

DRUGSTORE COM INC

FORM 10-Q (Quarterly Report)

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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 September 30, 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 November 1, 2007, the registrant had 96,285,136 shares of common stock outstanding.

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DRUGSTORE.COM, INC.

FORM 10-Q

For the three and nine months ended September 30, 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		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Net sales	\$ 107,323	\$ 100,634	\$ 327,500	\$ 307,179
Costs and expenses:				
Cost of sales	82,431	79,012	252,810	240,846
Fulfillment and order processing	10,571	9,979	32,201	30,395
Marketing and sales	7,467	6,517	23,428	21,816
Technology and content	4,680	4,046	13,870	11,991
General and administrative	4,767	3,591	14,633	11,910
Amortization of intangible assets	240	531	990	1,592
Total costs and expenses	<u>110,156</u>	<u>103,676</u>	<u>337,932</u>	<u>318,550</u>
Operating loss	(2,833)	(3,042)	(10,432)	(11,371)
Interest income, net	459	449	1,265	1,292
Net loss	<u>\$ (2,374)</u>	<u>\$ (2,593)</u>	<u>\$ (9,167)</u>	<u>\$ (10,079)</u>
Basic and diluted net loss per share	<u>\$ (0.02)</u>	<u>\$ (0.03)</u>	<u>\$ (0.10)</u>	<u>\$ (0.11)</u>
Weighted average shares outstanding used to compute basic and diluted net loss per share	<u>95,664,011</u>	<u>93,488,258</u>	<u>95,056,884</u>	<u>93,198,037</u>

See accompanying notes to consolidated financial statements.

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

	September 30, 2007 <u>(Unaudited)</u>	December 31, 2006 <u>(Note 2)</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 9,962	\$ 13,393
Marketable securities	27,966	27,246
Accounts receivable, net of allowances	35,304	36,688
Inventories	22,500	26,469
Prepaid marketing expenses	2,290	2,290
Other current assets	3,606	2,615
Total current assets	101,628	108,701
Fixed assets, net	23,735	18,293
Other intangible assets, net	4,842	5,376
Goodwill	32,202	32,202
Prepaid marketing expenses and other	2,033	3,750
Total assets	<u>\$ 164,440</u>	<u>\$ 168,322</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 55,349	\$ 57,507
Accrued compensation	3,993	4,841
Accrued marketing expenses	3,292	3,661
Other current liabilities	1,144	1,292
Current portion of long-term debt obligations	2,695	3,949
Total current liabilities	66,473	71,250
Long-term debt obligations, less current portion	1,610	1,839
Deferred income taxes	945	945
Other long-term liabilities	1,394	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, 95,915,369 and 94,335,027 shares issued and outstanding	853,521	843,026
Accumulated other comprehensive income (loss)	5	(7)
Accumulated deficit	(759,508)	(750,341)
Total stockholders' equity	94,018	92,678
Total liabilities and stockholders' equity	<u>\$ 164,440</u>	<u>\$ 168,322</u>

See accompanying notes to consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Operating Activities:				
Net loss	\$ (2,374)	\$ (2,593)	\$ (9,167)	\$(10,079)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Depreciation	1,941	1,494	5,743	4,500
Amortization of marketing and sales agreements	572	572	1,717	1,717
Amortization of intangible assets	240	531	990	1,592
Stock-based compensation	2,147	1,760	7,114	5,016
Other	18	12	12	24
Changes in:				
Accounts receivable	958	1,476	1,384	(1,296)
Inventories	2,929	(1,800)	3,969	1,512
Prepaid marketing expenses and other current assets	(766)	124	(991)	488
Accounts payable, accrued expenses, and other liabilities	(1,225)	336	(3,739)	(4,453)
Net cash provided by (used in) operating activities	<u>4,440</u>	<u>1,912</u>	<u>7,032</u>	<u>(979)</u>
Investing Activities:				
Purchases of marketable securities	(5,379)	(5,125)	(16,540)	(18,031)
Sales and maturities of marketable securities	5,300	1,775	15,825	17,075
Purchases of fixed assets	(5,653)	(1,981)	(10,783)	(5,544)
Purchases of intangible assets	(456)	—	(456)	—
Net cash used in investing activities	<u>(6,188)</u>	<u>(5,331)</u>	<u>(11,954)</u>	<u>(6,500)</u>
Financing Activities:				
Proceeds from exercise of stock options and employee stock purchase plan	1,448	780	3,381	1,397
Borrowings on line of credit	—	1,000	300	1,000
Principal payments on capital leases and term loan obligations	(795)	(781)	(2,190)	(1,717)
Net cash provided by financing activities	<u>653</u>	<u>999</u>	<u>1,491</u>	<u>680</u>
Net decrease in cash and cash equivalents	(1,095)	(2,420)	(3,431)	(6,799)
Cash and cash equivalents at beginning of period	11,057	15,912	13,393	20,291
Cash and cash equivalents at end of period	<u>\$ 9,962</u>	<u>\$ 13,492</u>	<u>\$ 9,962</u>	<u>\$ 13,492</u>
Supplemental Cash Flow Information:				
Equipment acquired in capital lease agreements	<u>\$ 125</u>	<u>\$ 238</u>	<u>\$ 407</u>	<u>\$ 238</u>
Cash paid during the period for interest	<u>\$ 104</u>	<u>\$ 86</u>	<u>\$ 356</u>	<u>\$ 282</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, for shares related to the open offering period, from the calculation of diluted net loss per share, if 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		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
	(in thousands, except share and per share data)		(in thousands, except share and per share data)	
Numerator:				
Net loss	\$ (2,374)	\$ (2,593)	\$ (9,167)	\$ (10,079)
Denominator:				
Weighted average shares outstanding used in computation of basic and diluted net loss per share	95,664,011	93,488,258	95,056,884	93,198,037
Basic and diluted net loss per share	\$ (0.02)	\$ (0.03)	\$ (0.10)	\$ (0.11)

As of September 30, 2007 and October 1, 2006, there were 16,956,957 and 17,052,878 shares, respectively, of common stock subject to outstanding stock options and 865,000 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 drugstore.com. Options under this plan generally vest over four years, as follows: 20% of the shares vest after six months, and the

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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, of which certain 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 three-month period ended September 30, 2007, employees purchased 37,392 shares of our common stock under the 1999 ESPP in exchange for approximately \$94,000, and during the three-month period ended October 1, 2006, employees purchased 50,863 shares of common stock under the 1999 ESPP in exchange for approximately \$125,000. During the nine-month period ended September 30, 2007, employees purchased 92,585 shares of our common stock under the 1999 ESPP in exchange for approximately \$224,000, and during the nine-month period ended October 1, 2006, employees purchased 102,283 shares of common stock under the 1999 ESPP in exchange for approximately \$266,000.

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. In July 2007, we issued a fully vested warrant to purchase 50,000 shares of our common stock at \$2.53 per share, expiring in July 2017, in conjunction with a consulting agreement. The fair value of the warrant, determined using the Black-Scholes option pricing model, totaled \$121,000 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:

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Fulfillment and order processing	\$ 185	\$ 264	\$ 646	\$ 639
Marketing and sales	292	244	1,078	825
Technology and content	292	312	935	846
General and administrative	1,378	940	4,455	2,706
Total	<u>\$ 2,147</u>	<u>\$ 1,760</u>	<u>\$ 7,114</u>	<u>\$ 5,016</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	Weighted-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	(2,823,875)	2,823,875	\$ 2.76	
Options exercised	—	(1,487,757)	\$ 2.12	
Options forfeited	3,221,003	(3,221,003)	\$ 3.64	
Outstanding at September 30, 2007	9,590,690	16,956,957	\$ 3.47	
Vested and expected to vest at September 30, 2007		13,164,233	\$ 3.57	7.48
Exercisable at September 30, 2007		7,493,084	\$ 3.94	6.83

- (1) The balance as of December 31, 2006 has been adjusted for 153,982 shares forfeited during 2006 not reported in our annual report on 10-K for the year ended December 31, 2006.

