

# **PET VALU**™

## **Better Pet Nutrition**

**PET VALU, INC.**

**Quarterly Report**

**Twenty-Six Weeks Ended June 28, 2008**

(The financial statements contained herein are prepared in accordance with  
Accounting Principles Generally Accepted in the United States of America)  
(in U.S. dollars)

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# **Pet Valu, Inc.**

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# **Pet Valu, Inc.**

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

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 twenty-six week period ended June 28, 2008. The 2007 fiscal year refers to the 52-week period ended December 29, 2007. Unless otherwise indicated, all amounts are expressed in U.S. dollars. References to Canadian dollars are noted by using the International Monetary symbol for Canadian dollars, namely "C\$".

This MD&A is current as of August 6, 2008. Additional information relating to the Company, including the fiscal 2007 Annual Report of Pet Valu, Inc. and the Annual Information Form of Pet Valu, 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. 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 the 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 Company 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 June 28, 2008, there were 277 stores operating in Canada and 62 stores operating in the U.S. Of the 277 Canadian stores, 183 stores were franchised and 94 were company-owned. In the U.S., 60 of the 62 stores were company-owned and two were franchised. PET VALU stores are located in Ontario, Manitoba, Pennsylvania, New Jersey, Maryland and Virginia. The Company's Paulmac's Pet Food Inc. ("Paulmac's") stores are located in Ontario.

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. U.S. stores are operated by, or franchised through, Pet Valu, Inc.'s U.S. operating subsidiary, Pet Valu International Inc.

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### **Products and Services**

PET VALU and PAULMAC'S stores offer a wide range of pet food and pet-related supply products, including national and premium brand products. PET VALU stores also carry a broad selection of private label dog, cat and other pet foods marketed under trademarks owned by Pet Valu Canada Inc. 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 from Company warehouses.

In Canada, some PET VALU and most PAULMAC'S stores sell fish, birds, reptiles, and/or small animals and some offer grooming services. Stores in Canada and the U.S. carry a range of wild bird products and none sell dogs or cats. Some stores in Canada and the U.S., however, facilitate the adoptions of cats and/or dogs, on behalf of local animal welfare organizations.

The Company has ongoing programs to identify higher quality, differentiated merchandise brands as well as to develop additional private label offerings which take a wellness-focused approach to pet nutrition. Through the introduction of these specialty and private label food offerings as well as unique pet-related supply products the Company seeks to differentiate itself from many of its principal competitors in the sale of pet food and supplies.

### **Warehousing and Distribution**

The Company purchases, warehouses, and distributes pet food and pet-related supplies for and to all 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 in these facilities, inclusive of office space located therein, is approximately 460,000 square feet. Most of these facilities are located regionally to support local small box store delivery logistics. The Company also owns a parcel of land in Ontario of approximately 10 acres.

Distribution services in both countries are provided by a fleet of company-owned and leased vehicles and supplemented by outside carriers.

### **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 vast majority of their inventory 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. PET VALU 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 also pay distribution fees for the delivery of merchandise to their stores calculated on the basis of a percentage of the retail value of products and they contribute to a promotion fund which is used to defray certain Company expenses in relation to promotional activities. 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. PAULMAC's franchisees pay a 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. The Company is not currently offering new PAULMAC'S franchises.

The Company has a U.S. franchise system which differs from the Canadian system; however, the Company is not currently offering new PET VALU franchises in the U.S. and, as at June 28, 2008, there were only two U.S. franchises in operation.

# **Pet Valu, Inc.**

## **Key Accomplishments and New Developments**

During the first half of fiscal 2008, the Company pursued key priorities intended to improve results from operations, liquidity, capital resources and cash flow.

### **Reniching**

The Company's reniching program contributed to the strong results for the quarter and the year to date period. As part of this program, 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. New brands launched in the first half of the year include "Merrick's Before Grain", "Chicken Soup for the Pet Lover's Soul" and "Taste of the Wild". This aspect of reniching has improved, and is expected to continue to improve, operating profits and enhance the image of the Company as a specialty retailer. The other key component of the Company's reniching efforts involves the development of revised or new store location criteria reflecting changes in consumer traffic patterns, shopping centre developments, and competitive dynamics.

### **Inventory Accumulation**

The Company has anticipated and continues to anticipate increases in the cost of products that it sells due to the increasing costs of energy, agricultural products and livestock used either in the production of food products or as ingredients in food products sold by the Company. The Company's strategy with respect to these anticipated cost increases is to increase warehouse inventory levels of these products prior to price increases to allow gross profit margins to be maintained until retail prices can be adjusted without affecting the Company's competitive position. As a result, the Company's warehouse inventory levels have increased by approximately C\$1.7 million or 7.8% in the first half of 2008 and by approximately C\$1.6 million or 8.0% in fiscal 2007.

### **Peton Showcase**

During the second quarter, the Company hosted a two day tradeshow for its store staff and franchisees. The tradeshow, referred to as the "Peton Showcase" invited pet food and pet-related supply vendors to display new products, offer seminars to attendees and provide materials and advice regarding their products. The Peton Showcase was very successful as a launching for these new products. Corporate store managers and franchisees were encouraged to make use of all the materials and education offered by both the suppliers and Company staff, which is expected to enhance service levels and the overall customer experience. The Peton Showcase is typically held every other year and is sponsored by participating vendors.

### **Normal Course Issuer Bid**

In the second quarter of fiscal 2007, the Company commenced a normal course issuer bid ("NCI Bid"). Under the terms of the NCI Bid, the Company was permitted to purchase up to a maximum of 450,295 Exchangeable Shares. The NCI Bid commenced on or about May 28, 2007 and terminated on May 27, 2008. As at June 28, 2008, the Company had used approximately C\$5.4 million from operations to repurchase and cancel 431,000 Exchangeable Shares pursuant to the NCI Bid.

### **Board of Directors**

A new Board of Directors was elected at the May 8, 2008 annual and special meeting of stockholders, which included five new members and two incumbents.

### **Expression of Interest Regarding Possible Acquisition**

On July 14, 2008, the Company announced that it had received an unsolicited approach expressing interest in pursuing a possible acquisition of the Company. The Company has had preliminary discussions with representatives of the interested party, and the Company's board of directors continues to review and consider the approach with the advice and assistance of its financial advisor, TD Securities Inc., and its legal advisor. There can be no assurance, however, that any definitive transaction proposal will result from the approach, or that any transaction, if proposed, will be completed.

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### **Amendment of Bank Credit Agreement**

Subsequent to the end of the quarter, the Company entered into an amending agreement with its bank to amend the existing credit agreement that was executed in July 2006. The amendment increased the revolving line of credit from a maximum of C\$15 million to a maximum of C\$20 million with substantially the same terms as contained in the existing agreement. In addition, the amendment created a new C\$5 million term loan that bears interest at prime plus 1% and is repayable in 24 equal monthly installments.

### **Repayment of 10% Non-convertible Debentures**

Subsequent to the end of the quarter, in accordance with the debenture agreement, the scheduled repayment of principal and accrued interest for the 10% Non-convertible Debentures was made on July 24, 2008 by cash payments to the debenture holders. The amount of the payments was C\$8,877,836, made up of principal repayments of C\$8,820,000 and accrued interest of C\$57,836. These payments were financed from the new Bank Term Loan, the Company's Bank operating line and funds provided from operations.

### **Acquisition**

Subsequent to the end of the second quarter, the Company announced that it has entered into conditional agreements to acquire the shares of companies operating 15 "Berrys...Your PetsChoice" stores. These stores are all located in eastern Ontario. Subject to due diligence and other conditions, the transaction is expected to close in the third quarter.

### **Overall Performance**

The Company reported net income of \$3.6 million for the second quarter of fiscal 2008, which represented an improvement of \$0.8 million or 29.6% over the second quarter of fiscal 2007 results. For the year to date period, the Company reported net income of \$6.4 million, which represented an increase of \$1.9 million or 42.2% over the comparable period of the prior year. The increase in net income was primarily due to improvements in sales and blended gross profit margins. Sales increases are attributed to various strategies including store level, product and inventory accumulation strategies that have been implemented during the quarter and earlier. Blended gross profit margins increased as a result of a shift in sales 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 and from the benefits of the inventory accumulation program. For a more in depth discussion of revenues, gross profit and expenses, please refer to the section of this MD&A entitled "Comparison of Second Quarter of Fiscal 2008 to the Second Quarter of Fiscal 2007".

Cash flow from current operations was sufficient to meet all of the Company's debt obligations during the second quarter of fiscal 2008. There were no acquisitions during the quarter 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 on an on-going basis. Cash flow from operations was used to support the cost of repurchasing franchise store assets.

The Company anticipates that cash flow from current operations will be sufficient to meet debt servicing obligations for fiscal 2008. Future expansion will be funded through operating cash flow. The Company anticipates that it will continue to generate positive cash flow for the foreseeable future.

The Company's financial condition improved in the second quarter of fiscal 2008 due to positive cash flow from operations. The Company's capital structure remained similar to that at the end of fiscal 2007. There was no additional debt issued other than capital leases for capital asset additions.

