

DRUGSTORE COM INC

FORM 10-Q (Quarterly Report)

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Industry	Retail (Drugs)
Sector	Services
Fiscal Year	12/31

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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 **July 1, 2007**

or

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

For the transition period from _____ to _____

Commission File Number **000-26137**

drugstore.com, inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

04-3416255
(IRS Employer
Identification No.)

411 108th Avenue NE, Suite 1400, Bellevue, Washington 98004
(Address of principal executive offices including zip code)

(425) 372-3200
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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.

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

As of August 1, 2007, the registrant had 95,659,376 shares of common stock outstanding.

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DRUGSTORE.COM, INC.

FORM 10-Q

For the three and six months ended July 1, 2007

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

DRUGSTORE.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share data)
(unaudited)

	Three Months Ended		Six Months Ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
Net sales	\$ 110,412	\$ 102,436	\$ 220,177	\$ 206,545
Costs and expenses:				
Cost of sales	85,317	79,945	170,379	161,834
Fulfillment and order processing	10,656	10,239	21,630	20,416
Marketing and sales	7,872	6,322	15,961	15,299
Technology and content	4,475	4,003	9,190	7,945
General and administrative	5,157	4,025	9,866	8,319
Amortization of intangible assets	306	531	750	1,061
Total costs and expenses	113,783	105,065	227,776	214,874
Operating loss	(3,371)	(2,629)	(7,599)	(8,329)
Interest income, net	356	436	806	843
Net loss	\$ (3,015)	\$ (2,193)	\$ (6,793)	\$ (7,486)
Basic and diluted net loss per share	\$ (0.03)	\$ (0.02)	\$ (0.07)	\$ (0.08)
Weighted average shares outstanding used to compute basic and diluted net loss per share	95,006,512	93,136,203	94,753,321	93,052,927

See accompanying notes to consolidated financial statements.

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DRUGSTORE.COM, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	<u>July 1,</u> <u>2007</u>	<u>December 31,</u> <u>2006</u>
	<u>(Unaudited)</u>	<u>(Note 2)</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 11,057	\$ 13,393
Marketable securities	27,865	27,246
Accounts receivable, net of allowances	36,262	36,688
Inventories	25,429	26,469
Prepaid marketing expenses	2,290	2,290
Other current assets	2,840	2,615
Total current assets	<u>105,743</u>	<u>108,701</u>
Fixed assets, net	19,903	18,293
Other intangible assets, net	4,626	5,376
Goodwill	32,202	32,202
Prepaid marketing expenses and other	2,605	3,750
Total assets	<u>\$ 165,079</u>	<u>\$ 168,322</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 55,926	\$ 57,507
Accrued compensation	4,632	4,841
Accrued marketing expenses	3,160	3,661
Other current liabilities	1,213	1,292
Current portion of long-term debt obligations	3,040	3,949
Total current liabilities	<u>67,971</u>	<u>71,250</u>
Long-term debt obligations, less current portion	1,935	1,839
Deferred income taxes	945	945
Other long-term liabilities	1,466	1,610
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$.0001 par value, 10,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock, \$.0001 par value, stated at amounts paid in: 250,000,000 shares authorized, 95,327,445 and 94,335,027 shares issued and outstanding	849,926	843,026
Accumulated other comprehensive loss	(30)	(7)
Accumulated deficit	<u>(757,134)</u>	<u>(750,341)</u>
Total stockholders' equity	<u>92,762</u>	<u>92,678</u>
Total liabilities and stockholders' equity	<u>\$ 165,079</u>	<u>\$ 168,322</u>

See accompanying notes to consolidated financial statements.

DRUGSTORE.COM, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 1, 2007</u>	<u>July 2, 2006</u>	<u>July 1, 2007</u>	<u>July 2, 2006</u>
Operating Activities:				
Net loss	\$ (3,015)	\$ (2,193)	\$ (6,793)	\$ (7,486)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Depreciation	1,911	1,548	3,802	3,006
Amortization of marketing and sales agreements	573	573	1,145	1,145
Amortization of intangible assets	306	531	750	1,061
Stock-based compensation	2,536	1,553	4,967	3,256
Other	(6)	9	(6)	13
Changes in:				
Accounts receivable	748	(1,858)	426	(2,772)
Inventories	391	(469)	1,040	3,312
Prepaid marketing expenses and other current assets	343	175	(225)	364
Accounts payable, accrued expenses, and other liabilities	(690)	97	(2,514)	(4,789)
Net cash provided by (used in) operating activities	<u>3,097</u>	<u>(34)</u>	<u>2,592</u>	<u>(2,890)</u>
Investing Activities:				
Purchases of marketable securities	(11,955)	(2,033)	(19,101)	(12,906)
Sales and maturities of marketable securities	10,690	1,825	18,465	15,300
Purchases of fixed assets	(2,954)	(1,975)	(5,130)	(3,326)
Net cash used in investing activities	<u>(4,219)</u>	<u>(2,183)</u>	<u>(5,766)</u>	<u>(932)</u>
Financing Activities:				
Proceeds from exercise of stock options and employee stock purchase plan	1,270	366	1,933	617
Borrowings on line of credit	—	—	300	—
Principal payments on capital leases and term loan obligations	(718)	(589)	(1,395)	(1,174)
Net cash provided by (used in) financing activities	<u>552</u>	<u>(223)</u>	<u>838</u>	<u>(557)</u>
Net decrease in cash and cash equivalents	(570)	(2,440)	(2,336)	(4,379)
Cash and cash equivalents at beginning of period	11,627	18,352	13,393	20,291
Cash and cash equivalents at end of period	<u>\$ 11,057</u>	<u>\$ 15,912</u>	<u>\$ 11,057</u>	<u>\$ 15,912</u>
Supplemental Cash Flow Information:				
Equipment acquired in capital lease agreements	\$ 4	\$ —	\$ 282	\$ 238
Cash paid during the period for interest	<u>\$ 134</u>	<u>\$ 101</u>	<u>\$ 252</u>	<u>\$ 196</u>

See accompanying notes to consolidated financial statements.

DRUGSTORE.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Description of the Business

drugstore.com, inc. is a leading online provider of health, beauty, vision, and pharmacy products. We offer health, beauty, sexual well-being, household, and other non-prescription products and prescription medications through our website located at *www.drugstore.com*. We also offer prestige beauty products through our website located at *www.beauty.com* (which is also accessible through the drugstore.com website); contact lenses through our wholly owned subsidiary International Vision Direct Corp. and its subsidiaries, collectively referred to as Vision Direct, through websites located at *www.visiondirect.com*, *www.lensmart.com*, and *www.lensquest.com* (which are also accessible through the drugstore.com website); and customized nutritional supplement programs through our wholly owned subsidiary, Custom Nutrition Services, Inc. (CNS). Our products are also available toll-free by telephone at 1-800-DRUGSTORE and 1-800-VISIONDIRECT. Under the terms of an agreement with Rite Aid Corporation, or Rite Aid, customers are also able to order refill prescriptions for pickup at any Rite Aid store. We manage our business in four segments: over-the-counter (OTC), vision, mail-order pharmacy, and local pick-up pharmacy.

2. Basis of Presentation and Principles of Consolidation

We have prepared the accompanying consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial reporting. These consolidated financial statements are unaudited but, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals, necessary for a fair presentation of the consolidated balance sheets, statements of operations, and statements of cash flows for the periods presented. Operating results for the periods presented are not necessarily indicative of future results for the fiscal year ending December 30, 2007 or any other interim period, due to seasonal and other factors. We have derived the consolidated balance sheet as of December 31, 2006 from audited financial statements as of that date, but we have excluded certain information and footnotes required by GAAP for complete financial statements. You should read these consolidated financial statements in conjunction with the audited consolidated financial statements and accompanying notes included in our annual report on Form 10-K for the fiscal year ended December 31, 2006.

The accompanying consolidated financial statements include those of drugstore.com, inc. and our subsidiaries. We have eliminated all material intercompany transactions and balances.

We operate using a 52/53-week retail calendar year, with each of the fiscal quarters in a 52-week fiscal year representing a 13-week period. Fiscal years 2007 and 2006 are 52-week years.

3. Significant Accounting Policies

Estimates and Assumptions

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts of assets and liabilities, revenues and expenses, and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates include, but are not limited to, revenue recognition, inventories, goodwill and intangible assets, stock-based compensation, deferred taxes, and commitments and contingencies. Actual results could differ from our estimates, and these differences could be material.

Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Liabilities* (SFAS 159). SFAS 159 will become effective as of the beginning of the first fiscal year beginning after November 15, 2007. SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value that are not currently required to be measured at fair value. Accordingly, companies would then be required to report unrealized gains and losses on these items in earnings at each subsequent reporting date. The objective is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. We are currently in the process of evaluating the effects of the adoption of SFAS 159, but do not expect it to have a material impact on our consolidated financial statements.

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In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. SFAS 157 will become effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently evaluating the impact of adopting SFAS 157 on our consolidated financial statements, but do not expect it to have a material impact on our consolidated financial statements.

In June 2006, the FASB issued Financial Accounting Standards Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109 (SFAS 109)* (FIN 48), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 became effective beginning in the first quarter of 2007. We did not have any unrecognized tax benefits before or after the adoption of FIN 48. Our policy is to recognize interest and penalties related to the underpayment of income taxes as a component of income tax expense. To date, we have not incurred charges for interest or penalties in relation to the underpayment of income taxes. The tax years 1998 through the present remain open to examination by the major taxing jurisdictions to which we are subject.

4. Net Loss Per Share

We compute net loss per share using the weighted average number of shares of common stock outstanding. We exclude shares associated with stock options, warrants, and our employee stock purchase plan from the calculation of diluted net loss per share, as their effects are anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per share for the periods indicated:

	Three Months Ended		Six Months Ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
	(in thousands, except share and per share data)		(in thousands, except share and per share data)	
Numerator:				
Net loss	\$ (3,015)	\$ (2,193)	\$ (6,793)	\$ (7,486)
Denominator:				
Weighted average shares outstanding used in computation of basic and diluted net loss per share	<u>95,006,512</u>	<u>93,136,203</u>	<u>94,753,321</u>	<u>93,052,927</u>
Basic and diluted net loss per share	<u>\$ (0.03)</u>	<u>\$ (0.02)</u>	<u>\$ (0.07)</u>	<u>\$ (0.08)</u>

As of July 1, 2007 and July 2, 2006, there were 18,058,740 and 17,355,583 shares, respectively, of common stock subject to outstanding stock options and 815,000 and 615,000 shares, respectively, of common stock subject to warrants, all of which we excluded from the computation of diluted net loss per share, as their effect was anti-dilutive. If we had reported net income, the calculation of these per share amounts would have included the dilutive effect of these common stock equivalents using the treasury stock method.

5. Stockholders' Equity

Stock-Based Benefit Plans

1998 Stock Plan—Under the terms of our 1998 Stock Plan, as amended (1998 Stock Plan), our board of directors may grant incentive and nonqualified stock options to employees, officers, directors, agents, consultants, and independent contractors of

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drugstore.com. Options under this plan generally vest over four years, as follows: 20% of the shares vest after six months, and the remaining 80% vest quarterly over the subsequent 42 months. Option grants generally have exercise prices equal to the fair market value of the common stock on the date of grant and expire ten years from the date of grant. Our board of directors has delegated to the stock option subcommittee of the compensation committee of the board the authority to grant options within board-approved guidelines to certain recipients. In addition, our board of directors has authorized our chief executive officer to grant certain options in connection with offers of employment or consulting engagements, certain of which grants are subject to the board's subsequent ratification.

1999 Employee Stock Purchase Plan—Under the terms of our 1999 Employee Stock Purchase Plan, as amended (1999 ESPP), eligible employees may purchase common stock for a purchase price equal to 85% of the fair market value of our common stock on the first or last day, whichever is less, of the applicable six-month purchase period, which periods end in January and July of each year. During the six-month period ended July 1, 2007, employees purchased 55,193 shares of our common stock under the 1999 ESPP in exchange for approximately \$130,000, and during the six-month period ended July 2, 2006, employees purchased 51,420 shares of common stock under the 1999 ESPP in exchange for approximately \$141,000. No shares were purchased during the three-month periods ended July 1, 2007 and July 2, 2006, respectively.

Warrants

In June 2007, we issued to certain of our financial advisors a fully vested warrant to purchase 200,000 shares of our common stock at \$2.50 per share, which expires in June 2017. The fair value of the warrant, determined using the Black-Scholes option pricing model, totaled \$408,000 and is included in general and administrative expenses.

Stock-Based Compensation Expense

We account for the 1998 Stock Plan and the 1999 ESPP under the recognition and measurement principles of FASB Statement No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which requires measurement of compensation cost for all stock-based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. We determine the fair value of stock-based awards using the Black-Scholes option pricing model using the single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. As required by SFAS 123R, management made an estimate of expected forfeitures, and we are recognizing compensation costs only for those equity awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, we will record such amounts retrospectively as an increase or decrease in stock-based compensation in the period in which we revise the estimates. We consider many factors when estimating expected forfeitures, including historical voluntary termination behavior and actual option forfeitures. Actual results, and future changes in estimates, may differ substantially from our current estimates.

