

CENTRAL GARDEN & PET CO  
Form 10-Q  
August 03, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 24, 2006

or

**TRANSITION REPORT PURSUANT OF SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-20242

**CENTRAL GARDEN & PET COMPANY**

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

**68-0275553**  
(I.R.S. Employer  
Identification No.)

**1340 Treat Blvd., Suite 600, Walnut Creek, California 94597**

(Address of principle executive offices)

**(925) 948-4000**

(Registrant's telephone number, including area code)

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(Former name, former address and former fiscal year, if changed since last report)

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. x Yes " No

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock Outstanding as of July 21, 2006	21,572,543
Class B Stock Outstanding as of July 21, 2006	1,652,262

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**Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995**

This Form 10-Q includes forward-looking statements. Forward-looking statements include statements concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, financing needs, plans or intentions relating to acquisitions, our competitive strengths and weaknesses, our business strategy and the trends we anticipate in the industries and economies in which we operate and other information that is not historical information. When used in this Form 10-Q, the words estimates, expects, anticipates, projects, intends, believes and variations of such words or similar expressions are intended to identify forward-looking statements. All forward-looking statements, including, without limitation, our examination of historical operating trends, are based upon our current expectations and various assumptions. Our expectations, beliefs and projections are expressed in good faith, and we believe there is a reasonable basis for them, but we cannot assure you that our expectations, beliefs and projections will be realized.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this Form 10-Q. Important factors that could cause our actual results to differ materially from the forward-looking statements we make in this Form 10-Q are set forth in our Form 10-K for the fiscal year ended September 24, 2005 and Form 10-Q for the fiscal quarter ended March 25, 2006, including the factors described in the section entitled Risk Factors. If any of these risks or uncertainties materialize, or if any of our underlying assumptions are incorrect, our actual results may differ significantly from the results that we express in or imply by any of our forward-looking statements. We do not undertake any obligation to revise these forward-looking statements to reflect future events or circumstances. Presently known risk factors include, but are not limited to, the following factors:

consolidation trends in the retail industry;

dependence on a few customers for a significant portion of each of our businesses;

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uncertainty of our product innovations and marketing programs;

fluctuations in market prices for seeds and grains;

competition in our industries;

risks associated with our acquisition strategy;

adverse weather during the peak gardening season;

seasonality and fluctuations in our operating results and cash flows;

dependence upon our key executive officers;

rising energy prices;

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implementation of a new enterprise planning information system over the next several years;

potential environmental liabilities and product liability claims; and

pending litigation and claims.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****CENTRAL GARDEN & PET COMPANY****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share amounts)

(unaudited)

	September 24, 2005	June 24, 2006
<b>ASSETS</b>		
Current assets:		
Cash and equivalents	\$ 28,792	\$ 8,021
Accounts receivable (less allowance for doubtful accounts of \$11,712 and \$13,028)	184,896	278,591
Inventories	270,736	342,604
Prepaid expenses and other	25,853	36,109
<b>Total current assets</b>	<b>510,277</b>	<b>665,325</b>
Land, buildings, improvements and equipment net	110,595	139,609
Goodwill	364,847	379,076
Unallocated purchase price		287,904
Deferred income taxes and other assets	70,630	71,345
<b>Total</b>	<b>\$ 1,056,349</b>	<b>\$ 1,543,259</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 96,455	\$ 103,250
Accrued expenses	68,152	97,260
Current portion of long-term debt	2,210	3,022
<b>Total current liabilities</b>	<b>166,817</b>	<b>203,532</b>
Long-term debt	320,854	591,107
Other long-term obligations	18,500	20,254
Convertible redeemable preferred stock	3,000	3,000
Minority interest		1,887
Shareholders' equity:		
Class B stock, \$.01 par value: 1,654,462 and 1,652,262 shares outstanding at September 24, 2005 and June 24, 2006	16	16
Common stock, \$.01 par value: 33,419,556 shares issued and 19,659,691 and 21,774,310 shares outstanding at September 24, 2005 and June 24, 2006	334	218
Additional paid-in capital	577,073	543,691
Retained earnings	119,497	179,012
Deferred compensation	(4,377)	
Treasury stock	(145,581)	
Accumulated other comprehensive income	216	542

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Total shareholders equity	547,178	723,479
Total	\$ 1,056,349	\$ 1,543,259

See notes to condensed consolidated financial statements.

**Table of Contents****CENTRAL GARDEN & PET COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended		Nine Months Ended	
	June 25,	June 24,	June 25,	June 24,
	2005	2006	2005	2006
Net sales	\$ 413,193	\$ 506,694	\$ 1,057,623	\$ 1,200,757
Cost of goods sold and occupancy	282,941	334,983	714,456	800,296
Gross profit	130,252	171,711	343,167	400,461
Selling, general and administrative expenses	92,037	111,842	255,760	285,083
Income from operations	38,215	59,869	87,407	115,378
Interest expense	(6,130)	(12,213)	(17,038)	(28,784)
Interest income	127	1,582	337	2,869
Other income	2,939	1,371	4,593	3,223
Income before income taxes and minority interest	35,151	50,609	75,299	92,686
Income taxes	12,968	19,070	28,228	32,362
Minority interest		809		809
Net income	\$ 22,183	\$ 30,730	\$ 47,071	\$ 59,515
Income per common share:				
Basic	\$ 1.06	\$ 1.31	\$ 2.27	\$ 2.70
Diluted	\$ 1.03	\$ 1.28	\$ 2.19	\$ 2.62
Weighted average shares used in the computation of income per common share:				
Basic	20,890	23,377	20,735	22,060
Diluted	21,603	24,066	21,454	22,730

See notes to condensed consolidated financial statements.



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	<b>Nine Months Ended</b>	
	<b>June 25, 2005</b>	<b>June 24, 2006</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 47,071	\$ 59,515
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	14,161	18,628
Stock based compensation	629	3,928
Minority interest		809
Deferred income taxes		(1,084)
<b>Change in assets and liabilities (excluding businesses acquired):</b>		
Receivables	(15,886)	(47,585)
Inventories	(28,147)	(21,978)
Prepaid expenses and other assets	(6,746)	(18,942)
Accounts payable	(8,988)	(15,328)
Accrued expenses	27,761	22,168
Other long-term obligations	462	1,754
<b>Net cash provided by operating activities</b>	<b>30,317</b>	<b>1,885</b>
<b>Cash flows from investing activities:</b>		
Additions to land, buildings, improvements and equipment	(13,425)	(30,716)
Businesses acquired, net of cash acquired	(61,562)	(370,123)
Collection of note related to litigation settlement		16,058
Restricted investments	(391)	
<b>Net cash used in investing activities</b>	<b>(75,378)</b>	<b>(384,781)</b>
<b>Cash flows from financing activities:</b>		
Borrowings on revolving line of credit	236,000	826,530
Repayments of revolving line of credit	(271,000)	(697,678)
Proceeds from issuance of long-term debt	75,000	600,000
Repayments of long-term debt	(966)	(472,642)
Proceeds from issuance of common stock	4,140	109,529
Excess tax benefits from stock based awards		3,003
Deferred financing costs		(6,583)
Treasury stock repurchases	(528)	
<b>Net cash provided by financing activities</b>	<b>42,646</b>	<b>362,159</b>
Effect of exchange rate changes on cash and equivalents	104	(34)
<b>Net decrease in cash and equivalents</b>	<b>(2,311)</b>	<b>(20,771)</b>
Cash and equivalents at beginning of period	12,221	28,792

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Cash and equivalents at end of period	\$ 9,910	\$ 8,021
Supplemental information:		
Cash paid for interest	\$ 13,197	\$ 20,739
Cash paid for income taxes net	\$ 12,369	\$ 16,047

See notes to condensed consolidated financial statements.

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**CENTRAL GARDEN & PET COMPANY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three and Nine Months Ended June 24, 2006**

**(unaudited)**

**1. Basis of Presentation**

The condensed consolidated balance sheets of Central Garden & Pet Company and subsidiaries (the Company or Central ) as of June 24, 2006, the condensed consolidated statements of operations for the three and nine months ended June 25, 2005 and June 24, 2006 and the condensed consolidated statements of cash flows for the nine months ended June 25, 2005 and June 24, 2006 have been prepared by the Company, without audit. In the opinion of management, all adjustments (which include only normal recurring adjustments) considered necessary to present fairly the financial position, results of operations and cash flows of the Company for the periods mentioned above, have been made.

