

VCA ANTECH INC
Form 424B1
January 30, 2003

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10,050,000 Shares Common Stock

This is an offering of shares of common stock of VCA Antech, Inc. This prospectus relates to an offering of 10,050,000 shares.

VCA Antech, Inc. is offering 3,300,000 shares of the shares to be sold in this offering. The selling stockholders identified in this prospectus are offering an additional 6,750,000 shares. VCA Antech, Inc. will not receive any proceeds from the sale of shares by the selling stockholders.

Our common stock is quoted on The Nasdaq Stock Market's National Market under the symbol WOOF. The last reported sale price of our common stock on January 29, 2003 was \$15.49 per share.

See *Risk Factors* beginning on page 10 to read about the factors you should consider before buying shares of our common stock.

Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

	Per Share	Total
Initial price to public	\$ 15.25	\$ 153,262,500.00
Underwriting discount	\$ 0.76	\$ 7,638,000.00
Proceeds, before expenses, to VCA Antech, Inc.	\$ 14.49	\$ 47,817,000.00
Proceeds, before expenses, to the selling stockholders	\$ 14.49	\$ 97,807,500.00

To the extent that the underwriters sell more than 10,050,000 shares of common stock, the underwriters have the option to purchase up to an additional 1,507,500 shares from VCA Antech, Inc. and the selling stockholders at the initial price less the underwriting discount.

The underwriters expect to deliver the shares against payment in New York, New York on February 4, 2003.

Joint Book-Running Managers

Credit Suisse First Boston

Goldman, Sachs & Co.

**Banc of America Securities LLC
Salomon Smith Barney
Jefferies & Company, Inc.**

Wells Fargo Securities, LLC

Prospectus dated January 29, 2003.

DESCRIPTION OF ARTWORK:

The artwork includes the VCA Antech logo, VCA Animal Hospitals logo and Antech Diagnostics logo. The gatefold also includes pictures of a VCA animal hospital, a VCA veterinarian performing a surgical procedure, a VCA laboratory and a VCA laboratory worker. The following text is contained on this artwork: VCA Animal Hospitals: Largest network of free standing animal hospitals in the nation; 225* hospitals in 33 states. * as of September 30, 2002; Antech Diagnostics: Largest network of veterinary diagnostic laboratories in the nation; Established infrastructure serving 13,000 animal hospitals in all 50 states; 83 veterinary specialist consultants; Capitalizing on growing demand for diagnostics in veterinary medicine.

PROSPECTUS SUMMARY

You should read the following summary together with the more detailed information regarding our company and the common stock sold in this offering and our consolidated financial statements and notes to those statements appearing elsewhere in this prospectus. We urge you to read this entire prospectus carefully, including the Risk Factors section.

VCA Antech, Inc.

Our Business

We are a leading animal health care services company and operate the largest networks of veterinary diagnostic laboratories and free-standing, full-service animal hospitals in the United States. Our network of veterinary diagnostic laboratories provides sophisticated testing and consulting services used by veterinarians in the detection, diagnosis, evaluation, monitoring, treatment and prevention of diseases and other conditions affecting animals. Our network of animal hospitals offers a full range of general medical and surgical services for companion animals. We treat diseases and injuries, provide pharmaceutical products and offer a variety of pet wellness programs, including routine vaccinations, health examinations, diagnostic testing, spaying, neutering and dental care.

Diagnostic Laboratories

We operate the only full-service, veterinary diagnostic laboratory network serving all 50 states. Our 19 state-of-the-art, automated diagnostic laboratories service a diverse client base of over 13,000 animal hospitals, and non-affiliated animal hospitals generated approximately 95% of our laboratory revenue in 2001. We support our laboratories with what we believe is the industry's largest transportation network, which picks up an average of 20,000 to 25,000 samples daily. In the nine months ended September 30, 2002, we derived approximately 70.1% of our laboratory revenue from our clients in major metropolitan areas, where we offer twice-a-day pick-up service and same-day results. Outside of these areas, we typically provide test results to veterinarians before 8:00 a.m. the following day.

Our diagnostic spectrum includes over 300 different tests in the areas of chemistry, pathology, endocrinology, hematology and microbiology, as well as tests specific to particular diseases. In 2001, we handled approximately 6.9 million requisitions and performed approximately 18.3 million tests. Although modified to address the particular requirements of the species tested, the tests performed in our veterinary laboratories are similar to those performed in human clinical laboratories and utilize similar laboratory equipment and technologies.

From 1999 through the twelve months ended September 30, 2002, our laboratory revenue, laboratory operating income and laboratory operating income before depreciation and amortization increased at compounded annual growth rates of 14.5%, 24.0% and 20.6%, respectively. We will refer to operating income before depreciation and amortization as EBITDA. In the twelve months ended September 30, 2002, our laboratory operating income was \$50.7 million, or 33.8% of our laboratory revenue, and our laboratory EBITDA was \$54.0 million, or 36.1% of our laboratory revenue.

Animal Hospitals

At September 30, 2002, we operated 225 animal hospitals in 33 states that were supported by over 750 veterinarians. In addition to general medical and surgical services, we offer specialized treatments for companion animals, including advanced diagnostic services, internal medicine, oncology, ophthalmology, dermatology and cardiology. We also provide pharmaceutical products for

use in the delivery of treatments by our veterinarians and pet owners. Our facilities typically are located in high-traffic, densely populated areas and have an established reputation in the community with a stable client base. Since 2000, our animal hospitals have been connected to an enterprise-wide management information system. This system provides us opportunities to manage our animal hospitals more effectively and to implement throughout our animal hospital network veterinarian practices and procedures that we have identified, tested and believe to provide a high level of client care.

From 1999 through the twelve months ended September 30, 2002, our animal hospital revenue, animal hospital operating income and our animal hospital EBITDA increased at compounded annual growth rates of 10.9%, 25.6% and 18.9%, respectively. In the twelve months ended September 30, 2002, our animal hospital operating income was \$50.1 million, or 17.3% of our animal hospital revenue, and our animal hospital EBITDA was \$60.0 million, or 20.7% of our animal hospital revenue.

Our Opportunity

We intend to continue to grow by capitalizing on the following market opportunities:

Large, Growing Market. According to the 2001-2002 American Pet Products Manufacturers Association Pet Owners Survey, the ownership of pets is widespread, with over 62% of U.S. households owning at least one pet, including companion and other animals. The U.S. population of companion animals is approximately 188 million, including about 141 million dogs and cats. According to the U.S. Pet Ownership & Demographics Sourcebook published by the American Veterinary Medical Association, over \$11 billion was spent on companion animal health care services in 1996, with an annual growth rate of over 9.5% from 1991 through 1996 for spending on dogs and cats. We believe this growth is primarily driven by an increased emphasis on pet health and wellness, continued technological developments driving new and previously unconsidered diagnostic tests, procedures and treatments, and favorable demographic trends supporting a growing pet population.

Rapidly Growing Veterinary Diagnostic Testing Services. We believe that outsourced diagnostic testing is among the fastest growing segments of the animal health care services industry. Reflecting this trend, our laboratory internal revenue growth has averaged 11.4% over the last three fiscal years. The growth in outsourced diagnostic testing resulted from an overall increase in the number of tests requisitioned by veterinarians and from veterinarians' increased reliance on outsourced diagnostic testing rather than in-house testing. The overall increase in the number of tests performed is primarily due to the growing focus by veterinarians on wellness and monitoring programs, the emphasis in veterinary education on utilizing diagnostic tests for more accurate diagnoses and continued technological developments in veterinary medicine leading to new and improved tests. The increased utilization of outsourced testing is primarily due to the relative low cost and high accuracy rates provided by outside laboratories and the diagnostic consulting provided by experts employed by the leading outside laboratories.

Attractive Client Payment Dynamics. The animal health care services industry does not experience the problems of extended payment collection cycles or pricing pressures from third-party payors faced by human health care providers. Outsourced laboratory testing is a wholesale business that collects payments directly from animal hospitals, generally on terms requiring payment within 30 days of the date the charge is invoiced. Fees for animal hospital services are due and typically paid for at the time of the service. For example, over 95% of our animal hospital services are paid for in cash or by credit card at the time of the service. In addition, over the past three fiscal years, our bad debt expense has averaged only 1% of total revenue.

Competitive Strengths

We believe we are well positioned for profitable growth due to the following competitive strengths:

Market Leader. We are a market leader in each of the business segments in which we operate. We maintain the only veterinary diagnostic laboratory network serving all 50 states, which is supported by the largest group of consulting veterinary specialists in the industry. Our network of animal hospitals and veterinarians is the largest in the United States. We believe that it would be difficult, time consuming and expensive for new entrants or existing competitors to assemble a comparable nationwide laboratory or animal hospital network.

Compelling Business Model. The fixed cost nature of our business allows us to generate strong margins, particularly on incremental revenues. In each quarter since 1999, we have generated positive laboratory internal revenue growth. The growth in our laboratory revenue, combined with greater utilization of our infrastructure, has enabled us to improve our laboratory operating margin from 27.1% in 1999 to 33.8% for the twelve months ended September 30, 2002, and our laboratory adjusted EBITDA margin from 31.2% to 36.1% over the same period. In each quarter since 1999, we have generated positive animal hospital same-facility revenue growth. Due to the operating leverage associated with our animal hospital business, the increase in animal hospital revenue has enabled us to improve our animal hospital operating margin from 12.3% in 1999 to 17.3% for the twelve months ended September 30, 2002, and our animal hospital adjusted EBITDA margin from 17.1% to 20.7% over the same period. These high margins, combined with our modest working capital needs and low maintenance capital expenditures, provide cash that we can use for acquisitions or to reduce indebtedness.

Leading Team of Specialists. We believe our laboratories are a valuable diagnostic resource for veterinarians. Due to the trend towards offering specialized services in veterinary medicine, our network of 83 specialists, which includes veterinarians, chemists and other scientists with expertise in fields such as pathology, internal medicine, oncology, cardiology, dermatology, neurology and endocrinology, provides us with a significant competitive advantage. These specialists are available to consult with our laboratory clients, providing a compelling reason for them to use our laboratories rather than those of our competitors, most of whom offer no comparable service. Our team of specialists represents the largest interactive source for readily available diagnostic advice in the veterinary industry and interact with animal health care professionals over 90,000 times a year.

