

# **PET VALU**™

## **Better Pet Nutrition**

**PET VALU, INC.**

**Quarterly Report**

**Thirty-Nine Weeks Ended September 30, 2006**

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

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# Pet Valu, Inc.

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# **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 November 9, 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, objectives, business prospects and opportunities. The forward-looking information reflects predictions and does not in any way reflect a guarantee. 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; the availability of suitable store locations; 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. The Company cautions that this is not an exhaustive list of factors that may affect the forward-looking information in this MD&A. Potential investors and readers are urged to give careful consideration to all of these factors in evaluating any forward-looking information and are cautioned not to place undue reliance on such information.

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 September 30, 2006, there were 285 stores in operation in Canada and 67 stores operating in the U.S. Of the 285 Canadian stores, 206 stores were franchised and 79 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, cat litter 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, 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.

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The Company has ongoing programs to identify offerings of higher quality, differentiated merchandise brands as well as to develop additional 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 pet-related 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 465,000 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 where applicable, 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 typically 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 and New Developments**

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

#### **Reniching project**

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 three quarters of fiscal 2006, the Company introduced several new high-quality products including Performatrin Ultra Slim Care, Performatrin Ultra Cat food, Mewsprint, Homepath, Canidae, and Nutram, which are available in most of the Company's stores. This component of 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 openings and closures in Canada and in the U.S. during the first three quarters of fiscal 2006.

During the third 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.

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## **Bank Credit Facilities**

On July 14, 2006, the Company entered into a new credit agreement with Bank of Montreal and Harris, N.A. The credit agreement provides the Company with a C\$15 million revolving line of credit for a term of five years and a C\$5 million term loan to be repaid over twenty-four months. The credit agreement contains a financial covenant in relation to debt service and certain limitations regarding indebtedness, liens, leases, dividends and capital expenditures.

## **Debenture Issuance and Repayment**

A private placement of 10% non-convertible unsecured subordinated debentures of Pet Valu Canada Inc. in the principal amount of C\$8.8 million was completed on July 24, 2006. The debentures are guaranteed by Pet Valu, Inc. The proceeds from the private placement along with the availability from the revolving line of credit referenced above were used to make repayment to the debenture trustee and, in certain cases, the debenture holders directly of C\$15.1 million of debentures which matured on July 24, 2006. On October 31, 2006, the Company prepaid the entire principal amount of C\$15 million of a 12.5% debenture which was otherwise due on September 30, 2009.

## **Warrant Exercises**

Warrants of Pet Valu Canada Inc. which were listed for trading on the Toronto Stock Exchange under the symbol PVC.WT expired on July 24, 2006. Proceeds from the exercise of warrants on or before July 24, 2006 totaled C\$7,967,456. These proceeds reduced the borrowing from the revolving line of credit that was used to make repayment, as referred to above, of C\$15.1 million of debentures.

## **Franchise Repurchases**

During the last twelve months, the number of company-owned stores in Canada increased by 17. This increase was primarily due to the repurchase of several franchises where it was determined that the stores would operate more profitably as company-owned stores and therefore generate higher net income for the Company. The decision to invest in these repurchases was based on the projected return on investment. As a result of converting franchise stores to company-owned stores, sales and revenues, gross profits, store operating expenses and net income all increased. 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".

## **Overall Performance**

Net income for the third quarter of fiscal 2006 was \$2.1 million as compared to \$1.4 million in the third quarter of fiscal 2005. For the year to date in fiscal 2006, net income was \$4.3 million as compared to \$3.2 million for same period 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 revenue received from franchises resulting partly from the reduction in the number of franchises. 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 third 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 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. included the opening of two new stores in the third quarter offset by the closing of two existing stores and the opening of five new stores for the year to date offset by the closing of four existing stores. Given that most stores in the U.S. are less than 3,000 square feet in size, 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 third quarter of fiscal 2006 due to positive cash flow from operations. The Company's capital structure reflects the capital investment resulting from the exercise of warrants on or before July 24, 2006 and the private placement of new debt in the amount of C\$8.8 million. The proceeds from these transactions along with C\$5 million drawn on the term loan portion of the current bank credit arrangements and cash flow from operations, were used to make repayment to the debenture trustee and, in certain cases, the debenture holder directly of C\$15.1 million of subordinated debt on July 24, 2006 and to prepay on October 31, 2006 C\$15 million of subordinated debt otherwise due on September 30, 2006. Please refer to the section of this MD&A entitled "Key Accomplishments and New Developments" for further details of these matters.

In general terms, competition in pet food and pet-related supply retailing continued to increase in the first three quarters 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.

# Pet Valu, Inc.

## Summary of Quarterly Results

### Eight quarter summary

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

	Fiscal 2004 4 <sup>th</sup> Quarter	1 <sup>st</sup> Quarter	Fiscal 2005 2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter	1 <sup>st</sup> Quarter	Fiscal 2006 2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter
System-wide sales *	\$ 45,994	\$ 40,793	\$ 40,026	\$ 42,350	\$ 48,582	\$ 43,354	\$ 44,715	\$ 47,082
Sales and revenue	35,934	31,917	31,619	33,307	37,563	34,081	35,501	37,454
Gross profit	9,937	8,099	8,442	9,041	11,754	9,223	9,919	11,169
Net income	2,364	808	1,013	1,420	4,013	922	1,218	2,126
Net income before non-comparable items **	2,009	808	1,013	1,420	3,175	922	1,218	2,126
Net income per share – basic	0.32	0.11	0.14	0.19	0.54	0.12	0.16	0.25
Net income per share – diluted	0.28	0.10	0.12	0.16	0.46	0.11	0.13	0.21
Non comparable items								
Promotion fund allowance	-	-	-	-	582	-	-	-
(Gain) loss on foreign exchange	(3)	-	-	-	-	-	-	-
Litigation costs	(46)	-	-	-	-	-	-	-
Loss on debt extinguishment	4	-	-	-	-	-	-	-
Future tax recovery on NOLs	(325)	-	-	-	(1,210)	-	-	-
Applicable tax on non-comparable items	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.