The following table summarizes stock-based compensation by operating function recorded in the Statement of Operations:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 1, 2007</u>	<u>July 2, 2006</u>	<u>July 1, 2007</u>	<u>July 2, 2006</u>
Fulfillment and order processing	\$ 186	\$ 154	\$ 461	\$ 375
Marketing and sales	372	257	786	581
Technology and content	285	262	643	534
General and administrative	1,693	880	3,077	1,766
Total	<u>\$ 2,536</u>	<u>\$ 1,553</u>	<u>\$4,967</u>	<u>\$3,256</u>

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Stock Option Activity

The following table summarizes activity under our 1998 Stock Plan:

	Outstanding Options			Weighted-Average Remaining Contractual Term
	Shares Available for Grant	Number of Shares	Average Exercise Price per Share	
Outstanding at December 31, 2006 (1)	4,493,562	18,841,842	\$ 3.50	
Additional shares authorized	4,700,000	—	—	
Options granted	(1,024,300)	1,024,300	\$ 2.92	
Options exercised	—	(248,021)	\$ 2.15	
Options forfeited	1,491,014	(1,491,014)	\$ 3.74	
Outstanding at April 1, 2007	9,660,276	18,127,107	\$ 3.46	
Options granted	(1,326,300)	1,326,300	\$ 2.59	
Options exercised	—	(689,204)	\$ 1.84	
Options forfeited	705,463	(705,463)	\$ 3.76	
Outstanding at July 1, 2007	9,039,439	18,058,740	\$ 3.45	
Vested and expected to vest at July 1, 2007		13,498,223	\$ 3.56	7.64
Exercisable at July 1, 2007		7,401,954	\$ 3.93	6.89

(1) The balance as of December 31, 2006 has been adjusted for 153,982 shares forfeited during 2006 not previously reported.

6. Line of Credit

In April 2007, we entered into an amended and restated loan and security agreement with our existing bank. This agreement includes a revolving line of credit allowing for borrowings of up to \$10.0 million, which accrue interest at the prime rate. The revolving line of credit matures in March 2008. The agreement allows for the conversion of up to \$2.5 million of the outstanding balance into a term loan within 60 days of maturity. For the six months ended July 1, 2007, borrowings under the existing line of credit totaled \$1.3 million, of which \$1.0 million was converted into a term loan in April 2007 and \$300,000 remains outstanding as of July 1, 2007 under the amended and restated loan and security agreement. The term loan will be paid in 36 monthly installments and accrues interest at the prime rate plus 0.50%.

7. Commitments and Contingencies

Legal Proceedings

State Sales Tax Claims. In early 2002, we received an arbitrary assessment notice from the state of New Jersey for past sales tax due from fiscal years 2000 and 2001, based on its best estimate of sales revenue numbers during those periods. In December 2002, we received a revised assessment from the state of New Jersey for 2000 and 2001 in the amount of \$221,626 in tax, plus penalties in the amount of \$11,081 and interest that continues to accrue. We do not currently collect and do not believe that we are required to collect New Jersey sales tax. In March 2003, we filed an appeal of the revised assessment with the Tax Court of New Jersey, based on the fact that the state of New Jersey is pursuing its claim specifically against one of our consolidated subsidiaries that is not a retailing entity in that state. The appeal is pending, and trial was held on November 30, and December 1, 2006. Briefing is complete, and we expect to have oral argument on the legal issues on August 14, 2007. Due to the uncertainty of the appeal, we have not recorded any amounts in the accompanying financial statements with respect to the sales tax alleged to be due. If we are unsuccessful in our appeal, the state of New Jersey would probably expand its assessment to include other years for which we did not collect sales tax. That additional assessment, along with attendant interest and penalties, could be material. We have not accrued any amounts for this matter, as it is not reasonably possible to estimate our liability, if any. However, the ultimate outcome of this matter could result in substantial tax liabilities for our past sales and have a material adverse affect on our financial position and results of operations.

Class Action Laddering Litigation. On and after July 6, 2001, eight stockholder class action lawsuits were filed in the United States District Court for the Southern District of New York (the "Court") naming drugstore.com as a defendant, along with the underwriters and certain of our present and former officers and directors (the "Individual Defendants"), in connection with our

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July 27, 1999 initial public offering and March 15, 2000 secondary offering (together, the “Offerings”). The complaints against drugstore.com have been consolidated into a single action, and a Consolidated Amended Complaint, which is now the operative complaint, was filed on April 19, 2002. The suit purports to be a class action filed on behalf of purchasers of our common stock during the period July 28, 1999 to December 6, 2000.

In general, the complaint alleges that the prospectuses through which we conducted the Offerings were materially false and misleading because they failed to disclose, among other things, that (i) the underwriters of the Offerings allegedly had solicited and received excessive and undisclosed commissions from certain investors in exchange for which the underwriters allocated to those investors material portions of the restricted number of shares issued in connection with the Offerings and (ii) the underwriters allegedly entered into agreements with customers whereby the underwriters agreed to allocate drugstore.com shares to customers in the Offerings in exchange for which customers agreed to purchase additional drugstore.com shares in the after-market at predetermined prices. The complaint asserts violations of various sections of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. The action seeks damages in an unspecified amount and other relief. The action is being coordinated with approximately 300 other nearly identical actions filed against other companies or their former officers and directors.

On July 15, 2002, the Company moved to dismiss all claims against us and the Individual Defendants. On October 9, 2002, the Court dismissed the Individual Defendants from the case without prejudice based on stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On February 19, 2003, the Court denied the motion to dismiss the complaint against drugstore.com. On October 13, 2004, the Court certified a class in six of the approximately 300 other nearly identical actions (the “focus cases”) and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The underwriter defendants appealed the decision, and the Second Circuit vacated the district court’s decision granting class certification in those six cases on December 5, 2006. Plaintiffs filed a petition for rehearing. On April 6, 2007, the Second Circuit denied the petition, but noted that plaintiffs could ask the District Court to certify more narrow classes than those that the Court rejected. Plaintiffs have not yet moved to certify a class in the case involving drugstore.com.

Prior to the Second Circuit’s December 5, 2007 ruling, drugstore.com, the plaintiff class, and the vast majority of the other issuer defendants, or, in the case of bankrupt issuers, their directors and officers, submitted a settlement agreement to the Court for approval. In light of the Second Circuit opinion, the parties agreed that the settlement could no longer be approved because the defined settlement class, like the litigation class, cannot be certified. On June 25, 2007, the Court approved a stipulation filed by the plaintiffs and the issuers which terminated the proposed settlement. The plaintiffs now plan to replead their complaints and move for class certification again.

Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter. We cannot predict whether we will be able to renegotiate a settlement that complies with the Second Circuit’s mandate, nor can we predict the amount of any such settlement and whether that amount would be greater than our insurance coverage. We are unable to estimate the potential damages that might be awarded if we were found liable, there arose a material limitation with respect to our insurance coverage, or the amount awarded were to exceed our insurance coverage. Because our liability, if any, cannot be reasonably estimated, no amounts have been accrued for this matter. An adverse outcome in this matter could have a material adverse affect on our financial position and results of operations.

Other. From time to time, we are subject to other legal proceedings and claims in the ordinary course of business. We are not currently aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse effect on our business prospects, financial condition or operating results.

8. Segment Information

We have four reporting segments: OTC, vision, mail-order pharmacy, and local pick-up pharmacy. The OTC segment is comprised of the sales and related costs of selling all non-prescription products through our websites, customized nutritional supplement programs through CNS, and net sales of consignment products. Our vision segment is comprised of sales and the related costs of selling contact lenses through Vision Direct. The mail-order pharmacy segment is comprised of sales and the related costs of selling pharmaceuticals through the drugstore.com website for mail-order delivery. The local pick-up pharmacy segment is comprised of sales and the related costs of selling pharmaceuticals through the drugstore.com website and the RiteAid.com website for pick-up at a local Rite Aid store. We operate and evaluate our business segments based on contribution margin results. We define contribution margin as net sales attributable to a segment, less the direct cost of these sales and the incremental (variable) costs of fulfilling, processing, and delivering the order (labor, packaging supplies, credit card fees, and royalty costs that are variable based on sales volume).

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The information presented below for these segments is information our management uses in evaluating operating performance.

	Three Months Ended		Six Months Ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
Over-the-Counter (OTC):				
Net sales	\$ 57,527	\$ 47,254	\$113,789	\$ 96,260
Cost of sales	40,810	32,633	80,461	67,296
Variable order costs (a)	5,180	4,385	10,548	8,713
Contribution margin (b)	<u>\$ 11,537</u>	<u>\$ 10,236</u>	<u>\$ 22,780</u>	<u>\$ 20,251</u>
Vision:				
Net sales	\$ 13,795	\$ 12,448	\$ 27,347	\$ 25,038
Cost of sales	10,475	9,623	20,971	19,416
Variable order costs (a)	651	648	1,298	1,309
Contribution margin (b)	<u>\$ 2,669</u>	<u>\$ 2,177</u>	<u>\$ 5,078</u>	<u>\$ 4,313</u>
Mail-Order Pharmacy:				
Net sales	\$ 12,451	\$ 17,405	\$ 25,929	\$ 35,705
Cost of sales	10,466	14,968	21,779	30,813
Variable order costs (a)	952	1,588	2,073	3,190
Contribution margin (b)	<u>\$ 1,033</u>	<u>\$ 849</u>	<u>\$ 2,077</u>	<u>\$ 1,702</u>
Local Pick-Up Pharmacy:				
Net sales (c)	\$ 26,639	\$ 25,329	\$ 53,112	\$ 49,542
Cost of sales	23,566	22,721	47,168	44,309
Variable order costs (a)	1,101	1,038	2,189	2,030
Contribution margin (b)	<u>\$ 1,972</u>	<u>\$ 1,570</u>	<u>\$ 3,755</u>	<u>\$ 3,203</u>
Consolidated:				
Net sales	\$110,412	\$102,436	\$220,177	\$206,545
Cost of sales	85,317	79,945	170,379	161,834
Variable order costs (a)	7,884	7,659	16,108	15,242
Consolidated contribution margin (b)	<u>\$ 17,211</u>	<u>\$ 14,832</u>	<u>\$ 33,690</u>	<u>\$ 29,469</u>
Less:				
Fixed fulfillment and order processing (d)	\$ 2,794	\$ 2,581	\$ 5,561	\$ 5,194
Marketing and sales (e)	7,850	6,321	15,922	15,279
Technology and content	4,475	4,003	9,190	7,945
General and administrative	5,157	4,025	9,866	8,319
Amortization of intangible assets	306	531	750	1,061
Operating loss	<u>\$ (3,371)</u>	<u>\$ (2,629)</u>	<u>\$ (7,599)</u>	<u>\$ (8,329)</u>

- (a) These amounts include all variable costs of fulfillment and order processing, including labor, packaging supplies, credit card fees, and those royalty costs that are variable based on sales volume. These amounts exclude depreciation, stock-based compensation, and fixed overhead costs.
- (b) Contribution margin represents a measure of how well each segment is contributing to our operating goals. We calculate it as net sales less the direct cost of goods sold, the incremental (variable) fulfillment and order processing costs of delivering orders to our customers, and variable royalty costs.
- (c) Net sales in our local pick-up pharmacy segment include co-payments totaling \$5.8 million and \$5.6 million for the three-month periods ended July 1, 2007, and July 2, 2006, respectively, and \$11.7 million and \$11.1 million for the six-month periods ended July 1, 2007 and July 2, 2006, respectively.
- (d) These amounts include all fixed costs of fulfillment and order processing that are not discernable by business segment.
- (e) These amounts exclude variable royalty expenses of \$22,000 and \$1,000 for the three-month periods ended July 1, 2007, and July 2, 2006, respectively, and \$39,000 and \$20,000 for the six-month periods ended July 1, 2007 and July 2, 2006, respectively.

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

You should read the following discussion and analysis in conjunction with the financial statements and accompanying notes included elsewhere in this quarterly report and in our annual report on Form 10-K for the fiscal year ended December 31, 2006.

Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements made in this quarterly report other than statements of historical fact, including statements regarding our future financial and operational performance, sources of liquidity and future liquidity needs, are forward-looking. Words such as “expects,” “believes,” “targets,” “may,” “will,” “plan,” “outlook,” “continue,” “remain,” “could,” “would,” “should,” and similar expressions or any variation of such expressions, are intended to identify forward-looking statements. Forward-looking statements are based on current expectations, and are not guarantees of future performance and involve assumptions, risks, and uncertainties. Actual performance may differ materially from those contained or implied in such forward-looking statements. Risks and uncertainties that could lead to such differences could include, among other things: effects of changes in the economy, changes in consumer spending, fluctuations in the stock market, changes affecting the Internet, online retailing and advertising, difficulties establishing our brand and building a critical mass of customers, the unpredictability of future revenues and expenses and potential fluctuations in revenues and operating results, risks related to business combinations and strategic alliances, possible tax liabilities relating to the collection of sales tax, consumer trends, the level of competition, seasonality, the timing and success of expansion efforts, changes in senior management, risks related to systems interruptions, possible governmental regulation, and the ability to manage a growing business. These factors described in this paragraph and other risks and uncertainties that could cause our actual results to differ significantly from management's expectations are discussed in the sections entitled “*Risk Factors*” in Part II, Item 1A of this quarterly report and Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended December 31, 2006. You should not rely on a forward-looking statement as representing our views as of any date other than the date on which we made the statement. We expressly disclaim any intent or obligation to update any forward-looking statement after the date on which we make it.

Overview

drugstore.com, inc. is a leading online provider of health, beauty, vision, and pharmacy products. We believe that we offer a better way for consumers to shop for these products through our web stores, including those located on the Internet at www.drugstore.com, www.beauty.com, www.visiondirect.com, www.lensmart.com, and www.lensquest.com.

Business Segments; Growth Strategies. We operate our business in four business segments: over-the-counter, or OTC, vision, mail-order pharmacy, local pick-up pharmacy.