High Quality Service Provider. We believe that we have built a reputation as a trusted animal health brand among veterinarians and pet owners alike. In our laboratories, we maintain rigorous quality assurance programs to ensure the accuracy of reported results. We calibrate our laboratory equipment several times daily with test specimens of known concentration or reactivity to assure accuracy and use only qualified personnel to perform testing. Further, our specialists review all test results outside of the range of established norms. As a result of these measures, we believe our diagnostic accuracy rate is over 99%. In our animal hospitals, we provide continuing education programs, promote the sharing of professional knowledge and expertise and have developed and implemented a program of best practices to promote quality medical care.

Shared Expertise Among Veterinarians. We believe our group of animal hospitals and veterinarians provide us with a competitive advantage through our collective expertise and experience. Our veterinarians consult with other veterinarians in our network to share information regarding the practice of veterinary medicine, which continues to expand our collective knowledge. We maintain an internal continuing education program for our veterinarians and have an established infrastructure for the dissemination of information on new developments in diagnostic testing, procedures and treatment programs.

Business Strategy

Our business strategy is to continue to expand our market leadership in animal health care services through our diagnostic laboratories and animal hospitals. Key elements of our strategy include:

Capitalizing on Our Leading Market Position to Generate Revenue Growth. Our leading market position in each of our business segments positions us to take advantage of favorable growth trends in the animal health care services industry. In our laboratories, we seek to generate revenue growth by capitalizing on the growing number of outsourced diagnostic tests and by increasing our market share. In our animal hospitals, we seek to generate revenue growth by capitalizing on the growing emphasis on pet health and wellness and favorable demographic trends supporting a growing pet population.

Leveraging Established Infrastructure to Improve Margins. Due to our established networks and the fixed cost nature of our business model, we are able to realize high margins on incremental revenues from both laboratory and animal hospital clients. For example, given that our nationwide transportation network servicing our laboratory clients is a relatively fixed cost, we are able to achieve significantly higher margins on most incremental tests ordered by the same client when picked up by our couriers at the same time. We estimate that in most cases, we realize an operating and EBITDA margin between 60% and 75% on these incremental tests.

Utilizing Enterprise-Wide Systems to Improve Operating Efficiencies. In 2001, we completed the migration of our animal hospital operations to an enterprise-wide management information system. This common system has enabled us to effectively manage the key operating metrics that drive our business. We use this system to help standardize our pricing, implement and monitor the effectiveness of targeted marketing programs, expand the services provided by our veterinarians and capture unbilled services.

Pursuing Selected Acquisitions. Although we have substantially completed our laboratory infrastructure, we may make selective, strategic laboratory acquisitions, with any new operations likely to be merged into existing facilities. Additionally, the fragmentation of the animal hospital industry provides us with significant expansion opportunities in our animal hospital segment. Depending on the attractiveness of the candidates and the strategic fit with our existing operations, we intend to acquire approximately 15 to 25 animal hospitals per year primarily utilizing internally generated cash.

Business Risks

Some of the key risks associated with our business strategy include:

Continued Growth. Our success depends, in part, on our ability to build on our position as a leading animal health care services company through a balanced program of internal growth initiatives and selective acquisitions of established animal hospitals and laboratories. We may be unable to successfully execute our growth strategy and, as a result, our business may be harmed.

Management of Growth. Our business and results of operations may be adversely affected if we are unable to manage our growth effectively, which may increase our costs of operations and hinder our ability to execute our business strategy.

Substantial Debt. Our substantial amount of debt, including senior and secured debt, as well as the guarantees of our subsidiaries and the security interests in our assets, could impair our ability to operate our business effectively and may limit our ability to take advantage of business opportunities.

Concentration of Ownership. Concentration of ownership among our existing executive officers, directors and principal stockholders may inhibit new investors from influencing significant corporate decisions. These stockholders will be able to significantly affect our management, our policies and all matters requiring stockholder approval.

Fixed Costs. A significant percentage of our expenses, particularly rent and personnel costs, are fixed costs and are based in part on expectations of revenue. We may be unable to reduce spending in a timely manner to compensate for any significant fluctuations in our revenues.

Our principal offices are located at 12401 West Olympic Boulevard, Los Angeles, California 90064-1022. Our telephone number is (310) 571-6500.

The Offering

Common stock offered	10,050,000 shares
By us	3,300,000 shares
By the selling stockholders	6,750,000 shares
Over-allotment granted	1,507,500 shares
By us	500,000 shares
By the selling stockholders	1,007,500 shares
Common stock to be outstanding after this offering	40,060,975 shares
Use of proceeds	We intend to use the net proceeds from this offering to repay indebtedness and for general corporate purposes. We will not receive any proceeds from the sale of shares by the selling stockholders.
Nasdaq National Market symbol	WOOF

Unless otherwise indicated, all share information in this prospectus is based on the number of shares outstanding as of September 30, 2002 and:

excludes 1,955,901 shares of common stock issuable upon exercise of outstanding options under our stock incentive plans, at a weighted average exercise price of \$9.95 per share;

excludes 650,000 shares available for future issuance under our stock incentive plans; and

assumes no exercise of the underwriters' over-allotment option.

Summary Consolidated Financial Data

The summary financial data for the years in the periods ended December 31, 2001, 2000 and 1999 were derived from our audited financial statements. The summary financial data for the nine month periods ended September 30, 2002 and 2001 were derived from our unaudited financial statements and include, in the opinion of management, all adjustments necessary for a fair presentation of our financial position and operating results for these periods and as of those dates. Our results for the interim periods are not necessarily indicative of our results for a full year's operations. The pro forma statement of operations data adjusts the financial data to give effect to this offering, our initial public offering, concurrent note offering by one of our wholly owned subsidiaries and the application of the net proceeds therefrom and the use of \$12.3 million cash on hand, as more fully described in note (2) below. You should read the following information together with Selected Historical Consolidated Financial Data,

Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this prospectus.

	Nine Months Ended September 30,		Year Ended December 31,		
	2002	2001	2001	2000	1999
(dollars in thousands)					
Statements of Operations Data:					
Laboratory revenue	\$ 116,911	\$ 101,855	\$ 134,711	\$ 119,300	\$ 103,282
Animal hospital revenue	225,383	207,665	272,113	240,624	217,988
Total revenue (1)	336,892	305,365	401,362	354,687	320,560
Operating income	75,000	33,680	27,706	19,205	47,016
Net income (loss) available to common stockholders	23,165	(22,368)	(46,574)	(13,802)	22,357
Pro forma net income (loss) available to common stockholders (2)	25,791		(24,130)		
Other Financial Data:					
Adjusted EBITDA (3) (4)	\$ 84,330	\$ 70,892	\$ 89,505	\$ 73,526	\$ 64,445
Adjusted EBITDA margin (5)	25.0%	23.2%	22.3%	20.7%	20.1%
Adjusted laboratory EBITDA (6)	\$ 43,734	\$ 35,264	\$ 45,561	\$ 38,827	\$ 32,273
Adjusted laboratory EBITDA margin (6)	37.4%	34.6%	33.8%	32.5%	31.2%
Adjusted animal hospital EBITDA (7)	\$ 49,472	\$ 43,159	\$ 53,658	\$ 42,985	\$ 37,237
Adjusted animal hospital EBITDA margin (7)	22.0%	20.8%	19.7%	17.9%	17.1%
Net cash provided by operating activities	\$ 60,838	\$ 49,316	\$ 57,104	\$ 60,054	\$ 38,467
Net cash used in investing activities	(29,700)	(30,331)	(36,202)	(47,679)	(13,676)
Net cash used in financing activities	(5,883)	(5,873)	(24,318)	(12,476)	(23,148)
Capital expenditures	13,405	9,929	13,481	22,555	21,803
Operating Data:					
Laboratory internal revenue growth (8)	14.8%	11.5%	12.5%	12.6%	9.1%
Animal hospital same-facility revenue growth (9)	3.6%	4.4%	5.0%	7.0%	2.6%

As of September 30, 2002

	Actual	As Adjusted (10)	Pro Forma As Adjusted (11)
Balance Sheet Data:			
Cash and cash equivalents	\$ 32,358	\$ 7,602	\$ 13,978
Total assets	513,380	489,984	499,019
Total debt	388,834	373,048	339,346
Total stockholders' equity	64,914	59,339	102,076

- (1) Includes other revenue of \$1.5 million for each of the nine months ended September 30, 2002 and 2001, and \$2.0 million, \$925,000 and \$5.1 million for the years ended December 31, 2001, 2000 and 1999. Total revenue is net of intercompany eliminations of \$6.9 million and \$5.7 million for the nine months ended September 30, 2002 and 2001, and \$7.5 million, \$6.2 million and \$5.8 million for the years ended December 31, 2001, 2000 and 1999.

- (2) The pro forma statement of operations data for the nine months ended September 30, 2002 and the year ended December 31, 2001 are presented as if this offering, our initial public offering, concurrent note offering by one of our wholly owned subsidiaries and the application of the net proceeds therefrom, and our use of \$12.3 million of cash on hand, which occurred in November 2001, occurred on January 1, 2001.
- (3) EBITDA is operating income before depreciation and amortization. Adjusted EBITDA for the 2001 and 2000 periods represents EBITDA adjusted to exclude non-cash compensation and management fees paid pursuant to our management services agreement with Leonard Green & Partners, which was terminated in November 2001. Adjusted EBITDA for the 2001 periods also excludes agreement termination costs and write-down of assets. Adjusted EBITDA for the 2000 period also excludes recapitalization costs. Adjusted EBITDA for the 1999 period represents EBITDA adjusted to exclude Year 2000 remediation expense and other non-cash operating items. No adjustments were made to the EBITDA calculations for 2002.

EBITDA and adjusted EBITDA are not measures of financial performance under generally accepted accounting principles, or GAAP. EBITDA should not be considered in isolation or as a substitute for net income, cash flows from operating activities and other income or cash flow statement data prepared in accordance with GAAP, or as a measure of profitability or liquidity. We believe EBITDA is a useful measure of our operating performance as it reflects earnings before the impact of items that may change from period to period for reasons not directly related to our operations, such as the depreciation and amortization, interest and taxes and other non-operating or non-recurring items. EBITDA also is an important component of the financial ratios included in our debt covenants and provides us with a measure of our ability to service our debt and meet capital expenditure requirements from our operating results. Our calculation of EBITDA may not be comparable to similarly titled measures reported by other companies.