# Pet Valu, Inc.

## Summary of Quarterly Results

### Eight quarter summary

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

	Fiscal 2006		Fiscal 2007				Fiscal 2008	
	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter	1 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter	1 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter
System-wide sales <sup>(1)</sup>	\$ 47,301	\$ 50,712	\$ 45,300	\$ 48,528	\$ 52,496	\$ 60,323	\$ 53,270	\$ 54,592
Sales and revenue	37,454	40,001	35,893	38,645	41,518	46,937	42,800	44,257
Gross profit	11,169	13,346	10,246	11,918	12,873	16,016	13,511	15,122
Net income	2,126	3,253	1,749	2,774	3,140	4,719	2,838	3,595
Net income before non-comparable items <sup>(2)</sup>	2,150	3,809	1,749	2,774	3,140	4,705	2,838	3,841
Net income per share – basic	0.25	0.37	0.20	0.32	0.36	0.55	0.32	0.38
Net income per share – diluted	0.21	0.32	0.17	0.27	0.31	0.46	0.28	0.35
Net income per share before non-comparable items <sup>(3)</sup>								
Basic	0.25	0.44	0.20	0.32	0.36	0.55	0.32	0.41
Diluted	0.22	0.37	0.17	0.27	0.31	0.46	0.28	0.38
Non comparable items								
Shareholder proxy costs	-	-	-	-	-	-	-	370
Executive employment related payment	-	-	-	-	-	640	-	-
Promotion fund allowance	-	(180)	-	-	-	(466)	-	-
Loss on debt extinguishment	-	1,138	-	-	-	-	-	-
Future tax recovery on NOLs	-	(154)	-	-	-	(125)	-	-
Financing initiatives costs	38	-	-	-	-	-	-	-
Applicable tax on non-comparable items	(14)	(248)	-	-	-	(63)	-	(124)

<sup>(1)</sup> System-wide sales represent retail sales to customers through company-owned and franchise stores.

<sup>(2)</sup> 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.

<sup>(3)</sup> Net income per share 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 per share before non-comparable items may differ from other companies. Management believes net income per share 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.

A one-time payment of approximately \$640,000 was made in first quarter of fiscal 2008 in relation to an employment contract between the CEO of the Company and the Company. The contract expired as of December 31, 2007. A new contract was executed with the CEO effective January 1, 2008. The new contract does not contain provisions for any one-time payments of similar magnitude.

The Company and its franchisees make contributions to the Canadian promotion fund, which is used for marketing and advertising activities. The Company determined that the deficit balance of the promotion fund at the end of fiscal 2007 was likely to be recovered in fiscal 2008 having regard to the magnitude of the promotion fund deficit and the Company's assessment of its future promotional plans. Therefore, the allowance that was initially provided at the end of fiscal 2005, and adjusted in fiscal 2006, has been reversed in full.

The Company reduced the valuation allowance relating to the NOL carryforwards for tax purposes of the U.S. operations in both fiscal 2007 and 2006. The result of the reduction in the valuation allowance is a future tax recovery of \$0.1 million in fiscal 2007 and \$0.2 million in fiscal 2006.

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The Company does not have a significant exposure to seasonal fluctuations among its product lines. Historically, fourth quarter earnings tend to be stronger due to higher store sales and increased margins.

The Company is comprised of various Canadian and U.S. subsidiaries. Generally, the country in which the subsidiary operates will determine the functional currency. The reporting currency for the consolidated financial statements is U.S. dollars. Therefore, for each subsidiary whose functional currency is not U.S. dollars, the statement of operations and the balance sheet are converted to U.S. dollars at the end of the period using the average foreign currency exchange rate for the period and the end of period foreign currency exchange rate, respectively. For the second quarter and the first half of fiscal 2008 the Canadian dollar was 8.7% and 12.7% stronger than the comparable period of the prior year, respectively. At June 28, 2008, the Canadian dollar was 3.0% weaker than at December 29, 2007. These effects were somewhat offset when the results of operations and balance sheets of subsidiaries which use the U.S. dollar as their functional currency were consolidated with the results of operations and balance sheets of the Canadian subsidiaries.

### **Comparison of the Second Quarter of Fiscal 2008 to the Second Quarter of Fiscal 2007**

#### **Store Operations**

During the second quarter of fiscal 2008, there was a net decrease of two stores, both of which were in Canada. For the year to date period, there was a net decrease of four stores, all of which were 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 in the first and second quarter of fiscal 2008 were identified by an evaluation of criteria such as cash flow contribution and the Company's ability to negotiate favourable lease termination arrangements.

In the second quarter of fiscal 2008, the average number of stores in operation was 340, six stores less than the average for the second quarter of the prior year. In the U.S., the average number of stores in operation during the second quarter of fiscal 2008 was 62, a decrease of five stores from the prior year. The average number of stores in operation in Canada decreased by two to 278 stores, comprised of 184 franchised stores and 94 company-owned stores as compared to the second quarter of the prior year during which there were 199 franchised stores and 81 company-owned stores in operation. For the year to date, the average number of stores in operation was 1.6 fewer in Canada and 5.7 fewer in the U.S. for a total of 7.3 fewer stores as compared to the comparable period of fiscal 2007.

#### **System-wide sales**

System-wide sales represent retail sales to customers through company-owned and franchise stores. During the second quarter of fiscal 2008, system-wide sales increased by \$6.1 million or 12.5% from the prior year to \$54.6 million. The change in foreign currency exchange rates resulted in an increase in system-wide sales from the prior year of \$3.6 million. Before the effects of the change in foreign currency exchange rates, the system-wide sales in the Canadian operations increased by \$2.2 million or 5.5%. The system-wide sales in the U.S. operations increased by \$0.3 million or 2.9%. For the year to date period, system-wide sales increased by \$14 million or 15.0% from the prior year. Before the effects of the change in foreign currency exchange rates, the system-wide sales increased by \$3.9 million or 5.1% in the Canadian operations and by \$0.1 million or 0.8% in the U.S. operations.

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 for the second quarter of fiscal 2008 increased over the second quarter of the prior year by 5.7% in Canada and by 8.8% in the U.S. For the year to date period, comparable store sales increased by 5.4% in Canada and by 7.9% in the U.S. as compared to the prior year. Factors contributing to the increase in Canada include product differentiation strategies, store image strategies, and in-store inventory positions. As a result of differentiation strategies, higher margin product sales have continued to show strong growth, while lower margin product sales declines have moderated. Store image strategies and improved in-store inventory positions have contributed to more positive shopping experiences for customers, resulting in higher sales levels. Similar factors existed in the U.S.

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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 \$5.6 million or 14.5% in the second quarter of fiscal 2008 as compared to the second quarter of fiscal 2007 and by \$12.5 million or 16.8% for the year to date period in fiscal 2008 as compared to the comparable period of the prior year. In the second quarter of fiscal 2008, the change in foreign currency exchange rates resulted in an increase in sales and revenue of \$2.9 million. Before the effects of the change in foreign currency exchange rates, the sales and revenue in the Canadian operations increased by \$2.5 million or 8.3%. The sales and revenue from the U.S. operations increased by \$0.2 million or 2.6%. In Canada, increases in comparable store sales and increases in the number of company-owned stores in operation contributed to the increase in sales and revenue while fewer franchised stores in operation partially offset these increases. In the U.S., increases in comparable store sales contributed to the increase in sales and revenue which was partially offset by decreases in the average number of stores in operation.

### **Gross profit**

Gross profit on sales and revenue increased by \$3.2 million or 26.9% in the second quarter of fiscal 2008 as compared to the comparable period of the prior year. In the second quarter of fiscal 2008, the change in foreign currency exchange rates resulted in an increase in gross profit of \$1.1 million. Before the effects of the change in foreign currency exchange rates, gross profit in the Canadian operations increased by \$2.0 million or 22.0%. In the U.S. operations, gross profit increased by \$0.1 million or 2.9%. For the year to date period, gross profit on sales and revenue increased by \$6.5 million or 29.2%. Before the effects of the change in foreign currency exchange rates, gross profit in the Canadian operations increased by \$3.8 million or 22.3%. In the U.S. operations, gross profit was consistent with the prior year for the year to date period. The change in foreign currency exchange rates resulted in an increase in gross profit of \$2.7 million.

Blended gross profit margins increased to 34.2% in the second quarter of fiscal 2008, as compared to 30.8% in the second quarter of fiscal 2007. For the year to date period, blended gross profit margins increased to 32.9% as compared to 29.7% for the comparable period of the prior year. The Company's reniching program, which has generated higher sales and higher gross profits margins, the increase in the number of company-owned stores in Canada and the inventory accumulation program contributed to the increase in gross profit margins.

