

## drugstore.com, inc.

411 108th Avenue NE, Suite 1400  
Bellevue, Washington 98004

**RECOMMENDED GUIDELINE:**

**\$100,000**

**PAYMENT QUALITY INDEX:**

**89%**

**REPORT DATE:**

**01/17/2008**

**SHORT-TERM RISK:**

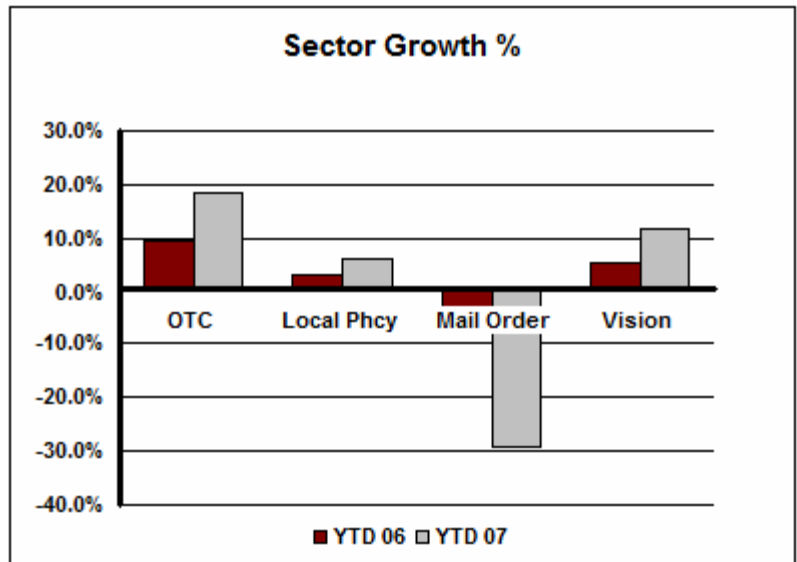
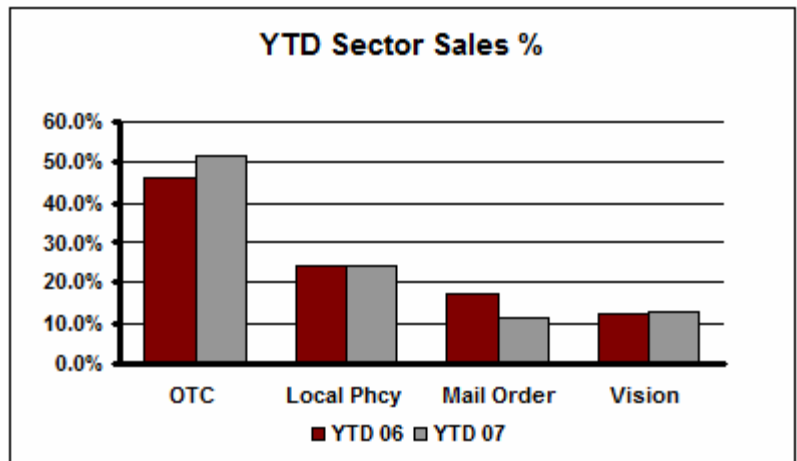
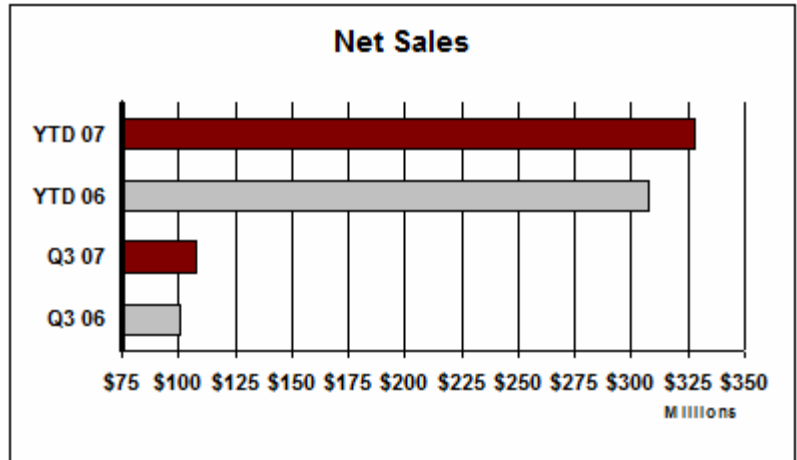
**Moderate**