For the Company's foreign business in the UK, the local currency is the functional currency. Assets and liabilities are translated using the exchange rate in effect at the balance sheet date. Income and expenses are translated at the average exchange rate for the period. Comprehensive income was \$59.8 million for the nine month period ended June 24, 2006 and includes net earnings of \$59.5 million and foreign currency translation adjustments of \$0.3 million that are excluded from net earnings but reported in accumulated other comprehensive income, a separate component of shareholders' equity. Comprehensive income was \$47.6 million for the nine month period ended June 25, 2005 and included net earnings of \$47.1 million and foreign currency translation adjustments of \$0.5 million. Deferred taxes are not provided on translation gains and losses, because the Company expects earnings of its foreign subsidiary to be permanently reinvested. Transaction gains and losses are included in results of operations.

Due to the seasonal nature of the Company's garden business, the results of operations for the three and nine month periods ended June 24, 2006 and June 25, 2005 are not indicative of the operating results that may be expected for the entire fiscal year. These interim financial statements should be read in conjunction with the annual audited financial statements, accounting policies and financial notes thereto, included in the Company's 2005 Annual Report on Form 10-K, which has previously been filed with the Securities and Exchange Commission.

***Minority Interest***

Minority interest in the Company's condensed consolidated financial statements represents the 20% interest not owned by Central in a consolidated subsidiary. Since the Company controls this subsidiary (effective as of March 2006) its financial statements are fully consolidated with those of the Company, and the minority owner's 20% share of the subsidiary's net assets and results of operations is deducted and reported as minority interest.

**2. Stock Based Compensation**

The Company has various non-qualified stock-based compensation programs, which provide for stock option grants and restricted stock awards. The grant date fair value of restricted stock awards is amortized over the vesting period. Stock options may be granted to officers, key employees and directors. Stock options granted are generally exercisable with a 30 month cliff vesting and 42 month expiration, but are also granted with vesting increments of 20% per year beginning three years from the date of grant and expiring 8 years from the date of grant. Prior to fiscal 2006, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations and provided the required pro forma disclosures of SFAS No. 123, *Accounting for Stock-Based Compensation*.

Beginning in fiscal 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment*, and elected to adopt the standard using the modified prospective transition method. Under this transition method, compensation cost associated with stock options recognized in fiscal 2006 includes: (1) amortization related to the remaining unvested portion of all share based payments granted prior to, but not vested as of September 24, 2005, based on the grant date fair value estimated in accordance with the original pro forma footnote disclosure provisions of FASB Statement No. 123 and (2) amortization related to all share based payments granted subsequent to September 24, 2005, based on the grant date fair value estimated in accordance with the provisions of FASB Statement No. 123 (R). Accordingly, stock compensation expense is recognized over the requisite

service period using the straight-line attribution method. Previously reported amounts have not been restated.

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The Company recognized share based compensation expense of \$1.4 million and \$3.9 million for the three and nine month periods ended June 24, 2006, respectively, as a component of selling, general and administrative expenses. Share based compensation expense in the third quarter of fiscal 2006 consisted of \$1.0 million for stock options and \$0.4 million for restricted stock awards.

Had compensation expense for the Company's various stock option plans been determined based upon the projected fair values at the grant dates for awards under those plans in accordance with SFAS No. 123, the Company's pro-forma net earnings, basic and diluted earnings per common share for the three and nine month periods ended June 25, 2005 would have been as follows:

	Three Months Ended June 25,	Nine Months Ended June 25,
	2005 (in thousands)	2005 (in thousands)
Net income, as reported	\$ 22,183	\$ 47,071
Deduct: Total stock-based employee compensation expense determined under fair value based method for awards, net of related tax effects	(494)	(1,331)
Pro forma net income	\$ 21,689	\$ 45,740
Net income per common equivalent share:		
Basic as reported	\$ 1.06	\$ 2.27
Basic pro forma	\$ 1.04	\$ 2.21
Diluted as reported	\$ 1.03	\$ 2.19
Diluted pro forma	\$ 1.00	\$ 2.13

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model. Expected stock price volatilities are estimated based on the Company's implied historical volatility. The expected term of options granted is based on analyses of historical employee termination rates and option exercises. The risk-free rates are based on U.S. Treasury yields, for notes with comparable terms as the option grants, in effect at the time of the grant. For purposes of this valuation model, no dividends have been assumed. Assumptions used in the Black-Scholes model are presented below:

Stock plans:	
Average expected life in years	3 or 6 years
Expected volatility	29%
Risk-free interest rate	4.3%

The following table summarizes option activity for the nine months ended June 24, 2006:

	Number of shares (in thousands)	Weighted average exercise price per share	Weighted average remaining contractual life (in years)	Aggregate intrinsic value (in thousands)
Outstanding at September 24, 2005	1,640	\$ 27.01		
Granted	576	45.51		
Exercised	(295)	20.73		
Cancelled or expired	(65)	36.64		
Outstanding at June 24, 2006	1,856	33.37	3.3	\$ 61,924
Exercisable at June 24, 2006	446	\$ 25.64	0.9	\$ 11,441



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The weighted average fair value of options granted during the nine months ended June 24, 2006 and June 25, 2005 was \$13.52 and \$10.22, respectively. The total intrinsic value of options exercised during the nine months ended June 24, 2006 and June 25, 2005 was \$7.8 million and \$18.1 million, respectively.

As of June 24, 2006, there was \$7.2 million of total unrecognized compensation cost related to nonvested stock options, which is expected to be recognized over a remaining weighted-average vesting period of 1.9 years.

**Restricted Stock Awards:** As of June 24, 2006, there were 0.3 million shares of restricted stock awards outstanding. The awards generally vest in 20% or 25% increments, after a three year waiting period, over a seven year period of employment after the grant date.

Restricted stock award activity during the nine months ended June 24, 2006 is summarized as follows:

	Number of shares (in thousands)
Outstanding at September 24, 2005	141
Granted	129
Exercised	(1)
Cancelled or expired	(13)
Outstanding at June 24, 2006	256

The weighted average grant-date fair value of restricted stock awards granted during the first nine months of fiscal 2006 and fiscal 2005 was \$47.81 and \$36.74, respectively.

As of June 24, 2006, there was \$8.8 million of unrecognized compensation cost related to nonvested restricted stock awards, which is expected to be recognized over a weighted-average period of 3.0 years.

**3. Earnings Per Share**

The following is a reconciliation of the numerators and denominators of the basic and diluted per share computations for income from continuing operations:

	Three Months Ended June 24, 2006			Nine Months Ended June 24, 2006		
	Income	Shares	Per Share	Income	Shares	Per Share
	(in thousands, except per share amounts)					
<b>Basic EPS:</b>						
Net income	\$ 30,730	23,377	\$ 1.31	\$ 59,515	22,060	\$ 2.70
<b>Effect of dilutive securities:</b>						
Options to purchase common stock		347	(.02)		368	(.05)
Restricted shares		256	(.01)		216	(.03)
Convertible preferred stock		86			86	
<b>Diluted EPS:</b>						
Net income attributable to common shareholders	\$ 30,730	24,066	\$ 1.28	\$ 59,515	22,730	\$ 2.62

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	Three Months Ended June 25, 2005			Nine Months Ended June 25, 2005		
	Income	Shares	Per Share	Income	Shares	Per Share
(in thousands, except per share amounts)						
<b>Basic EPS:</b>						
Net income	\$ 22,183	20,890	\$ 1.06	\$ 47,071	20,735	\$ 2.27
<b>Effect of dilutive securities:</b>						
Options to purchase common stock		498	(.02)		533	(.06)
Restricted shares		129	(.01)		100	(.01)
Convertible preferred stock		86			86	(.01)
<b>Diluted EPS:</b>						
Net income attributable to common shareholders	\$ 22,183	21,603	\$ 1.03	\$ 47,071	21,454	\$ 2.19

Options to purchase 1,855,903 shares of common stock at prices ranging from \$12.80 to \$53.71 per share were outstanding at June 24, 2006 and options to purchase 1,873,103 shares of common stock at prices ranging from \$7.54 to \$48.14 per share were outstanding at June 25, 2005. For the three month periods ended June 24, 2006 and June 25, 2005, options to purchase 52,584 and 7,800 shares of common stock, respectively, were outstanding but were not included in the computation of diluted earnings per share because the option exercise prices were greater than the average market price of the common shares and, therefore, the effect would be anti-dilutive. For the nine month periods ended June 24, 2006 and June 25, 2005, options to purchase 52,584 and 30,680 shares of common stock, respectively, were outstanding but were not included in the computation of diluted earnings per share because the option exercise prices were greater than the average market price of the common shares and, therefore, the effect would be anti-dilutive.