The calculation of EBITDA and adjusted EBITDA is shown below (dollars in thousands):

	Nine Months Ended September 30,		Year Ended December 31,		
	2002	2001	2001	2000	1999
Operating income	\$ 75,000	\$ 33,680	\$ 27,706	\$ 19,205	\$ 47,016
Depreciation and amortization	9,330	19,121	25,166	18,878	16,463
EBITDA	84,330	52,801	52,872	38,083	63,479
Management fees (a)		1,860	2,273	620	
Agreement termination costs			17,552		
Recapitalization costs				34,268	
Year 2000 remediation expense					2,839
Other non-cash operating items (b)		16,231	16,808	555	(1,873)
Adjusted EBITDA	\$ 84,330	\$ 70,892	\$ 89,505	\$ 73,526	\$ 64,445

(a) Management fees were paid pursuant to our management services agreement and are included in selling, general and administrative expense in our statements of operations. Effective November 27, 2001, the parties terminated the management services agreement.

(b) Other non-cash operating items include a write-down of assets of \$8.6 million and non-cash compensation of \$1.4 million included in direct costs and \$6.2 million included in selling, general and administrative expense for the nine months ended September 30, 2001; a write-down of assets of \$9.2 million and non-cash compensation of \$1.4 million included in direct costs and \$6.2 million included in selling, general and administrative expense for the year ended December 31, 2001; non-cash compensation of \$103,000 included in direct costs and \$452,000 included in selling, general and administrative expense for the year ended December 31, 2000 and reversal of restructuring charges of \$1.9 million for the year ended December 31, 1999.

- (4) Adjusted EBITDA is the sum of adjusted laboratory EBITDA, adjusted animal hospital EBITDA and other revenue, less corporate selling, general and administrative expense, excluding non-cash compensation and management fees and including the effect of gain (loss) on sale of assets.

The calculation of adjusted EBITDA is shown below (dollars in thousands):

	Nine Months Ended September 30,		Year Ended December 31,		
	2002	2001	2001	2000	1999
Adjusted laboratory EBITDA	\$ 43,734	\$ 35,264	\$ 45,561	\$ 38,827	\$ 32,273
Adjusted animal hospital EBITDA	49,472	43,159	53,658	42,985	37,237
Other revenue	1,500	1,500	2,000	925	5,100
Corporate selling, general and administrative expense (a)	(10,456)	(8,906)	(11,832)	(9,211)	(10,165)
Gain (loss) on sale of assets	80	(125)	118		
Adjusted EBITDA	\$ 84,330	\$ 70,892	\$ 89,505	\$ 73,526	\$ 64,445

- (a) Corporate selling, general and administrative expense excludes non-cash compensation of \$771,000 and management fees of \$1.9 million for the nine months ended September 30, 2001, non-cash compensation of \$771,000 and management fees of \$2.3 million for the year ended December 31, 2001; and non-cash compensation of \$56,000 and management fees of \$620,000 for the year ended December 31, 2000. Management fees were paid pursuant to our management services agreement. Effective November 27, 2001, the parties terminated the management services agreement.

- (5) Adjusted EBITDA margin is calculated by dividing adjusted EBITDA by total revenue.
- (6) Adjusted laboratory EBITDA excludes non-cash compensation of \$4.3 million for the nine months ended September 30, 2001, and non-cash compensation of \$4.3 million and \$311,000 for the years ended December 31, 2001 and 2000. Adjusted laboratory EBITDA margin is calculated by dividing adjusted laboratory EBITDA by laboratory revenue.
- (7) Adjusted animal hospital EBITDA excludes non-cash compensation of \$2.6 million for the nine months ended September 30, 2001, and non-cash compensation of \$2.6 million and \$188,000 for the years ended December 31, 2001 and 2000. Adjusted animal hospital EBITDA margin is calculated by dividing adjusted animal hospital EBITDA by animal hospital revenue.
- (8) Laboratory internal revenue growth is calculated using laboratory revenue as reported, adjusted to exclude, for those laboratories that we did not own for the entire period presented, an estimate of revenue generated by these newly acquired laboratories subsequent to the date of our purchase. We calculate this estimate of revenue for each newly acquired laboratory using an historical twelve-month revenue figure (in some cases on an annualized basis) provided to us by the seller of the acquired laboratory, which amount is increased by our laboratory revenue growth rate for the prior year. In calculating the laboratory revenue growth rate for the year in which the acquisition occurred, we exclude from our reported laboratory revenue the estimated annual revenue attributable to newly acquired laboratories multiplied by a fraction representing the portion of the year that we owned the related facility. In calculating the laboratory revenue growth rate for the year following the acquisition, we exclude from our reported laboratory revenue the estimated annual revenue attributable to newly acquired laboratories multiplied by a fraction representing the portion of the year that we did not own the facility. To determine laboratory internal revenue growth rate for the applicable period, we compare laboratory revenue net of estimated laboratory revenue of acquired laboratories to laboratory revenue as reported for the prior comparable period. We believe this fairly presents laboratory internal revenue growth for the periods presented, although our calculation may not be comparable to similarly titled measures reported by other companies.
- (9) Animal hospital same-facility revenue growth is calculated using the combined revenue of the animal hospitals owned and managed for the entire periods presented.
- (10) The as adjusted balance sheet data are presented as if (a) the issuance of \$25.0 million in additional senior term C notes under our senior credit facility; (b) the redemption of the entire principal amount of our 13.5% senior subordinated notes; and (c) the redemption of \$30.0 million principal amount of our 15.5% senior notes, each of which occurred in October 2002, had occurred at September 30, 2002.
- (11) The pro forma as adjusted balance sheet data are presented as if (a) this offering and the application of the net proceeds therefrom; (b) the issuance of \$25.0 million in additional senior term C notes under our senior credit facility; (c) the redemption of the entire principal amount of our 13.5% senior subordinated notes; and (d) the redemption of \$30.0 million principal amount of our 15.5% senior notes, each of which occurred in October 2002, had occurred at September 30, 2002.

RISK FACTORS

You should carefully consider the risks and uncertainties described below and other information included in this prospectus in evaluating us and our business. If any of the events described below occur, our business and financial results could be adversely affected in a material way. This could cause the trading price of our common stock to decline, perhaps significantly.

Risks Related to Our Business

If we are unable to effectively execute our growth strategy, we may not achieve our desired economies of scale and our margins and profitability may decline.

Our success depends in part on our ability to build on our position as a leading animal health care services company through a balanced program of internal growth initiatives and selective acquisitions of established animal hospitals and laboratories. If we cannot implement or effectively execute these initiatives and acquisitions, our results of operations will be adversely affected. Even if we effectively implement our growth strategy, we may not achieve the economies of scale that we have experienced in the past or that we anticipate. Our internal growth rate may decline and could become negative. Our laboratory internal revenue growth rate has fluctuated between 9.1% and 12.6% for each fiscal year from 1999 through 2001. Similarly, our animal hospital same-facility revenue growth rate has fluctuated between 2.6% and 7.0% over the same fiscal years. Our internal growth may continue to fluctuate and may be below our historical rates. Any reductions in the rate of our internal growth may cause our revenues and margins to decrease. Our historical growth rates and margins are not necessarily indicative of future results.

Our business and results of operations may be adversely affected if we are unable to manage our growth effectively.

Since January 1, 1996, we have experienced rapid growth and expansion. Our failure to manage our growth effectively may increase our costs of operations and hinder our ability to execute our business strategy. Our rapid growth has placed, and will continue to place, a significant strain on our management and operational systems and resources. At January 1, 1996, we operated 59 hospitals, operated laboratories servicing approximately 9,000 customers in 27 states and had approximately 1,150 full-time equivalent employees. At September 30, 2002, we operated 225 hospitals, operated laboratories servicing approximately 13,000 customers in all 50 states and had approximately 3,500 full-time equivalent employees. If our business continues to grow, we will need to continue to improve and enhance our overall financial and managerial controls, reporting systems and procedures, and expand, train and manage our workforce in order to maintain control of expenses and achieve desirable economies of scale. We also will need to increase the capacity of our current systems to meet additional demands.

Difficulties integrating new acquisitions may impose substantial costs and cause other problems for us.

Our success depends on our ability to timely and cost-effectively acquire, and integrate into our business, additional animal hospitals and laboratories. Any difficulties in the integration process may result in increased expense, loss of customers and a decline in profitability. We expect to acquire 15 to 25 animal hospitals per year, however, based on the opportunity, the number could be higher. Historically we have experienced delays and increased costs in integrating some hospitals primarily where we acquire a large number of hospitals in a single region at or about the same time. In these cases, our field management may spend a predominant amount of time integrating these new hospitals

and less time managing our existing hospitals in those regions. During these periods, there may be less attention directed to marketing efforts or staffing issues. In these circumstances, we also have experienced delays in converting the systems of acquired hospitals into our systems, which results in increased payroll expense to collect our results and delays in reporting our results, both for a particular region and on a consolidated basis. These factors have resulted in decreased revenue, increased costs and lower margins. We continue to face risks in connection with our acquisitions including:

negative effects on our operating results;

impairment of goodwill and other intangible assets;

dependence on retention, hiring and training of key personnel, including specialists; and

contingent and latent risks associated with the past operations of, and other unanticipated problems arising in, an acquired business.

The process of integration may require a disproportionate amount of the time and attention of our management, which may distract management's attention from its day-to-day responsibilities. In addition, any interruption or deterioration in service resulting from an acquisition may result in a customer's decision to stop using us. For these reasons, we may not realize the anticipated benefits of an acquisition, either at all or in a timely manner. If that happens and we incur significant costs, it could have a material adverse impact on our business.

The carrying value of our goodwill could be subject to impairment write-downs.

At September 30, 2002, our balance sheet reflected \$332.5 million of goodwill, which is a substantial portion of our total assets of \$513.4 million at that date. We expect that the aggregate amount of goodwill on our balance sheet will increase as a result of future acquisitions. We continually evaluate whether events or circumstances have occurred that suggest that the fair market value of each of our reporting units exceeds their carrying values. If we determine that the fair market value of one of our reporting units does not exceed its carrying value, this may result in an impairment write-down of the goodwill for that reporting unit. The impairment write-down would be reflected as expense and could have a material adverse effect on our results of operations during the period in which we recognize the expense. In 2002, an independent valuation group concluded that the fair value of our goodwill exceeded its carrying value and accordingly, as of that date, there were no goodwill impairment issues. However, in the future we may incur impairment charges related to the goodwill already recorded or arising out of future acquisitions or as a result of the sale or closure of animal hospitals.

We require a significant amount of cash to service our debt and expand our business as planned.

We have, and will continue to have, a substantial amount of debt. Our substantial amount of debt requires us to dedicate a significant portion of our cash flow from operations to pay down our indebtedness and related interest, thereby reducing the funds available to use for working capital, capital expenditures, acquisitions and general corporate purposes.

