

# **PET VALU<sup>TM</sup>**

## **Better Pet Nutrition**

**PET VALU, INC.**

**ANNUAL REPORT 2007**

(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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## Company Profile

The first PET VALU store was opened in Ontario, Canada in 1976 by Geoff and Carole Holt. By 1977, there were three stores in the Toronto area. Ten years later, the company had over 75 locations and began to franchise existing stores. In 1993, with more than 120 stores, the company went public on the Toronto Stock Exchange ("TSX"). The TSX stock symbol for Pet Valu Canada Inc., Pet Valu, Inc.'s publicly traded Canadian operating subsidiary, is PVC. In 1995, the company opened its first U.S. store in Bowie, Maryland.

The Company is a specialty retailer and wholesaler of pet food and pet-related supplies. As of February 2008, it had over 340 stores located in Ontario, Manitoba, Maryland, Virginia, Pennsylvania, and New Jersey. The Canadian stores operate under the names PET VALU®, PET VALU BETTER PET NUTRITION® and PAULMAC'S PET FOOD®, and together comprise the largest number of retail outlets in Canada dedicated to the sale of food and supplies for dogs, cats, caged birds, wild birds, fish, reptiles and small animals. The Company offers a wide range of pet food and pet-related supply products, including national and premium brands of pet foods, private label pet foods and pet supplies, purchased from over 200 suppliers in 11 countries. The products are purchased, warehoused and distributed to all franchised and corporate stores through Peton Distributors Inc., a wholly owned subsidiary of Pet Valu Canada Inc.

Our philosophy is to provide pet owners with a wide selection of better quality pet foods and pet-related supply products than can generally be found at grocery stores and mass merchandisers. We offer friendly customer service and good value in conveniently located stores. Stores range in size from 1,000 to 4,000 square feet and are located in or near neighbourhood shopping plazas. Our franchisees and staff are knowledgeable about the needs of pets. We encourage them to augment their expertise through informational product seminars, and articles in our in-house publication, the FOCUS.

## President's Message

Dear Shareholder:

I am pleased to report a growth in net income excluding non-comparable items for 2007 over 2006 of 50.7%. As a result, the average compound growth in net income excluding non-comparable items over the past four years has exceeded 50% per annum.

Projects initiated over the past four years have had fairly immediate impacts; however, many of our remaining projects, while generating high returns, require higher infrastructure commitments, particularly in our staffing and equipment capabilities in the areas of information technology and systems development. Key projects, many of which relate to technological improvements, have longer lead-times for completion resulting in longer periods of expense absorption prior to the realization of benefits. It is extremely important that the Company significantly enhance its capacities in the areas of Information Technology and Systems Development, as high competency in these areas represents a current precondition for effective and efficient retail management.

Most beneficial effects of these projects are expected to occur in 2009, 2010, and thereafter. That being said, management will attempt to prioritize some initiatives with a more immediate profit impact into the project mix, however, it is difficult to predict the outcome from these efforts. In the area of business growth, certain potential acquisitions are currently under assessment.

Pet Valu has developed a process for identifying opportunities which are then assessed as to bottom-line and balance sheet impacts as well as execution issues. In this regard a substantial number of initiatives and opportunities have been identified that should expand Pet Valu's operations and profits going forward for several years. While it would be competitively imprudent to set these out in detail, the nature of these opportunities reflect both strategic marketing initiatives and the development of technological solutions involving materials handling and inventory management. While our capacities in the area of technological development have historically reflected a corporate strength, an expansion of corporate strengths can sometimes create strategic improvements that can take decades for competitors to catch up with.

I would like to express my appreciation to the employees and to members of management who have been the driving forces within their respective areas to achieve the strong earnings growth at Pet Valu over the past several years.

Yours truly



Geoffrey F. Holt  
Chief Executive Officer

## 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 Annual 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 2007 fiscal year – the 52-week period ended December 29, 2007. The 2006 fiscal year refers to the 52-week period ended December 30, 2006 and the 2005 fiscal year refers to the 52-week period ended December 31, 2005. 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 March 14, 2008. Additional information relating to the Company, including 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 the President's Message, 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 and President's Message. 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 the end of fiscal 2007, there were 281 stores operating in Canada and 62 stores operating in the U.S. Of the 281 Canadian stores, 189 stores were franchised and 92 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 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 Pet Food Inc. ("Paulmac's"). U.S. stores are operated by, or franchised through, Pet Valu, Inc.'s U.S. operating subsidiary, Pet Valu International Inc.

**Products and Services**

PET VALU and PAULMAC'S stores offer a wide range of pet food and pet-related supply products, 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 company-owned and franchise stores in Canada and the U.S. There are eight leased and two owned distribution facilities in Canada and two leased distribution facilities in the U.S. Total space 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 acquired a parcel of land in Ontario in July 2007 for the purpose of building a custom designed warehouse to suit future warehousing requirements. The Company utilized the availability in its existing bank operating line to pay the C\$1.9 million acquisition price of the land.

Distribution services in both countries are provided by a fleet of company-owned and leased vehicles and supplemented by outside carriers and short-term rentals. Distribution services include delivery of merchandise to company-owned and franchise stores, as well as pick up of merchandise from some vendors to improve the utilization of the fleet.

**Franchising**

In Canada, Company revenues in relation to franchise operations are generated from fees and gains on the sale of franchises, from ongoing merchandise sales to franchisees, and from royalty and other income from franchise operations. Franchisees purchase the majority of their inventory 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 December 29, 2007, there were only two U.S. franchises in operation.

## **Key Accomplishments and New Developments**

During fiscal 2007, the Company pursued key priorities intended to improve results from operations, liquidity, capital resources and cash flow.

### **Reniching**

The Company continued to pursue a long-term objective of shifting its product offering to higher-margin, high-quality pet products, which include pet specialty brands and private label products featuring a wellness-focused approach to pet nutrition. During fiscal 2007, the Company introduced several high-quality products to its line-up. These include food products under the third party brand WELLNESS, a variety of upgraded dog formulations under the Company's private label PERFORMATRIN NATURAL brand and cat formulations under the Company's PERFORMATRIN brand, and various toys and treats. 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.

In 2005, the Company commenced re-branding efforts with the introduction of the Company's PET VALU BETTER PET NUTRITION trademark, now used in addition to the PET VALU trademark and name. Together with the continued transition from the "discount" image in association with the PET VALU business, this additional mark is indicative of efforts to transform the Company's image from discount retailer to purveyor of higher quality products. In 2006, the Company opened a prototype store in midtown Toronto, Ontario, to test new store design elements that embody the BETTER PET NUTRITION concept. Since then, new stores or relocated stores have included design elements first tested in the prototype.

### **Franchise Repurchases**

During fiscal 2007, the number of company-owned stores in Canada increased by 14. This increase was primarily due to the repurchase of several franchises where it was determined that the stores would operate more profitably as company-owned stores and therefore generate higher net income for the Company. The decision to invest in these repurchases was based on the projected return on investment. As a result of converting franchise stores to company-owned stores, sales and revenues, gross profits, store operating expenses and net income all increased. For a more in depth discussion of revenues, gross profit and expenses, please refer to the section of this MD&A entitled "Results of Operations".

### **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 is permitted to purchase up to a maximum of 450,295 Exchangeable Shares. The NCI Bid commenced on or about May 28, 2007 and terminates on May 27, 2008, subject to any application to renew same the Company may make with the TSX in the future. As at December 29, 2007, the Company had used approximately C\$3.8 million from operations to repurchase and cancel 299,600 Exchangeable Shares pursuant to the NCI Bid.

### **Vendor Product Recalls**

In fiscal 2007, certain vendors of the Company announced recalls of certain production runs for certain products. These recalls received significant media attention and raised some concern within the industry. However, the number of recalled products carried by the Company was limited. Accordingly, the recalls have not had a material negative effect on the sales or the results of operations of the Company. The Company's 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, is believed to be providing a competitive advantage to the Company with respect to consumers looking for alternative foods for their pets. The Company does not anticipate this issue having a material impact on the Company's sourcing of products. Litigation related to certain recalls is discussed in the Risks and Uncertainties section of this MD&A under the Litigation heading.

**Land Acquisition and Warehouse Development**

In July 2007, the company acquired a 9.6 acre parcel of land in Whitby, Ontario for \$1.9 million. The Company plans to design and build warehousing facilities on the land to accommodate current and future expansion of product lines carried. The new facility also has the potential to replace some of the Company's existing leased facilities. The cost of building the facility is expected to be financed by cash flow from operations and, as required, a conventional mortgage.

**Development of New Facilities for the Company's Information Technologies**

In fiscal 2007, the Company substantially completed the installation of new facilities to accommodate the Company's back office computer systems and allow for the expansion of business intelligence and other systems to facilitate greater analysis of the impacts of strategic decisions intended to improve profitability of the Company.

**Recent Changes in Vendor Practices**

Following a recent decision of the Supreme Court of the United States relaxing the federal rule against minimum retail pricing in that jurisdiction, certain vendors announced a new practice of setting minimum retail pricing policies in relation to their products. The current impact on the Company related to these specific vendors is minimal.

**Overall Performance**

The Company reported net income of \$12.4 million for fiscal 2007. During the year there were several non-comparable items including a one-time employment related payment to the CEO of the Company, a reversal of a provision against a promotion fund receivable, and an income tax recovery of \$0.1 million related to the recognition of U.S. net operating loss ("NOL") carryforwards. The total impact on net income of these non-comparable items was less than \$0.1 million on a net basis. Therefore, net income before non-comparable items remained at \$12.4 million, which represented an improvement of \$4.2 million over fiscal 2006 results on a comparable basis. Net income in fiscal 2006 was \$7.5 million. Net income before non-comparable items for fiscal 2006 was \$8.2 million.

The increase in net income before non-comparable items was primarily due to improvements in sales and blended gross profit margins. Sales increases are attributed to various store level and product strategies that have been implemented during the past year 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. For a more in depth discussion of revenues, gross profit and expenses, please refer to the section of this MD&A entitled "Results of Operations".

Cash flow from current operations was sufficient to meet all of the Company's debt obligations during the year. There were no acquisitions during fiscal 2006 that required funding. Acquisitions of certain property and equipment were funded through vendor leasing programs. In Canada, as part of regular operations, franchises were repurchased and sold on an on-going basis. Cash flow required to support the cost of repurchasing franchise store assets was partially offset by cash received from the sale of Company-owned store assets to new franchisees.

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 fiscal 2007 due to positive cash flow from operations. The Company's capital structure remained similar to that at the end of fiscal 2006. There was no additional debt issued other than capital leases for capital asset additions.

**Selected Annual Information**

The Company's financial information is prepared using U.S. generally accepted accounting principles ("GAAP"). The reporting currency is U.S. dollars. The functional currency is U.S. dollars for the U.S. operations and Canadian dollars for the Canadian operations. As the Canadian operations comprise the majority of the consolidated operations, the foreign currency exchange rate between the Canadian and U.S. dollars may have a material effect on the consolidated U.S. dollar results.

**Three year summary**

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

	<u>Dec 29, 2007</u>	<u>Dec 30, 2006</u>	<u>Dec 31, 2005</u>
Number of Stores			
Company owned	152	144	130
Franchised	191	208	221
Total number of stores	<u>343</u>	<u>352</u>	<u>351</u>
System-wide sales <sup>(1)</sup>	206,647	186,542	171,751
Sales and revenue	162,993	147,037	134,406
EBITDA <sup>(2)</sup>	21,918	16,232	14,101
EBITDA before non-comparable items	22,092	17,397	14,682
Depreciation	1,808	1,881	1,769
Net Interest Expense	2,081	3,509	3,902
Net income	12,382	7,519	7,254
Net income before non-comparable items <sup>(3)</sup>	12,368	8,207	6,416
Net income per share –basic	1.42	0.93	0.97
Net income per share –diluted	1.20	0.79	0.84
Net income per shares before non-comparable items <sup>(4)</sup>			
basic	1.42	1.02	0.86
diluted	1.20	0.86	0.74
Cash flow provided by operating activities	9,924	10,790	10,589
Financial Position			
Working Capital (Deficit) – non cash	4,445	7,415	(2,368)
Total Assets	71,911	58,256	54,609
Long-term liabilities	7,672	16,136	19,451
Shareholders' equity	30,336	18,597	4,083

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

<sup>(2)</sup> Earnings before interest, taxes, depreciation and amortization of goodwill 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 EBITDA may differ from other companies. Management believes EBITDA is a useful supplemental measure as it provides investors with an indication of cash available prior to debt service, capital expenditures and income taxes.

<sup>(3)</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>(4)</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.

Non-comparable items include (1) foreign currency exchange gains on long term monetary items, (2) any future income tax recovery relating to the NOL carryforwards of the U.S. operations, (3) any loss on extinguishment of debt, (4) litigation costs, (5) any allowance for promotion fund deficit, (6) any costs related to financings not pursued and (7) a one-time employment related payment to the CEO. For a more in depth discussion of non-comparable items, please refer to the section of this MD&A entitled "Results of Operations".

Net income before non-comparable items for fiscal 2007 increased by \$4.2 million or 51% over fiscal 2006. The improvement in net income before non-comparable items was a result of an increase in sales and blended gross profit margins. Blended gross profit margins increased as a result of the shift in sales to higher margin, high-quality 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.