**LONG-TERM RISK:**

**High**

## SALES & GROWTH ANALYSIS:

**Net Sales** in Q3 07, ended September 30, 2007, **increased 6.2% to \$107.3 million. YTD 07 net sales totaled \$327.5 million, a 6.6% improvement over the prior year period.** Drugstore.com reports sales in four business segments: over the counter (OTC), mail order pharmacy, local pharmacy pick-up (through an arrangement with Rite-Aid) and vision care. Growth in net sales stemmed primarily from a 16% and 17% increase in the number of OTC orders on a quarterly and annual basis, respectively. In addition to volume growth, the average OTC sale grew to \$57 in Q3 and YTD 07, versus \$55 and \$56 in the comparable prior year periods, respectively. However, since the average value of an OTC transaction is lower than that of the other segments, and growth in this segment was more pronounced than in the other business segments, the average overall sales transaction was down in the current period. **The average sale during the quarter and year-to-date period totaled \$77, down \$2 or 2.6% on average, as compared to the comparable periods of the prior year. Drugstore.com also continues to experience a deterioration in the mail order pharmacy segment's business as a result of the decision not to participate in Medicare Part-D. The company provides services to Pharmacy Benefit Management (PBM) companies via its mail order pharmacy segment, and the segment's sales have also declined as a result of the severance of several of these relationships.** Vision sales were boosted in the current period by improved technology which translated to higher sales of higher priced contact lenses. Growth in local pick-up pharmacy sales was attributed to 3% growth in traffic, and a slightly higher value of each transaction. Drugstore.com's web-based business is unique as compared to other drug retailers, but like traditional retailers, drugstore.com is dependent upon existing customer loyalty, growing sales within the existing customer base and acquiring new customers. However, drugstore.com is not able to expand its customer base by opening stores in existing markets and entering new markets; therefore, customer retention becomes of the utmost importance. **In Q3 07 and YTD 07, 82% of sales were to repeat customers. This compares to 84% in the prior year quarter and 83% in the prior year-to-date period.**



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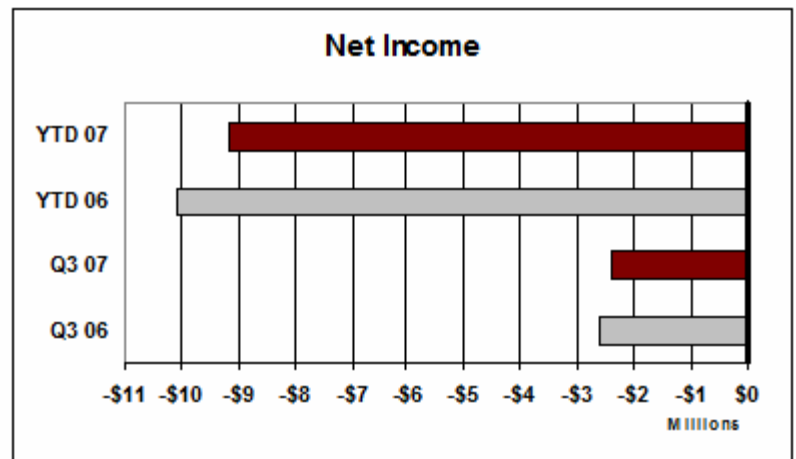
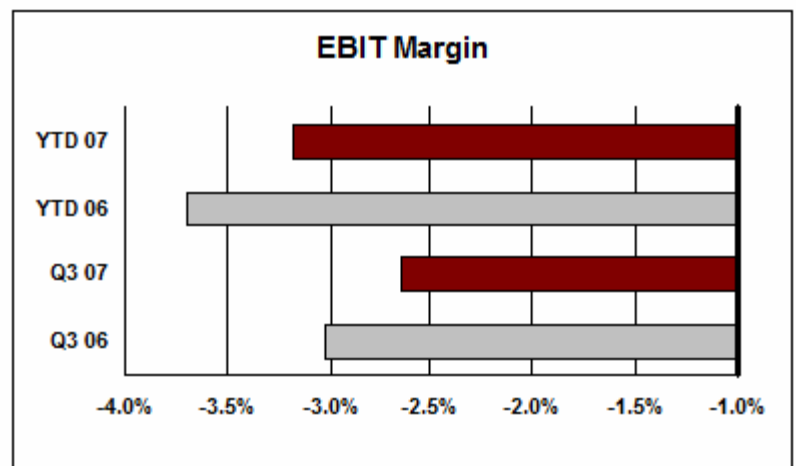
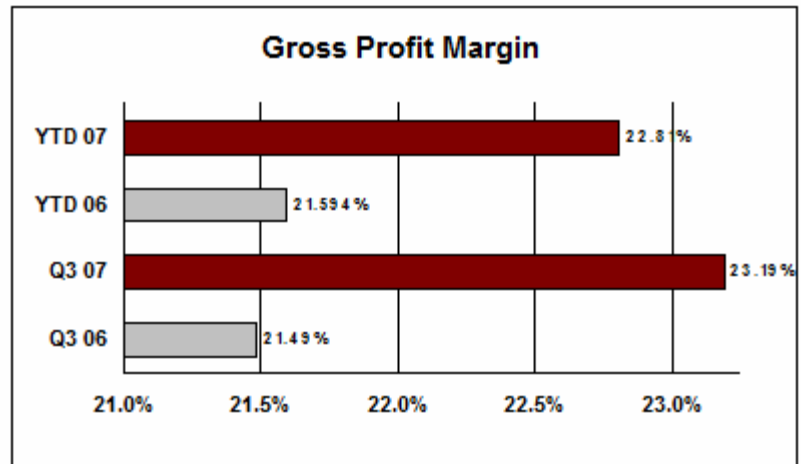
## MARGIN ANALYSIS:

