

## **PARAGON PHARMACIES LIMITED**

### **MANAGEMENT DISCUSSION & ANALYSIS FOR THE YEAR ENDED AUGUST 31, 2009**

**As at December 8, 2009**

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited (the "Company") for the year ended August 31, 2009. This discussion and analysis should be read in conjunction with the Company's annual audited consolidated financial statements and accompanying notes for the year ended August 31, 2009. The audited consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). All references to dollars are in Canadian funds unless otherwise indicated. Additional information relating to the Company is available at [www.paragonpharmacies.com](http://www.paragonpharmacies.com) or [www.sedar.com](http://www.sedar.com).

#### **FORWARD LOOKING STATEMENTS**

This discussion of the consolidated financial condition and results of operations of the Company contains forward-looking statements regarding, among other things, the Company's beliefs, plans, objectives, strategies, estimates, intentions and expectations, including as they relate to its operating and financial results, capital expenditures and the ability to execute on its operating, investing and financing strategies. Consequently, actual results and events may differ materially from those included in, contemplated or implied by such forward looking statements for a variety of reasons. Forward-looking statements are subject to inherent risks and uncertainties including, but not limited to, market and general economic conditions, certain property and casualty risks, the ability to attract and retain pharmacists, the availability and terms of financing, changes in the Company's relationship with its key suppliers, competitive factors, changes in regulatory environments affecting the Company's business, and the accuracy in management's assumptions (see "RISKS AND RISK MANAGEMENT"). This list is not exhaustive of the factors that may affect any of the Company's forward-looking statements. Investors and others should carefully consider these and other factors and not place undue reliance on these forward-looking statements. In addition, these forward-looking statements relate to the date on which they were made and the Company disclaims and has no intention or obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

#### **NON-GAAP FINANCIAL MEASURES**

The Company reports its financial results in accordance with Canadian GAAP. However, the MD&A contains references to non-GAAP financial measures, such as operating income, gross margin, comparable store revenue, EBITDA (earnings before interest and accretion expense, interest income, depreciation and amortization, stock based compensation, other items including loss from equity investments, and income taxes), EBITDA per common share; cash interest expense, net debt and total capitalization. Non-GAAP financial measures do not have standardized meanings prescribed by GAAP and therefore may not be comparable to similar measures presented by other reporting issuers.

## Management's Discussion and Analysis *(continued)*

These non-GAAP financial measures have been included in this Management's Discussion and Analysis as they are measures which management uses to assist in evaluating the Company's operating performance against its expectations and against other companies in the retail pharmacy industry. Management believes that non-GAAP financial measures assist in identifying underlying operating trends.

These non-GAAP financial measures, particularly EBITDA, are also common measures used by investors, financial analysts and rating agencies. These groups may use EBITDA and other non-GAAP financial measures to value the Company and assess the Company's ability to service its debt.

### OVERVIEW

Paragon is headquartered in Kelowna, British Columbia and currently employs over 400 full and part time staff. The Corporation owns and operates 19 retail pharmacies and 3 central fill pharmacies in British Columbia, Alberta and Manitoba.

### STRATEGIES AND OUTLOOK

The Company continues to focus on business strategies designed to support continued revenue growth, build customer loyalty, improve profitability and expand brand awareness.

The talent, skill and dedication of the Company's pharmacy, front store and post office employees are primary contributors to the Company establishing itself as the community pharmacy of choice and are a key factor in building customer loyalty. The Company will continue strengthening training and development programs and focusing on improved customer service. Recent changes to pharmacy regulations will allow the Company to expand its professional service offerings to its customers in support of their health and wellness goals and the Company is active in moving forward on these opportunities.

The Company's strong capital position will enable it to continue to search for new business development opportunities through acquisitions of pharmacies, prescriptions and new store developments in Western Canada. The Company is focused on developing growth in its long term care operations through improved service and innovative technology and processes. Specifically the Company expects to begin automating certain processes in its pharmacies that will increase service; enhance quality control and increase efficiencies.

The Company will continue to search for cost reductions and efficiency improvements to offset the impact of the continued softness in the Canadian economy. The pharmacy industry is facing significant change that will impact prices of generic drugs and pharmacy allowances. These changes together with general economic conditions will pose significant risks to the current economic model of pharmacy and will necessitate the ability to adapt to new economic models. Companies with capital that take advantage of these opportunities will succeed. The Company's success in achieving its objectives is dependent on its ability to adapt to these regulatory changes.

### SUMMARY

#### **Key Operating, Investing and Financial Metrics**

The following provides a summary of the Company's performance for the year ended August 31, 2009 compared to the year ended August 31, 2008.

