishment	-	206	4	-	-	-	-	-
Future tax recovery on NOLs	-	-	(325)	-	-	-	(1,210)	-
Applicable tax on non-comparable items	(72)	(175)	15	-	-	-	(210)	-

\* System-wide sales represent retail sales to customers through company-owned and franchise stores.

\*\* Net income before non-comparable items is not a recognized measure under GAAP. As this measure does not have a standardized meaning prescribed by GAAP, the Company's method of calculating net income before non-comparable items may differ from other companies. Management believes net income before non-comparable items is a useful supplemental measure as it provides investors with a measure that can be used to compare year over year net income without the effects of non-recurring or non-operational activities.

## **Pet Valu, Inc.**

Non-comparable items include (1) foreign exchange gains on long term monetary items, (2) future income tax recoveries relating to the net operating loss ("NOL") carryforwards of the U.S. operations, (3) loss on extinguishment of debt, (4) litigation costs and (5) allowance for promotion fund deficit. For a more in depth discussion of non-comparable items, please refer to the section of this MD&A entitled "Results of Operations".

During fiscal 2005 and 2004, the value of the U.S. dollar declined against the Canadian dollar. This decline was significant enough to cause notable effects on the financial statements of the Company. Foreign currency exchange rates are used in the operational activities of the Company to calculate gains or losses on foreign denominated monetary items, and to convert the results of Canadian operations from the operating currency of Canadian dollars to the reporting currency of U.S. dollars. Operationally, the change in the foreign currency exchange rate resulted in decreased product costs for the Canadian operations. Foreign currency exchange gains or losses on long-term monetary items are disclosed separately in the Consolidated Statement of Operations. The Canadian operations use the Canadian dollar as their operating currency. Therefore, the financial statements of the Canadian operations are converted to U.S. dollars upon consolidation with the U.S. operations. As the Canadian operations comprise a significant portion of the total operations, the majority of items in the financial statements are affected by the change in the U.S. / Canada currency exchange rate.

The Company reviews the likelihood of a realization of the NOL carryforwards of the U.S. operations on a regular basis. The Company believes it is more likely than not that a portion of the NOL carryforwards will be realized based on the current and projected taxable income of the U.S. operations. The Company reduced the valuation allowance relating to the NOL carryforwards for tax purposes of the U.S. operations in the fourth quarter of fiscal 2005 and 2004. There was no change in the valuation allowance in the first quarter of fiscal 2006. At the end of the first quarter of fiscal 2006, the valuation allowance was \$7.7 million.

Until September 30, 2004, some of the debentures of the Company were not denominated in the same currency as the operating currency of the issuing corporation. More specifically, \$10.24 million of debentures issued by the Canadian operating subsidiary, Pet Valu Canada Inc., were U.S. dollar denominated debentures. As a result, the Company recognized a gain or loss on foreign exchange from these debentures. The gain or loss is disclosed separately in the Consolidated Statement of Operations. Up to September 30, 2004, the Company had recognized a gain on foreign exchange as the Canadian dollar had strengthened slightly from its previous year-end level. These debentures were repaid on September 30, 2004 from the proceeds of a C\$15 million financing completed that day, as more particularly described in Note 3(c) to the Consolidated Financial Statements of the Company.

The Company and its franchisees make contributions to the Canadian promotion fund, which is used for marketing and advertising activities. As of the end of fiscal 2005, the Company determined that the deficit balance of the promotion fund was unlikely to be recovered in the next fiscal year due to the magnitude of the promotion fund deficit and the Company's assessment of its future promotional plans. Therefore, an allowance of \$0.6 million was provided for in the fourth quarter of fiscal 2005.

The Company does not have a significant exposure to seasonal fluctuations among its product lines. Traditionally, fourth quarter earnings tend to be stronger due to higher store sales and increased margins, particularly in the month of December.

### **Results of Operations**

#### **Impact of a strengthening of the Canadian dollar versus the U.S. dollar**

The Company is comprised of various Canadian and U.S. subsidiaries. Generally, the country in which the subsidiary operates will determine the functional currency. The reporting currency for the consolidated financial statements is U.S. dollars. Therefore, the statement of operations for each subsidiary whose functional currency is not U.S. dollars is converted to U.S. dollars at the end of the period using the year-to-date average foreign currency exchange rate. During fiscal 2005 and the first quarter of fiscal 2006, the Canadian dollar strengthened significantly. The result of this strengthening was that each line item in the statements of operations of subsidiaries using Canadian dollars as their functional currency increased in U.S. dollar value by 6% in the first quarter of fiscal 2006 and 7% in fiscal 2005. This effect was somewhat offset when the results of operations of subsidiaries which use the U.S. dollar as their functional currency were consolidated with the results of operations of the Canadian subsidiaries. In all areas of the following analysis, the change in the foreign currency exchange rate will have the effect of increasing fiscal 2006 dollar amounts as compared to those of fiscal 2005.

#### **Store Operations**

During the first quarter of fiscal 2006, there was a net increase of one store in the U.S. and a net decrease of two stores in Canada. Store operations are evaluated on an on-going basis with openings and closings resulting from shifts in demographics, quality of locations, population growth, and competition. The stores that were closed were identified by an evaluation of criteria such as cash flow contribution and the Company's ability to negotiate favourable lease termination arrangements. The Company believes that the Canadian markets in which the Company operates are highly competitive, mature markets where growth is limited to normal population changes, inflation, changes in per pet spending, and consolidation within the industry itself.

## **Pet Valu, Inc.**

In the first quarter of fiscal 2006, the average number of stores in operation was 350, which was the same as the average for the first quarter of the prior year. An increase of five stores in the U.S. was offset by a decrease of five stores in Canada.

### **System-wide sales**

System-wide sales represent retail sales to customers through company-owned and franchise stores. During the first quarter of fiscal 2006, system-wide sales increased by \$2.6 million or 6.3% from the prior year to \$43.4 million. The change in foreign exchange rates resulted in an increase in system-wide sales from the prior year of \$2.0 million. Before the effects of the change in foreign exchange rates, the system-wide sales in the Canadian operations increased by \$0.1 million or 0.4%. The system-wide sales in the U.S. operations increased by \$0.4 million or 4.8%.

Comparable store sales represent a year-over-year comparison of the same group of stores that were open during both years of comparison. A store becomes comparable one year after its first full month of operation. Comparable store sales increased by 0.7% in Canada and increased by 1.1% in the U.S. Increases in competition, and the effects of the Company's shift towards a more upscale product offering held sales growth to a modest level.