During fiscal 2007, 2006 and 2005, the value of the U.S. dollar declined against the Canadian dollar. This decline was significant enough to cause notable effects on the financial statements of the Company. Foreign currency exchange rates are used to convert the results of Canadian operations from the operating currency of Canadian dollars to the reporting currency of U.S. dollars, which are then consolidated with the U.S. operations. As the Canadian operations comprise a significant portion of the total operations, the majority of items in the financial statements are affected by the change in the U.S. / Canada currency exchange rate. Operationally, the change in the foreign currency exchange rate resulted in decreased product costs for the Canadian operations, as discussed above.

The Company reviews the likelihood of a realization of the NOL carryforwards of the U.S. operations on a regular basis. The Company believes it is more likely than not that a portion of the NOL carryforwards will be realized based on the current and projected taxable income of the U.S. operations. As current results of the U.S. operations have improved, the Company has reduced the valuation allowance relating to the NOL carryforwards for tax purposes of the U.S. operations. The result of the reduction in the valuation allowance in fiscal 2007 is a future tax recovery of \$0.1 million as compared to a future tax recovery and reduction in the valuation allowance of \$0.2 million in fiscal 2006 and \$1.2 million in fiscal 2005. At the end of fiscal 2007, the valuation allowance was \$5.6 million.

## **Summary of Quarterly Results**

### **Eight quarter summary**

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

	Fiscal 2007			
	1 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter
System-wide sales	\$ 45,300	\$ 48,528	\$ 52,496	\$ 60,323
Sales and revenue	35,893	38,645	41,518	46,937
Gross profit	10,246	11,918	12,873	16,016
Net income	1,749	2,774	3,140	4,719
Net income before non-comparable items	1,749	2,774	3,140	4,705
Net income per share – basic	0.20	0.32	0.36	0.55
Net income per share – diluted	0.17	0.27	0.31	0.46
Net income per share before non-comparable items - basic	0.20	0.32	0.36	0.55
- diluted	0.17	0.27	0.31	0.46
Non-comparable items				
Executive employment related payment	-	-	-	640
Promotion fund allowance	-	-	-	(466)
Future tax recovery on NOLs	-	-	-	(125)
Applicable tax on non-comparable items	-	-	-	(63)

	Fiscal 2006			
	1 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter
System-wide sales	\$ 43,603	\$ 44,926	\$ 47,301	\$ 50,712
Sales and revenue	34,081	35,501	37,454	40,001
Gross profit	9,223	9,919	11,169	13,346
Net income	922	1,218	2,126	3,253
Net income before non-comparable items	976	1,272	2,150	3,809
Net income per share – basic	0.12	0.16	0.25	0.37
Net income per share – diluted	0.11	0.13	0.21	0.32
Net income per share before non-comparable items - basic	0.13	0.17	0.25	0.44
- diluted	0.12	0.14	0.22	0.37
Non-comparable items				
Promotion fund allowance	-	-	-	(180)
Loss on debt extinguishment	-	-	-	1,138
Future tax recovery on NOLs	-	-	-	(154)
Financing initiatives costs	84	85	38	-
Applicable tax on non-comparable items	(30)	(31)	(14)	(248)

A one-time payment was made 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 magnitudes.

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.

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 is no longer unlikely to be recovered in the next fiscal year due to the magnitude of the promotion fund deficit and the Company's assessment of its future promotional plans. Therefore, the allowance that was initially provided at the end of fiscal 2005, and adjusted in fiscal 2006, has been reversed in full.

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

## **Results of Operations**

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

The Company is comprised of various Canadian and U.S. subsidiaries. Generally, the country in which the subsidiary operates will determine the functional currency. The reporting currency for the consolidated financial statements is U.S. dollars. Therefore, the statement of operations for each subsidiary whose functional currency is not U.S. dollars is converted to U.S. dollars at the end of the period using the average foreign currency exchange rate for the period. During fiscal 2007, 2006 and 2005, the Canadian dollar strengthened significantly. The result of this strengthening was that each line item in the statements of operations of subsidiaries using Canadian dollars as their functional currency increased in U.S. dollar value by 5.5% in fiscal 2007, 6.8% in fiscal 2006, and 7.4% in fiscal 2005. This effect was somewhat offset when the results of operations of subsidiaries which use the U.S. dollar as their functional currency were consolidated with the results of operations of the Canadian subsidiaries. In all areas of the following analysis, the change in the foreign currency exchange rate will have the effect of increasing fiscal 2007 dollar amounts as compared to those of fiscal 2006 and fiscal 2006 dollar amounts as compared to those of fiscal 2005.

**Non-comparable items**

Non-comparable items are non-recurring and/or non-operational items incurred by the Company during the year. Non-comparable items include loss on debt extinguishment, an allowance (recovery) for the deficit balance in the promotion fund account, costs relating to certain financing initiatives that were cancelled, a one-time employment related payment to the CEO and future tax recovery of unrealized net operating loss carryforwards of the U.S. operations. A loss on debt extinguishment resulted from the prepayment on October 30, 2006, of a C\$15 million debenture and is arrived at by computing the difference between the book value of the debenture at the time of repayment and the amount repaid. The Company and its franchisees make contributions to the Canadian promotion fund, which is used for marketing and advertising activities. As of the end of fiscal 2005, the Company determined that the deficit balance of the promotion fund was unlikely to be recovered in the next fiscal year due to the magnitude of the promotion fund deficit and the Company's assessment of its future promotional plans. Therefore an allowance was provided. In fiscal 2006 and fiscal 2007, a recovery was recognized as a result of a reduction in the deficit balance. To address the repayment on July 24, 2006 of C\$15.1 million of debentures, the Company incurred legal and other costs in relation to a potential financing initiative that was ultimately not pursued. The future tax recovery of NOLs relates to the recognition of the recoverability of a part of the income tax NOLs arising from the U.S. operations.

**Comparison of Fiscal 2007 to Fiscal 2006****Store Operations**

During fiscal 2007, there was a net decrease of seven stores in the U.S. and two stores in Canada. Store operations are evaluated on an on-going basis with openings and closings resulting from shifts in demographics, quality of locations, population growth, and competition. The stores that were closed in fiscal 2007 were identified by an evaluation of criteria such as cash flow contribution and the Company's ability to negotiate favourable lease termination arrangements. The Company believes that the Canadian markets in which the Company operates are highly competitive, mature markets where growth is limited to normal population changes, inflation, changes in per pet spending, and consolidation within the industry itself.

In fiscal 2007, the average number of stores in operation was 346, four stores less than the average for the prior year. In the U.S., the average number of stores in operation during fiscal 2007 was 66, a decrease of one store. The average number of stores in operation in Canada decreased by three to 280 stores. Canadian store expansion opportunities continues to be limited by the maturity of market and demographic shifts.

**System-wide sales**

System-wide sales represent retail sales to customers through company-owned and franchise stores. During fiscal 2007, system-wide sales increased by \$20.1 million or 10.8% from the prior year to \$206.6 million. The change in foreign currency exchange rates resulted in an increase in system-wide sales from the prior year of \$10.3 million. Before the effects of the change in foreign currency exchange rates, the system-wide sales in the Canadian operations increased by \$9.2 million or 6.0%. The system-wide sales in the U.S. operations increased by \$0.6 million or 1.8%.

Comparable store sales represent a year-over-year comparison of the same group of stores that were open during both years of comparison. A store becomes comparable one year after its first full month of operation. Comparable store sales increased by 6.5% in Canada and by 3.6% in the U.S. Factors contributing to the increase in Canada include product differentiation strategies, store image strategies, in-store inventory positions, and changes in competition. 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 in-store inventory positions have contributed to more positive shopping experiences for customers, resulting in higher sales levels. Adjustments in competition in certain markets appear to have had a more positive impact on the sales than increases in competition in certain other markets. Similar factors existed in the U.S.; however, increases in competition in certain markets had a greater negative impact on overall sales than in Canada.

**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 \$16.0 million or 10.9% in fiscal 2007 as compared to fiscal 2006. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase in sales and revenue of \$8.7 million. Before the effects of the change in foreign currency exchange rates, the sales and revenue in the Canadian operations increased by \$6.6 million or 4.5%. The sales and revenue from the U.S. operations increased by \$0.7 million or 1.9%. Increases in comparable store sales contributed to the increase in sales and revenue in Canada and the U.S. Decreases in the average number of stores in operation in the U.S. and Canada partially offset the sales increases from comparable store sales.

In fiscal 2007, total merchandise sales through company-owned stores increased by \$10.0 million to \$72.2 million, accounting for an increase of 6.8% in consolidated sales and revenue. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase of \$2.0 million in merchandise sales through company-owned stores. Before the effects of the change in foreign currency exchange rates, the merchandise sales through company-owned stores in the Canadian operations increased by \$7.0 million or 24.5%. In the U.S. operations, merchandise sales through company-owned stores increased by \$1.0 million or 3.0%. Increases in the average number of company-owned stores in Canada and the increase in comparable store sales contributed to the increased merchandise sales in Canada. In the U.S. stores, increases in comparable store sales, which were partially offset by decreases in the average number of company-owned stores, contributed to the increased merchandise sales in company-owned stores.

Merchandise revenue from franchisees includes (1) merchandise sales at U.S. franchise stores; and (2) merchandise sold to Canadian franchisees together with related franchise distribution charges, royalty revenue and percentage rent revenue. Total merchandise revenue from franchise stores increased by \$5.9 million to \$88.7 million, accounting for a 4.0% increase in consolidated sales and revenue. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase of \$4.5 million in merchandise revenue from franchise stores. Before the effects of the change in foreign currency exchange rates, the merchandise revenue from franchise stores in the Canadian operations increased by \$1.7 million or 2.1%. In the U.S. operations, merchandise revenue from franchise stores decreased by \$0.3 million or 20.1%. A reduction of one franchise during the year in the U.S. operation contributed to the decrease in merchandise revenue from franchisees. In the Canadian operations, increases in comparable store sales were partially offset by a 5.8% decrease in the average number of franchise stores in operation, contributing to the increase in merchandise revenue from franchise stores.

Initial fees, other revenues and gains on the sale of franchises in fiscal 2007 of \$0.9 million was \$0.2 million more than the prior year.

Wholesale revenue in fiscal 2007 of \$1.1 million increased by \$0.1 million as compared to the prior year.

**Gross profit**

Gross profit on sales and revenue increased by \$7.4 million or 16.9% in 2007 as compared to the previous year. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase in gross profit of \$2.1 million. Before the effects of the change in foreign currency exchange rates, gross profit in the Canadian operations increased by \$5.4 million or 16.2%. In the U.S. operations, gross profit decreased by \$0.1 million or 0.5%.

Blended gross profit margins increased to 31.3% in fiscal 2007, as compared to 29.7% in fiscal 2006. Blended gross profit margins in the U.S. stores decreased by 0.4% over the prior year. Canadian company-owned stores achieved an increase in blended gross profit margins of 0.2%.

**Store operating expenses**

Store operating expenses increased by \$1.2 million or 8.0% in fiscal 2007 as compared to fiscal 2006. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase of \$0.4 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 12.5%. In the U.S. operations, store operating expenses decreased by \$0.1 million or 1.3% compared to the prior year. On a per store basis, store operating costs decreased by 0.3% in Canada and increased by 0.7% in the U.S. Excluding a non-comparable adjustment to the promotion fund allowance, store operating costs on a per store basis in Canada increased by 2.7%. Increased store wages and bank charges contributed to the increase in store operating expenses in Canada and the U.S.

**General and administrative expenses**

General and administrative expenses increased by \$1.6 million or 12.0% in fiscal 2007 as compared to fiscal 2006. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase of \$0.8 million in general and administrative expenses. Before the effects of the change in foreign currency exchange rates, general and administrative expenses in the Canadian operations increased by \$0.8 million or 6.7%. In the U.S. operations, general and administrative expenses were consistent with the prior year. Included in the general and administrative costs of the Canadian operations for fiscal 2007 was a one time payment in relation to the employment of the CEO of the Company.

**Net interest expense**

Net interest expense decreased by \$1.4 million or 40.7% in fiscal 2007 as compared to fiscal 2006. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase of \$0.1 million in net interest expense. Before the effects of the change in foreign currency exchange rates, net interest expense in the Canadian operations decreased by \$1.3 million or 38.0%. In the U.S. operations, net interest expense decreased by \$0.2 million as compared to the prior year.

**Net income**

Net income for fiscal 2007 was \$12.4 million as compared to \$7.5 million in fiscal 2006. Net income before non-comparable items for fiscal 2007 was \$12.4 million as compared to \$8.2 million in fiscal 2006. Net income before non-comparable items increased in both U.S. and Canadian operations. The fiscal 2007 net income before non-comparable items for the Canadian operations was \$10.1 million as compared to \$6.2 million in fiscal 2006. Sales increases and improvements in blended gross profit margins were partially offset by increases in operating expenses. The fiscal 2007 net income before non-comparable items for the U.S. operations was \$2.2 million as compared to \$2.0 million in fiscal 2006. The increase was primarily due to improvements in sales.

**Comparison of Fiscal 2006 to Fiscal 2005****Store Operations**

During fiscal 2006, there was a net increase of three stores in the U.S. and a net decrease of two stores in Canada.