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 nine months ended September 30, 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 September 30, 2007. The term loan totaled \$1.5 million at September 30, 2007 and accrues interest at the prime rate plus 0.50% (8.25% at September 30, 2007) and matures in March 2010.

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 oral argument on the legal issues was held on August 14, 2007. We are now awaiting the tax court's decision. 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 probable and 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 July 27, 1999 initial public offering and March 15, 2000 secondary offering (together, the "Offerings"). 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.

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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 October 9, 2002, the Court dismissed the Individual Defendants from the case without prejudice. On February 19, 2003, the Court denied our motion to dismiss the complaint. On December 5, 2006, the Second Circuit vacated a decision by the district court granting class certification in six of the coordinated cases, which are intended to serve as test, or “focus,” cases. The plaintiffs selected these six cases, which do not include us. On April 6, 2007, the Second Circuit denied a petition for rehearing filed by plaintiffs, but noted that plaintiffs could ask the district court to certify more narrow classes than those that were rejected.

Prior to the Second Circuit’s December 5, 2006 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, could not be certified. On June 25, 2007, the district court approved a stipulation filed by the plaintiffs and the issuers terminating the proposed settlement. On August 14, 2007, the plaintiffs filed amended complaints in the six focus cases. The amended complaints include a number of changes, such as changes to the definition of the purported class of investors, and the elimination of the individual defendants as defendants. On September 27, 2007, the plaintiffs filed a motion for class certification in the six focus cases. If the plaintiffs are successful in obtaining class certification, they are expected to amend the complaint against us and the other non-focus case issuers in the same manner that they amended the complaints against the focus case issuers and to seek certification of a class in our case.

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 effect 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.

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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, including drop ship arrangements with our vendors, 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).

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

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Over-the-Counter (OTC):				
Net sales	\$ 54,623	\$ 45,605	\$ 168,412	\$141,865
Cost of sales	38,630	31,848	119,091	99,144
Variable order costs (a)	5,232	4,482	15,780	13,194
Contribution margin (b)	<u>\$ 10,761</u>	<u>\$ 9,275</u>	<u>\$ 33,541</u>	<u>\$ 29,527</u>
Vision:				
Net sales	\$ 14,851	\$ 12,701	\$ 42,198	\$ 37,739
Cost of sales	11,284	9,932	32,255	29,348
Variable order costs (a)	737	608	2,035	1,917
Contribution margin (b)	<u>\$ 2,830</u>	<u>\$ 2,161</u>	<u>\$ 7,908</u>	<u>\$ 6,474</u>
Mail-Order Pharmacy:				
Net sales	\$ 11,485	\$ 17,178	\$ 37,414	\$ 52,883
Cost of sales	9,419	14,830	31,198	45,643
Variable order costs (a)	963	1,256	3,036	4,446
Contribution margin (b)	<u>\$ 1,103</u>	<u>\$ 1,092</u>	<u>\$ 3,180</u>	<u>\$ 2,794</u>
Local Pick-Up Pharmacy:				
Net sales (c)	\$ 26,364	\$ 25,150	\$ 79,476	\$ 74,692
Cost of sales	23,098	22,402	70,266	66,711
Variable order costs (a)	1,084	1,034	3,273	3,064
Contribution margin (b)	<u>\$ 2,182</u>	<u>\$ 1,714</u>	<u>\$ 5,937</u>	<u>\$ 4,917</u>
Consolidated:				
Net sales	\$ 107,323	\$100,634	\$ 327,500	\$307,179
Cost of sales	82,431	79,012	252,810	240,846
Variable order costs (a)	8,016	7,380	24,124	22,621
Consolidated contribution margin (b)	<u>\$ 16,876</u>	<u>\$ 14,242</u>	<u>\$ 50,566</u>	<u>\$ 43,712</u>
Less:				
Fixed fulfillment and order processing (d)	\$ 2,579	\$ 2,621	\$ 8,140	\$ 7,816
Marketing and sales (e)	7,443	6,495	23,365	21,774
Technology and content	4,680	4,046	13,870	11,991
General and administrative	4,767	3,591	14,633	11,910
Amortization of intangible assets	240	531	990	1,592
Operating loss	<u>\$ (2,833)</u>	<u>\$ (3,042)</u>	<u>\$ (10,432)</u>	<u>\$ (11,371)</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.

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- (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 \$5.7 million and \$5.5 million for the three-month periods ended September 30, 2007, and October 1, 2006, respectively, and \$17.4 million and \$16.6 million for the nine-month periods ended September 30, 2007 and October 1, 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 \$24,000 and \$22,000 for the three-month periods ended September 30, 2007, and October 1, 2006, respectively, and \$63,000 and \$42,000 for the nine-month periods ended September 30, 2007 and October 1, 2006, respectively.

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,” “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 at 1-800-DRUGSTORE, including nutritional supplements sold through our subsidiary Custom Nutrition Services, Inc., or CNS. We source our OTC products from various manufacturers and distributors. We also sell advertising on our primary OTC site www.drugstore.com. 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. During 2007, we have focused 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.

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- *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. During 2007, we have focused on a strategy of balancing customer acquisition with net margin in order to maximize our profits, which has resulted in net sales growth and improved gross margins.
- *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 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 growth in this segment will substantially depend on our ability to grow prescription volumes through these efforts. Our decision not to participate in the low-margin Medicare Part D prescription drug benefit program offered by the U.S. government has continued to have a negative impact on our growth but has had a favorable impact on our gross margin during 2007.
- *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. During 2007, our net sales in the local pick-up pharmacy segment have not been a significant source of growth, as we focused 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 September 30, 2007, we reported consolidated total net sales of \$107.3 million, which reflected a \$6.7 million, or 7%, increase over the three-month period ended October 1, 2006. For the nine-month period ended September 30, 2007, we reported consolidated net sales of \$327.5 million, which reflected a \$20.3 million, or 7%, increase over the nine-month period ended October 1, 2006. Our net sales growth was driven by a 10% year-over-year increase in our total order volume for the three- and nine-month periods ended September 30, 2007, to 1.4 million orders and 4.4 million orders, respectively. Our average net sales per order declined slightly to \$75 for the three- and nine-month periods ended September 30, 2007, from \$77 for the three- and nine-month periods ended October 1, 2006. Our revenues benefited from strong growth in our OTC segment, in which net sales grew by 20% and 19%, respectively, year-over-year for the three- and nine-month periods ended September 30, 2007. Our revenues also benefited from year-over-year growth of 17% and 12%, respectively, for the three- and nine-month periods ended September 30, 2007 in our vision segment and 5% and 6%, 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 33% for the third quarter of 2007 and 29% for the nine-month period ended September 30, 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 September 30, 2007, when compared to the three-month period ended October 1, 2006, and declined slightly to 103% of net sales for the nine-month period ended September 30, 2007, compared 104% for the nine-month period ended October 1, 2006. During the three- and nine-month periods ended September 30, 2007 our overall cost of goods sold as a percentage of net sales year-over-year decreased 170 basis points and 120 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 and consulting fees during the third quarter of 2007 and the nine-month period ended September 30, 2007. We also recognized \$387,000 and \$2.1 million of additional stock-based compensation in the three- and nine-month periods ended September 30, 2007 compared to the same periods in 2006.

