

PETMED EXPRESS INC  
Form 10-K  
May 31, 2011

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-K**

**x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended March 31, 2011**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 000-28827**

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**PETMED EXPRESS, INC.**

(Exact name of registrant as specified in its charter)

**FLORIDA**  
(State or other jurisdiction of  
incorporation or organization)

**65-0680967**  
(IRS Employer  
Identification No.)

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**1441 S.W. 29<sup>th</sup> Avenue, Pompano Beach, Florida 33069**  
(Address of principal executive offices) (Zip Code)

**Registrant's telephone number, including area code: (954) 979-5995**

**Securities registered under Section 12(b) of the Act:**

| <u>Title of each class</u>     | <u>Name of each exchange on which registered</u>                 |
|--------------------------------|--|
| COMMON STOCK, \$.001 PAR VALUE | The NASDAQ Stock Market LLC<br><br>(NASDAQ Global Select Market) |

**Securities registered under Section 12(g) of the Act:**

NONE

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.  S

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer", "large accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (check one):

|                         |    |                           |    |
|-------------------------|----|---------------------------|----|
| Large accelerated filer | .. | Accelerated filer         | x  |
| Non-accelerated filer   | .. | Smaller reporting company | .. |

(Do not check if smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  
.. No x

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant as of September 30, 2010, the last business day of the registrant's most recently completed second fiscal quarter, was \$387.0 million based on the closing sales price of the registrant's Common Stock on that date, as reported on the NASDAQ Global Select Market.

The number of shares of the registrant's Common Stock outstanding as of May 27, 2011 was 21,636,065.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

**Information to be set forth in our Proxy Statement relating to our 2011 Annual Meeting of Stockholders to be held on July 29, 2011 is incorporated by reference in Items 10, 11, 12, 13, and 14 of Part III of this report.**

**PETMED EXPRESS, INC.**

**2011 Annual Report on Form 10-K**

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## **PART I**

### **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

Certain information in this Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify these forward-looking statements by the words "believes," "intends," "expects," "may," "will," "should," "plan," "projects," "contemplates," "intends," "budgets," "predicts," "estimates," "anticipates," or similar expressions. These statements are based on our beliefs, as well as assumptions we have used based upon information currently available to us. Because these statements reflect our current views concerning future events, these statements involve risks, uncertainties and assumptions. Actual future results may differ significantly from the results discussed in the forward-looking statements. A reader, whether investing in our common stock or not, should not place undue reliance on these forward-looking statements, which apply only as of the date of this Annual Report.

When used in this Annual Report on Form 10-K, "PetMed Express," "1-800-PetMeds," PetMeds, "PetMed," PetMeds.com, "PetMed Express.com," "the Company," "we," "our," and "us" refer to PetMed Express, Inc. and our wholly-owned subsidiaries.

### **ITEM 1.**

#### **BUSINESS**

##### **General**

PetMed Express, Inc. and subsidiaries, d/b/a 1-800-PetMeds, is a leading nationwide pet pharmacy. The Company markets prescription and non-prescription pet medications, and other health products for dogs and cats, direct to the consumer. The Company offers consumers an attractive alternative for obtaining pet medications in terms of convenience, price, and speed of delivery.

The Company markets its products through national television, online, and direct mail/print advertising campaigns, which aim to increase the recognition of the 1-800-PetMeds brand name, and PetMeds family of trademarks, increase

traffic on its website at [www.1800petmeds.com](http://www.1800petmeds.com), acquire new customers, and maximize repeat purchases. Our fiscal year end is March 31, our executive offices are located at 1441 S.W. 29<sup>th</sup> Avenue, Pompano Beach, Florida 33069, and our telephone number is (954) 979-5995.

## **Our Products**

We offer a broad selection of products for dogs and cats. Our current product line contains approximately 1200 SKUS. These products include a majority of the well-known brands of medication, such as Frontline Plus®, K9 Advantix® II, Advantage® II, Heartgard Plus®, Sentinel®, Interceptor®, Program®, Revolution®, Deramaxx®, and Rimadyl®. Generally, our prices are competitive with the prices for medications charged by veterinarians and retailers. In March 2010, the Company started offering for sale additional pet supplies on our website, which are drop shipped to our customers by third parties. These pet supplies include: beds, crates, stairs, strollers, and other popular pet supplies.

We research new products, and regularly select new products or the latest generation of existing products to become part of our product selection. In addition, we also refine our current products to respond to changing consumer-purchasing habits. Our website is designed to give us the flexibility to change featured products or promotions. Our product line provides customers with a wide variety of selections across the most popular health categories for dogs and cats. Our current products include:

*Non-Prescription Medications (OTC):* Flea and tick control products, bone and joint care products, vitamins and nutritional supplements, and hygiene products.

*Prescription Medications (Rx):* Heartworm preventatives, arthritis, thyroid, diabetes, and pain medications, antibiotics, and other specialty medications, as well as generic substitutes.

## Sales

The following table provides a breakdown of the percentage of our total sales by each category during the indicated periods:

|   | <b>Year Ended March 31,</b> |             |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2011</b>                 | <b>2010</b> | <b>2009</b> |
| Non-prescription medications            | 61%                         | 64%         | 68%         |
| Prescription medications                | 38%                         | 35%         | 31%         |
| Shipping and handling charges and other | 1%                          | 1%          | 1%          |
| Total                                   | 100%                        | 100%        | 100%        |

We offer our products through three main sales channels: Internet through our website, telephone contact center through our toll-free number, and direct mail/print through 1-800-PetMeds catalogs, brochures, and postcards. We have designed our catalogs and website to provide a convenient, cost-effective, and informative shopping experience that encourages consumers to purchase products important for a pet's health and quality of life. We believe that these multiple channels allow us to increase the visibility of our brand name and provide our customers with increased shopping flexibility and excellent service.

### *Internet*

We seek to combine our product selection and pet health information with the shopping ease of the Internet to deliver a convenient and personalized shopping experience. Our website offers health and nutritional product selections for dogs and cats, and relevant editorial and easily obtainable or retrievable resource information. From our home page, customers can search our website for products and access resources on a variety of information on dogs and cats. Customers can shop at our website by category, product line, individual product, or symptom. We attracted approximately 16.0 million visitors to our website during fiscal 2011, approximately 14% of those visitors placed an order, and our website generated approximately 71% of our total sales for the same time period.

In February 2006, we began sponsorship of a website called "PetHealth101" which is located at [www.PetHealth101.com](http://www.PetHealth101.com). In PetHealth101, pet owners have access to health information covering pets' behavior and illnesses, and natural and pharmaceutical remedies specifically for a pet's problems. PetHealth101 is periodically updated with the latest research for pet owners. In fiscal 2012, the PerHealth101 content will be incorporated into our main website.



*Telephone Contact Center*

Our customer care representatives receive and process inbound and outbound customer calls, facilitate our live web chat, and process customer e-mails. Our telephone system is equipped with certain features including pop-up screens and call blending capabilities that give us the ability to efficiently utilize our customer care representatives' time, providing excellent customer care, service, and support. Our customer care representatives receive a base salary and are rewarded with commissions for sales, and bonuses and other awards for achieving certain quality goals.

*Direct Mail/Print*

The 1-800-PetMeds catalog is a full-color catalog that features our most popular products. The catalog is produced by a combination of in-house writers, production artists, and independent contractors. We mail catalogs, brochures, and postcards in response to requests generated from our advertising and as part of direct mail campaigns to our customers.

**Our Customers**

Approximately 2.6 million customers have purchased from us within the last two years. We attracted approximately 645,000 and 815,000 new customers in fiscal 2011 and 2010, respectively. Our customers are located throughout the United States, with approximately 50% of customers residing in California, Florida, Texas, New York, Pennsylvania, Virginia, North Carolina, and Georgia. Our primary focus has been on retail customers and the average purchase was approximately \$79 for fiscal 2011 compared to \$80 for fiscal 2010.

## **Marketing**

The goal of our marketing strategy is to build brand recognition, increase customer traffic, add new customers, build strong customer loyalty, maximize reorders, and develop incremental revenue opportunities. We have an integrated marketing campaign that includes television advertising, online marketing, direct mail/print and e-mail.

### *Television Advertising*

Our television advertising is designed to build brand equity, create brand awareness, and generate initial purchases of products via the telephone and the Internet. We have used :30 and :15 second television commercials to attract new customer orders. Our television commercials typically focus on our ability to rapidly deliver to customers the same medications offered by veterinarians, but at reduced prices. We generally purchase advertising on national cable channels to target our key demographic group – women, ages 30 to 65. We believe that television advertising is particularly effective and instrumental in building brand awareness.

### *Online Marketing*

We supplement our traditional advertising with online advertising and marketing efforts. We make our brand available to Internet consumers by purchasing targeted keywords and achieving prominent placement on the top search engines and search engine networks, including Google, Bing™, and Yahoo®. We utilize Internet banner advertisements and we are also members of the LinkShare Network, which is an affiliate program with merchant clients and affiliate websites.

### *Direct Mail/Print and E-mail*

We use direct mail/print and e-mail to acquire new customers and to remind our existing customers to reorder.

## **Operations**

### *Order Processing*

We provide our customers with toll-free telephone access to our customer care representatives. Our call center generally operates from 8:00 AM to 11:00 PM, Monday through Thursday, 8:00 AM to 9:00 PM on Friday, 9:00 AM to 6:00 PM on Saturday, and 10:00 AM to 5:00 PM on Sunday, Eastern Time. The process of customers purchasing products from 1-800-PetMeds consists of a few simple steps. A customer first places a call to our toll-free telephone number or visits our website. The following information is needed to process prescription orders: pet information, prescription information, and the veterinarian's name and phone number. This information is entered into our computer system. Then our pharmacists and pharmacy technicians verify all prescriptions. The order process system checks for the verification for prescription medication orders and a valid payment method for all orders. An invoice is generated and printed in our fulfillment center, where items are picked, and then shipped via United States Postal Service, Federal Express, or UPS. Our customers enjoy the convenience of rapid home delivery, with approximately 78% of all orders being shipped within 24 hours of ordering. Our website allows customers to easily browse and purchase all of our products online. Our website is designed to be fast, secure, and easy to use with order and shipping confirmations, and with online order tracking capabilities.

### *Customer Care and Support*

We believe that a high level of customer care and support is critical in retaining and expanding our customer base. Customer care representatives participate in ongoing training programs under the supervision of our training managers. These training sessions include a variety of topics such as product knowledge, computer usage, customer service tips, and the relationship between our Company and veterinarians. Our customer care representatives respond to customers' e-mails and calls that are related to products, order status, prices, and shipping. Our customer care representatives also respond to customers through our live web chat. We believe our customer care representatives are a valuable source of feedback regarding customer satisfaction. Our customer returns and credits averaged approximately 1.4% of total sales for fiscal 2011.

### *Warehousing and Shipping*

We inventory our products and fill most customer orders from our corporate headquarters in Pompano Beach, Florida. We have an in-house fulfillment and distribution operation, which is used to manage the entire supply chain, beginning with the placement of the order, continuing through order processing, and then fulfilling and shipping of the product to the customer. We offer a variety of shipping options, including next day delivery. We ship to anywhere in the United States served by the United States Postal Service, Federal Express, and UPS. Priority orders are expedited in our fulfillment process. Our goal is to ship the products the same day that the order is received. For prescription medications, our goal is to ship the product immediately after the prescription has been authorized by the customer's veterinarian.

### *Purchasing*

We purchase our products from a variety of sources, including certain manufacturers, domestic distributors, and wholesalers. There were seven suppliers from whom we purchased approximately 50% of all products in fiscal 2011. We purchase the majority of our health and nutritional supplements directly from manufacturers. We believe having strong relationships with product manufacturers will ensure the availability of an adequate volume of products ordered by our customers, and will enable us to provide more and better product information. Historically, substantially all the major manufacturers of prescription and non-prescription medications have declined to sell these products to direct marketing companies, such as our Company. (See Risk Factors.) Part of our growth strategy includes developing direct relationships with the leading pharmaceutical manufacturers of the more popular prescription and non-prescription medications. In March 2010 Bayer started making their products available directly to pet specialty retailers and internet sites, including our Company.

### **Technology**

We utilize integrated technologies in our call centers, e-commerce, order entry, and inventory control/fulfillment operations. Our systems are custom configured by the Company to optimize our computer telephone integration and mail-order processing. The systems are designed to maintain a large database of specialized information and process a large volume of orders efficiently and effectively. Our systems provide our customer care representatives, and our customers on our website, with real time product availability information and updated customer information to enhance our customer care. We also have an integrated direct connection for processing credit cards to ensure that a valid credit card number and authorization have been received at the same time our customer care representatives are on the phone with the customer or when a customer submits an order on our website. Our information systems provide our customer care representatives with records of all prior contact with a customer, including the customer's

address, phone number, e-mail address, prescription information, order history, payment history, and notes.

## Competition

The pet medications market is competitive and highly fragmented. Our competitors consist of veterinarians, online and traditional retailers. We believe that the following are the principal competitive factors in our market:

.

Product selection and availability, including the availability of prescription and non-prescription medications;

.

Brand recognition;

.

Reliability and speed of delivery;

.

Personalized service and convenience;

.

Price; and

.

Quality of website content.

We compete with veterinarians for the sale of prescription and non-prescription pet medications and other health products. Many pet owners may prefer the convenience of purchasing their pet medications or other health products at the time of a veterinarian visit, or may be hesitant to offend their veterinarian by not purchasing these products from the veterinarian. In order to effectively compete with veterinarians, we must continue to educate pet owners about the service, convenience, and savings offered by our Company.



According to the American Pet Products Manufacturers Association, pet spending in the United States increased 6.2% to \$48.3 billion in 2010. Pet supplies and medications represented \$10.9 billion, or 23% of the total spending on pets in the United States. The pet medication market that we participate in is estimated to be approximately \$3.8 billion, with veterinarians having the majority of the market share. The dog and cat population is approximately 165 million, with approximately 62% of all households owning a pet.

We believe that the following are the main competitive strengths that differentiate 1-800-PetMeds from the competition:

.  
Channel leader, in an estimated \$3.8 billion industry;

.  
1-800-PetMeds brand name;

.  
Licensed pharmacy to conduct business in 50 states, and awarded Vet-VIPPS<sup>CM</sup> (Veterinary-Verified Internet Pharmacy Practice Site) accreditation by the National Association of Boards of Pharmacy®;

.  
Exceptional customer care and support

### **Intellectual Property**

We conduct our business under the trade name 1-800-PetMeds and use a family of names all containing the term PetMeds or PetMed in some form. We believe this trade name, which is also our toll-free telephone number, and the PetMeds family of trademarks, have added significant value and are an important factor in the marketing of our products. We have also obtained the right to use and control the Internet addresses [www.1800petmeds.com](http://www.1800petmeds.com), [www.1888petmeds.com](http://www.1888petmeds.com), [www.petmedexpress.com](http://www.petmedexpress.com), [www.petmed.com](http://www.petmed.com), and [www.petmeds.com](http://www.petmeds.com). We do not expect to lose the ability to use the Internet addresses; however, there can be no assurance in this regard and the loss of these addresses may have a material adverse effect on our financial position and results of operations. We are the exclusive owners of United States Trademark Registrations for PetMed Express and Design®, 1888PetMeds and Design®, 1-800-PetMeds and Design®, 1-800-PetMeds®, and PetMeds®.

## **Government Regulation**

Dispensing prescription medications is governed at the state level by the Board of Pharmacy, or similar regulatory agencies, of each state where prescription medications are dispensed. We are subject to regulation by the State of Florida and are licensed as a community pharmacy by the Florida Board of Pharmacy. Our current license is valid until February 28, 2013, and prior to that date a renewal application will be submitted to the Board of Pharmacy. Our pharmacy practice is also licensed and/or regulated by 49 other state pharmacy boards and, with respect to our products, by other regulatory authorities including, but not necessarily limited to, the United States Food and Drug Administration ( FDA ) and the United States Environmental Protection Agency. As a licensed pharmacy in the State of Florida, we are subject to the Florida Pharmacy Act and regulations promulgated thereunder. To the extent that we are unable to maintain our license as a community pharmacy with the Florida Board of Pharmacy, or if we do not maintain the licenses granted by other state pharmacy boards, or if we become subject to actions by the FDA, or other enforcement regulators, our distribution of prescription medications to pet owners could cease, which could have a material adverse effect on our financial condition and results of operations.