- Revenue of \$86.134 million (2008: \$83.718 million), an increase of 2.9%. (Refer to page 6 for further explanation)
- Comparable store revenue reduction of (1.6%) (excluding tobacco and home health care)
  - Comparable store pharmacy revenue growth of 2.6%
  - Comparable store front store revenue<sup>1</sup> reduction of (13.1%) (excluding tobacco and home health care). (Refer to page 6 for further explanation)
- Gross margin<sup>2</sup> as a percentage of revenue of 36.5% (2008: 34.0%), an increase of 2.5%. (Refer to page 6 for further explanation)
- Operating income<sup>3</sup> of \$8.640 million (2008: \$5.878 million), an increase of 47.0%. (Refer to page 7 for further explanation)
- EBITDA of \$4.001 million (2008: \$1.393 million), an increase of 187.2%. (Refer to page 7 for further explanation)

<sup>1</sup> Front store revenue includes all non-pharmacy revenue and excludes home health care stores.

<sup>2</sup> Gross margin is defined as revenue minus cost of sales

<sup>3</sup> Operating income defined as revenue less cost of sales and operating expenses but excluding corporate and other costs, interest and accretion expense, amortization, stock based compensation and other items

#### **Fourth Quarter**

- During the quarter, the Company completed its rebranding activities in Alberta with all locations operating as Paragon in that market. This initiative also included instore upgrades being performed at these locations.
- In June 2009, the Company's 50% interest in a store in Cochrane, Alberta was sold resulting in a loss of \$0.08 million. The Company was able to recover \$0.76 million of advances made in respect to this store as part of the transaction.
- During the quarter the Company completed its relocation of its Airdrie, Alberta store which opened in July 2009. A newly constructed medical clinic next to this location will be opening in 2010.
- The Company constructed a new clinical format 1,000 square foot pharmacy in Kelowna during the quarter. This location is part of a health focused professional building, including an adjacent medical practice. The pharmacy opened in early September, 2009.
- The Company began renovations to relocate one of its Kelowna locations to a new 9,000 square foot pharmacy within the same shopping centre. The store opened in September 2009 after only a six week build out.

## Management's Discussion and Analysis *(continued)*

- In August 2009, the Company closed its Canadian Medial Supplies operation. The loss from this location in the fourth quarter was \$0.206 million. This decision enables the Company to focus its energies and capital on its core pharmacy operations.
- In the fourth quarter the Company commenced discussions with an independent pharmacy to consolidate the script business with an existing Paragon location in Calgary. This transaction closed in November 2009 and is expected to add an additional 12,000 prescriptions to the Paragon store.
- During the quarter, the Company recorded a provision of \$0.200 million in respect to a review currently being performed in respect to reimbursements of drug costs claimed under a provincial health program in 2008 (Refer to page 16).
- In response to the President's departure from the Company in late August 2009, Denis Taillieu, a member of the Board of Directors stepped in as interim Chief Executive Officer (CEO). The Board is actively seeking a full-time CEO.

### SELECTED ANNUAL INFORMATION

The following table provides a summary of certain selected consolidated annual financial information for the Company. The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). All references to dollars are in Canadian funds unless otherwise indicated.

(thousands of dollars)	2009	2008	2007
Revenue	\$86,134	\$83,718	\$66,146
Operating income <sup>1</sup>	8,640	5,878	4,787
EBITDA	4,001	1,393	1,893
Net loss	(7,181)	(10,125)	(3,575)
- Net loss per share - Basic	(\$0.08)	(\$0.24)	(\$0.10)
- Net loss per share – Diluted	(\$0.08)	(\$0.24)	(\$0.10)
Total assets	57,204	62,837	57,787
Total long-term financial liabilities <sup>2,3</sup>	14,190	33,591	23,402

<sup>1</sup> Operating income defined as revenue less cost of sales and operating expenses but excluding corporate and other costs, interest and accretion expense, amortization, stock based compensation and other items

<sup>2</sup> Includes current portion of long-term financial liabilities: 2009: \$10,640; 2008: \$2,459; 2007: \$2,824.

<sup>3</sup> Includes convertible debenture of 2009: \$Nil; 2008:\$17,233. 2007:\$14,733. This liability was eliminated in November 2008 through the conversion and repayment of the debenture and the issuance of equity

### 2009

In fiscal 2009, total revenue increased 2.9% and operating income increased 47.0% from 2008, reflecting the acquisitions in 2008 of Teulon, Alentex and the Okanagan and West Coast central fills for a full year in 2009. Total comparable store revenue declined by 1.6% with comparable pharmacy revenue up 2.6% and comparable front store revenue (all non-pharmacy revenue excluding tobacco and home health care sales) down 13.1% over 2008. EBITDA increased 187.2% from 2008 as a result of increased operating income and improved margins from prior year. (Refer to page 7)

## Management's Discussion and Analysis *(continued)*

Included in net loss for 2009 were interest and accretion expenses of \$5.413 million relating to the convertible debenture which was retired on November 14, 2008, through execution of a note conversion and subscription agreement (Refer to page 7).