In October 2002, we borrowed \$25.0 million in additional senior term C notes. These proceeds and cash on-hand were used to voluntarily repay the entire outstanding principal amount on our 13.5% senior subordinated notes and \$30.0 million in principal on our 15.5% senior notes. The following table details our debt balances at September 30, 2002 and the pro forma balances as if the additional senior

term C notes were incurred and the voluntary repayment of our 13.5% senior subordinated notes and a portion of our 15.5% senior notes had occurred on September 30, 2002 (dollars in thousands):

	As of September 30, 2002		
	Actual	Adjustment	Pro Forma
Senior term C notes	\$ 142,703	\$ 25,000	\$ 167,703
13.5% senior subordinated notes	15,000	(15,000)	
9.875% senior subordinated notes	170,000		170,000
15.5% senior notes	66,715	(30,000)	36,715
Other	1,658		1,658
	396,076		376,076
Less unamortized discount	(7,242)	4,214	(3,028)
Total debt obligations	\$ 388,834		\$ 373,048

The following table sets forth our scheduled principal and interest payments due by us for each of the years ending December 31, adjusted to reflect the impact of the no-fee swap agreement with Wells Fargo, which became effective November 29, 2002, the additional senior term C notes borrowed and the voluntary repayment of our 13.5% senior subordinated notes and a portion of our 15.5% senior notes, which occurred in October 2002 (dollars in thousands):

	2002	2003	2004	2005(1)	2006(1)
Long-term debt	\$ 3,541	\$ 1,894	\$ 1,860	\$ 4,044	\$ 21,487
Fixed interest	20,694	19,333	19,134	21,328	22,448
Variable interest	7,714	6,966	7,698	10,614	11,313
Collar agreement	2,340				
PIK interest				16,610	
Total	\$ 34,289	\$ 28,193	\$ 28,692	\$ 52,596	\$ 55,248

(1) We intend to use the proceeds from this offering to repay the entire outstanding principal amount of our 15.5% senior notes. If we repay the entire outstanding principal amount of these notes, our future cash obligations as set forth in the table above will be reduced by \$23.0 million in 2005 and \$5.3 million in 2006.

We have both fixed-rate and variable-rate debt. Our variable-rate debt is based on a variable-rate component plus a fixed margin. Our interest rate on the variable rate component of our debt was approximately 1.89% for 2002. For purposes of the foregoing table, we have estimated the interest rate on the variable rate component of our debt to be 2.50%, 3.00%, 3.50% and 4.00% for years 2003 through 2006, respectively. Our consolidated financial statements included in this prospectus discuss these variable-rate notes in more detail.

On November 7, 2002 we entered into a no-fee swap agreement with Wells Fargo Bank effective November 29, 2002 and expiring November 29, 2004. The agreement swaps monthly variable LIBOR rates for a fixed rate of 2.22% on a notional amount of \$40.0 million. The agreement qualifies for hedge accounting.

Through March 2005, interest on our 15.5% senior notes is payable semi-annually and, at our option, in cash or by issuing additional 15.5% senior notes. After March 2005, interest is payable semi-annually, in cash. Any additional 15.5% senior notes are considered PIK interest and are reflected in the above table. These notes have the same terms as the original notes except they mature in September 2005. We have issued additional 15.5% senior notes for all of our historical interest payments on the 15.5% senior notes and intend to continue doing so pending consummation of this offering.

Our ability to make payments on our debt, and to fund acquisitions, will depend on our ability to generate cash in the future. Insufficient cash flow could place us at risk of default under our debt agreements or could prevent us from expanding our business as planned. Our ability to generate cash is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. Our business may not generate sufficient cash flow from operations, our strategy to increase operating efficiencies may not be realized and future borrowings may not be available to us under our senior credit facility in an amount sufficient to enable us to service our debt or to fund our other liquidity needs. In order to meet our debt obligations, we may need to refinance all or a portion of our debt. We may not be able to refinance any of our debt on commercially reasonable terms or at all.

Our debt instruments may adversely affect our ability to run our business.

Our substantial amount of debt, as well as the guarantees of our subsidiaries and the security interests in our assets and those of our subsidiaries, could impair our ability to operate our business effectively and may limit our ability to take advantage of business opportunities. For example, our indentures and senior credit facility:

- limit our funds available to repay the 15.5% senior notes and 9.875% senior subordinated notes;

- limit our ability to borrow additional funds or to obtain other financing in the future for working capital, capital expenditures, acquisitions, investments and general corporate purposes;

- limit our ability to dispose of our assets, create liens on our assets or to extend credit;

- make us more vulnerable to economic downturns and reduce our flexibility in responding to changing business and economic conditions;

- limit our flexibility in planning for, or reacting to, changes in our business or industry;

- place us at a competitive disadvantage to our competitors with less debt; and

- restrict our ability to pay dividends, repurchase or redeem our capital stock or debt, or merge or consolidate with another entity.

The terms of our indentures and senior credit facility allow us, under specified conditions, to incur further indebtedness, which would heighten the foregoing risks. If compliance with our debt obligations materially hinders our ability to operate our business and adapt to changing industry conditions, we may lose market share, our revenue may decline and our operating results may suffer.

Our failure to satisfy covenants in our debt instruments will cause a default under those instruments.

In addition to imposing restrictions on our business and operations, our debt instruments include a number of covenants relating to financial ratios and tests. Our ability to comply with these covenants may be affected by events beyond our control, including prevailing economic, financial and industry conditions. The breach of any of these covenants would result in a default under these instruments. An event of default would permit our lenders and other debtholders to declare all amounts borrowed from them to be due and payable, together with accrued and unpaid interest. Moreover, these lenders and other debtholders would have the option to terminate any obligation to make further extensions of credit under these instruments. If we are unable to repay debt to our lenders, these lenders and other debtholders could proceed against our assets.

Due to the fixed cost nature of our business, fluctuations in our revenue could adversely affect our operating income.

Approximately 57% of our expense, particularly rent and personnel costs, are fixed costs and are based in part on expectations of revenue. We may be unable to reduce spending in a timely manner to compensate for any significant fluctuations in our revenue. Accordingly, shortfalls in revenue may adversely affect our operating income.

The significant competition in the companion animal health care services industry could cause us to reduce prices or lose market share.

The companion animal health care services industry is highly competitive with few barriers to entry. To compete successfully, we may be required to reduce prices, increase our operating costs or take other measures that could have an adverse effect on our financial condition, results of operations, margins and cash flow. If we are unable to compete successfully, we may lose market share.

There are many clinical laboratory companies that provide a broad range of laboratory testing services in the same markets we service. Our largest competitor for outsourced laboratory testing services is Idexx Laboratories, Inc. which currently competes or intends to compete in most of the same markets in which we operate. Also, Idexx and several other national companies provide on-site diagnostic equipment that allows veterinarians to perform their own laboratory tests.

Our primary competitors for our animal hospitals in most markets are individual practitioners or small, regional, multi-clinic practices. Also, regional pet care companies and some national companies, including operators of super-stores, are developing multi-regional networks of animal hospitals in markets in which we operate. Historically, when a competing animal hospital opens in close proximity to one of our hospitals, we have reduced prices, expanded our facility, retained additional qualified personnel, increased our marketing efforts or taken other actions designed to retain and expand our client base. As a result, our revenue may decline and our costs may increase.

We may experience difficulties hiring skilled veterinarians due to shortages that could disrupt our business.

As the pet population continues to grow, the need for skilled veterinarians continues to increase. If we are unable to retain an adequate number of skilled veterinarians, we may lose customers, our revenue may decline and we may need to sell or close animal hospitals. As of September 30, 2002, there were 28 veterinary schools in the country accredited by the American Veterinary Medical Association. These schools graduate approximately 2,100 veterinarians per year. There is a shortage of skilled veterinarians across the country, particularly in some regional markets in which we operate animal hospitals including Northern California. During these shortages in these regions, we may be unable to hire enough qualified veterinarians to adequately staff our animal hospitals, in which event we may lose market share and our revenues and profitability may decline.

If we fail to comply with governmental regulations applicable to our business, various governmental agencies may impose fines, institute litigation or preclude us from operating in certain states.

The laws of many states prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. These laws vary from state to state and are enforced by the courts and by regulatory authorities with broad discretion. As of September 30, 2002 we operated 58 animal hospitals in 11 states with these laws, including 21 in New York. We may experience difficulty in expanding our operations into other states with similar laws. Given varying and uncertain interpretations of the veterinary laws of each state, we may not be in compliance with restrictions on the corporate practice of veterinary medicine in all states. A determination that we are in violation of

applicable restrictions on the practice of veterinary medicine in any state in which we operate could have a material adverse effect on us, particularly if we were unable to restructure our operations to comply with the requirements of that state.

All of the states in which we operate impose various registration requirements. To fulfill these requirements, we have registered each of our facilities with appropriate governmental agencies and, where required, have appointed a licensed veterinarian to act on behalf of each facility. All veterinarians practicing in our clinics are required to maintain valid state licenses to practice.

Any failure in our information technology systems or disruption in our transportation network could significantly increase testing turn-around time, reduce our production capacity and otherwise disrupt our operations.

Our laboratory operations depend, in part, on the continued and uninterrupted performance of our information technology systems and transportation network. Our growth has necessitated continued expansion and upgrade of our information technology systems and transportation network. Sustained system failures or interruption in our transportation network or in one or more of our laboratory operations could disrupt our ability to process laboratory requisitions, perform testing, provide test results in a timely manner and/or bill the appropriate party. We could lose customers and revenue as a result of a system or transportation network failure.

Our computer systems are vulnerable to damage or interruption from a variety of sources, including telecommunications failures, electricity brownouts or blackouts, malicious human acts and natural disasters. Moreover, despite network security measures, some of our servers are potentially vulnerable to physical or electronic break-ins, computer viruses and similar disruptive problems. Despite the precautions we have taken, unanticipated problems affecting our systems could cause interruptions in our information technology systems. Our insurance policies may not adequately compensate us for any losses that may occur due to any failures in our systems.

In addition, over time we have significantly customized the computer systems in our laboratory business. We rely on a limited number of employees to upgrade and maintain these systems. If we were to lose the services of some or all of these employees, it may be time-consuming for new employees to become familiar with our systems, and we may experience disruptions in service during these periods.

Any substantial reduction in the number of available flights or delays in the departure of flights will disrupt our transportation network and our ability to provide test results in a timely manner. In addition, our Test Express service, which services customers outside of major metropolitan areas, is dependent on flight services in and out of Memphis and the transportation network of Federal Express. Any sustained interruption in either flight services in Memphis or the transportation network of Federal Express would result in increased turn-around time for the reporting of test results to customers serviced by our Test Express service.