**Gross Margin** improved to 23.2% of sales in Q3 07, up from 21.5% of sales in Q3 06. YTD 07 gross margin was 22.8% of sales, as opposed to 21.6% in the prior year-to-date period. The improvement in gross margin is indicative of the shift in sales toward the OTC segment, which carries the highest gross margin of all drugstore.com operating segments. **Although the OTC segment shift was primarily responsible for the growth in gross margin, management reports that the company enjoyed an improvement across all business segments.**

Even with the improvement in gross margin, **EBIT Margin** continues to be negative. Drugstore.com continues to experience other cost increases which are deteriorating operating profits, or EBIT. Shipping costs continue to outpace revenues paid by customers to cover these costs. The company continues to offer promotional free shipping programs designed to grow sales via sustaining their existing customers and procuring new customers. As the business shifts toward the OTC segment, shipping costs are growing, since the average cost to ship an OTC order is higher than in the other segments. Drugstore.com's costs associated with filling and processing orders, including pharmacy, were down slightly at 9.8% of sales on a quarterly and year-to-date basis, as compared to 9.9% for both prior year respective periods. The company's expenses related to technology increased to 4.2% in YTD 07, up from 3.9% in the prior year period, while other general and administrative expenses increased to 4.5%, as opposed to 3.9% in the prior period. Overall, **operating expenses increased to 25.8% in Q3 07, up 0.3% over the prior year quarter. On a year-to-date basis, operating expenses represented 26% of sales in the current period, versus 25.3% a year ago. The increase in expenses more than offset the benefit in higher gross margin and produced a negative trend in EBIT.** While the EBIT margin trended negatively in the current period, the operating loss in actual dollars declined in the third quarter to \$2.8 million, down from \$3 million in the prior year. YTD 07 operating loss was \$10.4 million, down from \$11.4 million in the comparable period of last year.

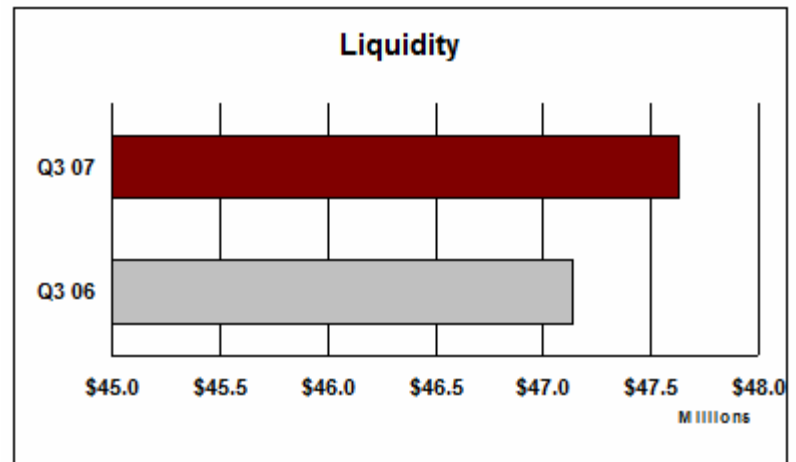
## PROFITABILITY:

The only variation in **Net Income** and operating income (EBIT) are earnings on the company's cash, equivalents and marketable securities. This interest income, which is expressed net of interest expense was relatively flat period over period at \$459,000 in Q3 07, versus \$449,000 in Q3 06. YTD 07 interest earnings totaled \$1.265 million, as compared to \$1.292 million in YTD 06. The company had no provision for or benefit from income taxes as a result of continued losses.