## **Employees**

We currently have 204 full time employees, including: 118 in customer care and marketing; 34 in fulfillment and purchasing; 38 in our pharmacy; 4 in information technology; 3 in administrative positions; and 7 in management. None of our employees are represented by a labor union, or governed by any collective bargaining agreements. We consider relations with our employees to be satisfactory.

## **Available Information**

We file annual, quarterly, and current reports, proxy statements, and other information with the Securities and Exchange Commission ("SEC"). Our SEC filings, including our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act are available to the public free of charge over the Internet at our website at [www.1800petmeds.com](http://www.1800petmeds.com) or at the SEC's web site at [www.sec.gov](http://www.sec.gov). Our SEC filings will be available through our website as soon as reasonably practicable after we have electronically filed or furnished them to the SEC. Information contained on our website is not incorporated by reference into this annual report on Form 10-K.





You may also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Room 1580, Washington D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330 or on the Internet at [www.sec.gov](http://www.sec.gov). The Company's Code of Business Conduct and Ethics and the charters for each of our committees of the Board of Directors may be found in our 2004 Proxy which was filed on June 30, 2004. You may also obtain a copy of our Code of Business Conduct and Ethics and the charters for each of our committees of the Board of Directors free of charge by contacting Investor Relations at 1-800-738-6337.

## ITEM 1A.

### RISK FACTORS

You should carefully consider the risks and uncertainties described below, and all the other information included in this Annual Report on Form 10-K before you decide to invest in our common stock. Any of the following risks could materially adversely affect our business, financial condition, or operating results and could result in a loss of your investment.

*We may inadvertently fail to comply with various state regulations covering the dispensing of prescription pet medications which may subject us to reprimands, sanctions, probations, fines, suspensions, or the loss of one or more of our pharmacy licenses.*

The sale and delivery of prescription pet medications is generally governed by state laws and state regulations. Since our pharmacy is located in the State of Florida, the Company is governed by the laws and regulations of the State of Florida. Each prescription pet medication sale we make is likely also to be covered by the laws of the state where the customer is located. The laws and regulations relating to the sale and delivery of prescription pet medications vary from state to state, but generally require that prescription pet medications be dispensed with the authorization from a prescribing veterinarian. To the extent that we are unable to maintain our license as a community pharmacy with the Florida Board of Pharmacy, or if we do not maintain the licenses granted by other state boards, or if we become subject to actions by the FDA, or other enforcement regulators, our distribution of prescription medications to pet owners could cease, which could have a material adverse effect on our operations.

The Company is a party to routine litigation and administrative complaints incidental to its business. Management does not believe that the resolution of any or all of such routine litigation and administrative complaints is likely to have a material adverse effect on the Company's financial condition or results of operations. While we make every effort to fully comply with all applicable state rules, laws, and regulations, from time to time we have been the subject of administrative complaints regarding the authorization of prescriptions prior to shipment. We cannot assure you that we will not continue to be the subject of administrative complaints in the future. We cannot guarantee you that we

will not be subject to reprimands, sanctions, probations, or fines, or that one or more of our pharmacy licenses will not be suspended or revoked. If we were unable to maintain our license as a community pharmacy in the State of Florida, or if we are not granted licensure in a state that begins to require licensure, or if one or more of the licenses granted by other state boards should be suspended or revoked, our ability to continue to sell prescription medications and to continue our business as it is presently conducted could be in jeopardy.

*We currently purchase a portion of our prescription and non-prescription medications from third party distributors and we are not an authorized distributor of these products. We do not have any guaranteed supply of medications at any pre-established prices.*

The majority of our sales were attributable to sales of prescription and non-prescription medications. Historically, substantially all the major pharmaceutical manufacturers have declined to sell prescription and non-prescription pet medications directly to us. In order to assure a supply of these products, we purchase medications from various secondary sources, including a variety of domestic distributors. Our business strategy includes seeking to establish direct purchasing arrangements with major pet pharmaceutical manufacturing companies. If we are not successful in achieving this goal, we will continue to rely upon secondary sources.

We cannot guarantee that if we continue to purchase prescription and non-prescription pet medications from secondary sources that we will be able to purchase an adequate supply to meet our customers' demands, or that we will be able to purchase these products at competitive prices. As these products represent a significant portion of our sales, our failure to fill customer orders for these products could adversely impact our sales. If we are forced to pay higher prices for these products to ensure an adequate supply, we cannot guarantee that we will be able to pass along to our customers any increases in the prices we pay for these medications. This inability to pass along increased prices could materially adversely affect our financial condition and results of operations.

*Our failure to properly manage our inventory may result in excessive inventory carrying costs, or inadequate supply of products, which could materially adversely affect our financial condition and results of operations.*

Our current product line contains approximately 1200 SKUs. A significant portion of our sales is attributable to products representing approximately 90 SKUs, including the most popular flea and tick, and heartworm preventative brands. We need to properly manage our inventory to provide an adequate supply of these products and avoid excessive inventory of the products representing the balance of the SKUs. We generally place orders for products with our suppliers based upon our internal estimates of the amounts of inventory we will need to fill future orders. These estimates may be significantly different from the actual orders we receive.

In the event that subsequent orders fall short of original estimates, we may be left with excess inventory. Significant excess inventory could result in price discounts and increased inventory carrying costs. Similarly, if we fail to have an adequate supply of some SKUs, we may lose sales opportunities. We cannot guarantee that we will maintain appropriate inventory levels. Any failure on our part to maintain appropriate inventory levels may have a material adverse effect on our financial condition and results of operations.

*Resistance from veterinarians to authorize prescriptions, or attempts/efforts on their part to discourage pet owners to purchase from internet mail-order pharmacies could cause our sales to decrease and could materially adversely affect our financial condition and results of operations.*

Since we began our operations some veterinarians have resisted providing our customers with a copy of their pet's prescription or authorizing the prescription to our pharmacy staff, thereby effectively preventing us from filling such prescriptions under state law. We have also been informed by customers and consumers that veterinarians have tried to discourage pet owners from purchasing from internet mail-order pharmacies. Sales of prescription medications represented approximately 38% of our sales for the fiscal year. Although veterinarians in some states are required by law to provide a pet owner with a prescription if medically appropriate, if the number of veterinarians who refuse to authorize prescriptions should increase, or if veterinarians are successful in discouraging pet owners from purchasing from internet mail-order pharmacies, our sales could decrease and our financial condition and results of operations may be materially adversely affected.

*Significant portions of our sales are made to residents of eight states. If we should lose our pharmacy license in one or more of these states, our financial condition and results of operations would be materially adversely affected.*

While we ship pet medications to customers in all 50 states, approximately 50% of our sales for the fiscal year ended March 31, 2011 were made to customers located in the states of California, Florida, Texas, New York, Pennsylvania,

Virginia, North Carolina, and Georgia. If for any reason our license to operate a pharmacy in one or more of those states should be suspended or revoked, or if it is not granted or renewed, our ability to sell prescription medications to residents of those states would cease and our financial condition and results of operations in future periods would be materially adversely affected.

*We face significant competition from veterinarians and online and traditional retailers and may not be able to compete profitably with them.*

We compete directly and indirectly with veterinarians for the sale of pet medications and other health products. Veterinarians hold a competitive advantage over us because many pet owners may find it more convenient or preferable to purchase these products directly from their veterinarians at the time of an office visit. We also compete directly and indirectly with both online and traditional retailers. Both online and traditional retailers may hold a competitive advantage over us because of longer operating histories, established brand names, greater resources, and/or an established customer base. Online retailers may have a competitive advantage over us because of established affiliate relationships to drive traffic to their website. Traditional retailers may hold a competitive advantage over us because pet owners may prefer to purchase these products from a store instead of online or through catalog or telephone methods. In order to effectively compete in the future, we may be required to offer promotions and other incentives, which may result in lower operating margins and adversely affect the results of operations.

We also face a significant challenge from our competitors forming alliances with each other, such as those between online and traditional retailers. These relationships may enable both their retail and online stores to negotiate better pricing and better terms from suppliers by aggregating the demand for products and negotiating volume discounts, which could be a competitive disadvantage to us.

*The content of our website could expose us to various kinds of liability, which, if prosecuted successfully, could negatively impact our business.*

Because we post product and pet health information and other content on our website, we face potential liability for negligence, copyright infringement, patent infringement, trademark infringement, defamation, and/or other claims based on the nature and content of the materials we post. Various claims have been brought, and sometimes successfully prosecuted, against Internet content distributors. We could be exposed to liability with respect to the unauthorized duplication of content or unauthorized use of other parties' proprietary technology. Although we maintain general liability insurance, our insurance may not cover potential claims of this type, or may not be adequate to indemnify us for all liability that may be imposed. Any imposition of liability that is not covered by insurance, or is in excess of insurance coverage, could materially adversely affect our financial condition and results of operations.

*We may not be able to protect our intellectual property rights, and/or we may be found to infringe on the proprietary rights of others.*

We rely on a combination of trademarks, trade secrets, copyright laws, and contractual restrictions to protect our intellectual property rights. These afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy our non-prescription private label generic equivalents, when and if developed, as well as aspects of our sales formats, or to obtain and use information that we regard as proprietary, including the technology used to operate our website and our content, and our trademarks. Litigation or proceedings before the United States Patent and Trademark Office or other bodies may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets and domain names, or to determine the validity and scope of the proprietary rights of others. Any litigation or adverse proceeding could result in substantial costs and diversion of resources, and could seriously harm our business and operating results. Third parties may also claim infringement by us with respect to past, current, or future technologies. We expect that participants in our market will be increasingly involved in infringement claims as the number of services and competitors in our industry segment grows. Any claim, whether meritorious or not, could be time-consuming, result in costly litigation, cause service upgrade delays, or require us to enter into royalty or licensing agreements. These royalty or licensing agreements might not be available on terms acceptable to us or at all.

*If we are unable to protect our Internet addresses or to prevent others from using Internet addresses that are confusingly similar, our business may be adversely impacted.*

Our Internet addresses, [www.1800petmeds.com](http://www.1800petmeds.com), [www.1888petmeds.com](http://www.1888petmeds.com), [www.petmedexpress.com](http://www.petmedexpress.com), [www.petmed.com](http://www.petmed.com), and [www.petmeds.com](http://www.petmeds.com) are critical to our brand recognition and our overall success. If we are unable to protect these Internet addresses, our competitors could capitalize on our brand recognition. There may be similar Internet addresses used by competitors. Governmental agencies and their designees generally regulate the acquisition and maintenance

of Internet addresses. The regulation of Internet addresses in the United States and in foreign countries has changed, and may undergo further change in the near future. Furthermore, the relationship between regulations governing Internet addresses and laws protecting trademarks and similar proprietary rights is unclear. Therefore, we may not be able to protect our own Internet addresses, or prevent third parties from acquiring Internet addresses that are confusingly similar to, infringe upon, or otherwise decrease the value of our Internet addresses.

*Since all of our operations are housed in a single location, we are more susceptible to business interruption in the event of damage to or disruptions in our facility.*

Our headquarters and distribution center are located in two buildings in one location in South Florida, and most of our shipments of products to our customers are made from this sole distribution center. We have no present plans to establish any additional distribution centers or offices. Because we consolidate our operations in one location, we are more susceptible to power and equipment failures, and business interruptions in the event of fires, floods, and other natural disasters than if we had additional locations. Furthermore, because we are located in South Florida, which is a hurricane-sensitive area, we are particularly susceptible to the risk of damage to, or total destruction of, our headquarters and distribution center and surrounding transportation infrastructure caused by a hurricane. We cannot assure you that we are adequately insured to cover the amount of any losses relating to any of these potential events, business interruptions resulting from damage to or destruction of our headquarters and distribution center, or power and equipment failures relating to our call center or websites, or interruptions or disruptions to major transportation infrastructure, or other events that do not occur on our premises. The occurrence of one or more of these events could adversely impact our ability to generate revenues in future periods.

*Our operating results are difficult to predict and may fluctuate, and a portion of our sales are seasonal.*

Factors that may cause our operating results to fluctuate include:

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Our ability to obtain new customers at a reasonable cost, retain existing customers, or encourage reorders;

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Our ability to increase the number of visitors to our website, or our ability to convert visitors to our website into customers;

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The mix of medications and other pet products sold by us;

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Our ability to manage inventory levels or obtain an adequate supply of products;

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Our ability to adequately maintain, upgrade, and develop our website, the systems that we use to process customers orders and payments, or our computer network;

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Increased competition within our market niche;

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Price competition;

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New products introduced to the market, including generics.

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Increases in the cost of advertising;

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The amount and timing of operating costs and capital expenditures relating to expansion of our product line or operations; and

Disruption of our toll-free telephone service, technical difficulties, or systems and Internet outages or slowdowns.

Because our operating results are difficult to predict, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. The majority of our product sales are affected by the seasons, due to the seasonality of mainly heartworm, and flea and tick medications. For the quarters ended June 30, 2010, September 30, 2010, December 31, 2010, and March 31, 2011, Company sales were 32%, 26%, 20%, and 22%, respectively. In addition to the seasonality of our sales, our annual and quarterly operating results have fluctuated in the past and may fluctuate significantly in the future due to a variety of factors, many of which are out of our control. Any change in one or more of these factors could materially adversely affect our financial condition and results of operations in future periods.

*Our stock price fluctuates from time to time and may fall below expectations of securities analysts and investors, and could subject us to litigation, which may result in you suffering a loss on your investment.*

The market price of our common stock may fluctuate significantly in response to a number of factors, many of which are out of our control. These factors include: quarterly variations in operating results; changes in accounting treatments or principles; announcements by us or our competitors of new products and services offerings; significant contracts, acquisitions, or strategic relationships; additions or departures of key personnel; any future sales of our common stock or other securities; stock market price and volume fluctuations of publicly-traded companies; and general political, economic, and market conditions.

In some future quarter our operating results may fall below the expectations of securities analysts and investors, which could result in a decrease in the trading price of our common stock. In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may be the target of similar litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources, which could seriously harm our business and operating results.

*We may issue additional shares of preferred stock that could defer a change of control or dilute the interests of our common stockholders. Our charter documents could defer a takeover effort which could inhibit your ability to receive an acquisition premium for your shares.*

Our charter permits our Board of Directors to issue up to 5.0 million shares of preferred stock without stockholder approval. Currently there are 2,500 shares of our Convertible Preferred Stock issued and outstanding. This leaves a little less than 5.0 million shares of preferred stock available for issuance at the discretion of our Board of Directors.

These shares, if issued, could contain dividend, liquidation, conversion, voting, or other rights which could adversely affect the rights of our common stockholders and which could also be utilized, under some circumstances, as a method of discouraging, delaying, or preventing a change in control. Provisions of our articles of incorporation, bylaws and Florida law could make it more difficult for a third party to acquire us, even if many of our stockholders believe it is in their best interest.

*Our investments in auction rate securities are subject to risks which may adversely affect our liquidity.*

The Company has \$12.5 million (par) invested in auction rate securities ( ARS ) which were classified as long term investments in our financial statements as of March 31, 2011. Our ARS investments are not mortgage-backed based but are municipal-based and the securities underlying the ARS are currently rated AAA, the highest rating available by a rating agency. Our ARS consist of closed-end fund preferred ARS, whose interest rates are reset, typically every seven to twenty-eight days. Liquidity for our ARS historically has been provided by an auction process which has allowed us the opportunity to sell the securities at each auction date, and for those securities not sold, resets the applicable interest rate every seven or twenty-eight days. Although auctions had been successful prior to February 2008, auctions for our ARS have failed, which therefore has eliminated our ability to sell these securities through the standard auction process. Currently there is no liquid market for these securities. There is no assurance that future auctions in our ARS will succeed. An auction failure means that the parties wishing to sell their securities cannot be matched with an adequate volume of buyers. In the event that there is a failed auction the indenture governing the security requires the issuer to pay interest at a contractually defined rate which may or may not correspond to market rates for other types of similar short-term instruments. Our securities for which auctions have failed will continue to accrue interest at the contractual rate and be subject to the auction process every seven or twenty-eight days until the auction succeeds, the issuer redeems the securities, or the security matures. As a result, our ability to liquidate our investment in these securities and use the cash proceeds in the near term may be limited.