- *Over-the-counter (OTC)* . Our OTC segment includes all non-prescription products sold online through our web stores at www.drugstore.com, www.beauty.com, www.visiondirect.com, www.lensmart.com, and www.lensquest.com, or over the telephone, including nutritional supplements sold through our subsidiary Custom Nutrition Services, Inc., or CNS. We source our OTC products from various manufacturers and distributors. We believe that continued growth in this segment will depend on our ability to offer customers a superior shopping experience and service, including providing a broad selection of basic necessity items and hard-to-find specialty items, which encourages customers to return to our websites and make repeat, replenishment, and impulse purchases. In 2007, we will continue to focus on improving our customers' shopping experience by enhancing our internal search technology and website conversion, expanding our category offerings through the introduction of our drop ship program, and making key investments in our prestige Beauty.com website.
- *Vision* . The vision segment includes contact lenses sold through our wholly owned subsidiary International Vision Direct Corp. and its subsidiaries, collectively referred to as Vision Direct, through websites located at www.visiondirect.com, www.lensmart.com, and www.lensquest.com, or over the telephone at 1-800-VISIONDIRECT. We purchase our contact lens inventory directly from various manufacturers and other distributors. In 2007, we are focusing on a strategy of balancing customer acquisition with net margin in order to maximize our profits, rather than focusing exclusively on revenue growth.
- *Mail-Order Pharmacy* . Our mail-order pharmacy segment includes prescription drugs and supplies, other than prescription contact lenses, sold online through the pharmacy section of the drugstore.com web store or over the telephone and delivered to customers through our mail-order facility. We procure our prescription inventory through Rite Aid Corporation as part of our ongoing relationship. We market to both cash-paying and insurance-covered individuals, and we also serve as a third-party provider of mail-order prescription fulfillment services for pharmacy benefit managers, or PBMs. We sell over 5,000 prescription drugs, including many specialty drugs for the treatment of chronic conditions such as cancer, HIV, and multiple sclerosis, which are not carried by brick-and-mortar pharmacies and require special handling or service. In this segment, we focus our marketing efforts directly on consumers online and through doctors to maximize growth in our cash prescription

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and specialty pharmacy business. In addition to the sale of prescription drugs, we sell advertising on our website, to monetize the more than one million unique visitors per month researching drugs and other healthcare content provided on the site. We anticipate that continued growth in this segment in 2007 will substantially depend on our ability to grow prescription volumes through these efforts. We anticipate that our decision not to participate in the low-margin Medicare Part D prescription drug benefit program offered by the U.S. government will continue to have a negative impact on our growth but a favorable impact on our gross margin.

- *Local Pick-Up Pharmacy* . Our local pick-up pharmacy business segment includes prescription refills sold online through the drugstore.com web store or the Rite Aid web store at www.RiteAid.com (which is powered by the drugstore.com web store) or over the telephone and picked up by customers at Rite Aid stores. In this segment, Rite Aid acts as our fulfillment partner. Our success in this segment depends on our ability to leverage our relationship with Rite Aid through its marketing media, including Rite Aid store receipts, weekly Rite Aid advertising circulars, and e-mail refill reminders. In 2007, we anticipate that net sales in the local pick-up pharmacy segment will not be a significant source of growth, as we continue to focus the majority of our marketing efforts on our OTC segment.

Revenues . We generate revenue primarily from product sales and shipping fees. For the three-month period ended July 1, 2007, we reported consolidated total net sales of \$110.4 million, which reflected an \$8.0 million, or 8%, increase over the three-month period ended July 2, 2006. For the six-month period ended July 1, 2007, we reported consolidated net sales of \$220.2 million, which reflected a \$13.6 million, or 7%, increase over the six-month period ended July 2, 2006. Our net sales growth was driven by a 12% year-over-year increase in our total order volume for the second quarter of 2007, to 1.5 million orders, and an 11% year-over-year increase in total order volume for the six-month period ended July 1, 2007, to 3.0 million orders. Our average net sales per order declined slightly to \$75 for the three- and six-month periods ended July 1, 2007, from \$77 for the three- and six-month periods ended July 2, 2006. Our revenues benefited from strong growth in our OTC segment, in which net sales grew by 22% and 18%, respectively, year-over-year for the three- and six-month periods ended July 1, 2007. Our revenues also benefited from year-over-year growth of 11% and 9%, respectively, for the three- and six-month periods ended July 1, 2007 in our vision segment and 5% and 7%, respectively, in our local pick-up pharmacy segment. These increases were partially offset by a year-over-year decrease in mail-order pharmacy net sales of 28% for the second quarter of 2007 and 27% for the six-month period ended July 1, 2007.

Expenses . Our operating expenses, including cost of goods sold, remained consistent as a percentage of net sales at 103% during the three-month period ended July 1, 2007, when compared to the three-month period ended July 2, 2006, and was 103% of net sales for the six-month period ended July 1, 2007, compared to 104% of net sales for the six-month period ended July 2, 2006. During the three- and six-month periods ended July 1, 2007 our overall cost of goods sold as a percentage of net sales year-over-year decreased 70 basis points and 100 basis points, respectively, due to a favorable shift in our product mix to higher margin OTC sales, as well as improvement in pharmaceutical and vision margins. Our improved gross margins were offset by increased marketing expenses resulting from increased order volumes and search advertising costs, increased technology and content expenses as a result of ongoing enhancements to our IT infrastructure, and increased general and administrative expenses primarily due to higher stock based compensation expenses during the second quarter of 2007 and the six-month period ended July 1, 2007. We recognized \$983,000 and \$1.7 million, or 1% of net sales, of additional stock-based compensation in the three- and six-month periods ended July 1, 2007 compared to the same periods in 2006.

Net Loss; Cash Position . Our net loss for the three-month period ended July 1, 2007 increased by 37%, or \$822,000 to \$3.0 million, compared to \$2.2 million for the three-month period ended July 2, 2006, however decreased by 9%, or \$693,000, to \$6.8 million, compared to \$7.5 million for the six-month period ended July 2, 2006. We ended the second quarter of 2007 with \$38.9 million in cash, cash equivalents and marketable securities, compared to \$40.6 million at December 31, 2006, and \$39.7 million at July 2, 2006. This balance reflects cash generated from operating activities in the six-month period ended July 1, 2007 of \$2.6 million, \$5.1 million for capital expenditures, and \$1.4 million to repay debt obligations, offset by proceeds of \$1.9 million from the exercise of employee stock options and purchases under our employee stock purchase plan and \$300,000 of borrowings under our line of credit.

Significant Accounting Judgments

The preparation of financial statements in conformity with U.S. generally accepted accounting principles, or GAAP, requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The Securities and Exchange Commission, or SEC, has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations and that require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we have identified the significant accounting policies and judgments addressed below. We also have other key accounting policies that involve

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the use of estimates, judgments, and assumptions that are significant to understanding our results. Additional information about our significant accounting policies is included in Note 1 of our consolidated financial statements included in Part I of our annual report on Form 10-K for the fiscal year ended December 31, 2006. Although we believe that our estimates, assumptions, and judgments are reasonable, they are based on information presently available. Actual results may differ significantly from these estimates under different assumptions, judgments, or conditions. In addition, any significant unanticipated changes in any of our assumptions could have a material adverse effect on our business, financial condition and results of operations.

Revenue Recognition

We recognize revenues in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*.

We record revenues from sales of OTC (other than Weil-related CNS sales, as described below), vision, and mail-order pharmacy, net of promotional discounts, cancellations, rebates, and returns allowances. We recognize revenue when the following revenue recognition criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the selling price or fee earned is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. We generally require payment by credit card at the point of sale. We estimate return allowances, which reduce product sales by our estimate of expected product returns, based on our historical experience. Historically, product returns have not been significant and have not differed significantly from our estimates.

We recognize revenues from sales of customized vitamins sold through our fulfillment agreement with Weil when products are shipped and title passes to the customer. In accordance with Emerging Issues Task Force Issue No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, or EITF 99-19, we record revenues generated by the Weil agreement in our OTC segment on a net basis, because we act as an agent, based on the fact that we earn a fixed dollar amount per customer transaction regardless of the amount billed to the customer, and we do not bear general inventory risk associated with these sales. We recognize non-Weil customized vitamin sales on a gross basis, net of promotional discounts, cancellations, rebates, and returns allowances. Net sales in our OTC segment also include consignment service fees earned under our agreement with General Nutrition Corporation, or GNC, and agreements with other consignment vendors, which we also record on a net basis, because we do not take title to the inventory and do not establish pricing.

We recognize revenues from sales of prescription products ordered online or by telephone through the drugstore.com web store or the RiteAid.com web store (which is powered by the drugstore.com web store) for pick-up at a Rite Aid store, including co-payments that Rite Aid receives and collects on our behalf when the customer picks up the product. In these circumstances, we use Rite Aid as our fulfillment partner. In accordance with EITF 99-19, we record revenues in our local pick-up pharmacy segment on a gross basis, because we act as a principal, based on the fact that, among other things, we bear both inventory risk and credit and collection risk associated with these sales.

For insured prescriptions in both our local pick-up and mail-order segments, the co-payment and the insurance reimbursement (which together make up the amount due to drugstore.com) constitute the full value of the prescription drug sale, and we receive this entire amount as cash. We therefore recognize the entire amount as revenue when we ship the order to the customer (for mail order prescriptions) or when the customer picks up the order (for local pick-up prescriptions).

From time to time, we provide incentive offers to our customers to encourage purchases. Such offers include discounts on specific current purchases, or future rebates based on a percentage of the current purchase, as well as other offers. We treat discounts, when our customers accept them, as a reduction in the sales price of the related transaction and we present them as a net amount in net sales. We treat rebates as a reduction in the sales price based on estimated redemption rates. We estimate redemption rates using our historical experience for similar offers. Historically, our redemption rates have not differed materially from our estimates, which we adjust quarterly.

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Inventories

We value our inventories at the lower of cost (using the weighted-average cost method) or the current estimated market value. We regularly review inventory quantities on hand and adjust our inventories for shrinkage and slow-moving, damaged, and expired inventory, which we record as the difference between the cost of the inventory and the estimated market value based on management's assumptions about future demand for the products we offer and market conditions. We use a variety of methods to reduce the quantity of slow-moving inventory, including reducing sales prices on our websites, negotiating returns to vendors, and liquidating inventory through third parties. If our estimates of future product demand or our assumptions about market conditions are inaccurate, we could understate or overstate the provision required for excess and obsolete inventory. Historically, inventory reserves have not differed materially from our estimates.

Goodwill and Other Intangible Assets

In accordance with Statement of Financial Accounting Standards No. 142, *Accounting for Goodwill and Other Intangibles*, or SFAS 142, we test for impairment of goodwill at the beginning of the fourth quarter and whenever indicators of impairment occur. The first phase of the test screens for impairment. If we determine impairment, the second phase measures the amount of impairment by comparing the fair value of the applicable reporting unit to its carrying value. We determine fair value using either a discounted cash flow methodology or methodology based on comparable market prices.

We review our indefinite-lived intangible assets for impairment when indicators of impairment occur and annually at the beginning of the fourth quarter. We compare the carrying value of the asset to its estimated fair value and record an impairment charge when the carrying value of the asset exceeds the estimated fair value.

In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, or SFAS 144, we review the carrying values of our amortized long-lived assets, including definite-lived intangible assets, whenever an indicator of impairment occurs. When facts and circumstances indicate that the carrying values of long-lived assets may be impaired, we perform an evaluation of recoverability. We determine whether impairment exists based on any excess of the carrying value over the expected future cash flows, as estimated through undiscounted cash flows, excluding interest charges. We measure any resulting impairment charge based on the difference between the carrying value of the asset and its fair value, as estimated through expected future discounted cash flows, discounted at a rate of return for an alternate investment.

If our estimates of revenue growth or future cash flows prove to be inaccurate, we may have a future impairment of goodwill, other intangible assets, or long-lived assets.

Stock-Based Compensation

We account for our stock-based awards under the provisions of SFAS 123R, which requires measurement of compensation cost for all stock-based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. We calculate the fair value of our stock options granted to employees using the Black-Scholes option pricing model using the single-option approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. We base our computation of expected volatility on our historical volatility, adjusted for changes in capital structure and corporate changes, information available that may indicate future volatility, and observable mean reversion tendencies of historical volatility. We compute expected life using the simplified method outlined by SEC Staff Accounting Bulletin No. 107, *Share-Based Payment*, or SAB 107. Under this method, our expected term is equal to the sum of the weighted average vesting term plus the original contractual term divided by two, which results in a six-year expected term. We base the risk-free interest rate on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term. Where the expected term of our stock-based awards does not correspond with the terms for which interest rates are quoted, we average the rates quoted for the closest available term maturities. A dividend yield of 0% is considered appropriate as we have not issued and do not anticipate issuing any dividends in the near future. When estimating forfeitures, we consider historical voluntary termination behavior in addition to actual option forfeitures. In conjunction with this analysis, we identified distinct subgroups: non-management employees, management employees, our chief executive officer, board members, and other non-employees. We apply an estimated forfeiture rate of approximately 35% to non-management and management employee subgroups, based on the weighted average termination behavior of those subgroups. We apply a forfeiture rate of 0% to our chief executive officer, board members, and non-employees. If our estimated forfeiture rate changes, we retrospectively increase or decrease stock-based compensation in the period of change. Any such revisions to the estimates we use to calculate the fair value of our stock-based awards could have a material impact on our results of operations and financial position. See Note 5 of our consolidated financial statements, *Stockholders' Equity*, included in Part I, of Item 1 of this quarterly report.