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 the 2004 and 2005 fiscal years and the first three quarters of fiscal 2006, 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 any of the first three quarters of fiscal 2006. At the end of the third quarter of fiscal 2006, the valuation allowance was \$7.7 million.

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's expectations have not changed and therefore the allowance has been maintained at the end of the third quarter of fiscal 2006.

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.

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## **Results of Operations**

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

The Company is comprised of Pet Valu, Inc. and 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 three quarters 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 7% in the third quarter of fiscal 2006 as compared to the third quarter of the prior year, 8% in the first three quarters of fiscal 2006 as compared to the first three quarters of fiscal 2005 and 7% in fiscal 2005 as compared to fiscal 2004. 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 third quarter of fiscal 2006, there was no net change in the number of stores in the U.S. and a net increase of three stores in Canada. For the year to date, there was a net increase of one store in the U.S. and no net change of the number of 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.

In the third quarter of fiscal 2006, the average number of stores in operation was 351, which was four stores more than the average for the third quarter of the prior year. The increase in the number of stores in the U.S. was four, while the number of stores in Canada was unchanged. For the year to date, the average number of stores in operation was 350 for fiscal 2006 and 348 for fiscal 2005.

### **System-wide sales**

System-wide sales represent retail sales to customers through company-owned and franchise stores. During the third quarter of fiscal 2006, system-wide sales increased by \$4.7 million or 11.2% from the prior year to \$47.1 million. For the year to date, system wide sales increased by \$12.7 million or 10.3%. The change in foreign exchange rates resulted in an increase in system-wide sales from the prior year of \$2.5 million for the quarter and \$8.1 million for the year to date. Before the effects of the change in foreign exchange rates, the system-wide sales in the Canadian operations increased by \$1.8 million or 5.5% for the quarter and \$2.5 million or 2.6% for the year to date. The system-wide sales in the U.S. operations increased by \$0.4 million or 4.5% for the quarter and \$1.3 million or 5.2% for the year to date. The increase in the system-wide sales in the U.S. operations is partially due to an increase in the average number of stores open.

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 in Canada increased by 5.8% and 3.3% for the third quarter and for the year to date, respectively. Comparable store sales in the U.S. operations increased by 1.4% and 1.2% for the third quarter and for the year to date, respectively.

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## 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 \$4.1 million or 12.4% in the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005 and increased by \$10.2 million or 10.5% for the year to date. The change in foreign exchange rates resulted in an increase in sales and revenue of \$1.9 million in the third quarter and \$6.1 million for the year to date. Before the effects of the change in foreign exchange rates, the sales and revenue in the Canadian operations increased by \$1.9 million or 7.6% for the quarter and \$2.9 million or 4.0% for the year to date. The sales and revenue in the U.S. operations increased by \$0.3 million or 4.1% in the third quarter and \$1.2 or 5.0% for the year to date. In Canada, increases in comparable store sales and retail sales at corporate stores, which were 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 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 third quarter of fiscal 2006, total merchandise sales through company-owned stores increased by \$2.9 million to \$15.9 million. For the year to date, total merchandise sales through company-owned stores increased by \$7.0 million to \$38.0 million. The change in foreign currency exchange rates resulted in an increase of \$0.5 million for the third quarter and \$1.5 million for the year to date 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 \$1.9 million or 37.6% for the quarter and \$3.8 million or 25.3% for the year to date. In the U.S. operations, merchandise sales through company-owned stores increased by \$0.5 million or 6.0% for the quarter and \$1.7 million or 7.3% for the year to date. The increase in both the U.S. and Canada was partially due to increases in comparable store sales and an increase in the average number of company-owned stores open during the period. The average number of corporate stores in Canada increased by 25.8% to 78 for the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005 and by 16.0% to 73.4 for the year to date. The average number of stores in the U.S. increased by 7.2% to 66.8 for the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005 and by 8.3% to 66.7 for the year to date.

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 \$1.3 million to \$21.1 million in the third quarter and by \$3.4 million to \$60.7 million for the year to date. The change in foreign currency exchange rates resulted in an increase in merchandise revenue from franchise stores of \$1.4 million for the third quarter and \$4.4 million for the year to date. Before the effects of the change in foreign currency exchange rates, the merchandise revenue from franchise stores in the Canadian operations for the quarter was consistent with the prior and decreased by \$0.6 million or 1.1% for the year to date. In the U.S. operations, merchandise revenue from franchise stores decreased by \$0.1 million or 17.6% for the quarter and \$0.4 million or 23.6% for the year to date. The number of franchise stores open in the U.S. operations decreased from five in fiscal 2005 to four in fiscal 2006, contributing to the large percentage decline in merchandise revenue from franchisees. A decrease in the average number of franchise stores open in the Canadian operation of 16 or 7.8% for the third quarter as compared to the prior year and a decrease of 13.2 stores or 6.3% for the year to date contributed to the decrease in merchandise revenue from franchisees.

Initial fees and gains on the sale of franchises in the third quarter of fiscal 2006 of \$0.2 million were \$0.1 million less than the same quarter of the prior year. For the year to date, fees and gains were \$0.3 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 third quarter of fiscal 2006 and for the year to date of \$0.2 million and \$0.7 million, respectively, were consistent with the prior year.