### 2008

In fiscal 2008, total revenue increased 26.6% and operating income increased 22.8% from 2007, reflecting the acquisitions of Teulon, Alentex and the Okanagan and Westcoast central fills for part of the year as well as Nordic for a full year in 2008. Total same store revenue was up 6% with pharmacy same store revenue up 11% and front store same store revenue (all non-pharmacy revenue) flat year over year.

Included in total net loss for 2008 were interest and accretion expenses of \$7.527 million which related to the convertible debenture.

### RESULTS OF OPERATIONS

The following table presents a summary of certain selected operating data and consolidated financial information for the Company:

(Thousands of dollars except per share amounts)	2009 \$	2008 \$	\$ Change	% Change
Revenue	86,134	83,718	2,416	2.9%
Gross Margin	31,419	28,151	3,268	11.6%
Operating Expenses <sup>1</sup>	22,779	22,273	506	2.3%
Operating Income	8,640	5,878	2,762	47.0%
Corporate and other costs	4,639	4,485	154	3.4%
EBITDA <sup>2</sup>	4,001	1,393	2,608	187.2%
Stock-based compensation	68	121	(53)	(43.8%)
Amortization	4,409	3,690	719	19.5%
Interest and accretion expense <sup>3</sup>	6,676	7,936	(1,260)	(15.9%)
Other Items <sup>4</sup>	29	(229)	258	112.7%
Net (Loss)	(7,181)	(10,125)	2,944	29.1%
EBITDA per common share				
- Basic	\$0.05	\$0.03	\$0.02	66.7%
- Diluted	\$0.05	\$0.03	\$0.02	66.7%
Loss per common share				
- Basic	(\$0.08)	(\$0.24)	\$0.16	66.7%
- Diluted	(\$0.08)	(\$0.24)	\$0.16	66.7%

<sup>1</sup> Operating expenses include store level selling, general and administration expenses (excludes corporate expenses, amortization, interest expense and stock-based compensation)

<sup>2</sup> EBITDA defined as earnings before interest expense, income taxes, amortization, stock-based compensation and other items as defined.

<sup>3</sup> Interest expense includes bank charges and interest 2009: \$0.133 million (2008: \$0.229 million); interest on long term debt 2009: \$0.796 million, (2008: \$0.780 million); and interest income of 2009: \$0.153 million (2008: \$0.668 million). The financing costs on the convertible debenture are a non-cash item and include interest and accretion on the debenture.

<sup>4</sup> Other items include gain on equity investments of 2009: \$0.031 million (2008: \$0,277 million loss).

## Management's Discussion and Analysis *(continued)*

The following table provides a quantitative reconciliation of net income (loss) to EBITDA:

(Thousands of dollars)	2009 \$	2008 \$	2007 \$
Net loss	(7,181)	(10,125)	(3,575)
Add (deduct) the following:			
Interest and accretion expense	6,676	7,936	2,856
Amortization	4,409	3,690	2,159
Stock based compensation	68	121	201
Other items	29	(229)	252
EBITDA	4,001	1,393	1,893

### Revenue

Revenue is comprised of sales to customers of the Company's retail pharmacies, home health care store and central fill pharmacies. Revenue was \$86.134 million in 2009 compared to \$83.718 million in 2008, an increase of \$2.416 million or 2.9%. Increases were a result of growth in comparable store pharmacy revenue and a full year of revenue for the Alentex, Teulon, and Central Fill acquisitions in 2008 partially offset by a decrease in comparable store front store revenue.

Growth in pharmacy revenue was impacted by reductions in changes to dispensing fees that came into effect in British Columbia in February 2009 along with the continuing shift to lower priced generic drugs from brand products.

The significant decline in front store revenue was in part due to the overall weak economic conditions and the impact of provincial legislation that restricts the display of tobacco products in BC and prohibited the sale of tobacco products in Alberta as of January 1, 2009. The resulting decline in traffic also has directly affected other front store sales. In addition, the Airdrie location which was under redevelopment in 2009 contributed to the decline in total sales. Sales in Airdrie are \$0.996 million lower in 2009 than in the prior year which represents a 23.2% reduction.

### Gross Margin

Gross margin is calculated as revenue less cost of sales. Cost of sales is comprised of the cost of goods sold through the Company's retail pharmacies, home health care store and central fill pharmacies. Gross margin was \$31.419 million in 2009 compared to \$28.151 million in 2008, an increase of \$3.268 million or 11.6%. This is due to a 3.3% improvement in pharmacy margin over 2008, and the benefit of a full year of operations for Alentex, Teulon and Central Fills that were acquired in 2008. Gross margin as a percentage of revenue increased to 36.5% from 34.0% in 2008 due to the revenue mix changing to a greater percentage of sales coming from higher margin pharmacy revenues and a declining percentage from lower margin front store sales.