### **Sales and revenue**

Sales and revenue represent retail sales through company-owned stores in Canada and the U.S., retail sales through franchise stores in the U.S., merchandise sales to franchisees in Canada, initial and continuing franchise fees in both countries, and wholesale sales to third parties. The Company's sales and revenue increased by \$2.2 million or 6.8% in the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005. The change in foreign exchange rates resulted in an increase in sales and revenue of \$1.5 million. Before the effects of the change in foreign exchange rates, the sales and revenue in the Canadian operations increased by \$0.3 million or 1.2%. The sales and revenue in the U.S. operations increased by \$0.4 million or 4.8%. In Canada, increases in comparable store sales and retail sales at corporate stores, which was partly due to an increase in the number of corporate stores, contributed to an increase in sales and revenue. This increase in sales and revenue was partially offset by a reduction in the wholesale revenue and other revenue received from franchises due to a reduction in the number of franchise stores. In the U.S., an increase in the average number of stores in operation and an increase in comparable store sales contributed to the increase in sales and revenue.

In the first quarter of fiscal 2006, total merchandise sales through company-owned stores increased by \$1.7 million to \$14.1 million, accounting for a 5.3% increase in consolidated sales and revenue. The change in foreign currency exchange rates resulted in an increase of \$0.4 million in merchandise sales through company-owned stores. Before the effects of the change in foreign currency exchange rates, the merchandise sales through company-owned stores in the Canadian operations increased by \$0.7 million or 14.9%. In the U.S. operations, merchandise sales through company-owned stores increased by \$0.6 million or 7.8%. The average number of corporate stores in Canada increased by 9.4% to 70 for the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005. The average number of corporate stores in the U.S. increased by 11.7% to 62 for the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005.

Merchandise revenue from franchisees includes (1) merchandise sales at U.S. franchise stores; and (2) merchandise sold to Canadian franchisees together with related franchise distribution charges, royalty revenue and percentage rent revenue. Total merchandise revenue from franchise stores increased by \$0.6 million to \$19.6 million, accounting for a 2.0% increase in consolidated sales and revenue. The change in foreign currency exchange rates resulted in an increase of \$1.1 million in merchandise revenue from franchise stores. Before the effects of the change in foreign currency exchange rates, the merchandise revenue from franchise stores in the Canadian operations decreased by \$0.3 million or 1.6%. In the U.S. operations, merchandise revenue from franchise stores decreased by \$0.2 million or 33.0%. Two fewer franchises in the U.S. operation during the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005 and a decrease of 11 or 4.9% in the average number of franchise stores open in the Canadian operation contributed to the decrease in merchandise revenue from franchisees.

Initial fees and gains on the sale of franchises in the first quarter of fiscal 2006 of \$0.2 million was \$0.2 million less than the prior year, primarily due to fewer sales of corporate stores to new franchisees resulting in lower initial franchise fees.

Wholesale revenue in the first quarter of fiscal 2006 of \$0.2 million was consistent with the prior year.

### **Gross profit**

Gross profit on sales and revenue increased by \$1.1 million or 13.9% in the first quarter of fiscal 2006 as compared to the previous year. The change in foreign currency exchange rates resulted in an increase in gross profit of \$0.4 million. Before the effects of the change in foreign currency exchange rates, gross profit in the Canadian operations increased by \$0.7 million or 12.1%. In the U.S. operations, gross profit increased by 1.6%.

Blended gross profit margins increased to 27.1% in the first quarter of fiscal 2006, as compared to 25.4% in the first quarter of fiscal 2005. Gross profit margins in the U.S. stores were consistent with the first quarter of the prior year. Canadian company-owned stores achieved an increase in gross profit margins of 1.3% as compared to the first quarter of the prior year.

# Pet Valu, Inc.

## **Store operating expenses**

Store operating expenses increased by \$0.4 million or 12.4% in the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005. The change in foreign currency exchange rates resulted in an increase of \$0.1 million in store operating expenses. Before the effects of the change in foreign exchange rates, store operating expenses in the Canadian operations increased by \$0.1 million or 10.6%. In the U.S. operations, store operating expenses were \$0.2 million or 8.6% higher than the first quarter of the prior year. On a per store basis, store operating costs increased by 1.1% in Canada and by 0.4% in the U.S. Increased minimum wages in Ontario were offset by reductions in most of the other expenses on a per store basis in Canada.

## **General and administrative expenses**

General and administrative expenses increased by \$0.5 million or 19.4% in the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005. The change in foreign currency exchange rates resulted in an increase of \$0.2 million in general and administrative expenses. Before the effects of the change in foreign currency exchange rates, general and administrative expenses in the Canadian operations increased by \$0.3 million. In the U.S. operations, general and administrative expenses were consistent with the prior year. Included in the general and administrative costs of the Canadian operations for the first quarter of fiscal 2006 were one time costs incurred in relation to the Company's refinancing efforts, increased costs in relation to the development and procurement of new wellness focused products, and stock option compensation expense resulting from U.S. GAAP pronouncements adopted in the third quarter of fiscal 2005.

## **Net interest expense**

Net interest expense decreased 2.9% in the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005. The change in foreign currency exchange rates resulted in an increase of \$0.1 million in net interest expense. Before the effects of the change in foreign currency exchange rates, net interest expense in the Canadian operations decreased by \$0.1 million or 6.6%. In the U.S. operations, net interest expense was consistent with the prior year.

## **Net income**

Net income for the first quarter of fiscal 2006 was \$0.9 million as compared to net income of \$0.8 million in the first quarter of fiscal 2005. The increase in net income was primarily due to increased sales and revenues and improvements in blended gross profit margins. Sales and revenues increased due to an increase in retail sales at corporate stores, which was partially due to an increase in the number of corporate stores, offset by a reduction in the wholesale revenue and other revenue received from franchises due to a reduction in the number of franchise stores. Blended gross profit margins increased as a result of a shift to higher margin products, and a strengthening of the Canadian dollar which increased margins on products purchased in U.S. dollars for sale in the Canadian operations in Canadian dollars.