## Gross profit

Gross profit on sales and revenue increased by \$2.1 million or 23.5% in the third quarter of fiscal 2006 as compared to the same quarter of the prior year. For the year to date, gross profit on sales and revenue increased by \$4.7 million or 18.5% as compared to the prior year. The change in foreign currency exchange rates resulted in an increase in gross profit of \$0.6 million and \$1.7 million for the third quarter and for the year to date, respectively. Before the effects of the change in foreign currency exchange rates, gross profit in the Canadian operations increased by \$1.6 million or 25.0% for the third quarter and \$3.0 million or 16.4% for the year to date. In the U.S. operations, gross profit decreased by 3.0% for the third quarter and increased by 0.6% for the year to date. Increases in store occupancy costs from the new stores opened in the U.S. with low sales levels in the first year of operations contributed to the decrease in gross profit for the U.S. operations.

Blended gross profit margins increased to 29.8% in the third quarter of fiscal 2006, as compared to 27.1% in the third quarter of fiscal 2005. Gross profit margins in the U.S. stores were consistent with the third quarter of the prior year. Canadian company-owned stores achieved an increase in gross profit margins of 1.5% as compared to the prior year.

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## Store operating expenses

Store operating expenses increased by \$0.5 million or 13.4% in the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005. For the year to date, store operating expenses increased \$1.4 million or 13.9%. The change in foreign currency exchange rates resulted in an increase in store operating expenses of \$0.1 million in the third quarter and \$0.4 million for the year to date. Before the effects of the change in foreign exchange rates, store operating expenses in the Canadian operations increased by \$0.4 million or 29.8% for the third quarter and \$0.8 million or 20.1% for the year to date. In the U.S. operations, store operating expenses were \$0.1 million or 4.1% lower than the prior year for the third quarter and \$0.2 million or 2.7% higher than the prior year for the year to date. On a per store basis, store operating costs in Canada increased by 3.1% in the third quarter and 3.6% for the year to date. In Canada, an increase in wages and benefits contributed to the increase in store operating expenses. Structural pay range increases for store staff to accommodate an increase in minimum wage rates in Ontario, new incentive programs and increased hours to better service customers contributed to the increase in wages and benefits. In the U.S., store operating costs on a per store basis decreased by 10.6% in the quarter and 5.1% for the year to date. The elimination of certain advertising activity and the continued focus on store wage costs and service levels contributed to the decline in operating costs on a per store basis in the U.S.

## General and administrative expenses

General and administrative expenses increased by \$0.6 million or 21.0% in the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005. For the year to date, general and administrative expenses increased \$1.8 million or 22.2%. The change in foreign currency exchange rates resulted in an increase in general and administrative expenses of \$0.2 million in the third quarter and \$0.7 million for the year to date. Before the effects of the change in foreign currency exchange rates, general and administrative expenses in the Canadian operations increased by \$0.4 million or 14.6% in the third quarter and \$1.1 million or 14.2% for the year to date. 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 three quarters of fiscal 2006 were one time costs of approximately \$169,000 incurred in relation to the Company's refinancing efforts, increased costs in relation to the development and procurement of new wellness focused products, costs related to the new executive staff and corporate facilities, 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 by 6.5% in the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005 and decreased by 4.5% for the year to date. The change in foreign currency exchange rates resulted in an increase of \$0.1 million in net interest expense in the third quarter and \$0.2 million for the year to date. Before the effects of the change in foreign currency exchange rates, net interest expense in the Canadian operations decreased by \$0.1 million or 10.9% in the third quarter and \$0.3 million or 9.8% for the year to date. In the U.S. operations, net interest expense was consistent with the prior year.

## Net income

Net income for the third quarter of fiscal 2006 was \$2.1 million as compared to \$1.4 million in the third quarter of fiscal 2005. For the year to date in fiscal 2006, net income was \$4.3 million as compared to \$3.2 million for same period 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 revenue received from franchises resulting partly from the reduction in the number of franchises. 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

At the end of the third quarter of fiscal 2006, the Company had a non-cash working capital deficit of \$3.7 million, representing a decrease of \$4.7 million from the non-cash working capital surplus at the end of the second quarter of \$1.0 million. Cash flow from operations was offset by the reclassification of \$13.0 million of subordinated debentures to current liabilities on August 1, 2006. Pet Valu Canada Inc. gave irrevocable notice of its intention to prepay on October 31, 2006 the principal amount of C\$15.0 million of 12.5% subordinated debentures otherwise due on September 30, 2009. As a result these debentures were classified as current liabilities and therefore reduced working capital. These debentures were repaid on October 31, 2006 using a combination of the Company's available cash, short-term investments and available credit from its bank operating lines.

Merchandise accounts payable leveraging (trade payables as a percentage of inventory) increased to 22.4% as of September 30, 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 \$9.4 million to \$64.0 million at September 30, 2006, as compared to \$54.6 million at the end of fiscal 2005. Total assets increased primarily due to increased short term investments in anticipation of the prepayment of the 12.5% subordinated debentures.

## **Pet Valu, Inc.**

Net cash used in operating activities in the third quarter of fiscal 2006 was \$6.9 million as compared to net cash provided by operations of \$4.3 million in the third quarter of fiscal 2005. For the year to date, cash provided by operating activities was \$7.0 million as compared to \$5.7 million for fiscal 2005. The increases were primarily due to the increase in operating income and for the quarter a decrease in prepaid expenses. Prepaid expenses include rent payments on stores and warehouses that are paid in advance on the first day of the month.

Net cash used in investing activities for the third quarter of fiscal 2006 of \$0.3 million was consistent with the prior year. For the year to date, net cash used in investing activities increased by \$1.2 million to \$1.9 million as compared to \$0.7 million in fiscal 2005. An increase in purchases of property and equipment and the repurchase of franchises 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.