Net Loss; Cash Position . Our net loss for the three-month period ended September 30, 2007 decreased by 8%, or \$219,000 to \$2.4 million, compared to \$2.6 million for the three-month period ended October 1, 2006, and decreased by 9%, or \$912,000, to \$9.2 million, compared to \$10.1 million for the nine-month period ended October 1, 2006. We ended the third quarter of 2007 with \$37.9 million in cash, cash equivalents and marketable securities, compared to \$40.6 million at December 31, 2006 and at October 1, 2006.

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This balance reflects cash generated from operating activities in the nine-month period ended September 30, 2007 of \$7.0 million, proceeds received of \$3.4 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. These increases were offset by \$11.2 million for capital expenditures and asset acquisitions and \$2.2 million to repay debt obligations.

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 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 evaluate the criteria of EITF 99-19, in determining whether it is appropriate to record the gross amount of product sales and related costs in conjunction with our drop ship arrangements with vendors. Generally, when we are the primary party obligated in a transaction, are subject to inventory risk, have latitude in establishing prices and selecting suppliers, or have several but not all of these indicators, we record revenue on a gross basis.

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).

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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.

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

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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.

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 – Legal Proceedings*, included in Part I, of Item 1 of this quarterly report.

Results of Operations

Net Sales

	Three Months Ended			Nine Months Ended		
	September 30, 2007	% Change	October 1, 2006	September 30, 2007	% Change	October 1, 2006
	(in thousands, except per order data)			(in thousands, except per order data)		
Total net sales	\$ 107,323	6.6%	\$100,634	\$ 327,500	6.6%	\$307,179
Total customer orders shipped	1,434	10.1%	1,303	4,388	10.4%	3,973
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 16% increase in order volume for the three-month period ended September 30, 2007, and a 17% increase in order volume for the nine-month period ended September 30, 2007, in our OTC segment. Revenues from repeat customers represented 82% of net sales in the three- and nine-month periods ended September 30, 2007, compared to 84% of net sales in the third quarter of 2006 and 83% of net sales in the nine-month period ended October 1, 2006. The year-over-year decrease in average net sales per order for the three- and nine-month periods ended September 30, 2007 resulted from a higher mix of OTC orders, which have lower average net sales per order. Compared to the third quarter and the nine-month period ended October 1, 2006, net sales in our OTC segment increased by \$9.0 million and \$26.5 million, net sales in our vision segment increased by \$2.2 million and \$4.5 million, and net sales in our local pick-up pharmacy segment increased by \$1.2 million and \$4.8 million, respectively, all of which were partially offset by a decrease in net sales in our mail-order pharmacy segment of \$5.7 million and \$15.5 million, respectively.

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OTC Net Sales

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change	2006	2007	% Change	2006
	(in thousands, except per order data)					
OTC net sales	\$ 54,623	19.8%	\$ 45,605	\$ 168,412	18.7%	\$ 141,865
<i>Segmented net sales information:</i>						
% of total net sales from OTC	50.9%		45.3%	51.4%		46.2%
Average net sales per order	\$ 57	3.6%	\$ 55	\$ 57	1.8%	\$ 56

Net sales in our OTC segment increased year-over-year for the three-month period ended September 30, 2007, as a result of an increase in order volume. The number of orders in our OTC segment grew year-over-year by 16% to 966,000 for the third quarter of 2007, compared to 830,000 for the third quarter of 2006 with the average net sales per order for the third quarter of 2007 increasing year-over-year to \$57 from \$55. During the nine-month period ended September 30, 2007 the number of OTC orders grew year-over year by 15% to 3.0 million compared to 2.5 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. The slight year-over-year increase in average net sales per order for the three- and nine-month periods ended September 30, 2007 is primarily the result of increased sales of higher priced prestige beauty products.

Vision Net Sales

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change	2006	2007	% Change	2006
	(in thousands, except per order data)					
Vision net sales	\$ 14,851	16.9%	\$ 12,701	\$ 42,198	11.8%	\$ 37,739
<i>Segmented net sales information:</i>						
% of total net sales from vision	13.8%		12.6%	12.9%		12.3%
Average net sales per order	\$ 101	9.8%	\$ 92	\$ 99	10.0%	\$ 90

Net sales in our vision segment increased year-over-year in the three- and nine-month periods ended September 30, 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 \$101 for the three-month period ended September 30, 2007 compared to \$92 for the three-month period ended October 1, 2006 and increased to \$99 for the nine-month period ended September 30, 2007 compared to \$90 for the nine-month period ended October 1, 2006. The number of orders in this segment increased to 146,000 for the three-month period ended September 30, 2007, compared to 138,000 for the three-month period ended October 1, 2006, and increased to 428,000 for the nine-month period ended September 30, 2007, compared to 421,000 for the nine-month period ended October 1, 2006 as a result of increases in orders from repeat customers.

Mail-Order Pharmacy Net Sales

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change	2006	2007	% Change	2006
	(in thousands, except per order data)					
Mail-order pharmacy net sales	\$ 11,485	-33.1%	\$ 17,178	\$ 37,414	-29.3%	\$ 52,883
<i>Segmented net sales information:</i>						
% of total net sales from mail-order pharmacy	10.7%		17.1%	11.4%		17.2%
Average net sales per order	\$ 151	-14.2%	\$ 176	\$ 157	-3.7%	\$ 163

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Net sales in our mail-order pharmacy segment decreased year-over-year for the three- and nine-month periods ended September 30, 2007 as a result of decreases in order volume. Included in net sales of our mail-order pharmacy segment for the three- and nine-month periods ended September 30, 2007 were wholesale orders to one party of \$71,000 and \$1.0 million, respectively, and included in net sales for the three- and nine-month periods ended October 1, 2006 were wholesale orders to one party for \$2.0 million. The wholesale orders increased our average net sales per order by \$1 and \$4 for the three- and nine-month periods ended September 30, 2007, respectively, and increased our net sales per order by \$21 and \$6 for the three- and nine-month periods ended October 1, 2006, respectively. The number of orders in this segment decreased 22% year-over-year to 76,000 for the three-month period ended September 30, 2007, compared to 98,000 for the same period in 2006, and decreased 27% year-over-year to 238,000 for the nine-month period ended September 30, 2007, compared to 324,000 for the same period in 2006, as a result of a year-over-year decrease of 49% and 53% in orders from PBMs, due to our decision to exit unprofitable partnerships, in the three- and nine-month periods ended September 30, 2007, respectively, and decreases in new and repeat orders.

Local Pick-up Pharmacy Net Sales

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change	2006	2007	% Change	2006
	(in thousands, except per order data)			(in thousands, except per order data)		
Local pick-up pharmacy net sales	\$ 26,364	4.8%	\$ 25,150	\$ 79,476	6.4%	\$ 74,692
<i>Segmented net sales information:</i>						
% of total net sales from local pick-up pharmacy	24.6%		25.0%	24.3%		24.3%
Average net sales per order	\$ 106	1.9%	\$ 104	\$ 106	—	\$ 106