As of March 31, 2011, the Company held \$12.5 million in ARS, at par, which were classified as long term investments and the Company recorded an unrealized impairment loss of approximately \$2,000 for the year then ended. As of March 31, 2011, cumulative losses of \$110,000 were recognized within the accumulated other comprehensive loss account, based upon an assessment by the outside third party appraisal firm. The \$110,000 impairment was recorded as temporary due to the fact that the Company has both the ability and intent to hold these securities until anticipated recovery or maturity. However, it could take until the final maturity or issuer refinancing of the underlying debt for us to realize the recorded value of our investments in these securities. If the issuers of our ARS are unable to successfully close future auctions or redeem or refinance the securities and their credit ratings deteriorate, we may in the future be required to record an additional impairment charge on these investments, or may need to sell these securities on a secondary market. Although we believe we will be able to liquidate our investments in these securities without any significant loss, the timing and financial impact of such an outcome is uncertain. Based on our expected cash expenditures, our cash and cash equivalents balance, and other potential sources of cash, we do not anticipate that the potential lack of liquidity of these investments in the near term will adversely affect our ability to execute our current business plan.

*The United States Environmental Protection Agency ( EPA ) has announced its intention to increase restrictions on flea and tick products and to caution consumers to use these products with extra care. The Company s sales and profits in future periods could be adversely impacted if sales for these products decline.*

The EPA is taking a series of actions to increase the safety of spot-on pesticide products for flea and tick control for cats and dogs. In 2008 the EPA received 44,000 complaints about certain spot-on pest prevention products, including some flea and tick control products that the Company currently sells. The complaints reported adverse reactions ranging from mild effects such as skin irritations to more serious effects such as seizures and, in some cases, death of the pet. Since that time, the EPA received additional information from the pet spot-on pesticide registrants and others and began an intensive evaluation of these products. Among immediate actions that the EPA is going to pursue are: requiring manufacturers of spot-on pesticide products to improve labeling, making instructions clearer to prevent product misuse; requiring more precise label instructions to ensure proper dosage per pet weight; requiring clear markings to differentiate between dog and cat products, and disallowing similar brand names for dog and cat products. There can be no assurances that this action by the EPA will not adversely affect our future sales and profits.

**ITEM 1B.**

**UNRESOLVED STAFF COMMENTS**

None

**ITEM 2.**

**PROPERTIES**

Our facilities, including our principal executive offices, are located at 1441 S.W. 29<sup>th</sup> Avenue and 2900 Gateway Drive, Pompano Beach, Florida 33069. The Company leases its 65,300 square foot executive offices, warehouse facility, customer service and pharmacy contact centers under a non-cancelable operating lease, through May 31, 2015. The Company is responsible for certain maintenance costs, taxes, and insurance under this lease. The future minimum annual lease payments are as follows: \$745,000 for fiscal 2012, \$767,000 for fiscal 2013, \$784,000 for fiscal 2014, \$794,000 for fiscal 2015, and \$133,000 for fiscal 2016, a lease payment total of \$3.2 million. Rent expense was \$724,000, \$703,000, and \$641,000 for the years ended March 31, 2011, 2010 and 2009, respectively.

**ITEM 3.**

**LEGAL PROCEEDINGS**

In October 2009, the Company was notified that it was named as a defendant in a multi-defendant lawsuit, filed in the United States District Court for the Eastern District of Texas, Marshall Division, seeking declaratory, injunctive, and monetary relief styled Charles E. Hill & Associates, Inc. v. ABT Electronics, Inc., et al, Cause No. 2:09-CV-313. The lawsuit alleges that the Company is infringing on patents related to electronic catalog systems. From the outset, the vendor that provides the Company with the Internet software had been defending and indemnifying the Company. However, effective February 15, 2011, the company that acquired this vendor declined to provide any further indemnification of the Company. The Company is continuing to defend itself, and at this stage, it is difficult to assess any possible outcome or estimate any potential loss in the event of an adverse outcome.

The Company has settled complaints that had been filed with various states' pharmacy boards in the past. There can be no assurance made that other states will not attempt to take similar actions against the Company in the future. The Company initiates litigation to protect its trade or service marks. There can be no assurance that the Company will be successful in protecting its trade or service marks. Legal costs related to the above matters are expensed as incurred.

**ITEM 4.**

**(REMOVED AND RESERVED)**

**PART II****ITEM 5.****MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock, par value \$.001 per share, began trading publicly in 1997. Our common stock is currently traded on the NASDAQ Global Select Market ( NASDAQ ) under the symbol PETS. The prices set forth below reflect the range of high and low closing sale prices per share in each of the quarters of fiscal 2011 and 2010 as reported by the NASDAQ.

|                     |             |            |
|---------------------|-------------|------------|
| <b>Fiscal 2011:</b> | <b>High</b> | <b>Low</b> |
| First Quarter       | \$24.50     | \$17.34    |
| Second Quarter      | \$18.45     | \$15.45    |
| Third Quarter       | \$18.80     | \$15.21    |
| Fourth Quarter      | \$17.89     | \$14.39    |
| <b>Fiscal 2010:</b> | <b>High</b> | <b>Low</b> |
| First Quarter       | \$17.55     | \$14.19    |
| Second Quarter      | \$19.26     | \$14.37    |
| Third Quarter       | \$19.74     | \$15.53    |
| Fourth Quarter      | \$23.30     | \$17.82    |

There were 94 holders of record of our common stock at May 27, 2011, and we estimate there were approximately 13,000 beneficial stockholders on that date.

*Dividend Policy*

On August 3, 2009, the Company's Board of Directors declared its first quarterly dividend of \$0.10 per share on its common stock, and on August 2, 2010, the Company's Board of Directors increased the quarterly dividend to \$0.125 per share. The Company intends to continue to pay regular quarterly dividends; however the declaration and payment of future dividends is discretionary and will be subject to a determination by the Board of Directors each quarter following its review of the Company's financial performance.

During fiscal 2011, our Board of Directors declared the following dividends:

| <b>Declaration Date</b> | <b>Per Share Dividend</b> | <b>Record Date</b> | <b>Total Amount (In thousands)</b> | <b>Payment Date</b> |
|-------------------------|---------------------------|--------------------|------------------------------------|---------------------|
|                         |                           |                    | \$                                 |                     |
| May 3, 2010             | \$0.100                   | May 14, 2010       | 2,299                              | May 28, 2010        |
|                         |                           |                    | \$                                 |                     |
| August 2, 2010          | \$0.125                   | August 13, 2010    | 2,864                              | August 27, 2010     |
|                         |                           |                    | \$                                 |                     |
| November 1, 2010        | \$0.125                   | November 12, 2010  | 2,848                              | November 26, 2010   |
|                         |                           |                    | \$                                 |                     |
| January 31, 2011        | \$0.125                   | February 11, 2011  | 2,811                              | February 25, 2011   |

On May 6, 2011, the Company's Board of Directors declared a quarterly dividend of \$0.125 per share on its common stock. The \$2.8 million dividend was paid on May 27, 2011, to shareholders of record at the close of business on May 16, 2011.

#### *Share Repurchase Plan*

On November 8, 2006, the Company's Board of Directors approved a share repurchase plan of up to \$20.0 million. On October 31, 2008 and November 1, 2010, the Company's Board of Directors approved a second and third share repurchase plan, respectively, for an additional \$20.0 million. The repurchase plan is intended to be implemented through purchases made from time to time in either the open market or through private transactions at the Company's discretion, subject to market conditions and other factors, in accordance with Securities and Exchange Commission requirements. There can be no assurances as to the precise number of shares that will be repurchased under the share repurchase plan, and the Company may discontinue the share repurchase plan at any time subject to compliance with applicable regulatory requirements. Shares purchased pursuant to the share repurchase plan will either be cancelled or held in the Company's treasury.



During fiscal 2011 the Company repurchased approximately 791,000 shares of the Company's outstanding common stock for approximately \$12.2 million, averaging approximately \$15.47 per share. During fiscal 2010 the Company did not repurchase any of its own shares. As of March 31, 2011, the Company had approximately \$17.7 million remaining under the Company's share repurchase plan. All shares repurchased in fiscal 2011 were subsequently retired. Subsequent to March 31, 2011, the Company repurchased approximately 695,000 of its own shares for approximately \$9.0 million. Since the inception of the share repurchase plan, approximately 3.8 million shares have been repurchased under the plan for approximately \$51.3 million, averaging approximately \$13.56 per share, with approximately \$8.7 million remains available for repurchase, as of May 27, 2011.

### *Performance Graph*

Set forth below is a graph comparing the five year cumulative performance of our Common Stock with the Standard & Poor's Composite-500 Stock Index (the S&P 500), the Nasdaq Composite, and the Russell 2000, from March 31, 2006 to March 31, 2011. The graph assumes that \$100 was invested on March 31, 2006 in each of our Common Stock, the S&P 500, the Nasdaq Composite, and the Russell 2000 and that all dividends were reinvested. The performance graph and related information below shall not be deemed filed with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that we specifically incorporate it by reference into such filing.

Performance graph data:

|                             | <b>Fiscal Year Ended March 31,</b> |             |             |             |             |             |
|-----------------------------|------------------------------------|-------------|-------------|-------------|-------------|-------------|
|                             | <b>2006</b>                        | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>2010</b> | <b>2011</b> |
| <b>Nasdaq Composite</b>     | 100.00                             | 103.50      | 97.41       | 65.33       | 102.49      | 118.86      |
| <b>S&amp;P 500</b>          | 100.00                             | 109.73      | 102.15      | 61.62       | 90.31       | 102.39      |
| <b>Russell 2000</b>         | 100.00                             | 104.65      | 89.91       | 55.25       | 88.69       | 110.25      |
| <b>PetMed Express, Inc.</b> | 100.00                             | 66.69       | 62.41       | 92.74       | 124.76      | 89.25       |

*Securities Authorized for Issuance under Equity Compensation Plans*

The following table sets forth securities authorized for issuance under equity compensation plans, including individual compensation arrangements, by us under our 2006 Employee Equity Compensation Restricted Stock Plan and 2006 Outside Director Equity Compensation Restricted Stock Plan as of March 31, 2011:

**EQUITY COMPENSATION PLAN INFORMATION**  
**(In thousands, except for per share amounts)**

| <b>Plan category</b>                | <b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b> | <b>Weighted average exercise price of outstanding options, warrants and rights</b> | <b>Number of securities remaining available for future issuance under equity compensation plans</b> |
|-------------------------------------|--|--|---|
| 2006 Employee Restricted Stock Plan | 481  | -  | 519   |
| 2006 Director Restricted Stock Plan | 122  | -  | 78  |
| Total                               | 603  |  | 597   |

**ITEM 6.****SELECTED FINANCIAL DATA**

The following selected financial data should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations," the Consolidated Financial Statements and notes thereto, and other financial information included elsewhere in this Annual Report on Form 10-K. The Consolidated Statements of Income data set forth below for the fiscal years ended March 31, 2011, 2010, and 2009 and the Consolidated Balance Sheet data as of March 31, 2011 and 2010 have been derived from our audited Consolidated Financial Statements which are included elsewhere in this Annual Report on Form 10-K. The Consolidated Statements of Income data set forth below for the fiscal years ended March 31, 2008 and 2007 and the Consolidated Balance Sheet data as of March 31, 2009, 2008 and 2007 have been derived from our audited Consolidated Financial Statements which are not included in this Annual Report on Form 10-K.

**CONSOLIDATED STATEMENTS OF INCOME DATA****(In thousands, except for per share amounts)****Fiscal Year Ended March 31,**

|   | <b>2011</b> | <b>2010</b> | <b>2009</b> | <b>2008</b> | <b>2007</b> |
|---|-------------|-------------|-------------|-------------|-------------|
|   | \$          | \$          | \$          | \$          | \$          |
| Sales   | 231,642     | 238,266     | 219,412     | 188,336     | 162,246     |
| Cost of sales   | 147,686     | 146,405     | 134,085     | 114,122     | 97,680      |
| Gross profit  | 83,956      | 91,861      | 85,328      | 74,214      | 64,566      |
| Operating expenses                                    | 50,932      | 51,319      | 51,127      | 46,218      | 43,066      |
| Net income  | 20,871      | 26,002      | 22,976      | 20,022      | 14,444      |
| Net income per common share:                          |             |             |             |             |             |
| Basic   | 0.93        | 1.15        | 0.99        | 0.83        | 0.60        |
| Diluted   | 0.92        | 1.14        | 0.98        | 0.82        | 0.60        |
| Weighted average number of common shares outstanding: |             |             |             |             |             |
| Basic   | 22,514      | 22,617      | 23,306      | 24,088      | 24,109      |
| Diluted   | 22,643      | 22,746      | 23,482      | 24,299      | 24,271      |
| Cash dividends declared per common share              | 0.475       | 0.300       | -           | -           | -           |

**CONSOLIDATED BALANCE SHEET DATA****(In thousands)**

|  | <b>2011</b> | <b>2010</b> | <b>March 31,<br/>2009</b> | <b>2008</b> | <b>2007</b> |
|--|-------------|-------------|---------------------------|-------------|-------------|
|--|-------------|-------------|---------------------------|-------------|-------------|

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|                      | \$      | \$     | \$      | \$     | \$     |        |
|----------------------|---------|--------|---------|--------|--------|--------|
| Working capital      |         | 80,643 | 79,412  | 54,630 | 38,804 | 50,613 |
| Total assets         | 106,287 |        | 104,170 | 81,963 | 73,455 | 61,218 |
| Total liabilities    | 9,282   |        | 7,313   | 6,995  | 6,421  | 7,355  |
| Shareholders' equity | 97,005  |        | 96,857  | 74,968 | 67,034 | 53,864 |

**NON FINANCIAL DATA (UNAUDITED)**

(In thousands)

|                                    | <b>2011</b> | <b>2010</b> | <b>March 31,<br/>2009</b> | <b>2008</b> | <b>2007</b> |
|------------------------------------|-------------|-------------|---------------------------|-------------|-------------|
| New customers acquired             | 645         | 815         | 802                       | 710         | 681         |
| Total accumulated customers<br>(1) | 6,108       | 5,463       | 4,648                     | 3,846       | 3,136       |

(1) includes both active and inactive customers

## ITEM 7.

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

#### Executive Summary

PetMed Express was incorporated in the state of Florida in January 1996. The Company's common stock is traded on the NASDAQ Global Select Market under the symbol PETS. The Company began selling pet medications and other pet health products in September 1996. Presently, the Company's product line includes approximately 1,200 of the most popular pet medications, health products, and supplies for dogs and cats. In March 2010 the Company started offering for sale additional pet supplies on its website, and these items are drop shipped to customers by third parties.

The Company markets its products through national television, online, and direct mail/print advertising campaigns which aim to increase the recognition of the 1-800-PetMeds brand name, and PetMeds family of trademarks, increase traffic on its website at [www.1800petmeds.com](http://www.1800petmeds.com), acquire new customers, and maximize repeat purchases. Approximately 71% of all sales were generated via the Internet in fiscal 2011, compared to 68% in fiscal 2010. The Company's sales consist of products sold mainly to retail consumers. The Company's sales returns average was approximately 1.4% of sales for the fiscal year ended March 31, 2011 and approximately 1.5% for the fiscal year ended March 31, 2010. The twelve-month average purchase was approximately \$79 and \$80 per order for the fiscal years ended March 31, 2011 and 2010, respectively.

#### Critical Accounting Policies

Our discussion and analysis of our financial condition and the results of our operations are based upon our Consolidated Financial Statements and the data used to prepare them. The Company's Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America. On an ongoing basis we re-evaluate our judgments and estimates including those related to product returns, bad debts, inventories, long term investments, and income taxes. We base our estimates and judgments on our historical experience, knowledge of current conditions, and our beliefs of what could occur in the future considering available information. Actual results may differ from these estimates under different assumptions or conditions. Our estimates are guided by observing the following critical accounting policies.

Revenue recognition

The Company generates revenue by selling pet medication products and pet supplies primarily to retail consumers. The Company's policy is to recognize revenue from product sales upon shipment, when the rights of ownership and risk of loss have passed to the customer. Outbound shipping and handling fees are included in sales and are billed upon shipment. Shipping expenses are included in cost of sales. The majority of the Company's sales are paid by credit cards and the Company usually receives the cash settlement in two to three banking days. Credit card sales minimize accounts receivable balances relative to sales. The Company maintains an allowance for doubtful accounts for losses that the Company estimates will arise from customers' inability to make required payments, arising from either credit card charge-backs or insufficient funds checks. The Company determines its estimates of the uncollectibility of accounts receivable by analyzing historical bad debts and current economic trends. At March 31, 2011 and 2010 the allowance for doubtful accounts was approximately \$6,000 and \$5,000, respectively.