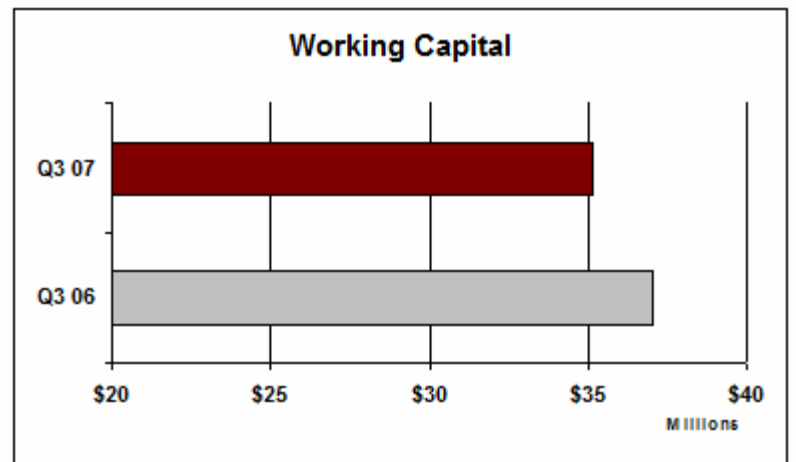


## LIQUIDITY & SOLVENCY:

**Liquidity** is defined as cash plus bank availability. In April 2007 drugstore.com amended its bank line of credit, increasing availability from \$7.5 million to \$10 million. At the end of Q3 07, the company had \$300,000 in outstanding borrowings, net of \$1 million in debt that was converted to a term loan in April, according to a provision allowing up to \$2.5 million to be converted. **In addition to increased bank availability, period over period, drugstore.com maintains a substantial balance, \$37.9 million, in cash in marketable securities.** As stated previously, historically drugstore.com has relied heavily on the sale of securities to fund their business needs. As of the end of Q3 07, the company had generated proceeds of \$419.7 million via the sale of these securities.

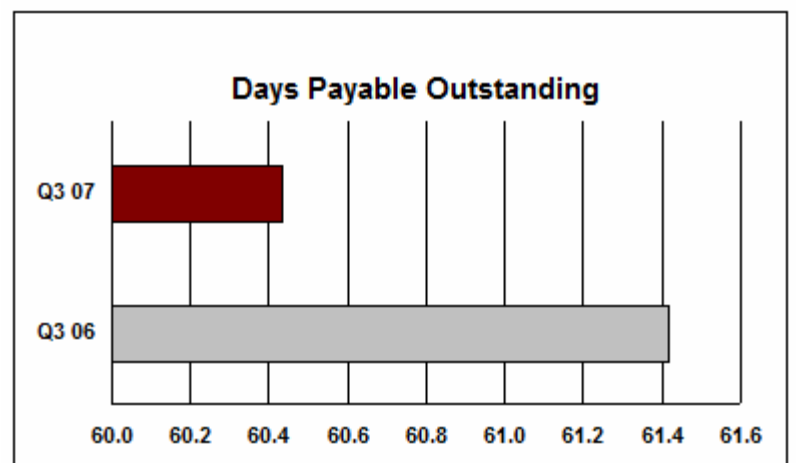


**Working Capital** trended down slightly in the current quarter as compared to the same period of the prior year. Total current assets declined \$834,000, while current liabilities inched up \$1.1 million. The increase in current assets occurred primarily as a result of a \$2.7 million reduction in cash and marketable securities and a nominal decrease in receivables, partially offset by a \$0.5 million increase in inventory and a \$1.5 million increase in other assets. **Liquid assets remain substantial with approximately \$38 million in current assets invested in cash and marketable securities.** The increase in current liabilities stems from a \$1.4 million increase in accounts payable, partially offset by an approximately \$200,000 reduction in debt due in the short-term, and a reduction in other liabilities of roughly the same amount.