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Legal Proceedings

We are currently involved in various claims and legal proceedings. Periodically, we review the status of each significant matter and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be estimated, we accrue a liability for the estimated loss. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and legal proceedings and may revise our estimates. Any such revisions in the estimates of the potential liabilities could have a material impact on our future results of operations and financial position. For a description of our material legal proceedings, see Note 7 of our consolidated financial statements, *Commitments and Contingencies*, included in Part I, of Item 1 of this quarterly report.

Results of Operations

Net Sales

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change	July 2, 2006	July 1, 2007	% Change	July 2, 2006
	(in thousands, except per order data)			(in thousands, except per order data)		
Total net sales	\$110,412	7.8%	\$102,436	\$220,177	6.6%	\$206,545
Total customer orders shipped	1,477	11.7%	1,322	2,954	10.6%	2,670
Average net sales per order	\$ 75	-2.6%	\$ 77	\$ 75	-2.6%	\$ 77

Net sales include gross revenues from sales of product and related shipping fees, net of discounts and provision for sales returns, and other allowances. Net sales also include consignment service fees earned from our arrangement with GNC and other consignment vendors, under which we do not take title to the inventory and cannot establish pricing. We record on a net basis consignment service fees, which constitute approximately 1% of total net sales in each period presented. We bill orders to the customer's credit card or, in the case of prescriptions covered by insurance, we bill the co-payment to the customer's credit card and the remainder of the prescription price to insurance. We record sales of pharmaceutical products covered by insurance as the sum of the amounts received from the customer and the third party.

Total net sales increased year-over-year primarily as a result of a 20% increase in order volume for the three-month period ended July 1, 2007, and an 18% increase in order volume for the six-month period ended July 1, 2007, in our OTC segment. Revenues from repeat customers increased to 83% of net sales in the second quarter 2007 and for the six-month period ended July 1, 2007, compared to 82% for the same periods of 2006. The year-over-year decrease in average net sales per order for the three- and six-month periods ended July 1, 2007 resulted from a higher mix of OTC orders, which have lower average net sales per order. Compared to the second quarter and the six-month period ended July 1, 2006, net sales in our OTC segment increased by \$10.3 million and \$17.5 million, net sales in our local pick-up pharmacy segment increased by \$1.3 million and \$3.6 million, and net sales in our vision segment increased by \$1.3 million and \$2.3 million, respectively, all of which were partially offset by a decrease in net sales in our mail-order pharmacy segment of \$5.0 million and \$9.8 million, respectively.

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OTC Net Sales

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change	July 2, 2006	July 1, 2007	% Change	July 2, 2006
	(in thousands, except per order data)			(in thousands, except per order data)		
OTC net sales	\$57,527	21.7%	\$47,254	\$113,789	18.2%	\$96,260
<i>Segmented net sales information:</i>						
% of total net sales from OTC	52.1%		46.1%	51.7%		46.6%
Average net sales per order	\$ 57	1.8%	\$ 56	\$ 57	1.8%	\$ 56

Net sales in our OTC segment increased year-over-year for the three-month period ended July 1, 2007, as a result of an increase in order volume. The number of orders in our OTC segment grew year-over-year by 20% to 1.0 million for the second quarter of 2007, compared to 842,000 for the second quarter of 2006 with the average net sales per order for the second quarter of 2007 increasing year-over-year to \$57 from \$56. During the six-month period ended July 1, 2007 the number of OTC orders grew year-over-year by 18% to 2.0 million compared to 1.7 million in the same period of 2006, and the average net sales per order also increased to \$57 from \$56. The number of customer orders includes new and repeat orders made through the drugstore.com website and websites of our subsidiaries and orders generated through our fulfillment agreement with Weil. The increase in OTC order volumes in 2007 as compared to 2006 was driven by increased orders from both new and repeat customers as a result of our increasing active customer base and our continued efforts to improve customer retention and conversion resulting from our ongoing website enhancements.

Vision Net Sales

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change	July 2, 2006	July 1, 2007	% Change	July 2, 2006
	(in thousands, except per order data)			(in thousands, except per order data)		
Vision net sales	\$13,795	10.8%	\$12,448	\$27,347	9.2%	\$25,038
<i>Segmented net sales information:</i>						
% of total net sales from vision	12.5%		12.2%	12.4%		12.1%
Average net sales per order	\$ 99	10.0%	\$ 90	\$ 97	10.2%	\$ 88

Net sales in our vision segment increased year-over-year in the three- and six-month periods ended July 1, 2007 as a result of an increase in average net sales per order driven primarily by selling a greater proportion of higher-priced, newer-technology contact lenses, and to a lesser extent, an increase in the average number of items per order and price increases for certain SKUs (none of which were individually material). Net sales per order increased to \$99 for the three-month period ended July 1, 2007 compared to \$90 for the three-month period ended July 2, 2006 and increased to \$97 for the six-month period ended July 1, 2007 compared to \$88 for the six-month period ended July 2, 2006. The number of orders in this segment increased slightly to 140,000 for the three-month period ended July 1, 2007, compared to 138,000 for the three-month period ended July 2, 2006, and decreased approximately 1% to 281,000 for the six-month period ended July 1, 2007, compared to 283,000 for the six-month period ended July 2, 2006.

Mail-Order Pharmacy Net Sales

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change	July 2, 2006	July 1, 2007	% Change	July 2, 2006
	(in thousands, except per order data)			(in thousands, except per order data)		
Mail-order pharmacy net sales	\$12,451	-28.5%	\$17,405	\$25,929	-27.4%	\$35,705
<i>Segmented net sales information:</i>						
% of total net sales from mail-order pharmacy	11.3%		17.0%	11.8%		17.3%
Average net sales per order	\$ 160	-0.6%	\$ 161	\$ 160	1.3%	\$ 158

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Net sales in our mail-order pharmacy segment decreased year-over-year for the three- and six-month periods ended July 1, 2007 as a result of decreases in order volume. Included in net sales of our mail-order pharmacy segment for the three- and six-month periods ended July 1, 2007 were wholesale orders to one party for \$336,000 and \$950,000, respectively, which increased our average net sales per order by \$4 and \$6 for the three- and six-month periods ended July 1, 2007. The number of orders in this segment decreased 28% year-over-year to 78,000 for the three-month period ended July 1, 2007, compared to 108,000 for the same period in 2006, and decreased 29% year-over-year to 162,000 for the six-month period ended July 1, 2007, compared to 226,000 for the same period in 2006, as a result of decreases in new and repeat orders.

Local Pick-up Pharmacy Net Sales

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change	July 2, 2006	July 1, 2007	% Change	July 2, 2006
	(in thousands, except per order data)			(in thousands, except per order data)		
Local pick-up pharmacy net sales	\$26,639	5.2%	\$25,329	\$53,112	7.2%	\$49,542
<i>Segmented net sales information:</i>						
% of total net sales from local pick-up pharmacy	24.1%		24.7%	24.1%		24.0%
Average net sales per order	\$ 105	1.9%	\$ 103	\$ 105	-1.9%	\$ 107

The increase in net sales in our local pick-up pharmacy segment for the three-month period ended July 1, 2007 reflects a 3% year-over-year increase in the number of orders in this segment, to 253,000, compared to 245,000 for the second quarter of 2006, as a result of an increase in orders from repeat customers. In addition, the segment experienced a slight increase in the average net sales per order to \$105 per order during the three-month period ended July 1, 2007 compared to \$103 per order for the three-month period ended July 2, 2006 primarily due to a 3% increase in the average number of prescriptions filled per order. The increase in net sales for the six-month period ended July 1, 2007 reflects a 9% year-over-year increase in the number of orders in this segment, to 504,000 for the six-month period ended July 1, 2007 compared to 462,000 for the six-month period ended July 2, 2006, as a result of increases in orders from repeat customers. The decrease in average net sales per order resulted primarily from a 1% decline year-over-year in the average number of prescriptions filled per order and, to a lesser extent, a lower number of higher-priced brand-name prescriptions filled compared to lower-priced generic prescriptions filled. Orders in this segment are driven by Rite Aid through its marketing media, including Rite Aid store receipts, weekly Rite Aid advertising circulars, and e-mail refill reminders.

Customer Data

Approximately 341,000 and 679,000 new customers placed orders during the three- and six-month periods ended July 1, 2007, increasing our total customer base to approximately 9.1 million customers since inception. Orders from repeat customers as a percentage of total orders remained consistent year-over-year at 77% for the second quarter of 2007, compared to the same period in 2006, and increased year-over-year for the six-month period ended July 1, 2007 to 77% compared to 76% for the same period in 2006, as a result of an increase in our trailing 12-month active customer base. Active customer base includes those customers who have purchased at least once within the last 12 months. Both the active customer base (a trailing 12-month number) and average annual spend per active customer exclude net sales and orders generated by our CNS fulfillment relationship with Weil, and reflect only the activity of customers making purchases through the web sites of drugstore.com and its subsidiaries.

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Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
Cost of sales	\$85,317	6.7%	\$79,945	\$170,379	5.3%	\$161,834
Gross margin dollars	\$25,095	11.6%	\$22,491	\$ 49,798	11.4%	\$ 44,711
Gross margin percentage	22.7%		22.0%	22.6%		21.6%

Cost of sales consists primarily of the cost of products sold to our customers, including allowances for shrinkage and damaged, slow-moving, and expired inventory, outbound and inbound shipping costs, and expenses related to promotional inventory included in shipments to customers. Payments that we receive from vendors in connection with volume purchase or rebate allowances and payment discount terms are netted against cost of sales.

Total cost of sales increased in absolute dollars in the three- and six-month periods ended July 1, 2007, compared to the three- and six-month periods ended July 2, 2006, as a result of growth in order volume and net sales. Total gross margin percentage increased year-over-year for the three- and six-month periods ended July 1, 2007, primarily as a result of a larger proportion of net sales in our OTC segment, which is our highest-margin segment, and improved gross margins in our mail-order and local pick-up pharmacy segments and vision segment.

We include in net sales our revenues from shipping charges to customers, which were \$4.0 million and \$3.3 million in the three-month periods ended July 1, 2007, and July 2, 2006, respectively, and were \$7.7 million and \$6.7 million in the six-month periods ended July 1, 2007 and July 2, 2006, respectively. We include in cost of sales outbound shipping costs, which were \$6.3 million and \$5.0 million in the three-month periods ended July 1, 2007 and July 2, 2006, respectively, and were \$12.1 million and \$10.5 million in the six-month periods ended July 1, 2007 and July 2, 2006, respectively. We expect to continue to subsidize a portion of customers' shipping costs for the foreseeable future, through certain free shipping options, as a strategy to attract and retain customers.

OTC Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
OTC cost of sales	\$40,810	25.1%	\$32,633	\$80,461	19.6%	\$67,296
<i>Segmented cost of sales information:</i>						
OTC gross margin dollars	\$16,717		\$14,621	\$33,328		\$28,964
OTC gross margin percentage	29.1%		30.9%	29.3%		30.1%

The year-over-year increase in cost of sales in our OTC segment in absolute dollars for the three- and six-month periods ended July 1, 2007 resulted from increased order volume and net sales. The year-over-year decrease in gross margin percentage for the three- and six-month periods ended July 1, 2007 was primarily a result of higher per-order net shipping costs.

Vision Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
Vision cost of sales	\$10,475	8.9%	\$9,623	\$20,971	8.0%	\$19,416
<i>Segmented cost of sales information:</i>						
Vision cost gross margin dollars	\$ 3,320		\$2,825	\$ 6,376		\$ 5,622
Vision cost gross margin percentage	24.1%		22.7%	23.3%		22.5%

The year-over-year increase in cost of sales in our vision segment both in absolute dollars and in terms of gross margin percentage for the three- and six-month periods ended July 1, 2007 was primarily as a result of a shift in product mix to sales of higher cost, newer technology contact lenses, and higher per order net shipping revenues, partially offset by increased promotional activity in both the three- and six-month periods and a slight decline in order volume in the six-month period.

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Mail-Order Pharmacy Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
Mail-order pharmacy cost of sales	\$10,466	-30.1%	\$14,968	\$21,779	-29.3%	\$30,813
<i>Segmented cost of sales information:</i>						
Mail-order pharmacy gross margin dollars	\$ 1,985		\$ 2,437	\$ 4,150		\$ 4,892
Mail-order pharmacy gross margin percentage	15.9%		14.0%	16.0%		13.7%

The year-over-year decrease in cost of sales in our mail-order pharmacy segment in absolute dollars for the three- and six-month periods ended July 1, 2007 resulted from a decrease in order volume and net sales. The year-over-year increase in gross margin percentage in this segment for three- and six-month periods ended July 1, 2007 resulted from improved margins from exiting unprofitable partnerships with certain PBMs and our review of pricing and profitability of pharmaceutical products.

Local Pick-up Pharmacy Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
Local pick-up pharmacy cost of sales	\$23,566	3.7%	\$22,721	\$47,168	6.5%	\$44,309
<i>Segmented cost of sales information:</i>						
Local pick-up gross margin dollars	\$ 3,073		\$ 2,608	\$ 5,944		\$ 5,233
Local pick-up gross margin percentages	11.5%		10.3%	11.2%		10.6%

The year-over-year increase in cost of sales in our local pick-up pharmacy segment in absolute dollars in the three- and six-month periods ended July 1, 2007 resulted from an increase in order volume and net sales. The year-over-year increase in gross margin percentage in this segment for the three- and six-month periods ended July 1, 2007 was primarily a result of selling a higher proportion of higher-margin generic drugs, compared to lower-margin branded drugs, as well as higher product margins on sales of branded drugs.