The increase in net sales in our local pick-up pharmacy segment for the three-month period ended September 30, 2007 reflects a 3% year-over-year increase in the number of orders in this segment, to 249,000, compared to 241,000 for the third 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 \$106 during the three-month period ended September 30, 2007 compared to \$104 for the three-month period ended October 1, 2006, primarily due to increased prices of brand name drugs as a result of a 4% average increase in prescription costs, offset slightly by a greater number of prescriptions filled with lower priced generic drugs compared to higher priced brand name drugs. The increase in net sales for the nine-month period ended September 30, 2007 reflects a 7% year-over-year increase in the number of orders in this segment, to 753,000 for the nine-month period ended September 30, 2007 compared to 703,000 for the nine-month period ended October 1, 2006, as a result of increases in orders from repeat customers. The average net sales per order remained consistent at \$106 for the nine-month period ended September 30, 2007 and October 1, 2006. 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 326,000 and 1.0 million new customers placed orders during the three-and nine-month periods ended September 30, 2007, increasing our total customer base to approximately 9.5 million customers since inception. Orders from repeat customers as a percentage of total orders decreased slightly to 76% for the third quarter of 2007, compared to 77% in the same period in 2006, and remained consistent at 76% year-over-year for the nine-month period ended September 30, 2007 and October 1, 2006. Our active customer base increased 12% to 2.4 million year-over-year for the nine-months ended September 30, 2007, compared to the same period in 2006, and the average annual spend per active customer was \$180. 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			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Cost of sales	\$ 82,431	4.3%	\$ 79,012	\$ 252,810	5.0%	\$240,846
Gross margin dollars	\$ 24,892	15.1%	\$ 21,622	\$ 74,690	12.6%	\$ 66,333
Gross margin percentage	23.2%		21.5%	22.8%		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 nine-month periods ended September 30, 2007, compared to the three- and nine-month periods ended October 1, 2006, as a result of growth in order volume and net sales. Total gross margin percentage increased year-over-year for the three- and nine-month periods ended September 30, 2007, primarily as a result of a larger proportion of net sales in our OTC segment, which is our highest-margin segment, as well as improved gross margins in all of our other segments.

Shipping

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Shipping activity:						
Shipping revenue	\$ 3,851	15.6%	\$ 3,331	\$ 11,583	15.2%	\$ 10,056
Shipping costs	(\$6,053)	18.0%	(\$5,131)	(\$18,131)	15.7%	(\$15,674)
Net shipping loss	(\$2,202)	22.3%	(\$1,800)	(\$6,548)	16.6%	(\$5,618)
Percentage of net sales:						
Shipping revenue	3.6%		3.3%	3.5%		3.3%
Shipping costs	-5.6%		-5.1%	-5.5%		-5.1%
Net shipping loss	-2.1%		-1.8%	-2.0%		-1.8%

Our net shipping loss for the three- and nine-month periods ended September 30, 2007 increased in absolute dollars and as a percentage of net sales compared to the same periods ended October 1, 2006 due to a higher mix of OTC orders, which have a higher net shipping loss than orders in our other segments. We include in net sales our revenues from shipping charges to customers and we include in cost of sales outbound shipping costs. 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			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
OTC cost of sales	\$ 38,630	21.3%	\$ 31,848	\$ 119,091	20.1%	\$ 99,144
<i>Segmented cost of sales information:</i>						
OTC gross margin dollars	\$ 15,993		\$ 13,757	\$ 49,321		\$ 42,721
OTC gross margin percentage	29.3%		30.2%	29.3%		30.1%

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The year-over-year increase in cost of sales in our OTC segment in absolute dollars for the three- and nine-month periods ended September 30, 2007 resulted from increased order volume and net sales. The year-over-year decrease in gross margin percentage for the three- and nine-month periods ended September 30, 2007 was primarily a result of higher per-order net shipping costs.

Vision Cost of Sales and Gross Margin

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Vision cost of sales	\$ 11,284	13.6%	\$ 9,932	\$ 32,255	9.9%	\$ 29,348
<i>Segmented cost of sales information:</i>						
Vision gross margin dollars	\$ 3,567		\$ 2,769	\$ 9,943		\$ 8,391
Vision gross margin percentage	24.0%		21.8%	23.6%		22.2%

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 nine-month periods ended September 30, 2007 was primarily as a result of a shift in product mix to sales of higher cost, newer technology contact lenses, an increase in order volume, and higher per order net shipping revenues, partially offset by increased promotional activity in both the three- and nine-month periods.

Mail-Order Pharmacy Cost of Sales and Gross Margin

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Mail-order pharmacy cost of sales	\$ 9,419	-36.5%	\$ 14,830	\$ 31,198	-31.6%	\$ 45,643
<i>Segmented cost of sales information:</i>						
Mail-order pharmacy gross margin dollars	\$ 2,066		\$ 2,348	\$ 6,216		\$ 7,240
Mail-order pharmacy gross margin percentage	18.0%		13.7%	16.6%		13.7%

The year-over-year decrease in cost of sales in our mail-order pharmacy segment in absolute dollars for the three- and nine-month periods ended September 30, 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 nine-month periods ended September 30, 2007 resulted from improved margins from exiting unprofitable partnerships with certain PBMs in 2006 and our ongoing review of pricing and profitability of pharmaceutical products.

Local Pick-up Pharmacy Cost of Sales and Gross Margin

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Local pick-up pharmacy cost of sales	\$ 23,098	3.1%	\$ 22,402	\$ 70,266	5.3%	\$ 66,711
<i>Segmented cost of sales information:</i>						
Local pick-up gross margin dollars	\$ 3,266		\$ 2,748	\$ 9,210		\$ 7,981
Local pick-up gross margin percentages	12.4%		10.9%	11.6%		10.7%

The year-over-year increase in cost of sales in our local pick-up pharmacy segment in absolute dollars in the three- and nine-month periods ended September 30, 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 nine-month periods ended September 30, 2007 was primarily a result of selling a higher proportion of higher margin generic drugs compared to lower margin brand name drugs.

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Fulfillment and Order Processing Expenses

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Fulfillment and order processing expenses	\$ 10,571	5.9%	\$ 9,979	\$ 32,201	5.9%	\$ 30,395
Percentage of net sales	9.8%		9.9%	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 nine-month periods ended September 30, 2007 included \$8.0 million of variable costs and \$2.6 million of fixed costs, and \$24.1 million of variable costs and \$8.1 million of fixed costs, respectively, compared to \$7.4 million of variable costs and \$2.6 million of fixed costs and \$22.6 million of variable costs and \$7.8 million of fixed costs for the three- and nine-month periods ended October 1, 2006. Variable fulfillment and order processing expenses increased year-over-year for the three-month period ended September 30, 2007, compared to the three-month period ended October 1, 2006, due to increases in order 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 were flat year-over-year for the third quarter of 2007 compared to the third quarter of 2006, and increased for the nine-month period ended September 30, 2007, compared to the nine-month period ended October 1, 2006, as a result of increased depreciation expense of \$258,000 and increased personnel costs of \$107,000, partially offset by a decrease in other operational costs. Fulfillment and order processing expenses as a percentage of net sales decreased in both the three- and nine-month periods ended September 30, 2007 as greater order volumes resulted in improved utilization of our primary distribution center.

Marketing and Sales Expenses

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Marketing and sales expenses	\$ 7,467	14.6%	\$ 6,517	\$ 23,428	7.4%	\$ 21,816
Percentage of net sales	7.0%		6.5%	7.2%		7.1%

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 \$5.2 million and \$16.3 million for the three- and nine-month periods ended September 30, 2007, respectively, and were \$4.3 million and \$15.2 million for the three- and nine-month periods ended October 1, 2006, respectively.

The year-over-year increase in marketing and sales expenses in absolute dollars and as a percentage of net sales for the three-month period ended September 30, 2007 was primarily due to increased search advertising costs and other promotional costs of \$851,000, and to a lesser extent an increase in expenses from third-party service providers and stock-based compensation expense. Marketing and sales expenses increased year-over-year in absolute dollars and as a percentage of net sales for the nine-month period ended September 30, 2007, primarily due to increased search advertising and other promotional costs of \$2.9 million, offset by \$1.8 million in final costs related to our brand advertising campaign that we incurred in the first quarter of 2006, and increased employee related expenses of \$486,000 and stock based compensation of \$253,000. The increase in search advertising costs was primarily due to increased OTC order volume and increased advertising to drive new customer orders. Marketing and sales dollars per new customer remained consistent at \$23 in the third quarter of 2007 compared to the third quarter of 2006, but declined in the nine-month period ended September 30, 2007 to \$23, from \$24 for the same period in 2006.