## **Liquidity and Financial Position**

During the first quarter of fiscal 2006, the Company's non-cash working capital deficit was reduced by \$1.3 million to \$1.0 million. Cash flow from operations contributed to the reduction in the working capital deficit. Subordinated debentures of Pet Valu Canada Inc. in the principal amount of C\$15.1 million will mature on July 24, 2006 and as a result are classified as current liabilities causing the working capital to be in a deficit position. The Company previously announced a private placement of up to C\$15.0 million, the proceeds from which can be used along with availability from the Company's bank operating line to repay these debentures and possibly other debt with higher interest rates. No additional working capital requirements are expected in fiscal 2006; however, as store locations are added in the future, inventory requirements may increase.

Merchandise accounts payable leveraging (trade payables as a percentage of inventory) increased to 22.8% as of April 1, 2006 as compared to 21.8% as of December 31, 2005. The Company maintains a relatively low level of leveraging due to efforts to realize increased vendor discounts and allowances.

Total assets increased by \$1.2 million to \$55.8 million at April 1, 2006, as compared to \$54.6 million at the end of fiscal 2005. Total assets increased primarily due to increased prepaid expenses which include warehouse and store rents paid in advance on the first day of the month.

Cash provided by operating activities in the first quarter of fiscal 2006 was \$0.6 million as compared to \$0.7 million in the first quarter of fiscal 2005. The decrease was primarily due to changes in prepaid expenses. Changes in working capital used \$1.0 million of cash in the first quarter of fiscal 2006 as compared to a net use of \$0.3 million of cash in the first quarter of fiscal 2005.

Net cash used in investing activities for the first quarter of fiscal 2006 increased by \$0.6 million to \$0.9 million as compared to \$0.3 million used in the first quarter of fiscal 2005. An increase in purchases of property and equipment and the repurchase of franchises resulting in repurchased goodwill contributed to the increase in the use of cash for investing activities. The purchases of property and equipment consisted mainly of replacements for automotive and computer equipment. Franchise repurchases also resulted in purchases of property and equipment including store equipment, leaseholds and goodwill.

## **Pet Valu, Inc.**

Net cash used in financing activities in the first quarter of fiscal 2006 was \$0.4 million as compared to \$0.2 million of cash provided by financing activities in the first quarter of fiscal 2005. Cash was used to make scheduled principal repayments of long-term debt and reduce the amount of funds borrowed under the bank operating facility. In the first quarter of fiscal 2005, the Company used its bank operating facility to repay Pet Valu Canada Inc. debentures as well as to make scheduled principal repayments of long-term debt.

There were no acquisitions during the first quarter of fiscal 2006 that required funding. Acquisitions of certain property and equipment were funded through vendor leasing programs. In Canada, as part of regular operations, franchises were repurchased and sold on an on-going basis. Cash flow was required to support the cost of repurchasing franchise store assets. Store expansion in the U.S. resulted in the opening of two new stores. As the typical size of a store in the U.S. is approximately 2,500 square feet, the amount of funding required to set up equipment and fill the store with inventory is not significant.

The Company anticipates that cash flow from current operations along with availability from its bank operating line and a previously announced private placement by Pet Valu Canada inc. will be sufficient to meet debt servicing obligations for fiscal 2006, including the repayment of C\$15.1 million of debentures maturing on July 24, 2006. Future expansion will be funded through operating cash flow. The Company anticipates that it will continue to generate positive cash flow for the foreseeable future.

### **Capital Resources**

On November 14, 2000, the Company completed a banking arrangement with Bank of Montreal for a senior line of credit. The facility was a floating rate loan restricted by borrowing base calculations and certain general covenants. The total borrowing capability before borrowing base calculations was C\$18.0 million.

In fiscal 2004, the Company entered into an agreement with Bank of Montreal to extend the terms of the senior line of credit. Pursuant to this agreement, the term of the agreement was extended to July 13, 2006 on substantially the same terms as the original agreement.

In anticipation of the expiry of this facility, the Company is continuing discussions to renew or replace the facility. It is expected that a senior line of credit satisfactory to the Company will be obtained to renew or replace the expiring one in a timely fashion.

At April 1, 2006, the Company had utilized \$0.8 million of the senior line of credit as compared to \$1.9 million at the end of fiscal 2005. Pursuant to its banking agreement, in addition to the borrowing base restrictions, the Company must also comply with certain general covenants which include, among other things, minimum debt service ratios and a minimum consolidated tangible net worth calculation as defined. The Company is in compliance with these covenants.

Pet Valu Canada Inc. had previously announced a private placement of non-convertible unsecured subordinated debt of up to C\$15.0 million. This transaction is expected to be completed on July 24, 2006.

Pet Valu Canada Inc. has warrants to purchase exchangeable shares of Pet Valu Canada Inc. outstanding that will expire on July 24, 2006. These warrants are currently exercisable at C\$7.00 per warrant. If all of the warrants were exercised prior to their expiry, proceeds of C\$14.1 million would be received by Pet Valu Canada Inc. and recorded as shareholders' equity.

In the first quarter of fiscal 2005, the Company repaid \$0.5 million of 7% convertible debentures of Pet Valu Canada Inc. and \$2.2 million of 8.5% convertible debentures of Pet Valu Canada Inc.

The Company does not have any commitments with respect to future capital expenditures. Replacement of existing capital assets will occur as required. Additions of furniture and fixtures are normally financed through internal cash flow. Additions of tractors, trailers, warehouse material handling equipment, and some computer and office equipment may be financed through vendor leasing programs.

### **Off-Balance Sheet Arrangements**

There are no new off-balance sheet arrangements. Please see the discussion of off-balance sheet arrangements in the MD&A for the year ended December 31, 2005.

# **Pet Valu, Inc.**

## **Risks and Uncertainties**

The Company is exposed to a number of risks in the normal course of its business that have the potential to affect operating performance. Exposure to certain risks is an integral part of carrying on business.

### **Competition**

The Company's stores compete with four main types of competitors: (i) grocery product retailers; (ii) pet food specialty stores; (iii) pet product superstores; and (iv) pet shops.

Grocery product retailers including grocery stores, mass merchandisers, warehouse clubs, and convenience retailers (such as some convenience stores, discount stores, drug stores, and hardware general merchandise stores) are competitors primarily for the sale of pet food; pet shops are competitors primarily with respect to pet-related supplies; and pet food specialty stores and pet product superstores are competitors with respect to all product categories in varying degrees.

The Company's stores compete with these groups by seeking to offer products at competitive prices as well as higher margin, high quality products including private label and natural and wellness focused products, and by seeking to provide a convenient, friendly, service-oriented shopping environment in which customers may discuss their pets and obtain product information and advice about the care of their pets from knowledgeable staff. The Company believes that this kind of environment provides it with a competitive advantage by engendering a level of customer loyalty that facilitates repeat sales of its products.

