

August 15, 2008

**Key Metrics**

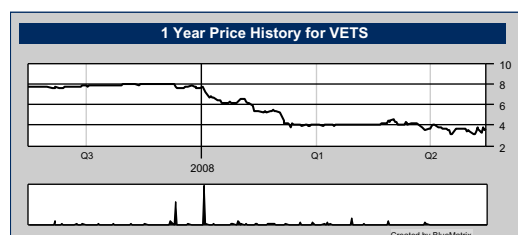
VETS - NASDAQ	\$3.68
Pricing Date	08/14/2008
Price Target	NA
52-Week Range	\$8.04-\$3.00
Shares Outstanding (mm)	23.7
Market Capitalization (\$mm)	\$87.2
3-Mo Average Daily Volume	16,921
Institutional Ownership	42%
Debt/Total Capital	16.0%
ROE	NM
Book Value/Share	\$2.48
Price/Book	1.5x
Dividend Yield	NM
LTM EBITDA Margin	NM

**EPS(\$)** FY: December

	2007A	Prior 2008E	Curr. 2008E	Prior 2009E	Curr. 2009E
1Q-Mar	(0.21)	--	(0.13)A	--	(0.04)E
2Q-Jun	(0.12)	(0.08)E	(0.22)A	--	(0.01)E
3Q-Sep	(0.15)	(0.04)E	(0.09)E	--	0.01E
4Q-Dec	(0.16)	(0.01)E	(0.08)E	--	0.02E
FY	(0.64)	(0.26)E	(0.51)E	0.28E	(0.02)E
P/E	NM		NM		NM

**Revenue(\$mm)**

	2007A	Prior 2008E	Curr. 2008E	Prior 2009E	Curr. 2009E
1Q-Mar	17.4	--	17.8A	--	23.8E
2Q-Jun	17.7	19.0E	17.9A	--	27.6E
3Q-Sep	17.7	25.8E	19.8E	--	28.9E
4Q-Dec	16.4	29.1E	21.0E	--	28.9E
FY	69.3	91.7E	76.6E	150.8E	109.2E



**Company Description:** Pet DRx Corporation ([www.petdrx.com](http://www.petdrx.com)) provides primary veterinary and specialty care services to companion animals through a network of veterinary hospitals in California. Its services include general medical treatment for pets, including preventive care, such as vaccinations, examinations, spraying, and dental care; and a range of specialized diagnostic and medical services, such as x-ray, ultra-sound internal medicine, surgery, cardiology ophthalmology, dermatology, oncology, and other services.

## Pet DRx Corporation

### Rating: Hold

#### 2Q Results Disappoint; Review of Operations/Acquisition Pipeline Underway

**Investment Highlights:**

- **Pet DRx reports 2Q08 EPS of (\$0.22), \$0.14 below our estimate.** The disappointing results were due to lower-than-expected sales and hospital margin growth.
- **Sales up slightly Y/Y but lower than projected.** 2Q08 sales expanded 1.1% on similar comparable store sales gains. No hospitals were added Y/Y. Comparable store sales gains came in lower than anticipated due to challenging comparisons versus last year's pet food recall boost and slightly lower foot traffic in a challenging economy. The majority of the hospitals achieved positive 10% same store sales yet a handful of underperforming units hampered overall growth as key veterinarians departed.
- **Gross/Hospital margins up Y/Y 240 bps yet down sequentially.** Hospital margins expanded Y/Y 240 bps to 7.1% primarily due to improved centralized purchasing patterns. Once again, the majority of hospitals performed well with roughly 14% margins, yet the underperforming units reduced total profits.
- **Cash levels drop following pay-down of debt.** Cash at the end of the quarter fell sequentially from \$29.5mm to \$9.0mm as the company used its cash to reduce sequential debt by roughly \$15mm. With total debt of \$11mm, interest expense payments should fall dramatically. Management believes it has access to capital should the need arise to support its growth-through-acquisition strategy.
- **Guidance suspended as management reviews operations.** Pet DRx has temporarily suspended guidance as the company reviews operations and the projected acquisition pipeline. The company remains behind expectations with one acquisition completed, one definitive agreement announced, and two letters of intent signed. Accordingly, we are lowering our acquisition projection to 8 from roughly 15. With fewer hospitals and lower hospital margins now anticipated, we are reducing our 2008 and 2009 sales estimates to \$76.6mm and \$109.2mm, along with our EPS estimates to (\$0.51) and (\$0.02), respectively.
- **CFO resigns for family reasons; replacement expected by November.** The company announced the resignation of CFO Gregory Eisenhower as he has decided to leave the firm for family reasons. He will remain with Pet DRx until November 30th, at which time the company expects a replacement to be named.
- **Downgrading to Hold; awaiting additional acquisitions.** While the acquisition pipeline appears to be full, transactions have been slow to develop. We believe more substantial top-line growth is required to drive EPS and cash flow and thus, we are downgrading VETS shares to Hold until more acquisition traction is achieved.