### Operating Expenses

Operating expenses include all store level selling, general and administration expenses (which include wages and benefits), store occupancy costs, marketing and administration/other costs and excludes all corporate costs, interest and accretion expense, amortization, stock based compensation and other items as defined.

## Management's Discussion and Analysis *(continued)*

Operating expenses were \$22.779 million in 2009 compared to \$22.273 million in 2008, an increase of \$0.506 million or 2.3%. This was primarily a result of having a full year of operations for Alentex, Teulon and Central Fills that were acquired during 2008. Operating expenses as a percentage of revenue were 26.4% compared to 26.6% for 2008.

### **Operating Income**

Operating income is income generated from store level operations before corporate costs, amortization, interest and accretion expense, stock-based compensation and other items as defined.

Operating income was \$8.640 million in 2009 compared to \$5.878 million in 2008, an increase of \$2.762 million or 47.0%. This increase is a result of additional revenues from prior year acquisitions, improved pharmacy margins, and cost containment initiatives that were implemented during the year that reduced labour and product distribution expenses.

### **Corporate and Other Costs**

Corporate and other costs include all costs related to the corporate and administration offices including wages, benefits, occupancy, marketing, administration, and public company costs but excluding stock based compensation. Corporate and other costs were \$4.639 million in 2009 compared to \$4.485 million in 2008, an increase of \$0.154 million or 3.4%. This increase is the net effect of higher spending in areas such as recruitment, travel, and consulting that was offset by planned reductions in professional fees and marketing expenses.

### **EBITDA**

EBITDA was \$4.001 million in 2009 compared to \$1.393 million in 2008, an increase of \$2.608 million or 187.2%. The increase in EBITDA was primarily a result of the additional earnings contributed by the 2008 acquisitions, and the reduction in operating labour and distribution expenses, offset by the losses from Canadian Medical Supplies \$(0.310 million) and greenfield operation losses of \$(0.603 million).

### **Interest and accretion expense**

Interest and accretion expense includes financing costs on the convertible debenture, bank charges and interest, interest on long-term debt and capital leases and is reported net of interest income.

Financing costs on the convertible debenture comprised of accretion, accrued interest, and amortization of financing costs. Total financing costs on the convertible debenture were \$5.413 million in 2009 compared to \$7.527 in 2008 and included accretion of \$1.711 million, accrued interest of \$1.272 million, \$1.374 million inducement fee and \$1.056 million of amortization of financing costs.

Interest and accretion expense, excluding amounts related to the convertible debenture, were \$1.263 million compared to \$0.409 million in 2008, an increase of \$0.854 million. Bank charges and interest were \$0.133 million (2008 - \$0.229 million); interest and amortization of related financing costs on long-term debt was \$1.283 million (2008 - \$0.848 million) due to higher debt levels; and interest income was \$0.153 million (2008 - \$0.668 million). Interest income declined due to falling interest rates.

**Amortization**

Amortization of capital and intangible assets were \$4.409 million in 2009 compared to \$3.690 million in 2008, an increase of \$0.719 million or 19.5%. This increase is primarily a result of a full year of amortization on the capital and intangible assets acquired in the Teulon, Alentex, and the Okanagan and Westcoast central fill acquisitions during 2008 and the amortization on the capital and intangible assets of the newly built Centuria store that opened in October 2009.

**Stock based compensation**

Stock based compensation was \$0.068 million in 2009 compared to \$0.121 million in 2008, a decrease of \$0.053 million or 43.8%.

**Net loss**

The net loss was \$7.181 million compared to a net loss of \$10.125 million in 2008, a decreased loss of \$2.944 million or 29.1%. The improvement is primarily due to an increase in operating income over the prior year and a reduction in financing cost relating to the convertible debenture.

**FINANCIAL POSITION**

The following table provides a summary of certain information with respect to the Company's financial position at the end of the periods indicated

Thousands of dollars	2009 \$	2008 \$
Cash and cash in escrow	(14,980)	(14,269)
Bank indebtedness	-	921
Current portion of long-term debt and capital leases	10,640	2,459
Convertible debenture	-	17,233
Long-term debt and capital leases <sup>1</sup>	3,550	13,899
Net debt <sup>2</sup>	(790)	20,243
Shareholders' equity <sup>3</sup>	33,648	18,313
Total capitalization	32,858	38,556
Net debt: Shareholders' equity	(0.02:1)	1.11:1
Net debt: Total capitalization	(0.02:1)	0.52:1
EBITDA: Cash interest expense <sup>4</sup>	5.16:1	3.97:1

<sup>1</sup> Excludes the equity portion of the convertible debenture at August 31, 2008 of \$7,524.

<sup>2</sup> Net debt is defined as total bank indebtedness, long term debt (including current portion), capital leases (including current portion), convertible debenture and is net of cash and restricted cash.

<sup>3</sup> Includes the equity portion of the convertible debenture at August 31, 2008 of \$7,524.