Net cash provided by financing activities in the third quarter of fiscal 2006 was \$3.7 million as compared to net cash used in financing activities of \$3.4 million in the third quarter of fiscal 2005. For the year to date, net cash provided by financing activities was \$4.0 million as compared to cash used in financing activities of \$4.5 million in fiscal 2005. In both years, cash was used to make scheduled principal repayments of long-term debt. In the third quarter of fiscal 2006, the Company received \$6.2 million from the exercise of certain warrants and stock options by their holders resulting in the issue of exchangeable shares of Pet Valu Canada Inc, \$7.8 million from a private placement of new debentures and \$4.4 million from term debt provided by the Company's new bank credit agreement. These amounts were offset by the repayment, as previously described, in respect of debentures which matured on July 24, 2006. In fiscal 2005, the Company used its bank operating facility to repay certain Pet Valu Canada Inc. debentures and preferred shares.

There were no acquisitions during the third 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 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. included the opening of two new stores in the third quarter offset by the closing of two existing stores and the opening of five new stores for the year to date offset by the closing of four existing stores. Given that most stores in the U.S. are less than 3,000 square feet in size, the amount of funding required to set up equipment and stock the store with inventory is not significant.

No additional working capital requirements are expected in fiscal 2006; however, as store locations are added in the future, inventory requirements may increase.

The Company anticipates that cash flow from current operations will be sufficient to meet debt servicing obligations for fiscal 2006 and 2007. The Company anticipates that it will continue to generate positive cash flow for the foreseeable future.

### **Capital Resources**

On July 14, 2006, the Company entered into a new credit agreement with Bank of Montreal and Harris, N.A. The credit agreement provides the Company with a C\$15 million revolving line of credit for a term of five years and a C\$5 million term loan to be repaid over twenty-four months. The credit agreement contains a financial covenant in relation to debt service and certain limitations regarding indebtedness, liens, leases, dividends and capital expenditures. This new credit agreement replaces a previous agreement with Bank of Montreal in effect since November 14, 2000 (as amended and extended from time to time) which provided the Company with a senior line of credit for a total borrowing capability before borrowing base calculations of C\$18.0 million. The Company was in compliance with the covenants contained in the new credit agreement to the date hereof.

At September 30, 2006, the Company had no borrowings from its C\$15 million revolving line of credit as compared to \$1.9 million borrowed pursuant to the previous bank agreement at the end of fiscal 2005. Under the new credit agreement, the Company was required to draw on the C\$5 million term loan on or before September 30, 2006. In preparation for the prepayment of certain other subordinated debt, referred to above, the Company borrowed the full C\$5 million pursuant to the term loan on September 30, 2006.

On April 10, 2006, Pet Valu Canada Inc. announced a private placement of non-convertible unsecured subordinated debt. This transaction was completed on July 24, 2006 for total proceeds of C\$8.8 million.

Pet Valu Canada Inc. had warrants to purchase exchangeable shares of Pet Valu Canada Inc. listed on the Toronto Stock Exchange that expired on July 24, 2006. Immediately prior to their expiry, these warrants were exercisable at C\$7.00 per warrant. On or before July 24, 2006, 1,138,208 warrants were exercised and an equivalent number of exchangeable shares were issued for proceeds of C\$8,967,456 which was recorded as shareholders' equity by Pet Valu Canada Inc.

## **Pet Valu, Inc.**

In the year to date period ending October 1, 2005, the Company repaid \$0.8 million of 7% convertible debentures of Pet Valu Canada Inc., \$2.2 million of 8.5% convertible debentures of Pet Valu Canada Inc. and \$1.1 million of class A preferred shares 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.

### **Transactions with Related Parties**

On July 24, 2006, Pet Valu Canada Inc. completed a private placement of non-convertible unsecured subordinated debentures in the principal amount of C\$8,820,000.

The direct or indirect investors in the private placement included, among others, certain directors and/or officers of Pet Valu, Inc. and Pet Valu Canada Inc. In particular, Geoffrey F. Holt, who is a director and officer of both companies, invested C\$5,000,000 through Holtcorp Inc., a personal holding company; Douglas Lunau, who is a director of both companies, invested C\$3,000,000 through the Lunau Family Trust; Breena Holt, who is a director of both companies and a part-time employee of Pet Valu Canada Inc., invested C\$150,000; Darryl Squires, who is a director of both companies, invested C\$20,000; and John Turner, who is an officer and part-time employee of Pet Valu Canada Inc., invested C\$150,000.

The private placement was completed to assist Pet Valu Canada Inc. in repaying, as previously described, the 8.5% debentures of Pet Valu Canada Inc. in the principal amount of C\$15.1 million which matured on July 24, 2006, and was offered to all holders of such debentures. Holtcorp Inc. and Mr. Turner were among such holders.

Included in the repayment of the 8.5% debentures were repayments of \$5,002,500 and \$126,675 made to Holtcorp Inc. and John Turner, respectively.

### **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 three quarters 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.

# **Pet Valu, Inc.**

## **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.

## **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 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.

# Pet Valu, Inc.

## 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.

## 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.

## Outstanding Share Data

The following table contains the number of outstanding voting or equity securities at September 30, 2006 and the end of fiscal 2005. Please refer to notes 4 and 5 of the financial statements for additional information.

	<u>September 30, 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.	8,707,436	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
Warrants of Pet Valu Canada Inc. issued September 30, 2004	851,944	876,944

## 2006 Outlook

The key objectives of the Company include a reduction of net interest expense and financial leverage. The repayment of C\$15.1 million of debt on July 24, 2006, offset somewhat by the issuance of C\$8.8 million of new debt on the same date, and the prepayment of C\$15 million of debt on October 31, 2006, have contributed to the achievement of these objectives. The Company continues to evaluate the possibility of further long-term debt prepayments as well as the repurchase of other securities that will simplify Pet Valu's financial structure.

Another ongoing objective to receive priority this year and through 2007 is to improve our technological systems and increase automation, including an expansion of IT facilities and capacities. A definitive competitive advantage in this area should be achievable and the cost of related software development is not expected to be substantial as the work will, for the most part, be completed in-house.