Shares of common stock from the assumed conversion of the Company's convertible preferred stock, issued in February 2004, were also included in the computation of diluted EPS for the three and nine month periods ended June 24, 2006 and June 25, 2005.

**4. Unallocated Purchase Price**

Unallocated purchase price as of June 24, 2006 represents unallocated business acquisition costs of approximately \$300 million because the Company has not yet finalized its allocation of the purchase price to the fair value of assets acquired for certain acquisitions (see Note 7 Acquisitions).

**5. Long-Term Debt**

On February 28, 2006, the Company entered into \$650 million in senior secured credit facilities to finance the acquisition of Farnam Companies, Inc. and to refinance the existing \$125 million revolving credit facility maturing in May 2008 and the existing \$175 million term loan maturing in May 2009. The new credit facilities consist of a \$350 million revolving credit facility maturing in February 2011 and a \$300 million term loan maturing in September 2012. Interest on the revolving credit facility is based on a rate equal to prime plus a margin, which fluctuates from 0% to 0.25% or LIBOR plus a margin which fluctuates from 0.75% to 1.375%, determined quarterly based on consolidated total debt to consolidated EBITDA for the most recent trailing 12-month period. Interest on the term loan is based on a rate equal to LIBOR + 1.50% or the prime rate plus 0.50%, at the Company's option. The term loan is payable in quarterly installments of \$750,000 with the balance payable in September 2012. This facility is secured by substantially all of the Company's assets, contains certain financial covenants which require the Company to maintain minimum levels of interest coverage and maximum levels of total debt to EBITDA, and which restrict the Company's ability to repurchase the Company's stock, make investments in or acquisitions of other businesses and pay dividends above certain levels over the life of the facility.

**6. Shareholders Equity**

In March 2006, the Company issued 1,975,000 shares of common stock at an offering price per share of \$53.50. The offering raised approximately \$105 million in net proceeds.

Effective December 14, 2005, the Company retired all of its treasury stock, which consisted of 13,759,865 common shares. Upon retirement, the excess of the aggregate treasury stock purchase price over par value was allocated to additional paid-in capital.





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In April 2006, the Company acquired the rights to the Ironite® Products brand of natural soil supplements and intellectual property for approximately \$6 million in cash. Ironite, a registered trademark since 1956, is a leading producer of environmentally-friendly soil supplements that promote healthy plant color and deeper root structures. The Company has not yet finalized its allocation of the purchase price to the fair value of assets acquired.

In March 2006, the Company increased its equity interest in Tech Pac, L.L.C. from 20% to 80%. The Company paid approximately \$21 million in cash and deposited approximately \$16 million in cash in an escrow account for possible contingent performance based payments over the next five years (included in Other Assets in our condensed consolidated balance sheet). The Company previously acquired its 20% interest in Tech Pac upon its acquisition of Gulfstream Home & Garden, Inc. which held a 20% interest in Tech Pac at the time of the acquisition in February 2005. Tech Pac is a leading supplier of insect control branded products in the lawn and garden market place. Tech Pac's leading brands include Sevin®, a broad-based insecticide, Over nOut® for fire ant control and RooTone, a leading root stimulant for the gardening enthusiast. The purchase price exceeded the fair value of the net tangible assets acquired by approximately \$15 million, which is presently included in unallocated purchase price in our condensed consolidated balance sheet since the Company has not yet finalized its allocation of the purchase price to the fair value of intangible assets acquired. The consolidated financial statements include the results of Tech Pac from the date of acquisition. The final allocation of the purchase price to intangible assets will likely result in an adjustment of operating results recognized to date.

In February 2006, the Company acquired Farnam Companies, Inc. for approximately \$287 million in cash, plus \$4 million in cash for the purchase of related real property. Farnam is a leading marketer and manufacturer of innovative health care products primarily for horses, household pets and livestock sold through over-the-counter and veterinary channels. In addition to the internationally recognized Farnam umbrella brand, Farnam's portfolio of industry leading brands includes Equicare®, ComboCare®, IverCare®, and Repeel® for horses; D-Worm®, BioSpot® and Scratchex® for household pets; and Adams® and Bite Free® insect controls for home and yard care. In its fiscal year ending November 30, 2005, Farnam had net sales of approximately \$160 million. The purchase price exceeded the fair value of the net tangible assets acquired by approximately \$230 million, which is presently included in unallocated purchase price in our condensed consolidated balance sheet since the Company has not yet finalized its allocation of the purchase price to the fair value of intangible assets acquired. The consolidated financial statements include the results of Farnam from the date of acquisition. The final allocation of the purchase price to intangible assets will likely result in an adjustment of operating results recognized to date.

The following table summarizes on a pro forma basis the unaudited consolidated results of operations of the Company as if the Farnam acquisition had occurred at the beginning of the periods presented. The pro forma consolidated results of operations include adjustments to give effect to interest expense on acquisition-related debt and certain other purchase accounting adjustments. The pro forma information is not necessarily indicative of the results of operations that would have occurred had the purchase been made at the beginning of the periods presented, nor of the future results of the combined operations.

	<b>Nine Months Ended</b>	
	<b>June 25, 2005</b>	<b>June 24, 2006</b>
	<b>(in thousands, except per share amounts)</b>	
Net sales	\$ 1,178,985	\$ 1,254,504
Gross profit	399,821	426,793
Income from operations	99,893	117,258
Income before income taxes	74,470	85,799
Net income	45,139	53,880
Income per common share:		
Basic	\$ 2.18	\$ 2.44
Diluted	\$ 2.10	\$ 2.37

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In February 2006, the Company acquired the assets of Breeder's Choice Pet Foods Inc. for approximately \$25 million in cash. Breeder's Choice is a leading branded marketer and manufacturer of premium all natural, healthy dog and cat food sold exclusively in the pet specialty channel under the brands AvoDerm®, Pinnacle®, Active Care® and Advanced Pet Diets®. The purchase price exceeded the fair value of the net tangible assets acquired by approximately \$16 million, which is presently included in unallocated purchase price in our condensed consolidated balance sheet since the Company has not yet finalized its allocation of the purchase price to the fair value of intangible assets acquired. The consolidated financial statements include the results of Breeder's Choice from the date of acquisition. The final allocation of the purchase price to intangible assets will likely result in an adjustment of operating results recognized to date.

In December 2005, the Company acquired certain intellectual property assets from Shirlo, Inc. for approximately \$10 million in cash. The assets acquired from Shirlo, Inc. include the company's exclusive marketing rights to etofenprox, an insect adulticide approved for on-animal use. The acquired assets were combined with Wellmark International, a wholly owned subsidiary of Central. The purchase price exceeded the fair value of net assets acquired by approximately \$2 million, which was recorded as goodwill.

**8. Segment Information**

Management has determined that the reportable segments of the Company are Garden Products and Pet Products, based on the level at which the chief operating decision making group reviews the results of operations to make decisions regarding performance assessment and resource allocation.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 25, 2005</b>	<b>June 24, 2006</b>	<b>June 25, 2005</b>	<b>June 24, 2006</b>
	<b>(in thousands)</b>			
<b>Net sales:</b>				
Garden Products	\$ 249,771	\$ 278,897	\$ 579,035	\$ 618,593
Pet Products	163,422	227,797	478,588	582,164
<b>Total net sales</b>	<b>\$ 413,193</b>	<b>\$ 506,694</b>	<b>\$ 1,057,623</b>	<b>\$ 1,200,757</b>
<b>Income from operations:</b>				
Garden Products	\$ 21,402	\$ 27,409	\$ 44,814	\$ 53,252
Pet Products	23,580	29,636	65,264	73,256
Corporate	(6,767)	2,824	(22,671)	(11,130)
<b>Total income from operations</b>	<b>38,215</b>	<b>59,869</b>	<b>87,407</b>	<b>115,378</b>
Interest expense - net	(6,003)	(10,631)	(16,701)	(25,915)
Other income	2,939	1,371	4,593	3,223
Income taxes	(12,968)	(19,070)	(28,228)	(32,362)
Minority interest		(809)		(809)
<b>Net income</b>	<b>\$ 22,183</b>	<b>\$ 30,730</b>	<b>\$ 47,071</b>	<b>\$ 59,515</b>
<b>Depreciation and amortization:</b>				
Garden Products	\$ 1,775	\$ 1,461	\$ 4,682	\$ 4,529
Pet Products	3,127	5,598	8,877	13,062
Corporate	184	392	602	1,037
<b>Total depreciation and amortization</b>	<b>\$ 5,086</b>	<b>\$ 7,451</b>	<b>\$ 14,161</b>	<b>\$ 18,628</b>

Corporate income from operations at June 24, 2006, includes a gain of \$9.9 million as a reduction of selling, general and administrative expense as a result of a legal settlement (see Note 9 - Contingencies).