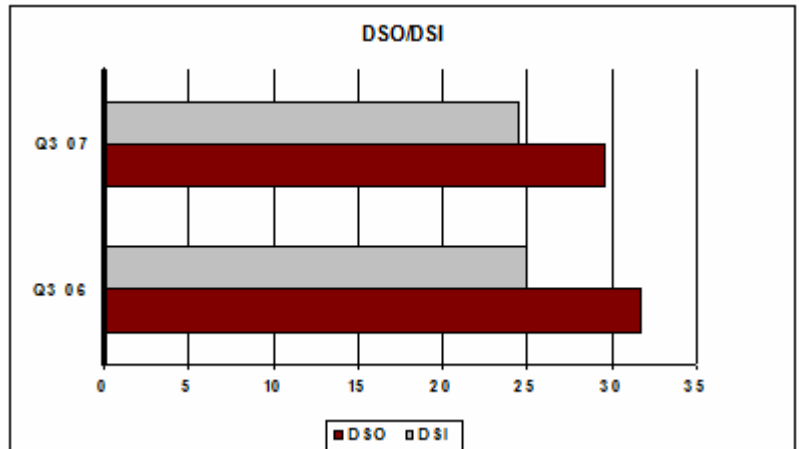
## EFFICIENCY:

**Days Payable Outstanding** improved by approximately one full day in Q3 07 as compared to the same period of the prior year. While the actual outstanding accounts payable balance increased \$1.4 million period over period, days payable outstanding decreased since outstanding payables relative to inventory sold through was lower in the current quarter. **There is no indication of a slow down in vendor payments.**



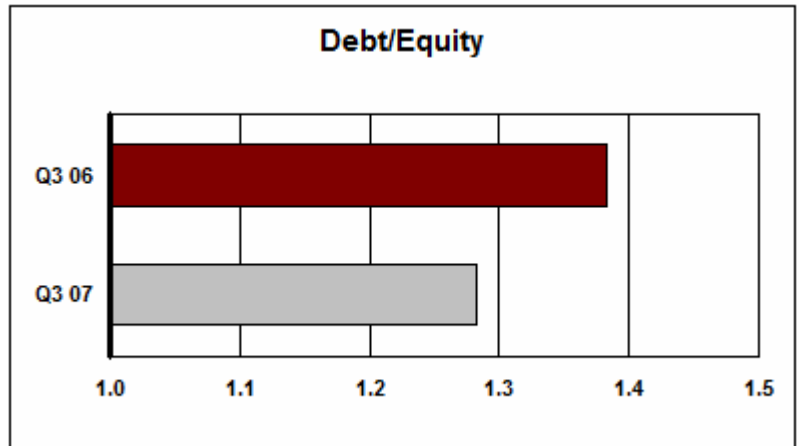
## EFFICIENCY (continued):

At the end of Q3 07, drugstore.com had approximately 24.6 **Days Sales in Inventory (DSI)** on hand, **an improvement over just over 25 days in inventory on hand at the end of Q3 06**. The steady level of inventory indicates that although the company's business is changing relative to a shift between business sectors, obsolete inventory does not appear to be an issue. Likewise, **Days Sales Outstanding (DSO)** has **improved by approximately two days, another indication of a slight improvement in efficiency of operations**.



## LEVERAGE:

The **Debt to Equity** position has improved in the current quarter as compared to the third period of the prior year. The improvement resulted from a slight improvement in equity relative to a smaller increase in total liabilities. Total debt was approximately \$66.5 million at the end of the current quarter, up from \$65.4 million a year ago. Shareholder equity at the close of the current third quarter was approximately \$94 million, an improvement as compared to equity of \$92.6 million in the comparable period of the prior year.



## OUTLOOK:

Drugstore.com remains a struggling online business, which has not turned a profit since its inception in 1999. While the company is growing the number of sales, and has made progress in shifting its merchandise mix to boost profitability in the OTC segment, challenges that lie ahead include the ability to reverse the decline in average sales and the downward spiral in its mail-order business. While there is uncertainty regarding the company's ability to continue to fund its business needs via the sale of securities, we believe that the company's liquid assets on hand, coupled with additional availability on the bank line, are ample in the short-term. However, credit risk will continue to mount period after period unless the company can make great strides in improving profitability at an operating level.