#### Valuation of inventory

Inventories consist of prescription and non-prescription pet medications and pet supplies that are available for sale and are priced at the lower of cost or market value using a weighted average cost method. The Company writes down its inventory for estimated obsolescence. The inventory reserve was approximately \$63,000 and \$73,000 for the fiscal years ended March 31, 2011 and 2010, respectively.

#### Advertising

The Company's advertising expense consists primarily of television advertising, Internet marketing, and direct mail/print advertising. Television advertising costs are expensed as the advertisements are televised. Internet costs are expensed in the month incurred and direct mail/print advertising costs are expensed when the related catalogs, brochures, and postcards are produced, distributed, or superseded.

## Accounting for income taxes

The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes* (ASC Topic 740), which generally requires recognition of deferred tax assets and liabilities for the expected future tax benefits or consequences of events that have been included in the Consolidated Financial Statements or tax returns.

Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting carrying values and the tax bases of assets and liabilities, and are measured by applying enacted tax rates and laws for the taxable years in which those differences are expected to reverse.

**Results of Operations**

The following should be read in conjunction with the Company's Consolidated Financial Statements and the related notes thereto included elsewhere herein. The following table sets forth, as a percentage of sales, certain operating data appearing in the Company's Consolidated Statements of Income:

|  | <b>Fiscal Year Ended March 31,</b> |             |             |
|--|------------------------------------|-------------|-------------|
|  | <b>2011</b>                        | <b>2010</b> | <b>2009</b> |
| Sales                                    | 100.0%                             | 100.0%      | 100.0%      |
| Cost of sales                            | 63.8                               | 61.4        | 61.1        |
| Gross profit                             | 36.2                               | 38.6        | 38.9        |
| Operating expenses:                      |                                    |             |             |
| General and administrative               | 9.6                                | 9.4         | 9.8         |
| Advertising                              | 11.8                               | 11.6        | 13.1        |
| Depreciation                             | 0.6                                | 0.6         | 0.4         |
| Total operating expenses                 | 22.0                               | 21.6        | 23.3        |
| Income from operations                   | 14.2                               | 17.0        | 15.6        |
| Total other income                       | 0.2                                | 0.1         | 0.7         |
| Income before provision for income taxes | 14.4                               | 17.1        | 16.3        |
| Provision for income taxes               | 5.4                                | 6.2         | 5.8         |
| Net income                               | 9.0%                               | 10.9%       | 10.5%       |



## **Fiscal 2011 Compared to Fiscal 2010**

### **Sales**

Sales decreased by approximately \$6.7 million, or 2.8%, to approximately \$231.6 million for the fiscal year ended March 31, 2011, from approximately \$238.3 million for the fiscal year ended March 31, 2010. The decrease in sales for the fiscal year ended March 31, 2011 was primarily due to decreased new order sales offset by an increase in reorder sales. The decrease in new order sales may be attributed to an increase in customer acquisition costs, due to a reduction in response rates, as a result of increased competition and softer demand. The Company acquired approximately 645,000 new customers for the year ended March 31, 2011, compared to approximately 815,000 new customers for the same period the prior year.

The following chart illustrates sales by various sales classifications:

| Sales (In thousands) | Year Ended March 31, |        |         |        |             |            |
|----------------------|----------------------|--------|---------|--------|-------------|------------|
|                      | 2011                 | %      | 2010    | %      | \$ Variance | % Variance |
|                      | \$                   |        | \$      |        | \$          |            |
| Reorder Sales        | 184,341              | 79.6%  | 177,805 | 74.6%  | 6,536       | 3.7%       |
|                      | \$                   |        | \$      |        | \$          |            |
| New Order Sales      | 47,301               | 20.4%  | 60,461  | 25.4%  | (13,160)    | -21.8%     |
|                      | \$                   |        | \$      |        | \$          |            |
| Total Net Sales      | 231,642              | 100.0% | 238,266 | 100.0% | (6,624)     | -2.8%      |
|                      | \$                   |        | \$      |        | \$          |            |
| Internet Sales       | 165,473              | 71.4%  | 162,803 | 68.3%  | 2,670       | 1.6%       |
|                      | \$                   |        | \$      |        | \$          |            |
| Contact Center Sales | 66,169               | 28.6%  | 75,463  | 31.7%  | (9,294)     | -12.3%     |
|                      | \$                   |        | \$      |        | \$          |            |
| Total Net Sales      | 231,642              | 100.0% | 238,266 | 100.0% | (6,624)     | -2.8%      |

Sales may be adversely affected in fiscal 2012 due to increased competition and consumers giving more consideration to price and trading down to less expensive brands, including generics, some of which we may not carry. In response to these trends, the Company implemented a more aggressive pricing strategy combined with increased advertising while continuing to expand our product offerings into pet supplies. This more aggressive pricing strategy will result in a decrease to gross profit margins, and no guarantees can be made that the Company's efforts will be successful, or that sales will grow in the future.

The majority of our product sales are affected by the seasons, due to the seasonality of mainly heartworm, and flea and tick medications. For the quarters ended June 30, September 30, December 31, and March 31 of fiscal 2011, the Company's sales were approximately 32%, 26%, 20%, and 22%, respectively.

#### Cost of sales

Cost of sales increased by \$1.3 million, or 0.9%, to \$147.7 million for the fiscal year ended March 31, 2011, from \$146.4 million for the fiscal year ended March 31, 2010. The increase in cost of sales is directly related to increased product costs. As a percentage of sales, cost of sales was 63.8% in fiscal 2011, as compared to 61.4% in fiscal 2010.

The cost of sales percentage increase can be mainly attributed to more aggressive sales promotions, reduced product retail pricing, and increases in our product costs.

### **Gross profit**

Gross profit decreased by \$7.9 million, or 8.6%, to \$84.0 million for the fiscal year ended March 31, 2011, from \$91.9 million for the fiscal year ended March 31, 2010. Gross profit as a percentage of sales for fiscal 2011 and 2010 was 36.2% and 38.6%, respectively. The gross profit percentage decrease can be mainly attributed to more aggressive sales promotions, reduced product retail pricing, and increases in our product costs.

### **General and administrative expenses**

General and administrative expenses decreased by \$141,000, or 0.6%, to \$22.2 million for the fiscal year ended March 31, 2011 from \$22.3 million for the fiscal year ended March 31, 2010. The decrease in general and administrative expenses for the fiscal year ended March 31, 2011 was primarily due to the following: a \$153,000 decrease in insurance expenses, due to a reduction in insurance premiums; a \$78,000 decrease to licenses and fees, due to a one time charge recognized in fiscal 2010; and a \$58,000 net decrease in other expenses, including telephone expenses, travel expense, bank service fees, payroll expenses, and office expenses. Offsetting the decrease was a \$60,000 increase in professional fees, which includes investor relations and pharmacy fees; a \$58,000 increase in property expenses, and a \$30,000 increase to bad debt expense. General and administrative expenses as a percentage of sales was 9.6% compared to 9.4% for the fiscal years ended March 31, 2011 and 2010, respectively. The increase in general and administrative expenses as a percentage of sales can mainly be attributed to a reduction in sales in fiscal 2011.

### **Advertising expenses**

Advertising expenses decreased by approximately \$300,000, or 1.1%, to approximately \$27.4 million for the year ended March 31, 2011, from approximately \$27.7 million for the year ended March 31, 2010. The decrease in advertising expenses for fiscal 2011 can be attributed to a reduction in television remnant space inventory at prices the Company was willing to pay. The advertising costs of acquiring a new customer, defined as total advertising costs divided by new customers acquired, increased to \$42 for the year ended March 31, 2011,



compared to \$34 for the year ended March 31, 2010. Advertising cost of acquiring a new customer can be impacted by the advertising environment, the effectiveness of our advertising creative, increased advertising spending, and price competition.

Historically, the advertising environment fluctuates due to supply and demand. A more favorable advertising environment may positively impact future new order sales, whereas a less favorable advertising environment may negatively impact future new order sales. As a percentage of sales, advertising expense was 11.8 % and 11.6% for the years ended March 31, 2011 and 2010, respectively. The increase in advertising expense as a percentage of total sales for the year ended March 31, 2011 can be attributed to decreased sales and increased new customer acquisition costs due to a reduction in response rates, as a result of increased competition and softer demand. The Company currently anticipates advertising as a percentage of sales to be approximately 13% for fiscal 2012. However, the advertising percentage will fluctuate quarter to quarter due to seasonality and advertising availability. For the fiscal year ended March 31, 2011, quarterly advertising expenses as a percentage of sales ranged between 10% and 14%.

### **Depreciation**

Depreciation increased by approximately \$54,000, or 4.1%, to approximately \$1.4 for the year ended March 31, 2011, from approximately \$1.3 million for the year ended March 31, 2010. This increase to depreciation for the year ended March 31, 2011 can be attributed to an increase in new property and equipment additions relating to the warehouse, pharmacy, and customer call center over the past 2 fiscal years.

### **Other income**

Other income increased by approximately \$53,000, to approximately \$253,000 for the year ended March 31, 2011 from approximately \$200,000 for the year ended March 31, 2010. The increase to other income for the year ended March 31, 2011 can be attributed to increased interest income. Interest income may decrease in the future as the Company utilizes its cash balances on its share repurchase plan, with approximately \$17.7 million remaining as of March 31, 2011, on any quarterly dividend payment, or on its operating activities.

### **Provision for income taxes**

For the fiscal years ended March 31, 2011 and 2010, the Company recorded an income tax provision for approximately \$12.4 and \$14.7 million, respectively. The effective tax rate for the fiscal years ended March 31, 2011

and 2010 were 37.3% and 36.2%, respectively. The effective tax rate increase for the year ended March 31, 2011 was attributed to a one-time \$280,000 tax charge to reconcile the remaining net operating loss carryforward in the first quarter of fiscal 2011. The Company estimates its effective tax rate will be approximately 37.0% for fiscal 2012.

### **Net income**

Net income decreased by approximately \$5.1 million, or 19.7%, to approximately \$20.9 million for the fiscal year ended March 31, 2011 from approximately \$26.0 million for the fiscal year ended March 31, 2010. The decrease was mainly attributable to the reduction in gross profit margin and new order sales in fiscal 2011.

### **Fiscal 2010 Compared to Fiscal 2009**

#### **Sales**

Sales increased by approximately \$18.9 million, or 8.6%, to approximately \$238.3 million for the fiscal year ended March 31, 2010, from approximately \$219.4 million for the fiscal year ended March 31, 2009. The increase in sales for the fiscal year ended March 31, 2010 was primarily due to increased reorder sales offset by a decrease in new order sales. The decrease in new order sales may be attributed to a reduction in advertising spending for the fiscal year, along with a reduction in the average order size. The Company has committed certain dollar amounts specifically designated towards television, online, and direct mail/print advertising to stimulate sales, create brand awareness, and acquire new customers. There can be no assurances that this growth trend will continue, due to increasing competition from veterinarians and traditional and online retailers, and a reduction in our average order size. The Company acquired approximately 815,000 new customers for the year ended March 31, 2010, compared to approximately 802,000 new customers for the same period the prior year.

The following chart illustrates sales by various sales classifications:

| Sales (In thousands) | Year Ended March 31, |        |         |        |             |            |
|----------------------|----------------------|--------|---------|--------|-------------|------------|
|                      | 2010                 | %      | 2009    | %      | \$ Variance | % Variance |
|                      | \$                   |        | \$      |        | \$          |            |
| Reorder Sales        | 177,805              | 74.6%  | 156,934 | 71.5%  | 20,871      | 13.3%      |
|                      | \$                   |        | \$      |        | \$          |            |
| New Order Sales      | 60,461               | 25.4%  | 62,478  | 28.5%  | (2,017)     | -3.2%      |
|                      | \$                   |        | \$      |        | \$          |            |
| Total Net Sales      | 238,266              | 100.0% | 219,412 | 100.0% | 18,854      | 8.6%       |
|                      | \$                   |        | \$      |        | \$          |            |
| Internet Sales       | 162,803              | 68.3%  | 143,284 | 65.3%  | 19,519      | 13.6%      |
|                      | \$                   |        | \$      |        | \$          |            |
| Contact Center Sales | 75,463               | 31.7%  | 76,128  | 34.7%  | (665)       | -0.9%      |
|                      | \$                   |        | \$      |        | \$          |            |
| Total Net Sales      | 238,266              | 100.0% | 219,412 | 100.0% | 18,854      | 8.6%       |

Sales may be adversely affected in fiscal 2011 due to increased retail and on-line competition and the lack of television remnant space availability at affordable prices. Television advertising has been the Company's predominant marketing method for several years. Historically, there has been a direct correlation between the amount of television advertising done by the Company and its sales. Sales may also be affected by consumers giving more consideration to price and trading down to less expensive retail brands, which we may not carry. In response to these trends, the Company is currently attempting to shift some advertising dollars from television to both on-line and print campaigns, and offer more promotions to our existing database to encourage reorders and reactivate inactive customers. However, there can be no assurances that the alternative advertising strategies to television will have the same impact on our sales and more aggressive sales promotions could also result in a decrease to gross profit margins. No guarantees can be made that the Company's efforts will be successful, or that sales will continue to grow.

The majority of our product sales are affected by the seasons, due to the seasonality of mainly heartworm, and flea and tick medications. For the quarters ended June 30, September 30, December 31, and March 31 of fiscal 2010, the Company's sales were approximately 33%, 26%, 20%, and 21%, respectively.

**Cost of sales**

Cost of sales increased by \$12.3 million, or 9.2%, to \$146.4 million for the fiscal year ended March 31, 2010, from \$134.1 million for the fiscal year ended March 31, 2009. The increase in cost of sales is directly related to the increase in sales in fiscal 2010 as compared to fiscal 2009. As a percentage of sales, cost of sales was 61.4% in fiscal 2010, as compared to 61.1% in fiscal 2009. The percentage increase can be mainly attributed to increases in our product costs, offset by a reduction in freight expenses due to a shift from priority to standard shipping.

**Gross profit**

Gross profit increased by \$6.6 million, or 7.7%, to \$91.9 million for the fiscal year ended March 31, 2010, from \$85.3 million for the fiscal year ended March 31, 2009. Gross profit as a percentage of sales for fiscal 2010 and 2009 was 38.6% and 38.9%, respectively. The gross profit percentage decrease can be mainly attributed to increases in our product costs, offset by a reduction in freight expenses due to a shift from priority to standard shipping.

**General and administrative expenses**

General and administrative expenses increased by \$736,000, or 3.4%, to \$22.3 million for the fiscal year ended March 31, 2010 from \$21.6 million for the fiscal year ended March 31, 2009. The increase in general and administrative expenses for the fiscal year ended March 31, 2010 was primarily due to the following: a \$513,000 increase in payroll expenses which can be attributed to the addition of new employees in the customer care and pharmacy departments enabling the Company to sustain its growth; a \$384,000 increase in credit card and bank service fees which is directly attributable to increased sales in the fiscal year; a \$211,000 increase in property expenses which can be directly attributed to increased rent due to the 15,000 square feet warehouse and pharmacy expansion; and a \$88,000 increase in license expenses which can be directly attributed to increased fees associated with the state of Ohio. Offsetting the increase was a \$283,000 reduction in professional fees, with the majority of the decrease relating to legal and pharmacy fees; a \$61,000 decrease in telephone expenses, a \$56,000 decrease in bad debt expense, and a \$60,000 decrease in other expenses including office and insurance expenses. General and administrative expenses as a percentage of sales was 9.4% compared to



9.8% for the fiscal years ended March 31, 2010 and 2009, respectively. The decrease in general and administrative expenses as a percentage of sales can mainly be attributed to efficiencies in payroll expenses and a reduction of professional fees.

### **Advertising expenses**

Advertising expenses decreased by approximately \$1.0 million, or 3.7%, to approximately \$27.7 million for the year ended March 31, 2010, from approximately \$28.7 million for the year ended March 31, 2009. The decrease in advertising expenses for the year can be mainly attributed to a shortage in the remnant television advertising inventory. During the year the Company planned to commit certain amounts specifically designated towards television, online, and direct mail/print advertising to stimulate sales, create brand awareness, and acquire new customers. The advertising costs of acquiring a new customer, defined as total advertising costs divided by new customers acquired, was \$34 for the year ended March 31, 2010, compared to \$36 for the year ended March 31, 2009.