In general terms, competition in pet food and pet-related supply retailing continued to increase in the first quarter of 2006. Pet product superstores and pet food specialty stores continued to expand the number of retail outlets. The Company expects continued increases in competition and plans to address these challenges by employing strategies focused on its key competitive strengths in customer service, convenience, and expanded private label, specialty and wellness focused products, focusing on front line staff training to enhance its customer service, and increasing its efforts to source new products.

### **Dependence on Key Personnel**

The success of the Company is dependent to a significant degree upon the expertise and experience of its senior management, most of whom have been with the Company for many years. The Company's continued success could depend on its ability to retain current management or hire comparable replacement personnel.

### **Reliance on Suppliers, Product Lines and Current Distribution Arrangements**

The Company purchases significant amounts of its merchandise from certain key suppliers. A termination or interruption in the flow of merchandise from any of these vendors or any other significant suppliers of pet food or pet-related supplies offered by the Company could have an adverse impact on the Company.

### **Risks Associated with Foreign Operations**

The Company does not have operations outside Canada or the U.S. However, it does purchase certain of its goods for resale from foreign suppliers in foreign currencies. The foreign exchange rate at the time of purchase is included in the calculation of the cost of the product. There are, therefore, the usual risks associated with exchange rate fluctuations. The Company does not feel that purchases of this type are sufficient in magnitude to warrant hedging of currency rates.

The Company's merchandise purchases include products that are subject to various laws and rules, including those administered by the Food and Drug Administration in the U.S. and the Canadian Food Inspection Agency in Canada. These agencies are empowered to act to prevent the importing of goods for various reasons within their mandate. Broad import restrictions could negatively impact the ability of the Company to source products demanded by its customers. For example, import and export controls on animal protein ingredients of pet products pursuant to events such as the discovery of bovine spongiform encephalopathy in cattle or the H5 virus in poultry could disrupt the supply of products available for the Company to sell, or affect the price of brand name products or the raw material ingredients for its private label products.

### **Leases**

The Company leases space for most of the company-owned and franchise stores, as well as the majority of warehouse and office facilities. The terms of the leases vary by location. In the event of unreasonable rent increases upon renewal of store leases or an inability to secure renewals, relocation costs are minimized due to store sizes. With respect to warehouse and office facilities, the Company expects that it will be in a position to find adequate facilities in the event that it is unable to reach satisfactory extensions of lease terms at current locations.

### **Environmental Matters**

As an owner, occupier, and lessor of property, the Company is subject to various laws relating to environmental matters. Under such laws an owner, occupier, or lessor could be liable for the costs of removal and remediation of certain contaminants with respect to the properties it owns, occupies, or leases. These risks are believed to be limited.

## **Pet Valu, Inc.**

### **Litigation**

The Company's wholly owned subsidiary, Paulmac's, is currently defending a motor vehicle claim where the amount claimed for damages totals C\$3.6 million and the limit of insurance coverage is C\$2.0 million. Moreover, the plaintiffs make a claim for punitive damages and there is no insurance coverage for punitive damages. While the outcome of this litigation is not certain, the Company believes that there are substantive defences to this claim.

Pet Valu, Inc. and its affiliates (other than Paulmac's) have, both before and after this claim, and Paulmac's has, since its acquisition by Pet Valu Canada Inc., maintained automobile insurance coverage limits which have been, and are, well in excess of the above limit and which have been, and are, adequate in the view of management to cover future risks similar to the above.

In addition to the matter referenced to above, the Company is, from time to time, named as a defendant in legal proceedings arising from its normal business activities. Although the amount of any liability that could arise with respect to such actions cannot be estimated, in the opinion of the Company, any such liability is not likely to have a material adverse effect on its financial position, operating results or liquidity.

### **Seasonality**

The Company does not have a significant exposure to seasonal fluctuations among its product lines. Traditionally, fourth quarter earnings tend to be stronger due to higher store sales and increased margins, particularly in the month of December.

### **Inflation**

The results of operations and financial condition are presented based upon historical cost. While it is difficult to accurately measure the impact of inflation, the Company believes that the effects of inflation on its operations have been immaterial over the last three years.

### **Market risks**

The Company does not engage in financial transactions for trading or speculative purposes.

### **Interest rate risk**

The Company believes that debt subject to variable interest rates is at an acceptable level and that any current obligations affected by minor fluctuations in rates can be met by current operations.

### **Expansion Plans**

The Company's continued expansion depends, to a significant degree, on the ability of its stores to maintain sales and margins, as well as its ability to obtain favourable store sites, to compete in existing and new geographic markets, and to secure or generate adequate financial resources.

### **Other Risks**

Additional risks include: the ability of the Company to successfully implement its strategic initiatives and whether such strategic initiatives will yield the expected benefits; changes in consumer spending; general economic conditions and normal business uncertainty; customer preferences toward product offerings; adverse climate changes; the occurrence of a pandemic or other catastrophic event which could create shortages of labour, products or services required to operate the business profitably; and changes in the laws, rules and regulations applicable to the Company or the markets in which the Company operates. Although most of these risks are beyond the Company's control, with respect to the risk of a pandemic, the Company is currently preparing a comprehensive contingency plan.

### **Critical accounting estimates**

There are no new critical accounting estimates. Please see the discussion of critical accounting estimates in the MD&A for the year ended December 31, 2005.

### **Changes in Accounting Policies including Initial Adoption**

There are no changes in accounting policies. Please see the discussion of changes in accounting policies in the MD&A for the year ended December 31, 2005.

## Pet Valu, Inc.

### Outstanding Share Data

The following table contains the number of outstanding voting or equity securities at April 1, 2006 and the end of fiscal 2005. Please refer to notes 4 and 5 of the financial statements for additional information.