<sup>4</sup> Cash interest expense excludes financing costs on the convertible debenture and amortization of other financing costs and is net of interest income.

## OUTSTANDING SHARE DATA

The Company had 97.6 million common shares and 0.6 million options to acquire its common shares outstanding at August 31, 2009. As of November 19, 2009 the Company had 97.4 million common shares as result of cancellation of 0.2 million through normal course issuer bid initiated in October 2009. Further details are available in Note 13 and Note 24 of the audited consolidated financial statements as at August 31, 2009.

## LIQUIDITY AND CAPITAL RESOURCES

The Company has an operating line of credit facility of a maximum of \$3 million, bearing interest at prime plus 1.25% per annum. The operating line is secured by a general security agreement representing a first charge on all the assets and undertakings of the Company and its subsidiaries, unlimited guarantees of advances by the Company and its subsidiaries, subordination/priority agreements with a certain supplier and an assignment of fire insurance over assets of the Company and its subsidiaries. At August 31, 2009, the Company had issued letters of credit aggregating \$0.5 million (2008 - \$0.5 million) leaving \$2.5 million of the \$3 million facility available. The Company was in compliance with its financial covenants as at August 31, 2009.

The Company's principal capital requirements are to fund working capital needs and renovate existing stores. These capital requirements have generally been satisfied by a combination of cash flow from operations and borrowings under its term and operating line of credit facility and the issuance of common shares. Capital required to fund acquisitions of pharmacies have been obtained through a combination of cash, debt financing and the issuance of common shares.

As a result of a conversion of the debenture earlier in the year, details of which are set out in Note 11 to the audited consolidated financial statements as at August 31, 2009, funds previously in escrow were released to the Company. At August 31, 2009 the Company has on deposit \$15.0 million available to fund capital projects relating to existing stores as well as for working capital and acquisitions. The Company currently holds a significant portion of these funds in guaranteed deposits pending refinancing of its bank debt.

### Operating Activities

Cash flow from operating activities in 2009 increased to \$6.262 million from \$3.528 million in 2008. The increase was primarily due to a reduction in accounts receivable and inventory.

### Financing Activities

Net cash expenditures used in financing activities was (\$3.897) million in 2009 compared to cash from financing activities of \$4.538 million in 2008. The Company raised \$8.568 million net of financing costs, and used these funds and an additional \$3.897 million to repay convertible and long term debt obligations. The cash from financing activities in 2008 resulted from the financing received in the second quarter that year relating to acquisitions less scheduled debt repayments.

### Investing Activities

Net cash from investing activities was \$12.074 million in 2009 compared to \$10.359 million in 2008. The current year relates primarily to the conversion of the debenture in the first quarter in which \$13.830 million of funds previously held in escrow were released to the Company, net of capital expenditures of \$1.811 million. The prior year reflected the impact of \$14.173 million of acquisitions; \$2.717 million of capital expenditures less \$7.030 million of funds released from escrow.

### Convertible Debenture

In May 2007, the Company issued a \$20.0 million convertible debenture. The proceeds from the issuance of the convertible debenture were restricted for future acquisitions as reviewed and approved by the Board of Directors and were not available for general corporate purposes. Cash from the issuance of the convertible debentures to the extent not invested had been held in escrow and its use restricted. The debenture holder could also demand repayment of the unspent funds and related interest on the first anniversary if less than 50% of the proceeds from the debenture had not been invested at that time.

The convertible debenture provided for a minimum interest rate of 15% and the interest rate could be adjusted (i) should the Company not spend a minimum of 50% of the debenture proceeds within one year or (ii) if the purchase price of the businesses financed with proceeds from the convertible debenture exceeded predetermined criteria. In May 2008, the Company had not invested 50% of the proceeds from the issuance of the debenture. The Company and the debenture holder at that time renegotiated various terms of the convertible debenture resulting in the un-invested funds remaining with the Company at an interest rate of 20% per annum and the \$3,000,000 interest accrued to that time being repaid with the issuance of 6,332,445 shares.

Effective November 14, 2008, the Company and the debenture holder also agreed that the interest adjustment owing under the convertible debenture as a result of purchase cost of investments exceeding predetermined criteria would be \$650,000. This interest expense was recorded in the three months ended November 30, 2008.

On November 14, 2008, the Company and the holder of the \$20.0 million convertible debenture reached agreement to accelerate the conversion of the debenture as follows:

- a) The Company repaid the debenture holder \$8,766,486 including accrued interest of \$316,486 which the debenture holder then reinvested in 33,717,264 common shares of the Company at \$0.26 per common share.
- b) The remaining \$11,550,000 principal owing under the debenture and accrued interest of \$2,159,055 were converted at \$.8028 per common share into 14,387,145 common shares and at \$0.35 per common share into 6,168,729 common shares respectively.
- c) A conversion inducement fee equal to forgone interest for early conversion at the rate otherwise payable to the scheduled maturity of May 2, 2009 including an agreed interest adjustment amount, in the aggregate of \$1,374,170, convertible at \$0.35 per share for an aggregate of 3,926,200 common shares.