Advertising cost of acquiring a new customer can be impacted by the advertising environment, the effectiveness of our advertising creative, increased advertising spending, and price competition from veterinarians and other retailers of pet medications. Historically, the advertising environment fluctuates due to supply and demand. A more favorable advertising environment may positively impact future new order sales, whereas a less favorable advertising environment may negatively impact future new order sales. As a percentage of sales, advertising expense was 11.6% and 13.1% for the years ended March 31, 2010 and 2009, respectively. The decrease in advertising expense as a percentage of total sales for the year ended March 31, 2010 can be attributed to increased sales with declining new customer acquisition costs and a reduction in advertising spending. The Company currently anticipates advertising as a percentage of sales to range between approximately 11.0% and 12.0% for fiscal 2011. However, the advertising percentage will fluctuate quarter to quarter due to seasonality and advertising availability. For the fiscal year ended March 31, 2010, quarterly advertising expenses as a percentage of sales ranged between 10% and 13%.

### **Depreciation**

Depreciation increased by approximately \$507,000, or 62%, to approximately \$1.3 million for the year ended March 31, 2010, from approximately \$815,000 for the year ended March 31, 2009. This increase to depreciation for the year ended March 31, 2010 can be attributed to an increase in new property and equipment additions relating to the warehouse, pharmacy, and customer call center expansion in fiscal 2009.

### **Other income**

Other income decreased by approximately \$1.3 million, or 86%, to approximately \$201,000 for the year ended March 31, 2010 from approximately \$1.5 million for the year ended March 31, 2009. The decrease to other income can be primarily attributed to decreased interest income due to a reduction in interest rates. The decrease can also be attributed to a reduction in advertising revenue generated from our website. Interest income may decrease in the future due to a reduction in interest rates and also as the Company utilizes its cash balances on its \$20.0 million share repurchase plan, with approximately \$10.0 million remaining as of March 31, 2010, on any quarterly dividend payment, or on its operating activities.

### **Provision for income taxes**

For the fiscal years ended March 31, 2010 and 2009, the Company recorded an income tax provision for approximately \$14.7 and \$12.7 million, respectively. The effective tax rate for the fiscal years ended March 31, 2010 and 2009 were 36.2% and 35.6%, respectively. The effective tax rate increase was due to less tax-free interest income for the year compared to the same period the prior year. The Company estimates its effective tax rate will range between approximately 36.5% and 37.0% for fiscal 2011.

### **Net income**

Net income increased by approximately \$3.0 million, or 13.2%, to approximately \$26.0 million for the fiscal year ended March 31, 2010 from approximately \$23.0 million for the fiscal year ended March 31, 2009. The increase was mainly attributable to the Company's sales growth and our success in leveraging our operating expenses.

## Liquidity and Capital Resources

The Company's working capital at March 31, 2011 and 2010 was approximately \$80.6 million and approximately \$79.4 million, respectively. The \$1.2 million increase in working capital was primarily attributable to cash flow generated from operations, offset by share repurchases and dividends paid. Net cash provided by operating activities was \$30.1 million and \$27.7 million for the fiscal years ended March 31, 2011 and 2010, respectively. Net cash used in investing activities was \$10.8 million for the year ended March 31, 2011, compared to net cash provided by investing activities of \$1.1 million for the year ended March 31, 2010. This change can be attributed to an increase in the Company's short term investments during the year ended March 31, 2011. Net cash used in financing activities was \$22.8 million and \$5.8 million for the years ended March 31, 2011 and 2010, respectively. This change was primarily due to the Company paying approximately \$10.7 million in dividends for the year ended March 31, 2011 and purchasing 791,000 shares of its common stock for approximately \$12.2 million in fiscal 2011, compared to the Company paying approximately \$6.8 million in dividends and not purchasing any shares of its common stock in fiscal 2010. As of March 31, 2011 the Company had approximately \$17.7 million remaining under the Company's share repurchase plan. Subsequent to March 31, 2011, the Company repurchased approximately 695,000 of its own shares for approximately \$9.0 million, averaging approximately \$13.01 per share. On May 6, 2011 our Board of Directors declared a \$0.125 per share dividend. The Board established a May 16, 2011 record date and a May 27, 2011 payment date. Depending on future market conditions the Company may utilize its cash and cash equivalents on the remaining balance of its current share repurchase plan, on quarterly dividends, or on its operating activities.

The Company has \$12.5 million, at par, invested in ARS which were classified as long term investments in our financial statements as of March 31, 2011. Our ARS investments are not mortgage-backed based but are municipal-based and the securities underlying the ARS are currently rated AAA, the highest rating available by a rating agency. Our ARS consist of closed-end fund preferred ARS, whose interest rates are reset, typically every seven to twenty-eight days. In fiscal 2011, the fair value of investments was based upon a valuation assessment by an outside third party, conducted in April 2011. The Company recorded an unrealized impairment loss of \$110,000, in fiscal 2011, within accumulated other comprehensive loss, based upon an assessment of the fair value of these ARS. The \$110,000 impairment was recorded as temporary due to the fact that the Company has both the ability and intent to hold these securities until anticipated recovery or maturity. However, it could take until the final maturity or issuer refinancing of the underlying debt for us to realize the recorded value of our investments in these securities. If the issuers of our ARS are unable to successfully close future auctions or redeem or refinance the securities and their credit ratings deteriorate, we may in the future be required to record an additional impairment charge on these investments, or may need to sell these securities on a secondary market. Although we believe we will be able to liquidate our investments in these securities without any significant loss, the timing and financial impact of such an outcome is uncertain. Based on our expected cash expenditures, our cash and cash equivalents balance, and other potential sources of cash, we do not anticipate that the potential lack of liquidity of these investments in the near term will adversely affect our ability to execute our current business plan.

As of both March 31, 2011 and 2010 the Company had no outstanding lease commitments except for the lease for its 65,300 square foot facility. We are not currently bound by any long or short term agreements for the purchase or lease of capital expenditures. Any amounts expended for capital expenditures would be the result of an increase in the

capacity needed to adequately provide for any increase in our business. To date we have paid for any needed additions to our capital equipment infrastructure from working capital funds and anticipate this being the case in the future. Presently, we have approximately \$500,000 forecasted for capital expenditures in fiscal 2012 which will be funded through cash from operations. The Company's primary source of working capital is cash from operations. The Company presently has no need for alternative sources of working capital, and has no commitments or plans to obtain additional capital.

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

The Company had no off-balance sheet arrangements as of March 31, 2011.

**Contractual Obligations and Commitments (In thousands)**

|                               | <b>Total</b> | <b>Less than<br/>1 year</b> | <b>1-2 years</b> | <b>3-5 Years</b> | <b>More than<br/>5 years</b> |
|-------------------------------|--------------|-----------------------------|------------------|------------------|------------------------------|
|                               | \$           | \$                          | \$               | \$               | \$                           |
| Property lease                | 3,223        | 745                         | 767              | 1,711            | -                            |
|                               | \$           | \$                          | \$               | \$               | \$                           |
| Executive employment contract | 1,100        | 550                         | 550              | -                | -                            |
|                               | \$           | \$                          | \$               | \$               | \$                           |
| Total obligations             | 4,323        | 1,295                       | 1,317            | 1,711            | -                            |

**Recent Accounting Pronouncements**

The Company does not believe that any recently issued, but not yet effective, accounting standards, if currently adopted, will have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

**ITEM 7A.****QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk generally represents the risk that losses may occur in the value of financial instruments as a result of movements in interest rates, foreign currency exchange rates, and commodity prices. Our financial instruments include cash and cash equivalents, short and long term investments, accounts receivable, and accounts payable. The book values of cash equivalents, short and long term investments, accounts receivable, and accounts payable are considered to be representative of fair value because of the short maturity of these instruments. Interest rates affect our return on excess cash and investments. As of March 31, 2011, we had \$49.7 million in cash and cash equivalents, \$10.1 million in short term investments and \$12.4 million in long term investments. A majority of our cash and cash equivalents and investments generate interest income based on prevailing interest rates.

A significant change in interest rates would impact the amount of interest income generated from our excess cash and investments. It would also impact the market value of our investments. Our investments are subject to market risk, primarily interest rate and credit risk. Our investments are managed by a limited number of outside professional managers within investment guidelines set by our Board of Directors. Such guidelines include security type, credit quality, and maturity, and are intended to limit market risk by restricting our investments to high-quality debt instruments with both short and long term maturities. We do not hold any derivative financial instruments that could expose us to significant market risk. At March 31, 2011, we had no debt obligations.

**ITEM 8.**

**FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**PETMED EXPRESS, INC. AND SUBSIDIARIES**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders

PetMed Express, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of PetMed Express, Inc. and Subsidiaries as of March 31, 2011 and 2010, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended March 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PetMed Express, Inc. and Subsidiaries as of March 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2011, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), PetMed Express, Inc. and Subsidiaries' internal control over financial reporting as of March 31, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated May 27, 2011 expressed an unqualified opinion on the effectiveness of PetMed Express, Inc. and Subsidiaries' internal control over financial reporting.



/s/ McGladrey & Pullen, LLP

McGladrey & Pullen, LLP

New York, New York

May 27, 2011

**PETMED EXPRESS, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

(In thousands)

|  | March 31,<br>2011 | March 31,<br>2010 |
|--|-------------------|-------------------|
| <b><u>ASSETS</u></b>   |                   |                   |
| Current assets:  |                   |                   |
| Cash and cash equivalents  | \$ 49,660         | \$ 53,143         |
| Short term investments - available for sale  | 10,116            | -                 |
| Accounts receivable, less allowance for doubtful<br>accounts of \$6 and \$5, respectively  | 1,985             | 2,097             |
| Inventories - finished goods   | 25,140            | 29,064            |
| Prepaid expenses and other current assets  | 1,036             | 610               |
| Deferred tax assets  | 1,003             | 1,255             |
| Prepaid income taxes   | 664               | 330               |
| Total current assets   | 89,604            | 86,499            |
| <br>   |                   |                   |
| Long term investments  | 12,390            | 12,392            |
| Property and equipment, net  | 3,433             | 4,429             |
| Intangible asset   | 860               | 850               |
| <br>   |                   |                   |
| Total assets   | \$ 106,287        | \$ 104,170        |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>   |                   |                   |
| Current liabilities:   |                   |                   |
| Accounts payable   | \$ 6,452          | \$ 4,776          |
| Accrued expenses and other current liabilities   | 2,509             | 2,312             |
| Total current liabilities  | 8,961             | 7,088             |
| <br>   |                   |                   |
| Deferred tax liabilities   | 321               | 225               |
| <br>   |                   |                   |
| Total liabilities:   | 9,282             | 7,313             |
| <br>   |                   |                   |
| Commitments and contingencies  |                   |                   |
| <br>   |                   |                   |
| Shareholders' equity:  |                   |                   |
| Preferred stock, \$.001 par value, 5,000 shares authorized;<br>3 convertible shares issued and outstanding with a<br>liquidation preference of \$4 per share | 9                 | 9                 |
| Common stock, \$.001 par value, 40,000 shares authorized;<br>22,331 and 22,990 shares issued and outstanding, respectively                                   | 22                | 23                |

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|  |            |            |
|--|------------|------------|
| Additional paid-in capital                 | -          | 2,628      |
| Retained earnings                          | 97,115     | 94,305     |
| Accumulated other comprehensive loss       | (141)      | (108)      |
| Total shareholders' equity                 | 97,005     | 96,857     |
| Total liabilities and shareholders' equity | \$ 106,287 | \$ 104,170 |

See accompanying notes to consolidated financial statements.

**PETMED EXPRESS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**(In thousands, except for per share amounts)**

|   |    | <b>Year Ended March 31,</b> |             |             |
|---|----|-----------------------------|-------------|-------------|
|   |    | <b>2011</b>                 | <b>2010</b> | <b>2009</b> |
| Sales   | \$ | 231,642                     | \$ 238,266  | \$ 219,412  |
| Cost of sales   |    | 147,686                     | 146,405     | 134,085     |
| Gross profit  |    | 83,956                      | 91,861      | 85,327      |
| Operating expenses:                                   |    |                             |             |             |
| General and administrative                            |    | 22,200                      | 22,341      | 21,605      |
| Advertising   |    | 27,357                      | 27,657      | 28,707      |
| Depreciation  |    | 1,375                       | 1,321       | 814         |
| Total operating expenses                              |    | 50,932                      | 51,319      | 51,126      |
| Income from operations                                |    | 33,024                      | 40,542      | 34,201      |
| Other income (expense):                               |    |                             |             |             |
| Interest income, net                                  |    | 381                         | 196         | 1,056       |
| Other, net  |    | (128)                       | 4           | 408         |
| Loss on disposal of property and<br>equipment         |    | -                           | -           | (9)         |
| Total other income                                    |    | 253                         | 200         | 1,455       |
| Income before provision for income taxes              |    | 33,277                      | 40,742      | 35,656      |
| Provision for income taxes                            |    | 12,406                      | 14,740      | 12,680      |
| Net income  | \$ | 20,871                      | \$ 26,002   | \$ 22,976   |
| Net income per common share:                          |    |                             |             |             |
| Basic   | \$ | 0.93                        | \$ 1.15     | \$ 0.99     |
| Diluted   | \$ | 0.92                        | \$ 1.14     | \$ 0.98     |
| Weighted average number of common shares outstanding: |    |                             |             |             |
| Basic   |    | 22,514                      | 22,617      | 23,306      |
| Diluted   |    | 22,643                      | 22,746      | 23,482      |
| Cash dividends declared per common share              | \$ | 0.475                       | \$ 0.300    | \$ -        |

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See accompanying notes to consolidated financial statements.

**PETMED EXPRESS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

**Fiscal years ended March 31, 2009, March 31, 2010, and March 31, 2011**

**(In thousands)**

|  | <b>Convertible<br/>Preferred Stock</b> |                | <b>Common<br/>Stock</b> |                | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Treasury<br/>Stock</b> | <b>Other<br/>Comprehensive<br/>Loss</b> | <b>Total</b> |
|--|--|----------------|-------------------------|----------------|---|------------------------------|---------------------------|---|--------------|
|  | <b>Shares</b>                          | <b>Amounts</b> | <b>Shares</b>           | <b>Amounts</b> |   |                              |                           |   |              |
| Balance, March 31, 2008  | 3\$                                    | 9              | 23,734\$                | 24\$           | 8,396\$                                   | 58,639\$                     | (34)\$                    |   | -\$ 67,034   |
| Issuance of common stock from exercise of stock options  | -                                      | -              | 225                     | -              | 1,893                                     | -                            | -                         | -                                       | 1,893        |
| Issuance of restricted stock   | -                                      | -              | 78                      | -              | -   | -                            | -                         | -                                       | -            |
| Share based compensation   | -                                      | -              | -                       | -              | 1,464                                     | -                            | -                         | -                                       | 1,464        |
| Tax benefit related to stock options exercised   | -                                      | -              | -                       | -              | 268                                       | -                            | -                         | -                                       | 268          |
| Repurchased and retired shares   | -                                      | -              | (1,350)                 | (1)            | (18,480)                                  | -                            | 34                        | -                                       | (18,447)     |
| Allocation of retirement of repurchased shares of additional paid in capital and retained earnings | -                                      | -              | -                       | -              | 6,459                                     | (6,459)                      | -                         | -                                       | -            |
| Net income   | -                                      | -              | -                       | -              | -   | 22,976                       | -                         | 22,976                                  | 22,976       |

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|   |   |   |        |    |       |         |   |           |         |
|---|---|---|--------|----|-------|---------|---|-----------|---------|
| Other comprehensive loss:                               |   |   |        |    |       |         |   |           |         |
| Unrealized loss on long term investments                |   |   |        |    |       |         |   | (220)     | (220)   |
| Total comprehensive income                              |   |   |        |    |       |         |   | \$ 22,756 | -       |
| Balance, March 31, 2009                                 | 3 | 9 | 22,687 | 23 | -     | 75,156  | - | (220)     | 74,968  |
| Issuance of common stock from exercise of stock options | - | - | 102    | -  | 735   | -       | - | -         | 735     |
| Issuance of restricted stock                            | - | - | 201    | -  | -     | -       | - | -         | -       |
| Share based compensation                                | - | - | -      | -  | 1,594 | -       | - | -         | 1,594   |
| Tax benefit related to stock options exercised          | - | - | -      | -  | 299   | -       | - | -         | 299     |
| Dividends declared                                      | - | - | -      | -  | -     | (6,853) | - | -         | (6,853) |
| Net income  | - | - | -      | -  | -     | 26,002  | - | 26,002    | 26,002  |
| Other comprehensive loss:                               |   |   |        |    |       |         |   |           |         |
| Net Change in unrealized gain on long term investments  |   |   |        |    |       |         |   | 112       | 112     |
| Total comprehensive income                              |   |   |        |    |       |         |   | \$ 26,114 | -       |
|   | 3 | 9 | 22,990 | 23 | 2,628 | 94,305  | - | (108)     | 96,857  |