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	September 24,	
	2005	June 24, 2006
	(in thousands)	
<b>Assets:</b>		
Garden Products	\$ 330,884	\$ 445,180
Pet Products	273,481	413,138
Corporate	451,984	684,941
<b>Total assets</b>	<b>\$ 1,056,349</b>	<b>\$ 1,543,259</b>
<b>Goodwill (included in corporate assets):</b>		
Garden Products	\$ 169,456	\$ 169,525
Pet Products	195,391	209,551
<b>Total goodwill</b>	<b>\$ 364,847</b>	<b>\$ 379,076</b>

Corporate assets at June 24, 2006, include unallocated purchase consideration related to the Company's acquisitions of approximately \$300 million.

**9. Contingencies**

*TFH Litigation.* On March 24, 2006, the trial court entered a final judgment in the TFH litigation (described below) awarding Central \$26,584,538. Thereafter, in June 2006, the parties agreed to a settlement of all outstanding claims pursuant to which the Axelrods paid \$26 million to Central.

In December 1997, Central acquired all of the stock of TFH Publications, Inc. (TFH) from Herbert and Evelyn Axelrod (the Axelrods). In connection with the transaction, Central made a \$10 million loan to the Axelrods (the Axelrod Loan), which was evidenced by a Promissory Note. In September 1998, the Axelrods brought suit against Central and certain executives of Central for damages and relief from their obligations under the Promissory Note. Central counterclaimed against the Axelrods for enforcement of the Promissory Note, damages and other relief, alleging, among other things, fraud and breaches of warranties. These actions, *Herbert R. Axelrod and Evelyn Axelrod v. Central Garden & Pet Company; Glen S. Axelrod; Gary Hersch; William E. Brown; Robert B. Jones; Glenn Novotny; and Neill Hines*, Docket No. MON-L-5100-99, and *TFH Publications, Inc. v. Herbert Axelrod et al.*, Docket No. L-2127-99 (consolidated cases), were in the New Jersey Superior Court.

On September 1, 2005, a civil jury returned its verdict in the TFH litigation following a five-month trial. The jury returned an overall verdict in favor of Central. With regard to Central's claims against the Axelrods, the jury awarded Central \$20,340,000. The jury rejected most of the Axelrods' claims against Central. The jury did find that Central had breached Consulting Agreements with the Axelrods and awarded \$3.7 million in damages. The Axelrods also maintained that, as a result of an arbitration determination made before trial concerning a claimed purchase price adjustment, they were entitled to an additional approximately \$2.6 million.

Following trial, the trial court decided various motions directed at issues of prejudgment interest, Central's claim for attorneys fees and expenses, and the posting of appropriate security during the appeal. As a result of these motions and the jury's prior verdict, the court entered judgment on March 24, 2006 awarding Central \$26,584,538 comprised of \$22,604,969 in damages and prejudgment interest (inclusive of all offsets due the Axelrods) and \$3,979,569 in fees and expenses. On May 23, 2006, the parties agreed to a settlement of all outstanding claims pursuant to which the Axelrods paid \$26 million to Central. Central recorded a one-time gain as a reduction to selling, general and administrative expenses, where the related legal amounts incurred were previously expensed, in the amount of \$9.9 million after consideration of the note and other related amounts previously accrued on its financial statements and reversed previously reserved interest income of \$1.0 million.

*Phoenix Fire.* On August 2, 2000, a fire destroyed Central's leased warehouse space in Phoenix, Arizona, and an adjoining warehouse space leased by a third party. At the time of the fire, Central maintained property insurance covering losses to the leased premises, Central's inventory and equipment, and loss of business income. Central also maintained liability insurance providing \$52 million of coverage (with no deductible), plus additional coverage for any amount of pre-judgment interest that Central might be obligated to pay.

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On July 31, 2001, the adjoining warehouse tenant, Cardinal Health, and its insurers (the Cardinal Plaintiffs ), filed a lawsuit against Central and other parties in the Superior Court of Arizona, Maricopa County. The Cardinal Plaintiffs sought to recover from Central, Arch Chemical Company ( Arch ) and others approximately \$60 million in compensatory damages, plus pre-judgment interest and punitive damages. See *Cardinal Health Inc., et al. v. Central Garden & Pet Company, et al., Civil Case No. CV2001-013152*. On

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January 25, 2006, Central and its insurers, along with Arch and its insurers, entered into a Stipulation for Settlement with the Cardinal Plaintiffs. On March 10, 2006, the parties executed the final settlement documentation. The terms of the settlement are confidential, and the amounts which Central and Arch will each be required to contribute to the settlement will be determined in an arbitration proceeding, which began July 10, 2006 and is scheduled to conclude on August 11, 2006. Central's ultimate payment obligation towards the settlement with the Cardinal Plaintiffs will be paid entirely by Central's insurers.

Local residents also filed a purported class action lawsuit alleging claims for bodily injury and property damage as a result of the fire. The residents' lawsuit was settled as to all parties, and the Court approved the settlement. As part of the settlement, Central's liability insurers paid \$7,825,000 on behalf of Central in May 2004.

The warehouse owner, B&L, and its insurer (the B&L Plaintiffs), as well as several nearby businesses, also filed lawsuits for property damage and business interruption, which were coordinated with the Cardinal Plaintiffs' lawsuit. The lawsuits by nearby businesses have been dismissed, or settled with payments from Central's insurers. The remaining lawsuit by the B&L Plaintiffs is pending in the Superior Court of Arizona, Maricopa County. The B&L Plaintiffs currently are claiming damages of approximately \$10 million. There are various factual and legal issues regarding the liability, if any, of Central, the amount of recoverable damages, and the extent of Central's available insurance coverage, all of which will depend on the outcome of complex litigation. Central has not recognized any liability in this regard as of June 24, 2006.

### **10. Consolidating Condensed Financial Information of Guarantor Subsidiaries**

Certain wholly owned subsidiaries of the Company (as listed below, collectively the Guarantor Subsidiaries) have guaranteed fully and unconditionally, on a joint and several basis, the obligation to pay principal and interest under the Company's \$150,000,000 9-1/8% Senior Subordinated Notes (the Notes) issued on January 30, 2003 and under the Bank Credit Agreement dated February 28, 2006. Certain subsidiaries and operating divisions are not guarantors of the Notes and have been included in the Parent financial results below. Those subsidiaries that are guarantors of the Notes are as follows:

Farnam Companies, Inc. (including Thompson's Veterinary Supplies, Inc.)

Four Paws Products Ltd.

Grant Laboratories, Inc.

Gulfstream Home & Garden, Inc.

Interpet USA, LLC

Kaytee Products, Incorporated

Matthews Redwood & Nursery Supply, Inc.

New England Pottery LLC

Norcal Pottery Products, Inc.

Pennington Seed, Inc. (including Phaeton Corporation (dba Unicorn Labs), Pennington Seed, Inc. of Nebraska, Gro Tec, Inc., Seeds West, Inc., All-Glass Aquarium Co., Inc. (including Oceanic Systems, Inc.), and Cedar Works, LLC.)

Pets International, Ltd.

T.F.H. Publications, Inc.

Wellmark International

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In lieu of providing separate unaudited financial statements for the Guarantor Subsidiaries, the Company has included the accompanying unaudited condensed consolidating financial statements based on the Company's understanding of the Securities and Exchange Commission's interpretation and application of Rule 3-10 of the Securities and Exchange Commission's Regulation S-X.