Our program 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, is proceeding on track and will be pursued during 2007. An internal group has been formed, including the recent recruitment and planned recruitment of strong additions to our management team, to pursue this objective.

The Company's "re-niching" under the "Better Pet Nutrition" concept, including enhancements to store ambience and signage along with a continued shift in product offerings to high quality products featuring a wellness-focused approach to pet nutrition is also proceeding on track and will continue through 2007.

Among the key projects of the Company currently being pursued 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. Similarly, the Company will assess the feasibility and best strategies to expand in Western Canada. 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.

Finally, the Company intends to pursue its priority in the area of product development in combination with the pursuit of strategies relating to the development and protection of associated intellectual property.

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.**

November 9, 2006

To the Shareholders of Pet Valu, Inc.:

An auditor has not reviewed the consolidated balance sheet of Pet Valu, Inc. as at September 30, 2006, nor the consolidated statements of operations and cash flows for the thirty-nine 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)

	September 30, 2006	December 31, 2005
<b>Assets</b>		
<b>Current assets</b>		
Cash and short-term investments	\$ 10,827	\$ 1,674
Receivables (Less allowances of \$657, 2005 - \$632)	2,626	3,146
Inventories	23,192	23,804
Prepaid expenses	1,109	929
Deferred income tax assets	836	828
<b>Total current assets</b>	<b>38,590</b>	<b>30,381</b>
Notes receivable (Less allowances of \$39, 2005 - \$38)	52	66
Deferred charges	1,713	1,686
Property and equipment, net of accumulated depreciation and amortization	5,336	4,905
Goodwill	14,470	13,593
Deferred income taxes	3,801	3,978
<b>Total assets</b>	<b>\$ 63,962</b>	<b>\$ 54,609</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Bank overdraft	\$ 866	\$ 1,559
Bank operating loans (Note 3)	1,123	1,862
Current portion of long-term debt including capital lease obligations (Note 4)	2,732	560
Current portion of deferred gain on warehouse sale	232	226
Accounts payable and accrued liabilities	11,814	11,369
Income taxes payable	1,690	2,602
Debentures (Note 5)	12,994	12,897
<b>Total current liabilities</b>	<b>31,451</b>	<b>31,075</b>
Deferred franchise revenue	12	20
Deferred gain on warehouse sale	459	605
Deferred rent payable	2,050	2,055
Long-term debt including capital lease obligations, less current maturities (Note 4)	3,275	1,204
Debentures (Note 5)	11,201	15,567
<b>Total liabilities</b>	<b>48,448</b>	<b>50,526</b>
<b>Shareholders' Equity (Deficit)</b>		
Capital Stock (Note 6)	19,677	12,454
Retained earnings (accumulated deficit)	1,971	(2,296)
Accumulated other comprehensive loss	(5,442)	(5,383)
Treasury stock – exchangeable shares, at cost	(692)	(692)
<b>Total shareholders' equity</b>	<b>15,514</b>	<b>4,083</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 63,962</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 and per share data)

	Thirteen Weeks Ended		Thirty-Nine Weeks Ended	
	Sept. 30, 2006	Oct. 1, 2005	Sept. 30, 2006	Oct. 1, 2005
<b>System-wide retail sales</b>	\$ 47,082	\$ 42,350	\$ 135,151	\$ 123,169
<b>Sales and revenue</b>	\$ 37,454	\$ 33,307	\$ 107,036	\$ 96,843
Cost of sales including occupancy costs	26,285	24,265	76,725	71,261
<b>Gross profit</b>	11,169	9,042	30,311	25,582
Store operating expenses excluding occupancy costs	3,873	3,416	11,286	9,906
General and administrative expenses	3,183	2,630	9,942	8,133
	4,113	2,996	9,083	7,543
Net interest expense	926	990	2,846	2,981
Income before income taxes	3,187	2,006	6,237	4,562
Income taxes provision	1,061	586	1,970	1,321
<b>Net income</b>	\$ 2,126	\$ 1,420	\$ 4,267	\$ 3,241
Basic EPS (Note 2)	\$ 0.25	\$ 0.19	\$ 0.54	\$ 0.43
Diluted EPS (Note 2)	0.21	0.16	0.46	0.38
Weighted average number of common stock and exchangeable shares outstanding:				
Basic (Note 2)	8,460,294	7,496,518	7,865,042	7,496,518
Diluted (Note 2)	10,130,396	8,867,686	9,528,280	8,933,478