The loss of Mr. Robert Antin, our Chairman, President and Chief Executive Officer, could materially and adversely affect our business.

We are dependent upon the management and leadership of our Chairman, President and Chief Executive Officer, Robert Antin. We have an employment contract with Mr. Antin that may be terminated at the option of Mr. Antin. We do not maintain any key man life insurance coverage for Mr. Antin. The loss of Mr. Antin could materially adversely affect our business.

Risks Associated with this Offering

Concentration of ownership among our existing executive officers, directors and principal stockholders may prevent new investors from influencing significant corporate decisions.

At November 30, 2002, our executive officers, directors and principal stockholders beneficially owned, in the aggregate, approximately 47.2% of our outstanding common stock. Following this offering, these persons will own, in the aggregate, approximately 29.0% of our outstanding common stock. As a result, these stockholders are able to significantly affect our management, our policies and all matters requiring stockholder approval. The directors supported by these stockholders will be able to significantly affect decisions relating to our capital structure, including decisions to issue additional capital stock, implement stock repurchase programs and incur indebtedness. This concentration of ownership may have the effect of deterring hostile takeovers, delaying or preventing changes in control or changes in management, or limiting the ability of our other stockholders to approve transactions that they may deem to be in their best interests.

Future sales of shares of our common stock in the public market may depress our stock price and make it difficult for you to recover the full value of your investment in our shares.

If our existing stockholders sell substantial amounts of our common stock in the public market following this offering or if there is a perception that these sales may occur, the market price of our common stock could decline. Based on shares outstanding as of September 30, 2002, upon completion of this offering we will have outstanding approximately 40,060,975 shares of common stock. Of these shares, 25,979,507 shares of common stock are freely tradable, without restriction, in the public market, unless the shares offered in the offering are purchased by affiliates, 265,304 shares are eligible for sale in the public market at various times, subject to the restrictions of Rule 144 of the Securities Act of 1933, and 272,396 shares are eligible for sale in the public market subject to the restrictions of Rule 701 of the Securities Act of 1933. After the lockup agreements pertaining to this offering expire 90 days from the date of this prospectus unless waived, an additional 2,053,548 shares of common stock will be freely tradable, without restriction, in the public market, 11,218,823 shares will be eligible for sale in the public market at various times, subject to the restrictions of Rule 144 of the Securities Act of 1933, and 271,397 shares will be eligible for sale in the public market subject to the restrictions of Rule 701 of the Securities Act of 1933.

The price of our common stock may be volatile.

The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities. These fluctuations often have been unrelated or disproportionate to the operating performance of publicly traded companies. In the past, following periods of volatility in the market price of a particular company's securities, securities class-action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation of this type is often expensive to defend and may divert management's attention and resources from the operation of our business.

Political events and the uncertainty resulting from them may have a material adverse effect on our operating results.

The terrorist attacks that took place in the United States on September 11, 2001, along with the United States' military campaign against terrorism in Afghanistan and elsewhere, ongoing violence in the Middle East and increasing speculation regarding future military action against Iraq have created

many economic and political uncertainties, some of which may affect the markets in which we operate, our operations and profitability and your investment. The potential near-term and long-term effect these attacks may have for our customers, the markets for our services and the U.S. economy are uncertain. The consequences of any terrorist attacks, or any armed conflicts which may result, are unpredictable and we may not be able to foresee events that could have an adverse effect on our markets, our business or your investment.

Our stock price may be adversely affected because our results of operations may fluctuate significantly from quarter to quarter.

Our operating results may fluctuate significantly in the future. If our quarterly revenue and operating results fall below the expectations of securities analysts and investors, the market price of our common stock could fall substantially. Historically, after eliminating the effect of acquisitions, we have experienced higher revenue in the second and third quarters than in the first and fourth quarters. The demand for our veterinary services is higher during warmer months because pets spend a greater amount of time outdoors, where they are more likely to be injured and are more susceptible to disease and parasites. Also, use of veterinary services may be affected by levels of infestation of fleas, heartworms and ticks, and the number of daylight hours. A substantial portion of our costs are fixed and do not vary with the level of demand for our services. Therefore, net income for the second and third quarters at individual animal hospitals and veterinary diagnostic laboratories generally is higher than in the first and fourth quarters.

Operating results also may vary depending on a number of factors, many of which are outside our control, including:

- demand for our tests;
- changes in our pricing policies or those of our competitors;
- the hiring and retention of key personnel;
- wage and cost pressures;
- changes in fuel prices or electrical rates;
- costs related to acquisitions of technologies or businesses; and
- seasonal and general economic factors.

Takeover defense provisions may adversely affect the market price of our common stock.

Various provisions of Delaware corporation law and of our corporate governance documents may inhibit changes in control not approved by our board of directors and may have the effect of depriving you of an opportunity to receive a premium over the prevailing market price of our common stock in the event of an attempted hostile takeover. In addition, the existence of these provisions may adversely affect the market price of our common stock. These provisions include:

- a classified board of directors;
- a prohibition on stockholder action through written consents;
- a requirement that special meetings of stockholders be called only by our board of directors, the Chairman of our board of directors, our President or our Chief Executive Officer;
- advance notice requirements for stockholder proposals and nominations; and
- availability of blank check preferred stock.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements under Prospectus Summary, Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations, Business, and elsewhere in this prospectus are forward-looking statements. We generally identify forward-looking statements in this prospectus using words like believe, intend, expect, estimate, may, should, plan, project, contemplate, anticipate, predict, or similar expressions. These statements involve known and unknown risks, uncertainties, and other factors, including those described in the Risk Factors section, that may cause our or our industry's actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by these forward-looking statements. Except as required by applicable law, including the securities laws of the United States, and the rules and regulations of the Securities and Exchange Commission, we do not plan to publicly update or revise any forward-looking statements after we distribute this prospectus, whether as a result of any new information, future events or otherwise.

We use market data and industry forecasts and projections throughout this prospectus, which we have obtained from market research, publicly available information and industry publications. These sources generally state that the information they provide has been obtained from sources believed to be reliable, but that the accuracy and completeness of such information are not guaranteed. The forecasts and projections are based on industry surveys and the preparers' experience in the industry and there is no assurance that any of the projected amounts will be achieved. Similarly, we believe that the surveys and market research others have performed are reliable, but we have not independently verified this information.

You should rely only on the information contained in this prospectus or any supplement and any information incorporated by reference in this prospectus or any supplement. We have not authorized anyone to provide you with any information that is different. If you receive any unauthorized information, you must not rely on it. You should disregard anything we said in an earlier document that is inconsistent with what is included in or incorporated by reference in this prospectus. You should not assume that the information in this prospectus or any supplement is current as of any date other than the date on the front page of this prospectus.

USE OF PROCEEDS

We expect to receive approximately \$47.1 million in net proceeds, after deducting underwriting discounts and commissions and estimated offering expenses payable by us, from the sale of shares of our common stock in this offering based on the sale of 3,300,000 shares at a public offering price of \$15.25 per share. If the underwriters exercise their over-allotment option in full, we expect our additional net proceeds to be approximately \$7.2 million. We will not receive any proceeds from the sale of the shares by the selling stockholders in this offering.

We intend to use the net proceeds from this offering:

to repay the entire outstanding principal amount, or approximately \$36.7 million, of our 15.5% senior notes due 2010 at a redemption price of 110% of the principal amount, for an aggregate of \$40.4 million, plus accrued and unpaid interest; and
for general corporate purposes.

If the underwriters exercise their over-allotment option, any additional net proceeds received by us will be used for general corporate purposes. We will not receive any proceeds from the sale of the shares by the selling stockholders pursuant to the exercise of the over-allotment option.

Pending application of the net proceeds as described above, we intend to invest the net proceeds in short-term investment grade securities.

PRICE RANGE OF OUR COMMON STOCK

Since November 21, 2001, our common stock has traded on The Nasdaq Stock Market's National Market under the symbol WOOF. From September 20, 2000 through November 20, 2001, our common stock was not publicly traded. From March 19, 1993 through September 19, 2000, our common stock was traded on the Nasdaq National Market under the symbol VCAI. The following table sets forth the range of high and low bid information per share for our common stock as quoted on the Nasdaq National Market for the periods indicated. The stock prices for fiscal 2000 have been restated to reflect a fifteen-for-one stock split effected concurrent with the consummation of our recapitalization in September 2000.

	High	Low
Fiscal 2002 by Quarter		
Fourth	\$ 16.40	\$ 12.16
Third	\$ 16.48	\$ 11.90
Second	\$ 16.36	\$ 12.71
First	\$ 14.62	\$ 11.65
Fiscal 2001 by Quarter		
Fourth (commencing November 21, 2001)	\$ 12.45	\$ 8.83
Fiscal 2000 by Quarter		
Third (through September 19, 2000)	\$ 0.99	\$ 0.90
Second	\$ 0.93	\$ 0.83
First	\$ 0.96	\$ 0.68

At December 31, 2002, the closing price of our common stock on the Nasdaq National Market was \$15.00, and at that date, there were approximately 97 holders of record of our common stock.

DIVIDEND POLICY

We have not paid cash dividends on our common stock, and we do not anticipate paying cash dividends in the foreseeable future. In addition, our senior credit facility and the indentures governing our outstanding senior and senior subordinated notes place limitations on our ability to pay dividends or make other distributions in respect of our common stock. Any future determination as to the payment of dividends on our common stock will be restricted by these limitations, will be at the discretion of our board of directors and will depend on our results of operations, financial condition, capital requirements and other factors deemed relevant by the board of directors, including the General Corporation Law of the State of Delaware, which provides that dividends are only payable out of surplus or current net profits.

CAPITALIZATION

The following table sets forth our capitalization as of September 30, 2002:

on an actual basis;

on an as adjusted basis to reflect transactions that occurred in October 2002; and

on a pro forma as adjusted basis to reflect transactions that occurred in October 2002 and this offering at a public offering price of \$15.25 per share and the intended application of the net proceeds therefrom.