Fulfillment and Order Processing Expenses

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
Fulfillment and order processing expenses	\$10,656	4.1%	\$10,239	\$21,630	5.9%	\$20,416
Percentage of net sales	9.7%		10.0%	9.8%		9.9%

Fulfillment and order processing expenses include payroll and related expenses for personnel engaged in purchasing, fulfillment, distribution, and customer care activities (including warehouse personnel and pharmacists engaged in prescription verification activities), distribution center equipment and packaging supplies, per-unit fulfillment fees charged by Rite Aid for prescriptions ordered through the drugstore.com website and picked up at a Rite Aid store, credit card processing fees, and bad debt expenses. These expenses also include rent and depreciation related to equipment and fixtures in our distribution center and call center facilities. Variable fulfillment costs represent the incremental (variable) costs of fulfilling, processing, and delivering the order that are variable based on sales volume.

Fulfillment and order processing expenses for the three- and six-month periods ended July 1, 2007 included \$7.9 million of variable costs and \$2.8 million of fixed costs, and \$16.1 million of variable costs and \$5.5 million of fixed costs, respectively compared to \$7.6 million of variable costs and \$2.6 million of fixed costs and \$15.2 million of variable costs and \$5.2 million of fixed costs for the three- and six-month periods ended July 2, 2006. Variable fulfillment and order processing expenses increased year-over-year for the three-month period ended July 1, 2007 compared to the three-month period ended July 2, 2006 due to increases in order

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volume in our OTC segment, partially offset by a decrease in order volume in our mail-order pharmacy segment. Fixed fulfillment and order processing expenses increased as a result of increased personnel costs of \$171,000, increased depreciation and stock-based compensation expense of \$105,000, partially offset by a decrease in other operating costs of \$75,000 for the three-month period ended July 1, 2007 compared to the three-month period ended July 2, 2006. Fixed fulfillment and order processing expenses increased as a result of increased depreciation expense of \$140,000, increased stock-based compensation expense of \$86,000, and increased personnel costs of \$135,000, partially offset by a decrease in other operational costs for the six-month period ended July 1, 2007 compared to the six-month period ended July 2, 2006. Fulfillment and order processing expenses as a percentage of net sales decreased in both the three- and six-month periods ended July 1, 2007 as greater order volumes resulted in improved utilization of our primary distribution center.

Marketing and Sales Expenses

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
Marketing and sales expenses	\$7,872	24.5%	\$6,322	\$15,961	4.3%	\$15,299
Percentage of net sales	7.1%		6.2%	7.2%		7.4%

Marketing and sales expenses include advertising expenses, promotional expenditures, and payroll and related expenses for personnel engaged in marketing and merchandising activities. Advertising expenses include our obligations under various advertising contracts. Advertising and promotional costs were \$5.6 million and \$11.1 million for the three- and six-month periods ended July 1, 2007, respectively, and were \$4.1 million and \$10.8 million for the three- and six-month periods ended July 2, 2006, respectively.

The year-over-year increase in marketing and sales expenses in absolute dollars for both the three- and six-month periods ended July 1, 2007 and as a percentage of net sales for the three month period ended July 1, 2007 was primarily due to increased search advertising and promotional costs, and to a lesser extent an increase in stock-based compensation expense of \$115,000. Marketing and sales expenses decreased year-over-year as a percentage of net sales for the six-month period ended July 1, 2007, primarily due to \$1.8 million in final costs related to our brand advertising campaign that we incurred in the first quarter of 2006. Marketing and sales dollars per new customer increased in the second quarter of 2007 to \$23, compared to \$21 in the second quarter of 2006, but declined in the six-month period ended July 1, 2007 to \$24, from \$25 for the same period in 2006.

Technology and Content Expenses

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
Technology and content expenses	\$4,475	11.8%	\$4,003	\$9,190	15.7%	\$7,945
Percentage of net sales	4.1%		3.9%	4.2%		3.8%

Technology and content expenses consist primarily of payroll and related expenses for personnel engaged in developing, maintaining, and making routine upgrades and enhancements to our websites. Technology and content expenses also include Internet access and hosting charges, depreciation on hardware and IT structures, utilities, and website content and design expenses.

The year-over-year increase in technology and content expenses both in absolute dollars and as a percentage of net sales for the three- and six-month periods ended July 1, 2007 resulted primarily from increased depreciation expense of \$298,000 and \$668,000, respectively, resulting from the acquisition of software and computer equipment related to enhancements to our IT infrastructure in 2006, and increased maintenance costs related to acquired software tools, and to a lesser extent, increased other operational costs to support our growth in our IT infrastructure.

General and Administrative Expenses

	Three Months Ended			Six Months Ended		
	July 1, 2007	% Change (\$ in thousands)	July 2, 2006	July 1, 2007	% Change (\$ in thousands)	July 2, 2006
General and administrative expenses	\$5,157	28.1%	\$4,025	\$9,866	18.6%	\$8,319
Percentage of net sales	4.7%		3.9%	4.5%		4.0%

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General and administrative expenses consist of payroll and related expenses for executive and administrative personnel, corporate facility expenses, professional service expenses, and other general corporate expenses.

The year-over-year increase in general and administrative expenses both in absolute dollars and as a percentage of net sales for the three- and six-month periods ended July 1, 2007 resulted primarily from an increase in stock-based compensation of \$813,000 and \$1.3 million, respectively, as a result of increased option grants and related option fair values, warrants issued in connection with an advisory agreement, as well as increased consulting expenses related to improved operational efficiencies.

Amortization of Intangible Assets

	Three Months Ended			Six Months Ended		
	July 1,		July 2,	July 1,		July 2,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Amortization of intangible assets	\$ 306	-42.4%	\$ 531	\$ 750	-29.3%	\$ 1,061

Amortization of intangible assets includes the amortization expense associated with assets acquired in connection with our acquisitions of CNS and Acumins, Inc., and assets acquired in connection with our agreements with Rite Aid and GNC, and other intangible assets, including a technology license agreement, domain names, and trademarks.

The year-over-year decrease in amortization expense for three- and six-month periods ended July 1, 2007 resulted from certain intangible assets being fully amortized in 2006 and the three-month period ended July 1, 2007.

Interest Income and Expense

	Three Months Ended			Six Months Ended		
	July 1,		July 2,	July 1,		July 2,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Interest income, net	\$ 356	-18.3%	\$ 436	\$ 806	-4.4%	\$ 843

Interest income consists of earnings on our cash, cash equivalents, and marketable securities, and interest expense consists primarily of interest associated with capital lease and debt obligations. The year-over-year decrease in net interest income for the three- and six-month periods ended July 1, 2007 was a result of lower average invested balances in cash and cash equivalents, partially offset by increased average invested balances in marketable securities.

Income Taxes

There was no provision or benefit for income taxes for the three- and six-month periods ended July 1, 2007 and July 2, 2006 due to our ongoing operating losses.

Off-Balance Sheet Transactions

We have not entered into any off-balance sheet transactions.

Liquidity and Capital Resources

We have incurred net losses of \$757.1 million since inception. We believe that we will continue to incur net losses for at least the next year, and possibly longer. From our inception through July 1, 2007, we have financed our operations primarily through the sale of equity securities, including common and preferred stock, yielding net cash proceeds of \$418.3 million.

Discussion of Cash Flows

The following table provides information regarding our cash flows for the six-month periods ended July 1, 2007 and July 2, 2006.

	Six Months Ended		
	July 1, 2007	\$ Change (in thousands)	July 2, 2006
	Cash provided by (used in) operating activities	\$ 2,592	\$ 5,482
Cash used in investing activities	\$(5,766)	\$(4,834)	\$(932)
Cash provided by (used in) financing activities	\$ 838	\$ 1,395	\$(557)
Net decrease in cash and cash equivalents	\$(2,336)	\$ 2,043	\$(4,379)

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Net cash provided by operating activities for the six-month period ended July 1, 2007 primarily reflects a net loss of \$6.8 million and the use of \$1.3 million in cash for operating assets and liabilities, offset by non-cash expenses related to depreciation and amortization of \$5.7 million and stock based compensation expense of \$5.0 million. Net cash used in operating activities for the six-month period ended July 2, 2006 primarily reflects a net loss of \$7.5 million and the use of \$3.9 million in cash for operating assets and liabilities, partially offset by \$8.5 million of non-cash activities. The year-over-year improvement in cash provided by operating activities was primarily driven by a \$0.7 million decrease in our net loss, a \$2.2 million increase in non-cash activities, primarily stock based compensation expense, and a \$2.6 million change related to operating assets and liabilities.

Net cash used in investing activities for the six-month period ended July 1, 2007 is primarily attributable to the purchase of marketable securities and the acquisition of fixed assets, offset by the sales and maturities of marketable securities. Net cash provided by investing activities for the six-month period ended July 2, 2006 is primarily attributable to sales and maturities of marketable securities, offset by purchases of marketable securities and the acquisition of fixed assets. The year-over-year increase in net cash used in investing activities was primarily as a result of decreased sales and maturities of marketable securities, partially offset by a decrease in purchases of marketable securities.

Net cash provided by financing activities for the six-month period ended July 1, 2007 was primarily attributable to proceeds received from exercises of employee stock options and purchases under our employee stock purchase plan and borrowings under our revolving bank line of credit, partially offset by the repayment of debt obligations. Net cash used in financing activities for the six-month period ended July 2, 2006 was attributable to payments on our debt obligations, partially offset by proceeds received from exercises of employee stock options and purchases under our employee stock purchase plan.

Until required for other purposes, our cash and cash equivalents are maintained in deposit accounts or highly liquid investments with remaining maturities of 90 days or less at the time of purchase. Our marketable securities, which include commercial paper, auction rate securities, corporate notes, and government bonds, are considered short-term as they are available to fund current operations.

Liquidity Sources, Requirements and Contractual Cash Requirements and Commitments

Our principal sources of liquidity are our cash, cash equivalents, and marketable securities. Historically, our principal liquidity requirements have been to meet our working capital and capital expenditure needs.

Our primary source of cash is sales made through our websites, for which we collect cash from credit card settlements or insurance reimbursements. Our primary uses of cash are purchases of inventory, salaries, marketing expenses, and overhead and fixed costs. Any projections of our future cash needs and cash flows are subject to substantial uncertainty for the reasons discussed in the sections entitled “*Risk Factors*” in Part II, Item 1A of this quarterly report and Part I, Item 1A of our annual report on Form 10-K for the year ended December 31, 2006.

In April 2007, we entered into an amended and restated loan and security agreement with our existing bank. This agreement includes a revolving line of credit allowing for borrowings of up to \$10.0 million, which accrue interest at the prime rate. The revolving line of credit matures in March 2008. The agreement allows for the conversion of up to \$2.5 million of the outstanding balance into a term loan within 60 days of maturity. For the six months ended July 1, 2007, borrowings under the existing line of credit totaled \$1.3 million, of which \$1.0 million was converted into a term loan in April 2007 and \$300,000 remains outstanding as of July 1, 2007 under the amended and restated loan and security agreement. The term loan will be paid in thirty-six monthly installments and accrues interest at the prime rate plus 0.50%.

As of July 1, 2007, we did not have any future material non-cancelable commitments to purchase goods or services.

We believe that our cash and marketable securities on hand plus our sources of cash will be sufficient to fund our operations and anticipated capital expenditures. However, any projections about our future cash needs and cash flows are subject to substantial uncertainty. As a result, we may need to raise additional monies to fund our operating activities or for strategic flexibility (if, for example, we decide to pursue business or technology acquisitions) or if our expectations regarding our operations and anticipated capital expenditures change. We have assessed in the past, and will continue to assess, opportunities for raising additional funds by selling equity, equity-related or debt securities, obtaining additional credit facilities, or obtaining other means of financing for strategic

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reasons or to further strengthen our financial position. We cannot be certain that additional financing will be available to us on acceptable terms when required, or at all. Furthermore, if we were to raise additional funds through the issuance of securities, such securities may have rights, preferences, or privileges senior to those of the rights of our common stock and our stockholders may experience additional dilution.

Management Outlook

For the third quarter of fiscal year 2007, we are targeting net sales in the range of \$109.0 million to \$111.0 million and a net loss in the range of \$3.0 million to \$3.5 million.

Item 3. *Quantitative and Qualitative Disclosures about Market Risk*

We have assessed our vulnerability to certain market risks, including interest rate risk associated with marketable securities, accounts receivable, accounts payable, capital lease obligations, bank line of credit, and cash and cash equivalents. Due to the short-term nature of these investments and our investment policies and procedures, we have determined that the risk associated with interest rate fluctuations related to these financial instruments is not material to us.

We have interest rate exposure arising from our financing facilities, which have variable rates. These variable interest rates are affected by changes in short-term interest rates. We manage our interest rate exposure by maintaining a conservative debt-to-equity ratio. We believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations, and cash flows will not be material. Our financing facilities expose our net earnings to changes in short-term interest rates because interest rates on the underlying obligations are variable. Borrowings outstanding under the variable interest-bearing financing facilities totaled \$1.9 million at July 1, 2007, and the highest interest rate attributable to this outstanding balance was 8.75% at July 1, 2007. A change in net earnings resulting from a hypothetical 10% increase or decrease in interest rates would not be material.

We have investment risk exposure arising from our investments in marketable securities. As of July 1, 2007, we had \$27.9 million of securities classified as “marketable securities.” We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that declines in the fair value of such assets below our accounting basis are other-than-temporary.

Item 4. *Controls and Procedures*

We have performed an evaluation under the supervision and with the participation of our management, including our chief executive officer, chief financial officer, and chief accountant of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15 (e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act). Based on that evaluation, our management, including our chief executive officer, chief financial officer, and chief accountant concluded that, as of July 1, 2007, our disclosure controls and procedures were effective in ensuring that all material information required to be disclosed in reports filed or submitted by us under the Exchange Act is made known to them in a timely fashion.