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		Thirty-nine Weeks Ended	
	Sept. 30, 2006	Oct. 1, 2005	Sept. 30, 2006	Oct. 1, 2005
<b>Operating activities</b>				
Net income	\$ 2,126	\$ 1,420	\$ 4,267	\$ 3,241
Adjustments to reconcile net income to net cash provided				
By operating activities:				
Depreciation	486	421	1,427	1,341
Deferred income taxes	172	34	208	(14)
Loss on disposal of property and equipment	1	5	6	20
Amortization of debenture discount	42	53	154	156
Stock based compensation costs	36	18	105	18
Deferred charges	(132)	7	(33)	(237)
Deferred franchise revenue	-	-	-	1
Amortization of deferred gain on warehouse sale	(57)	(54)	(171)	(159)
Loss on disposal of goodwill	39	-	96	-
Changes in other operating assets and liabilities:				
Decrease (increase) in receivables	192	(397)	628	(583)
Decrease in inventories	554	1,316	1,376	876
Decrease (increase) in prepaid expenses	1,495	(37)	(148)	177
Increase (decrease) in payables	1,923	1,467	(913)	814
Net cash provided by operating activities	6,877	4,253	7,002	5,651
<b>Investing activities</b>				
Purchases of property and equipment	(294)	(213)	(1,525)	(531)
Proceeds on disposal of property and equipment	24	17	24	37
Purchase of store goodwill	-	(140)	(427)	(140)
Notes and other receivables	(9)	2	7	(36)
Net cash used in investing activities	(279)	(334)	(1,921)	(670)
<b>Financing activities</b>				
(Repayment) borrowing of short-term financing	(198)	(2,705)	(804)	1,711
Decrease in bank overdraft	(1,019)	(526)	(747)	(1,630)
Repayment of capital lease obligation	(94)	(76)	(278)	(216)
Repayment of note payable	(69)	(77)	(121)	(135)
Borrowing (repayment) of term loan financing	4,407	(39)	4,356	(83)
Repayment of bank mortgage financing	(8)	(7)	(24)	(22)
Proceeds from issuance of Exchangeable Shares under stock option plans and warrants	6,206	-	7,184	-
Redemption of class A preferred shares	-	-	-	(1,118)
Tax on cancellation of warrants	(67)	-	(67)	-
Proceeds from issuance of 10% non-convertible debentures	7,792	-	7,792	-
Repayment of debentures	(13,300)	-	(13,300)	(2,970)
Net provided by (used in) financing activities	3,650	(3,430)	3,991	(4,463)
Effect of exchange rate changes on cash	129	(72)	81	(98)
Net increase in cash	10,377	417	9,153	420
<b>Cash – Beginning of fiscal period</b>	<b>450</b>	<b>55</b>	<b>1,674</b>	<b>52</b>
<b>Cash – End of fiscal period</b>	<b>\$ 10,827</b>	<b>\$ 472</b>	<b>\$ 10,827</b>	<b>\$ 472</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 references denoted 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 ("US 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 except as noted below.

#### Short-term Investments

The Company's short-term investments, consisting of a bankers acceptance, represent funds available for current operations. In accordance with SFAS, No. 115, "Accounting for Certain Investments in Debt and Equity Securities," these short-term investments are classified as available-for-sale and are carried at cost or par value, which approximates the fair market value. These securities have stated maturities of 30 days and are priced and traded as short-term instruments.

#### Stock-based Compensation Plans

The Company has stock-based compensation plans which are described in Note 7. 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 earnings per share and diluted earnings per share would have been equal to the proforma amounts indicated below:

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

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sept. 30, 2006	Oct. 1, 2005	Sept. 30, 2006	Oct. 1, 2005
Net income applicable to holders of Common Stock and Exchangeable Shares – as reported	\$ 2,126	\$ 1,420	\$ 4,267	\$ 3,241
Add: stock-based employee compensation expenses included in reported net income, net of related tax effects	36	18	105	18
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards net of related tax effects	(36)	(18)	(105)	(46)
Pro forma net income	\$ 2,126	\$ 1,420	\$ 4,267	\$ 3,213
Earnings per share:				
Basic EPS - as reported	0.25	0.19	0.54	0.43
- pro forma	0.25	0.19	0.54	0.43
Diluted EPS - as reported	0.21	0.16	0.46	0.38
- pro forma	0.21	0.16	0.46	0.38

### 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 dilutive effect of equity and debt instruments convertible into either Common Stock or Exchangeable Shares (see Note 6).

# Pet Valu, Inc.

## 2. Net Earnings per Share (continued)

In the third quarter of fiscal 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. Some of this debt (i.e., debt convertible into 621,636 Exchangeable Shares) was repaid in fiscal 2005. Stock options and warrants to purchase 1,490,474 Exchangeable Shares and/or Common Stock were outstanding on September 30, 2006 (October 1, 2005 –3,572,329). 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.

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		Thirty-Nine Weeks Ended	
	Sept. 30, 2006	Oct. 1, 2005	Sept. 1, 2006	Oct. 1, 2005
Net income for the year	\$ 2,126	\$ 1,420	\$ 4,267	\$ 3,241
Net income applicable to holders of Common Stock and Exchangeable Shares				
Basic	\$ 2,126	\$ 1,420	\$ 4,267	\$ 3,241
Interest on 7% debenture	-	-	-	6
Interest on 8.5% debenture	45	41	132	140
Diluted	\$ 2,171	\$ 1,461	\$ 4,399	\$ 3,387
Basic EPS	\$ 0.25	\$ 0.19	\$ 0.54	\$ 0.43
Diluted EPS	\$ 0.21	\$ 0.16	\$ 0.46	\$ 0.38
Weighted average number of Common Stock and Exchangeable Shares outstanding:				
Basic	8,460,294	7,496,518	7,865,042	7,496,518
Effect of conversion of class A preferred shares	-	-	-	90,186
Effect of dilutive stock options outstanding	389,761	255,562	390,001	173,208
Effect of dilutive warrants outstanding	607,614	442,878	600,510	368,770
Effect of conversion of 7% debenture	-	-	-	30,557
Effect of conversion of 8.5% debenture	672,727	672,728	672,727	774,239
Diluted	10,130,396	8,867,686	9,528,280	8,933,478

## 3. Bank Operating Loans

In July 2006, the Company entered into an amended and restated credit agreement with Bank of Montreal and Harris, N.A. The credit agreement provides the Company with a C\$15 million revolving line of credit for a term of five years and a C\$5 million term loan to be repaid over twenty-four months. Borrowings under the revolving line of credit are limited to the lesser of the loan ceiling of C\$15 million and a borrowing base calculation related to inventories and franchise receivables. On September 30, 2006 the borrowings outstanding under the revolving line of credit, the borrowing base calculation and the resulting availability were \$1,122,742 (December 31, 2005-\$1,862,419), \$12,810,141 (December 31, 2005 - \$12,779,400), and \$11,687,399 (December 31, 2005 – \$10,916,981), respectively. Interest is calculated using the bank's prime rate plus 0.25% per annum. The interest rates at September 30, 2006 were 6.25% for Canadian dollar borrowings and 8.50% for U.S. dollar borrowings. In addition, a fee of 0.25% is charged on the unused portion of the credit facility.