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Balance, March  
31, 2010

|   |   |   |       |     |          |          |   |        |          |
|---|---|---|-------|-----|----------|----------|---|--------|----------|
| Issuance of<br>common stock<br>from<br>exercise of<br>stock options   | - | - | 46    | -   | 340      | -        | - | -      | 340      |
| Issuance of<br>restricted stock,<br>net   | - | - | 86    | -   | -        | -        | - | -      | -        |
| Share based<br>compensation   | - | - | -     | -   | 2,171    | -        | - | -      | 2,171    |
| Dividends<br>declared   | - | - | -     | -   | -        | (10,822) | - | -      | (10,822) |
| Repurchased<br>and retired<br>shares  | - | - | (791) | (1) | (12,246) | -        | - | -      | (12,247) |
| Deferred tax<br>adjustment<br>related to<br>restricted<br>stock and stock<br>options                                    | - | - | -     | -   | (132)    | -        | - | -      | (132)    |
| Allocation of<br>retirement of<br>repurchased<br>shares of<br>additional<br>paid in<br>capital and<br>retained earnings | - | - | -     | -   | 7,239    | (7,239)  | - | -      | -        |
| Net income  | - | - | -     | -   | -        | 20,871   | - | 20,871 | 20,871   |
| Other<br>comprehensive<br>loss:   |   |   |       |     |          |          |   |        |          |
| Net Change<br>in unrealized<br>loss on<br>short term<br>investments   |   |   |       |     |          |          |   | (31)   | (31)     |
| Net Change<br>in unrealized   |   |   |       |     |          |          |   |        |          |



|                                     |     |   |           |       |      |           |        |                |
|-------------------------------------|-----|---|-----------|-------|------|-----------|--------|----------------|
| loss on<br>long term<br>investments |     |   |           |       |      |           | (2)    | (2)            |
| Total<br>comprehensive<br>income    |     |   |           |       |      | \$        | 20,838 | -              |
| Balance, March<br>31, 2011          | 3\$ | 9 | 22,331 \$ | 22 \$ | - \$ | 97,115 \$ | - \$   | (141)\$ 97,005 |

See accompanying notes to consolidated financial statements.

**PETMED EXPRESS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

|   | Year Ended March 31, |           |           |
|---|----------------------|-----------|-----------|
|   | 2011                 | 2010      | 2009      |
| Cash flows from operating activities:   |                      |           |           |
| Net income  | \$ 20,871            | \$ 26,002 | \$ 22,976 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                      |           |           |
| Depreciation  | 1,375                | 1,321     | 815       |
| Share based compensation  | 2,171                | 1,594     | 1,464     |
| Deferred income taxes   | 348                  | (305)     | 497       |
| Loss on disposal of property and equipment  | -                    | -         | 9         |
| Bad debt expense  | 48                   | 18        | 74        |
| (Increase) decrease in operating assets and increase (decrease) in liabilities:   |                      |           |           |
| Accounts receivable   | 64                   | 766       | (1,380)   |
| Inventories - finished goods  | 3,924                | (2,286)   | (8,868)   |
| Prepaid income taxes  | (335)                | 32        | (362)     |
| Prepaid expenses and other current assets   | (426)                | 144       | (62)      |
| Accounts payable  | 1,964                | 313       | (313)     |
| Income taxes payable  | -                    | -         | (185)     |
| Accrued expenses and other current liabilities                                    | 102                  | 86        | 301       |
| Net cash provided by operating activities   | 30,106               | 27,685    | 14,966    |
| Cash flows from investing activities:   |                      |           |           |
| Net change in investments   | (10,146)             | 2,150     | 14,870    |
| Purchases of property and equipment   | (667)                | (1,047)   | (3,208)   |
| Purchases of intangible asset   | (10)                 | -         | (485)     |
| Net proceeds from the sale of property and equipment                              | -                    | -         | 2         |
| Net cash (used in) provided by investing activities                               | (10,823)             | 1,103     | 11,179    |
| Cash flows from financing activities:   |                      |           |           |
| Dividends paid  | (10,727)             | (6,805)   | -         |
| Purchases of treasury stock   | (12,247)             | -         | (18,448)  |
| Proceeds from the exercise of stock options                                       | 340                  | 735       | 1,893     |
| Tax benefit related to stock options exercised                                    | -                    | 299       | 268       |
| Tax adjustment related to stock compensation                                      | (132)                | -         | -         |
| Net cash used in financing activities   | (22,766)             | (5,771)   | (16,287)  |
| Net (decrease) increase in cash and cash equivalents                              | (3,483)              | 23,017    | 9,858     |
| Cash and cash equivalents, at beginning of year                                   | 53,143               | 30,126    | 20,268    |

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|  |    |        |    |        |    |        |
|--|----|--------|----|--------|----|--------|
| Cash and cash equivalents, at end of year            | \$ | 49,660 | \$ | 53,143 | \$ | 30,126 |
| Supplemental disclosure of cash flow information:    |    |        |    |        |    |        |
| Cash paid for income taxes                           | \$ | 12,578 | \$ | 14,719 | \$ | 16,462 |
| Retirement of treasury stock                         | \$ | 12,247 | \$ | -      | \$ | 18,482 |
| Property and equipment purchases in accounts payable | \$ | 130    | \$ | 418    | \$ | 772    |
| Dividends payable in accrued expenses                | \$ | 143    | \$ | 48     | \$ | -      |

See accompanying notes to consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1)

### Summary of Significant Accounting Policies

#### Organization

PetMed Express, Inc. and subsidiaries, d/b/a 1-800-PetMeds (the Company), is a leading nationwide pet pharmacy. The Company markets prescription and non-prescription pet medications, health products, and supplies for dogs and cats, direct to the consumer. The Company markets its products through national television, online, and direct mail/print advertising campaigns, which aim to increase the recognition of the 1-800-PetMeds brand name and PetMeds family of trademarks, increase traffic on its website at [www.1800petmeds.com](http://www.1800petmeds.com), acquire new customers, and maximize repeat purchases. The majority of all of the Company's sales are to residents in the United States. The Company's executive offices are located in Pompano Beach, Florida. The Company's fiscal year end is March 31, and references herein to fiscal 2011, 2010, or 2009 refer to the Company's fiscal years ended March 31, 2011, 2010, and 2009, respectively.

#### Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated in consolidation.

#### Revenue Recognition

The Company generates revenue by selling pet medication products and pet supplies mainly to retail consumers. The Company's policy is to recognize revenue from product sales upon shipment, when the rights of ownership and risk of loss have passed to the customer. Outbound shipping and handling fees are included in sales and are billed upon shipment. Shipping expenses are included in cost of sales. The majority of the Company's sales are paid by credit cards and the Company usually receives the cash settlement in two to three banking days. Credit card sales minimize the accounts receivable balances relative to sales. The Company maintains an allowance for doubtful accounts for losses that the Company estimates will arise from the customers' inability to make required payments, arising from either credit card charge-backs or insufficient funds checks. The Company determines its estimates of the

uncollectibility of accounts receivable by analyzing historical bad debts and current economic trends. At March 31, 2011 and 2010, the allowance for doubtful accounts was approximately \$6,000 and \$5,000, respectively.

### **Cash and Cash Equivalents**

The Company considers all highly liquid investments with maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents at March 31, 2011 and 2010 consisted of the Company's cash accounts and money market accounts with a maturity of three months or less. The carrying amount of cash equivalents approximates fair value. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

### **Short and Long Term Investments**

The Company's short term investment balance consists of short term bond mutual funds. The Company's long term investment balance consists of auction rate securities (ARS), which are investments with contractual maturities generally between 20 to 30 years, in the form of municipal bonds and preferred stock, whose interest rates reset, typically every seven to twenty-eight days, through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par. Beginning in February 2008, auctions failed for the ARS held because sell orders exceeded buy orders. These failures are not believed to be a credit issue, but rather are caused by a lack of liquidity. The funds associated with these failed auctions may not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1)

### Summary of Significant Accounting Policies (Continued)

As a result, these securities with failed auctions have been classified as long-term assets in the Consolidated Balance Sheet due to the fact that they were not currently trading at such date, and conditions in the general markets created uncertainty as to when successful auctions would be reestablished. These ARS are recorded at estimated fair value and have variable interest rates that are recorded as interest income. In accordance with ASC Topic 320 (SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*), short term investments and long term investments are classified as available-for-sale, with any changes in fair value to be reflected in other comprehensive income. The Company evaluates its long term investments for impairment and whether impairment is other-than-temporary, and, if other- than-temporary, then the measurement of the impairment loss is a charge to net income. Unrealized gains and losses are deemed temporary and are included in accumulated other comprehensive income. The Company recognized a temporary impairment on its ARS investments during fiscal 2011 and fiscal 2010. The Company does not believe that the underlying credit quality of the assets has been impacted; however the temporary impairment is mainly due to the lack of liquidity. The Company is currently trying to liquidate all ARS.

### Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Inventories

Inventories consist of prescription and non-prescription pet medications and pet supplies that are available for sale and are priced at the lower of cost or market value using a weighted average cost method. The Company writes down its inventory for estimated obsolescence. The inventory reserve was approximately \$63,000 and \$73,000 at March 31, 2011 and 2010, respectively.

## **Property and Equipment**

Property and equipment are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets. The furniture, fixtures, equipment, and computer software are depreciated over periods ranging from three to seven years. Leasehold improvements and assets under capital lease agreements are amortized over the shorter of the underlying lease agreement or the useful life of the asset.

## **Long-lived Assets**

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Recoverability of assets is measured by a comparison of the carrying amount of the asset to the undiscounted cash flows expected to be generated from the asset.

## **Intangible Asset**

The intangible asset consists of a toll-free telephone number and an internet domain name. In October 2008, the Company paid \$485,000 for expenses related to acquiring the internet domain name, [www.petmed.com](http://www.petmed.com). In accordance with the ASC Topic 350 (SFAS No. 142, *Goodwill and Other Intangible Assets*) the intangible assets are not being amortized, and are subject to an annual review for impairment.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1)

### Summary of Significant Accounting Policies (Continued)

#### Advertising

The Company's advertising expenses consist primarily of television advertising, online marketing, and direct mail/print advertising. Television advertising costs are expensed as the advertisements are televised. Internet costs are expensed in the month incurred and direct mail/print costs are expensed when the related catalogs, brochures, and postcards are produced, distributed, or superseded.

#### Fair Value of Financial Instruments

The carrying amounts of the Company's cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to the short-term nature of these instruments.

#### Comprehensive Income

The Company applies ASC Topic 220 (SFAS No. 130, *Reporting Comprehensive Income*) which requires that all items that are recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The items of other comprehensive income that are typically required to be displayed are foreign currency items, minimum pension liability adjustments, and unrealized gains and losses on certain investments in debt and equity securities. The Company evaluates its long term investments for impairment and whether impairment is other-than-temporary, and measurement of an impairment loss as a charge to net income. Unrealized gains and losses are deemed temporary and are included in accumulated other comprehensive income. At March 31, 2011, 2010 and 2009 the Company recognized a temporary impairment on its ARS investments, and this unrealized loss was included in accumulated other comprehensive income. The following is a summary of our comprehensive income (in thousands):



|  | <b>2011</b> | <b>March 31,<br/>2010</b> | <b>2009</b> |
|--|-------------|---------------------------|-------------|
|  | \$          | \$                        | \$          |
| Net income   | 20,871      | 26,002                    | 22,976      |
| Net change in unrealized loss<br>on short term investments                       | (31)        | -                         | -           |
| Net change in unrealized (loss) gain and<br>redemptions on long term investments | (2)         | 112                       | (220)       |
|  | \$          | \$                        | \$          |
| Comprehensive income   | 20,838      | 26,114                    | 22,756      |

### Income Taxes

The Company accounts for income taxes under the provisions of ASC Topic 740 (SFAS No. 109, *Accounting for Income Taxes*) which generally requires the recognition of deferred tax assets and liabilities for the expected future tax benefits or consequences of events that have been included in the consolidated financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting carrying values and the tax bases of assets and liabilities, and are measured by applying enacted tax rates and laws for the taxable years in which those differences are expected to reverse. The Company adopted the provisions of ASC Topic 740 (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* - an interpretation of FASB Statement No. 109 ) ( FIN 48 ), in the first quarter of fiscal 2008. As required by FIN 48, which clarifies ASC Topic 740 (SFAS No. 109, *Accounting for Income Taxes*) the Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the Consolidated Financial Statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, the Company applied FIN 48 to all tax positions for which the statute of limitations remained open. The Company files tax returns in the U.S. federal jurisdiction and Florida and Georgia. With few exceptions, the Company is no longer subject to U.S. federal, state or local income tax examinations by tax authorities for years before March 31, 2008.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1)

### Summary of Significant Accounting Policies (Continued)

Upon implementing FIN 48, the Company did not recognize any additional liabilities for unrecognized tax positions. The adoption of FIN 48 had no material impact on the Company's consolidated financial position, results of operations, or cash flows in fiscal 2011. Any interest and penalties related to income taxes will be recorded to other income (expenses).

### Business Concentrations

The Company purchases its products from a variety of sources, including certain manufacturers, domestic distributors, and wholesalers. We have multiple suppliers for each of our products to obtain the lowest cost. There were seven suppliers from whom we purchased approximately 50% of all products in fiscal 2011, compared to five suppliers from whom we purchased approximately 50% of all products in fiscal 2010.

### Accounting for Share Based Compensation

The Company records compensation expense associated with stock options and restricted stock in accordance with ASC Topic 718 (SFAS No. 123R, *Share Based Payment*, which is a revision of SFAS No. 123). The Company adopted the modified prospective transition method provided under ASC Topic 718 (SFAS No. 123R). The compensation expense related to all of the Company's stock-based compensation arrangements is recorded as a component of general and administrative expenses.

### Recent Accounting Pronouncements

The Company does not believe that any recently issued, but not yet effective, accounting standards, if currently adopted, will have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

(2)

### **Long Term Investments**

The long term investment balances consist of ARS investments. Our ARS consist of closed-end fund preferred ARS, with interest rates that reset, typically every seven to twenty-eight days. These ARS are currently rated AAA, the highest rating available by a rating agency. The fair value of our ARS investments was assessed by management with the assistance of an outside third party appraisal firm, during the fourth quarter of fiscal 2011. As of March 31, 2011, the Company held \$12.5 million in ARS, at par, which were classified as long term investments and the Company recorded an unrealized impairment loss of approximately \$2,000 for the year then ended. As of March 31, 2011, cumulative losses of \$110,000 were recognized within the accumulated other comprehensive loss account. The \$110,000 impairment was recorded as temporary due to the fact that the Company has the intent and the ability to hold these securities until anticipated recovery or maturity, and does expect to fully recover the cost basis of the investment.

(3)

### **Fair Value Measurements**

Effective April 1, 2008, the Company adopted ASC Topic 820 (SFAS 157), except as it applies to non-financial assets and non-financial liabilities subject to ASC Topic 320 (FSP SFAS 157-2). ASC Topic 320 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. ASC Topic 820 (SFAS 157) establishes a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 - Unobservable inputs which are supported by little or no market activity.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(3)

## Fair Value Measurements (Continued)

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company's cash equivalents are classified within Level 1, with the exception of the investments in ARS. The Company's investments in ARS are classified within Level 3 because they are valued using a discounted cash flow model. Some of the inputs to this model are unobservable in the market and are significant.