	<u>April 1, 2006</u>	<u>December 31, 2005</u>
Common Stock of Pet Valu, Inc.	100	100
Additional Special Voting Stock of Pet Valu, Inc.	9,626,274	9,626,274
Exchangeable Shares of Pet Valu Canada Inc.	7,526,108	7,501,158
Common Shares of Pet Valu Canada Inc. (held by Pet Valu, Inc.)	1	1
Non-voting securities convertible into Exchangeable Shares of Pet Valu Canada Inc.		
8.5% debentures of Pet Valu Canada Inc.	672,727	672,727
Warrants of Pet Valu Canada Inc. listed on TSX	2,007,305	2,007,305
Warrants of Pet Valu Canada Inc. issued September 30, 2004	876,944	876,944

### 2006 Outlook

One of the Company's objectives is the reduction of interest expense. During the balance of 2006, the Company plans to utilize the proceeds from the exercise of warrants expiring on July 24, 2006 plus the proceeds of its previously announced private placement in combination with its bank line availability at the time, to retire all 8.5% debt maturing on July 24, 2006 as well as a portion of the 12.5% debentures due in September, 2009. The extent of the combined proceeds available from these three sources is unknown at this time and, therefore, the extent of a decline in interest expense cannot be predicted.

A second objective is to improve our technological systems and increase automation. A definitive competitive advantage in this area should be achievable and the cost is not expected to be substantial as the work will, for the most part, be completed in-house.

A third objective is to assess the Company's practices, systems and strategies and to ensure that they are compatible with "best practices" as they apply in the coming decade. An internal "corporate re-engineering group" has been formed, including the recent recruitment of high talent individuals from the consulting industry, to complete this objective along with various other corporate projects. Once major projects have been completed, members of this group will be absorbed into the executive body of the Company in order to manage expected business growth.

Among the key projects of the Company in 2006 being undertaken by the new corporate re-engineering group is the development of a new U.S. market expansion plan. This plan will address all strategies and activities required to effect profitable U.S. niche positioning on and outside the eastern seaboard. Similarly, the corporate re-engineering group will assess the feasibility and best strategies to expand in Canada to Alberta and British Columbia. Any U.S. or Canadian expansion will only be undertaken if and when it is determined to be worthwhile to do so in balance with other opportunities.

In general, the focus of the Company will be on growth in earnings and cash flow with a strong emphasis on building for the future.

## **Pet Valu, Inc.**

May 11, 2006

To the Shareholders of Pet Valu, Inc.:

An auditor has not reviewed the consolidated balance sheet of Pet Valu, Inc. as at April 1, 2006, nor the consolidated statements of operations and cash flows for the thirteen week period then ended.

# Pet Valu, Inc.

## Consolidated Balance Sheets

In accordance with accounting principles generally accepted in the United States of America

(Unaudited)

(In thousands of U.S. dollars)

April 1, 2006      December 31, 2005

### Assets

#### Current assets

Cash	\$	923	\$	1,674
Accounts receivable		1,686		1,945
Other receivables		1,052		1,201
Inventories		23,915		23,804
Prepaid expenses		2,848		929
Deferred income tax assets		828		828

<b>Total current assets</b>		<b>31,252</b>		<b>30,381</b>
Notes receivable (Less allowances of \$38, 2005 - \$38)		52		66
Deferred charges		1,622		1,686
Property and equipment, net of accumulated depreciation and amortization		5,027		4,905
Goodwill		13,900		13,593
Deferred income taxes		3,956		3,978
<b>Total assets</b>	<b>\$</b>	<b>55,809</b>	<b>\$</b>	<b>54,609</b>

### Liabilities and Shareholders' Equity

#### Current liabilities

Bank overdraft	\$	2,306	\$	1,559
Bank operating loans		790		1,862
Current portion of long-term debt including capital lease obligations		526		560
Current portion of deferred gain on warehouse sale		222		226
Trade accounts payable		5,456		5,201
Accrued liabilities		3,132		3,709
Accrued wages and benefits		3,024		2,459
Income taxes payable		3,054		2,602
Subordinated debentures (Note 3)		12,862		12,897

<b>Total current liabilities</b>		<b>31,372</b>		<b>31,075</b>
Deferred franchise revenue		16		20
Deferred gain on warehouse sale		550		605
Deferred rent payable		2,039		2,055
Long-term debt including capital lease obligations, less current maturities		1,198		1,204
Subordinated debentures (Note 3)		15,535		15,567
<b>Total liabilities</b>		<b>50,710</b>		<b>50,526</b>

#### Shareholders' Equity (Deficit)

Capital Stock (Note 4)		12,539		12,454
Accumulated deficit		(1,374)		(2,296)
Accumulated other comprehensive loss		(5,374)		(5,383)
Treasury stock – exchangeable shares, at cost		(692)		(692)

<b>Total shareholders' equity</b>		<b>5,099</b>		<b>4,083</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$</b>	<b>55,809</b>	<b>\$</b>	<b>54,609</b>

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

# Pet Valu, Inc.

## Consolidated Statements of Operations

In accordance with accounting principles generally accepted in the United States of America

(Unaudited)

(In thousands of U.S. dollars, except number of shares)

	Thirteen Weeks Ended	
	April 1, 2006	April 2, 2005
<b>System-wide retail sales</b>	\$ 43,354	\$ 40,793
<b>Sales and revenue</b>	\$ 34,081	\$ 31,917
Cost of sales including occupancy costs	24,858	23,818
<b>Gross profit</b>	<b>9,223</b>	<b>8,099</b>
Store operating expenses excluding occupancy costs	3,589	3,193
General and administrative expenses	3,348	2,803
	<b>2,286</b>	<b>2,103</b>
Net interest expense	959	987
Income before income taxes	1,327	1,116
Income taxes provision	405	308
<b>Net income</b>	<b>\$ 922</b>	<b>\$ 808</b>
Basic EPS (Note 2)	\$ 0.12	\$ 0.11
Diluted EPS (Note 2)	0.11	0.10
Weighted average number of common stock and exchangeable shares outstanding:		
Basic (Note 2)	7,514,562	7,496,518
Diluted (Note 2)	9,069,766	8,978,837

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

# Pet Valu, Inc.

## Consolidated Statements of Cash Flows

In accordance with accounting principles generally accepted in the United States of America

(Unaudited)

(In thousands of U.S. dollars)