The facility is collateralized by liens against all assets of the Company, subject to certain permitted encumbrances.

Pursuant to the above agreement, in addition to its borrowing base restrictions, the Company must comply with certain general covenants which include, among others, a minimum consolidated debt service ratio. The Company was in compliance with these covenants at September 30, 2006.

# Pet Valu, Inc.

## 4. Long-term Debt (In thousands of U.S. dollars)

	September 30, 2006			December 31, 2005		
	Long-term	Current	Total	Long-term	Current	Total
Bank term loan	\$ 2,237	\$ 2,237	\$ 4,474	\$ -	\$ -	\$ -
Term loan	-	13	13	5	69	74
Supplier notes payable	337	112	449	442	111	553
Other notes payable	36	32	68	61	38	99
Capitalized lease obligations	665	338	1,003	696	342	1,038
<b>Total</b>	<b>\$ 3,275</b>	<b>\$ 2,732</b>	<b>\$ 6,007</b>	<b>\$ 1,204</b>	<b>\$ 560</b>	<b>\$ 1,764</b>

### Bank Term Loan

The bank term loan is part of the amended and restated credit agreement (see Note 3). The loan bears interest at prime plus 1% (7% at September 30, 2006) and matures September 30, 2008. The loan is repayable in 24 equal monthly installments.

### Term Loan

The term loan bears interest at 8%. The loan matures in 2007 and is secured by a mortgage on a certain property.

### Supplier Notes Payable

During fiscal 2000, the Company entered into loan agreements with a certain supplier. These loans are payable in annual principal installments of C\$50,000 and US\$67,500, respectively and mature in 2010. The loans bear interest, payable monthly, at Canadian bank prime (6% at September 30, 2006) and U.S. prime (8.25% at September 30, 2006), respectively. Pursuant to the loan agreements, the Company must meet certain merchandise purchase targets. If the targets are not met, the principal repayments are accelerated based on a formula.

### Other Notes Payable

Other notes payable bear interest at annual rates ranging between 6.00% and 8.25%, have various maturity dates from 2008 to 2009, and are unsecured.

### Capital Lease Obligations

The Company financed certain automotive equipment and computer and office equipment under capital leases with a capitalized cost included in property and equipment of \$1,860,220 and \$1,616,998 as at September 30, 2006 and December 31, 2005, respectively. Accumulated depreciation relating to these assets was \$890,837 and \$592,545 as at September 30, 2006 and December 31, 2005, respectively.

Future repayments are as follows:  
(In thousands of U.S. dollars)

	Term Loan	Bank Term Loan	Supplier Notes Payable	Other Notes Payable	Capitalized Lease Obligations	Total
2006	\$ 8	\$ 559	\$ -	\$ 8	\$ 147	\$ 722
2007	5	2,237	112	33	368	2,755
2008	-	1,678	112	25	291	2,106
2009	-	-	112	2	199	313
2010	-	-	113	-	93	206
2011	-	-	-	-	45	45
2012	-	-	-	-	30	30
	<b>\$ 13</b>	<b>\$ 4,474</b>	<b>\$ 449</b>	<b>\$ 68</b>	<b>\$ 1,173</b>	<b>\$ 6,177</b>
Less: Interest	-	-	-	-	170	170
Current maturities	13	2,237	112	32	338	2,732
<b>Total</b>	<b>\$ -</b>	<b>\$ 2,237</b>	<b>\$ 337</b>	<b>\$ 36</b>	<b>\$ 665</b>	<b>\$ 3,275</b>

# Pet Valu, Inc.

## 5. Debentures

(In thousands of U.S. dollars)

	September 30, 2006			December 31, 2005		
	Face Value (Converted from C\$)	Unamortized Discount	Net	Face Value (Converted from C\$)	Unamortized Discount	Net
8.5% non-convertible	\$ -	\$ -	\$ -	\$ 12,945	\$ 48	\$ 12,897
12.5% non-convertible	13,420	426	12,994	12,898	512	12,386
8.5% convertible	3,310	-	3,310	3,181	-	3,181
10.0% non-convertible	7,891	-	7,891	-	-	-
	\$ 24,621	\$ 426	\$ 24,195	\$ 29,024	\$ 560	\$ 28,464
Balance Sheet Classification						
Current	13,420	426	12,994	12,945	48	12,897
Non-Current	11,201	-	11,201	16,079	512	15,567
	\$ 24,621	\$ 426	\$ 24,195	\$ 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 6). 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 7) 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 was amortized over the remaining term of the debentures. Amortization of \$49,387 (C\$55,936) and \$58,844 (C\$72,025) was included in net interest expense for the first three quarters of 2006 and 2005, respectively. Repayment to the debenture trustee and in certain cases to debenture holders directly was made on July 24, 2006 with proceeds from a private placement of 10% non-convertible unsecured subordinated debentures (see Note 5(d)) and availability from the bank revolving line of credit.

### (b) 8.5% Convertible

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

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

### (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 \$105,134 (C\$119,074) and \$97,283 (C\$119,074) was included in net interest expense for the first three quarters of 2006 and 2005, respectively. As a result of the repayment of C\$2.6 million of the debentures referred to in Note 5(b), 47,256 of the warrants issued to Penfund referred to above were cancelled on March 31, 2005. On October 31, 2006 the Company prepaid the entire principle amount of the 12.5% non-convertible debenture (see Note 9).

### (d) 10% Non-convertible

A private placement of 10% non-convertible unsecured subordinated debentures of Pet Valu Canada Inc. and guaranteed by Pet Valu, Inc. in the principal amount of C\$8.8 million was completed on July 24, 2006. The proceeds from the private placement and availability from the bank revolving line of credit were used to make repayment to the debenture trustee and, in certain cases, the debenture holders directly of C\$15.1 million of debentures which matured on July 24, 2006. Interest on the 10% debentures is paid quarterly.