Assets and liabilities measured at fair value are summarized below (in thousands):

|   | Fair Value Measurement at March 31, 2011 Using |  |   |  |
|---|--|--|---|--|
|   | March 31,<br>2011                              | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:   |  |  |   |  |
| Cash and Cash<br>equivalents - money<br>markets funds | \$ 49,660                                      | \$ 49,660  | \$ -  | -  |
| Short term investments -<br>bond mutual funds         | 10,116   | 10,116   | -   | -  |
| Long term investments -<br>auction rate<br>securities | 12,390   | -  | -   | 12,390   |
|   | \$ 72,166                                      | \$ 59,776  | \$ -  | 12,390   |

The following table is a reconciliation of financial assets measured at fair value using unobservable inputs (Level 3) during the year ended March 31, 2011 (in thousands):

| Auction Rate Securities<br>Ended March 31, |      |
|--|------|
| 2011                                       | 2010 |

|  |    |        |    |         |
|--|----|--------|----|---------|
| Balance, beginning of year                                   | \$ | 12,392 | \$ | 14,430  |
| Redemption of securities                                     |    | -      |    | (2,150) |
| Recovery of valuation  |    | -      |    | 220     |
| Total unrealized loss included in other comprehensive income |    | (2)    |    | (108)   |
| Balance, end of year   | \$ | 12,390 | \$ | 12,392  |

Long term investments measured at fair value using Level 3 inputs are comprised of ARS. Although ARS would typically be measured using Level 2 inputs, the recent failure of auctions and the lack of market activity and liquidity required that these securities be measured using Level 3 inputs. The Company's ARS consist of closed-end fund preferred ARS, with interest rates that reset, typically every seven to twenty-eight days. The fair value of our ARS investments was assessed by management with the assistance of an outside third party appraisal firm, which was conducted during the fourth quarter of fiscal 2011. The fair value was calculated using a discounted cash flow valuation model. The three inputs used in determining the fair values of the ARS were:

(1)

Forecasted interest payments cash flows - In failed ARS auctions interest rates are set by the terms of the prospectus. For almost all of the securities the terms are a combination of two components: the determination of a base rate which is based on the maximum of two indexes, or a single index as defined in the prospectus. Base rates are adjusted through either a multiplication factor or an addition of a spread factor as defined in the prospectus which is dependent on the credit rating of the security. Our ARS are currently rated AAA, the highest rating available by a rating agency.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(3)

### Fair Value Measurements (Continued)

(2)

Discount rate calculation - The discount rates were calculated from the applicable forward curve plus a credit risk/liquidity spread. The credit risk spread was estimated via the credit spreads for 1-3 year term, AAA rated, debt over US Treasury notes and bonds which were determined to be 50 basis points (0.50%). To address the continued illiquidity of the Company's ARS portfolio, an additional spread of 0.30% was added to the credit risk spread. This spread is based on the required yield attributable to liquidity for AAA rated debt, as determined by empirical studies. Specifically, research on municipal bond yields indicate that for AAA rated securities, the liquidity component represents approximately 7-10% of the required yield. In total, a credit risk/liquidity spread of 0.80% was utilized.

(3)

A present value calculation was performed utilizing the cash flow of the forecasted interest payments combined with the discount rate determined above.

As of March 31, 2011, the Company held \$12.5 million in ARS, at par, which were classified as long term investments and the Company recorded an unrealized impairment loss of approximately \$2,000 for the year then ended. As of March 31, 2011, cumulative losses of \$110,000 were recognized within the accumulated other comprehensive loss account, based upon an assessment by the outside third party appraisal firm. The \$110,000 impairment was recorded as temporary due to the fact that the Company has the intent and the ability to hold these securities until anticipated recovery or maturity, and does expect to fully recover the cost basis of the investment.

(4)

### Property and Equipment

Major classifications of property and equipment consist of the following (in thousands):

|                                   | <b>March 31,</b> | <b>2011</b> | <b>2010</b> |
|-----------------------------------|------------------|-------------|-------------|
| Leasehold improvements            | \$               | 1,063       | \$ 858      |
| Computer software                 |                  | 2,236       | 2,244       |
| Furniture, fixtures and equipment |                  | 5,194       | 5,450       |
|                                   |                  | 8,493       | 8,552       |
| Less: accumulated depreciation    |                  | (5,060)     | (4,123)     |
| Property and equipment, net       | \$               | 3,433       | \$ 4,429    |

(5)

**Accrued Expenses and Other Current Liabilities**

Major classifications of accrued expenses and other current liabilities consist of the following (in thousands):

|  | <b>March 31,</b> | <b>2011</b> | <b>2010</b> |
|--|------------------|-------------|-------------|
| Accrued sales tax                              | \$               | 505         | \$ 496      |
| Accrued credit card fees                       |                  | 421         | 408         |
| Accrued salaries and benefits                  |                  | 475         | 368         |
| Accrued professional expenses                  |                  | 185         | 176         |
| Accrued advertising expenses                   |                  | 196         | 135         |
| Accrued sales return allowance                 |                  | 155         | 164         |
| Other accrued liabilities                      |                  | 572         | 565         |
| Accrued expenses and other current liabilities | \$               | 2,509       | \$ 2,312    |



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(6)

**Income Taxes**

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities are as follows (in thousands):

|                                 | <b>2011</b> | <b>March 31,</b> | <b>2010</b> |
|---------------------------------|-------------|------------------|-------------|
| Deferred tax assets:            |             |                  |             |
| Bad debt and inventory reserves | \$          | 25               | \$ 29       |
| Accrued expenses                |             | 543              | 622         |
| Deferred stock compensation     |             | 336              | 505         |
| Net operating loss carryforward |             | 349              | 728         |
| Deferred tax assets             |             | 1,253            | 1,884       |
| Less: valuation allowance       |             | -                | -           |
| Total deferred tax assets       |             | 1,253            | 1,884       |
| Deferred tax liabilities:       |             |                  |             |
| Property and equipment          |             | (571)            | (854)       |
| Total net deferred taxes        | \$          | 682              | \$ 1,030    |

The change in the valuation allowance for the years ended March 31, 2011 and 2010 was approximately \$0 and \$333,000, respectively. At March 31, 2011, the Company had federal net operating loss carryforwards of approximately \$941,000. The federal net operating loss carryforwards expire in the years 2013 through 2020. The use of such net operating loss carryforwards is limited to approximately \$266,000 annually due to a change of control on November 22, 2000. The components of the income tax provision consist of the following (in thousands):

|  | <b>Year Ended March 31,</b> |             |             |
|--|-----------------------------|-------------|-------------|
|  | <b>2011</b>                 | <b>2010</b> | <b>2009</b> |

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|                                  |    |        |    |        |           |
|----------------------------------|----|--------|----|--------|-----------|
| Current taxes                    |    |        |    |        |           |
| Federal                          | \$ | 11,007 | \$ | 13,738 | \$ 11,097 |
| State                            |    | 1,052  |    | 1,307  | 1,086     |
| Total current taxes              |    | 12,059 |    | 15,045 | 12,183    |
| Deferred taxes                   |    |        |    |        |           |
| Federal                          |    | 317    |    | (279)  | 453       |
| State                            |    | 30     |    | (26)   | 44        |
| Total deferred taxes             |    | 347    |    | (305)  | 497       |
| Total provision for income taxes | \$ | 12,406 | \$ | 14,740 | \$ 12,680 |

The reconciliation of income tax provision computed at the U.S. federal statutory tax rates to income tax expense is as follows (in thousands):

|  |    | <b>2011</b> | <b>Year Ended March 31,<br/>2010</b> |        | <b>2009</b> |
|--|----|-------------|--------------------------------------|--------|-------------|
| Income taxes at U.S. statutory rates           | \$ | 11,647      | \$                                   | 14,260 | \$ 12,480   |
| State income taxes, net of federal tax benefit |    | 714         |                                      | 823    | 750         |
| Permanent differences                          |    | (64)        |                                      | (123)  | (477)       |
| Other  |    | 109         |                                      | 113    | 27          |
| Change in valuation allowance                  |    | -           |                                      | (333)  | (100)       |
| Total provision for income taxes               | \$ | 12,406      | \$                                   | 14,740 | \$ 12,680   |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(7)

### Shareholders Equity

#### Preferred Stock

In April 1998, the Company issued 250,000 shares of its \$.001 par value preferred stock at a price of \$4.00 per share, less issuance costs of \$112,187. Each share of the preferred stock is convertible into approximately 4.05 shares of common stock at the election of the shareholder. The shares have a liquidation value of \$4.00 per share and may pay dividends at the sole discretion of the Company. The Company does not anticipate paying dividends to the preferred shareholders in the foreseeable future. Each share of preferred stock is entitled to one vote on all matters submitted to a vote of shareholders of the Company. As of March 31, 2011 and 2010, 2,500 shares of the convertible preferred stock remained unconverted and outstanding.

#### Share Repurchase Plan

On November 8, 2006, the Company's Board of Directors approved a share repurchase plan of up to \$20.0 million. On October 31, 2008 and November 1, 2010, the Company's Board of Directors approved a second and third share repurchase plan, respectively, for an additional \$20.0 million. The repurchase plan is intended to be implemented through purchases made from time to time in either the open market or through private transactions at the Company's discretion, subject to market conditions and other factors, in accordance with Securities and Exchange Commission requirements. There can be no assurances as to the precise number of shares that will be repurchased under the share repurchase plan, and the Company may discontinue the share repurchase plan at any time subject to compliance with applicable regulatory requirements. Shares purchased pursuant to the share repurchase plan will either be cancelled or held in the Company's treasury. During fiscal 2011 the Company repurchased approximately 791,000 shares of the Company's outstanding common stock for approximately \$12.2 million, averaging approximately \$15.47 per share. During fiscal 2010 the Company did not repurchase any of its own shares. During fiscal 2009 the Company repurchased approximately 1.3 million shares of the Company's outstanding common stock for approximately \$18.4 million, averaging approximately \$13.70 per share. As of March 31, 2011 the Company had approximately \$17.7 million remaining under the Company's share repurchase plan.

#### Dividends

On August 3, 2009, the Company's Board of Directors declared its first quarterly dividend of \$0.10 per share on its common stock, and on August 2, 2010, the Company's Board of Directors increased the quarterly dividend to \$0.125 per share. The Company intends to continue to pay regular quarterly dividends; however the declaration and payment of future dividends is discretionary and will be subject to a determination by the Board of Directors each quarter following its review of the Company's financial performance. During fiscal 2011, our Board of Directors declared the following dividends:

| <b>Declaration Date</b> | <b>Per Share Dividend</b> | <b>Record Date</b> | <b>Total Amount<br/>(In thousands)</b> | <b>Payment Date</b> |
|-------------------------|---------------------------|--------------------|--|---------------------|
|                         |                           |                    | \$                                     |                     |
| May 3, 2010             | \$0.100                   | May 14, 2010       | 2,299                                  | May 28, 2010        |
|                         |                           |                    | \$                                     |                     |
| August 2, 2010          | \$0.125                   | August 13, 2010    | 2,864                                  | August 27, 2010     |
|                         |                           |                    | \$                                     |                     |
| November 1, 2010        | \$0.125                   | November 12, 2010  | 2,848                                  | November 26, 2010   |
|                         |                           |                    | \$                                     |                     |
| January 31, 2011        | \$0.125                   | February 11, 2011  | 2,811                                  | February 25, 2011   |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(8)

### Stock Options and Restricted Stock

The PetMed Express, Inc. 1998 Stock Option Plan (the Plan) provided for the issuance of qualified options to officers and key employees, and nonqualified options to directors, consultants, and other service providers, to purchase the Company's common stock. The Company had reserved 5.0 million shares of common stock for issuance under the Plan. The exercise prices of options issued under the Plan must be equal to or greater than the market price of the Company's common stock as of the date of issuance. The Company had 46,166 options outstanding under the Plan at March 31, 2010, and no options outstanding at March 31, 2011. Options generally vest ratably over a three-year period commencing on the first anniversary of the grant with respect to options granted to employees/directors under the Plan. No options have been issued since May 2005. The 1998 Plan expired on July 31, 2008. Cash received from stock options exercised for the fiscal years ended March 31, 2011, 2010, and 2009 was approximately \$340,000, \$735,000, and \$1.9 million, respectively. The income tax benefits from stock options exercised totaled approximately \$0, \$299,000, and \$268,000, for the fiscal years ended March 31, 2011, 2010, and 2009, respectively. At March 31, 2011, there were no exercisable stock options. At March 31, 2010, the number of options exercisable was 46,166, and the weighted-average exercise price of those options was \$7.37. Adjustments were made for options forfeited prior to vesting. As of March 31, 2011 and 2010 the Company had no non-vested stock options. The Company's net income for the fiscal years ended March 31, 2011 and 2010 includes approximately \$0 and \$24,000 of stock option compensation expense, respectively. As of March 31, 2011, there was no unrecognized compensation expense, aggregate intrinsic value, or weighted average remaining term, related to vested stock option awards.

On July 28, 2006, the Company received shareholder approval for the adoption of the 2006 Employee Equity Compensation Restricted Stock Plan (the Employee Plan) and the 2006 Outside Director Equity Compensation Restricted Stock Plan (the Director Plan). The purpose of the plans is to promote the interests of the Company by securing and retaining both employees and outside directors. The Company has reserved 1.0 million shares of common stock for issuance under the Employee Plan, and 200,000 shares of common stock for issuance under the Director Plan. The value of the restricted stock is determined based on the market value of the stock at the issuance date. The restriction period or forfeiture period is determined by the Company's Board and is to be no less than 1 year and no more than ten years. The Company had 481,227 restricted common shares issued under the Employee Plan and 122,000 restricted common shares issued under the Director Plan at March 31, 2011, all shares of which were issued subject to a restriction or forfeiture period which will lapse ratably on the first, second, and third anniversaries of the date of grant, and the fair value of which is being amortized over the three-year restriction period. For the years ended March 31, 2011 and 2010, the Company recognized \$2.2 million and \$1.6 million, respectively, of compensation expense related to the Employee and Director Plans. A summary of the Company's non-vested restricted stock as of March 31, 2011 is as follows:

|  | <b>Employee<br/>Plan<br/>Number of<br/>Shares<br/>(In thousands)</b> | <b>Director<br/>Plan<br/>Number of<br/>Shares<br/>In<br/>thousands)</b> | <b>Total Plans<br/>Number of<br/>Shares<br/>(In<br/>thousands)</b> |
|--|--|---|--|
| Non-vested restricted stock outstanding at March 31,<br>2010 | 232  | 48  | 280  |
| Restricted stock granted                                     | 61   | 30  | 91   |
| Restricted stock vested                                      | (93)   | (24)  | (117)  |
| Restricted stock forfeited or expired                        | (4)  | -   | (4)  |
| Non-vested Restricted stock outstanding at March 31,<br>2011 | 196  | 54  | 250  |

At March 31, 2011 and 2010, there were 249,755 and 279,692 non-vested restricted stock shares outstanding, respectively. During the fiscal years ended March 31, 2011 and 2010, the Company issued, net of forfeitures, 86,584 and 201,034 restricted shares, respectively. At March 31, 2011 and 2010, there were \$3.7 million and \$4.5 million of unrecognized compensation cost related to the non-vested restricted stock awards, respectively, which is expected to be recognized over the remaining weighted average vesting period of 1.6 and 2.2 years.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(9)

**Net Income Per Share**

In accordance with the provisions of ASC Topic 260 (SFAS No. 128, *Earnings Per Share* ) basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per common share includes the dilutive effect of potential restricted stock and stock options exercised and the effects of the potential conversion of preferred shares, calculated using the treasury stock method. Outstanding stock options, restricted stock, and convertible preferred shares issued by the Company represent the only dilutive effect reflected in diluted weighted average shares outstanding.

The following is a reconciliation of the numerators and denominators of the basic and diluted net income per share computations for the periods presented (in thousands, except for per share amounts):

|  | 2011      | Year Ended March 31,<br>2010 | 2009      |
|--|-----------|------------------------------|-----------|
| Net income (numerator):  |           |                              |           |
| Net income   | \$ 20,871 | \$ 26,002                    | \$ 22,976 |
| Shares (denominator)   |           |                              |           |
| Weighted average number of common shares<br>outstanding used in basic computation        | 22,514    | 22,617                       | 23,306    |
| Common shares issuable upon exercise<br>of stock options and vesting of restricted stock | 119       | 119                          | 166       |
| Common shares issuable upon<br>conversion<br>of preferred shares                         | 10        | 10                           | 10        |
| Shares used in diluted computation   | 22,643    | 22,746                       | 23,482    |
| Net income per common share:   |           |                              |           |
| Basic  | \$ 0.93   | \$ 1.15                      | \$ 0.99   |
| Diluted  | \$ 0.92   | \$ 1.14                      | \$ 0.98   |

At March 31, 2011 and 2010, all common stock options and restricted stock were included in the diluted net income per common share computation as their exercise prices were less than the average market price of the common shares for the period.