	Thirteen Weeks Ended	
	April 1, 2006	April 2, 2005
<b>Operating activities</b>		
Net income	\$ 922	\$ 808
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	450	422
Deferred income taxes	18	17
Loss on disposal of property and equipment	1	3
Amortization of debenture discount	55	52
Stock based compensation costs	34	-
Deferred charges	50	(289)
Deferred franchise revenue	-	1
Amortization of deferred gain on warehouse sale	(56)	(53)
Loss on disposal of goodwill	57	-
Changes in other operating assets and liabilities:		
Decrease (increase) in receivables	400	(55)
Increase in inventories	(195)	(974)
Increase in prepaid expenses	(1,937)	(119)
Increase in payables	752	875
<b>Net cash provided by operating activities</b>	<b>551</b>	<b>688</b>
<b>Investing activities</b>		
Purchases of property and equipment	(473)	(236)
Proceeds on disposal of property and equipment	-	8
Purchase of store goodwill	(427)	-
Notes and other receivables	10	(52)
<b>Net cash used in investing activities</b>	<b>(890)</b>	<b>(280)</b>
<b>Financing activities</b>		
(Repayment) borrowing of short-term financing	(1,076)	5,211
Increase (decrease) in bank overdraft	762	(2,242)
Repayment of capital lease obligation	(93)	(66)
Repayment of note payable	(8)	(10)
Repayment of term loan financing	(44)	(6)
Repayment of bank mortgage financing	(8)	(7)
Issuance of Exchangeable Shares	50	-
Repayment of debentures	-	(2,659)
<b>Net (cash used in) provided by financing activities</b>	<b>(417)</b>	<b>221</b>
Effect of exchange rate changes on cash	5	18
Net (decrease) increase in cash	(751)	647
<b>Cash – Beginning of fiscal period</b>	<b>1,674</b>	<b>52</b>
<b>Cash – End of fiscal period</b>	<b>\$ 923</b>	<b>\$ 699</b>

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

# Pet Valu, Inc.

## Notes to Consolidated Financial Statements

In accordance with accounting principles generally accepted in the United States of America

(Unaudited)

(Canadian dollar reporting shall be cited as C\$)

### 1. Significant Accounting Policies

The unaudited interim consolidated financial statements (the "financial statements") have been prepared by management in accordance with U.S. generally accepted accounting principles ("GAAP") and include the accounts of Pet Valu, Inc. and its subsidiaries. These financial statements do not contain all disclosures required by U.S. GAAP for annual financial statements, and accordingly, the financial statements should be read in conjunction with the most recently prepared annual financial statements for the 52 week period ended December 31, 2005.

These financial statements follow the same accounting policies and their methods of application as described in the most recent annual financial statements for the 52 week period ended December 31, 2005

**Stock-based Compensation Plans** The Company has stock-based compensation plans which are described in Note 5. On July 3, 2005, the Company adopted SFAS No. 123(R) "Stock Based Compensation". Under SFAS No. 123(R), the Company is required to use a fair value method for estimating the value of the stock options and to record compensation costs for any stock option outstanding for which the requisite service period has not yet been completed. The Company previously accounted for the plans under the Accounting Principles Board's Opinion No. 25, under which no compensation expense was recognized with respect to these plans. Any consideration paid upon exercise of options and the issue of shares is credited to share capital. Prior to July 3, 2005, if compensation cost for the options issued under the plans had been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income, basic EPS and diluted EPS would have been equal to the proforma amounts indicated below:

(In thousands of U.S. dollars, except for per share amounts)

	Thirteen Weeks Ended	
	April 1, 2006	April 2, 2005
Net income applicable to holders of Common Stock and Exchangeable Shares – as reported	\$ 922	\$ 808
Add: stock-based employee compensation expenses included in reported net income, net of related tax effects	34	-
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards net of related tax effects	(34)	14
Pro forma net income	\$ 922	\$ 794
Earnings per share:		
Basic EPS - as reported	0.12	0.11
- pro forma	0.12	0.11
Diluted EPS - as reported	0.11	0.10
- pro forma	0.11	0.10

### 2. Net Earnings per Share

Basic earnings per share ("EPS") exclude potentially dilutive securities and are computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed assuming the conversion or exercise of all dilutive securities such as preferred stock, options and warrants.

In order to reflect the economic substance of the Company's capital structure, the computation of basic EPS is based on the aggregate number of shares of common stock of Pet Valu, Inc. ("Common Stock") and exchangeable shares of its subsidiary, Pet Valu Canada Inc. ("Exchangeable Shares"), excluding treasury stock. Diluted EPS is based on the diluted effect of equity and debt instruments convertible into either Common Stock or Exchangeable Shares (see Note 4).

In the first quarter of 2006 and fiscal 2005, the calculation of diluted EPS included certain stock options, warrants, preferred shares and convertible debt outstanding during the relevant period. Class A preferred shares of Pet Valu Canada Inc. were convertible into 167,488 Exchangeable Shares until their redemption date in fiscal 2005. The debt was convertible into 1,294,363 Exchangeable Shares. Debt convertible into 621,636 Exchangeable Shares was repaid in fiscal 2005. Stock options and warrants to purchase 3,542,899 Exchangeable Shares and/or Common Stock were outstanding on April 1, 2006 (April 2, 2005 – 3,575,769). The Company uses the treasury method to determine the number of Exchangeable Shares to be added to the denominator due to dilutive warrants and options.

# Pet Valu, Inc.

## 2. Net Earnings per Share (continued)

Net income applicable to holders of Common Stock and Exchangeable Shares:  
(In thousands of U.S. dollars, except for number of shares)

	Thirteen Weeks Ended	
	April 1, 2006	April 2, 2005
Net income for the year	\$ 922	\$ 808
Net income applicable to holders of Common Stock and Exchangeable Shares		
Basic	\$ 922	\$ 808
Interest on 7% debenture	-	6
Interest on 8.5% debenture	68	59
Diluted	\$ 990	\$ 873
Basic EPS	\$ 0.12	\$ 0.11
Diluted EPS	\$ 0.11	\$ 0.10
Weighted average number of Common Stock and Exchangeable Shares outstanding:		
Basic	7,514,562	7,496,518
Effect of conversion of class A preferred shares	-	167,488
Effect of dilutive stock options outstanding	345,731	54,119
Effect of dilutive warrants outstanding	536,746	191,777
Effect of conversion of 7% debenture	-	91,672
Effect of conversion of 8.5% debenture	672,727	977,263
Diluted	9,069,766	8,978,837

## 3. Subordinated Debentures

(In thousands of U.S. dollars)