During the quarter ended July 1, 2007, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

See Note 7 of our consolidated financial statements, “*Commitments and Contingencies—Legal Proceedings*,” included in Part I, Item 1 of this quarterly report, for a discussion of the material legal proceedings to which we are a party.

Item 1A. Risk Factors

The risk factor disclosure included under Item 1A of our annual report on Form 10-K for the fiscal year end December 31, 2006, filed with the Securities and Exchange Commission on March 16, 2007 (the “Form 10-K”) has not materially changed other than as set forth below.

We have a history of generating significant losses, and may never be profitable.

We have incurred net losses of \$757.1 million through July 1, 2007. To date, we have not become profitable, and we may never achieve profitability. We expect to continue to incur net losses for at least the next year, and possibly longer. As a result, our stock price may decline and investors may lose all or a part of their investment in our common stock.

The information above updates and should be read in conjunction with the discussion of our risk factors contained in Item 1A of the Form 10-K.

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

On June 19, 2007, in connection with the performance of services, we issued to certain of our financial advisors a fully vested warrant to purchase 200,000 shares of our common stock at \$2.50 per share, which expires in June 2017. The issuance of this warrant was exempt from registration under the Securities Act of 1933, as amended, as a private offering under Section 4(2) of the Securities Act.

Item 3. Defaults Upon Senior Securities.

None.

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

We held our annual meeting of stockholders on June 6, 2007, where our stockholders voted on the following matters:

Proposal 1: Our stockholders elected the following directors:

<u>Nominee</u>	<u>Votes For</u>	<u>Votes Withheld</u>
Richard W. Bennet III	84,106,879	1,294,374
Geoffrey R. Entress	84,082,914	1,318,339
Jeffrey M. Killeen	83,128,784	2,272,469
Dawn G. Lepore	84,070,566	1,330,687
William D. Savoy	82,685,870	2,715,383
Gregory S. Stanger	83,642,376	1,758,877

Proposal 2: Our stockholders ratified the appointment of Ernst & Young LLP to serve as our independent registered public accounting firm for fiscal year 2007, with 83,278,291 votes for, 2,033,953 against and 89,010 abstentions.

Item 5. Other Information.

(a) On April 4, 2007, the compensation committee of our board of directors adopted an incentive bonus plan under which certain of our employees, including our chief executive officer, chief financial officer, and other executive officers, may receive semi-annual cash bonuses based on the individual’s performance and our achievement in fiscal year 2007 of specified targets related to net revenue and adjusted EBITDA.

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Adjusted EBITDA is a non-GAAP measure defined as earnings before interest, taxes, depreciation, and amortization of intangible assets and non-cash marketing expenses, adjusted to exclude the impact of stock-based compensation expense. Management believes that adjusted EBITDA, as defined, provides useful information to the company and to investors by excluding certain items that may not be indicative of the company's core operating results. Net income (loss) is the closest GAAP financial measure in terms of comparability to adjusted EBITDA.

The executive officer's target bonus level is a factor of his or her position and responsibilities. Generally, the executive officers are eligible to receive an aggregate target bonus, if any, of 25% of his or her annual salary. Dawn Lepore, our chief executive officer and chairman of the board, is eligible for an aggregate target bonus ranging from 50% to 150% of her annual salary. Thère du Pont, our senior vice president, operations and chief financial officer, who joined the company earlier this year, is eligible for a target bonus of 60% of his salary earned in 2007.

Under the plan, if we achieve specific graduated net revenue and adjusted EBITDA thresholds, each executive officer could be eligible to receive anywhere from 0% of his or her target bonus amount, if we fail to meet the thresholds, to 200% of the target amount, if we vastly exceed our expected performance for the year. In addition, an executive officer could be eligible to receive up to an additional 50% of his or her target bonus amount, based on his or her achievement of individual performance objectives.

The bonus is payable in two payments. First, on August 3, 2007, we paid bonuses to our executive officers equal to five percent of such officer's year-to-date salary earned as of June 30, 2007, based on our achievement of specific, graduated mid-year net revenue and adjusted EBITDA thresholds established by the compensation committee. Under this plan, we paid bonuses of \$10,000 to Ms. Lepore, \$5,356 to Luke Friang, our vice president and chief information officer, and \$6,644 to Robert Barton, our former vice president, finance and operations and chief financial officer, who resigned earlier this year. Then, in February 2008, we will pay the balance of any bonus amount earned if we achieve specific graduated full-year net revenue and adjusted EBITDA thresholds, plus any additional amount based on the executive officer's achievement of his or her individual performance. The compensation committee implemented the mid-year bonus payment in order to align employees' incentives more closely with our quarterly as well as full-year results.

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Item 6. Exhibits

<u>Exhibit No.</u>	<u>Exhibit Description</u>
3.1	Amended and Restated Certificate of Incorporation of drugstore.com, inc. (incorporated by reference to Exhibit 3.2 to drugstore.com, inc.'s registration statement on Form S-1 filed February 9, 2000 (Registration No. 333-96441)).
3.1a	Certificate of Designation of Series 1 Preferred Stock of drugstore.com, inc. (incorporated by reference to Exhibit 3.1a to drugstore.com, inc.'s quarterly report on Form 10-Q for the Quarter Ended July 2, 2000 (SEC File No. 000-26137)).
3.2	Amended and Restated Bylaws of drugstore.com, inc. dated January 7, 2005 (incorporated by reference to Exhibit 3.2 to drugstore.com inc.'s annual report on Form 10-K for the Fiscal Year Ended January 1, 2006 (SEC File No. 000-26137)).
4.1	Form of Warrant issued June 19, 2007.
10.1	Offer Letter to Thère du Pont dated May 15, 2007 (incorporated by reference to Exhibit 10.1 to drugstore.com, inc.'s current report on Form 8-K dated May 21, 2007 (SEC File No. 000-26137)).
10.2	Change of Control Agreement between drugstore.com, inc. and Thère du Pont date May 21, 2007 (incorporated by reference to Exhibit 10.2 to drugstore.com, inc.'s current report on Form 8-K dated May 21, 2007 (SEC File No. 000-26137))
31.1	Certification of Dawn G. Lepore, President, Chief Executive Officer and Chairman of the Board of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Eleuthère I. du Pont, Senior Vice President of Operations and Chief Financial Officer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Dawn G. Lepore, President, Chief Executive Officer and Chairman of the Board of drugstore.com, inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Eleuthère I. du Pont, Senior Vice President of Operations and Chief Financial Officer of drugstore.com, inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

DRUGSTORE.COM, INC.
(Registrant)

By: /s/ Eleuthère I. du Pont
Eleuthère I. du Pont
*Senior Vice President of Operations and Chief
Financial Officer*

Date: August 8, 2007

THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 OR THE LAWS OF ANY STATE. THEY MAY NOT BE SOLD OR OTHERWISE TRANSFERRED UNLESS THEY ARE REGISTERED UNDER SUCH ACT AND APPLICABLE STATE SECURITIES LAWS OR AN EXEMPTION FROM REGISTRATION IS AVAILABLE.

_____ Warrants

drugstore.com, inc.
WARRANT CERTIFICATE
Warrant No. W- __

This warrant certificate (“Warrant Certificate”) certifies that for value received _____ or registered assigns (the “Holder”) is the owner of the number of warrants (“Warrants”) specified above, each of which entitles the Holder thereof to purchase, at any time on or before the Expiration Date (hereinafter defined) one fully paid and non-assessable share of Common Stock, \$0.0001 par value (“Common Stock”), of drugstore.com, inc., a Delaware corporation (the “Company”), at a purchase price of \$2.50 per share of Common Stock in lawful money of the United States of America in cash or by certified or cashier’s check or a combination of cash and certified or cashier’s check, subject to adjustment as hereinafter provided.

1 Warrant; Purchase Price

Each Warrant shall entitle the Holder to purchase one share of Common Stock of the Company and the purchase price payable upon exercise of the Warrants shall initially be \$2.50 per share of Common Stock, subject to adjustment as hereinafter provided (the “Purchase Price”). The Purchase Price and number of shares of Common Stock issuable upon exercise of each Warrant are subject to adjustment as provided in Article 6.

2 Exercise; Expiration Date

2.1 The Warrants are exercisable, at the option of the Holder, at any time after issuance and on or before the Expiration Date, upon surrender of this Warrant Certificate to the Company together with a duly completed Notice of Exercise, in the form attached hereto as Exhibit A, and payment of an amount equal to the Purchase Price times the number of Warrants to be exercised. In the case of exercise of less than all the Warrants represented by this Warrant Certificate, the Company shall cancel the Warrant Certificate upon the surrender thereof and shall execute and deliver a new Warrant Certificate for the balance of such Warrants.

2.2 The term “Expiration Date” shall mean 5:00 p.m. New York time on June 5, 2017 or if such date shall in the State of New York be a holiday or a day on which banks are authorized to close, then 5:00 p.m. New York time the next following date that in the State of New York is not a holiday or a day on which banks are authorized to close.

3 Registration and Transfer on Company Books

3.1 The Company shall maintain books for the registration and transfer of the Warrants and the registration and transfer of the shares of Common Stock issued upon exercise of the Warrants.

3.2 Prior to due presentment for registration of transfer of this Warrant Certificate, or the shares of Common Stock issued upon exercise of the Warrants, the Company may deem and treat the registered Holder as the absolute owner thereof.

3.3 Neither this Warrant nor the shares of Common Stock issuable upon exercise hereof have been registered under the Securities Act of 1933, as amended (the “Act”). The Holder will not transfer this Warrant or issue or transfer the shares of Common Stock issuable upon exercise hereof unless (i) there is an effective registration covering such Warrant or such shares, as the case may be, under the Act and applicable states securities laws, (ii) it first receives a letter from an attorney, acceptable to the Company’s board of directors or its agents, stating that in the opinion of the attorney the proposed issue or transfer is exempt from registration under the Act and under all applicable state securities laws, or (iii) the transfer is made pursuant to Rule 144 under the Act. Subject to the foregoing, this Warrant Certificate, the Warrants represented hereby, and the shares of Common Stock issued upon exercise of the Warrants, may be sold, assigned or otherwise transferred voluntarily by the Holder to officers or directors of the Holder, to members of such persons’ immediate families, or to the Holder’s parent or subsidiary corporations. The Company shall register upon its books any permitted transfer of a Warrant Certificate, upon surrender of same to the Company with a written instrument of transfer duly executed by the registered Holder or by a duly authorized attorney. Upon any such registration of transfer, new Warrant Certificate(s) shall be issued to the transferee(s) and the surrendered Warrant Certificate shall be canceled by the Company. A Warrant Certificate may also be exchanged, at the option of the Holder, for new Warrant Certificates representing in the aggregate the number of Warrants evidenced by the Warrant Certificate surrendered.

3.4 The Warrant and the Common Stock issuable upon exercise of the Warrant will be acquired for investment and not with a view to the sale or distribution of any part thereof, and the Holder has no present intention of selling or engaging in any public distribution of the same except pursuant to a registration or exemption pursuant to the 1933 Act.

3.5 The Holder has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of its investment, and has the ability to bear the economic risks of its investment.

3.6 Holder is an “*accredited investor*” within the meaning of Rule 501 of Regulation D under the 1933 Act, as presently in effect.

4 Reservation of Shares

The Company covenants that it will at all times reserve and keep available out of its authorized Common Stock, solely for the purpose of issuance upon exercise of the Warrants, such number of shares of Common Stock as shall then be issuable upon the exercise of all outstanding Warrants. The Company covenants that all shares of Common Stock that shall be issuable upon exercise of the Warrants shall be duly and validly issued and, upon payment for such shares as set forth herein, fully paid and non-assessable and free from all taxes, liens and charges with respect to the issue thereof, and that upon issuance such shares shall be listed on each national securities exchange, if any, on which the other shares of outstanding Common Stock of the Company are then listed.

5 Loss or Mutilation

Upon receipt by the Company of reasonable evidence of the ownership of and the loss, theft, destruction or mutilation of any Warrant Certificate and, in the case of loss, theft or destruction, of indemnity reasonably satisfactory to the Company, or, in the case of mutilation, upon surrender and cancellation of the mutilated Warrant Certificate, the Company shall execute and deliver in lieu thereof a new Warrant Certificate representing an equal number of Warrants.

6 Adjustment of Purchase Price and Number of Shares Deliverable

6.1 The number of shares of Common Stock purchasable upon the exercise of each Warrant (such shares being referred to in this Section 6 as the “Warrant Shares”) and the Purchase Price with respect to the Warrant Shares shall be subject to adjustment as follows:

(a) In case the Company shall (i) declare a dividend or make a distribution on its Common Stock payable in shares of its capital stock, (ii) subdivide its outstanding shares of Common Stock through stock split or otherwise, (iii) combine its outstanding shares of Common Stock into a smaller number of shares of Common Stock, or (iv) issue by reclassification of its Common Stock (including any such reclassification in connection with a consolidation or merger in which the Company is the continuing corporation) other securities of the Company, the number and/or nature of Warrant Shares purchasable upon exercise of each Warrant immediately prior thereto shall be adjusted so that the Holder shall be entitled to receive the kind and number of Warrant Shares or other securities of the Company which he would have owned or have been entitled to receive after the happening of any of the events described above, had such Warrant been exercised immediately prior to the happening of such event or any record date with respect thereto. An adjustment made pursuant to this paragraph (a) shall become effective retroactively as of the record date of such event.