(10)

**Valuation and Qualifying Accounts**

Activity in the Company's valuation and qualifying accounts consists of the following (in thousands):

|  |    | <b>2011</b> |    | <b>Year Ended March 31,<br/>2010</b> |    | <b>2009</b> |
|--|----|-------------|----|--------------------------------------|----|-------------|
| Allowance for doubtful accounts:               |    |             |    |                                      |    |             |
| Balance at beginning of period                 | \$ | 5           | \$ | 59                                   | \$ | 32          |
| Provision for doubtful accounts                |    | 48          |    | 17                                   |    | 74          |
| Write-off of uncollectible accounts receivable |    | (47)        |    | (71)                                 |    | (47)        |
| Balance at end of year                         | \$ | 6           | \$ | 5                                    | \$ | 59          |
| Valuation allowance for deferred tax assets:   |    |             |    |                                      |    |             |
| Balance at beginning of period                 | \$ | -           | \$ | 333                                  | \$ | 433         |
| Reductions                                     |    | -           |    | (333)                                |    | (100)       |
| Balance at end of year                         | \$ | -           | \$ | -                                    | \$ | 333         |



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(11)

### Commitments and Contingencies

#### Legal Matters and Routine Proceedings

In October 2009, the Company was notified that it was named as a defendant in a multi-defendant lawsuit, filed in the United States District Court for the Eastern District of Texas, Marshall Division, seeking declaratory, injunctive, and monetary relief styled Charles E. Hill & Associates, Inc. v. ABT Electronics, Inc., et al, Cause No. 2:09-CV-313. The lawsuit alleges that the Company is infringing on patents related to electronic catalog systems. From the outset, the vendor that provides the Company with the Internet software had been defending and indemnifying the Company. However, effective February 15, 2011, the company that acquired this vendor declined to provide any further indemnification of the Company. The Company is continuing to defend itself, and at this stage, it is difficult to assess any possible outcome or estimate any potential loss in the event of an adverse outcome.

The Company has settled complaints that had been filed with various states' pharmacy boards in the past. There can be no assurances made that other states will not attempt to take similar actions against the Company in the future. The Company initiates litigation to protect its trade or service marks. There can be no assurance that the Company will be successful in protecting its trade or service marks. Legal costs related to the above matters are expensed as incurred.

#### Employment Agreements

On February 8, 2010, the Company amended the CEO's existing Executive Employment Agreement and entered into Amendment No. 3 to the Executive Employment Agreement with Mr. Akdag. The Agreement amended certain provisions of the Executive Employment Agreement as follows: the term of the Agreement is for three years, commencing on March 16, 2010; Mr. Akdag's salary was increased to \$550,000 per year throughout the term of the Agreement, and Mr. Akdag was granted 120,000 shares of restricted stock. The restricted stock was granted on March 16, 2010, in accordance with the Company's 2006 Employee Equity Compensation Restricted Stock Plan and the restrictions shall lapse ratably over a three-year period, and as of March 31, 2011, there were 80,000 unvested shares

of restricted stock.

#### Operating Lease

The Company leases its 65,300 square foot executive offices, warehouse facility, and customer service and pharmacy contact centers under a non-cancelable operating lease. On January 29, 2010, the Company signed a sixth addendum to its existing lease extending the terms of the lease until May 31, 2015. The Company is responsible for certain maintenance costs, taxes, and insurance under this lease. The future minimum annual lease payments are as follows:

| <b><u>Years Ending March 31, (in thousands)</u></b> |    |       |
|---|----|-------|
| 2012  | \$ | 745   |
| 2013  |    | 767   |
| 2014  |    | 784   |
| 2015  |    | 794   |
| 2016  |    | 133   |
| Total lease payments                                | \$ | 3,223 |

Rent expense was \$724,000, \$703,000, and \$641,000 for the years ended March 31, 2011, 2010 and 2009, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(12)****Sales by Category**

The following table provides a breakdown of the percentage of total sales by each category during the indicated periods:

|   | <b>Year Ended March 31,</b> |             |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2011</b>                 | <b>2010</b> | <b>2009</b> |
| Non-prescription medications            | 61%                         | 64%         | 68%         |
| Prescription medications                | 38%                         | 35%         | 31%         |
| Shipping and handling charges and other | 1%                          | 1%          | 1%          |
| Total                                   | 100%                        | 100%        | 100%        |

**(13)****Employee Benefit Plan**

The Company maintains a 401(k) Savings Plan for eligible employees. The plan is a defined contribution plan that is administered by the Company. All regular, full-time employees are eligible for voluntary participation upon completing one year of service and having attained the age of 21. The plan provides for growth in savings through contributions and income from investments. It is subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended. Plan participants are allowed to contribute a specified percentage of their base salary. In 2006, the Company adopted a matching plan which is funded subsequent to the calendar year. During the years ended March 31, 2011 and 2010, the Company charged \$168,000 and \$154,000, respectively, of 401(k) matching contribution and administration expense to general and administrative expenses.

**(14)****Quarterly Financial Data (Unaudited)**

Summarized unaudited quarterly financial data for fiscal 2011 and 2010 is as follows (in thousands, except for per share amounts):

| <b><u>Quarter Ended:</u></b>        | <b>June 30, 2010</b> | <b>September 30, 2010</b> | <b>December 31, 2010</b> | <b>March 31, 2011</b> |
|-------------------------------------|----------------------|---------------------------|--------------------------|-----------------------|
|                                     | \$                   | \$                        | \$                       | \$                    |
| Sales                               | 74,369               | 61,245                    | 45,118                   | 50,910                |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Gross Profit                        | 27,226               | 22,330                    | 16,925                   | 17,475                |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Income from operations              | 11,827               | 7,727                     | 7,027                    | 6,443                 |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Net income                          | 7,225                | 4,977                     | 4,522                    | 4,147                 |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Diluted net income per common share | 0.32                 | 0.22                      | 0.20                     | 0.19                  |

| <b><u>Quarter Ended:</u></b>        | <b>June 30, 2009</b> | <b>September 30, 2009</b> | <b>December 31, 2009</b> | <b>March 31, 2010</b> |
|-------------------------------------|----------------------|---------------------------|--------------------------|-----------------------|
|                                     | \$                   | \$                        | \$                       | \$                    |
| Sales                               | 77,169               | 62,447                    | 48,354                   | 50,296                |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Gross Profit                        | 29,286               | 23,682                    | 18,828                   | 20,065                |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Income from operations              | 12,599               | 9,831                     | 8,385                    | 9,727                 |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Net income                          | 8,075                | 6,265                     | 5,590                    | 6,072                 |
|                                     | \$                   | \$                        | \$                       | \$                    |
| Diluted net income per common share | 0.36                 | 0.28                      | 0.25                     | 0.27                  |

(15)

### Subsequent Events

On May 6, 2011, the Company's Board of Directors declared a quarterly dividend of \$0.125 per share on its common stock. The \$2.8 million dividend was paid on May 27, 2011, to shareholders of record at the close of business on May 16, 2011. Subsequent to March 31, 2011, the Company repurchased approximately 695,000 of its own shares for approximately \$9.0 million, averaging approximately \$13.01 per share.

## REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of the Company is responsible for the preparation and integrity of the Consolidated Financial Statements appearing in our Annual Report on Form 10-K. The financial statements were prepared in conformity with generally accepted accounting principles appropriate in the circumstances and, accordingly, include certain amounts based on our best judgments and estimates. Financial information in the Annual Report on Form 10-K is consistent with that in the financial statements.

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) under the Securities Exchange Act of 1934 ( Exchange Act ). The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Consolidated Financial Statements. Our internal control over financial reporting is supported by a team of consultants and appropriate reviews by management, written policies and guidelines, careful selection and training of qualified personnel, and a written Corporate Code of Business Conduct and Ethics adopted by our Company's Board of Directors, applicable to all Company Directors and all officers and employees of our Company and subsidiaries.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective, can only provide reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Audit Committee ( Committee ) of our Company's Board of Directors, comprised solely of Directors who are independent in accordance with the requirements of The NASDAQ Stock Market LLC listing standards, the Exchange Act and the Company's Corporate Governance Guidelines, meets with the independent auditors and management periodically to discuss internal control over financial reporting, and auditing and financial reporting matters. The Committee reviews with the independent auditors the scope and results of the audit effort. The Committee also meets periodically with the independent auditors without management present to ensure that the independent auditors have free access to the Committee. Our Audit Committee's Report can be found in the Company's 2011 Proxy Statement.

Management assessed the effectiveness of the Company's internal control over financial reporting as of March 31, 2011. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on our assessment, management believes that the Company maintained effective internal control over financial reporting as of March 31, 2011.

The Company's independent auditors, McGladrey & Pullen, LLP, a registered public accounting firm, are appointed by the Audit Committee of the Company's Board of Directors, subject to ratification by our Company's shareholders. McGladrey & Pullen, LLP have audited and reported on the Consolidated Financial Statements of PetMed Express, Inc. and subsidiaries, and issued a report on the Company's internal control over financial reporting. The reports of the independent auditors are contained in our Annual Report on Form 10-K.

/s/ Menderes Akdag

Menderes Akdag

Chief Executive Officer, President, Director

May 27, 2011

/s/ Bruce S. Rosenbloom

Bruce S. Rosenbloom

Chief Financial Officer

May 27, 2011

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**  
**ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Board of Directors and Stockholders  
PetMed Express, Inc:

We have audited PetMed Express, Inc. and Subsidiaries (hereafter referred to as PetMed ) internal control over financial reporting as of March 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). PetMed s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Report of Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, PetMed Express, Inc. maintained, in all material respects, effective internal control over financial reporting as of March 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of PetMed Express, Inc. and our report dated May 27, 2011 expressed an unqualified opinion.

/s/ McGladrey & Pullen, LLP

McGladrey & Pullen, LLP

New York, New York  
May 27, 2011

**ITEM 9.**

**CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A.**

**CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

The Company's management, including our Chief Executive Officer and Chief Financial Officer, has conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended) as of March 31, 2011, the end of the period covered by this report (the "Evaluation Date"). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of the Evaluation Date, that our disclosure controls and procedures were effective such that the information relating to PetMed Express, Inc., including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission (SEC) reports (i) is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms and (ii) is accumulated and communicated to our management including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

*Management's Report on Internal Control over Financial Reporting*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of March 31, 2011 based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control - Integrated Framework*, our management concluded that the Company maintained effective internal control over financial reporting as of March 31, 2011, as stated in our report which is included herein. Our internal control over financial reporting as of March 31, 2011 has been audited by McGladrey & Pullen LLP, an independent registered public accounting firm, as stated in their report which is included

herein.

*Changes in Internal Controls over Financial Reporting*

There have been no changes in our internal controls over financial reporting during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B.**

**OTHER INFORMATION**

Not applicable.

### **PART III**

#### **ITEM 10.**

##### **DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE**

The information required by this item will be set forth in our Proxy Statement, to be filed with the SEC within 120 days after the end of the fiscal year ended March 31, 2011, relating to our 2011 Annual Meeting of Stockholders to be held on July 29, 2011, and is incorporated herein by reference.

#### **ITEM 11.**

##### **EXECUTIVE COMPENSATION**

The information required by this item will be set forth in our Proxy Statement, to be filed with the SEC within 120 days after the end of the fiscal year ended March 31, 2011, relating to our 2011 Annual Meeting of Stockholders to be held on July 29, 2011, and is incorporated herein by reference.

#### **ITEM 12.**

##### **SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by this item (other than information required by Item 201(d) of Regulation S-K with respect to equity compensation plans, which is set forth under Item 5. in this Annual Report on Form 10-K) will be set forth in our Proxy Statement, to be filed with the SEC within 120 days after the end of the fiscal year ended March 31, 2011, relating to our 2011 Annual Meeting of Stockholders to be held on July 29, 2011, and is incorporated herein by reference.

#### **ITEM 13.**

##### **CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this item will be set forth in our Proxy Statement, to be filed with the SEC within 120 days after the end of the fiscal year ended March 31, 2011, relating to our 2011 Annual Meeting of Stockholders to be held on July 29, 2011, and is incorporated herein by reference.

**ITEM 14.**

**PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by this item will be set forth in our Proxy Statement, to be filed with the SEC within 120 days after the end of the fiscal year ended March 31, 2011, relating to our 2011 Annual Meeting of Stockholders to be held on July 29, 2011, and is incorporated herein by reference.

**PART IV**

**ITEM 15.**

**EXHIBITS, FINANCIAL STATEMENT SCHEDULES**

**(a) The following documents are filed as part of this report on Form 10-K.**

**(1) Consolidated Financial Statements**

**The following exhibits are filed as part of this report on Form 10-K.**

**(3) Articles of Incorporation and By-Laws**

3.1

Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Registration Statement on Form 10-SB, File No. 000-28827, filed January 10, 2000).

3.2

By-Laws of the Corporation (incorporated by reference to Exhibit 3.2 to the Registration Statement on Form 10-SB, File No. 000-28827, filed January 10, 2000).

**(4) Instruments Defining the Rights of Security Holders**

4.1

Specimen common stock certificate (incorporated by reference to Exhibit 4.2 to the Registration Statement on Form 10-SB, File No. 000-28827, filed January 10, 2000).

**(10) Material Contracts**

10.1

1998 Stock Option Plan incorporated by reference to Exhibit 10.1 to the Registration Statement on Form 10-SB, File No. 000-28827, filed January 10, 2000).

10.2

Employment Agreement with Menderes Akdag (incorporated by reference to Exhibit 10 of the Registrant's Form 8-K filed March 30, 2001).

10.3

Agreement for the Sale and Leaseback of the Land and Building (incorporated by reference to Exhibit 99.1 of the Registrant's Form 8-K filed June 14, 2001).

10.4

Amendment Number 1 to Executive Employment Agreement with Menderes Akdag (incorporated by reference to Exhibit 99.1 of the Registrant's Form 8-K filed March 18, 2004).

10.5

Amendment Number 2 to Executive Employment Agreement with Menderes Akdag (incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K filed February 28, 2007).

10.6

2006 Employee Equity Compensation Restricted Stock Plan (incorporated by reference to our definitive Proxy Statement for our 2006 Annual Meeting of Stockholders filed June 22, 2006).

10.7

2006 Outside Director Equity Compensation Restricted Stock Plan (incorporated by reference to our definitive Proxy Statement for our 2006 Annual Meeting of Stockholders filed June 22, 2006).

10.8

Employment Letter with Bruce Rosenbloom dated May 30, 2001 (incorporated by reference to Exhibit 10.9 of the Registrant's Form 8-K filed April 7, 2009).

10.9

Amendment Number 3 to Executive Employment Agreement with Menderes Akdag (incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K filed February 8, 2010).

#### **(14) Corporate Code of Ethics**

14.1

Corporate Code of Ethics (incorporated by reference to our definitive Proxy Statement for our 2004 Annual Meeting of Stockholders filed June 30, 2004).

#### **(21) Subsidiaries of Registrant**

21.1

Subsidiaries of Registrant\*

**(31)**

#### **Certifications**

31.1

Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).\*



31.2

Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).\*

(32)

**Certifications**

32.1

Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 1350.\*\*

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\*Filed herewith

\*\*Furnished herewith

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: May 31, 2011

**PETMED EXPRESS, INC.**

(the registrant )

By: /s/ Menderes Akdag  
Menderes Akdag

Chief Executive Officer and President

(principal executive officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities on May 31, 2011.

**SIGNATURE**

**TITLE**

/s/ Menderes Akdag

Chief Executive Officer and President

Menderes Akdag

(principal executive officer)

/s/ Robert C. Schweitzer

Officer and Director

Robert C. Schweitzer

Chairman of the Board

/s/ Bruce S. Rosenbloom

Director

Chief Financial Officer and Treasurer

(principal financial and accounting officer)

Bruce S. Rosenbloom

Officer

/s/ Ronald J. Korn

Director

Ronald J. Korn

/s/ Gian M. Fulgoni

Director

Gian M. Fulgoni

/s/ Frank J. Formica

Director

Frank J. Formica