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Technology and Content Expenses

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Technology and content expenses	\$ 4,680	15.7%	\$ 4,046	\$ 13,870	15.7%	\$ 11,991
Percentage of net sales	4.4%		4.0%	4.2%		3.9%

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 nine-month periods ended September 30, 2007 resulted primarily from increased depreciation expense of \$340,000 and \$1.0 million, respectively, related to acquisitions of computer hardware and software enhancements to our IT infrastructure in 2006, and increased maintenance costs related to acquired software tools, and to a lesser extent, an increase in other operational costs to support our growth in our IT infrastructure.

General and Administrative Expenses

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
General and administrative expenses	\$ 4,767	32.7%	\$ 3,591	\$ 14,633	22.9%	\$ 11,910
Percentage of net sales	4.4%		3.6%	4.5%		3.9%

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 nine-month periods ended September 30, 2007 resulted primarily from an increase in stock-based compensation of \$438,000 and \$1.7 million, respectively, as a result of increased option grants and related option fair values, warrants issued in connection with certain advisory and consulting agreements, as well as increased consulting expenses related to improved operational efficiencies, and to a lesser extent, an increase in employee related expenses of \$49,000 and \$498,000 in the three- and nine-month periods ended September 30, 2007, respectively, compared to the same periods ended October 1, 2006.

Amortization of Intangible Assets

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Amortization of intangible assets	\$ 240	-54.8%	\$ 531	\$ 990	-37.8%	\$ 1,592

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. In the third quarter of 2007, we acquired for \$456,000 certain trademarks and intangibles associated with our new, private label de-luxe™ brand of natural, spa quality personal care products.

The year-over-year decrease in amortization expense for three- and nine-month periods ended September 30, 2007 resulted from certain intangible assets being fully amortized in 2006 and 2007.

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Interest Income and Expense

	Three Months Ended			Nine Months Ended		
	September 30,		October 1,	September 30,		October 1,
	2007	% Change (\$ in thousands)	2006	2007	% Change (\$ in thousands)	2006
Interest income, net	\$ 459	2.2%	\$ 449	\$ 1,265	-2.1%	\$ 1,292

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. Net interest income increased slightly in the third quarter of 2007 compared to the third quarter of 2006, and decreased year over year for the nine-month period ended September 30, 2007 as a result of lower average invested balances, partially offset by increases in average interest rates.

Income Taxes

There was no provision or benefit for income taxes for the three- and nine-month periods ended September 30, 2007 and October 1, 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 \$759.5 million since inception. We may continue to incur net losses for the next year, and possibly longer. From our inception through September 30, 2007, we have financed our operations primarily through the sale of equity securities, including common and preferred stock, yielding net cash proceeds of \$419.7 million.

Discussion of Cash Flows

The following table provides information regarding our cash flows for the nine-month periods ended September 30, 2007 and October 1, 2006.

	Nine Months Ended		
	September 30,		October 1,
	2007	\$ Change (in thousands)	2006
Cash provided by (used in) operating activities	\$ 7,032	\$ 8,011	(\$979)
Cash used in investing activities	(\$11,954)	(\$5,454)	(\$6,500)
Cash provided by financing activities	\$ 1,491	\$ 811	\$ 680
Net decrease in cash and cash equivalents	(\$3,431)	\$ 3,368	(\$6,799)

Net cash provided by operating activities for the nine-month period ended September 30, 2007 reflects a net loss of \$9.2 million offset primarily by non-cash expenses related to depreciation and amortization of \$8.5 million, and stock based compensation expense of \$7.1 million, and to a lesser extent \$623,000 in cash for operating assets and liabilities. Net cash used in operating activities for the nine-month period ended October 1, 2006 primarily reflects a net loss of \$10.1 million and the use of \$3.7 million in cash for operating assets and liabilities, partially offset by \$12.8 million of non-cash activities. The year-over-year improvement in cash provided by operating activities was primarily driven by a \$4.4 million change related to operating activities, \$2.7 million increase in non-cash activities, primarily stock based compensation expense and depreciation, and a \$0.9 million change in net loss.

Net cash used in investing activities for the nine-month periods ended September 30, 2007 and October 1, 2006 was primarily attributable to the purchase of marketable securities and the acquisition of fixed assets and intangibles, offset by the sales and maturities of marketable securities. The year-over-year increase in net cash used in investing activities was primarily as a result of increased purchases of fixed assets and intangibles.

Net cash provided by financing activities for the nine-month periods ended September 30, 2007 and October 1, 2006 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.

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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 nine months ended September 30, 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 September 30, 2007. The term loan totaled \$1.5 million at September 30, 2007 and accrues interest at the prime rate plus 0.50% (8.25% at September 30, 2007) and matures in March 2010.

As of September 30, 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 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 fourth quarter of fiscal year 2007, we are targeting net sales in the range of \$120.0 million to \$125.0 million and a net loss of \$0.5 million to net income of \$0.5 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 \$1.5 million at September 30, 2007, and the highest interest rate attributable to this outstanding balance was 8.25% at September 30, 2007. A change in net earnings resulting from a hypothetical 10% increase or decrease in interest rates would not be material.

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We have investment risk exposure arising from our investments in marketable securities. As of September 30, 2007, we had \$28.0 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 September 30, 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 September 30, 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 \$759.5 million through September 30, 2007. To date, we have not become profitable, and we may never achieve profitability. We may continue to incur net losses for 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 July 19, 2007, we issued to certain consultants a fully vested warrant to purchase 50,000 shares of our common stock at \$2.53 per share, expiring in July 2017, in conjunction with the performance of services under a consulting agreement. 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.

None.

Item 5. Other Information.

None.

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Item 6. Exhibits

Exhibit

<u>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 July 19, 2007.
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.

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: November 7, 2007

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE BEEN ACQUIRED FOR INVESTMENT. THIS WARRANT AND THE SECURITIES TO BE ISSUED UPON EXERCISE OF THIS WARRANT HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "1933 ACT") OR ANY STATE SECURITIES LAWS. SUCH SECURITIES MAY NOT BE SOLD OR TRANSFERRED IN THE ABSENCE OF SUCH REGISTRATION OR AN EXEMPTION THEREFROM UNDER THE 1933 ACT AND ANY APPLICABLE STATE SECURITIES LAWS.

**WARRANT TO PURCHASE _____ SHARES
OF THE COMMON STOCK OF
*drugstore.com inc.***

EFFECTIVE DATE: July 19, 2007

EXPIRATION DATE: July 19, 2017

This certifies that _____ or its transferees or assigns (each individually, the "**Holder**") for the agreed upon value of **\$2.53** and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, shall be entitled to purchase from **DRUGSTORE . COM INC .**, a *Delaware* corporation (the "**Company**"), having its principal place of business at *411 108th Ave NE, Suite 1400, Bellevue, WA 98004*, a maximum of _____ fully paid and nonassessable shares of the Company's Common Stock ("**Common Stock**") for cash at a price equal to **\$2.53** per share (the "**Exercise Price**") at any time, or from time to time, up to and including 5:00 p.m. Pacific time on the Expiration Date, upon the surrender to the Company at its principal place of business (or at such other location as the Company may advise the Holder in writing) of this Warrant properly endorsed, a Form of Subscription in substantially the form attached hereto duly filled in and signed and, as applicable, upon payment in cash or by check of the aggregate Exercise Price for the number of shares for which this Warrant is being exercised determined in accordance with the provisions hereof, or the surrender of the right to acquire the number of shares of Common Stock determined in accordance with Section 1.2. The Exercise Price and the number of shares of Common Stock purchasable hereunder are subject to adjustment as provided in Section 3 of this Warrant.