In fiscal 2006, the average number of stores in operation was 350, which was two stores more than the average for the prior year. In the U.S. the average number of stores in operation during fiscal 2006 was 67, which was an increase of five. The U.S. increase was offset by a decrease in the average number of stores in operation in Canada by three to 283 stores.

**System-wide sales**

During fiscal 2006, system-wide sales increased by \$14.8 million or 8.6% from the prior year to \$186.5 million. The change in foreign currency exchange rates resulted in an increase in system-wide sales from the prior year of \$9.3 million. Before the effects of the change in foreign currency exchange rates, the system-wide sales in the Canadian operations increased by \$4.0 million or 2.9%. The system-wide sales in the U.S. operations increased by \$1.5 million or 4.3%.

Comparable store sales increased by 3.5% in Canada and by 0.6% in the U.S. Factors contributing to the increase in Canada included product differentiation strategies, changes in competition, and a return to seasonal temperatures in the summer of fiscal 2006. As a result of differentiation strategies, higher margin product sales continued to show strong growth, while lower margin product sales declines have moderated. Reductions in competition in certain markets had a more positive impact on the sales than increases in competition in certain other markets. The summer of fiscal 2006 was more typical with moderate seasonal temperatures as compared to the persistent unseasonably hot weather during the summer of fiscal 2005. Canadian sales gains continued to be somewhat limited by the maturity of markets and demographic shifts. Similar factors existed in the U.S.; however, increases in competition in certain markets had a greater negative impact on overall sales than in Canada.

**Sales and revenue**

The Company's sales and revenue increased by \$12.6 million or 9.4% in fiscal 2006 as compared to fiscal 2005. In fiscal 2006, the change in foreign currency exchange rates resulted in an increase in sales and revenue of \$7.1 million. Before the effects of the change in foreign currency exchange rates, the sales and revenue in the Canadian operations increased by \$4.1 million or 4.1%. The sales and revenue from the U.S. operations increased by \$1.4 million or 4.1%. Increases in comparable store sales contributed to the increase in sales and revenue in Canada and the U.S. An increase in the average number of stores in operation in the U.S. also contributed to the increased sales and revenue from the U.S. operations.

In fiscal 2006, total merchandise sales through company-owned stores increased by \$9.2 million to \$62.2 million, accounting for an increase of 6.8% in consolidated sales and revenue. In fiscal 2006, the change in foreign currency exchange rates resulted in an increase of \$1.8 million in merchandise sales through company-owned stores. Before the effects of the change in foreign currency exchange rates, the merchandise sales through company-owned stores in the Canadian operations increased by \$5.5 million or 25.0%. In the U.S. operations, merchandise sales through company-owned stores increased by \$1.9 million or 6.2%. Increases in the average number of company-owned stores and the increase in comparable store sales contributed to the increased merchandise sales in both Canada and the U.S.

Total merchandise revenue from franchise stores increased by \$3.6 million to \$82.8 million, accounting for a 2.7% increase in consolidated sales and revenue. In fiscal 2006, the change in foreign currency exchange rates resulted in an increase of \$5.2 million in merchandise revenue from franchise stores. Before the effects of the change in foreign currency exchange rates, the merchandise revenue from franchise stores in the Canadian operations decreased by \$1.0 million or 1.4%. In the U.S. operations, merchandise revenue from franchise stores decreased by \$0.5 million or 23.4%. A reduction of one franchise during the year in the U.S. operation and a decrease of 5.8% in the average number of franchise stores open in the Canadian operation contributed to the decrease in merchandise revenue from franchisees.

Initial fees, other revenues and gains on the sale of franchises in fiscal 2006 of \$0.7 million was \$0.4 million less than the prior year.

Wholesale revenue in fiscal 2006 of \$1.0 million increased by \$0.1 million as compared to the prior year.

**Gross profit**

Gross profit on sales and revenue increased by \$6.3 million or 16.9% in 2006 as compared to the previous year. In fiscal 2006, the change in foreign currency exchange rates resulted in an increase in gross profit of \$2.1 million. Before the effects of the change in foreign currency exchange rates, gross profit in the Canadian operations increased by \$4.0 million or 14.7%. In the U.S. operations, gross profit increased by \$0.2 million or 2.3%.

Blended gross profit margins increased to 29.7% in fiscal 2006, as compared to 27.8% in fiscal 2005. Blended gross profit margins in the U.S. stores increased by 0.3% over the prior year. Canadian company-owned stores achieved an increase in blended gross profit margins of 2.3%.

**Store operating expenses**

Store operating expenses increased by \$1.0 million or 7.4% in fiscal 2006 as compared to fiscal 2005. In fiscal 2006, the change in foreign currency exchange rates resulted in an increase of \$0.5 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 \$0.3 million or 5.8%. In the U.S. operations, store operating expenses increased by \$0.2 million or 2.9% as compared to the prior year. On a per store basis, store operating costs decreased by 8.6% in Canada and decreased by 4.4% in the U.S. Excluding a non-comparable promotion fund allowance in fiscal 2005 and partial reversal in 2006, store operating costs on a per store basis in Canada increased by 3.3%. Increased store wages contributed to the increase in store operating expenses in Canada. In the U.S., decreases in wages and advertising contributed to the decrease in store operating expenses.

**General and administrative expenses**

General and administrative expenses increased by \$2.1 million or 19.4% in fiscal 2006 as compared to fiscal 2005. In fiscal 2006, the change in foreign currency exchange rates resulted in an increase of \$0.8 million in general and administrative expenses. Before the effects of the change in foreign currency exchange rates, general and administrative expenses in the Canadian operations increased by \$1.3 million. In the U.S. operations, general and administrative expenses were consistent with the prior year. Included in the general and administrative costs of the Canadian operations for fiscal 2006 were one time costs incurred in relation to the Company's refinancing efforts, increased costs in relation to the development and procurement of new wellness focused products, costs related to new executive staff and corporate facilities, and stock option compensation expense resulting from U.S. GAAP pronouncements adopted in the third quarter of fiscal 2005.

**Net interest expense**

Net interest expense decreased by \$0.4 million or 10.1% in fiscal 2006 as compared to fiscal 2005. In fiscal 2006, the change in foreign currency exchange rates resulted in an increase of \$0.2 million in net interest expense. Before the effects of the change in foreign currency exchange rates, net interest expense in the Canadian operations decreased by \$0.6 million or 14.5%. In the U.S. operations, net interest expense was consistent with the prior year.

**Net income**

Net income for fiscal 2006 was \$7.5 million as compared to \$7.3 million in fiscal 2005. Net income before non-comparable items for fiscal 2006 was \$8.2 million as compared to \$6.4 million in fiscal 2005. Net income before non-comparable items increased in both U.S. and Canadian operations. The fiscal 2006 net income before non-comparable items for the Canadian operations was \$6.2 million as compared to \$4.5 million in fiscal 2005. Sales increases and improvements in blended gross profit margins were partially offset by increases in operating expenses. The fiscal 2006 net income before non-comparable items for the U.S. operations was \$2.0 million as compared to \$1.9 million in fiscal 2004. The increase was primarily due to improvements in sales and gross profit margins.

**Liquidity and Financial Position**

At the end of fiscal 2007, the Company had non-cash working capital of \$4.4 million, which was \$3.0 million less than the non-cash working capital of \$7.4 million at the end of fiscal 2006. The reclassification from long-term to current of subordinated debentures in the amount of \$9.0 million as of December 29, 2007 contributed to the decrease in non-cash working capital in 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.

Merchandise accounts payable leveraging (trade payables over inventory) decreased to 20.1% as of December 29, 2007 as compared to 26.8% as of December 30, 2006 and 21.8% as of December 31, 2005. The Company maintains a relatively low level of leveraging due to efforts to realize increased vendor discounts and allowances.

Total assets increased by approximately \$13.6 million to \$71.9 million at December 29, 2007, as compared to \$58.3 million at the end of fiscal 2006 and \$54.6 million at the end of fiscal 2005. In fiscal 2007, the change in foreign currency exchange rates resulted in an increase of \$9.5 million in total assets. Before the effects of the change in foreign currency exchange rates, total assets in the Canadian operations increased by \$5.1 million or 11.4%. In the U.S. operations, total assets decreased by \$0.9 million. An increase in warehouse inventory levels and an increase in the number of corporate stores operating in Canada contributed to an increase in inventory of \$3.0 million for fiscal 2007 as compared to the prior year end. The acquisition of a 9.6 acre parcel of land in Ontario increased assets by \$1.9 million. Increases in the number of corporate stores in Canada resulting from the opening of new stores and repurchases of franchise stores contributed to an increase in the net book value of property and equipment of \$0.2 million and an increase in goodwill of \$0.7 million.

Cash provided by operating activities in fiscal 2007 was \$9.9 million as compared to \$10.8 million in fiscal 2006. In fiscal 2007, \$4.4 million of cash from operations was used for working capital items including an increase in inventory levels, a reduction in payables and increased income tax installments. In fiscal 2006, \$0.1 million of cash from operations was used for working capital items. Cash flow from operations in fiscal 2008 is expected to be used to finance an increase in working capital items, primarily due to increases in inventory levels and prepaid expenses due to the timing of the fiscal 2008 year end in relation to beginning of the month rent payments.

Net cash used in investing activities for fiscal 2007 was \$4.7 million as compared to \$2.6 million used in fiscal 2006. In fiscal 2007, the acquisition of land in Whitby Ontario, the development of new computer facilities, the repurchase of franchise store equipment and goodwill in Canada and leasehold improvements in existing stores all contributed to the increase in investing activities beyond normal levels for replacements of existing assets.

Net cash used in financing activities in fiscal 2007 was \$5.7 million as compared to \$7.6 million of cash used in financing activities in fiscal 2006. In fiscal 2007 the Company 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.

There were no acquisitions during fiscal 2007 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 and sold on an on-going basis. Cash flow required to support the cost of repurchasing franchise store assets was partially offset by cash received from the sale of Company-owned store assets to new franchisees.

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 intends to address these maturities in a timely manner.

### **Table of contractual obligations**

(amounts stated in thousands of US dollars)

Contractual obligations, including payments due for each of the next five years and thereafter, are shown in the following table:

	Total	2008	2009	2010	2011	2012	Payments due within the year 2013 & thereafter
Long-term debt (excluding capital lease obligations)	\$ 2,505	\$ 2,266	\$ 120	\$ 119	\$ -	\$ -	\$ -
Capital lease obligations	1,392	438	322	216	166	147	103
Operating leases	74,045	15,781	13,248	10,848	8,988	6,968	18,212
Subordinated debentures	12,769	8,995	3,774	-	-	-	-
<b>Total contractual obligations</b>	<b>\$ 90,711</b>	<b>\$ 27,480</b>	<b>\$ 17,464</b>	<b>\$ 11,183</b>	<b>\$ 9,154</b>	<b>\$ 7,115</b>	<b>\$ 18,315</b>

Included in operating leases are lease payments for store, warehouse and office facilities. The Company generally sublets store locations to its franchisees. Lease payments by franchisees offset the total operating lease payments of the Company. At the end of fiscal 2007, the total amounts assumed by franchisees for the next 5 years and thereafter was \$29.4 million.

### **Capital Resources**

On July 14, 2006, the Company entered into a new credit agreement with Bank of Montreal and Harris, N.A. (the "Credit Agreement") 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 Credit Agreement replaced a previous agreement with Bank of Montreal in effect since November 14, 2000 (as amended and extended from time to time) which provided the Company with a senior line of credit for a total borrowing capability before borrowing base calculations of C\$18.0 million. The Company is in compliance with the covenants contained in the Credit Agreement as of the date hereof.

At the end of fiscal 2007, the Company had utilized C\$3.2 million of the revolving line of credit as compared to C\$3.6 million at the end of fiscal 2006 and C\$2.2 million at the end of fiscal 2005. 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 is currently being repaid in equal monthly installments over a 24 month period.

On December 29, 2007, Pet Valu Canada Inc. had outstanding C\$8.8 million of 10% non-convertible unsecured subordinated debentures, which mature on July 24, 2008 and C\$3.7 million of 8.5% convertible unsecured subordinated debentures, which mature on December 29, 2009. Pet Valu Canada Inc. expects that it will be in a position to meet its repayment obligations in respect of the 10% debentures in the event that they mature in their entirety on July 24, 2008.

Subsequent to December 29, 2007, 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. Although the development of a new warehouse facility and new information systems are expected to be significant expenditures, there has not yet been any formal commitments made with respect to these projects.

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

There are no off-balance sheet arrangements as of December 29, 2007 or December 30, 2006.

The Company does not have any 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 and 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 risk and interest rate risk 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**

The Company's accounts receivable are primarily from the Company's franchise operators. The Company assesses this credit risk on its accounts receivable 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.

### **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.

### **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.

#### **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.

#### **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, in certain 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.

In the early part of the fourth quarter of fiscal 2007, the above-mentioned actions in British Columbia and Ontario were stayed (i.e., not permitted to proceed at this time) by the courts of those provinces. These stays were granted because of determinations by those courts that one or more other potential class action lawsuits in which the Pet Valu Companies were not named as defendants should proceed instead. While the British Columbia and Ontario actions in which the Pet Valu Companies were joined or targeted to be joined were stayed, there remains the possibility that the Pet Valu Companies could be joined as defendants in the lawsuits presently existing in Ontario and British Columbia that were not stayed.