EQUITY RESEARCH

## PetDRx (VETS)

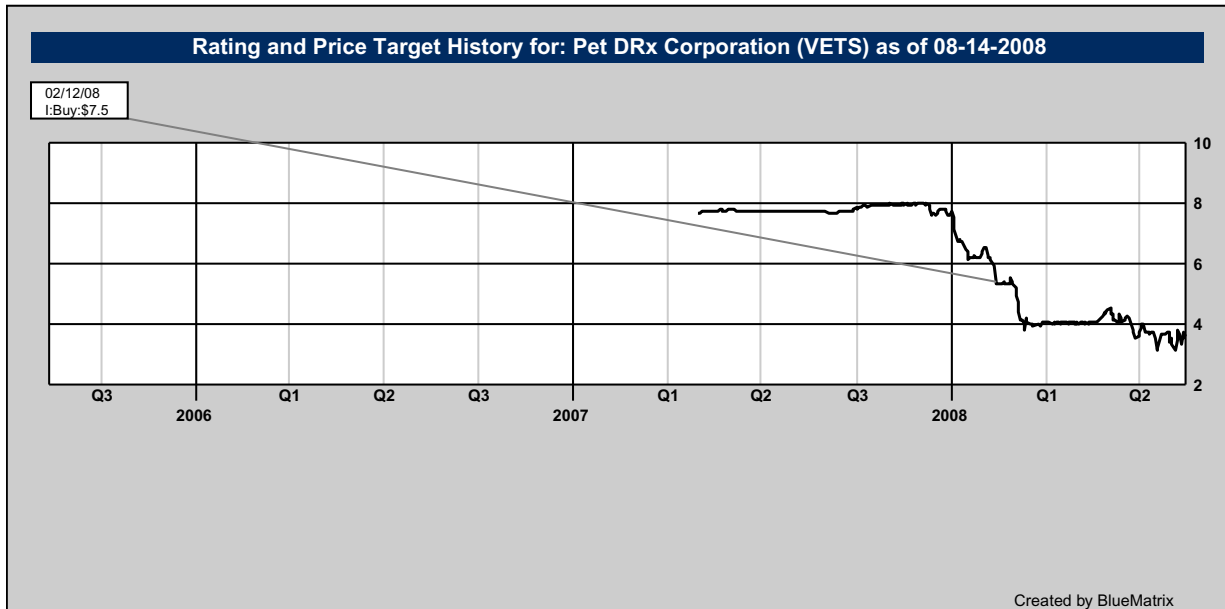
(In Millions, Except Per Share Data)