**Table of Contents****CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS****Three Months Ended June 24, 2006****(in thousands)****(unaudited)****Guarantor**

	<b>Parent</b>	<b>Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$ 155,954	\$ 379,171	\$ (28,431)	\$ 506,694
Cost of products sold and occupancy	106,478	256,936	(28,431)	334,983
Gross profit	49,476	122,235		171,711
Selling, general and administrative expenses	37,268	74,574		111,842
Income from operations	12,208	47,661		59,869
Interest net	(10,680)	49		(10,631)
Other income (loss)	(1,539)	2,910		1,371
Income (loss) before income taxes and minority interest	(11)	50,620		50,609
Income taxes	4	(19,638)	564	(19,070)
Minority interest	(809)			(809)
Net income (loss)	(816)	30,982	564	30,730
Equity in undistributed income of guarantor subsidiaries	31,546		(31,546)	
Net income (loss)	\$ 30,730	\$ 30,982	\$ (30,982)	\$ 30,730

**CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS****Three Months Ended June 25, 2005****(in thousands)****(unaudited)****Guarantor**

	<b>Parent</b>	<b>Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$ 152,246	\$ 304,742	\$ (43,795)	\$ 413,193
Cost of products sold and occupancy	114,449	212,287	(43,795)	282,941
Gross profit	37,797	92,455		130,252
Selling, general and administrative expenses	32,580	59,457		92,037
Income from operations	5,217	32,998		38,215
Interest net	(6,038)	35		(6,003)
Other income	1,668	1,271		2,939
Income before income taxes	847	34,304		35,151
Income taxes	(321)	(12,982)	335	(12,968)
Net income	526	21,322	335	22,183
Equity in undistributed income of guarantor subsidiaries	21,657		(21,657)	

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Net income (loss)	\$ 22,183	\$ 21,322	\$ (21,322)	\$ 22,183
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**Table of Contents****CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS**

Nine Months Ended June 24, 2006

(in thousands)

(unaudited)

Guarantor

	Parent	Subsidiaries	Eliminations	Consolidated
Net sales	\$ 376,151	\$ 906,425	\$ (81,819)	\$ 1,200,757
Cost of products sold and occupancy	261,941	620,174	(81,819)	800,296
Gross profit	114,210	286,251		400,461
Selling, general and administrative expenses	96,231	188,852		285,083
Income from operations	17,979	97,399		115,378
Interest net	(26,081)	166		(25,915)
Other income	(805)	4,028		3,223
Income (loss) before income taxes and minority interest	(8,907)	101,593		92,686
Income taxes	3,286	(36,221)	573	(32,362)
Minority interest	(809)			(809)
Net income (loss)	(6,430)	65,372	573	59,515
Equity in undistributed income of guarantor subsidiaries	65,945		(65,945)	
Net income (loss)	\$ 59,515	\$ 65,372	\$ (65,372)	\$ 59,515

**CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS**

Nine Months Ended June 25, 2005

(in thousands)

(unaudited)

Guarantor

	Parent	Subsidiaries	Eliminations	Consolidated
Net sales	\$ 398,322	\$ 777,840	\$ (118,539)	\$ 1,057,623
Cost of products sold and occupancy	295,973	537,022	(118,539)	714,456
Gross profit	102,349	240,818		343,167
Selling, general and administrative expenses	89,991	165,769		255,760
Income from operations	12,358	75,049		87,407
Interest net	(16,902)	201		(16,701)
Other income	2,255	2,338		4,593
Income (loss) before income taxes	(2,289)	77,588		75,299
Income taxes	873	(29,421)	320	(28,228)
Net income (loss)	(1,416)	48,167	320	47,071
Equity in undistributed income of guarantor subsidiaries	48,487		(48,487)	

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Net income (loss)	\$ 47,071	\$ 48,167	\$ (48,167)	\$ 47,071
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**Table of Contents****CONSOLIDATING CONDENSED BALANCE SHEET  
June 24, 2006**

(in thousands)

(unaudited)

	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>				
Cash and equivalents	\$ (9,864)	\$ 17,885	\$	\$ 8,021
Accounts receivable	83,344	212,790	(17,543)	278,591
Inventories	101,206	241,398		342,604
Prepaid expenses and other	20,157	15,952		36,109
Total current assets	194,843	488,025	(17,543)	665,325
Land, buildings, improvements and equipment, net	26,449	113,160		139,609
Goodwill	379,076			379,076
Investment in guarantor subsidiaries	718,430		(718,430)	
Unallocated purchase price, deferred income taxes and other assets	98,902	263,792	(3,445)	359,249
<b>Total</b>	<b>\$ 1,417,700</b>	<b>\$ 864,977</b>	<b>\$ (739,418)</b>	<b>\$ 1,543,259</b>

**LIABILITIES AND SHAREHOLDERS EQUITY**

Accounts payable	\$ 40,705	\$ 80,088	\$ (17,543)	\$ 103,250
Accrued expenses and other current liabilities	54,811	45,471		100,282
Total current liabilities	95,516	125,559	(17,543)	203,532
Long-term debt	591,000	107		591,107
Other long-term obligations	2,818	20,881	(3,445)	20,254
Convertible redeemable preferred stock	3,000			3,000
Minority interest	1,887			1,887
Shareholders equity	723,479	718,430	(718,430)	723,479
<b>Total</b>	<b>\$ 1,417,700</b>	<b>\$ 864,977</b>	<b>\$ (739,418)</b>	<b>\$ 1,543,259</b>

**CONSOLIDATING CONDENSED BALANCE SHEET  
September 24, 2005**

(in thousands)

(unaudited)

	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>				
Cash and equivalents	\$ 22,732	\$ 6,060	\$	\$ 28,792
Accounts receivable	50,804	147,517	(13,425)	184,896
Inventories	71,871	198,865		270,736
Prepaid expenses and other	12,903	12,950		25,853
Total current assets	158,310	365,392	(13,425)	510,277
Land, buildings, improvements and equipment, net	11,154	99,441		110,595
Goodwill	364,847			364,847
Investment in guarantor subsidiaries	371,249		(371,249)	
Deferred income taxes and other assets	38,338	35,737	(3,445)	70,630
<b>Total</b>	<b>\$ 943,898</b>	<b>\$ 500,570</b>	<b>\$ (388,119)</b>	<b>\$ 1,056,349</b>

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LIABILITIES AND SHAREHOLDERS' EQUITY				
Accounts payable	\$ 43,383	\$ 66,497	\$ (13,425)	\$ 96,455
Accrued expenses and other current liabilities	28,402	41,960		70,362
Total current liabilities	71,785	108,457	(13,425)	166,817
Long-term debt	320,731	123		320,854
Other long-term obligations	1,204	20,741	(3,445)	18,500
Convertible redeemable preferred stock	3,000			3,000
Shareholders' equity	547,178	371,249	(371,249)	547,178
Total	\$ 943,898	\$ 500,570	\$ (388,119)	\$ 1,056,349

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**CONSOLIDATING CONDENSED STATEMENT OF CASH FLOWS**  
**Nine Months Ended June 24, 2006**  
(in thousands)

	(unaudited)			
	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided (used) by operating activities	\$ 11,660	\$ 59,214	\$ (68,989)	\$ 1,885
Expenditures for land, buildings, improvements and equipment	(15,353)	(15,363)		(30,716)
Assets acquired	(60,281)	(309,842)		(370,123)
Collection of note related to litigation settlement	16,058			16,058
Investment in guarantor subsidiaries	(346,855)	277,866	68,989	
Net cash provided (used) by investing activities	(406,431)	(47,339)	68,989	(384,781)
Borrowings on revolving line of credit	826,530			826,530
Repayments on revolving line of credit	(697,678)	(16)		(697,694)
Proceeds from issuance of long-term debt	600,000			600,000
Payments on long-term debt	(472,626)			(472,626)
Proceeds from issuance of stock	109,529			109,529
Tax benefits on options exercised	3,003			3,003
Deferred financing costs	(6,583)			(6,583)
Net cash provided (used) by financing activities	362,175	(16)		362,159
Effect of exchange rate changes on cash		(34)		(34)
Net increase (decrease) in cash and equivalents	(32,596)	11,825		(20,771)
Cash and equivalents at beginning of period	22,732	6,060		28,792
Cash and equivalents at end of period	\$ (9,864)	\$ 17,885	\$	\$ 8,021

**CONSOLIDATING CONDENSED STATEMENT OF CASH FLOWS**  
**Nine Months Ended June 25, 2005**  
(in thousands)

	(unaudited)			
	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided (used) by operating activities	\$ 83,671	\$ (5,187)	\$ (48,167)	\$ 30,317
Expenditures for land, buildings, improvements and equipment	3,498	(16,923)		(13,425)
Businesses acquired	(61,562)			(61,562)
Investments	(391)			(391)
Investment in guarantor subsidiaries	(63,893)	15,726	48,167	
Net cash provided (used) by investing activities	(122,348)	(1,197)	48,167	(75,378)
Repayments under lines of credit, net	(35,000)			(35,000)
Payments on long-term debt	(1,037)	71		(966)
Proceeds from issuance of long-term debt	75,000			75,000
Proceeds from issuance of stock	4,140			4,140
Payments to reacquire stock	(528)			(528)

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Net cash provided (used) by financing activities	42,575	71	42,646
Effect of exchange rate changes on cash		104	104
Net increase (decrease) in cash and equivalents	3,898	(6,209)	(2,311)
Cash and equivalents at beginning of period	5,028	7,193	12,221
Cash and equivalents at end of period	\$ 8,926	\$ 984	\$ 9,910



**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Overview**

Central Garden & Pet is a leading innovator, marketer and producer of quality branded products. We are one of the largest suppliers in the Lawn and Garden and Pet supplies industries. The total lawn and garden industry is estimated to be approximately \$51 billion in retail sales. We estimate the applicable portion of the lawn and garden supplies market to our business is approximately \$15 billion. The total pet industry is estimated to be approximately \$37 billion in retail sales. We estimate the applicable portion of the pet supplies market to our business is approximately \$8.5 billion.