	April 1, 2006			December 31, 2005		
	Face Value (Converted from C\$)	Unamortized Discount	Net	Face Value (Converted from C\$)	Unamortized Discount	Net
8.5% subordinated (non-convertible)	\$ 12,889	\$ 27	\$ 12,862	\$ 12,945	\$ 48	\$ 12,897
8.5% subordinate (convertible)	3,168	-	3,168	3,181	-	3,181
12.5% subordinated (non-convertible)	12,843	476	12,367	12,898	512	12,386
	\$ 28,900	\$ 503	\$ 28,397	\$ 29,024	\$ 560	\$ 28,464
Balance Sheet Classification						
Current	12,889	27	12,862	12,945	48	12,897
Non-Current	16,011	476	15,535	16,079	512	15,567
	\$ 28,900	\$ 503	\$ 28,397	\$ 29,024	\$ 560	\$ 28,464

### (a) 8.5% Non-Convertible

In fiscal 1996, Pet Valu Canada Inc. raised C\$15.1 million through the sale of units to its subscribing Common and Exchangeable Shareholders (see Note 4). Each unit consisted of one C\$7.50 principal amount 8.5% non-convertible subordinated unsecured debenture of Pet Valu Canada Inc. due July 24, 2006 and one Exchangeable Share purchase warrant (see Note 5) of Pet Valu Canada Inc. The fair value of these warrants was allocated to shareholders' equity, resulting in a debenture discount of \$0.7 million (C\$1.0 million), which is being amortized over the remaining term of the debentures. Amortization of \$20,792 (C\$24,008) and \$19,575 (C\$24,008) was included in net interest expense for the first quarter of 2006 and 2005, respectively. Interest is paid quarterly.

# Pet Valu, Inc.

## 3. Subordinated Debentures (continued)

### (b) 8.5% Convertible

In fiscal 1999, an agreement was completed creating new 8.5% convertible subordinated unsecured debentures of Pet Valu Canada Inc. in the amount of C\$6.3 million. These debentures replaced certain existing 7% convertible debentures and one non-convertible unsecured debenture together with a corresponding exchangeable share purchase warrant (see Note 5).

These debentures are convertible, at any time, into Exchangeable Shares at a conversion price of C\$5.50 per share and are repayable by Pet Valu Canada Inc. on the terms specified in the applicable debenture holder agreement. Debentures totaling C\$2.6 million, along with accrued interest thereon, were repaid in fiscal 2005. The balance of C\$3.7 million is due in 2009. Interest on these debentures is paid quarterly.

### (c) 12.5% Non-Convertible

In fiscal 2004, Pet Valu Canada Inc. issued to Penfund Mezzanine Limited Partnership II ("Penfund") a C\$15.0 million secured subordinated debenture and share purchase warrants entitling Penfund to purchase up to 924,200 Exchangeable Shares. The fair value of these warrants at the time of issue was \$0.6 million (C\$0.8 million), which was allocated to shareholders' equity and deducted as a debenture discount, which is being amortized over the five year term of the debenture. Amortization of \$34,374 (C\$39,691) and \$32,362 (C\$39,691) was included in net interest expense for first quarter 2006 and 2005, respectively. As a result of the repayment of C\$2.6 million of the debentures referred to in Note 3(b), 47,256 of the warrants issued to Penfund referred to above were cancelled on March 31, 2005.

## 4. Capital Stock

### Authorized

1	Special Voting Stock with a par value of \$1.00.
9,626,274	Additional Special Voting Stock with a par value of \$0.0001 per share, possessing as a class a total number of votes equal to the number of outstanding Exchangeable Shares from time to time not owned by Pet Valu, Inc. or any of its subsidiaries.
100,000,000	Preferred Stock with 8% cumulative dividends, a par value of \$0.0624 per share, redeemable at the option of both the Company and the holder based on terms as defined.
20,000,000	Common Stock with a par value of \$0.0001 per share, possessing one vote per share.

### Issued and Outstanding

(In thousands of U.S. dollars, except for number of shares)

	April 1, 2006		December 31, 2005	
	Shares Issued and Outstanding	Amount	Shares Issued and Outstanding	Amount
Special Voting Stock	-	\$ -	-	\$ -
Additional Special Voting Stock	9,626,274	1	9,626,274	1
Common Stock	100	-	100	-
Additional paid-in capital		12,538		12,453
		\$ 12,539		\$ 12,454

In fiscal 2000, the Company reacquired the 100,000,000 shares of Preferred Stock and 1,000,000 warrants as part of a private placement arranged by Bedford (See Note 9e). The Preferred Stock is now held by one of Pet Valu Canada Inc.'s subsidiaries, PVUS Holdings Inc. and is eliminated on consolidation. The warrants were cancelled.

### Pet Valu Canada Inc. Shares

	Authorized	Issued	Outstanding	April 1, 2006	December 31, 2005
				Pet Valu, Inc. Common Equivalents	Pet Valu, Inc. Common Equivalents
Common Shares, no par value	Unlimited	1	1	-	-
Exchangeable Shares, no par value	Unlimited	7,879,808	7,526,108	7,526,108	7,501,158
Class A Preferred Shares, no par value	7,000,000	-	-	-	-
Class B Preferred Shares, no par value	176,845	-	-	-	-
Class C Preferred Shares, no par value	1	-	-	-	-

# Pet Valu, Inc.

## 4. Capital Stock (continued)

Pet Valu Canada Inc. had one common share issued to Pet Valu, Inc. as of April 1, 2006 and December 31, 2005, which has been eliminated in consolidation.

### Exchangeable Shares

Pet Valu, Inc. and Pet Valu Canada Inc. have an agreement under which the Exchangeable Shares have the right to dividends and can vote on an equivalent basis with the Common Stock and have exercise privileges which could result in the exchange of the Exchangeable Shares for Common Stock, at the option of the holder. The Exchangeable Shares vote in Pet Valu, Inc. through the Additional Special Voting Stock, which is held by CIBC Mellon Trust Company as trustee.

In order to reflect the economic substance of the Company's capital structure, the value of the Exchangeable Shares and equity instruments of Pet Valu Canada Inc. convertible into Exchangeable Shares have been included in shareholders' equity in the consolidated financial statements.

Pet Valu, Inc. held 353,700 Exchangeable Shares at April 1, 2006 and December 31, 2005, in treasury at cost, in anticipation of grants under certain warrants. No shares were repurchased to date in fiscal 2006 and none were repurchased in fiscal 2005.

## 5. Stock Options and Warrants

The Company's Executive Stock Option Plan and Board Stock Option Plan (collectively, the "Plans") provide for the granting of options to purchase Exchangeable Shares to certain full-time employees and to members of the Company's Board of Directors. Required disclosure information with respect to these Plans has been combined due to the similarities of the Plans.