In fiscal 2007, the Pet Valu Companies learned that a motion was to be brought to join them as defendants in a potential class action lawsuit pending in the Province of Manitoba. That lawsuit makes similar allegations to those made in the other proceedings referred to above. Subsequent to the end of fiscal 2007, the motion to add the Pet Valu Companies was adjourned by the Court and the plaintiffs have not taken further steps to have this motion heard by the Court.

As a result of the court decisions in British Columbia and Ontario, and since the plaintiffs motion to add the Pet Valu Companies has not been heard by the Manitoba Court, there are currently no lawsuits concerning the aforesaid allegedly tainted products proceeding against the Pet Valu Companies in those three provinces.

The lawsuits in Saskatchewan and Newfoundland continue to exist. Because the Pet Valu Companies do not carry on business in any Canadian provinces other than Ontario and Manitoba, they have advised plaintiff's counsel in the Saskatchewan action of their intention to bring a motion to challenge their joinder as defendants in that action on jurisdictional grounds though the motion has not yet been brought. The Pet Valu Companies are also considering bringing challenges with respect to the Newfoundland action. In the event that any of these challenges were not successful, the Pet Valu Companies will defend themselves vigorously.

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. Traditionally, fourth quarter earnings tend to be stronger due to higher store sales and increased margins, particularly in the month of December.

### **Inflation**

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

### **Market risks**

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

**Expansion Plans**

Expansion by the Company 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, to compete in existing markets, and to secure or generate adequate financial resources.

**Other Risks**

Additional risks include: the ability of the Company to successfully implement its strategic initiatives and whether such strategic initiatives will yield the expected benefits; changes in consumer spending; general economic conditions and normal business uncertainty; customer preferences toward product offerings; adverse climate changes; the occurrence of a pandemic or other catastrophic event which could create shortages of labour, products or services required to operate the business profitably; and changes in the laws, rules and regulations applicable to the Company or the markets in which the Company operates.

**Transactions with related parties**

On November 12, 2007, Pet Valu Canada Inc. repurchased the assets used in connection with the PET VALU franchise store located at 1801 Dundas Street East, Whitby, Ontario. A 50% shareholder of the franchisee corporation which owned these assets is an officer of Pet Valu Canada Inc., John Fleming. The other 50% shareholder is Mr. Fleming's spouse. Mr. Fleming is the Vice-President, Business Development of Pet Valu Canada Inc. The aggregate purchase price, subject to adjustments referred to in the agreement of purchase and sale, was C\$375,000. The decision to invest in this repurchase was based on the projected return on investment.

There were no other transactions with related parties in fiscal 2007.

**Critical accounting estimates**

The preparation of financial statements requires the Company to estimate the effect of various matters that are inherently uncertain as of the date of the financial statements. Each of these required estimates varies in regard to the level of judgment involved and its potential impact on the Company's reported financial results. Estimates are deemed critical when a different estimate could have reasonably been used or where changes in the estimate are reasonably likely to occur from period to period, and would materially impact the Company's financial condition, changes in financial condition or results of operations. The Company's significant accounting policies are discussed in Note 1 of the Notes to Consolidated Financial Statements; critical estimates inherent in these accounting policies are discussed in the following paragraphs.

**Allowance for doubtful accounts**

The Company records an allowance for doubtful accounts to reflect management's best estimate of losses inherent in its franchise accounts receivable as of the balance sheet date. This allowance is established through a charge to operating expenses and represents amounts of current and past due franchise accounts receivable balances and notes receivable balances which management estimates may not be collected. The Company calculates the allowance for doubtful accounts using a model that considers the current condition of the franchisee. The Company's calculation is then reviewed by management to assess whether, based on economic events, additional analyses are required to appropriately estimate losses. Management believes that the allowance for doubtful accounts is adequate to cover anticipated potential losses in the franchise accounts receivables; however, significant deterioration in the condition of the franchisees, or in the overall health of the economy, could materially change these expectations.

**Allowance for promotion fund deficit**

Pet Valu Canada Inc. maintains a promotion fund, which is used to offset marketing and advertising activities performed by Pet Valu Canada Inc. When the promotion fund is in a deficit position, the deficit balance is included in other receivables. An allowance for the promotion fund is recorded to reflect management's best estimate of losses inherent in the deficit balance of the promotion fund as of the balance sheet date. This allowance is established through a charge to the provision and represents amounts which management estimates may not reverse. Management prepares an estimate of the amount of the deficit that will reverse in the near term through a review of the projected marketing and advertising activities and the expected funding. The Company calculates the allowance for promotion fund as the difference between the deficit balance and the amount which will reverse in the near term as estimated by management. There is no allowance provided at December 29, 2007. An allowance was provided for the full amount of the promotion fund deficit, \$430,196, at December 30, 2006.

**Inventory valuation**

All inventories are counted as close to year-end as possible without impacting operational activities including peak pre-Christmas sales activity. Inventories are valued at the lower of cost or net realizable value, with cost determined using the retail inventory method ("RIM") under the first-in, first-out ("FIFO") cost flow assumption. Inherent in the RIM calculation are certain significant management judgments and estimates, which impact the ending inventory valuation at cost as well as resulting gross margins. The methodologies utilized by the Company in its application of the RIM are consistent for all periods presented. Such methodologies include the development of cost-to-retail ratios and the groupings of homogeneous classes of merchandise. Management believes that the application of the Company's RIM and of FIFO provides an inventory valuation which reasonably approximates cost using a first in, first out assumption, and results in carrying inventory at the lower of cost or net realizable value.

**Vendor allowances**

The Company receives allowances and rebates from its vendors through a variety of programs and arrangements. Given the promotional nature of the Company's business, the allowances are generally intended to offset the Company's direct and indirect costs of promoting (including markdowns and product margins support), advertising and selling the vendors' products in its stores. Vendor allowances are recognized as a reduction of cost of goods sold when the purpose for which the vendor funds were intended to be used has been fulfilled. Accordingly, a reduction or increase in vendor allowances has an inverse impact on cost of sales.

**Income taxes**

Deferred income tax assets and liabilities are established for temporary differences between the financial reporting bases and the income tax bases of the Company's assets and liabilities and loss carry forwards at substantively enacted tax rates expected to be in effect when such assets or liabilities are realized or settled. Deferred income tax assets are reduced by a valuation allowance if, in the judgment of the Company's management, it is more likely than not that such assets will not be realized. The Company's income tax NOL carryforwards in U.S. jurisdictions give rise to a deferred tax asset. The Company performs an evaluation of the deferred tax asset incorporating positive and negative evidence including the current and projected results of operations in the U.S. jurisdictions and based on these results a valuation allowance is recorded. In the event new circumstances make the future realization of these tax benefits more or less likely, the valuation allowance will be reduced or increased with the change either debited or credited to income, as required.

**Goodwill**

Goodwill represents the excess purchase price of acquired businesses over the fair value of the net assets acquired. The Company's goodwill relates to the leveraged buyout of the Company in 1990, a business acquired in fiscal 1998 and the repurchase of franchises. An annual impairment test is performed for each reporting unit with goodwill recorded in the unit. The test compares the fair value of the reporting unit to its carrying amount. Based on the results of this test, the Company has determined that the value of its goodwill was not impaired as of December 29, 2007.

**Changes in Accounting Policies including Initial Adoption**

In September 2006, the Financial Accounting Standards Board ("FASB") issued a statement of financial accounting standards ("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 will not have 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 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. 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.

In June 2006, FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 was effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 has not had a material effect on the Company's consolidated financial position, results of operations or cash flows.

In June 2006, FASB ratified the consensus of the Emerging Issues Task Force (EITF) Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That Is Gross versus Net Presentation)". Issue No. 06-3 states that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer including sales, use, value added and some excise taxes are an accounting policy decision. The Company excludes such taxes from the presentation of sales. The adoption of Issue 06-03 has not had a material effect on its consolidated financial position, results of operations or cash flows.

In September 2006, FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An amendment of FASB statements No. 87,88,106 and 132(R)." SFAS 158 requires that employers recognize the funded status of defined benefit pension and other postretirement benefit plans as a net asset or liability on the balance sheet and recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as a component of net periodic benefit cost. SFAS 158 requires that the funded status of the plan and the required disclosure requirements are effective for the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations was effective for fiscal years ending after December 15, 2008. The Company maintains a defined contribution 401(K) and profit sharing plan; consequently the adoption of SFAS 158 has not had a material effect on its 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 the end of fiscal 2007 and 2006. Please refer to notes 10 and 11 of the fiscal 2007 financial statements for additional information.

	<u>Mar. 14, 2008</u>	<u>Dec. 29, 2007</u>	<u>Dec. 30, 2006</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.	9,345,160	8,566,416	8,743,516
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	851,944

Subsequent to year end, Pet Valu Canada Inc. repurchased and cancelled 75,200 Exchangeable Shares under a normal course issuer bid at a cost of C\$970,240.

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

**2008 Outlook**

The Company has several key operating objectives for fiscal 2008 and thereafter.

A primary objective will be to continue the re-engineering of existing operating practices to highest industry standards. In this regard, the Company will be seeking to improve its technological systems, improve upon the performance management systems as they apply to the execution of operating practices and initiatives to realize business improvements, and continue to develop both waste reduction and energy conservation programs.

The Company plans to build upon its existing competitive strengths in relation to store service and differentiated product selection. This includes expanding the number of high quality differentiated brand name products and the continued development of specialized private label pet food formulations and pet supply products. As well, the Company plans improvements to the customer shopping experience through continued efforts to advance the level of knowledgeable service provided by store staff, improvements in the utilization of store space, and enhancements to the overall store image.

The Company intends to focus on growth strategies within existing markets. These strategies will include the expansion of the number of stores where opportunities for either acquisition or greenfield development are available and meet targeted returns. The Company also plans to expand sales in existing stores through the optimization of product offerings that are tailored to each store location.

The current franchising system in Canada, which has been in place for more than 20 years, will be reviewed during the year. The goal is to develop a system that more closely aligns the mutual interests of the franchisees with that of the Company.

The Company's financial goals include the efficient utilization of available capital by applying cash to projects that meet targeted returns. Significant capital expenditures are expected during fiscal 2008 and fiscal 2009 in relation to the development of infrastructure including the building and equipping of a new automated warehouse facility, the acquisition of small box competitor locations where feasible, the renewal of a normal course issuer bid, and the development of new systems reflecting forward looking technological improvements.

In general, the current focus of the Company will be toward generating incremental profit improvements from existing operations and creating infrastructure strengths necessary to support platforms for future growth.

While the average compound growth in earnings over the past four years exceeds 50% per annum, 2008 may not follow that trend. Projects initiated over the past four years have had fairly immediate impacts; however, many of the remaining projects, while generating high returns, require higher infrastructure investments, particularly in our staffing and equipment capabilities in the areas of information technology and systems development. In addition, projects which relate to technological improvements, have longer lead-times for completion resulting in longer periods of expense absorption prior to the realization of benefits. Most beneficial effects of these projects would occur in 2009, 2010, and thereafter. Management will attempt to prioritize some initiatives with a more immediate profit impact into the project mix, but it is difficult to predict project mix outcomes.

**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. In addition, the Company has evaluated the effectiveness of the disclosure controls and procedures as of the end of the filing period of December 29, 2007 and concluded that these controls are effective.

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 year that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## Responsibility for Financial Reporting

These consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States. Management is responsible for their integrity, objectivity and reliability and, where necessary, they reflect management's best estimates and judgements. All financial information in the annual report is consistent with the consolidated financial statements. Management is also responsible for the maintenance of financial and operating systems, which include effective controls, to provide reasonable assurance that the Company's assets are safeguarded and that reliable financial information is produced.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises these responsibilities through its Audit Committee. The Audit Committee meets with management and the independent auditors, Grant Thornton, to satisfy itself that management's responsibilities are properly discharged and to review and report to the Board on the consolidated financial statements.

In accordance with Canadian generally accepted auditing standards, the independent auditors conduct an examination each year in order to express an opinion on the consolidated financial statements.



Geoffrey F. A. Holt  
President and Chief Executive Officer



Dale Winkworth  
Vice-President, Finance and Chief Financial Officer

March 14, 2008

## Auditors' Report

To the Shareholders of Pet Valu, Inc.:

We have audited the consolidated balance sheets of Pet Valu, Inc. as at December 29, 2007 and December 30, 2006 and the consolidated statements of operations, shareholders' equity and cash flows for the fiscal years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 29, 2007 and December 30, 2006 and the results of its operations and its cash flows for the fiscal years then ended in accordance with generally accepted accounting principles in the United States of America.