Our lawn and garden supplies products include: proprietary and non-proprietary grass seed; wild bird feed, feeders, bird houses and other birding accessories; weed, grass and other herbicide, insecticide and pesticide products; and decorative outdoor lifestyle and lighting products, including pottery, trellises and other wood products and holiday lighting. These products are sold under a number of brand names including Pennington, Rebels, Cedar Works, AMDRO, Grants, Lilly Miller, Sevin, Over n Out, Norcal Pottery, New England Pottery, GKI/Bethlehem Lighting and Matthews Four Seasons.

Our pet supplies products include: products for dogs and cats, including bones, premium healthy edible and non-edible chews, premium dog and cat food, leashes, collars, toys, pet carriers, grooming supplies and other accessories; products for birds, small animals and specialty pets, including food, cages and habitats, toys, chews and related accessories; animal and household health and insect control products; products for fish, reptiles and other aquarium-based pets, including aquariums, furniture and lighting fixtures, pumps and filters and water conditioners and supplements, and information and knowledge resources; and products for horses and livestock. These products are sold under a number of brand names including All-Glass Aquarium, Oceanic, Energy Savers Unlimited, Kent Marine, Interpet, TFH, Nylabone, Four Paws, Pet Select, Kaytee, Super Pet, Zodiac, Pre Strike, Altosid, Breeder's Choice and Farnam.

In fiscal 2005, our consolidated net sales were \$1.4 billion, of which our lawn and garden segment, or Garden Products, accounted for approximately \$740 million and our pet segment, or Pet Products, accounted for approximately \$640 million. In fiscal 2005, our income from operations was \$100.1 million of which Garden Products accounted for \$47.1 million and Pet Products accounted for \$83.7 million, before corporate expenses and eliminations of \$30.7 million.

Central was incorporated in Delaware in June 1992 and is the successor to a California corporation which was incorporated in 1955. References to we, us, our, or Central mean Central Garden & Pet Company and its subsidiaries and divisions, and their predecessor companies and subsidiaries.

**Background**

We have transitioned our company to a leading marketer and producer of branded products from a traditional pet and lawn and garden supplies distributor. We made this transition because we recognized the opportunity to build a portfolio of leading brands and improve profitability by capitalizing on our knowledge of the pet and lawn and garden supplies sectors, our strong relationships with retailers, and our nationwide sales and logistics network. Our goal was to diversify our business and improve operating margins by establishing a portfolio of leading brands. Since 1997, we have acquired numerous branded product companies and product lines, including Wellmark and Four Paws in fiscal 1997; Kaytee Products, TFH and Pennington Seed in fiscal 1998; Norcal Pottery in fiscal 1999; AMDRO and All-Glass Aquarium in fiscal 2000; Lilly Miller in fiscal 2001; Alaska Fish Fertilizer in fiscal 2002; Kent Marine, New England Pottery, Interpet, certain assets of KRB Seed Company, (dba Budd Seed), and Energy Savers Unlimited in fiscal 2004; Pets International and Gulfstream Home & Garden in fiscal 2005; and Farnam Companies, Inc., Breeder's Choice Pet Food Inc. and the Ironite brand in fiscal 2006.

While expanding our branded products business, we experienced adverse events in our distribution business. From 1995 to 1999, we were the master distributor of Round Up and Ortho. In January 1999, The Scotts Company, one of our largest distribution suppliers at the time, acquired Ortho and became the marketing agent for Round Up. In July 2000, Scotts terminated its relationship with us. Subsequently, we downsized our distribution operations and integrated these sales and logistics networks into our pet and lawn and garden products businesses to allow us to focus resources and provide strategic sales support for our brands. Virtually all of our sales before fiscal 1997 were derived from distributing other manufacturers' products. Since then, our branded product sales have grown to approximately \$1.1 billion, or approximately 78% of total sales, in fiscal 2005. During this same period, our sales of other manufacturers' products have declined to approximately 22% of total sales, and our gross profit margins have improved from 13.6% in fiscal 1996 to 32.1% in fiscal 2005.

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### **Recent Developments**

On March 24, 2006, the trial court entered a final judgment in the TFH litigation (see Note 9 Contingencies ) awarding Central \$26.6 million. On May 23, 2006, the parties agreed to a settlement of all outstanding claims pursuant to which the Axelrods paid \$26 million to Central. Central recorded a gain as a reduction of selling, general and administrative expenses, where the related legal amounts previously expensed were reported, in the amount of \$9.9 million after applying approximately \$16.1 million to the note balance and other related amounts previously accrued, and recognized interest income of \$1.0 million.

In April 2006, we acquired the rights to the Ironite® Products brand of natural soil supplements and intellectual property for approximately \$6 million in cash. Ironite, a registered trademark since 1956, is a leading producer of environmentally-friendly soil supplements that promote healthy plant color and deeper root structures.

In July 2006, the Company repurchased approximately 240,000 shares of its common stock for an aggregate price of approximately \$10 million.

### **New Accounting Pronouncements**

#### ***Accounting for Stock-Based Compensation***

Through 2005, we accounted for our stock plans using the intrinsic value method. Effective the beginning of fiscal 2006, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share-Based Payment, and elected the modified prospective application method upon adoption. SFAS No. 123(R) requires us to use a fair-value based method in determining stock-based compensation. Accordingly, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and expensed over the employees' requisite service period. Total compensation cost for our share based compensation plans in the first nine months of 2006 was \$3.9 million.

### **Critical Accounting Policies, Estimates and Judgments**

There have been no material changes to our critical accounting policies, estimates and assumptions or the judgments affecting the application of those accounting policies since our Annual Report on Form 10-K for the fiscal year ended September 24, 2005.

**Stock-based compensation:** In fiscal 2006, we adopted SFAS No. 123(R) using the modified prospective transition method and began accounting for our stock-based compensation using a fair-valued based recognition method. Under the provisions of SFAS No. 123(R), stock-based compensation cost is estimated at the grant date based on the fair-value of the award and is expensed ratably over the requisite service period of the award. Determining the appropriate fair-value model and calculating the fair value of stock-based awards at the grant date requires considerable judgment, including estimating stock price volatility, expected option life and forfeiture rates. We develop our estimates based on historical data and market information which can change significantly over time.

We use the Black-Scholes option valuation model to value employee stock awards. We estimate stock price volatility based on an average historical volatility of our stock. Estimated option life and forfeiture rate assumptions are also derived from historical data. We recognize compensation expense using the straight-line amortization method for stock based compensation awards with graded vesting. Had we used alternative valuation methodologies, the amount we expense for stock based payments could be significantly different.

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**Results of Operations**

**Three Months Ended June 24, 2006**

**Compared with Three Months Ended June 25, 2005**

Net sales for the three months ended June 24, 2006 increased \$93.5 million, or 22.6%, to \$506.7 million from \$413.2 million for the three months ended June 25, 2005. Pet Products' net sales increased \$64.4 million, or 39.4%, to \$227.8 million for the three months ended June 24, 2006 from \$163.4 million in the comparable fiscal 2005 period. Garden Products' net sales increased \$29.1 million, or 11.7%, to \$278.9 million for the three months ended June 24, 2006 from \$249.8 million in the comparable fiscal 2005 period. Our branded product sales increased \$96.5 million, while sales of other manufacturers' products decreased \$3.0 million. Our Pet Products' branded product sales increased \$64.0 million due to recent acquisitions, including Farnam. Our Garden Products' branded product sales increased \$32.5 million due primarily to recent acquisitions and increased pottery sales.

Gross profit for the three months ended June 24, 2006 increased \$41.5 million, or 31.8%, to \$171.7 million from \$130.2 million for the three months ended June 25, 2005. The gross profit increase was in both Pet Products and Garden Products. Gross profit as a percentage of net sales increased from 31.5% for the three months ended June 25, 2005 to 33.9% for the three months ended June 24, 2006 due to increased branded product sales in both Pet Products and Garden Products.