### **Store operating expenses**

Store operating expenses increased by \$0.7 million or 18.0% in the second quarter of fiscal 2008 as compared to the second quarter of fiscal 2007. In the second quarter of fiscal 2008, the change in foreign currency exchange rates resulted in an increase of \$0.2 million in store operating expenses. Before the effects of the change in foreign currency exchange rates, store operating expenses in the Canadian operations increased by \$0.6 million or 26.2%. In the U.S. operations, store operating expenses decreased by \$0.1 million or 2.9% compared to the prior year. On a per store basis, store operating costs increased by 7.7% in Canada and by 4.7% in the U.S. Canadian stores were impacted by increased wages as the Company increases its hourly rates and incentive programs to retain current employees and attract new employees. Additionally, certain store operating costs are variable in relation to sales and therefore are expected to increase as store sales increase. As a percentage of sales by company-owned stores, store operating expenses decreased from 25.2% to 24.0% in Canada and from 22.6% to 21.3% in the U.S.

For the year to date period, store operating expenses increased by \$1.4 million or 17.4% as compared to the comparable period of the prior year. The change in foreign currency exchange rates resulted in an increase of \$0.6 million in store operating expenses. Before the effects of the change in foreign currency exchange rates, store operating expenses in the Canadian operations increased by \$0.9 million or 22.7%. In the U.S. operations, store operating expenses decreased by \$0.1 million or 3.2% compared to the prior year. On a per store basis, store operating costs increased by 4.5% in Canada and by 5.8% in the U.S. As a percentage of sales by company-owned stores, store operating expenses decreased from 25.2% to 23.4% in Canada and from 22.7% to 21.8% in the U.S.

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### **General and administrative expenses**

General and administrative expenses increased by \$1.2 million or 34.0% in the second quarter of fiscal 2008 as compared to the second quarter of fiscal 2007 and increased by \$2.1 million or 31.7% for the year to date period. The change in foreign currency exchange rates resulted in an increase of \$0.3 million in general and administrative expenses in the second quarter and an increase of \$0.9 million for the year to date period. Before the effects of the change in foreign currency exchange rates, general and administrative expenses in the Canadian operations increased by \$0.8 million or 23.5% in the second quarter and by \$1.1 million or 17.3% for the year to date period. In the U.S. operations, general and administrative expenses increased by \$0.1 million for the second quarter and the year to date period. Expenses of \$0.4 million, in connection with the shareholder proxy contest conducted prior to the May 8, 2008 AGM, annual salary increases, and increases in staff compliment in various departments contributed to the increase in general and administrative expenses.

### **Net interest expense**

Net interest expense decreased by less than \$0.1 million or 5.4% in the second quarter of fiscal 2008 as compared to the second quarter of fiscal 2007 and by less than \$0.1 million or 6.6% for the year to date period. The reduction in net interest expense was primarily due to reductions to the bank term loans through monthly principal payments using operating cash flow.

### **Income taxes provision**

The provision for income taxes rose by \$0.5 million in the second quarter of fiscal 2008 and \$1.1 million for the year to date period as compared to the comparable periods of the prior year. The increase is due to an increase in income before income taxes and higher non-deductible permanent differences related primarily to foreign exchange on capital items partially offset by a reduction in the effective combined Canadian and Province of Ontario corporate income tax rates from 36.12% to 33.5%.

### **Net income**

Net income for the second quarter of fiscal 2008 was \$3.6 million as compared to \$2.8 million in the second quarter of fiscal 2007. For the year to date period, net income was \$6.4 million as compared to \$4.5 million for the comparable period of the prior year. The change in foreign currency exchange rates resulted in an increase of \$0.3 million in net income for the second quarter of fiscal 2008 as compared to the second quarter of the prior year and an increase of \$0.6 million for the year to date period for fiscal 2008 as compared to the comparable period of the prior year. Before the effects of the change in foreign currency exchange rates, net income in the Canadian operations increased by \$0.4 million in the second quarter and increased by \$1.2 million for the year to date. In the U.S. operations, net income increased by \$0.1 million in the second quarter and for the year to date period. Sales increases and improvements in blended gross profit margins were partially offset by increases in operating expenses.

### **Liquidity and Financial Position**

At June 28, 2008, the Company had non-cash working capital of \$9.9 million, which was \$5.5 million more than the non-cash working capital of \$4.4 million at the end of fiscal 2007. There are no requirements to increase working capital in fiscal 2008; however, as store locations are added in the future or the breadth of product lines are expanded, inventory requirements may increase. The Company's inventory accumulation program may also result in further increases in inventory levels.

Merchandise accounts payable leveraging (trade payables over inventory) increased to 20.7% as of June 28, 2008 as compared to 20.1% as of December 29, 2007. The Company maintains a relatively low level of leveraging due to efforts to realize increased vendor discounts and allowances.

Total assets increased by approximately \$1.6 million to \$73.5 million at June 28, 2008, as compared to \$71.9 million at December 29, 2007. The change in foreign currency exchange rates resulted in a decrease of \$1.9 million in total assets. Before the effects of the change in foreign currency exchange rates, total assets increased by \$3.5 million. An increase in warehouse inventory levels due to the inventory accumulation program, increases in store inventory and fixed assets from franchise repurchases and an increase in cash balances contributed to the increase in assets as compared to December 29, 2007.

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Cash provided by operating activities in the second quarter fiscal 2008 was \$3.5 million, which was consistent with the second quarter of fiscal 2007. For the year to date period, cash provided by operating activities was \$5.2 million as compared to \$0.5 million for the comparable period in fiscal 2007. An increase in net income contributed to the increase. In addition, in the first quarter of fiscal 2007, cash was used to pay 2006 income taxes for which no installments were made in 2006 resulting in a large use of cash from operations.

Net cash used in investing activities for the second quarter of fiscal 2008 was \$0.8 million, which was consistent with the second quarter of fiscal 2007. For the year to date period, cash used in investing activities was \$1.9 million as compared \$0.8 million for the comparable period of the prior year. The development of new computer facilities in early fiscal 2008, the repurchase of franchise stores in Canada and leasehold improvements in existing stores all contributed to the increase in investing activities.

There were no acquisitions during the second quarter of fiscal 2008 or for the year to date that required funding. Replacements of certain property and equipment were funded through vendor leasing programs. In Canada, as part of regular operations, franchises were repurchased on an on-going basis. During the quarter, the Company repurchased three franchise stores (2007 – six) for \$199,304 (2007 - \$370,596) and for the year to date period, the Company repurchased five franchise stores (2007 - 10) for \$751,587 (2007-\$528,612). Cash flow from operations was used to support the cost of repurchasing franchise store assets.

Net cash used in financing activities in the second quarter of fiscal 2008 was \$2.6 million as compared to \$3.2 million in the second quarter of fiscal 2007. For the year to date period, cash used in financing activities was \$2.4 million as compared to less than \$0.1 million provided by financing activities in the comparable period of the prior year. The Company received \$1.9 million from the exercise of warrants by certain warrant holders in the first quarter of fiscal 2008 and during both the first and second quarters made monthly payments on a term loan with its bank and acquired exchangeable shares of Pet Valu Canada Inc. under a normal course issuer bid.

The Company anticipates that cash flow from current operations will be sufficient to meet debt servicing obligations for fiscal 2008. Future expansion will be funded through operating cash flow. The Company anticipates that it will continue to generate positive cash flow for the foreseeable future.

The Company has certain debt obligations that will mature in fiscal 2008 and 2009. The Company has adequate financial resources to meet these maturities as they come due.

### **Capital Resources**

The Company's current 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. The Company is in compliance with the covenants contained in the Credit Agreement as of the date hereof. Subsequent to the end of the second quarter, the Company negotiated an amendment to the Credit Agreement, which increased the revolving line of credit from C\$15 million to C\$20 million and created a new C\$5 million term loan to replace the previous loan, which had been substantially repaid.

At June 28, 2008, the Company had utilized C\$2.8 million of the revolving line of credit as compared to C\$3.1 million at December 29, 2007. Under the Credit Agreement, the Company was required to draw on the C\$5 million term loan on or before September 30, 2006, which it did on September 30, 2006. The term loan required 24 equal monthly installments of C\$208,333. Subsequent to the end of the second quarter the principal owing on this term loan was repaid and a new term loan for C\$5 million was drawn.

On June 28, 2008, Pet Valu Canada Inc. had outstanding C\$8.8 million of 10% non-convertible unsecured subordinated debentures, with a maturity date of July 24, 2008 and C\$3.7 million of 8.5% convertible unsecured subordinated debentures, with a maturity date of December 29, 2009. Subsequent to the end of the second quarter, on July 24, 2008, the C\$8.8 million of 10% debentures was repaid using funds from the new term loan and operating line of credit.

## **Pet Valu, Inc.**

On March 5, 2008, 785,411 Tranche A Warrants and 66,533 Tranche B Warrants were exercised for proceeds of C\$1,936,754.

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 off-balance sheet arrangements as of June 28, 2008 or December 29, 2007.

### **Contingent Liabilities**

The Company has received a request from Goodwood Inc. seeking reimbursement of C\$488,919 in out-of-pocket expenses incurred in connection with the proxy contest to reconstitute the Pet Valu Board. No decision has been made regarding this request.