	As of September 30, 2002		
	Actual	As adjusted (1)	Pro forma as adjusted (2)
	(dollars in thousands)		
Total debt:			
Senior credit facility:			
Revolving credit facility (3)	\$	\$	\$
Senior term C notes (4)	142,703	167,703	167,703
13.5% senior subordinated notes due 2010	15,000		
9.875% senior subordinated notes due 2009	170,000	170,000	170,000
15.5% senior notes due 2010	66,715	36,715	
Other debt	1,658	1,658	1,658
Unamortized discount	(7,242)	(3,028)	(15)
Total debt	388,834	373,048	339,346
Stockholders' equity:			
Common stock, 75,000,000 shares authorized, 36,760,975 shares issued and outstanding, actual and as adjusted; 75,000,000 shares authorized and 40,060,975 shares issued and outstanding, pro forma as adjusted (5)	37	37	41
Additional paid-in capital	188,865	188,865	235,995
Notes receivable from stockholders	(240)	(240)	(240)
Accumulated deficit	(123,429)	(129,004)	(133,401)
Accumulated comprehensive loss	(319)	(319)	(319)
Total stockholders' equity	64,914	59,339	102,076
Total capitalization	\$ 453,748	\$ 432,387	\$ 441,422

- (1) The as adjusted data are presented as if (a) the issuance of \$25.0 million in additional senior term C notes under our senior credit facility; (b) the repayment of the entire outstanding principal amount of our 13.5% senior subordinated notes; and (c) the repayment of \$30.0 million in principal of our 15.5% senior notes, each of which occurred in October 2002, had occurred at September 30, 2002.
- (2) The pro forma as adjusted data are presented as if (a) this offering and the application of the net proceeds therefrom; (b) the issuance of \$25.0 million in additional senior term C notes under our senior credit facility; (c) the repayment of the entire outstanding principal amount of our 13.5% senior subordinated notes; and (d) the repayment of \$30.0 million in principal of our 15.5% senior notes, each of which occurred in October 2002, had occurred at September 30, 2002.
- (3) The revolving credit facility provides for borrowings of up to \$50.0 million, \$7.5 million of which was drawn in December 2002 and is outstanding.
- (4) On August 29, 2002, we repaid our senior term A and senior term B notes with the proceeds acquired from the issuance of senior term C notes, which bear a lower interest rate than the weighted average interest rate for the senior term A and senior term B notes. See Description of Certain Indebtedness for additional information.
- (5) Share information is based on the number of shares outstanding as of September 30, 2002, and:

excludes 1,955,901 shares of common stock issuable upon exercise of outstanding options under our stock incentive plans, at a weighted average exercise price of \$9.95 per share;

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excludes 650,000 shares available for future issuance under our stock incentive plans; and
assumes no exercise of the underwriters' over-allotment option.

SELECTED HISTORICAL CONSOLIDATED FINANCIAL DATA

Our selected historical consolidated financial data for the years ended December 31, 2001, 2000, 1999, 1998 and 1997 were derived from our audited financial statements. Our financial statements for each of the fiscal years ended December 31, 2001, 2000 and 1999 were audited by KPMG LLP. Our financial statements for each of the fiscal years ended December 31, 1998 and 1997 were audited by Arthur Andersen LLP. Our selected historical consolidated financial data for the nine months ended September 30, 2002 and 2001 have been derived from our unaudited interim financial statements and include, in the opinion of management, all adjustments necessary for a fair presentation of our financial position and operating results for these periods and as of those dates. Our results for the interim periods are not necessarily indicative of our results for a full year's operations. You should read the following information together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes. Our audited consolidated financial statements for the years ended December 31, 2001 and 2000 and for each of the three years in the period ended December 31, 2001 and our unaudited condensed, consolidated financial statements as of the nine months ended September 30, 2002 and 2001 are included in this prospectus.

	Nine Months Ended September 30,		Year Ended December 31,				
	2002	2001	2001	2000	1999	1998	1997
(dollars in thousands, except per share amounts)							
Statements of Operations Data:							
Laboratory revenue	\$ 116,911	\$ 101,855	\$ 134,711	\$ 119,300	\$ 103,282	\$ 89,896	\$ 68,997
Animal hospital revenue	225,383	207,665	272,113	240,624	217,988	191,888	165,848
Other revenue (1)	1,500	1,500	2,000	925	5,100	5,100	5,764
Intercompany	(6,902)	(5,655)	(7,462)	(6,162)	(5,810)	(5,845)	(4,696)
Total revenue	336,892	305,365	401,362	354,687	320,560	281,039	235,913
Direct costs	226,749	213,454	283,226	254,890	232,493	209,380	178,630
Selling, general and administrative	25,893	30,365	38,633	27,446	23,622	19,693	17,676
Depreciation and amortization	9,330	19,121	25,166	18,878	16,463	13,132	11,199
Agreement termination costs			17,552				
Recapitalization costs				34,268			
Year 2000 remediation expense					2,839		
Other operating and non-cash items	(80)	8,745	9,079		(1,873)		
Operating income (loss)	75,000	33,680	27,706	19,205	47,016	38,834	28,408
Net interest expense	30,541	32,387	42,918	19,892	9,449	8,832	7,411
Other (income) expense, net	(159)	233	168	1,800			
Income (loss) before minority interest, provision for income taxes and extraordinary item	44,618	1,060	(15,380)	(2,487)	37,567	30,002	20,997
Minority interest in income of subsidiaries	1,360	1,104	1,439	1,066	850	780	424
Provision for income taxes	18,092	6,741	445	2,199	14,360	12,954	9,347
Extraordinary loss on early extinguishment of debt (net of taxes)	2,001		10,159	2,659			
Increase in carrying amount of redeemable preferred stock		15,583	19,151	5,391			
Net income (loss) available to common stockholders	\$ 23,165	\$ (22,368)	\$ (46,574)	\$ (13,802)	\$ 22,357	\$ 16,268	\$ 11,226
Basic earnings (loss) per share	\$ 0.63	\$ (1.27)	\$ (2.39)	\$ (0.06)	\$ 0.07	\$ 0.05	\$ 0.04
Diluted earnings (loss) per share	\$ 0.63	\$ (1.27)	\$ (2.39)	\$ (0.06)	\$ 0.07	\$ 0.05	\$ 0.04
Shares used for computing basic earnings (loss) per share	36,744	17,643	19,509	234,055	315,945	305,250	294,390
Shares used for computing diluted earnings (loss) per share	37,088	17,643	19,509	234,055	329,775	329,100	315,195

	Nine Months Ended September 30,		Year Ended December 31,				
	2002	2001	2001	2000	1999	1998	1997
(dollars in thousands)							
Other Financial Data:							
Adjusted EBITDA (2) (3)	\$ 84,330	\$ 70,892	\$ 89,505	\$ 73,526	\$ 64,445	\$ 51,966	\$ 39,607
Adjusted EBITDA margin (4)	25.0%	23.2%	22.3%	20.7%	20.1%	18.5%	16.8%
Adjusted laboratory EBITDA (5)	\$ 43,734	\$ 35,264	\$ 45,561	\$ 38,827	\$ 32,273	\$ 24,215	\$ 20,142
Adjusted laboratory EBITDA margin (5)	37.4%	34.6%	33.8%	32.5%	31.2%	26.9%	29.2%
Adjusted animal hospital EBITDA (6)	\$ 49,472	\$ 43,159	\$ 53,658	\$ 42,985	\$ 37,237	\$ 31,975	\$ 23,243
Adjusted animal hospital EBITDA margin (6)	22.0%	20.8%	19.7%	17.9%	17.1%	16.7%	14.0%
Net cash provided by operating activities	\$ 60,838	\$ 49,316	\$ 57,104	\$ 60,054	\$ 38,467	\$ 27,123	\$ 22,674
Net cash used in investing activities	(29,700)	(30,331)	(36,202)	(47,679)	(13,676)	(19,474)	(16,368)
Net cash used in financing activities	(5,883)	(5,873)	(24,318)	(12,476)	(23,148)	(18,554)	(16,045)
Capital expenditures	13,405	9,929	13,481	22,555	21,803	11,678	7,241
Balance Sheet Data (at period end):							
Cash and cash equivalents	\$ 32,358	\$ 23,631	\$ 7,103	\$ 10,519	\$ 10,620	\$ 8,977	\$ 19,882
Net working capital	(6,176)	2,175	(2,574)	5,289	9,605	6,694	(4,454)
Total assets	513,380	501,227	468,521	483,070	426,500	393,960	386,089
Total debt	388,834	371,365	384,332	362,749	161,535	159,787	173,875
Total redeemable preferred stock		170,205		154,622			
Total stockholders' equity (deficit)	64,914	(97,946)	39,764	(81,310)	231,229	202,685	180,851

- (1) Other revenue includes consulting fees of \$1.5 million for each of the nine months ended September 30, 2002 and 2001, and consulting fees of \$2.0 million, \$925,000, \$5.1 million, \$5.1 million and \$4.7 million for the years ended December 31, 2001, 2000, 1999, 1998 and 1997. For the year ended December 31, 1997, other revenue also includes revenue from our pet product joint venture; we transferred the control of the joint venture to our joint venture partner in February 1997.
- (2) EBITDA is operating income before depreciation and amortization. Adjusted EBITDA for the 2001 and 2000 periods represents EBITDA adjusted to exclude non-cash compensation and management fees paid pursuant to our management services agreement with Leonard Green & Partners, which was terminated in November 2001. Adjusted EBITDA for the 2001 periods also excludes agreement termination costs and write-down of assets. Adjusted EBITDA for the 2000 period also excludes recapitalization costs. Adjusted EBITDA for the 1999 period represents EBITDA adjusted to exclude Year 2000 remediation expense and other non-cash operating items. No adjustments were made to the EBITDA calculations for 2002.

EBITDA and adjusted EBITDA are not measures of financial performance under generally accepted accounting principles, or GAAP. EBITDA should not be considered in isolation or as a substitute for net income, cash flows from operating activities and other income or cash flow statement data prepared in accordance with GAAP, or as a measure of profitability or liquidity. We believe EBITDA is a useful measure of our operating performance as it reflects earnings before the impact of items that may change from period to period for reasons not directly related to our operations, such as the depreciation and amortization, interest and taxes and other non-operating or non-recurring items. EBITDA also is an important component of the financial ratios included in our debt covenants and provides us with a measure of our ability to service our debt and meet capital expenditure requirements from our operating results. Our calculation of EBITDA may not be comparable to similarly titled measures reported by other companies.