Selling, general and administrative expenses increased \$19.8 million for the three months ended June 24, 2006 to \$111.8 million. Included in selling, general and administrative expenses for the three months ended June 24, 2006 is a gain of \$9.9 million from the Axelrod Settlement (see Note 9 Contingencies). Absent this benefit, selling, general and administrative expenses increased \$29.7 million, or 32.3%, from \$92.0 million for the three months ended June 25, 2005 to \$121.7 million for the three months ended June 24, 2006. The increase was due primarily to increased selling and delivery expenses. Note that as adjusted as a percentage of net sales, selling, general and administrative expenses increased to 24.0% for the three months ended June 24, 2006, compared to 22.3% in the comparable prior year period.

Selling and delivery expense increased \$19.0 million, or 37.1%, from \$51.2 million for the three months ended June 25, 2005 to \$70.2 million for the three months ended June 24, 2006. The increase was due primarily to the quarter's increased sales and recent acquisitions that generally have higher gross margins and higher selling costs.

Facilities expense increased slightly to \$2.9 million for the three months ended June 24, 2006 from \$2.8 million for the three months ended June 25, 2005.

Warehouse and administrative expense increased \$0.7 million. Absent the \$9.9 million gain from the Axelrod Settlement, warehouse and administrative expense increased \$10.6 million, or 27.9%, from \$38.0 million for the three months ended June 25, 2005 to \$48.6 million for the three months ended June 24, 2006. The increase was primarily in the Pet Products group related to recent acquisitions and restructuring charges. Corporate expenses increased \$0.3 million, reflecting \$1.4 million for stock based compensation as a result of adopting SFAS 123(R) partially offset by reduced expenditures for professional fees related to legal and litigation.

Net interest expense for the three months ended June 24, 2006 increased \$4.6 million, or 77.1%, to \$10.6 million from \$6.0 million for the three months ended June 25, 2005. The increase was due primarily to the higher average debt balance resulting from acquisitions financed through our \$650 million in senior secured credit facilities in the current fiscal year and slightly higher interest rates on our floating rate debt partially offset by increased interest income of \$1.0 million recognized as a result of the Axelrod settlement.

Other income decreased \$1.5 million from \$2.9 million reported for the quarter ended June 25, 2005 to \$1.4 million for the quarter ended June 24, 2006. The decrease was due primarily to the acquisition of an additional 60% equity interest in Tech Pac, previously accounted for as an equity method investment, the results of which are now included in our consolidated financial statements.

Our effective income tax rate for the quarter ended June 24, 2006 was 38.3% compared with 36.9% for the quarter ended June 25, 2005. The effective tax rate was lower in the prior year quarter due to a one-time net tax benefit resulting from the favorable resolution of various tax issues plus the additional recognition of tax credits.

**Table of Contents****Nine Months Ended June 24, 2006****Compared with Nine Months Ended June 25, 2005**

Net sales for the nine months ended June 24, 2006 increased \$143.2 million, or 13.5%, to \$1,200.8 million from \$1,057.6 million for the nine months ended June 25, 2005. Pet Products' net sales increased \$103.6 million, or 21.7%, to \$582.2 million for the nine months ended June 24, 2006 from \$478.6 million in the comparable fiscal 2005 period. Garden Products' net sales increased \$39.6 million, or 6.8%, to \$618.6 million for the nine months ended June 24, 2006 from \$579.0 million in the comparable fiscal 2005 period. Our branded product sales increased \$148.8 million, while sales of other manufacturers' products decreased \$5.6 million. Our Pet Products' branded product sales increased \$102.1 million due primarily to recent acquisitions. Our Garden Products' branded product sales increased \$46.7 million with approximately \$32 million in sales from recent acquisitions and also increased grass seed sales.

Gross profit for the nine months ended June 24, 2006 increased \$57.3 million, or 16.7%, to \$400.5 million from \$343.2 million for the nine months ended June 25, 2005. Pet Products' gross profit increased \$41.5 million, and Garden Products' gross profit increased \$15.8 million. Gross profit as a percentage of net sales increased to 33.4% for the nine months ended June 24, 2006 from 32.4% for the nine months ended June 25, 2005. The increased margin was due primarily to increased branded product sales, which generally have higher gross margins. More than 80% of the increased branded product sales were from acquisitions made in the last four fiscal quarters.

Selling, general and administrative expense increased \$29.3 million to \$285.1 million for the nine months ended June 24, 2006. Included in selling, general and administrative expenses for the nine months ended June 24, 2006, is a gain of \$9.9 million from the Axelrod Settlement (see Note 9 Contingencies). Absent this benefit, selling, general and administrative expenses increased \$39.2 million, or 15.3%, from \$255.8 million for the nine months ended June 25, 2005 to \$295.0 million for the nine months ended June 24, 2006. The increase was due primarily to increased selling expenses. As a percentage of net sales, selling, general and administrative expenses increased to 24.6% for the nine months ended June 24, 2006, compared to 24.2% in the comparable prior year period.

Selling and delivery expense increased \$26.9 million, or 20.2%, from \$133.0 million for the nine months ended June 25, 2005 to \$159.9 million for the nine months ended June 24, 2006. The increase was due primarily to increased sales in fiscal 2006, recent acquisitions that generally have higher gross margins and higher selling costs, and to increased expenditures on marketing programs.

Facilities expense increased \$0.9 million to \$9.6 million for the nine months ended June 24, 2006 from \$8.7 million for the nine months ended June 25, 2005. The increase was due primarily to facility relocation costs incurred in the first fiscal quarter of 2006 as part of our previously announced restructuring effort within Garden Products.

Warehouse and administrative expense increased \$1.5 million. Absent the \$9.9 million gain from the Axelrod Settlement, warehouse and administrative expense increased \$11.4 million, or 10.0%, from \$114.1 million for the nine months ended June 25, 2005 to \$125.5 million for the nine months ended June 24, 2006. The increase was due primarily to \$3 million for stock option compensation as a result of adopting SFAS 123(R), \$8 million related to recent acquisitions (primarily in the Pet Products group) and \$7 million for restructuring charges partially offset by approximately \$6 million of reduced professional fees, related primarily to legal and litigation expenses and Sarbanes-Oxley compliance costs.

Net interest expense for the nine months ended June 24, 2006 increased \$9.2 million, or 55.1%, to \$25.9 million from \$16.7 million for the nine months ended June 25, 2005. Of this increase, \$1.6 million represented a write-off of deferred financing fees and expenses associated with the early retirement of our \$125 million revolving credit facility and \$175 million term loan. The remainder of the increase was due primarily to the higher average debt balance resulting from acquisitions financed through our \$650 million senior secured credit facilities in the current year and slightly higher interest rates on our floating rate debt, partially offset by increased interest income of \$2.6 million.

Other income decreased \$1.4 million from \$4.6 million for the nine months ended June 25, 2005 to \$3.2 million for the nine months ended June 24, 2006. The decrease was due primarily to the acquisition of two companies previously accounted for as an equity method investment, the earnings of which are now included in our operating income in our consolidated financial statements.

Our effective income tax rate for the nine months ended June 24, 2006 was 35.2% compared with 37.5% for the nine months ended June 25, 2005. The lower rate reflects the reversal of tax contingency reserves (non cash) in the second quarter of fiscal 2006 of approximately \$2.6 million provided in prior periods. The reserves related to certain income tax credits taken on prior tax returns.

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### **Liquidity and Capital Resources**

We have financed our growth through a combination of bank borrowings, supplier credit, internally generated funds and sales of equity and debt securities to the public.

Historically, our business has been seasonal and our working capital requirements and capital resources tracked closely to this seasonal pattern. During the first fiscal quarter, accounts receivable reach their lowest level while inventory, accounts payable and short-term borrowings begin to increase. During the second fiscal quarter, receivables, accounts payable and short-term borrowings begin to increase, reflecting the build-up of inventory and related payables in anticipation of the peak lawn and garden selling season. During the third fiscal quarter, inventory levels remain relatively constant while accounts receivable peak and short-term borrowings start to decline as cash collections are received during the peak selling season. During the fourth fiscal quarter, inventory levels are at their lowest, and accounts receivable and payables are substantially reduced through conversion of receivables to cash. As a result of the reduction in sales of garden products manufactured by other parties as a percentage of overall sales, this seasonal pattern has become somewhat less significant.