The Company has reserved 1,054,310 Exchangeable Shares for issuance pursuant to its Plans of which 395,660 are available for grant.

The weighted average fair value of the Common Stock and Exchangeable Share options granted in fiscal 2006 was \$1.52 (2005 - \$1.54) per share. The fair value of the Common Stock and Exchangeable Share options granted is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions:

	Fiscal periods ended	
	April 1, 2006	December 31, 2005
Expected dividend rate	0%	0%
Expected volatility	40%	70%
Weighted average risk-free interest rate	4.0%	4.5%
Expected lives (years)	4 to 8	4 to 8

Pursuant to the terms of the Board Stock Option Plan, new board members receive options that vest and become exercisable at a rate of 2,000 per year of service on the Board. Such options expire three years after vesting. The Board Plan permits the board to grant additional options to existing directors as well.

Pursuant to the terms of the Executive Stock Option Plan, certain full time employees are eligible to receive options that may be granted from time to time by the Company. The option exercise period shall not exceed ten years.

As of April 1, 2006 there were 60,000 Board options vested and exercisable and 519,650 Executive options vested and exercisable with weighted average exercise prices of C\$1.60 and C\$2.99, respectively.

Information with respect to all options outstanding is as follows:  
(all amounts in Canadian dollars)

	Shares	Range of Exercise Prices	Weighted Average Exercise Price
Outstanding January 1, 2005	698,240	\$ 1.16 – 3.28	\$ 2.78
Granted	30,000	3.26	3.26
Exercised	(4,740)	2.80	2.80
Cancelled	(47,900)	1.16 – 3.28	2.29
Outstanding December 31, 2005	675,600	1.16 – 3.28	2.78
Granted	10,000	4.99	4.99
Exercised	(24,950)	1.16 - 3.28	2.34
Cancelled	(2,000)	2.75	2.75
Outstanding April 1, 2006	658,650	\$ 1.16 - 4.99	\$ 2.83

The weighted average remaining term of options outstanding at April 1, 2006 was 4.00 years.

# Pet Valu, Inc.

## 5. Stock Options and Warrants (continued)

The following table summarizes information about stock options outstanding at April 1, 2006:

Range of exercise price	Options Outstanding	Weighted Average Remaining Contractual Life(yrs)	Options outstanding Weighted Average Exercise Price	Options Exercisable	Options exercisable Weighted Average Exercise Price
\$ 1.16 – 1.83	67,040	2.85	\$ 1.52	58,040	\$1.1.51
2.06	50,000	8.64	2.06	10,000	2.06
2.75	4,000	1.29	2.75	4,000	2.75
2.80	280,610	3.73	2.80	286,120	2.80
3.26	20,000	5.11	3.26	-	3.26
3.28	227,000	3.54	3.28	231,000	3.28
4.99	10,000	5.82	4.99	-	4.99
	658,650			589,160	

## Warrants

In fiscal 2004, Pet Valu Canada Inc. issued share purchase warrants as part of a private placement financing entitling the holder to purchase up to 924,200 Exchangeable Shares of Pet Valu Canada Inc. The share purchase warrants were issued in three tranches, as follows: (1) 810,411 warrants exercisable at C\$2.00 ("Tranche A Warrants"), at the option of the holder; (2) 66,533 warrants exercisable at C\$5.50 ("Tranche B Warrants"), at the option of the holder; and (3) 47,256 warrants exercisable at C\$5.50 ("Tranche C Warrants"). Each warrant entitles the holder to purchase one Exchangeable Share. All warrants expire on September 30, 2009. The Tranche C Warrants were not automatically exercisable, but rather only became exercisable in certain circumstances, and were subject to cancellation if certain conversion rights held by unrelated third party investors were cancelled. The cancellation of said conversion rights was completed in fiscal 2005 and the Tranche C warrants were cancelled.

During fiscal 1996, Pet Valu Canada Inc. issued 2,007,305 warrants in connection with the 8.5% non-convertible subordinated unsecured debentures (see Note 9a). Each warrant entitles the holder to purchase one Exchangeable Share at a price equal to the greater of (i) C\$7.00; or (ii) the then current market price of an Exchangeable Share on the Toronto Stock Exchange less C\$7.00, at any time on or before July 24, 2006, subject to adjustment under certain events, as defined.

## 6. Contingencies

From time to time, the Company is named as a defendant in legal actions arising from its normal business activities. Although the amount of any liability that could arise with respect to currently pending actions cannot be estimated, in the opinion of the Company, any such liability will not likely have a material adverse effect on its financial position, operating results or liquidity.

# Pet Valu, Inc.

## 7. Segmented Financial Information

The Company operates exclusively in the pet product retail industry. The Company's reportable segments are based on geographic area. All intercompany revenues and expenses are eliminated in computing revenues and operating income. The accounting policies of the segments are the same as those described in Note 1 - Significant Accounting Policies.

Operating results and other financial data by segment were as follows:  
(in thousands of U.S. dollars)

	Thirteen weeks ended	
	April 1, 2006	April 2, 2005
<b>Sales and revenue to external customers</b>		
Canada	\$ 25,661	\$ 23,884
U.S.	8,420	8,033
<b>Total sales and revenue</b>	<b>\$ 34,081</b>	<b>\$ 31,917</b>
<b>Net interest expense</b>		
Canada	\$ 945	\$ 968
U.S.	14	19
<b>Total net interest expense</b>	<b>\$ 959</b>	<b>\$ 987</b>
<b>Net Income</b>		
Canada	\$ 769	\$ 571
U.S.	277	361
Intersegment elimination	(124)	(124)
<b>Total net income</b>	<b>\$ 922</b>	<b>\$ 808</b>
<b>Depreciation and amortization</b>		
Canada	\$ 360	\$ 332
U.S.	90	90
<b>Total depreciation and amortization</b>	<b>\$ 450</b>	<b>\$ 422</b>
<b>Purchases of property and equipment</b>		
Canada	\$ 392	\$ 180
U.S.	81	56
<b>Total purchases of property and equipment</b>	<b>\$ 473</b>	<b>\$ 236</b>

Total assets by segment were as follows:  
(in thousands of U.S. dollars)

	April 1, 2006	December 31, 2005
Canada	\$ 93,616	\$ 92,896
U.S.	13,579	13,296
Intersegment elimination	(51,386)	(51,583)
<b>Total assets</b>	<b>\$ 55,809</b>	<b>\$ 54,609</b>