The Warrant is being issued pursuant to the Agreement between the Company and the Holder dated as of **June 19, 2007** (the "Purchase Agreement"). The Holder of this Warrant is subject to certain restrictions, and entitled to certain rights as set forth in the Purchase Agreement. This Warrant is referred to as the "Warrant" in the Purchase Agreement.

This Warrant is subject to the following terms and conditions:

1. EXERCISE ; ISSUANCE OF CERTIFICATES ; PAYMENT FOR SHARES .

1.1 General. This Warrant is exercisable at the option of the holder of record hereof at any time or from time, to time, up to the Expiration Date for all or any part of the shares of Common Stock (but not for a fraction of a share), which may be purchased hereunder. This Warrant may be exercised by the holder of record hereof by tendering to the Company at its principal office a completed notice of exercise in the form attached hereto as **Exhibit A** (the

“*Notice of Exercise*”). The Company agrees that the shares of Common Stock purchased under this Warrant shall be and are deemed to be issued to the Holder hereof as the record owner of such shares as of the close of business on the date on which this Warrant, properly endorsed, and appropriate payment for such shares shall have each been delivered to the Company at its principal place of business. Certificates for the shares of Common Stock so purchased, together with any other securities or property to which the Holder is entitled upon such exercise, shall be delivered to the Holder by the Company at the Company’s expense within a reasonable time after the rights represented by this Warrant have been so exercised, and in any event, within ten (10) business days of such exercise. In case of a purchase of less than all the shares which may be purchased under this Warrant, the Company shall cancel this Warrant and execute and deliver a new Warrant or Warrants of like tenor for the balance of the shares purchasable under the Warrant surrendered upon such purchase to the Holder hereof within a reasonable time. Each stock certificate so delivered shall be in such denominations of Common Stock as may be requested by the Holder hereof and shall be registered in the name designated by such Holder.

1.2 Net Issue Exercise . Holder agrees that it cannot “net issue exercise” this Warrant in accordance with the provisions of this section, except in connection with or following an Organic Change (as defined in Section 3.3 below). Notwithstanding any provisions herein to the contrary, if the fair market value of one share of the Company’s Common Stock is greater than the Exercise Price (at the date of calculation as set forth below), in lieu of exercising this Warrant for cash, the Holder may elect a “Net Issue Exercise” pursuant to which it will receive shares equal to the value (as determined below) of this Warrant (or the portion thereof being exercised) by surrender of this Warrant at the principal office of the Company together with the properly endorsed Form of Subscription and notice of such election in which event the Company shall issue to the Holder a number of shares of Common Stock computed using the following formula:

$$X = \frac{Y(A-B)}{A}$$

Where X = the number of shares of Common Stock to be issued to the Holder

Y = the number of shares of Common Stock purchasable under the Warrant or, if only a portion of the Warrant is being exercised, the portion of the Warrant being exercised (at the date of such exercise)

A = the fair market value of one share of the Company’s Common Stock

B = Exercise Price (as adjusted to the date of such exercise).

For purposes of the above calculation, the fair market value of one share of Common Stock shall be determined by the Company’s Board of Directors in good faith, as of the date of exercise of the Warrant; provided, however, that where there is a public market for the Company’s Common Stock, the fair market value per share shall be the average of the closing prices of the Company’s Common Stock quoted on the Nasdaq National Market (or similar system) or on any exchange on which the Common Stock is listed, whichever is applicable, over the five (5) trading day period commencing on the trading day immediately following the day on which the Warrant is exercised.

2. SHARES TO BE FULLY PAID ; RESERVATION OF SHARES . The Company covenants and agrees that all shares of Common Stock which may be issued upon the exercise of the rights represented by this Warrant will, upon issuance, be duly authorized, validly issued, fully paid and nonassessable and free from all preemptive rights of any shareholder and free of all taxes, liens and charges with respect to the issue thereof. The Company further covenants and agrees that, during the period within which the rights represented by this Warrant may be exercised, the Company will at all times have authorized and reserved, for the purpose of issue or transfer upon exercise of the subscription rights evidenced by this Warrant, a sufficient number of shares of authorized but unissued Common Stock, or other securities and property, when and as required to provide for the exercise of the rights represented by this Warrant. The Company will take all such action as may be reasonably necessary to assure that such shares of Common Stock may be issued as provided herein without violation of any applicable law or regulation, or of any requirements of any domestic securities exchange upon which the Common Stock may be listed; provided, however, that the Company shall not be required to effect a registration under Federal or State securities laws with respect to such exercise. The Company will not take any action which would result in any adjustment of the Exercise Price (as set forth in Section 3 hereof) if the total number of shares of Common Stock issuable (i) upon exercise of the Warrant would exceed 10% of the total number of shares of Common Stock outstanding on the Effective Date or (ii) after such action upon exercise of all outstanding warrants, together with all shares of Common Stock then outstanding and all shares of Common Stock then issuable upon exercise of all options and upon the conversion of all convertible securities and other equity purchase rights then outstanding, would exceed the total number of shares of Common Stock then authorized by the Company's Articles/Certificate of Incorporation (the "Company Charter").

3. ADJUSTMENT OF EXERCISE PRICE AND NUMBER OF SHARES . The Exercise Price and the number of shares purchasable upon the exercise of this Warrant shall be subject to adjustment from time to time upon the occurrence of certain events described in Sections 3.1 and 3.2 below. Upon each adjustment of the Exercise Price, the Holder of this Warrant shall thereafter be entitled to purchase, at the Exercise Price resulting from such adjustment, the number of shares obtained by multiplying the Exercise Price in effect immediately prior to such adjustment by the number of shares purchasable pursuant hereto immediately prior to such adjustment, and dividing the product thereof by the Exercise Price resulting from such adjustment.

3.1 Subdivision or Combination of Stock . In case the Company shall at any time subdivide its outstanding shares of Common Stock into a greater number of shares, the Exercise Price in effect immediately prior to such subdivision shall be proportionately reduced, and conversely, in case the outstanding shares of Common Stock of the Company shall be combined into a smaller number of shares (by reverse stock split or otherwise), the Exercise Price in effect immediately prior to such combination shall be proportionately increased.

3.2 Dividends in Common Stock, Other Stock, Property, Reclassification . If at any time or from time to time the Holders of Common Stock (or any shares of stock or other securities at the time receivable upon the exercise of this Warrant) shall have received or become entitled to receive, without payment therefor,

(a) Common Stock or any shares of stock or other securities which are at any time directly or indirectly convertible into or exchangeable for Common Stock, or any rights or options to subscribe for, purchase or otherwise acquire any of the foregoing by way of dividend or other distribution,

(b) any cash paid or payable otherwise than as a cash dividend, or

(c) Common Stock or additional stock or other securities or property (including cash) by way of spinoff, split-up, reclassification, combination of shares or similar corporate rearrangement, (other than shares of Common Stock issued as a stock split or adjustments in respect of which shall be covered by the terms of Section 3.1 above),

then, and in each such case, the Holder hereof shall, upon the exercise of this Warrant, be entitled to receive, in addition to the number of shares of Common Stock receivable thereupon, and without payment of any additional consideration therefor, the amount of stock and other securities and property (including cash in the cases referred to in clauses (b) and (c) above) (collectively, “*Other Property*”) which such Holder would hold on the date of such exercise had he been the holder of record of such Common Stock as of the date on which holders of Common Stock received or became entitled to receive such Other Property. Notwithstanding the foregoing, the Company may, in lieu of delivering such Other Property to the Holder, adjust the Exercise Price of the Warrant or the number of shares of Common Stock to be delivered upon exercise of the Warrant as the Board of Directors, in its reasonable judgment, deems appropriate and equitable, in order to take into account the value of such Other Property.