**Future Liquidity**

The company estimates that sufficient means exist to satisfy the Company's working capital needs and debt-service requirements for the coming fiscal year. Future acquisitions or green field developments may require additional debt and equity financing to ensure compliance with credit facility covenants. As with all businesses today, the Company remains subject to the potential impact the recent global credit and financial crisis may have on its ability to refinance existing debt at current levels or to raise new debt or equity financing at reasonable rates or at all.

The Company has begun negotiations to replace existing financing with the expiration of its current facility in February 2010. Based on information currently available, the Company expects that a replacement facility will be secured.

**TRANSACTIONS WITH RELATED PARTIES**

In addition to the transactions set out in Note 11 to the consolidated financial statements, for the year ended August 31, 2009, the Company expensed \$0.15 million (2008 - \$0.20 million) for advisory fees due to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services for a shareholder.

For the year ended August 31, 2009, the Company expensed \$0.14 million (2008 - \$0.06 million) to one member of the Board of Directors for consulting services. The Company also paid \$0.19 million for the year ended August 31, 2009 (2008 - \$0.30 million) in rent for premises leased under operating leases with parties related by virtue of common management and directors. These transactions are in the normal course of operations and have been recorded at the exchange amount, which is the amount agreed to by the related parties.

**QUARTERLY INFORMATION**

**Summary of Quarterly Information**

The fiscal year-end of the Company is August 31 with quarter end falling on the following dates: November 30 (Quarter 1); February 28 (Quarter 2); May 31 (Quarter 3); August 31 (Quarter 4). The following table provides a summary of certain selected consolidated financial information for the Company for each of the eight most recently completed fiscal quarters. The consolidated financial statements have been prepared by management in accordance GAAP.

Thousands (except per share amounts)	Fourth Quarter		Third Quarter		Second Quarter		First Quarter	
	2009	2008	2009	2008	2009	2008	2009	2008
Revenue	20,537	22,094	21,615	22,357	22,204	21,590	21,783	17,677
EBITDA	972	(984)	1,425	957	1,110	1,105	476	315
- EBITDA per share - Basic	\$0.01	(\$0.03)	\$0.01	\$0.02	\$0.01	\$0.03	\$0.01	\$0.01
- EBITDA per share - Diluted	\$0.01	(\$0.03)	\$0.01	\$0.02	\$0.01	\$0.03	\$0.01	\$0.01
Net (loss) income	(449)	(4,029)	71	(2,406)	(411)	(1,797)	(6,392)	(1,893)
- Net loss per share - Basic	(\$0.01)	(\$0.09)	\$0.00	(\$0.06)	(\$0.01)	(\$0.04)	(\$0.13)	(\$0.05)
- Net loss per share - Diluted	(\$0.01)	(\$0.09)	\$0.00	(\$0.06)	(\$0.01)	(\$0.04)	(\$0.13)	(\$0.05)

## Management's Discussion and Analysis *(continued)*

The Company experienced a loss of \$0.449 million in the fourth quarter as compared to a loss of \$4.029 million in the same period in 2008. In the fourth quarter, the Company realized operating income of \$2.105 million (2008 - \$0.901 million) as a result of a 3.3% improvement in pharmacy and long term care margins and a reduction in operating and corporate expenses and reduced financing costs. Corporate costs were \$1.123 million for the fourth quarter (2008 - \$1.884 million). This reduction over prior year is mainly due to decreased spending on professional fees of \$0.305 million, public company costs of \$0.100 million, and consulting \$0.080 million.

Interest and accretion expense decreased to \$0.320 million from \$2.288 million in 2008 due to the debenture being converted in the first quarter resulting in no related financing costs in the fourth quarter. Amortization was \$1.308 million (2008 - \$1.210 million) reflecting the increased capital assets acquired during the 2009 fiscal year.

### **RISKS AND RISK MANAGEMENT**

The Company is exposed to a number of operating and financial risks. A summary of these are as follows:

#### **Competition**

Pharmacy operations are very competitive, particularly in the front store merchandise and non-prescription drug categories. Many of the Company's current competitors are of a size and scale of operations that greatly exceeds those of the Company. Thus they may have access to more favorable procurement terms and other operating benefits not available to the Company that permits them to have certain cost advantages. Additionally, as the Company's competitors in the retail pharmacy business include independent operators, banner groups, retail chains, mass merchandisers and larger supermarket chains with combination food/drug retail operations, the Company may need to reduce prices in front store merchandise or reduce dispensing fees to maintain or increase market share, which could have an adverse impact on the Company's earnings.