(b) In case the Company shall issue rights, options or warrants or securities convertible into Common Stock to the holders of its shares of Common Stock generally, entitling

them (for a period expiring within forty-five (45) days after the record date referred below in this paragraph (b)) to subscribe for or purchase shares of Common Stock at a price per share which (together with the value of the consideration, if any, paid for such rights, options, warrants or convertible securities) is lower on the record date referred to below than the then Market Price Per Share of Common Stock (as determined pursuant to Section 9.2) the number of Warrant Shares thereafter purchasable upon the exercise of each Warrant shall be determined by multiplying the number of Warrant Shares immediately theretofore purchasable upon exercise of each Warrant by a fraction, of which the numerator shall be the number of shares of Common Stock outstanding on such record date plus the number of additional shares of Common Stock offered for subscription or purchase, and of which the denominator shall be the number of shares of Common Stock outstanding on such record date plus the number of shares which the aggregate offering price of the total number of shares of Common Stock so offered would purchase at the then Market Price Per Share of Common Stock. Such adjustment shall be made whenever such rights, options, warrants or convertible securities are issued, and shall become effective retroactively as of the record date for the determination of shareholders entitled to receive such rights, options, warrants or convertible securities.

(c) In case the Company shall distribute to all holders of its shares of Common Stock, or all holders of Common Stock shall otherwise become entitled to receive, shares of capital stock of the Company (other than dividends or distributions on its Common Stock referred to in paragraph (a) above), evidences of its indebtedness or rights, options, warrants or convertible securities providing the right to subscribe for or purchase any shares of the Company's capital stock or evidences of its indebtedness (other than any rights, options, warrants or convertible securities referred to in paragraph (b) above), then in each case the number of Warrant Shares thereafter purchasable upon the exercise of each Warrant shall be determined by multiplying the number of Warrant Shares theretofore purchasable upon the exercise of each Warrant, by a fraction, of which the numerator shall be the then Market Price Per Share of Common Stock (as determined pursuant to Section 9.2) on the record date mentioned below in this paragraph (c), and of which the denominator shall be the then Market Price Per Share of Common Stock on such record date, less the then fair value per share (as determined by the Board of Directors of the Company, in good faith) of the portion of the shares of the Company's capital stock other than Common Stock, evidences of indebtedness, or of such rights, options, warrants or convertible securities, distributable with respect to each share of Common Stock. Such adjustment shall be made whenever any such distribution is made, and shall become effective retroactively as of the record date for the determination of shareholders entitled to receive such distribution.

(d) In the event of any capital reorganization or any reclassification of the capital stock of the Company or in case of the consolidation or merger of the Company with another corporation (other than a consolidation or merger in which the outstanding shares of the Company's Common Stock are not converted into or exchanged for other rights or interests), or in the case of any sale, transfer or other disposition to another corporation of all or substantially all the properties and assets of the Company, the Holder of each Warrant shall thereafter be entitled to purchase (and it shall be a condition to the consummation of any such reorganization, reclassification, consolidation, merger, sale, transfer or other disposition that appropriate

provisions shall be made so that such Holder shall thereafter be entitled to purchase) the kind and amount of shares of stock and other securities and property (including cash) which the Holder would have been entitled to receive had such Warrants been exercised immediately prior to the effective date of such reorganization, reclassification, consolidation, merger, sale, transfer or other disposition; and in any such case appropriate adjustments shall be made in the application of the provisions of this Article 6 with respect to rights and interest thereafter of the Holder of the Warrants to the end that the provisions of this Article 6 shall thereafter be applicable, as near as reasonably may be, in relation to any shares or other property thereafter purchasable upon the exercise of the Warrants. The provisions of this Section 6.1(d) shall similarly apply to successive reorganizations, reclassifications, consolidations, mergers, sales, transfers or other dispositions.

(e) Whenever the number of Warrant Shares purchasable upon the exercise of each Warrant is adjusted, as provided in this Section 6.1, the Purchase Price with respect to the Warrant Shares shall be adjusted by multiplying such Purchase Price immediately prior to such adjustment by a fraction, of which the numerator shall be the number of Warrant Shares purchasable upon the exercise of each Warrant immediately prior to such adjustment, and of which the denominator shall be the number of Warrant Shares so purchasable immediately thereafter.

6.2 In the event the Company shall declare a dividend, or make a distribution to the holders of its Common Stock generally, whether in cash, property or assets of any kind, including any dividend payable in stock or securities of any other issuer owned by the Company (excluding regularly payable cash dividends declared from time to time by the Company's Board of Directors or any dividend or distribution referred to in Section 6.1(a) or (c) above), the Purchase Price of each Warrant shall be reduced, without any further action by the parties hereto, by the Per Share Value (as hereinafter defined) of the dividend. For purposes of this Section 6.2, the "Per Share Value" of a cash dividend or other distribution shall be the dollar amount of the distribution on each share of Common Stock and the "Per Share Value" of any dividend or distribution other than cash shall be equal to the fair market value of such non-cash distribution on each share of Common Stock as determined in good faith by the Board of Directors of the Company.

6.3 In case the Company shall at any time or from time to time after issuance issue any shares of Common Stock or rights to acquire Common Stock (other than shares issued in any transactions covered by paragraph (a) of Section 6.1 hereof), for a consideration per share less than the Purchase Price with respect to the Warrant Shares in effect on the date of such issue, then, forthwith upon such issue, the Purchase Price with respect to the Warrant Shares shall be reduced to a price determined by dividing (a) the sum of (i) the number of shares of Common Stock of the Company outstanding immediately prior to such issue multiplied by the Purchase Price of the Warrant Shares in effect immediately prior to such issue, plus (ii) the consideration, if any, received by the Company upon such issue, by (b) the number of shares of Common Stock of the Company outstanding immediately after such issue. In addition to such adjustment to the Purchase Price, the number of Warrant Shares purchasable under each Warrant shall be increased to a number determined by dividing (x) the number of Warrant Shares purchasable under such Warrant immediately prior to such issue, multiplied by the Purchase Price in effect immediately

prior to such issuance, by (y) the Purchase Price of the Warrant Shares in effect immediately after the foregoing adjustment. For the purpose of the above determination, the follow provisions shall be applicable:

(a) In case the Company shall in any manner issue any options, warrants or other rights to subscribe for or to purchase shares of Common Stock, then, for the purposes of this Section 6.3, (i) all shares which the holders of such rights shall be entitled thereby to subscribe for or purchase shall be deemed to be issued as of the date of issue of such rights, and (ii) the minimum aggregate consideration payable pursuant to such rights for the shares covered thereby, plus the consideration, if any, received by the Company for such rights, shall be deemed to be the consideration actually received by the Company (as of the date of the issue of such rights) for the issue of the total number of shares underlying such rights.

(b) In case the Company shall in any manner issue any securities or obligations directly or indirectly convertible into or exchangeable for shares of Common Stock, then, for the purposes of this Section 6.3, (i) all shares to which holders of such securities or obligations shall thereby be entitled upon conversion or exchange shall be deemed to be issued as of the date of issue of such securities or obligations, and (ii) the aggregate amount received or receivable by the Company in consideration for the issue of such securities or obligations, plus the minimum aggregate amount of additional consideration, if any, payable upon conversion or exchange of such securities or obligations, shall be deemed to be the consideration actually received (as of the date of the issue of such securities or obligations) for the issue of the total number of shares issuable upon conversion or exchange of such securities or obligations.

(c) The consideration received by the Company for any shares of Common Stock, or rights to acquire Common Stock, shall be deemed to be the proceeds received for such shares or rights, excluding cash received on account of accrued interest or accrued dividends and after deducting therefrom any and all commissions and expenses paid or incurred by the Company for any underwriting of, or otherwise in connection with, the issue of such shares or rights.

(d) No adjustment of the Purchase Price of the Warrant Shares shall be made as a result of or in connection with the issuance of (i) any shares of Common Stock issuable upon the exercise or conversion of any options, convertible securities or other rights outstanding on the date of original issuance of this Warrant Certificate or (ii) any shares of Common Stock or options to purchase Common Stock hereafter issued in connection with any duly authorized employee stock option plan, stock purchase plan or restricted stock award plan of the Company.

(e) For the purposes of this Section 6.3, (i) the term "issue" of shares or securities by the Company shall be deemed to include any issuance, sale or other disposition of shares or securities of the Company, including shares held in the treasury of the Company, (ii) the term "Common Stock" shall include any capital stock of the Company other than preferred stock with a fixed limit on dividends and a fixed amount payable in the event of any liquidation, and (iii) in no event shall the Purchase Price with respect to the Warrant Shares be increased, or the number of Warrant Shares purchasable under any Warrant be decreased, as a result of the provisions of this Section 6.3.

6.4 No adjustment in the number of Warrant Shares purchasable under the Warrants, or in the Purchase Price with respect to the Warrant Shares, shall be required unless such adjustment would require an increase or decrease of at least 1% in the number of Warrant Shares issuable upon the exercise of such Warrant, or in the Purchase Price thereof; provided, however, that any adjustments which by reason of this Section 6.4 are not required to be made shall be carried forward and taken into account in any subsequent adjustment. All final results of adjustments to the number of Warrant Shares and the Purchase Price thereof shall be rounded to the nearest one thousandth of a share or the nearest cent, as the case may be. Anything in this Section 6 to the contrary notwithstanding, the Company shall be entitled, but shall not be required, to make such changes in the number of Warrant Shares purchasable upon the exercise of each Warrant, or in the Purchase Price thereof, in addition to those required by such Section, as it in its discretion shall determine to be advisable in order that any dividend or distribution in shares of Common Stock, subdivision, reclassification or combination of shares of Common Stock, issuance of rights, warrants or options to purchase Common Stock, or distribution of shares of stock other than Common Stock, evidences of indebtedness or assets (other than distributions of cash out of retained earnings) or convertible or exchangeable securities hereafter made by the Company to the holders of its Common Stock shall not result in any tax to the holders of its Common Stock or securities convertible into Common Stock.

6.5 Whenever the number of Warrant Shares purchasable upon the exercise of each Warrant or the Purchase Price of such Warrant Shares is adjusted, as herein provided, the Company shall mail to the Holder, at the address of the Holder shown on the books of the Company, a notice of such adjustment or adjustments, prepared and signed by the Chief Financial Officer or Secretary of the Company, which sets forth the number of Warrant Shares purchasable upon the exercise of each Warrant and the Purchase Price of such Warrant Shares after such adjustment, a brief statement of the facts requiring such adjustment and the computation by which such adjustment was made.

6.6 In the event that at any time prior to the expiration of the Warrants and prior to their exercise:

(a) the Company shall declare any distribution (other than a cash dividend or a dividend payable in securities of the Company with respect to the Common Stock); or

(b) the Company shall offer for subscription to the holders of the Common Stock any additional shares of stock of any class or any other securities convertible into Common Stock or any rights to subscribe thereto; or

(c) the Company shall declare any stock split, stock dividend, subdivision, combination, or similar distribution with respect to the Common Stock, regardless of the effect of any such event on the outstanding number of shares of Common Stock; or

(d) the Company shall declare a dividend, other than a dividend payable in shares of the Company's own Common Stock; or

(e) there shall be any capital change in the Company as set forth in Section 6.1(d); or

(f) there shall be a voluntary or involuntary dissolution, liquidation, or winding up of the Company (other than in connection with a consolidation, merger, or sale of all or substantially all of its property, assets and business as an entity);

(each such event hereinafter being referred to as a "Notification Event"), the Company shall cause to be mailed to the Holder, not less than twenty (20) days prior to the record date, if any, in connection with such Notification Event (provided, however, that if there is no record date, or if twenty (20) days prior notice is impracticable, as soon as practicable) written notice specifying the nature of such event and the effective date of, or the date on which the books of the Company shall close or a record shall be taken with respect to, such event. Such notice shall also set forth facts indicating the effect of such action (to the extent such effect may be known at the date of such notice) on the Purchase Price and the kind and amount of the shares of stock or other securities or property deliverable upon exercise of the Warrants. For purposes here of, a business day shall mean any day other than a Saturday, Sunday or any other day in which commercial banks are authorized by law to be closed in New York, New York.

6.7 The form of Warrant Certificate need not be changed because of any change in the Purchase Price, the number of Warrant Shares issuable upon the exercise of a Warrant or the number of Warrants outstanding pursuant to this Section 6, and Warrant Certificates issued before or after such change may state the same Purchase Price, the same number of Warrants, and the same number of Warrant Shares issuable upon exercise of Warrants as are stated in the Warrant Certificates theretofore issued pursuant to this Agreement. The Company may, however, at any time, in its sole discretion, make any change in the form of Warrant Certificate that it may deem appropriate and that does not affect the substance thereof, and any Warrant Certificates thereafter issued or countersigned, whether in exchange or substitution for an outstanding Warrant Certificate or otherwise, may be in the form as so changed.

7 Conversion Rights

7.1 In lieu of exercise of any portion of the Warrants as provided in Section 2.1 hereof, the Warrants represented by this Warrant Certificate (or any portion thereof) may, at the election of the Holder, be converted into the nearest whole number of shares of Common Stock equal to: (1) the product of (a) the number of Warrants to be so converted, (b) the number of shares of Common Stock then issuable upon the exercise of each Warrant and (c) the excess, if any, of (i) the Market Price Per Share (as determined pursuant to Section 9.2) with respect to the date of conversion over (ii) the Purchase Price in effect on the business day next preceding the date of conversion, divided by (2) the Market Price Per Share with respect to the date of conversion.