3.3 Reorganization, Consolidation, Merger or Sale . If any recapitalization or reorganization of the capital stock of the Company other than pursuant to Section 3.2(c) above, or any consolidation or merger of the Company with another corporation, or the sale of all or substantially all of its assets shall be effected in such a way that holders of Common Stock shall be entitled to receive stock, securities, or other assets or property as consideration for such holders’ shares of Common Stock (an “*Organic Change*”), then, as a condition of such Organic Change, lawful and adequate provisions shall be made by the Company whereby the Holder hereof shall thereafter have the right to purchase and receive (in lieu of the shares of the Common Stock of the Company immediately theretofore purchasable and receivable upon the exercise of the rights represented by this Warrant) such shares of stock, securities or other assets or property as may be issued or payable with respect to or in exchange for a number of outstanding shares of such Common Stock equal to the number of shares of such stock immediately theretofore purchasable and receivable upon the exercise of the rights represented by this Warrant. In the event of any Organic Change, appropriate provision shall be made by the Company with respect to the rights and interests of the Holder of this Warrant to the end that the provisions hereof (including, without limitation, provisions for adjustments of the Exercise Price and of the number of shares purchasable and receivable upon the exercise of this Warrant) shall thereafter be applicable, in relation to any shares of stock, securities or assets thereafter deliverable upon the exercise hereof. Prior to the consummation of any such consolidation, merger or sale, the successor entity (if other than the Company) resulting from such consolidation or the corporation purchasing such assets shall assume by written instrument reasonably

satisfactory in form and substance to the Holders executed and mailed or delivered to the registered Holder hereof at the last address of such Holder appearing on the books of the Company, the obligation to deliver to such Holder such shares of stock, securities or assets as, in accordance with the foregoing provisions, such Holder may be entitled to purchase.

3.4 Certain Events. If any change in the outstanding Common Stock of the Company or any other event occurs as to which the other provisions of this Section 3 are not strictly applicable or if strictly applicable would not fairly protect the purchase rights of the Holder of the Warrant in accordance with such provisions, then the Board of Directors of the Company shall make an adjustment in the number and class of shares available under the Warrant, the Exercise Price or the application of such provisions, so as to protect such purchase rights as aforesaid. The adjustment shall be such as will give the Holder of the Warrant upon exercise for the same aggregate Exercise Price the total number, class and kind of shares as the Holder would have owned had the Warrant been exercised prior to the event and had the Holder continued to hold such shares until after the event requiring adjustment.

3.5 Notices of Change.

(a) Immediately upon any adjustment in the number or class of shares subject to this Warrant and/or of the Exercise Price, the Company shall give written notice thereof to the Holder, setting forth in reasonable detail and certifying the calculation of such adjustment.

(b) The Company shall give written notice to the Holder at least 10 business days prior to the date on which the Company closes its books or takes a record for determining rights to receive any dividends or distributions.

(c) The Company shall also give written notice to the Holder at least 30 business days prior to the date on which an Organic Change shall take place.

4. ISSUE TAX. The issuance of certificates for shares of Common Stock upon the exercise of the Warrant shall be made without charge to the Holder of the Warrant for any issue tax (other than any applicable income taxes) in respect thereof; provided, however, that the Company shall not be required to pay any tax which may be payable in respect of any transfer involved in the issuance and delivery of any certificate in a name other than that of the then Holder of the Warrant being exercised.

5. CLOSING OF BOOKS. The Company will at no time close its transfer books against the transfer of any warrant or of any shares of Common Stock issued or issuable upon the exercise of any warrant in any manner which interferes with the timely exercise of this Warrant, unless otherwise required to do so by law.

6. NO VOTING OR DIVIDEND RIGHTS; LIMITATION OF LIABILITY. Nothing contained in this Warrant shall be construed as conferring upon the Holder hereof the right to vote or to consent or to receive notice as a shareholder of the Company or any other matters or any rights whatsoever as a shareholder 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 shall have been 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 hereof, shall give rise to any liability of such Holder for the Exercise Price or as a shareholder of the Company, whether such liability is asserted by the Company or by its creditors.

7. WARRANTS TRANSFERABLE . Subject to compliance with applicable federal and state securities laws and the provisions of Section 10(c) below, this Warrant and all rights hereunder are transferable, in whole or in part, without charge to the holder hereof (except for transfer taxes), upon surrender of this Warrant properly endorsed. Each taker and holder of this Warrant, by taking or holding the same, consents and agrees that this Warrant, when endorsed in blank, shall be deemed negotiable, and that the holder hereof, when this Warrant shall have been so endorsed, may be treated by the Company, at the Company's option, and all other persons dealing with this Warrant as the absolute owner hereof for any purpose and as the person entitled to exercise the rights represented by this Warrant, or to the transfer hereof on the books of the Company any notice to the contrary notwithstanding; but until such transfer on such books, the Company may treat the registered owner hereof as the owner for all purposes.

8. RIGHTS AND OBLIGATIONS SURVIVE EXERCISE OF WARRANT . The rights and obligations of the Company, of the holder of this Warrant and of the holder of shares of Common Stock issued upon exercise of this Warrant, shall survive the exercise of this Warrant.

9. FURTHER REPRESENTATIONS, WARRANTIES AND COVENANTS OF THE COMPANY .

(a) Articles and Bylaws . The Company has made available to Holder true, complete and correct copies of the Company Charter and Bylaws, as amended, through the date hereof.

(b) Due Authority . The execution and delivery by the Company of this Warrant and the performance of all obligations of the Company hereunder, including the issuance to Holder of the right to acquire the shares of Common Stock, have been duly authorized by all necessary corporate action on the part of the Company, and the Warrant is not inconsistent with the Company Charter or Bylaws and constitutes a legal, valid and binding agreement of the Company, enforceable in accordance with its terms.

(c) Consents and Approvals . No consent or approval of, giving of notice to, registration with, or taking of any other action in respect of any state, federal or other governmental authority or agency is required with respect to the execution, delivery and performance by the Company of its obligations under this Warrant, except for any filing required by applicable federal and state securities laws, which filing will be effective by the time required thereby.

(d) Issued Securities. All issued and outstanding shares of capital stock of the Company have been duly authorized and validly issued and are fully paid and nonassessable. All outstanding shares of capital stock were issued in full compliance with all federal and state securities laws.

(e) **Exempt Transaction.** Subject to the accuracy of the Holders representations in Section 10 hereof, the issuance of the Common Stock upon exercise of this Warrant will constitute a transaction exempt from (i) the registration requirements of Section 5 of the Securities Act of 1933, as amended (the “**1933 Act**”), in reliance upon Section 4(2) thereof, and (ii) the qualification requirements of the applicable state securities laws.

(f) **Compliance with Rule 144.** At the written request of the Holder, who proposes to sell Common Stock issuable upon the exercise of the Warrant in compliance with Rule 144 promulgated by the Securities and Exchange Commission, the Company shall furnish to the Holder, within thirty (30) days after receipt of such request, a written statement confirming the Company’s compliance with the filing requirements of the Securities and Exchange Commission as set forth in such Rule, as such Rule may be amended from time to time.