# Pet Valu, Inc.

## 6. 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)	September 30, 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		19,676		12,453
		\$ 19,677		\$ 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 Capital Corporation. 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

	September 30, 2006			December 31, 2005	
	Authorized	Issued	Outstanding	Pet Valu, Inc. Common Equivalents	Pet Valu, Inc. Common Equivalents
Common Shares, no par value	Unlimited	1	1	-	-
Exchangeable Shares, no par value	Unlimited	9,061,136	8,707,436	8,707,436	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 Canada Inc. had one common share issued to Pet Valu, Inc. as of September 30, 2006 and December 31, 2005, which has been eliminated in consolidation.

### Exchangeable Shares

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 September 30, 2006 and December 31, 2005, in treasury at cost. No shares were repurchased to date in fiscal 2006 and none were repurchased in fiscal 2005.

# Pet Valu, Inc.

## 7. 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 1,036,190 Exchangeable Shares for issuance pursuant to its Plans of which 397,660 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	
	September 30, 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 September 30, 2006 there were 61,000 Board options vested and exercisable and 507,530 Executive options vested and exercisable with weighted average exercise prices of C\$1.77 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	(43,070)	1.16 - 3.28	2.35
Cancelled	(4,000)	1.16 - 2.75	1.96
Outstanding September 30, 2006	638,530	\$ 1.16 - 4.99	\$ 2.84

The weighted average remaining term of options outstanding at September 30, 2006 was 3.55 years.

The following table summarizes information about stock options outstanding at September 30, 2006:

Range of exercise price	Options Outstanding	Weighted Average Remaining Contractual Life(yrs)	Options outstanding		Options exercisable	
			Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price	
\$ 1.16 – 1.83	59,040	2.62	\$ 1.56	55,040	\$1.57	
2.06	50,000	8.14	2.06	10,000	2.06	
2.75	4,000	0.79	2.75	4,000	2.75	
2.80	272,490	3.23	2.80	272,490	2.80	
3.26	20,000	4.61	3.26	4,000	3.26	
3.28	223,000	3.04	3.28	223,000	3.28	
4.99	10,000	5.32	4.99	-	4.99	
	638,530			568,530		

# Pet Valu, Inc.

## 7. Stock Options and Warrants (continued)

### 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. Prior to September 30, 2006, 25,000 of the Tranche A warrants were exercised.

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 5a). Each warrant entitled 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. On or before July 24, 2006 there were 1,138,208 warrants exercised for total proceeds of C\$7,967,456. The remaining 869,097 warrants expired unexercised.

## 8. 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.

## 9. Subsequent Events

On October 31, 2006, the Company prepaid the entire principal amount of the 12.5% non-convertible subordinated debenture held by Penfund which was otherwise due on September 30, 2009. The debenture was issued in fiscal 2004 for C\$15.0 million along with 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 was being amortized over the five year term of the debenture. On the date of repayment the unamortized discount was C\$462,776. In addition to the principal, a prepayment premium of C\$150,000 was also paid. As a result of the prepayment the Company will recognize a loss on extinguishment of debt of C\$612,776. The Company will also be required to write off the deferred charges of C\$677,601 related to the arrangement of the debt financing. 785,411 Tranche A Warrants and 66,533 Tranche B Warrants remain outstanding.

# Pet Valu, Inc.

## 10. 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		Thirty-nine weeks ended	
	September 30, 2006	October 1, 2005	September 30, 2006	October 1, 2005
<b>Sales and revenue to external customers</b>				
Canada	\$ 28,726	\$ 24,926	\$ 81,211	\$ 72,255
U.S.	8,728	8,381	25,825	24,588
<b>Total sales and revenue</b>	<b>\$ 37,454</b>	<b>\$ 33,307</b>	<b>\$ 107,036</b>	<b>\$ 96,843</b>
<b>Net interest expense</b>				
Canada	\$ 914	\$ 990	\$ 2,868	\$ 2,944
U.S.	12	-	(22)	37
<b>Total net interest expense</b>	<b>\$ 926</b>	<b>\$ 990</b>	<b>\$ 2,846</b>	<b>\$ 2,981</b>
<b>Net Income</b>				
Canada	\$ 1,834	\$ 1,171	\$ 3,578	\$ 2,511
U.S.	416	373	1,062	1,103
Intersegment elimination	(124)	(124)	(373)	(373)
<b>Total net income</b>	<b>\$ 2,126</b>	<b>\$ 1,420</b>	<b>\$ 4,267</b>	<b>\$ 3,241</b>
<b>Depreciation and amortization</b>				
Canada	\$ 379	\$ 334	\$ 1,131	\$ 1,075
U.S.	107	87	296	266
<b>Total depreciation and amortization</b>	<b>\$ 486</b>	<b>\$ 421</b>	<b>\$ 1,427</b>	<b>\$ 1,341</b>
<b>Purchases of property and equipment</b>				
Canada	\$ 259	\$ 117	\$ 1,153	\$ 372
U.S.	35	96	372	159
<b>Total purchases of property and equipment</b>	<b>\$ 294</b>	<b>\$ 213</b>	<b>\$ 1,525</b>	<b>\$ 531</b>

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

	September 30, 2006	December 31, 2005
Canada	\$ 103,455	\$ 92,896
U.S.	14,243	13,296
Intersegment elimination	(53,736)	(51,583)
<b>Total assets</b>	<b>\$ 63,962</b>	<b>\$ 54,609</b>

## 11. Reclassifications

Certain amounts in the consolidated financial statements for the prior fiscal year periods have been reclassified to be consistent with current fiscal year's presentation.