The calculation of EBITDA and adjusted EBITDA is shown below (dollars in thousands):

	Nine Months Ended September 30,		Year Ended December 31,				
	2002	2001	2001	2000	1999	1998	1997
Operating income	\$ 75,000	\$ 33,680	\$ 27,706	\$ 19,205	\$ 47,016	\$ 38,834	\$ 28,408
Depreciation and amortization	9,330	19,121	25,166	18,878	16,463	13,132	11,199
EBITDA	84,330	52,801	52,872	38,083	63,479	51,966	39,607
Management fees (a)		1,860	2,273	620			
Agreement termination costs			17,552				

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Recapitalization costs				34,268			
Year 2000 remediation expense					2,839		
Other non-cash operating items (b)		16,231	16,808	555	(1,873)		
Adjusted EBITDA	\$ 84,330	\$ 70,892	\$ 89,505	\$ 73,526	\$ 64,445	\$ 51,966	\$ 39,607

- (a) Management fees were paid pursuant to our management services agreement and are included in selling, general and administrative expense in our statements of operations. Effective November 27, 2001, the parties terminated the management services agreement.

- (b) Other non-cash operating items include a write-down of assets of \$8.6 million and non-cash compensation of \$1.4 million included in direct costs and \$6.2 million included in selling general and administrative expense for the nine months ended September 30, 2001; a write-down of assets of \$9.2 million and non-cash compensation of \$1.4 million included in direct costs and \$6.2 million included in selling, general and administrative expense for the year ended December 31, 2001; non-cash compensation of \$103,000 included in direct costs and \$452,000 included in selling, general and administrative expense for the year ended December 31, 2000; reversal of restructuring charges of \$1.9 million for the year ended December 31, 1999.
- (3) Adjusted EBITDA is the sum of adjusted laboratory EBITDA, adjusted animal hospital EBITDA and other revenue, less corporate selling, general and administrative expense, excluding non-cash compensation and management fees and including the effect of gain (loss) on sale of assets. For the year ended December 31, 1997, adjusted EBITDA also includes EBITDA of our pet products joint venture of \$168,000.

The calculation of adjusted EBITDA is shown below (dollars in thousands):

	Nine Months Ended September 30,		Year Ended December 31,				
	2002	2001	2001	2000	1999	1998	1997
Adjusted laboratory EBITDA	\$ 43,734	\$ 35,264	\$ 45,561	\$ 38,827	\$ 32,273	\$ 24,215	\$ 20,142
Adjusted animal hospital EBITDA	49,472	43,159	53,658	42,985	37,237	31,975	23,243
Other revenue	1,500	1,500	2,000	925	5,100	5,100	4,700
Corporate selling, general and administrative expense (a)	(10,456)	(8,906)	(11,832)	(9,211)	(10,165)	(9,324)	(8,646)
Gain (loss) on sale of assets	80	(125)	118				
Pet products joint venture EBITDA							168
Adjusted EBITDA	\$ 84,330	\$ 70,892	\$ 89,505	\$ 73,526	\$ 64,445	\$ 51,966	\$ 39,607

- (a) Corporate selling, general and administrative expense excludes non-cash compensation of \$771,000 and management fees of \$1.9 million for the nine months ended September 30, 2001, non-cash compensation of \$771,000 and management fees of \$2.3 million for the year ended December 31, 2001; and non-cash compensation of \$56,000 and management fees of \$620,000 for the year ended December 31, 2000. Management fees were paid pursuant to our management services agreement. Effective November 27, 2001, the parties terminated the management services agreement.
- (4) Adjusted EBITDA margin is calculated by dividing adjusted EBITDA by total revenue.
- (5) Adjusted laboratory EBITDA excludes non-cash compensation of \$4.3 million for the nine months ended September 30, 2001, and non-cash compensation of \$4.3 million and \$311,000 for the years ended December 31, 2001 and 2000. Adjusted laboratory EBITDA margin is calculated by dividing adjusted laboratory EBITDA by laboratory revenue.
- (6) Adjusted animal hospital EBITDA excludes non-cash compensation of \$2.6 million for the nine months ended September 30, 2001, and non-cash compensation of \$2.6 million and \$188,000 for the years ended December 31, 2001 and 2000. Adjusted animal hospital EBITDA margin is calculated by dividing adjusted animal hospital EBITDA by animal hospital revenue.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis of our financial condition and results of operations together with our consolidated financial statements and related notes included elsewhere in this prospectus. Some of the information contained in this discussion and analysis or set forth elsewhere in this prospectus, including information with respect to our plans and strategies for our business, includes forward-looking statements that involve risks and uncertainties. You should review the Risk Factors section of this prospectus for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in this prospectus.

Overview

We operate a leading animal health care services company and operate the largest networks of veterinary diagnostic laboratories and free-standing, full-service animal hospitals in the United States. Our network of veterinary diagnostic laboratories provides sophisticated testing and consulting services used by veterinarians in the detection, diagnosis, evaluation, monitoring, treatment and prevention of diseases and other conditions affecting animals. Our animal hospitals offer a full range of general medical and surgical services for companion animals. We treat diseases and injuries, offer pharmaceutical products and perform a variety of pet wellness programs, including routine vaccinations, health examinations, diagnostic testing, spaying, neutering and dental care.

Our company was formed in 1986 by Robert Antin, Arthur Antin and Neil Tauber, who have served since our inception as our Chief Executive Officer, Chief Operating Officer and Senior Vice President of Development, respectively. During the 1990s, we established a premier position in the veterinary diagnostic laboratory and animal hospital markets through both internal growth and acquisitions. By 1997, we achieved a critical mass, building a laboratory network of 12 laboratories servicing animal hospitals in all 50 states and completing acquisitions for a total of 160 animal hospitals. At September 30, 2002, our laboratory network consisted of 19 laboratories serving all 50 states and our animal hospital network consisted of 225 animal hospitals in 33 states. We primarily focus on generating internal growth to increase revenue and profitability. In order to augment internal growth, we may selectively acquire laboratories and intend to acquire approximately 15 to 25 animal hospitals per year, depending upon the attractiveness of candidates and the strategic fit with our existing operations.

The following table summarizes our growth in facilities for the periods presented:

	Nine Months Ended September 30,		Year Ended December 31,		
	2002	2001	2001	2000	1999
Laboratories:					
Beginning of period	16	15	15	13	12
Acquisitions and new facilities	3		1	3	3
Relocated into laboratories operated by us				(1)	(2)
End of period	19	15	16	15	13
Animal hospitals:					
Beginning of period	214	209	209	194	168
Acquisitions	18	18	21	24	39
Relocated into hospitals operated by us	(7)	(10)	(13)	(8)	(11)
Sold or closed		(3)	(3)	(1)	(2)
End of period	225	214	214	209	194
Owned at end of period	167	161	160	157	149
Managed at end of period	58	53	54	52	45

We were a publicly traded company from 1991 until September 2000, when we completed a recapitalization with an entity controlled by Leonard Green & Partners. The recapitalization was completed in a financial market that we believed did not adequately value companies of our size and type because the market's focus and attention was largely on technology and Internet-based companies. The recapitalization was financed by:

the contribution of \$155.0 million by a group of investors led by Leonard Green & Partners;

borrowings of \$250.0 million under a \$300.0 million senior credit facility;

the issuance of an aggregate of \$100.0 million of 15.5% senior notes; and

the issuance of an aggregate of \$20.0 million of 13.5% senior subordinated notes.

Our subsequent performance and the changing market dynamics supported the determination by our board of directors to re-enter the public sector. On November 27, 2001, we consummated our initial public offering. As a result of this offering and the underwriters' exercise of their over-allotment option, we issued 17,370,000 shares of common stock and received net proceeds of \$161.5 million. Concurrent with the consummation of our initial public offering, our wholly owned subsidiary issued \$170.0 million of senior subordinated notes. We applied the net proceeds from the offering and the sale of the senior subordinated notes, plus cash on hand, as follows:

redeemed all of our outstanding series A and series B redeemable preferred stock for \$173.8 million;

repaid \$100.0 million of our senior term A and B notes;

repaid \$59.1 million in principal of our 15.5% senior notes due 2010, at a redemption price of 110%, plus accrued and unpaid interest; and

repaid \$5.0 million in principal of our 13.5% senior subordinated notes due 2010, at a redemption price of 110%, plus accrued and unpaid interest.

In subsequent transactions, we:

repaid our senior term A and senior term B notes with the proceeds acquired from the issuance of senior term C notes, which bear a lower interest rate than the weighted average interest rate for the senior term A and senior term B notes;

repaid \$15.0 million, the entire outstanding principal amount, of our 13.5% senior subordinated notes due 2010, at a redemption price of 110%, plus accrued and unpaid interest; and

repaid \$30.0 million in principal amount of our 15.5% senior notes due 2010, at a redemption price of 110%, plus accrued and unpaid interest.

Basis of Reporting

General

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. We report our operations in three segments: laboratory, animal hospital and corporate. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expense, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue Recognition

Revenue is recognized only after the following criteria are met:

- there exists adequate evidence of the transaction;
- delivery of goods has occurred or services have been rendered; and
- the price is not contingent on future activity and collectibility is reasonably assured.

Laboratory Revenue

A portion of laboratory revenue is intercompany revenue that was generated by providing laboratory services to our animal hospitals. Laboratory internal revenue growth is calculated using laboratory revenue as reported, adjusted to exclude, for those laboratories that we did not own for the entire period presented, an estimate of revenue generated by these newly acquired laboratories subsequent to the date of our purchase. We calculate this estimate of revenue for each newly acquired laboratory using an historical twelve-month revenue figure (in some cases on an annualized basis) provided to us by the seller of the acquired laboratory, which amount is increased by our laboratory revenue growth rate for the prior year. In calculating the laboratory revenue growth rate for the year in which the acquisition occurred, we exclude from the reported laboratory revenue the estimated annual revenue attributable to newly acquired laboratories multiplied by a fraction representing the portion of the year that we owned the related facility. In calculating the laboratory revenue growth rate for the year following the acquisition, we exclude from our reported laboratory revenue the estimated annual revenue attributable to newly acquired laboratories multiplied by a fraction representing the portion of the year that we did not own the facility. To determine our laboratory internal revenue growth rate for the applicable period, we compare our laboratory revenue net of estimated laboratory revenue of newly acquired laboratories, to our laboratory revenue as reported for the prior comparable period. We believe this fairly presents our laboratory internal revenue growth for the periods presented. Our calculation may not be comparable to similarly titled measures by other companies, however, any differences in calculations or errors in estimates used would not have a material effect on our laboratory internal growth rates presented in this prospectus.

Laboratory revenue is presented net of discounts. Some discounts, such as those given to clients for prompt payment, are applied to clients' accounts in periods subsequent to the period the revenue was recognized. These discounts which are not yet applied to clients' accounts are estimated and deducted from revenue in the period the related revenue was recognized. These estimates are based upon historical experience. Errors in estimates would not have a material effect on our financial statements.