The Company does not have any other contingent liabilities. However, there are various claims outstanding against the Company including the matters referred to in the litigation paragraphs of the "Risks and Uncertainties" section of this MD&A

### **Financial Instruments**

The Company's consolidated financial statements include a number of financial instruments, in particular, cash and short-term investments, accounts receivable, other receivables, notes receivable, bank overdraft, bank operating loans, accounts payable and accrued liabilities, long term debt and subordinated debentures.

#### **Cash and short-term investments**

The Company's excess cash is invested in overnight deposits with high quality financial institutions to generate a return on these funds. The Company assesses the credit and interest rate risks on these investments as minimal.

#### **Long term debt**

The Company's long term debt consists of a term loan with its bank, capital leases and supplier and other notes payable. The term loan, which comprises the majority of the long term debt, and the supplier and other notes payable have floating rates of interest based on Canadian and U.S. bank prime. 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.

#### **Accounts Receivable and Other Receivable**

The Company's accounts receivable and other receivables are from its suppliers and the Company's franchise operators. The Company assesses the credit risk on its receivables from franchises to be minimal due to the short settlement terms on these receivables and the distributed nature of the balance between a large number of franchise operators. The Company assesses the credit risk on its receivables from its suppliers to be minimal due to its ability to offset any monies owed by the supplier against amounts owed to the supplier.

#### **Foreign currency exchange risk**

The Company is exposed to risks arising from fluctuations in currency exchange rates between Canadian dollars and United States dollars. Generally, this risk is minimal as the majority of the financial instruments are short term in nature and held in the local currency of the respective operating company.

# **Pet Valu, Inc.**

## **Risks and Uncertainties**

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

### **Competition**

The Company's stores compete with four main types of competitors: (i) grocery product retailers; (ii) pet food specialty stores; (iii) pet product superstores; and (iv) pet shops. Grocery product retailers include grocery stores, mass merchandisers, warehouse clubs, and convenience retailers such as some convenience stores, discount stores, drug stores, and hardware general merchandise stores.

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 expects continued increases in competition including increases to retail square footage in the pet product specialty sector which may decrease sales at established stores. The Company plans to address these challenges by employing strategies focused on its key competitive strengths. These include customer service, convenience, and the introduction of new specialty and wellness focused 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.

### **Economic Conditions and Resulting Product Cost Inflation**

Economic conditions including escalating costs in energy, agricultural products, and livestock used either in the production of food products or as ingredients in food products sold by the Company are resulting in inflation in the cost of many products sold by the Company. As a result, retail prices are expected to increase among all retailers. The Company's inventory accumulation strategy is expected to provide a competitive advantage in this regard. In the event that weaker economic conditions persist and consumers begin to change their purchasing patterns, the Company's convenient locations and strong private label programs are expected to provide it with an advantage.

### **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 currency 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 avian flu 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.

## **Pet Valu, Inc.**

### **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 should not be material due to store sizes. However, there is the usual risk associated with the loss of a profitable retail location and the inability to find a substitute location of equal profitability. The Company does not anticipate at the present time any material impact on profitability in relation to potential losses of desirable store locations. 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**

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 fiscal 2007 Pet Valu, Inc. and Pet Valu Canada Inc. (the "Pet Valu Companies") were joined, or targeted to be joined, as defendants, along with certain other pet food retailers as well as some manufacturers, in five potential class action lawsuits concerning the manufacture and sale of pet food products alleged to contain melamine. The actions in which the Pet Valu Companies were joined were commenced in British Columbia, Saskatchewan, and Newfoundland. Actions in which they were targeted to be joined were commenced in Ontario and Manitoba.

All five above actions and approximately 100 other actions commenced in the U.S. and Canada which do not involve the Pet Valu Companies have been the subject of negotiation which resulted in a settlement agreement in the first half of fiscal 2008. The settlement agreement has received preliminary approval of the U.S. and Canadian courts and final court approval is expected in the fourth quarter of fiscal 2008. The settlement agreement creates a settlement fund of US\$24 million to be administered by a neutral claims administrator that will allow a potential recovery of up to 100% of all economic damages incurred by pet owners subject to certain limitations. The Pet Valu Companies expect that the settlement will have no financial impact on them.

From time to time, the Company is named as a defendant in other legal proceedings 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 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. Historically, fourth quarter earnings tend to be stronger due to higher store sales and increased margins.

### **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.

## **Pet Valu, Inc.**

### **Market risks**

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

### **Expansion Plans**

Expansion by the Company either through greenfield development or synergistic acquisition depends on several factors including the ability of its stores to maintain sales and margins as well as its ability to obtain favourable store sites and / or identify synergistic competitors, to compete in existing or new markets, and to secure or generate adequate financial resources.

### **Other Risks**

Additional risks include: the ability of the Company to successfully implement its strategic initiatives and whether such strategic initiatives will yield the expected benefits; changes in consumer spending; 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.

### **Transactions with related parties**

The Company had the following transactions with related parties.

- a) Interest payments were made on debentures held by certain officers and former directors of C\$206,863 (2007 - C\$207,430) during the quarter and C\$416,573 (2007 - C\$622,290) for the year to date period. The principal amounts of these debentures were repaid on the maturity date of July 24, 2008, which was subsequent to the end of the quarter.
- b) Payments of C\$30,826 for the quarter and C\$34,681 for the year to date period were made to a former director of the Company for consulting services provided regarding various matters.

Please see the discussion of transactions with related parties in the MD&A for the year ended December 29, 2007.

### **Critical accounting estimates**

There were no new critical accounting estimates in the first or second quarter of fiscal 2008. Please see the discussion of critical accounting estimates in the MD&A for the year ended December 29, 2007.

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

In September 2006, the Financial Accounting Standards Board ("FASB") issued statement of financial accounting standard ("SFAS") No. 157, "Fair Value Measurement." SFAS 157 defines fair value and establishes a framework for measuring fair value. It also expands the disclosures required for fair value measurement. SFAS 157 applies to other accounting pronouncements that require fair value measurement; however it does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 157 has not had a material effect on the Company's consolidated financial position, results of operations or cash flows.

In February, 2007, FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities- Including an Amendment of FASB Statement No. 115." SFAS 159 permits an entity to have the option to measure selected financial instruments and certain other items at fair value at specified election dates. A business entity would report unrealized gains and losses on which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied on an instrument by instrument basis, is irrevocable and must be applied to an entire instrument. Most of the provisions of SFAS 159 are elective; however the amendment of SFAS No. 155, "Accounting for Certain Investments in Debt and Equity Securities", must be applied to all entities with available-for-sale and trading securities. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The adoption of SFAS 159 had no effect on the Company's consolidated financial position, results of operations or cash flows.

## Pet Valu, Inc.

In December 2007, FASB issued SFAS No. 160, "Noncontrolling Interest in Consolidated Financial Statements – An Amendment of ARB No. 51". SFAS 160 establishes new accounting and reporting standards for noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 requires that noncontrolling interests be reported as a component of equity within the consolidated financial statements, that changes in a parent company's ownership interest where the parent retains controlling interest be recorded as equity transactions and that upon deconsolidation the parent recognize a gain or loss in net income. The resulting gain or loss is to be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 is effective for fiscal years and interim periods beginning on or after December 15, 2008. The adoption of SFAS 160 will not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

In December 2007, FASB issued SFAS No. 141(R), "Business Combinations". SFAS 141(R) replaces SFAS No. 141, "Business Combinations". SFAS 141(R) establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest. SFAS 141(R) requires that an acquirer record the assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at fair value. It also provides guidance for recognizing and measuring goodwill obtained during a business combination. In addition, guidance is provided on disclosure requirements to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of SFAS 141(R) will not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

### Outstanding Share Data

The following table contains the number of outstanding voting or equity securities at June 28, 2008 and the end of fiscal 2007. Please refer to notes 9 and 10 of the financial statements for the twenty-six weeks ended June 28, 2008 for additional information.

	<u>Aug. 6, 2008</u>	<u>Jun. 28, 2008</u>	<u>Dec. 29, 2007</u>
Common Stock of Pet Valu, Inc.	100	100	100
Special Voting Stock of Pet Valu, Inc.	-	-	-
Additional Special Voting Stock of Pet Valu, Inc.	9,626,274	9,626,274	9,626,274
Exchangeable Shares of Pet Valu Canada Inc.	9,489,580	9,489,580	8,566,416
Common Shares of Pet Valu Canada Inc. (held by Pet Valu, Inc.)	1	1	1
Non-voting securities convertible into Exchangeable Shares of Pet Valu Canada Inc.:			
8.5% debentures of Pet Valu Canada Inc. (face value C\$3.7 million)	672,727	672,727	672,727
Warrants of Pet Valu Canada Inc. issued September 30, 2004	-	-	851,944

On March 5, 2008, 785,411 Tranche A Warrants and 66,533 Tranche B Warrants were exercised for proceeds of C\$1,936,754.

### Outlook

#### **Pursue Organic Growth**

Growth in comparable store sales has resulted from the Company's reniching programs, including the additions of new differentiated products and the continued development of private label products. These reniching programs have and are expected to continue to contribute to an increase in gross profit margins and improved customer selection.