Chartered Accountants  
Licensed Public Accountants  
Markham, Canada

February 29, 2008, except as to Note 17b which is as of March 5, 2008

**Consolidated Balance Sheets**

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

	December 29, 2007	December 30, 2006
<b>Assets</b>		
<b>Current assets</b>		
Cash and short-term investments	\$ 1,635,834	\$ 2,436,834
Accounts receivable	2,041,638	2,445,415
Other receivables (Note 3) (Less allowances of \$5,405, 2006 - \$430,194)	1,273,781	1,303,075
Inventories	32,541,967	25,631,495
Prepaid expenses and other assets	1,701,495	966,135
Deferred income tax assets (Note 13)	787,959	591,090
<b>Total current assets</b>	<b>39,982,674</b>	<b>33,374,044</b>
Notes receivable (Note 4) (Less allowances of \$4,724, 2005 - \$37,755)	24,192	41,541
Deferred charges (Note 1)	1,237,773	1,177,475
Property and equipment, net of accumulated depreciation and amortization (Note 5)	9,259,778	5,542,985
Goodwill (Note 1)	17,132,808	13,883,218
Deferred income taxes (Note 13)	4,273,630	4,236,523
<b>Total assets</b>	<b>\$ 71,910,855</b>	<b>\$ 58,255,786</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Bank overdraft	\$ 2,122,868	\$ 1,066,523
Bank operating loans (Note 6)	3,153,614	3,110,302
Current portion of long-term debt including capital lease obligations (Note 7)	2,625,284	2,610,596
Current portion of deferred gain on warehouse sale (Note 5)	269,080	222,117
Trade accounts payable	6,536,133	6,860,386
Accrued liabilities (Note 8)	4,597,761	3,625,373
Accrued wages and benefits	4,067,541	2,811,695
Income taxes payable (Note 13)	1,534,407	3,215,131
Subordinated debentures (Note 9)	8,995,410	-
<b>Total current liabilities</b>	<b>33,902,098</b>	<b>23,522,123</b>
Deferred franchise revenue (Note 3)	8,182	9,781
Deferred gain on warehouse sale (Note 5)	188,579	385,049
Deferred rent payable	2,629,650	2,155,726
Long-term debt including capital lease obligations, less current maturities (Note 7)	1,072,492	2,842,688
Subordinated debentures (Note 9)	3,773,585	10,743,093
<b>Total liabilities</b>	<b>41,574,586</b>	<b>39,658,460</b>
Commitments and contingencies (Notes 6, 14 & 15)		
Subsequent Events (Note 17)		
<b>Shareholders' Equity</b>		
Capital stock (Notes 10 & 11)	963	963
Additional paid in capital	19,585,169	19,802,745
Accumulated earnings	14,850,532	5,223,320
Accumulated other comprehensive loss	(3,408,410)	(5,737,717)
Treasury stock – exchangeable shares, at cost	(691,985)	(691,985)
<b>Total shareholders' equity</b>	<b>30,336,269</b>	<b>18,597,326</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 71,910,855</b>	<b>\$ 58,255,786</b>

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

Signed on behalf of the Board,

 Director

 Director

## Consolidated Statements of Operations

In accordance with accounting principles generally accepted in the United States of America  
(In U.S. dollars, except number of shares)

	Fiscal Years Ended	
	December 29, 2007	December 30, 2006
<b>Sales and revenue</b> (Note 3)	\$ 162,992,676	\$ 147,036,818
Cost of sales including occupancy costs	111,939,634	103,379,875
<b>Gross profit</b>	<b>51,053,042</b>	43,656,943
Store operating expenses excluding occupancy costs	16,312,508	15,099,524
General and administrative expenses	14,630,454	13,068,571
	<b>20,110,080</b>	15,488,848
Net interest expense (Note 12)	2,080,083	3,509,439
Loss on extinguishment of debt (Note 9)	-	1,137,799
Income before income taxes	<b>18,029,997</b>	10,841,610
Income taxes provision (Note 13)	5,648,436	3,322,244
<b>Net income</b>	<b>\$ 12,381,561</b>	<b>\$ 7,519,366</b>
Basic EPS (Note 2)	\$ 1.42	\$ 0.93
Diluted EPS (Note 2)	1.20	0.79
Weighted average number of common stock and exchangeable shares outstanding:		
Basic (Note 2)	8,733,707	8,080,304
Diluted (Note 2)	<b>10,453,559</b>	9,779,721

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

**Consolidated Statements of Shareholders' Equity**

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

	Additional Special Voting Stock	Additional Paid-in Capital	Accumulated Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity (Deficit)	Comprehensive Income (Loss)
Balance – December 31, 2005	\$ 963	\$ 12,453,589	\$ (2,296,046)	\$ (5,383,312)	\$(691,985)	\$ 4,083,209	
Comprehensive Income fiscal 2005							\$ 7,042,427
Stock-based compensation costs	-	139,682	-	-	-	139,682	
Income tax on cancellation of Warrants (Note 11)	-	(66,561)	-	-	-	(66,561)	
Issuance of Exchangeable Shares (Note 11)	-	7,276,035	-	-	-	7,276,035	
Net Income	-	-	7,519,366	-	-	7,519,366	7,519,366
Foreign currency translation Adjustments	-	-	-	(354,405)	-	(354,405)	(354,405)
Balance – December 30, 2006	\$ 963	\$ 19,802,745	\$ 5,223,320	\$ (5,737,717)	\$(691,985)	\$ 18,597,326	-
Comprehensive Income fiscal 2006							\$ 7,164,961
Stock-based compensation costs	-	145,675	-	-	-	145,675	
Repurchase of Exchangeable Shares (Note 10)	-	(617,651)	(2,754,349)	-	-	(3,372,000)	
Issuance of Exchangeable Shares (Note 11)	-	254,400	-	-	-	254,400	
Net Income	-	-	12,381,561	-	-	12,381,561	12,381,561
Foreign currency translation Adjustments	-	-	-	2,329,307	-	2,329,307	2,329,307
<b>Balance – December 29, 2007</b>	<b>\$ 963</b>	<b>\$ 19,585,169</b>	<b>\$ 14,850,532</b>	<b>\$ (3,408,410)</b>	<b>\$(691,985)</b>	<b>\$ 30,336,269</b>	<b>-</b>
<b>Comprehensive Income fiscal 2007</b>							<b>\$ 14,710,868</b>

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

**Consolidated Statements of Cash Flows**

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

	Fiscal Years Ended	
	December 29, 2007	December 30, 2006
<b>Operating activities</b>		
Net income	\$ 12,381,561	\$ 7,519,366
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,808,018	1,880,723
Deferred income taxes	(67,792)	(20,185)
Loss on disposal of property and equipment	47,242	6,772
Amortization of debenture discount	-	166,473
Loss on extinguishment of debt	-	1,139,407
Stock based compensation costs	143,981	139,797
Deferred charges	244,775	31,356
Amortization of deferred gain on warehouse sale	(240,751)	(228,248)
Write off of goodwill on store closures	7,934	105,600
Changes in other operating assets and liabilities:		
Decrease (increase) in receivables	968,377	(618,257)
Increase in inventories	(2,688,850)	(1,914,920)
Increase in prepaid expenses	(552,684)	(39,242)
(Decrease) increase in trade accounts payable	(1,279,228)	1,704,257
Increase in accrued liabilities	1,241,167	281,965
(Decrease) increase in income taxes payable	(2,089,320)	635,145
Net cash provided by operating activities	9,924,430	10,790,009
<b>Investing activities</b>		
Purchases of property and equipment	(4,135,537)	(2,227,125)
Proceeds on disposal of property and equipment	17,080	25,184
Purchase of store goodwill	(642,352)	(427,322)
Notes and other receivables	19,824	14,885
Net cash used in investing activities	(4,740,985)	(2,614,378)
<b>Financing activities</b>		
(Repayment) borrowing of short-term financing	(495,375)	1,286,265
Increase (decrease) in bank overdraft	779,898	(503,202)
Repayment of capital lease obligation	(365,592)	(369,856)
Issuance of Exchangeable Shares	266,648	7,276,037
Repayment of note payable	(120,281)	(121,581)
(Repayment) borrowing of term loan financing	(2,360,970)	3,943,827
Repurchase of Exchangeable Shares	(3,372,000)	-
Tax on cancellation of warrants	-	(66,561)
Repayment of debentures	-	(26,794,712)
Issuance of 10% non convertible debentures	-	7,792,208
Net cash used in financing activities	(5,667,672)	(7,557,575)
Effect of exchange rate changes on cash	(316,773)	145,070
Net (decrease) increase in cash	(801,000)	763,126
<b>Cash and short-term investments – Beginning of fiscal year</b>	<b>2,436,834</b>	<b>1,673,708</b>
<b>Cash and short-term investments – End of fiscal year</b>	<b>\$ 1,635,834</b>	<b>\$ 2,436,834</b>

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

## Notes to Consolidated Financial Statements

For the fiscal years ended December 29, 2007 and December 30, 2006

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

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

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

### 1. Significant Accounting Policies

**Background** Pet Valu, Inc. was incorporated in Delaware, U.S.A. on February 28, 1996 and is a specialty retailer and wholesaler of pet food and pet-related supplies and a franchiser of pet food and pet-related supply products. The operations now carried on through Pet Valu, Inc. and its subsidiaries began in 1976 in Ontario, Canada and in 1995 in the U.S. As of December 29, 2007, Pet Valu, Inc. and its subsidiaries had 189 franchised and 92 company-owned stores in Ontario and Manitoba (Canada) and 2 franchised and 60 company-owned stores in Maryland, Virginia, Pennsylvania and New Jersey (U.S.). These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP").

**Principles of Consolidation** The consolidated financial statements include the accounts of Pet Valu, Inc., its subsidiaries, Pet Valu Canada Inc., Pet Valu International Inc. and Realty Management Systems Inc., and subsidiaries of Pet Valu Canada Inc., including Paulmac's Pet Food Inc., All Pet Enterprises Limited, and Peton Distributors Inc. (collectively, the "Company"). All significant intercompany transactions and balances are eliminated on consolidation.

**Fiscal Year-end** The Company operates under a 52-week fiscal year ending on the Saturday nearest December 31. The consolidated financial statements for the years ended December 29, 2007 (fiscal 2007) and December 30, 2006 (fiscal 2006) each consisted of 52 weeks.

**Fair Value of Financial Instruments** 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, term loan and other notes payable approximated 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.

**Business and Credit Risk Concentration** Financial instruments which potentially subject the Company to concentrations of credit risk are cash and short-term investments and notes receivable. The Company's deposits are with various high quality financial institutions. The Company is dependent on key suppliers to provide sufficient quantities of inventory at competitive prices. The Company does not currently have any key suppliers who provide greater than 10% of the Company's inventory requirements.

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.

The bank operating loans and certain other loans and notes are subject to variable interest rates. The Company does not engage in hedging and, therefore, is subject to interest rate risk.

**Use of Estimates** The presentation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

**Cash and Short-term Investments** Cash and short-term investments included cash on hand, cash balances with banks and short-term investments in overnight deposit instruments with the Company's lender. Interest rates pertaining to the short-term investments range from 3.5% to 5.2%.

## 1. Significant Accounting Policies (Continued)

**Inventories and Cost of Sales** Merchandise inventories are valued at the lower of cost or net realizable value. Cost is determined utilizing the retail inventory method of accounting under the first in first out cost flow assumption and includes certain distribution and buying costs relating to the processing of merchandise. Cost of sales includes the cost of merchandise, plus store occupancy costs and certain foreign currency transaction gains/losses. Foreign currency gains included in cost of sales were \$779,498 and \$2,628 in fiscal 2007 and 2006, respectively.

The Company accounts for vendor rebates and allowances using EITF No. 02-16, "Accounting by a Reseller for Cash Consideration Received from a Vendor by a Customer (Including a Reseller of the Vendor's Products)". EITF 02-16 provides guidance on how the cash consideration received by a customer from a vendor should be classified in the customer's statement of income. The Company includes vendor rebates in the cost of sale or inventory as appropriate when the purchases occur.

**Property and Equipment** Property and equipment are stated at cost. Additions and improvements are capitalized, while repairs and maintenance are charged to expense as incurred. The straight-line method of depreciation is used for financial reporting purposes. Estimated useful lives (or remaining lease life) are as follows:

Buildings	25 years
Furniture and fixtures	3 to 10 years
Automotive equipment	5 to 10 years
Leasehold improvements	Over the shorter of the useful life or the remaining term of the lease (not exceeding 11 years)
Internally-developed software	5 years

The Company accounts for internally-developed software according to Statement of Financial Position ("SOP") 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." All capitalized software costs meet the characteristics of SOP 98-1. In particular, the software was internally developed or modified with the sole purpose of meeting the Company's internal requirements and neither at the time of development nor currently are there substantive plans to market the software externally.

During the year there were additions of \$392,464 to leasehold improvements that were not amortized as the assets were not available for service as of December 29, 2007.

**Long-Lived Assets** The Company accounts for long-lived assets using Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for Impairment and Disposal of Long-lived Assets." SFAS No. 144 requires that long-lived assets and certain identifiable intangibles to be held and used by the Company be reviewed for possible impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, future cash flows expected to result from the use of the asset and its disposition must be estimated. If the undiscounted value of the future cash flows is less than the carrying amount of the asset, impairment is recognized. Management has reviewed its property and equipment for impairment and believes that there has been no impairment of the Company's long-lived assets.

**Goodwill** The Company accounts for goodwill using SFAS No. 141 "Business Combination", and SFAS No. 142 "Goodwill and Intangible Assets". SFAS No. 141 requires the use of the purchase method of accounting for business combinations and prohibits the use of the pooling of interests method. SFAS No. 141 also refines the definition of intangible assets acquired in a purchase business combination.