#### **General economic conditions**

The Company currently operates in Western Canada and, like all businesses globally, it has been subject to the impact of the current global credit and financial crisis on consumers in its areas of operations and the discretionary spending available to them. General economic conditions have resulted in reduced consumer spending and have impacted the Company's profitability. Should these conditions continue to prevail, there will be further pressure on the Company's profitability.

As well, the Company is subject to the potential impact the crisis may have on its ability to raise debt or equity financing at reasonable rates or at all.

### **Key Personnel**

The successful operation of the Company's business depends upon the abilities, expertise, judgment, discretion, integrity and good faith of its executive officers, management, employees and consultants. In addition, the ability of the Company to expand its services will depend upon the ability to attract qualified personnel as needed. The demand for skilled employees is high and the supply is limited. The unexpected loss of the Company's key personnel or the inability to retain or recruit skilled personnel could have a material adverse effect on the Company's business, financial condition, results of operations and cash flows. In particular, the Company is dependent upon its ability to attract, motivate and retain pharmacists for its stores. Increased competition in the retail pharmacy business has led to a shortage of pharmacists in Western Canada. The inability to attract and retain pharmacists could adversely affect the Company's business and earnings.

At the present time, a director of the Company is serving as the Chief Executive Officer (CEO) of the Company while the Company seeks a new CEO. There is no certainty as to when this position will be filled. Upon the successful recruitment of a CEO, the Company expects to recruit or appoint a Chief Financial Officer (CFO).

### **Reliance on Information Systems and Technology**

The Company's business relies upon information technology systems to support its distribution, merchandise and pharmacy dispensing systems and to service customers at the point of sale. Its information technology systems may be vulnerable to unauthorized access, computer viruses, system failures, other malicious acts or acts of nature. Were a significant disruption to its information technology to occur, the Company's earnings could be adversely affected through loss of revenue and costs to rectify the disruption.

### **Industry and Regulatory**

The Company is reliant on prescription drug sales for a significant and growing portion of its sales and profits. Prescription drugs and their sales are subject to numerous federal, provincial, territorial and local laws and regulations. Changes to these laws and regulations, or non-compliance with these laws and regulations, could have a material adverse impact on the Company's business, sales and profitability. See also "REGULATORY CHANGES THAT IMPACT THE COMPANY'S INDUSTRY".

### **Internal Control Deficiencies**

The Company's inability to successfully address potential material weaknesses in internal controls or other control deficiencies may affect its ability to report its financial results on a timely and accurate basis and to comply with disclosure and other requirements.

### **Financial covenants in lending agreements**

The Company is dependent upon continued access to capital on terms acceptable to the Company, including bank indebtedness and lending facilities. There is no assurance that the Company will be able to comply with any or all financial covenants in the future. Should it not be able to meet covenants or arrange for amendments in the future, the Company would be exposed to the bank realizing on its security, thus hindering the ability of the Company to operate effectively.

### **Third-party Service Providers**

The Company is reliant upon third-party service providers in respect of certain of its operations, including a limited number of major suppliers of prescription drugs and specialized pharmacy equipment and software. Any negative events affecting these third-party service providers could, in turn, potentially impact the Company. The Company has entered into contractual arrangements to formalize these relationships and, to minimize operating risks; the Company actively manages its relationships with its third-party service providers.

### **Real Estate**

The Company's success is dependent, among other things, on acquiring and maintaining locations suitable for its pharmacy and retail operations. The Company's business may be impacted if it is unable to secure or maintain suitable locations on lease terms that are commercially reasonable.

### **Seasonality**

The Company's core prescription drug operations are not typically subject to seasonal fluctuations. Its front store operations may see quarterly variation resulting from holiday periods such as Christmas or Easter.

### **Financial Instruments**

The Company is exposed to a number of risks associated with financial instruments that have the potential to affect its operating and financial performance. The Company's primary financial instrument risk exposure is to interest rate risk. The Company's exposures to foreign currency risk, credit risk and other price risk are not considered to be material. The Company may use derivative financial instruments to manage certain of these risks. The Company does not use derivative financial instruments for trading or speculative purposes.

### **Exposure to Interest Rate Fluctuations**

The Company is exposed to fluctuations in interest rates by virtue of its borrowings under its bank credit facilities. Increases or decreases in interest rates will positively or negatively impact the financial performance of the Company. The Company does not consider its exposure to interest rate fluctuations to be material at this time.

### **Foreign Currency Exchange Risk**

The Company does not consider its exposure to foreign currency exchange rate risk to be material at this time as its revenues, costs of sales and expenses are substantially conducted in Canadian \$.

### **Credit Risk**

The Company does not consider its exposure to credit risk to be material as accounts receivable arise primarily in respect of prescription sales billed to governments and third-party drug plans.