These programs are on-going and include various degrees of product differentiation, staff training, facilities upgrades, and customer service initiatives. The Company will continue to focus on these programs for the foreseeable future with a goal of increasing sales, maintaining strong margins and improving the customer experience.

## **Pet Valu, Inc.**

### **Pursue Store Growth through Greenfield Expansion / Acquisition**

Store expansion will be pursued in Canada through greenfield development, and/or acquisitions that meet profit targets or otherwise realize synergies. Our target for store growth in fiscal 2008 remains at 25-30 stores in Canada.

As part of this targeted growth, subsequent to the end of the second quarter, Pet Valu announced that it has entered into conditional agreements to acquire the shares of companies operating 15 Berrys...Your PetsChoice stores. These stores are all located in eastern Ontario. Subject to due diligence and other conditions, the transaction is expected to close in the third quarter.

In the U.S., while we believe that there may be a niche opportunity to pursue, the U.S. market is quite different from the Canadian market and is more competitive. The Company is analyzing the opportunity for further expansion in the U.S.; however, the focus of the Company's growth plans will first be in Canada.

Pet Valu is currently exploring expansion in Canadian markets where the Company is not already operating, including Alberta, B.C., Saskatchewan and the Maritimes. These will be analysed and pursued to the extent that it is determined that targeted returns can be achieved and are sustainable.

### **Pursue initiatives to sustain growth**

Initiatives to sustain growth include:

- Reviewing the current information systems and inventory control systems. The goal will be to acquire or develop systems that are scalable and will support expansion initiatives and other initiatives to increase profitability.
- Continuing to develop warehousing, operating and distribution related infrastructure to meet the anticipated growth of the business.

### **Disclosure Controls and Procedures and Internal Controls over Financial Reporting**

The Company has designed disclosure controls and procedures to provide reasonable assurance that material information related to the Company is included in the annual filings.

The Company has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

There have been no changes in the Company's internal controls over financial reporting during the most recent interim period ended June 28, 2008 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **Pet Valu, Inc.**

August 6, 2008

To the Shareholders of Pet Valu, Inc.:

An auditor has not reviewed the consolidated balance sheet or the consolidated statement of shareholders' equity of Pet Valu, Inc. as at June 28, 2008, nor the consolidated statements of operations, comprehensive income and cash flows for the twenty-six 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 U.S. dollars)

	June 28, 2008	December 29, 2007
<b>Assets</b>		
<b>Current assets</b>		
Cash and short-term investments	\$ 2,665,559	\$ 1,635,834
Accounts receivable	2,192,549	2,041,638
Other receivables (Less allowances of \$5,244, 2007 - \$5,405)	571,029	1,273,781
Inventories	33,795,806	32,541,967
Prepaid expenses and other assets	1,361,386	1,701,495
Deferred income taxes (Note 2)	773,009	787,959
<b>Total current assets</b>	<b>41,359,338</b>	<b>39,982,674</b>
Notes receivable (Less allowances of \$4,583, 2007 - \$4,724)	14,764	24,192
Deferred rent receivable and other assets	1,153,177	1,237,773
Property and equipment, net of accumulated depreciation and amortization	9,719,566	9,259,778
Goodwill	16,987,260	17,132,808
Deferred income taxes (Note 2)	4,220,511	4,273,630
<b>Total assets</b>	<b>\$ 73,454,616</b>	<b>\$ 71,910,855</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Bank overdraft	\$ 828,980	\$ 2,122,868
Bank operating loans (Note 4)	2,757,309	3,153,614
Current portion of long-term debt including capital lease obligations (Note 6)	1,336,405	2,625,284
Current portion of deferred gain on warehouse sale	261,067	269,080
Trade accounts payable	7,014,135	6,536,133
Accrued liabilities	3,901,437	4,597,761
Accrued wages and benefits	3,545,342	4,067,541
Income taxes payable	451,087	1,534,407
Subordinated debentures (Note 7)	8,727,489	8,995,410
<b>Total current liabilities</b>	<b>28,823,251</b>	<b>33,902,098</b>
Deferred franchise revenue	7,272	8,182
Deferred gain on warehouse sale	54,891	188,579
Deferred rent payable	2,711,655	2,629,650
Long-term debt including capital lease obligations, less current maturities (Note 6)	1,281,393	1,072,492
Subordinated debentures (Note 7)	3,661,191	3,773,585
<b>Total liabilities</b>	<b>36,539,653</b>	<b>41,574,586</b>
Commitments and contingencies (Notes 4 & 12)		
<b>Shareholders' Equity</b>		
Capital stock (Notes 9 & 10)	963	963
Additional paid in capital	21,817,057	19,585,169
Accumulated earnings	19,719,726	14,850,532
Accumulated other comprehensive loss	(3,930,798)	(3,408,410)
Treasury stock – exchangeable shares, at cost	(691,985)	(691,985)
<b>Total shareholders' equity</b>	<b>36,914,963</b>	<b>30,336,269</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 73,454,616</b>	<b>\$ 71,910,855</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 U.S. dollars, except number of shares)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
<b>Sales and revenue</b>	<b>\$ 44,256,770</b>	\$ 38,645,114	<b>\$ 87,056,973</b>	\$ 74,538,418
Cost of sales including occupancy costs	<b>29,134,641</b>	26,726,532	<b>58,424,073</b>	52,374,131
<b>Gross profit</b>	<b>15,122,129</b>	11,918,582	<b>28,632,900</b>	22,164,287
Store operating expenses excluding occupancy costs	<b>4,839,216</b>	4,102,345	<b>9,333,701</b>	7,950,739
General and administrative expenses	<b>4,553,909</b>	3,398,919	<b>8,823,888</b>	6,697,537
	<b>5,729,004</b>	4,417,318	<b>10,475,311</b>	7,516,011
Net interest expense	<b>435,088</b>	459,864	<b>888,547</b>	951,816
Income before income taxes	<b>5,293,916</b>	3,957,454	<b>9,586,764</b>	6,564,195
Income taxes provision	<b>1,698,640</b>	1,184,179	<b>3,153,965</b>	2,041,680
<b>Net income</b>	<b>\$ 3,595,276</b>	\$ 2,773,275	<b>\$ 6,432,799</b>	\$ 4,522,515
Basic EPS (Note 3)	<b>\$ 0.38</b>	\$ 0.32	<b>\$ 0.71</b>	\$ 0.51
Diluted EPS (Note 3)	<b>0.35</b>	0.27	<b>0.63</b>	0.44
Weighted average number of common stock and exchangeable shares outstanding: Basic (Note 3)	<b>9,404,679</b>	8,739,197	<b>9,084,150</b>	8,816,846
Diluted (Note 3)	<b>10,334,805</b>	10,440,431	<b>10,328,469</b>	10,535,116

## Consolidated Statements of Comprehensive Income

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

(Unaudited)

(In U.S. dollars)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
<b>Net Income</b>	<b>\$ 3,595,276</b>	\$ 2,773,275	<b>\$ 6,432,799</b>	\$ 4,522,515
Other comprehensive income				
Unrealized foreign currency translation gains and losses	<b>194,017</b>	906,827	<b>(522,388)</b>	1,008,017
<b>Comprehensive Income</b>	<b>\$ 3,789,293</b>	\$ 3,680,102	<b>\$ 5,910,411</b>	\$ 5,530,532

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

# Pet Valu, Inc.

## Consolidated Statements of Shareholders' Equity

In accordance with accounting principles generally accepted in the United States of America  
(Unaudited)  
(In U.S. dollars)

		Additional Special Voting Stock	Additional Paid-in Capital	Accumulated Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity (Deficit)
Balance – December 30, 2006	\$	963	\$ 19,802,745	\$ 5,223,320	\$ (5,737,717)	\$ (691,985)	\$ 18,597,326
Stock-based compensation costs		–	145,675	–	–	–	145,675
Repurchase of Exchangeable Shares (Note 9)		–	(617,651)	(2,754,349)	–	–	(3,372,000)
Issuance of Exchangeable Shares (Note 10)		–	254,400	–	–	–	254,400
Net Income		–	–	12,381,561	–	–	12,381,561
Foreign currency translation Adjustments		–	–	–	2,329,307	–	2,329,307
Balance – December 29, 2007	\$	963	\$ 19,585,169	\$ 14,850,532	\$ (3,408,410)	\$ (691,985)	\$ 30,336,269
Stock-based compensation costs		–	77,774	–	–	–	77,774
Repurchase of Exchangeable Shares (Note 9)		–	(350,578)	(1,563,605)	–	–	(1,914,183)
Issuance of Exchangeable Shares (Note 10)		–	2,504,692	–	–	–	2,504,692
Net Income		–	–	6,432,799	–	–	6,432,799
Foreign currency translation Adjustments		–	–	–	(522,388)	–	(522,388)
<b>Balance – June 28, 2008</b>	<b>\$</b>	<b>963</b>	<b>\$ 21,817,057</b>	<b>\$ 19,719,726</b>	<b>\$ (3,930,798)</b>	<b>\$ (691,985)</b>	<b>\$ 36,914,963</b>