Goodwill represents the excess purchase price of acquired businesses over the fair value of the net assets acquired. Goodwill as shown on the consolidated balance sheets of the Company relates to the leveraged buyout of the Company in 1990, a business acquired in fiscal 1998 and the repurchase of franchises. In 2007, additions to goodwill amounted to \$642,352 (2006-\$427,322) in relation to the acquisition of franchises. It is the Company's policy to write-off goodwill related to reacquired stores when the store ceases operation. In 2007, a loss of \$7,934 was recorded on the disposal of goodwill (2006-\$105,600). When a store is refranchised, any goodwill recorded at the time the store was previously reacquired is included in the cost of assets sold.

## 1. Significant Accounting Policies (Continued)

Impairment tests were performed as of December 29, 2007 and December 30, 2006. Fair value was determined on a discounted cash flow calculation. Based on the results of these tests, the Company determined that its goodwill was not impaired. Goodwill is not subject to amortization.

**Deferred Charges** Debt issuance costs relating to the debentures referred to in Note 9 are recorded as deferred charges and are amortized over the term of the debentures on a straight-line basis. As of December 29, 2007 and December 30, 2006, the unamortized balance was \$40,919 and \$95,631 respectively.

Deferred financing costs relating to the senior line of credit referred to in Note 6 are recorded as deferred charges and are amortized over the term of the credit agreement. As of December 29, 2007 and December 30, 2006 the unamortized balance was \$108,383 and \$116,934, respectively.

The Company has various lease agreements which include scheduled rent increases over the non-cancelable lease term. Rent expense for such leases is recognized on a straight-line basis over the related lease term. The excess of rent expense over the actual cash paid is recorded as deferred rent payable. The Company has entered into sublease arrangements with its Canadian franchisees and has recognized revenues on a straight-line basis resulting in deferred rents receivable, which are also included in deferred charges.

**Revenue Recognition** The Company recognizes revenue from retail sales through company-owned stores, wholesale sales to other retailers, and revenues from its franchise operations. All revenues are recorded net of sales and use taxes.

Retail sales through company-owned stores are recognized at the time of sale. Wholesale sales to other retailers are recognized at the time of delivery.

The Company has individual franchise agreements which grant the individual franchisees the exclusive right to operate a franchise store. Initial site development fees, established business fees and franchise fees are collected in advance and recorded as income when the store commences operations as a franchise location. All initial fees are earned on the date of the store opening. On the sale of an existing company-owned store to a franchisee, costs relating to the sale of the store are charged to expense as incurred and proceeds (excluding fees) in excess of the net book value of store assets sold to the franchisee are recorded as a gain on the date of sale.

Ongoing revenue from Canadian franchise operations is comprised of royalties, percentage rents, franchise fees, fees for services, and wholesale merchandise sales. Royalties and percentage rents are based on the gross sales or imputed gross sales of the franchise and are recorded in income as earned. Franchise fees are non-refundable. Accordingly, revenue is recognized when the fees are collected. Fees for service are recognized when the service has been performed by the Company. Canadian franchisees purchase the majority of their inventory from the Company. Accordingly, the Company recognizes revenue from the wholesale sale of merchandise to these franchisees at the time of delivery.

Under the U.S. franchising system, the Company retains ownership of all inventories and recognizes revenue and records related expenses upon the sale of merchandise at the retail level. U.S. franchisees purchase the store equipment and are responsible for store operating costs, including labour for which they receive an allowance from the Company. In addition, U.S. franchisees are paid a royalty based on merchandise sales and compliance with operational standards. Royalties and store operating cost allowances paid by the Company to U.S. franchisees are recorded as store operating expenses.

**Stock-based Compensation Plans** The Company has stock-based compensation plans which are described in Note 11. The Company accounts for stock-based compensation using SFAS No. 123(R) "Stock Based Compensation". Under SFAS No. 123(R), the Company is required to use a fair value method for estimating the value of the stock options and to record compensation costs for any stock option outstanding for which the requisite service period has not yet been completed. Any consideration paid upon exercise of options and the issue of shares is credited to share capital.

## 1. Significant Accounting Policies (Continued)

**Income Taxes** The Company accounts for income taxes using SFAS No. 109, "Accounting for Income Taxes". SFAS No. 109 uses an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns as well as tax credit carryforwards and loss carryforwards. These deferred taxes are measured by applying substantively enacted tax rates. Future tax benefits, such as loss carryforwards, are recognized to the extent that such benefits are more likely than not to be realized during the carryforward period.

The Company adopted FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes" (FIN 48), on December 31, 2006. FIN 48 is an interpretation of SFAS No. 109, "Accounting for Income Taxes". Beginning fiscal 2007, the Company records the financial statement effects of an income tax position when it is more likely than not, based on the technical merits, that it will be sustained upon examination. A tax position that meets the more-likely-than-not recognition threshold is measured and recorded as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority. Previously recognized tax positions are derecognized in the first period in which it is no longer more likely than not that the tax position will be sustained. The benefit associated with previously unrecognized tax positions are generally recognized in the first period in which the more-likely-than-not threshold is met at the reporting date, the tax matter is ultimately settled through negotiation or litigation or when the related statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired. The recognition, derecognition, and measurement of tax positions are based on management's best judgment given the facts, circumstances and information available at the reporting date.

Differences between a tax position taken or expected to be taken in the Company's tax returns and the amount of benefit recognized and measured in the financial statements result in unrecognized tax benefits, which are recorded in the balance sheet as either a liability for unrecognized tax benefits or reductions to recorded tax assets, as applicable. Interest and penalties are accrued with respect to unrecognized tax benefits in accordance with the legislation of the respective taxing jurisdictions, which are recognized as a component of interest expense. As of December 29, 2007, there was no interest or penalties related to unrecognized tax benefits recorded in interest expense.

The adoption of FIN 48 did not have an impact in the Company's statements of operations and financial position and did not result in a cumulative adjustment in retained earnings at adoption.

During the year ended December 29, 2007, the Company recognized expenses related to interest and penalties totaling \$234,917 (2006 - \$167,892). The Company had no accrual for interest and penalties as of December 29, 2007 and December 30, 2006.

The Company and its subsidiaries file income tax returns in the United States and Canada. All taxation years after 1995 are subject to examination.

**Foreign Currency Translation** Pursuant to SFAS No. 52, "Foreign Currency Translation", the functional currency of the Canadian operations is Canadian dollars, the functional currency of the U.S. operations is U.S. dollars, and the reporting currency for the consolidated operations is U.S. dollars. Accordingly, the assets and liabilities of the Company's Canadian operating subsidiary, Pet Valu Canada Inc., are recorded in the functional currency of Canadian dollars and are translated into the reporting currency at the rate of exchange as of the balance sheet date. Revenues and expenses are translated at the average rates of exchange for the period of operation. Gains and losses arising from the translation are deferred and classified as a foreign currency translation adjustment within accumulated other comprehensive income.

**Store Pre-opening Costs** All costs associated with the opening of new stores are charged to expense as incurred.

**Advertising Costs** Advertising costs are charged to expense as incurred. Advertising expense was \$701,329 and \$845,587 in fiscal 2007 and 2006, respectively. In 2007, the entire remaining balance of the allowance for promotion fund deficit in the amount of \$466,283 was reversed and included as a reduction in advertising expense. In 2006, a partial reversal of the allowance for promotion fund deficit in the amount of \$179,371 was included as a reduction to advertising expense.

## 1. Significant Accounting Policies (Continued)

### Recently Issued 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 will not have 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 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. 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.

### Newly Adopted Accounting Standards

In June 2006, FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 was effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 has not had a material effect on the Company's consolidated financial position, results of operations or cash flows.

## 1. Significant Accounting Policies (Continued)

In June 2006, FASB ratified the consensus of the Emerging Issues Task Force (EITF) Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That Is Gross versus Net Presentation)". Issue No. 06-3 states that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer including sales, use, value added and some excise taxes are an accounting policy decision. The Company excludes such taxes from the presentation of sales. The adoption of Issue 06-03 has not had a material effect on the Company's consolidated financial position, results of operations or cash flows.

In September 2006, FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An amendment of FASB statements No. 87,88,106 and 132(R)." SFAS 158 requires that employers recognize the funded status of defined benefit pension and other postretirement benefit plans as a net asset or liability on the balance sheet and recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as a component of net periodic benefit cost. SFAS 158 requires that the funded status of the plan and the required disclosure requirements are effective for the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations was effective for fiscal years ending after December 15, 2008. The Company maintains a defined contribution 401(K) and profit sharing plan; consequently the adoption of SFAS 158 has not had a material effect on its consolidated financial position, results of operations or cash flows.

### Supplemental Cash Flow Information

	Fiscal Years Ended	
	December 29, 2007	December 30, 2006
Interest paid	\$ 2,029,607	\$ 3,193,845
Income taxes paid	\$ 8,316,128	\$ 3,110,702
Income taxes refunded	\$ 503,869	\$ 342,889

Non-cash investing and financing activities:

Capital lease obligations of \$382,568 and \$346,359 were entered into during fiscal 2007 and 2006, respectively.

## 2. Net Earnings per Share

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

In order to reflect the economic substance of the Company's capital structure, the computation of basic EPS is based on the aggregate number of shares of common stock of Pet Valu, Inc. ("Common Stock") and exchangeable shares of its subsidiary, Pet Valu Canada Inc. ("Exchangeable Shares"), excluding treasury stock. Diluted EPS is based on the diluted effect of equity and debt instruments convertible into either Common Stock or Exchangeable Shares (see Note 10).

In fiscal 2007 and fiscal 2006, 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 and warrants to purchase 1,331,894 Exchangeable Shares and/or Common Stock were outstanding on December 29, 2007 (December 30, 2006 – 1,454,394)(see Note 11). 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.

## 2. Net Earnings per Share (Continued)

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

	December 29, 2007	December 30, 2006
Net income for the year	\$ 12,381,561	\$ 7,519,366
Net income applicable to holders of Common Stock and Exchangeable Shares		
Basic	\$ 12,381,561	\$ 7,519,366
Interest on 8.5% debenture	188,851	175,761
Diluted	\$ 12,570,412	\$ 7,695,127
Basic EPS	\$ 1.42	\$ 0.93
Diluted EPS	\$ 1.20	\$ 0.79
Weighted average number of Common Stock and Exchangeable Shares outstanding:		
Basic	8,733,707	8,080,304
Effect of dilutive stock options outstanding	370,294	392,476
Effect of dilutive warrants outstanding	676,831	634,214
Effect of conversion of 8.5% debenture	672,727	672,727
Diluted	10,453,559	9,779,721

## 3. Franchise Operations

Included in other receivables were net amounts due from franchisees of \$1,182,609 and \$1,036,541 as of December 29, 2007 and December 30, 2006, respectively.

Included in sales and revenue were the following amounts with respect to Canadian franchise operations:

	Fiscal Years Ended	
	December 29, 2007	December 30, 2006
Merchandise sales to franchisees	\$ 69,120,000	\$ 64,688,000
Distribution charges	6,072,000	5,589,000
Initial franchise fees	317,000	259,000
Gain on sale of company-owned stores	8,000	10,000
Franchise royalties and other revenues	12,700,000	11,418,000
	\$ 88,217,000	\$ 81,964,000

In fiscal 2007 and 2006, the Company earned initial franchise fees and gains on the sale of company-owned stores of \$1,307 and \$11,031 respectively, through its U.S. franchise operations. Retail sales of merchandise through U.S. franchise stores were \$1,348,048 and \$1,686,152 in fiscal 2007 and 2006, respectively, and were included in sales and revenue. Royalties and other fees paid to U.S. franchisees in the amount of \$264,199 for fiscal 2007 and \$395,156 for fiscal 2006 were included in store operating expenses excluding occupancy costs.

### Promotion Fund

The Company's Canadian franchisees contribute a percentage of their weekly merchandise purchases to a promotion fund. This fund is used to offset marketing and advertising activities performed by the Company. Collections for this fund are made in accordance with the terms of applicable agreements made with each franchisee. The percentage of franchise merchandise purchases designated for the promotion fund is determined at the discretion of the Company, subject to certain restrictions contained in the franchise agreements.

### 3. Franchise Operations (Continued)

A deficit balance in the promotion fund may occur when the cumulative cost of marketing and advertising activities exceed the cumulative franchise funding. These differences can be short-term in nature, caused by timing of marketing and advertising activities in a given year as compared to franchise funding for that year, or long-term as part of strategic uses of the fund. The promotion fund had a deficit balance of \$112,854 and \$430,194 at the end of fiscal 2007 and 2006, respectively. During fiscal 2007 and 2006, the Company reduced marketing and advertising activities; as a result of the reduced activities, a recovery in the promotion fund deficit was obtained in the amount of \$466,283 (2006-\$179,371). The Company has reviewed the marketing and advertising activities, and the expected funding for the near term and concluded that due to the planned strategic uses of the fund, the deficit balance at the end of fiscal 2007 is expected to reverse in the near term. Accordingly, the Company has reversed the entire allowance for the promotion fund deficit in the amount of \$466,283. At the end of fiscal 2006, the Company maintained an allowance of \$430,194.

#### Bank Comfort Letters

On many occasions when requested by a lending institution, Pet Valu Canada Inc. has provided a comfort letter for the purpose of assisting franchisees in securing financing. In the comfort letter, Pet Valu Canada Inc. states that it will agree to purchase certain inventory and equipment necessary for the operation of the store at book value less 15% in the case where the lending institution is forced to realize on its security.