10. REPRESENTATIONS AND COVENANTS OF THE HOLDER.

This Warrant has been entered into by the Company in reliance upon the following representations and covenants of the Holder:

(a) **Investment Purpose.** 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.

(b) **Private Issue.** The Holder understands (i) that the Warrant and the Common Stock issuable upon exercise of this Warrant is not registered under the 1933 Act or qualified under applicable state securities laws on the ground that the issuance contemplated by this Warrant will be exempt from the registration and qualifications requirements thereof pursuant to Section 4(2) of the 1933 Act and any applicable state securities laws, and (ii) that the Company’s reliance on such exemption is predicated on the representations set forth in this Section 10.

(c) **Disposition or Transfer of Holders Rights.** In no event will the Holder make a disposition of, or otherwise transfer, the Warrant or the Common Stock issuable upon exercise of the Warrant unless and until (i) it shall have notified the Company of the proposed disposition, and (ii) if requested by the Company, it shall have furnished the Company with an opinion of counsel (which counsel may either be inside or outside counsel to the Holder) satisfactory to the Company and its counsel to the effect that (A) appropriate action necessary for compliance with the 1933 Act has been taken, or (B) an exemption from the registration requirements of the 1933 Act is available. Notwithstanding the foregoing, the restrictions imposed upon the transferability of any of its rights to acquire Common Stock or Common Stock issuable on the exercise of such rights do not apply to transfers from the beneficial owner of any of the aforementioned securities to its nominee or from such nominee to its beneficial owner, and shall terminate as to any particular share of Common Stock when (1) such security shall have been effectively registered under the 1933 Act and sold by the holder thereof in accordance with such registration or (2) such security shall have been sold without registration in compliance with Rule 144 under the 1933 Act, or (3) a letter shall have been issued to the Holder at its request by

the staff of the Securities and Exchange Commission or a ruling shall have been issued to the Holder at its request by such Commission stating that no action shall be recommended by such staff or taken by such Commission, as the case may be, if such security is transferred without registration under the 1933 Act in accordance with the conditions set forth in such letter or ruling and such letter or ruling specifies that no subsequent restrictions on transfer are required. Whenever the restrictions imposed hereunder shall terminate, as hereinabove provided, the Holder or holder of a share of Common Stock then outstanding as to which such restrictions have terminated shall be entitled to receive from the Company, without expense to such holder, one or more new certificates for the Warrant or for such shares of Common Stock not bearing any restrictive legend.

(d) Financial Risk . 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.

(e) Risk of No Registration . The Holder understands that if the Company does not register with the Securities and Exchange Commission pursuant to Section 12 of the 1933 Act, or file reports pursuant to Section 15(d), of the Securities Exchange Act of 1934 (the “**1934 Act**”), or if a registration statement covering the securities under the 1933 Act is not in effect when it desires to sell (i) the Warrant, or (ii) the Common Stock issuable upon exercise of the Warrant, it may be required to hold such securities for an indefinite period. The Holder also understands that any sale of the Warrant or the Common Stock issuable upon exercise of the Warrant which might be made by it in reliance upon Rule 144 under the 1933 Act may be made only in accordance with the terms and conditions of that Rule.

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

11. MODIFICATION AND WAIVER . This Warrant and any provision hereof may be changed, waived, discharged or terminated only by an instrument in writing signed by the party against which enforcement of the same is sought.

12. NOTICES . Any notice, request or other document required or permitted to be given or delivered to the holder hereof or the Company shall be delivered or shall be sent by an established overnight service provider (e.g., Federal Express), or registered or certified mail, postage prepaid, to each such holder at its address as shown on the books of the Company or to the Company at the address indicated therefor in the first paragraph of this Warrant or such other address as either may from time to time provide to the other in accordance with this Section.

13. BINDING EFFECT ON SUCCESSORS . This Warrant shall be binding upon any corporation succeeding the Company by merger, consolidation or acquisition of all or substantially all of the Company’s assets. All of the obligations of the Company relating to the Common Stock issuable upon the exercise of this Warrant shall survive the exercise and termination of this Warrant. All of the covenants and agreements of the Company shall inure to the benefit of the successors and assigns of the holder hereof.

14. DESCRIPTIVE HEADINGS AND GOVERNING LAW . The description headings of the several sections and paragraphs of this Warrant are inserted for convenience only and do not constitute a part of this Warrant. This Warrant shall be construed and enforced in accordance with, and the rights of the parties shall be governed by, the laws of the *State of Washington*, without giving effect to principles of conflicts of laws .

15. LOST WARRANTS . The Company represents and warrants to the Holder hereof that upon receipt of evidence reasonably satisfactory to the Company of the loss, theft, destruction, or mutilation of this Warrant and, in the case of any such loss, theft or destruction, upon receipt of an indemnity reasonably satisfactory to the Company, or in the case of any such mutilation upon surrender and cancellation of such Warrant, the Company, at its expense, will make and deliver a new Warrant, of like tenor, in lieu of the lost, stolen, destroyed or mutilated Warrant.

16. FRACTIONAL SHARES . No fractional shares shall be issued upon exercise of this Warrant. The Company shall, in lieu of issuing any fractional share, pay the holder entitled to such fraction a sum in cash equal to such fraction multiplied by the then effective Exercise Price.

I N W ITNESS W HEREOF , the Company has caused this Warrant to be duly executed by its officers, thereunto duly authorized.

DRUGSTORE . COM INC .
a *Delaware* corporation

By: _____

Name: Dawn G. Lepore

Title: Chief Executive Officer

ATTEST:

Secretary

ACCEPTED AND AGREED:

By: _____

Name: _____

Title: _____

EXHIBIT A

NOTICE OF EXERCISE

Date: _____, 200__

drugstore.com inc.
411 108th Ave NE, Suite 1400
Bellevue, WA 98004

Attn: President

Ladies and Gentlemen:

- The undersigned hereby elects to exercise the warrant issued to it by drugstore.com inc. (the "**Company**") and dated _____, (the "**Warrant**") and to purchase thereunder _____ shares of the Common Stock of the Company (the "**Shares**") at a purchase price of _____ Dollars (\$_____) per Share or an aggregate purchase price of _____ Dollars (\$_____) (the "**Exercise Price**"). Pursuant to the terms of the Warrant the undersigned has delivered the Exercise Price herewith in full in cash or by certified check or wire transfer.
- The undersigned hereby elects to convert _____ percent (____%) of the value of the Warrant into shares of Common Stock, pursuant to the net exercise provisions of Section 1.2 of the Warrant.

The undersigned represents that is acquiring the Common Stock for its own account, to hold for investment, and the undersigned will not make any sale, transfer or other disposition of the Common Stock in violation of the Securities Act of 1933, as amended (the "Securities Act"), or in violation of any applicable state securities law.

The undersigned has been advised that the Common Stock has not been registered under the Securities Act or state securities laws on the ground that this transaction is exempt from registration, and that reliance by the Company on such exemptions is predicated in part on the undersigned's representations set forth in this Notice of Exercise.

The undersigned has been informed that under the Securities Act, the Common Stock must be held indefinitely unless it is subsequently registered under the Act or unless an exemption from such registration is available with respect to any proposed transfer or disposition by the undersigned of the Common Stock.

Please issue a certificate or certificates representing said shares of Common Stock in the name of the undersigned or in such other name as is specified below:

Name: _____

Address: _____

Very truly yours,

By: _____

Title: _____

2.

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.

November 7, 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.

November 7, 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 September 30, 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

November 7, 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 September 30, 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.

Eleuthère I. du Pont

Sr. Vice President of Operations and Chief Financial
Officer

November 7, 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.