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 U.S. dollars)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
<b>Operating activities</b>				
Net income	\$ 3,595,276	\$ 2,773,275	\$ 6,432,799	\$ 4,522,515
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	498,144	444,242	979,099	873,391
Deferred income taxes	18,812	18,539	37,633	35,950
Gain on disposal of property and equipment	9,835	29,761	(298)	26,678
Stock based compensation costs	39,615	35,228	77,774	69,099
Deferred rent receivable and other assets	90,075	92,218	203,018	84,780
Amortization of deferred gain on warehouse sale	(64,073)	(58,813)	(128,516)	(114,044)
Changes in other operating assets and liabilities:				
(Increase) decrease in receivables	(230,567)	422,024	463,792	1,403,906
(Increase) decrease in inventories	(700,628)	76,672	(1,759,232)	(369,835)
Decrease (increase) in prepaid expenses	99,972	(86,959)	301,441	(536,217)
Increase (decrease) in trade accounts payable	753,633	406,858	643,664	(897,107)
Decrease in accrued liabilities	(603,035)	(461,706)	(1,016,300)	(517,142)
Increase (decrease) in income taxes payable	15,828	(128,702)	(1,041,326)	(4,025,705)
<b>Net cash provided by operating activities</b>	<b>3,522,887</b>	<b>3,562,637</b>	<b>5,193,548</b>	<b>556,269</b>
<b>Investing activities</b>				
Purchases of property and equipment	(651,122)	(395,085)	(1,130,208)	(663,476)
Proceeds on disposal of property and equipment	11,915	3,465	22,488	13,388
Acquisition of businesses (Note 5)	(199,304)	(370,596)	(751,587)	(528,612)
Notes and other receivables	4,023	4,243	8,070	10,206
<b>Net cash used in investing activities</b>	<b>(834,488)</b>	<b>(757,973)</b>	<b>(1,851,237)</b>	<b>(1,168,494)</b>
<b>Financing activities</b>				
(Decrease) increase in short-term financing	(1,128,075)	(466,652)	(303,429)	2,994,345
Decrease in bank overdraft	(600,039)	(465,750)	(1,234,937)	(172,422)
Repayment of capital lease obligation	(101,225)	(82,001)	(193,993)	(179,371)
Issuance of Exchangeable Shares	570,561	87,366	2,504,692	247,144
Repurchase of Exchangeable Shares	(651,317)	(1,678,168)	(1,914,183)	(1,678,168)
Repayment of note payable	(49,648)	(44,518)	(49,648)	(45,158)
Repayment of term loan financing	(624,061)	(575,658)	(1,253,441)	(1,121,541)
<b>Net cash (used in) provided by financing activities</b>	<b>(2,583,804)</b>	<b>(3,225,381)</b>	<b>(2,444,939)</b>	<b>44,829</b>
Effect of exchange rate changes on cash	(26,162)	(80,268)	132,353	(91,900)
Net increase (decrease) increase in cash	78,433	(500,985)	1,029,725	(659,296)
<b>Cash and short-term investments – Beginning of fiscal period</b>	<b>2,587,126</b>	<b>2,278,523</b>	<b>1,635,834</b>	<b>2,436,834</b>
<b>Cash and short-term investments – End of fiscal period</b>	<b>\$ 2,665,559</b>	<b>\$ 1,777,538</b>	<b>\$ 2,665,559</b>	<b>\$ 1,777,538</b>

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

# **Pet Valu, Inc.**

## **Notes to Consolidated Financial Statements**

For the twenty-six week periods ended June 28, 2008 and June 30, 2007

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

(All amounts are expressed in U.S. dollars, unless otherwise indicated.)

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

### **1. Significant Accounting Policies**

The unaudited interim consolidated financial statements (the "financial statements") have been prepared by management in accordance with accounting principles generally accepted in the United States of America ("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 29, 2007.

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 29, 2007, except as noted below.

#### **Reclassifications**

Certain reclassifications have been made to the prior year's financial statements to conform to current year's presentation.

#### **Newly Adopted Accounting Standards**

In September 2006, FASB issued SFAS No. 157, "Fair Value Measurement." SFAS 157 defines fair value and establishes a framework for measuring fair value. It also expands the disclosures required for fair value measurement. SFAS 157 applies to other accounting pronouncements that require fair value measurement; however it does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 157 has not had a material effect on the Company's consolidated financial position, results of operations or cash flows.

In February, 2007, FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities- Including an Amendment of FASB Statement No. 115." SFAS 159 permits an entity to have the option to measure selected financial instruments and certain other items at fair value at specified election dates. A business entity would report unrealized gains and losses on which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied on an instrument by instrument basis, is irrevocable and must be applied to an entire instrument. Most of the provisions of SFAS 159 are elective; however the amendment of SFAS No. 155, "Accounting for Certain Investments in Debt and Equity Securities", must be applied to all entities with available-for-sale and trading securities. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The adoption of SFAS 159 had no effect on the Company's consolidated financial position, results of operations or cash flows.

### **2. Income Taxes**

The Company's deferred tax assets are comprised of timing differences related to depreciable assets, intangible assets and net operating loss carryforwards. The Company reduces the deferred tax assets by a valuation allowance for the portion of the net operating loss carryforward that management determined does not meet the more likely than not criteria for recognition. An estimate of future taxable income is used in this determination. This estimate is revised once a year in the fourth quarter unless there has been a significant change in the results of operations. Therefore, unless otherwise stated there is no adjustment to the valuation allowance during the interim periods.

## Pet Valu, Inc.

### 3. 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 convertible debt, options and warrants.

In order to reflect the economic substance of the Company's capital structure, the computation of basic EPS is based on the aggregate number of shares of common stock of Pet Valu, Inc. ("Common Stock") and exchangeable shares of its subsidiary, Pet Valu Canada Inc. ("Exchangeable Shares"), excluding treasury stock. Diluted EPS is based on the diluted effect of equity and debt instruments convertible into either Common Stock or Exchangeable Shares (see Note 9).

In the second quarter of fiscal 2008 and fiscal 2007, the calculation of diluted EPS included certain stock options, warrants and convertible debt outstanding during the relevant period. The debt was convertible into 672,727 Exchangeable Shares. Stock options to purchase 338,830 Exchangeable Shares and/or Common Stock were outstanding on June 28, 2008 (June 30, 2007 – 1,334,114) (see Note 10). Warrants issued in fiscal 2004 to purchase 851,944 Exchangeable Shares were exercised on March 5, 2008. There are no warrants outstanding on June 28, 2008. 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 U.S. dollars, except for number of shares)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
Net income for the period	\$ 3,595,276	\$ 2,773,275	\$ 6,432,799	\$ 4,522,515
Net income applicable to holders of Common Stock and Exchangeable Shares				
Basic	\$ 3,595,276	\$ 2,773,275	\$ 6,432,799	\$ 4,522,515
Interest on 8.5% debenture	51,767	45,646	103,834	88,511
Diluted	\$ 3,647,043	\$ 2,818,921	\$ 6,536,633	\$ 4,611,026
Basic EPS	\$ 0.38	\$ 0.32	\$ 0.71	\$ 0.51
Diluted EPS	\$ 0.35	\$ 0.27	\$ 0.63	\$ 0.44
Weighted average number of Common Stock and Exchangeable Shares outstanding:				
Basic	9,404,679	8,739,197	9,084,150	8,816,846
Effect of dilutive stock options outstanding	257,399	360,316	319,979	379,825
Effect of dilutive warrants outstanding	-	668,191	251,613	665,718
Effect of conversion of 8.5% debenture	672,727	672,727	672,727	672,727
Diluted	10,334,805	10,440,431	10,328,469	10,535,116

### 4. 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 revolving line of credit for a term of five years and a C\$5,000,000 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 (C\$15 million on June 28, 2008) and a borrowing base calculation related to inventories and franchise receivables. On June 28, 2008 the borrowings outstanding under the credit facility were \$2,757,309 (December 29, 2007-\$3,153,614). The borrowing base calculation exceeded the C\$15,000,000 loan ceiling; therefore borrowings were limited to C\$15,000,000 at June 28, 2008 and December 29, 2007. Therefore, the availability at June 28, 2008 was C\$12,213,464 (December 29, 2007-C\$11,907,880). Interest on the revolving line of credit is calculated using the bank's prime rate plus 0.25% per annum. The interest rates at June 28, 2008 were 5.00% for Canadian dollar borrowings and 5.00% 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.

## Pet Valu, Inc.

### 4. Bank Operating Loans (Continued)

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 the covenants at June 28, 2008. Subsequent to June 28, 2008, an amending agreement was completed. See Note 14 for further information.

### 5. Business Acquisitions

Included in the consolidated financial results of the Company are repurchases of franchise stores. The repurchases have been accounted for through the purchase method.