### 4. Notes Receivable

Notes receivable included loans in the amount of \$28,916 and \$77,933 as of December 29, 2007 and December 30, 2006, respectively. The loans bore interest at a rate of prime plus 3% for Canadian franchisees (9.00% at December 29, 2007 and December 30, 2006). These notes were provided to various franchisees in connection with the purchase of their franchises and to provide working capital. The loans are for various terms not exceeding seven years.

### 5. Property and Equipment

	December 29, 2007	December 30, 2006
Land	\$ 2,078,174	\$ 80,404
Buildings	1,202,482	994,537
Furniture and fixtures	13,480,169	11,990,843
Automotive equipment	3,376,400	2,938,705
Leasehold improvements	4,578,705	3,153,506
Internally-developed software	1,569,450	1,328,805
	<b>26,285,380</b>	20,486,800
Less: Accumulated depreciation and amortization	17,025,602	14,943,815
	<b>\$ 9,259,778</b>	<b>\$ 5,542,985</b>

During fiscal 2007 and 2006, the Company recorded depreciation and amortization expense related to property and equipment of \$1,808,018 and \$1,880,723 respectively.

In 1999, the Company sold and leased back five of its Canadian warehouses. The sale resulted in gross proceeds of \$6,972,010 and a deferred pre-tax gain of \$1,759,075. The deferred gain is being amortized into income over the term of the various leases.

During the year there were additions of \$392,464 to leasehold improvements that were not amortized, as the assets were not placed in service as of December 29, 2007.

## 6. Bank Operating Loans

In July 2006, the Company entered into an amended and restated credit agreement with Bank of Montreal and Harris, N.A. The credit agreement provides the Company with a C\$15,000,000 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 of C\$15 million and a borrowing base calculation related to inventories and franchise receivables. On December 29, 2007 the borrowings outstanding under the credit facility, the borrowing base and the resulting availability were \$3,153,614 (2006-\$3,110,302), C\$15,000,000 (2006-C\$15,000,000), and C\$11,907,880 (2006- C\$11,375,254), respectively. Interest on the revolving line of credit is calculated using the bank's prime rate plus 0.25% per annum. The interest rates at December 29, 2007 were 6.25% for Canadian dollar borrowings and 8.0% for U.S. dollar borrowings. In addition, a fee of 0.25% is charged on the unused portion of the credit facility. (2006-0.25%)

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

Pursuant to the above agreement, in addition to its borrowing base restrictions, the Company must comply with certain general covenants which include, among others, a minimum consolidated debt service ratio. The Company was in compliance with the covenants at December 29, 2007.

## 7. Long-term Debt

	December 29, 2007			December 30, 2006		
	Long-term	Current	Total	Long-term	Current	Total
Bank term loan	\$ -	\$2,124,766	\$ 2,124,766	\$ 1,787,655	\$2,145,186	\$ 3,932,841
Term loan	-	-	-	-	5,148	5,148
Supplier notes payable	236,989	118,494	355,483	331,212	110,404	441,616
Other notes payable	1,839	22,962	24,801	28,030	32,803	60,833
Capitalized lease obligations	833,664	359,062	1,192,726	695,791	317,055	1,012,846
<b>Total</b>	<b>\$ 1,072,492</b>	<b>\$2,625,284</b>	<b>\$ 3,697,776</b>	<b>\$ 2,842,688</b>	<b>\$2,610,596</b>	<b>\$ 5,453,284</b>

### Bank Term Loan

The bank term loan is part of the amended and restated credit agreement (see Note 6). The loan bears interest at prime plus 1% (7% at December 29, 2007) and matures September 30, 2008. The loan is repayable in 24 equal monthly installments.

### Term Loan

The term loan bore interest at 8%. The loan matured in 2007 and was secured by a mortgage on a certain property.

### 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 (6% at December 29, 2007) and U.S. prime for U.S. dollar borrowings within the United States (7.25% at December 29, 2007), 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.

## 7. Long-term Debt (Continued)

### 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 \$2,014,021 and \$1,928,660 as at December 29, 2007 and December 30, 2006, respectively. Accumulated depreciation relating to these assets was \$872,489 and \$938,798 as at December 29, 2007 and December 30, 2006, respectively.

Future repayments are as follows:

	Bank Term Loans	Supplier Notes Payable	Other Notes Payable	Capitalized Lease Obligations	Total
2008	\$ 2,124,766	\$ 118,494	\$ 22,962	\$ 438,230	\$ 2,704,452
2009	-	118,494	1,839	321,361	441,694
2010	-	118,495	-	216,339	334,834
2011	-	-	-	166,065	166,065
2012	-	-	-	146,610	146,610
2013	-	-	-	102,809	102,809
2014	-	-	-	495	495
	\$ 2,124,766	\$ 355,483	\$ 24,801	\$ 1,391,909	\$ 3,896,959
Less: Interest	-	-	-	199,183	199,183
Current Maturities	2,124,766	118,494	22,962	359,062	2,625,284
<b>Total</b>	<b>\$ -</b>	<b>\$ 236,989</b>	<b>\$ 1,839</b>	<b>\$ 833,664</b>	<b>\$ 1,072,492</b>

## 8. Accrued Liabilities

	December 29, 2007	December 30, 2006
Accrued interest	\$ 357,989	\$ 264,146
Accrued rent, common area maintenance and realty taxes	866,631	869,516
Sales and use taxes	1,001,695	732,311
Supplies and services	2,371,446	1,759,400
	<b>\$ 4,597,761</b>	<b>\$ 3,625,373</b>

## 9. Subordinated Debentures

	December 29, 2007			December 30, 2006		
	Face Value (Converted from C\$)	Unamortized Discount	Net	Face Value (Converted from C\$)	Unamortized Discount	Net
8.5% subordinated (non-convertible)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
12.5% subordinated (non-convertible)	-	-	-	-	-	-
8.5% subordinate (convertible)	3,773,585	-	3,773,585	3,174,876	-	3,174,876
10% subordinate (non-convertible)	8,995,410	-	8,995,410	7,568,217	-	7,568,217
	<b>\$12,768,995</b>	<b>\$ -</b>	<b>\$12,768,995</b>	<b>\$10,743,093</b>	<b>\$ -</b>	<b>\$10,743,093</b>
Balance Sheet Classification						
Current	8,995,410	-	8,995,410	-	-	-
Non-Current	3,773,585	-	3,773,585	10,743,093	-	10,743,093
	<b>\$12,768,995</b>	<b>\$ -</b>	<b>\$12,768,995</b>	<b>\$10,743,093</b>	<b>\$ -</b>	<b>\$10,743,093</b>

### (a) 8.5% Non-Convertible

In fiscal 1996, Pet Valu Canada Inc. raised C\$15,054,788 through the sale of units to its subscribing Common and Exchangeable Shareholders (see Note 10). Each unit consisted of one C\$7.50 principal amount 8.5% non-convertible subordinated unsecured debenture of Pet Valu Canada Inc. due July 24, 2006 and one Exchangeable Share purchase warrant (see Note 11) of Pet Valu Canada Inc. The fair value of these warrants was allocated to shareholders' equity, resulting in a debenture discount of \$700,831 (C\$963,506), which was amortized over the remaining term of the debentures. Amortization of \$49,322 (C\$55,936) was included in net interest expense for fiscal 2006. Repayment to the debenture trustee and in certain cases to debenture holders directly was made on July 24, 2006 with proceeds from a private placement of 10% non-convertible unsecured subordinated debentures (see Note 9(d)) and availability from the bank revolving line of credit.

### (b) 12.5% Non-Convertible

In fiscal 2004, Pet Valu Canada Inc. issued to Penfund Mezzanine Limited Partnership II ("Penfund") a C\$15,000,000 secured subordinated debenture and share purchase warrants entitling Penfund to purchase up to 924,200 Exchangeable Shares. The fair value of these warrants at the time of issue was \$624,767 (C\$793,829), which was allocated to shareholders' equity, and deducted as a debenture discount, which was being amortized over the five year term of the debenture. Amortization of \$116,917 (C\$132,595) was included in net interest expense for fiscal 2006. As a result of the repayment of C\$2,627,934 of the debentures referred to in Note 9(c), 47,256 of the warrants issued to Penfund referred to above were cancelled on March 31, 2005. On October 31, 2006, the Company prepaid the entire principal amount of the 12.5% non-convertible subordinated debenture held by Penfund which was otherwise due on September 30, 2009. On the date of repayment, the unamortized discount was C\$462,776. In addition to the principal, a prepayment premium of C\$150,000 was also paid. The Company was also required to write off the deferred charges of C\$677,602 related to the arrangement of the debt financing. As a result of the prepayment, the Company recognized a loss on extinguishment of debt of \$1,137,799 (C\$1,290,378).

## 9. Subordinated Debentures (Continued)

### (c) 8.5% Convertible

In fiscal 1999, an agreement was completed creating new 8.5% convertible subordinated unsecured debentures of Pet Valu Canada Inc. in the amount of C\$6,327,934. These debentures replaced certain existing 7% convertible debentures and one non-convertible unsecured debenture together with a corresponding exchangeable share purchase warrant (see Note 11).

These debentures are convertible, at any time, into Exchangeable Shares at a conversion price of C\$5.50 per share and are repayable by Pet Valu Canada Inc. on the terms specified in the applicable debenture holder agreement. Debentures totaling C\$2,627,934, along with accrued interest thereon, were repaid in fiscal 2005. The balance of C\$3,700,000 is due in 2009. Interest on this debenture is paid quarterly.

### (d) 10% Non-convertible

A private placement of 10% non-convertible unsecured subordinated debentures of Pet Valu Canada Inc. and guaranteed by Pet Valu, Inc. in the principal amount of C\$8,820,000 was completed on July 24, 2006. The proceeds from the private placement and availability from the bank revolving line of credit were used to make repayment to the debenture trustee and, in certain cases, the debenture holders directly of C\$15,054,788 of the 8.5% debentures which matured 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.

The investors in the private placement included, among others, certain directors and/or officers of Pet Valu, Inc. and Pet Valu Canada, directly or indirectly. In particular, Geoffrey Holt, who is a director and officer of both companies, invested C\$5,000,000 through Holtcorp, a personal holding company; Douglas Lunau, who is a director of both companies, invested C\$3,000,000 through the Lunau Family Trust; Breena Holt, who is a director of both companies and a consultant to Pet Valu Canada, invested C\$150,000; Darryl Squires, who is a director of both companies, invested C\$20,000; and John Turner, who is an officer and part-time employee of Pet Valu Canada, invested C\$150,000. Interest paid to the related parties in fiscal 2007 was C\$832,000 (2006-C\$157,282). 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 is now C\$4,500,000 and that of Lunau Family Trust is now C\$3,500,000.

## 10. 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

	December 29, 2007		December 30, 2006	
	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		19,585,169		19,802,745
		<b>19,586,132</b>		<b>19,803,708</b>

## 10. Capital Stock (Continued)

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

### Pet Valu Canada Inc. Shares

				<b>December 29, 2007</b>	December 30, 2006
	<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	8,920,116	8,566,416	<b>8,566,416</b>	8,743,516
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 December 29, 2007 and December 30, 2006, 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 December 29, 2007 and December 30, 2006, in treasury at cost.

Pet Valu Canada Inc. repurchased and cancelled 299,600 Exchangeable Shares during fiscal 2007 under a normal course issuer bid for cash in the amount of \$3,372,000 (C\$3,762,460). No shares were repurchased in fiscal 2006.

## 11. 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 877,610 Exchangeable Shares of Pet Valu Canada Inc. for issuance pursuant to its Plans of which 397,660 are available for grant.

## 11. Stock Options and Warrants (Continued)

There were no Common Stock and Exchangeable Share options granted in fiscal 2007. The weighted average fair value of the Common Stock and Exchangeable Share options granted in fiscal 2006 was \$1.52 per share. The fair value of the Common Stock and Exchangeable Share options granted is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions:

	Fiscal years ended	
	December 29, 2007	December 30, 2006
Expected dividend rate	-	0%
Expected volatility	-	40%
Weighted average risk-free interest rate	-	4.0%
Expected lives (years)	-	4 to 8

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

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

As of December 29, 2007, there were 15,000 Board options vested and exercisable and 422,950 Executive options vested and exercisable with weighted average exercise prices of C\$3.06 and C\$2.97, 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 31, 2005	675,600	1.16 – 3.28	2.78
Granted	10,000	4.99	4.99
Exercised	(79,150)	1.16 – 3.28	2.60
Cancelled	(4,000)	1.16 – 2.75	1.96
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	\$ 1.30 – 4.99	\$ 2.97

The weighted average remaining term of options outstanding at December 29, 2007 was 2.52 years.

The following table summarizes information about stock options outstanding at December 29, 2007:

Range of exercise price	Options Outstanding	Weighted Average Remaining Contractual Life(yrs)	Options outstanding		Options exercisable	
			Average Exercise Price	Weighted Price	Options Exercisable	Weighted Average Exercise Price
\$ 1.30 – 1.46	5,720	3.05	\$ 1.44		3,720	\$1.43
2.06	50,000	6.89	2.06		30,000	2.06
2.75	2,000	0.04	2.75		2,000	2.75
2.80	195,730	1.98	2.80		195,730	2.80
3.26	20,000	3.37	3.26		8,000	3.26
3.28	196,500	1.79	3.28		196,500	3.28
4.99	10,000	4.07	4.99		2,000	4.99
	479,950				437,950	

## 11. Stock Options and Warrants (Continued)

### Warrants

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

In fiscal 2006, 25,000 of the Tranche A Warrants were exercised. On December 29, 2007 and December 30, 2006, 785,411 Tranche A Warrants and 66,533 Tranche B Warrants remained outstanding (see Note 17 b).