Quarter End	FY* 2006	Q1* Mar-07	Q2* Jun-07	Q3* Sep-07	Q4* Dec-07	FY* 2007	Q1 Mar-08	Q2 Jun-08	Q3E Sep-08	Q4E Dec-08	FYE 2008	Q1E Mar-09	Q2E Jun-09	Q3E Sep-09	Q4E Dec-09	FYE 2009
<b>Sales</b>	<b>70.3</b>	<b>17.4</b>	<b>17.7</b>	<b>17.7</b>	<b>16.4</b>	<b>69.3</b>	<b>17.8</b>	<b>17.9</b>	<b>19.8</b>	<b>21.0</b>	<b>76.6</b>	<b>23.8</b>	<b>27.6</b>	<b>28.9</b>	<b>28.9</b>	<b>109.2</b>
% Increase	NA	NA	NA	NA	NA	-1.4%	2.3%	1.1%	11.9%	27.8%	10.5%	33.4%	54.0%	46.0%	37.6%	42.6%
Cost of Goods Sold	67.4	17.1	16.9	16.2	15.6	65.9	16.1	16.6	18.1	19.1	70.0	20.9	24.0	24.9	24.6	94.4
As % Sales	95.9%	98.0%	95.3%	91.7%	95.2%	95.0%	90.4%	92.9%	91.5%	91.0%	91.4%	88.0%	87.0%	86.0%	85.0%	86.4%
% Increase	NA	NA	NA	NA	NA	-2.3%	-5.6%	-1.5%	11.6%	22.1%	6.3%	29.9%	44.2%	37.2%	28.5%	34.8%
<b>Gross Profit</b>	<b>2.9</b>	<b>0.4</b>	<b>0.8</b>	<b>1.5</b>	<b>0.8</b>	<b>3.4</b>	<b>1.7</b>	<b>1.3</b>	<b>1.7</b>	<b>1.9</b>	<b>6.6</b>	<b>2.9</b>	<b>3.6</b>	<b>4.0</b>	<b>4.3</b>	<b>14.8</b>
Margin	4.1%	2.0%	4.7%	8.3%	4.8%	5.0%	9.6%	7.1%	8.5%	9.0%	8.6%	12.0%	13.0%	14.0%	15.0%	13.6%
% Increase	124.5%	NA	NA	NA	NA	19.6%	384.9%	53.6%	14.6%	141.4%	90.9%	67.3%	181.9%	140.4%	129.4%	126.2%
SG&A	4.7	4.5	3.0	3.7	3.4	14.6	3.8	3.5	3.5	3.4	14.2	3.5	3.5	3.5	3.5	14.0
As % Sales	6.7%	25.9%	16.9%	21.0%	20.4%	21.1%	21.3%	19.6%	17.7%	16.2%	18.5%	14.7%	12.7%	12.1%	12.1%	12.8%
% Increase	NA	NA	NA	NA	NA	NA	-16.2%	17.1%	-5.9%	1.5%	-2.7%	-7.7%	-0.2%	0.0%	2.9%	-1.4%
<b>Operating Profit</b>	<b>(1.8)</b>	<b>(4.2)</b>	<b>(2.2)</b>	<b>(2.2)</b>	<b>(2.6)</b>	<b>(11.2)</b>	<b>(2.1)</b>	<b>(2.2)</b>	<b>(1.8)</b>	<b>(1.5)</b>	<b>(7.6)</b>	<b>(0.6)</b>	<b>0.1</b>	<b>0.5</b>	<b>0.8</b>	<b>0.8</b>
Margin	-2.6%	-23.9%	-12.2%	-12.7%	-15.6%	-16.1%	-11.7%	-12.5%	-9.2%	-7.2%	-10.0%	-2.7%	0.3%	1.9%	2.9%	0.8%
Interest Expense	4.3	1.1	1.1	1.1	1.0	4.3	1.2	2.7	0.3	0.3	4.5	0.3	0.3	0.3	0.3	1.2
Other Income	2.0	0.7	0.7	0.0	0.0	1.3	0.2	-0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
<b>Pretax Profit</b>	<b>(4.1)</b>	<b>(4.6)</b>	<b>(2.6)</b>	<b>(3.4)</b>	<b>(3.6)</b>	<b>(14.1)</b>	<b>(3.0)</b>	<b>(5.1)</b>	<b>(2.1)</b>	<b>(1.8)</b>	<b>(12.0)</b>	<b>(0.9)</b>	<b>(0.2)</b>	<b>0.2</b>	<b>0.5</b>	<b>(0.4)</b>
Margin	-5.9%	-26.3%	-14.7%	-19.0%	-21.7%	-20.4%	-16.9%	-28.4%	-10.6%	-8.6%	-15.7%	-4.0%	-0.8%	0.9%	1.9%	-0.3%
Taxes(benefit)	0.2	0.2	0.2	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Rate	-5.1%	-3.6%	-6.3%	-0.4%	0.0%	-2.4%	-0.3%	-0.8%	0.0%	0.0%	-0.4%	0.0%	0.0%	0.0%	0.0%	0.0%
<b>Net Income--Oper.</b>	<b>(4.4)</b>	<b>(4.7)</b>	<b>(2.8)</b>	<b>(3.4)</b>	<b>(3.6)</b>	<b>(14.5)</b>	<b>(3.0)</b>	<b>(5.1)</b>	<b>(2.1)</b>	<b>(1.8)</b>	<b>(12.1)</b>	<b>(0.9)</b>	<b>(0.2)</b>	<b>0.2</b>	<b>0.5</b>	<b>(0.4)</b>
<b>EPS--Operations</b>	<b>(0.20)</b>	<b>(0.21)</b>	<b>(0.12)</b>	<b>(0.15)</b>	<b>(0.16)</b>	<b>(0.64)</b>	<b>(0.13)</b>	<b>(0.22)</b>	<b>(0.09)</b>	<b>(0.08)</b>	<b>(0.51)</b>	<b>(0.04)</b>	<b>(0.01)</b>	<b>0.01</b>	<b>0.02</b>	<b>(0.02)</b>
Shares Out. Diluted	21.6	22.7	22.7	22.7	22.5	22.5	22.8	23.7	23.7	23.7	23.5	23.7	23.7	23.7	23.7	23.7

Source: Company reports and Morgan Joseph estimates

\* Pro Forma adjustments give effect as if XLNT acquired operations January 1, 2006

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Rating	Investment Banking Services/Past 12 Mos.	
	Percent	Percent
<b>BUY [B]</b>	<b>57.95</b>	<b>37.25</b>
<b>HOLD [H]</b>	<b>40.91</b>	<b>27.78</b>
<b>SELL [S]</b>	<b>1.14</b>	<b>0.00</b>

Meaning of Ratings

- A) Buy means reasonable outperformance relative to the market over 12-18 months.
- B) Hold means market-type risk adjusted performance; potential source of funds.
- C) Sell means expected to underperform the market.

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**Morgan Joseph & Co. Inc.**

600 Fifth Avenue, 19th Fl

New York, NY 10020

Tel. 212.218.3700

Fax. 212.218.3789

**Sales and Trading**

**New York**

Tel. 212.218.3767

Fax. 212.218.3705

**Pittsford**

Tel. 877.237.6542

Fax. 585.899.6029