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
Number of Stores Repurchased	3	6	5	10
Inventory	\$ 163,016	\$ 208,970	\$ 334,623	\$ 343,896
Property and equipment	32,088	61,177	61,126	84,267
Goodwill	4,200	100,449	355,838	100,449
Cash consideration	\$ 199,304	\$ 370,596	\$ 751,587	\$ 528,612

### 6. Long-term Debt

	June 28, 2008			December 29, 2007		
	Long-term	Current	Total	Long-term	Current	Total
Bank term loan	\$ -	\$ 824,592	\$ 824,592	\$ -	\$ 2,124,766	\$ 2,124,766
Supplier notes payable	184,476	116,976	301,452	236,989	118,494	355,483
Other notes payable	-	12,548	12,548	1,839	22,962	24,801
Capitalized lease obligations	1,096,917	382,289	1,479,206	833,664	359,062	1,192,726
Total	\$ 1,281,393	\$ 1,336,405	\$ 2,617,798	\$ 1,072,492	\$ 2,625,284	\$ 3,697,776

#### Bank Term Loan

The bank term loan is part of the amended and restated credit agreement (see Note 4). The loan bears interest at prime plus 1% (5.75% at June 28, 2008) and matures September 30, 2008. The loan is repayable in 24 equal monthly installments. See Note 14 for further information.

#### Supplier Notes Payable

During fiscal 2000, the Company entered into loan agreements with a 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 (4.75% at June 28, 2008) and U.S. prime for U.S. dollar borrowings within the United States (5.00% at June 28, 2008), 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 \$2,473,487 and \$2,014,021 as at June 28, 2008 and December 29, 2007, respectively. Accumulated depreciation relating to these assets was \$1,049,304 and \$872,489 as at June 28, 2008 and December 29, 2007, respectively.

## Pet Valu, Inc.

### 6. Long-term Debt (Continued)

Future repayments are as follows:

	Bank Term Loans	Supplier Notes Payable	Other Notes Payable	Capitalized Lease Obligations	Total
2008	\$ 824,592	\$ 67,500	\$ 10,709	\$ 264,108	\$ 1,166,909
2009	-	116,976	1,839	436,452	555,267
2010	-	116,976	-	330,346	447,321
2011	-	-	-	261,500	261,500
2012	-	-	-	223,613	223,613
2013	-	-	-	176,687	176,687
2014	-	-	-	77,563	77,563
2015 and thereafter	-	-	-	61,419	61,419
	\$ 824,592	\$ 301,452	\$ 12,548	\$ 1,831,688	\$ 2,970,280
Less: Interest	-	-	-	352,482	352,482
Current Maturities	824,592	116,976	12,548	382,289	1,336,405
Total	\$ -	\$ 184,475	\$ -	\$ 1,096,917	\$ 1,281,393

### 7. Subordinated Debentures

	June 28, 2008			December 29, 2007		
	Face Value (Converted from C\$)	Unamortized Discount	Net	Face Value (Converted from C\$)	Unamortized Discount	Net
8.5% subordinate (convertible)	3,661,191	-	3,661,191	3,773,585	-	3,773,585
10% subordinate (non-convertible)	8,727,489	-	8,727,489	8,995,410	-	8,995,410
	\$12,388,680	\$ -	\$12,388,680	\$12,768,995	\$ -	\$12,768,995
Balance Sheet Classification						
Current	8,727,489	-	8,727,489	8,995,410	-	8,995,410
Non-Current	3,661,191	-	3,661,191	3,773,585	-	3,773,585
	\$12,388,680	\$ -	\$12,388,680	\$12,768,995	\$ -	\$12,768,995

#### (a) 8.5% Convertible

Pet Valu Canada Inc. has an outstanding 8.5% convertible subordinated unsecured debenture in the amount of C\$3,700,000. 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. The debenture is due in 2009. Interest on this debenture is paid quarterly.

#### (b) 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\$8,820,000 was completed on July 24, 2006. Interest on the 10% debentures is paid quarterly. The initial term of these debentures is two years. The holders have an option to extend for an additional two years and the issuer has an option to prepay the debt after the completion of the first year of the extended period upon payment of a premium equal to 1% of the principal amount being repaid. However, the deadline for holders to exercise their options to extend the debenture term has expired and no holders have exercised their option to extend. Accordingly, the entire principal amount of C\$8,820,000 was repaid on the maturity date of July 24, 2008. See Note 14 for further information.

## Pet Valu, Inc.

### 7. Subordinated Debentures (Continued)

The investors in the private placement included, among others, certain then directors and/or officers of Pet Valu, Inc. and Pet Valu Canada, directly or indirectly. In particular, Geoffrey Holt, who was a director (until May of 2008) and continues to be an officer of both companies, invested C\$5,000,000 through Holtcorp, a personal holding company; Douglas Lunau, who was a director of both companies (until May of 2008), invested C\$3,000,000 through the Lunau Family Trust; Breena Holt, who was a director of both companies (until May of 2008) and a consultant to Pet Valu Canada, invested C\$150,000; Darryl Squires, who was a director of both companies (until May of 2008), invested C\$20,000; and John Turner, who is an officer and part-time employee of Pet Valu Canada, invested C\$150,000. Interest paid to the related parties in the first two quarters of 2008 was C\$416,573. Interest paid to the related parties in the first two quarters of 2007 was C\$622,290. As a result of a sale of certain of these debentures by Holtcorp Inc. to the Lunau Family Trust, completed on July 1, 2007, the principal amount of Holtcorp Inc.'s investment became C\$4,500,000 and that of Lunau Family Trust became C\$3,500,000.

### 8. Capital Disclosures

The Company considers its capital to include shareholders' equity and its subordinated debentures. As at June 28, 2008, the Company's capital was \$49,303,643 (December 29, 2007 - \$43,105,264).

The Company's objective when managing its capital is to seek continuous improvement in the return to its shareholders while maintaining a low to moderate tolerance level for risk. The objective is achieved by prudently managing the capital generated through internal growth and profitability, through the use of lower cost capital, including capital leases and bank debt, and raising share capital or debt when required to fund opportunities as they arise. The Company may also return capital to shareholders through the repurchase of shares or reduce debt where it determines either of these to be an effective method of achieving the above objective.

The Company does not use ratios in the management of its capital.

The Company is not subject to any externally imposed capital requirements, although the Company's credit agreement with its bank and certain subordinated debenture agreements contain certain restrictions on the issuance of debt, prepayment of debt, and dividends or distributions to shareholders.

### 9. Capital Stock

#### Authorized

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

	June 28, 2008		December 29, 2007	
	Shares Issued And Outstanding	Amount	Shares Issued and Outstanding	Amount
Additional Special Voting Stock	9,626,274	\$ 963	9,626,274	\$ 963
Common Stock	100	-	100	-
Additional paid-in capital		21,817,057		19,585,169
		<b>\$ 21,818,020</b>		<b>\$ 19,586,132</b>

## Pet Valu, Inc.

### 9. Capital Stock (Continued)

#### Pet Valu Canada Inc. Shares

	<b>June 28, 2008</b>			December 29, 2007	
	<b>Authorized</b>	<b>Issued Outstanding</b>		<b>Pet Valu, Inc. Common Equivalents</b>	Pet Valu, Inc. Common Equivalents
Common Shares, no par value	Unlimited	1	1	–	–
Exchangeable Shares, no par value	Unlimited	9,843,280	9,489,580	<b>9,489,580</b>	8,566,416
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 June 28, 2008 and December 29, 2007, 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. 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 June 28, 2008 and December 29, 2007, in treasury at cost.

Pet Valu Canada Inc. repurchased and cancelled Exchangeable Shares for cash under a normal course issuer bid as follows:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	<b>June 28, 2008</b>	June 30, 2007	<b>June 28, 2008</b>	June 30, 2007
Number of Shares Repurchased and Cancelled	<b>55,200</b>	149,300	<b>154,200</b>	149,300
Cash Consideration	<b>\$ 651,317</b>	\$ 1,678,168	<b>\$ 1,914,183</b>	\$ 1,678,168
	<b>C\$ 666,898</b>	C\$1,787,920	<b>C\$1,941,918</b>	C\$1,787,920

### 10. 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 674,990 Exchangeable Shares of Pet Valu Canada Inc. for issuance pursuant to its Plans of which 336,160 are available for grant.

## Pet Valu, Inc.

### 10. Stock Options and Warrants (Continued)

In the second quarter of fiscal 2008, there were no Common Stock and Exchangeable Share options granted. There were 79,500 Common Stock and Exchangeable Share options granted in the first quarter of fiscal 2008. The weighted average fair value of the Common Stock and Exchangeable Share options granted in fiscal 2008 was C\$3.06. There were no Common Stock and Exchangeable Share options granted in fiscal 2007. 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	
	June 28, 2008	December 29, 2007
Expected dividend rate	0%	-
Expected volatility	33%	-
Weighted average risk-free interest rate	3.0%	-
Expected lives (years)	3 years	-

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 June 28, 2008, there were 7,000 Board options vested and exercisable and 256,830 Executive options vested and exercisable with weighted average exercise prices of C\$2.49 and C\$3.81, 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 December 30, 2006	602,450	\$ 1.16 – 4.99	\$ 2.84
Granted	-	-	-
Exercised	(122,500)	1.16 – 3.28	2.34
Cancelled	-	-	-
Outstanding December 29, 2007	479,950	\$ 1.16 – 4.99	\$ 2.97
Granted	79,500	11.74	11.74
Exercised	(202,620)	2.06 – 4.99	3.09
Cancelled	(18,000)	3.26 – 4.99	3.84
Outstanding June 28, 2008	338,830	\$ 1.30 – 11.74	\$ 4.90

The weighted average remaining term of options outstanding at June 28, 2008 was 1.62 years.