We service two broad markets: pet supplies and lawn and garden supplies. Our pet supplies businesses generally sell products that have a year round selling cycle with very little change quarter to quarter. As a result, it is not necessary to maintain large quantities of inventory to meet peak demands. Additionally, this level sales cycle eliminates the need for manufacturers to give extended credit terms to either distributors or retailers. On the other hand, our lawn and garden businesses are highly seasonal with approximately 63% of Garden Products net sales occurring during the second and third fiscal quarters. For many manufacturers of garden products, this seasonality requires them to ship large quantities of their product well ahead of the peak consumer buying periods. To encourage distributors to stock large quantities of inventory, industry practice has been for manufacturers to give extended credit terms and/or promotional discounts.

The primary cash flows for the nine months ended June 24, 2006 were \$384.8 million in cash used in investing activities (primarily for the acquisition of businesses, (see Note 7 Acquisitions ) partially offset by \$1.9 million of cash provided by operating activities and \$362.2 million provided by financing activities. Cash flow from operating activities included \$9.9 million of the \$26 million received in the Axelrod settlement, with the remaining \$16.1 million included in investing activities (See Note 9 Contingencies ). Net cash provided by financing activities increased due to the issuance of \$650 million in senior secured facilities and the issuance of 1,975,000 shares of our common stock, the proceeds of which were used to refinance our existing credit facilities and to finance the acquisition of Farnam Companies, Inc.

At June 24, 2006, our total debt outstanding was \$594.1 million compared to \$345.4 million at June 25, 2005, due to the establishment of larger credit facilities to replace our existing credit facilities during our second fiscal 2006 quarter, the proceeds of which were used to acquire the stock of Farnam Companies, Inc. and finance seasonal working capital needs.

Concurrent with the acquisition of Farnam Companies, Inc., we arranged \$650 million in senior secured credit facilities to finance the acquisition and to replace our existing \$125 million revolving credit facility maturing in May 2008 and our existing \$175 million term loan maturing in May 2009. The new credit facilities consist of a \$350 million revolving credit facility maturing in February 2011 and a \$300 million term loan maturing in September 2012. Interest on the revolving credit facility is based on a rate equal to prime plus a margin, which fluctuates from 0% to 0.25% or LIBOR plus a margin which fluctuates from 0.75% to 1.375%, determined quarterly based on consolidated total debt to consolidated EBITDA for the most recent trailing 12-month period. Interest on the term loan is based on a rate equal to LIBOR + 1.50% or the prime rate plus 0.50%, at our option. The term loan is payable in quarterly installments of \$750,000 with the balance payable in September 2012. This facility is secured by substantially all of our assets, contains certain financial covenants which require us to maintain minimum levels of interest coverage and maximum levels of total debt to EBITDA, and which restrict our ability to repurchase our stock, make investments in or acquisitions of other businesses and pay dividends above certain levels over the life of the facility. We were in compliance with all financial covenants as of June 24, 2006. The balance outstanding at June 24, 2006 under the revolving credit facility was \$144.0 million, and the remaining available borrowing capacity was \$196.0 million, with \$10.0 million outstanding under certain letters of credit.

In March 2006, we deposited approximately \$16 million into an escrow account in connection with our purchase of an additional 60% equity interest in Tech Pac L.L.C. for possible contingent performance based payments over the next five years.

In July 2006, we repurchased approximately 240,000 shares of our common stock for an aggregate price of approximately \$10 million. We intend to continue our repurchases from time to time through 2006 depending on market conditions.

We believe that cash flows from operating activities, funds available under our credit facility, and arrangements with suppliers will be adequate to fund our presently anticipated working capital requirements for the foreseeable future. We anticipate that our capital expenditures will not exceed \$50 million for the next 12 months. The increased level of expected capital expenditures, compared to our historical rate, is due primarily to our implementation of a scalable enterprise-wide information technology platform to support future growth and to enable us to take advantage

of new applications and technologies. We have selected SAP as our software provider and

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anticipate investing approximately \$30 million over the next four years to implement our new information technology strategy. This initiative, when complete, will combine our numerous information systems into one enterprise system to provide a common ERP platform that will support many of our strategic initiatives and enhance our operating efficiency.

As part of our growth strategy, we have engaged in acquisition discussions with a number of companies in the past, and we anticipate that we will continue to evaluate potential acquisition candidates. If one or more material acquisition opportunities become available in the near future, we may require additional external capital. In addition, such acquisitions would subject us to the general risks associated with acquiring companies, particularly if the acquisitions are relatively large.

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

There have been no material changes to the information provided in our Annual Report on Form 10-K for the fiscal year ended September 24, 2005 regarding off-balance sheet arrangements.

### **Contractual Obligations**

There have been no material changes outside the ordinary course of business, except for an increase on long-term debt issued in connection with the Farnam acquisition, in our contractual obligations set forth in the Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources in our Annual Report on Form 10-K for the fiscal year ended September 24, 2005.

### **Weather and Seasonality**

Historically, our sales of lawn and garden products have been influenced by weather and climate conditions in the markets we serve. Additionally, Garden Products' business has been highly seasonal. In fiscal 2005, approximately 63% of Garden Products' net sales and 57% of our total net sales occurred in the Company's second and third fiscal quarters. Substantially all of Garden Products' operating income is typically generated in this period, which has historically offset the operating loss incurred during the first fiscal quarter of the year.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We believe there has been no material change in our exposure to market risk from that discussed in our fiscal 2005 Annual Report filed on Form 10-K.

### **Item 4. Controls and Procedures**

(a) Our Chief Executive Officer and Chief Financial Officer have reviewed, as of the end of the period covered by this report, the disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) that ensure that information relating to the Company required to be disclosed by us in the reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported in a timely and proper manner and that such information 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. Based upon this review, we believe that the controls and procedures in place are effective to ensure that information relating to the Company that is required to be disclosed by us in the reports that we file or submit under the Exchange Act is properly disclosed as required by the Exchange Act and related regulations.

(b) *Changes in internal controls.* There were no changes in our internal controls during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

On February 28, 2006, we purchased Farnam Companies, Inc. for approximately \$291 million. We continue to integrate Farnam's historical internal controls over financial reporting with our own internal controls over financial reporting. This integration may lead to our making changes in our or Farnam's historical internal controls over financial reporting in future periods.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

For information on our material legal proceedings, you should read Note 9 Contingencies to the unaudited condensed consolidated financial statements in Part I Item 1 of this report.

**Item 1A. Risk Factors**

There have been no material changes from the risk factors previously disclosed in our Form 10-K in response to Item 1A. to Part I of Form 10-K except as follows:

*Our acquisition strategy involves a number of risks.*

We have completed numerous acquisitions since 1997 and intend to grow through the acquisition of additional companies. We completed six acquisitions in fiscal 2004 and three in fiscal 2005. In addition, in February 2006 we completed the acquisition of Farnam Companies, Inc. for approximately \$291 million. Farnam constituted a very significant acquisition for us.

We are regularly engaged in acquisition discussions with a number of companies and anticipate that one or more potential acquisition opportunities, including those that would be material, may become available in the near future. If and when appropriate acquisition opportunities become available, we intend to pursue them actively. Acquisitions involve a number of special risks, including:

failure of the acquired business to achieve expected results;

diversion of management's attention;

failure to retain key personnel of the acquired business;

additional financing, if necessary and available, could increase leverage, dilute equity, or both;

the potential negative effect on our financial statements from the increase in goodwill and other intangibles; and

the high cost and expenses of completing acquisitions and risks associated with unanticipated events or liabilities.

These risks could have a material adverse effect on our business, results of operations and financial condition.

We have faced, and expect to continue to face, increased competition for acquisition candidates, which may limit the number of opportunities and may lead to higher acquisition prices. We cannot assure you that we will be able to identify, acquire, or manage profitably additional businesses or to integrate successfully any acquired businesses into our existing business without substantial costs, delays or other operational or financial difficulties. In future acquisitions, we also could incur additional indebtedness or pay consideration in excess of fair value, which could have a material adverse effect on our business, results of operations and financial condition.



**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Except as set forth in the table below, we did not repurchase any of our equity securities during the quarter ended June 24, 2006.

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Units) \$	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
March 26, 2006 - April 29, 2006				
April 30, 2006 - May 27, 2006				
May 28, 2006 - June 24, 2006				\$ 100,000,000
Total				\$ 100,000,000

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**Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350.

32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350.

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**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunder duly authorized.

CENTRAL GARDEN & PET COMPANY  
Registrant

Dated: August 3, 2006,

/s/ GLENN W. NOVOTNY  
Glenn W. Novotny

President and Chief Executive Officer

/s/ STUART W. BOOTH  
Stuart W. Booth

Executive Vice President and Chief Financial Officer