During fiscal 1996, Pet Valu Canada Inc. issued 2,007,305 warrants in connection with the 8.5% non-convertible subordinated unsecured debentures (see Note 9a). Each warrant entitled the holder to purchase one Exchangeable Share at a price equal to the greater of (i) C\$7.00; or (ii) the then current market price of an Exchangeable Share on the Toronto Stock Exchange less C\$7.00, at any time on or before July 24, 2006, subject to adjustment under certain events, as defined. In fiscal 2006, there were 1,138,208 warrants exercised for total proceeds of C\$7,967,456. The remaining 869,097 warrants expired unexercised.

## 12. Net Interest Expense

Net interest expense is comprised of:

	Fiscal years ended	
	December 29, 2007	December 30, 2006
Interest on bank indebtedness	\$ 471,798	\$ 249,918
Interest and penalties on taxes	234,917	167,892
Amortization of financing costs	94,245	228,470
Interest on notes payable and bank term loan	243,364	117,730
Interest on debentures	1,109,767	2,638,154
Amortization of debenture discount	-	166,239
Interest income	(74,008)	(58,964)
Interest expense, net	\$ 2,080,083	\$ 3,509,439

## 13. Income Taxes

Provisions for federal, state and foreign income taxes in the consolidated statements of operations consist of the following components:

	Fiscal years ended					
	December 29, 2007			December 30, 2006		
	Current	Deferred	Total	Current	Deferred	Total
U.S. federal taxes	\$ 27,541	\$ 288,300	\$ 315,841	\$ 21,951	\$ 634,971	\$ 656,922
U.S. state taxes	9,203	730,624	739,827	8,375	153,077	161,452
Non-U.S. taxes	5,665,752	70,626	5,736,378	3,312,356	133,791	3,446,147
Provision for income taxes before valuation allowance	5,702,496	1,089,550	6,792,046	3,342,682	921,839	4,264,521
Decrease in valuation allowance	-	(1,143,610)	(1,143,610)	-	(942,277)	(942,277)
Provision for income taxes	\$ 5,702,496	\$ (54,060)	\$ 5,648,436	\$ 3,342,682	\$ (20,438)	\$ 3,322,244

**13. Income Taxes (continued)**

In assessing the Company's ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company believes that there is sufficient positive evidence including the taxable income recorded in fiscal 2007 and 2006 and projected future taxable income to conclude that it is more likely than not that it will realize a portion of its deferred tax assets.

The Company's net deferred tax balance before valuation allowance was \$10,671,948. The deferred tax balance decreased by \$890,613 because the Company utilized net operating losses to reduce current year taxes. In addition, the deferred tax balance decreased by \$252,997 due to the expiration of state net operating losses and other adjustments.

The balance of the increase in the deferred tax assets relates to the Canadian operations.

The provision for income tax differs from the amount computed by applying the U.S. federal income tax rate of 34% as a result of the following:

	Fiscal years ended			
	December 29, 2007		December 30, 2006	
	Dollars	Percent	Dollars	Percent
Computed expected income tax expense	\$ 6,130,199	34.0%	\$ 3,686,147	34.0%
Permanent differences:				
Foreign exchange	(276,960)	(1.5)%	2,385	(0.0)%
Debt discount amortization	-	0.0%	103,718	1.0%
State income taxes net of federal benefit	488,286	2.7%	106,558	1.0%
Foreign tax rate differential	334,111	1.9%	187,713	1.7%
Other, net	116,410	0.6%	178,000	1.6%
Valuation allowance	(1,143,610)	(6.3)%	(942,277)	(8.7)%
Provision (benefit) for income taxes	\$ 5,648,436	31.4%	\$ 3,322,244	30.6%

The tax effects of temporary timing differences that give rise to significant portions of the deferred income tax assets and liabilities are as follows:

	December 29, 2007	December 30, 2006
Deferred tax assets:		
Loss carryforwards	\$ 9,166,243	\$ 10,205,790
Other items	2,066,070	1,760,529
Deferred tax assets before valuation allowance	11,232,313	11,966,319
Valuation allowance	(5,610,359)	(6,753,969)
Total deferred tax assets	5,621,954	5,212,350
Deferred tax liabilities:		
Intangible assets, net	(560,365)	(384,737)
Total deferred tax liabilities	(560,365)	(384,737)
Net deferred tax asset	\$ 5,061,589	\$ 4,827,613

Balance Sheet Classification	December 29, 2007	December 30, 2006
Current	\$ 787,959	\$ 591,090
Non-current	4,273,630	4,236,523
	\$ 5,061,589	\$ 4,827,613

**13. Income Taxes (continued)**

At December 29, 2007, the Company has available Canadian and U.S. federal and state net operating loss carryforwards of \$24,495,518 which can be carried forward through the years 2011-2026 and have been tax effected as per above.

**14. Commitments****Leases**

The Company had rental obligations, excluding certain realty tax, maintenance and other expenses on its office, warehouse and store premises, of the following annual amounts as of December 29, 2007:

	Assumed by Franchisees	Property Leases	Equipment Operating Leases	Total
2008	\$ 7,194,000	\$ 8,467,000	\$ 119,594	\$ 15,780,594
2009	5,902,000	7,277,000	69,157	13,248,157
2010	4,722,000	6,082,000	43,630	10,847,630
2011	3,936,000	5,008,000	43,630	8,987,630
2012	2,902,000	4,030,000	36,614	6,968,614
2013 and thereafter	4,741,000	13,441,000	30,495	18,212,495
	\$ 29,397,000	\$ 44,305,000	\$ 343,120	\$ 74,045,120

Rental expense for fiscal 2007 and 2006 was \$8,406,385 and \$7,567,285, respectively. This included contingent rents of \$29,154 in 2006. This is net of rent recoveries related to sublease arrangements with franchisees. In addition, total rent recovered from franchisees in fiscal 2007 and 2006 was \$6,865,911 and \$6,531,113, respectively. The Company is responsible for any lease obligations of the Company not met by franchisees. Store leases typically have an initial term of five years, with two five-year renewal options.

**15. Contingencies**

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

**16. Employee Savings Plan**

The Company maintains a defined contribution 401(K) and profit sharing plan which permits eligible employees who have completed one year of service and attained the age of 21 to make contributions by salary reduction of up to 60% of compensation. Under the plan, the Company makes mandatory matching contributions and discretionary profit sharing contributions. Matching contributions equal 50% of the first 6% of compensation that is contributed by each participating employee. Matching contributions vest at a rate of 20% per year, over the first 5 years of service. In connection with the required matching, the Company portion was \$77,793 and \$75,553 during fiscal 2007 and 2006, respectively. There have been no discretionary profit sharing contributions since the inception of the plan.

**17. Subsequent Events**

- a. Subsequent to year end, Pet Valu Canada Inc. repurchased and cancelled 75,200 Exchangeable Shares under a normal course issuer bid at a cost of C\$970,240.
- b. On March 5, 2008, 785,411 Tranche A Warrants and 66,533 Tranche B Warrants were exercised for proceeds of C\$1,936,754 (see Note 11).

## 18. Segmented Financial Information

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

Operating results and other financial data by segment for fiscal 2007 and 2006 were as follows:  
(in thousands of U.S. dollars)

	Fiscal years ended	
	December 29, 2007	December 30, 2006
Sales and revenue to external customers		
Canada	\$ 127,078	\$ 111,801
U.S.	35,915	35,236
<b>Total sales and revenue</b>	<b>\$ 162,993</b>	<b>\$ 147,037</b>
Net interest expense		
Canada	\$ 2,101	\$ 3,555
U.S.	(21)	(46)
<b>Total net interest expense</b>	<b>\$ 2,080</b>	<b>\$ 3,509</b>
Net Income		
Canada	\$ 10,481	\$ 5,880
U.S.	2,346	2,111
Intersegment elimination	(445)	(472)
<b>Total net income</b>	<b>\$ 12,382</b>	<b>\$ 7,519</b>
Depreciation and amortization		
Canada	\$ 1,396	\$ 1,481
U.S.	412	400
<b>Total depreciation and amortization</b>	<b>\$ 1,808</b>	<b>\$ 1,881</b>
Purchases of property and equipment		
Canada	\$ 3,793	\$ 1,725
U.S.	343	502
<b>Total purchases of property and equipment</b>	<b>\$ 4,136</b>	<b>\$ 2,227</b>

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

	December 29, 2007	December 30, 2006
Total assets		
Canada	\$ 118,401	\$ 95,165
U.S.	17,007	15,498
Intersegment elimination	(63,497)	(52,407)
<b>Total assets</b>	<b>\$ 71,911</b>	<b>\$ 58,256</b>
Capital assets and goodwill		
Canada	\$ 24,881	\$ 17,818
U.S.	1,512	1,608
<b>Total capital assets and goodwill</b>	<b>\$ 26,393</b>	<b>\$ 19,426</b>

## Corporate Directory

### Board Members\*

C. Ian Ross<sup>2</sup>  
Chairman<sup>3,4,5</sup>  
Director,  
Ontario Power Generation Inc.

Geoffrey F. A. Holt  
Board Member<sup>3,4,5</sup>  
Chief Executive Officer<sup>3,4,5</sup>  
President<sup>3,5</sup>

Gary Goertz<sup>1</sup>  
Board Member<sup>3,4,5</sup>  
Retired Executive  
Director,  
World Heart Corporation

Breana L. Holt  
Board Member<sup>3,4,5</sup>

Tony Iordanis<sup>1</sup>  
Board Member<sup>3,4,5</sup>  
Executive Vice-President,  
Picture Homes Millennium Inc.

Douglas Lunau<sup>2</sup>  
Board Member<sup>3,4,5</sup>  
Retired Executive  
Director,  
Menu Foods Gen Par Limited

Darryl Squires<sup>1,2</sup>  
Board Member<sup>3,4,5</sup>  
President,  
The Lake Partnership Inc.

### Officers

Ed Casey  
President and Chief Operating Officer<sup>4</sup>

David Stauble  
President and Chief Operating Officer,  
Peton Distributors Inc.  
Senior Vice-President, Merchandising<sup>4</sup>

Angelo Intorre  
Executive Vice-President<sup>5</sup>

John Turner  
Senior Vice-President,  
Business Development<sup>4,5</sup>

Michael Fitzgerald  
Secretary<sup>3,4,5</sup>  
Vice-President, Senior Counsel<sup>4</sup>

Dale Winkworth  
Vice-President, Finance and Chief Financial Officer<sup>3,4</sup>  
Vice-President<sup>5</sup>

Wayne Balsinger  
Vice-President, Accounting<sup>3</sup>  
Vice-President, Finance and Chief Financial Officer<sup>5</sup>

Jack Handa  
Vice-President, Information Technology and  
Systems and Chief Information Officer<sup>4</sup>

Carole Holt  
Treasurer<sup>3,4,5</sup>

John Fleming  
Vice-President,  
Business Development<sup>4,5</sup>

Christine A. Martin-Bevilacqua  
Vice-President, Human Resources<sup>4</sup>

Brian McKeown  
Vice-President, Corporate Security  
and Loss Prevention<sup>4,5</sup>

Denis McLaughlin  
Vice-President, Merchandising Pet  
Nutrition<sup>4</sup>

Phil Policelli  
Vice-President,  
Warehousing and Distribution<sup>4</sup>

Steve Rifle  
Vice-President, Real Estate<sup>4</sup>

Deborah Barook  
Assistant Vice-President,  
Senior Associate Counsel<sup>4</sup>

John Watson  
Assistant Vice-President,  
Marketing and Sales Planning<sup>4</sup>

Jim Young  
Assistant Vice-President,  
Store Operations<sup>4</sup>

Alexandra Moulard  
Assistant Vice-President,  
Senior Associate Counsel<sup>4</sup>

\* Term of office of all directors expires on the date of the annual meeting of stockholders of Pet Valu, Inc., namely, May 8, 2008. For information as to nominees for election on that date, please refer to Pet Valu, Inc.'s management information circular with respect to that meeting of stockholders.

1. Member of Audit Committee
2. Member of Corporate Governance and Compensation Committee
3. Pet Valu, Inc.
4. Pet Valu Canada Inc.
5. Pet Valu International Inc.

### Executive Offices

7300 Warden Ave., Suite 106  
Markham, Ontario  
L3R 9Z6  
905-946-1200  
Fax: 905-946-0658

U.S. Corporate Office

489 Devon Park Drive, Suite 320  
Wayne, PA 19087  
610-225-0800  
Fax: 610-225-0822

### Annual Meeting

Pet Valu, Inc.  
The Toronto Board of Trade  
77 Adelaide Street West  
First Canadian Place  
Toronto, Ontario  
May 8, 2008 – 2:30 pm

### Stock Exchange Listing

Toronto

### Stock Trading Symbol

PVC

### Auditors

Grant Thornton LLP  
15 Allstate Parkway, Suite 200  
Markham, Ontario  
L3R 5B4

### Fiscal Year End

Saturday closest to  
December 31

### Transfer Agent and Registrar

CIBC Mellon Trust Company  
Toronto, Ontario