The following table summarizes information about stock options outstanding at June 28, 2008:

Range of Exercise Price	Options outstanding			Options exercisable		
	Options Outstanding	Weighted Average Remaining Contractual Life (yrs)	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price	
\$ 1.30 – 1.46	5,720	2.55	\$ 1.44	3,720	\$1.43	
2.06	35,000	6.39	2.06	15,000	2.06	
2.80	143,110	1.48	2.80	143,110	2.80	
3.26	4,000	1.37	3.26	4,000	3.26	
3.28	71,500	1.29	3.28	71,500	3.28	
11.74	79,500	5.51	11.74	26,500	11.74	
	338,830			263,830		

# Pet Valu, Inc.

## 10. 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 entitled the holder to purchase one Exchangeable Share. All warrants were due to expire on September 30, 2009. The Tranche C Warrants were cancelled in fiscal 2005.

In fiscal 2006, 25,000 of the Tranche A Warrants were exercised. On March 5, 2008, the remaining 785,411 Tranche A Warrants and 66,533 Tranche B Warrants were exercised for proceeds of C\$1,936,754.

## 11. Financial Instruments

The Company has classified its assets and liabilities as follows:

<b>Asset/Liability</b>	<b>Classification</b>	<b>Measurement</b>
Cash and short-term investments	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Notes receivables	Loans and receivables	Amortized cost
Bank indebtedness and bank operating loans	Other liabilities	Amortized cost
Accounts payable and accruals	Other liabilities	Amortized cost
Capital lease obligations and other long-term debt	Other liabilities	Amortized cost
Subordinated debentures	Other liabilities	Amortized cost

The Company's estimate of the fair value of cash and short-term investments, trade accounts, notes receivable and other receivables, trade accounts payable, accrued liabilities, accrued wages and benefits and income taxes payable approximates their carrying value due to the short-term nature of these instruments. The estimated fair value of supplier notes payable, bank overdrafts, bank operating loans, a term loan and other notes payable approximates the carrying value because of their variable interest rates. The carrying value of capital lease obligations approximates their fair value as their interest rates approximate current market interest rates. The subordinated debentures are not listed for trading on a stock exchange and are not actively traded. Accordingly, as fair value of these debentures is not readily determinable, the debentures are recorded at amortized cost.

### Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk are cash and short-term investments and accounts receivable. The Company mitigates the risk on cash and short-term investments by the fact that its deposits are with various high quality financial institutions. The Company has receivables from its suppliers and from the Company's franchise operators. The credit risk on its receivables from suppliers is managed by the Company's ability to offset any monies owed by the supplier against amounts owed to the suppliers. The management of credit risk on its franchisee accounts receivable is maintained by having short settlement terms on these receivables.

### Liquidity Risk

The Company manages its liquidity risk by having various financing sources, including bank debt, subordinated debentures and capital leases. The Company prepares financial projections to ensure that it has sufficient funds to meet its contractual debt obligations.

### Exchange Risk

To the extent that the assets securing bank overdrafts and bank operating loans and other activities are not denominated in the same currency, changes in foreign currency exchange rates can expose the Company to foreign currency risk.

### Interest Rate Risk

The bank operating loans and certain other loans and notes are subject to variable interest rates. The Company does not engage in hedging to mitigate this risk.

## **Pet Valu, Inc.**

### **12. Contingencies**

The Company has received a request from Goodwood Inc. seeking reimbursement of C\$488,919 in out-of-pocket expenses incurred in connection with the proxy contest to reconstitute the Pet Valu Board. No decision has been made regarding this request.

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, including those referenced in the "Litigation" paragraph of the "Risks and Uncertainties" section of the Management's Discussion and Analysis issued concurrently with these financial statements, cannot be estimated, in the opinion of the Company, any such liability is unlikely to have a material adverse effect on its financial position, operating results or liquidity.

### **13. Related Party Transactions**

In addition to the amounts disclosed in Note 7 regarding interest payment on debentures held by certain officers and former directors, the Company made payments of C\$30,826 for the quarter and C\$34,681 for the year to date period to a former director of the Company for consulting services provided regarding various matters. No such payments were made in the first half of the prior year.

### **14. Subsequent Events**

#### **Amendments to Bank Credit Agreement**

On July 23, 2008, the Company entered into an amending agreement with its bank to amend the existing credit agreement that was executed in July 2006. The amendment increased the revolving line of credit from a maximum of C\$15 million to a maximum of C\$20 million. In addition, the amendment created a new C\$5 million term loan that bears interest at prime plus 1% and is repayable in 24 equal monthly installments. Concurrently with the execution of the amending agreement, the balance of the existing term loan plus all accrued interest, totaling C\$627,160, was repaid. All other terms in the existing credit agreement remained substantially the same.

#### **Repayment of 10% Non-convertible Debentures**

In accordance with the debenture agreement, the scheduled repayment of principal and accrued interest for the 10% Non Convertible Debentures (Note 7) was made on July 24, 2008 by cash payments to the debenture holders. The amount of the payments was C\$8,877,836, made up of principal repayments of C\$8,820,000 and accrued interest of C\$57,836. These payments were financed from the new Bank Term Loan (See Amendments to Bank Credit Agreement Above), the Company's Bank Operating Line (Note 4) and funds provided from operations.

#### **Acquisition**

On July 18, 2008, the Company announced that its Canadian operating company, Pet Valu Canada Inc., entered into a conditional agreement to acquire the shares of the companies operating 15 "Berrys...Your PetsChoice" stores. These stores are all located in eastern Ontario. Subject to due diligence and other conditions, the transaction is scheduled to close in the third quarter.

# Pet Valu, Inc.

## 15. 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.

	Thirteen weeks ended		Twenty-Six weeks ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
<b>Sales and revenue to external customers</b>				
Canada	\$ 35,129,141	\$ 29,749,051	\$ 69,236,449	\$ 56,825,982
U.S.	9,127,629	8,896,063	17,820,524	17,712,436
<b>Total sales and revenue</b>	<b>\$ 44,256,770</b>	<b>\$ 38,645,114</b>	<b>\$ 87,056,973</b>	<b>\$ 74,538,418</b>
<b>Net interest expense</b>				
Canada	\$ 435,693	\$ 476,675	\$ 892,531	\$ 983,959
U.S.	(605)	(16,811)	(3,984)	(32,143)
<b>Total net interest expense</b>	<b>\$ 435,088</b>	<b>\$ 459,864</b>	<b>\$ 888,547</b>	<b>\$ 951,816</b>
<b>Net Income</b>				
Canada	\$ 3,166,008	\$ 2,434,692	\$ 5,807,934	\$ 3,956,788
U.S.	553,726	463,041	873,781	814,643
Intersegment elimination	(124,458)	(124,458)	(248,916)	(248,916)
<b>Total net income</b>	<b>\$ 3,595,276</b>	<b>\$ 2,773,275</b>	<b>\$ 6,432,799</b>	<b>\$ 4,522,515</b>
<b>Depreciation and amortization</b>				
Canada	\$ 417,284	\$ 339,744	\$ 813,791	\$ 660,954
U.S.	80,860	104,498	165,308	212,437
<b>Total depreciation and amortization</b>	<b>\$ 498,144</b>	<b>\$ 444,242</b>	<b>\$ 979,099</b>	<b>\$ 873,391</b>
<b>Purchases of property and equipment</b>				
Canada	\$ 578,390	\$ 336,697	\$ 979,132	\$ 554,102
U.S.	72,732	58,388	151,076	109,374
<b>Total purchases of property and equipment</b>	<b>\$ 651,122</b>	<b>\$ 395,085</b>	<b>\$ 1,130,208</b>	<b>\$ 663,476</b>

Total assets and other financial data by segment were as follows:  
(in U.S. dollars)

	June 28, 2008	December 29, 2007
<b>Total assets</b>		
Canada	\$ 121,193,122	\$ 118,400,799
U.S.	18,570,834	17,007,032
Intersegment elimination	(66,309,340)	(63,496,976)
<b>Total assets</b>	<b>\$ 73,454,616</b>	<b>\$ 71,910,855</b>
<b>Capital assets and goodwill</b>		
Canada	\$ 25,152,743	\$ 24,880,880
U.S.	1,554,083	1,511,706
<b>Total capital assets and goodwill</b>	<b>\$ 26,706,826</b>	<b>\$ 26,392,586</b>