7.2 The conversion rights provided under this Section 7 may be exercised in whole or in part and at any time and from time to time while any Warrants remain outstanding. In order to exercise the conversion privilege, the Holder shall surrender to the Company, at its offices, this Warrant Certificate accompanied by a duly completed Notice of Conversion in the form attached hereto as Exhibit B. The Warrants (or so much thereof as shall have been surrendered for conversion) shall be deemed to have been converted immediately prior to the close of business on the day of surrender of such Warrant Certificate for conversion in accordance with the foregoing provisions. As promptly as practicable on or after the conversion date, the Company shall issue and shall deliver to the Holder (i) a certificate or certificates representing the number of shares of Common Stock to which the Holder shall be entitled as a result of the conversion, and (ii) if the Warrant Certificate is being converted in part only, a new certificate in principal amount equal to the unconverted portion of the Warrant Certificate.

8 Voluntary Adjustment by the Company

The Company may, at its option, at any time during the term of the Warrants, reduce the then current Purchase Price to any amount deemed appropriate by the Board of Directors of the Company and/or extend the date of the expiration of the Warrants.

9 Fractional Shares and Warrants; Determination of Market Price Per Share

9.1 Anything contained herein to the contrary notwithstanding, the Company shall not be required to issue any fraction of a share of Common Stock in connection with the exercise of Warrants. Warrants may not be exercised in such number as would result (except for the provisions of this paragraph) in the issuance of a fraction of a share of Common Stock unless the Holder is exercising all Warrants then owned by the Holder. In such event, the Company shall, upon the exercise of all of such Warrants, issue to the Holder the largest aggregate whole number of shares of Common Stock called for thereby upon receipt of the Purchase Price for all of such Warrants and pay a sum in cash equal to the remaining fraction of a share of Common Stock, multiplied by its Market Price Per Share (as determined pursuant to Section 9.2 below) as of the last business day preceding the date on which the Warrants are presented for exercise.

9.2 As used herein, the "Market Price Per Share" with respect to any date shall mean the closing price per share of Company's Common Stock for the trading day immediately preceding such date. The closing price for each such day shall be the last sale price regular way or, in case no such sale takes place on such day, the average of the closing bid and asked prices regular way, in either case on the principal securities exchange on which the shares of Common Stock of the Company are listed or admitted to trading, the last sale price, or in case no sale takes place on such day, the average of the closing bid and asked prices of the Common Stock on NASDAQ or any comparable system, or if the Common Stock is not reported on NASDAQ, or a comparable system, the average of the closing bid and asked prices as furnished by two members of the National Association of Securities Dealers, Inc. selected from time to time by the Company for that purpose. If such bid and asked prices are not available, then "Market Price Per Share" shall be equal to the fair market value of the Company's Common Stock as determined in good faith by the Board of Directors of the Company.

10 Registration Rights

10.1 No sale, transfer, assignment, hypothecation or other disposition of the Warrant Shares shall be made unless any such transfer, assignment or other disposition will comply with the rules and statutes administered by the Securities and Exchange Commission and (i) a registration statement under the Act, including such shares is currently in effect, or (ii) in the opinion of counsel satisfactory to the Company a current registration statement is not required for such disposition of the shares.

10.2 The Company agrees that the Holder shall have the one-time right, beginning on the date which is six months following the Company's initial public offering under the Act, upon written notice to the Company, to require that the Company prepare and promptly file a registration statement, as may be required under the Act, in connection with the public offering, on a time-to-time basis or otherwise, of not less than 50% of the then outstanding Warrant Shares. In connection therewith, the Company shall be obligated to prepare and file such registration statement within 45 days of receipt of any such initial notice and shall be further obligated to use its reasonable best efforts, including the filing of any amendments or supplements thereto, to have any such registration statement declared effective under the Act and the rules and regulations promulgated thereunder as soon as practicable after the filing date thereof. The Company shall also use its reasonable best efforts to keep any such registration statement, and the accompanying prospectus, effective and current under the Act at its expense for such period of time as is not otherwise burdensome to the Company, in no event to be less than 90 days. Notwithstanding anything to the contrary in this Warrant Certificate, the Company shall not be required to register any Warrant Shares pursuant to a request under Section 10 hereof if within twenty (20) days after its receipt of a request therefor, counsel for the Company delivers an opinion to the requesting Holder, in form and substance reasonably satisfactory to counsel for such Holder, that the proposed sale of Warrant Shares requested to be so registered may be effected in its entirety within a ninety (90) day following such request without registration and without any further holding period pursuant to SEC Rules 144 or 145(d) (if available).

10.3 In addition to the rights of the Holder pursuant to Section 10.2, the Company agrees that, at any time or times hereafter, as and when it intends to register any of its securities under the Act other than pursuant to a registration requested pursuant to Section 10.2 hereof, whether for its own account and/or on behalf of selling stockholders (except in connection with an offering on Form S-8 or an offering solely related to an acquisition or exchange on a Form S-4 or any subsequent similar form) the Company will notify the Holder of such intention (a "Registration Notice") and, upon request from the Holder, will use its reasonable best efforts to cause the Warrant Shares designated by the Holder to be registered under the Act. The number of Warrant Shares to be included in such offering may be reduced if and to the extent that the underwriter of securities included in the registration statement and offered by the Company shall be of the opinion that such inclusion would adversely affect the marketing of the securities to be sold by the Company therein; provided, however, that the

percentage of the reduction of such Warrant Shares shall be no greater than the percentage reduction of securities of other selling stockholders, as such percentage reductions are determined in the good faith judgment of the Company. The Company will use its reasonable best efforts to keep each such registration statement current for such period of time as is not otherwise burdensome to the Company, in no event to be less than 90 days.

10.4 Any registration statement referred to in subsection 10.2 or 10.3 hereof shall be prepared and processed in accordance with the following terms and conditions:

(i) the Holder will cooperate in furnishing promptly to the Company in writing any information requested by the Company in connection with the preparation, filing and processing of such registration statement.

(ii) To the extent requested by an underwriter of securities included in a registration statement referred to in Subsection 10.3 hereof and offered by the Company, the Holder will defer the sale of Warrant Shares for a period commencing twenty (20) days prior and terminating one hundred twenty (120) days after the effective date of the registration statement, provided that any principal shareholders of the Company who also have shares included in the registration statement will also defer their sales for a similar period.

(iii) The Company will furnish to the Holder such number of prospectuses or other documents incident to such registration as may from time to time be reasonably requested, and cause its shares to be qualified under the blue-sky laws of those states reasonably requested by the Holder.

(iv) The Company will indemnify the Holder (and any officer, director or controlling person of the Holder) and any underwriters acting on behalf of the Holder against all claims, losses, expenses, damages and liabilities (or actions in respect thereof) to which they may become subject under the Act or otherwise, arising out of or based upon any untrue or alleged untrue statement of any material facts contained in any registration statement filed pursuant hereto, or any document relating thereto, including all amendments and supplements, or arising out of or based upon the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein contained not misleading, and will reimburse the Holder (or such other aforementioned parties) or such underwriters for any legal and all other expenses reasonably incurred in accordance with investigating or defending any such claim, loss, damage, liability or action; provided, however, that the Company will not be liable where the untrue or alleged untrue statement or omission or alleged omission is based upon information furnished in writing to the Company by the Holder or any underwriter obtained by the Holder expressly for use therein, or as a result of the Holder's or any such underwriter's failure to furnish to the Company information duly requested in writing by counsel for the Company specifically for use therein. This indemnity agreement shall be in addition to any other liability the Company may have. The indemnity agreement of the Company contained in this paragraph (iv) shall remain operative and in full force and effect regardless of any investigation made by or on behalf of any indemnified party and shall survive the delivery of and payment for the Warrant Shares.

(v) The Holder will indemnify the Company (and any officer, director or controlling person of the Company) and any underwriters acting on behalf of the Company against all claims, losses, expenses, damages and liabilities (or actions in respect thereof) to which they may become subject under the Act or otherwise, arising out of or based upon any untrue or alleged untrue statement filed pursuant hereto, or any document relating thereto, including all amendments, and supplements, or arising out of or based upon the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein contained not misleading, and, will reimburse the Company (or such other aforementioned parties) or such underwriters for any legal and other expenses reasonably incurred in connection with investigating or defending any such claim, loss, damage, liability, or action; provided, however, that the Holder will be liable as aforesaid only to the extent that such untrue or alleged untrue statement or omission or alleged omission is based upon information furnished in writing to the Company by the Holder or any underwriter obtained by the Holder expressly for use therein, or as a result of its or such underwriter's failure to furnish the Company with information duly requested in writing by counsel for the Company specifically for use therein. This indemnity agreement contained in this paragraph (v) shall remain operative and in full force and effect regardless of any investigation made by or on behalf of any indemnified party and shall survive the delivery of and payment for the Warrant Shares.

(vi) Promptly after receipt by an indemnified party under this subsection 10.4 of notice of the commencement of any action, such indemnified party will, if a claim in respect thereof is to be made against the indemnifying party, promptly notify the indemnifying party of the commencement thereof, but the omission so to notify the indemnifying party will not relieve it from any liability which it may have to any indemnified party otherwise than under this subsection 10.4. In case any such action is brought against any indemnified party, and it notifies the indemnifying party of the commencement thereof, the indemnifying party will be entitled to participate in, and, to the extent that it may wish jointly with any other indemnifying party similarly notified, to assume the defense thereof, with counsel reasonably satisfactory to such indemnified party, and after notice from the indemnifying party of its election so to assume the defense thereof, the indemnifying party will not be liable to such indemnified party under this subsection 10.4 for any legal or other expenses subsequently incurred by such indemnified party in connection with the defense thereof, other than reasonable costs of investigation or out-of-pocket expenses or losses or cost incurred in collaborating in the defense.

(vii) Except as set forth in subsection 10.4(viii), the Company shall bear all costs and expenses incident to any registration pursuant to this Section 10.

(viii) The Holder shall pay any and all underwriters' discounts, commissions, brokerage fees and transfer taxes incident to the sale of any securities sold by such Holder pursuant to this Section 10, and shall pay the fees and expenses of any attorneys or accountants or other advisors retained by it.

10.5 Notwithstanding the foregoing, with respect to any demand made pursuant to Section 10.2, if the Company shall furnish to the Holder requesting to exercise the demand

right set forth in Section 10.2 above a certificate signed by the president of the Company stating that in the good faith judgment of the Board of Directors it would be seriously detrimental to the Company and its stockholders for such registration statement to be filed at the date filing would be required, and it is therefore essential to delay the filing of such registration statement, the Company shall have an additional period of not more than ninety (90) days within which to file such registration statement; provided, however, that the Company may exercise its delay right under this paragraph no more than one (1) time.

11 No Voting or Dividend Rights; Limitation of Liability

Nothing contained in this Warrant shall be construed as conferring on the Holder hereof the right to vote, to consent or to receive notice as a stockholder of the Company or any other matters or any rights whatsoever as a stockholder of the Company. No dividends or interest shall be payable or accrued in respect of this Warrant or the interest represented hereby or the shares purchasable hereunder until, and only to the extent that, this Warrant is exercised. No provisions hereof, in the absence of affirmative action by the Holder to purchase shares of Common Stock, and no mere enumeration herein of the rights or privileges of the Holder, shall give rise to any liability of such Holder for the Exercise Price or as a stockholder of the Company, whether such liability is asserted by the Company or by its creditors.

12 Governing Law

This Warrant Certificate shall be governed by and construed in accordance with the laws of the State of Delaware.

IN WITNESS WHEREOF, the Company has caused this Warrant Certificate to be duly executed by its officers thereunto duly authorized and its corporate seal to be affixed hereon, as of this _____ day of June, 2007.

drugstore.com, inc.

By: _____
Name: _____
Title: _____

[SEAL]

Attest:

Name: _____
Title: _____

NOTICE OF EXERCISE

The undersigned hereby irrevocably elects to exercise, pursuant to Section 2 of the Warrant Certificate accompanying this Notice of Exercise, _____ Warrants of the total number of Warrants owned by the undersigned pursuant to the accompanying Warrant Certificate, and herewith makes payment of the Purchase Price of such shares in full.

Name of Holder

Signature

Address:

NOTICE OF CONVERSION

The undersigned hereby irrevocably elects to convert, pursuant to Section 7 of the Warrant Certificate accompanying this Notice of Conversion, _____ Warrants of the total number of Warrants owned by the undersigned pursuant to the accompanying Warrant Certificate into shares of the Common Stock of the Company (the "Shares").

The number of Shares to be received by the undersigned shall be calculated in accordance with the provisions of Section 7.1 of the accompanying Warrant Certificate.

Name of Holder

Signature

Address:

CERTIFICATIONS

I, Dawn G. Lepore, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the registrant, drugstore.com, inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

August 8, 2007

/s/ Dawn G. Lepore

President, Chief Executive Officer and
Chairman of the Board

CERTIFICATIONS

I, Eleuthère I. du Pont, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the registrant, drugstore.com, inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

August 8, 2007

/s/ Eleuthère I. du Pont

Sr. Vice President of Operations and Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of drugstore.com, inc. (the "Company") for the period ending July 1, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Dawn G. Lepore, President, Chief Executive Officer and Chairman of the Board of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Dawn G. Lepore

President, Chief Executive Officer and Chairman of the Board

August 8, 2007

A signed original of this written statement required by Section 906 has been provided to drugstore.com, inc. and will be retained by drugstore.com, inc. and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of drugstore.com, inc. (the "Company") for the period ending July 1, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Eleuthère I. du Pont, Sr. Vice President of Operations and Chief Financial Officer, of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Eleuthère I. du Pont

Sr. Vice President of Operations and Chief Financial
Officer

August 8, 2007

A signed original of this written statement required by Section 906 has been provided to drugstore.com, inc. and will be retained by drugstore.com, inc. and furnished to the Securities and Exchange Commission or its staff upon request.