Animal Hospital Revenue

Animal hospital revenue is comprised of revenue of the animal hospitals that we own and the management fees of animal hospitals that we manage. Certain states prohibit business corporations from providing or holding themselves out as providers of veterinary medical care. In these states, we enter into arrangements with a veterinary medical group that provides all veterinary medical care, while we manage the administrative functions associated with the operation of the animal hospitals and we own or lease the hospital facility. In return for our services, the veterinary medical group pays us management fees. We do not consolidate the operations of animal hospitals that we manage. However, for purposes of calculating same-facility revenue growth in our animal hospitals, we use the combined revenue of animal hospitals owned and managed for the entire periods presented. Same-facility revenue growth includes revenue generated by customers referred from relocated or combined animal hospitals.

Other Revenue

Other revenue is comprised of consulting fees from Heinz Pet Products relating to the marketing of its proprietary pet food.

Direct Costs

Laboratory direct costs are comprised of all costs of laboratory services, including salaries of veterinarians, technicians and other non-administrative, laboratory-based personnel, facilities rent, occupancy costs and supply costs. Animal hospital direct costs are comprised of all costs of services and products at the hospitals, including salaries of veterinarians, technicians and all other hospital-based personnel employed by the hospitals we own, facilities rent, occupancy costs, supply costs, certain marketing and promotional expenses and costs of goods sold associated with the retail sales of pet food and pet supplies. Direct costs do not include salaries of veterinarians, technicians and certain other hospital-based personnel employed by the hospitals we manage. As a result, our direct costs are lower as a percentage of revenue than if we had consolidated the operating results of the animal hospitals we manage into our operating results.

Selling, General and Administrative

Our selling, general and administrative expense is divided between our laboratory, animal hospital and corporate segments. Laboratory selling, general and administrative expense consists primarily of sales and administrative personnel and selling, marketing and promotional expense. Animal hospital selling, general and administrative expense consists primarily of field management and administrative personnel, recruiting and certain marketing expenses. Corporate selling, general and administrative expense consists of administrative expense at our headquarters, including the salaries of corporate officers, professional expense, rent and occupancy costs.

EBITDA and Adjusted EBITDA

EBITDA is operating income before depreciation and amortization. Adjusted EBITDA for the 2001 and 2000 periods represents EBITDA adjusted to exclude non-cash compensation and management fees paid pursuant to our management services agreement with Leonard Green & Partners, which was terminated in November 2001. Adjusted EBITDA for the 2001 periods also excludes agreement termination costs and write-down of assets. Adjusted EBITDA for the 2000 period also excludes recapitalization costs. Adjusted EBITDA for the 1999 period represents EBITDA adjusted to exclude Year 2000 remediation expense and other non-cash operating items. No adjustments were made to the EBITDA calculations for 2002.

EBITDA and adjusted EBITDA are not measures of financial performance under generally accepted accounting principles, or GAAP. EBITDA should not be considered in isolation or as a substitute for net income, cash flows from operating activities and other income or cash flow statement data prepared in accordance with GAAP, or as a measure of profitability or liquidity. We believe EBITDA is a useful measure of our operating performance as it reflects earnings before the impact of items that may change from period to period for reasons not directly related to our operations, such as depreciation and amortization, interest and taxes and other non-operating or non-recurring items. EBITDA is also an important component of the financial ratios included in our debt covenants and provides us with a measure of our ability to service our debt and meet capital expenditure requirements from our operating results. Our calculation of EBITDA may not be comparable to similarly titled measures reported by other companies.

Non-Cash Compensation

Certain stock options granted in 2000 qualified as variable stock options. Related to these variable stock options, we recorded non-cash compensation of approximately \$7.6 million in the nine

months ended September 30, 2001 and the year ended December 31, 2001, and \$555,000 in the year ended December 31, 2000. Non-cash compensation is included in laboratory direct costs and in laboratory, animal hospital and corporate selling, general and administrative expense. In August 2001, all of these options were exercised.

Software Development Costs

We frequently research, develop and implement new software to be used internally, or enhance our existing internal software. We develop the software using our own employees and/or outside consultants. Most costs associated with the development of new software are expensed as incurred, particularly in the preliminary planning stages and the post-implementation and training stages. Costs related directly to the software design, coding, testing and installation are capitalized. Costs related to upgrades or enhancements of existing systems are capitalized if the modifications result in additional functionality.

Critical Accounting Policies and Significant Estimates

Under accounting principles generally accepted in the United States, management is required to make assumptions and estimates that directly impact our consolidated financial statements and related disclosures. Because of the uncertainties inherent in making assumptions and estimates, actual results in future periods may differ significantly from our assumptions and estimates. Management bases its assumptions and estimates on historical experience and on various other factors believed to be reasonable under the circumstances. The following represent what management believes are the critical accounting policies most affected by significant management estimates and judgments.

Workers Compensation Expense

On October 8, 2001, we entered into a one-year workers compensation insurance policy with a \$250,000 per-occurrence deductible and a stop-loss aggregate deductible of \$4.7 million. We have determined that \$3.9 million is a reasonable estimate of expected claims losses under this policy and we accrued for these losses over the twelve-month period ended September 30, 2002. In determining this estimate, in conjunction with the insurance carrier, we reviewed our five-year history of total claims losses, ratio of losses to premiums paid, payroll growth and the current risk control environment. We are pre-funding estimated claims losses to the insurance carrier of approximately \$2.9 million.

Impairment of Goodwill

Goodwill relates to acquisitions and represents the purchase price paid and liabilities assumed in excess of the fair market value of tangible assets acquired. Under the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, we are required to allocate our goodwill to identifiable reporting units, which are then tested for impairment using a two-step process detailed in the statement. The first step requires comparing the fair value of each reporting unit with its carrying amount, including goodwill. If that fair value exceeds the carrying amount, the second step of the process is not necessary and there are no impairment issues. If that fair value does not exceed that carrying amount, companies must perform the second step that requires a hypothetical allocation of the fair value of the reporting unit to the reporting unit's assets and liabilities as if the unit were just purchased by the company at the fair value price. In this hypothetical purchase, the excess of the fair value of the reporting unit over its re-evaluated, marked-to-market net assets would be the new basis for the reporting unit's goodwill and a write-down to this new value would be recognized as an expense.

We have determined that we have two reporting units, laboratory and animal hospital. We hired independent valuation experts to estimate the fair market value of these reporting units. The independent valuation experts concluded that the estimated value for each reporting unit is greater than the carrying amount of the net assets for those reporting units. Therefore, no impairment issues existed, and the second step of the test was not necessary. We plan to perform a valuation of our reporting units in the fourth quarter of each year or upon significant changes in our business environment.

Impairment of Long-lived Assets

We adopted SFAS No. 144, *Accounting for the Impairment of Disposal of Long-Lived Assets* on January 1, 2002. Under SFAS No. 144, we will continually evaluate whether events, circumstances or net losses at the entity level have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision or that the remaining balance of these assets may not be recoverable. When factors indicate that these assets should be evaluated for possible impairment, we will estimate the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the long-lived assets in question. If that estimate is less than the carrying value of the assets under review, we will recognize an impairment loss equal to that difference.

Legal Settlements

We are a party to various legal proceedings. Although we cannot determine the ultimate disposition of these proceedings, we can use judgment to reasonably estimate our liability for legal settlement costs that may arise as a result of these proceedings. Based on our prior experience, the nature of the current proceedings, and our insurance policy coverage for such matters, we have accrued \$900,000 as of September 30, 2002 for legal settlements as part of other accrued liabilities.

Results of Operations

The following table sets forth components of our statements of operations data expressed as a percentage of revenue for the indicated periods:

	Nine Months Ended September 30,		Year Ended December 31,		
	2002	2001	2001	2000	1999
Revenue:					
Laboratory	34.7%	33.4%	33.6%	33.6%	32.2%
Animal hospital	66.9	68.0	67.8	67.8	68.0
Other	0.4	0.5	0.5	0.3	1.6
Intercompany	(2.0)	(1.9)	(1.9)	(1.7)	(1.8)
Total revenue	100.0	100.0	100.0	100.0	100.0
Direct costs	67.3	69.9	70.6	71.9	72.5
Selling, general and administrative	7.7	9.9	9.6	7.6	7.4
Depreciation and amortization	2.7	6.3	6.3	5.4	5.1
Agreement termination costs			4.4		
Write-down and (gain) loss on sale of assets		2.9	2.2		
Recapitalization costs				9.7	
Year 2000 remediation expense					0.9
Reversal of restructuring charges					(0.6)
Operating income	22.3	11.0	6.9	5.4	14.7
Net interest expense	9.0	10.6	10.7	5.6	2.9
Other expense, net		0.1		0.5	
Minority interest	0.4	0.3	0.4	0.3	0.3
Provision for income taxes	5.4	2.2	0.1	0.6	4.5
Extraordinary loss on early extinguishment of debt, net of taxes	0.6		2.5	0.8	
Net income (loss)	6.9%	(2.2)%	(6.8)%	(2.4)%	7.0%

The following table is a summary of the components of operating income by segment for the nine months ended September 30, 2002 and 2001 and the last three fiscal years (dollars in thousands):

	<u>Laboratory</u>	<u>Animal Hospital</u>	<u>Corporate</u>	<u>Inter- company Eliminations</u>	<u>Total</u>
Nine Months Ended September 30, 2002					
Revenue	\$ 116,911	\$ 225,383	\$ 1,500	\$ (6,902)	\$ 336,892
Direct costs	65,545	168,106		(6,902)	226,749
Selling, general and administrative	7,632	7,805	10,456		25,893
Depreciation and amortization	2,138	6,166	1,026		9,330
Gain on sale of assets			(80)		(80)
Operating income (loss)	<u>\$ 41,596</u>	<u>\$ 43,306</u>	<u>\$ (9,902)</u>	<u>\$</u>	<u>\$ 75,000</u>
Nine Months Ended September 30, 2001					
Revenue	\$ 101,855	\$ 207,665	\$ 1,500	\$ (5,655)	\$ 305,365
Direct costs	61,566	157,543		(5,655)	213,454
Selling, general and administrative	9,305	9,523	11,537		30,365
Depreciation and amortization	3,457	10,829	4,835		19,121
Write-down and loss on sale of assets			8,745		8,745
Operating income (loss)	<u>\$ 27,527</u>	<u>\$ 29,770</u>	<u>\$ (23,617)</u>	<u>\$</u>	<u>\$ 33,680</u>
2001					
Revenue	\$ 134,711	\$ 272,113	\$ 2,000	\$ (7,462)	