## **REGULATORY CHANGES THAT IMPACT THE COMPANY'S INDUSTRY**

The British Columbia government followed the lead of the Alberta government by allowing pharmacists to adapt prescriptions effective January 2009. The move was designed to improve the public's access to drug therapy and reduce medication side-effects and emergency-room visits. Negotiations to establish a funding formula to cover the adaptation services provided by pharmacists are now under way. Additionally, the British Columbia government continues on the path towards introducing other drug program reforms sometime in the next several months.

## Management's Discussion and Analysis *(continued)*

The Ministry of Health Services has already experimented with a tendering approach to procurement of pharmaceuticals and related supplies. Widespread use of tendering could dramatically alter business relationships between pharmacy owners and generic manufacturers, who have traditionally supported pharmacies through professional allowances. Unless the government agrees to significant increases in dispensing fees or begins compensating pharmacists for other services, the economics of the British Columbia pharmacy industry could be severely impacted by a curtailment in such allowances.

On December 12, 2008, the British Columbia government announced an interim agreement that runs for calendar 2009. The agreement specified no tendering of generic drugs for the duration of the interim agreement, it reduced the allowances paid on newly approved (approved after January 1, 2009) generic molecules, and it limited the capitation on daily and weekly dispensing fees effective February 1, 2009. A new long term agreement relating to the pricing of generic drugs and a fee schedule for services provided by pharmacists is anticipated by the parties to be agreed to in the fall of 2009. The interim agreement will negatively impact the Company's revenues and gross margins in 2009.

Alberta is also in the process of developing a new pharmaceutical strategy and announced Phase 2 of its strategy on October 20, 2009. The AB strategy aims to reduce prescription drug costs for Alberta residents, employers and government; improve prescription drug use and provide better care and improved health of all in the province. The strategy also targets generic drug spending. With many new generic drugs coming available in the next 3-5 years, the Alberta government wants to reduce overspending on generics. The strategy limits the price of new generic drugs at 45% of the brand name product, which was previously set at 75%. Prices of existing generic drugs are also being reviewed with changes expected starting in April 2010. Alberta has provided certain transitional and regional relief which will initially mitigate the effect of the changes announced to date. Further details on Alberta's reform are expected to be announced in late 2009.

A second study by the federal Competition Bureau release on November 25, 2008 is recommending that provincial governments and insurance companies seek to recover a portion of their costs from the pharmacies themselves. These and other similar recommendations could adversely affect future revenue of pharmacies.

Paragon, other pharmacy service providers and pharmacy focused organizations continue to discuss opportunities to better use pharmacists' education and expertise to deliver quality healthcare as well as to outline the potential harm to their financial viability resulting from efforts to reduce generic drug prices. As in British Columbia, community pharmacy stakeholders in Alberta are working to raise compensation rates for dispensing services so that cost-cutting measures such as tendering do not force stores to reduce or eliminate services.

Across Canada, much attention is being paid to the latest developments in Ontario's overhaul of its public drug program. Despite a recent study that found a funding gap of up to \$9 per prescription exists in that province, the Ontario government is moving ahead with implementing "competitive agreements" that could further reduce pharmacy revenues by reducing generic allowances available to pharmacies. In early November 2008, the Ontario government awarded contracts of this nature for two commonly-prescribed molecules, Metformin and Enalapril.

## Management's Discussion and Analysis *(continued)*

The Company is closely monitoring these developments at the provincial level while seeking opportunities to explore additional pharmacy-related revenue streams to offset the inevitable decline in financial support from generic drug suppliers.

Effective January 1, 2009, tobacco sales in Alberta were no longer permitted from health care facilities, pharmacies, and stores that contain a pharmacy. Similar requirements in British Columbia have been deferred pending further review by that province.

### **ESTIMATES**

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used when accounting for items such as inventory provisions, income and other taxes and testing goodwill and long-lived assets for impairment. Changes in those estimates could materially affect the consolidated financial statements.

The Company's claim for reimbursement of drug costs and dispensing fees in 2008 at one of its facilities is currently under review by a provincial health authority. The outcome of this review on claims made is unknown at this time. The Company has provided an allowance of \$0.200 million in the fourth quarter in respect to this matter. Adjustments to this allowance will be reflected in the accounts once known.

### **OFF-BALANCE SHEET ARRANGEMENTS/VARIABLE INTEREST ENTITIES**

The Company has no off-balance sheet arrangements or variable interest entities.

### **CHANGES IN ACCOUNTING POLICIES**

Effective September 1, 2008, the Company adopted several new accounting standards. These include Section 1535, "Capital Disclosures", and Section 1400 "General Standards of Financial Statement Presentation". The impact of these new standards on the consolidated financial statements was additional disclosures being required.

Effective September 1, 2008, the Company also adopted Section 3862 "Financial Instruments Disclosures" and Section 3863 "Financial Instruments Presentation". The effect on the Company was incremental disclosures regarding the significance of financial instruments for the entity's financial position and performance and the nature, extent and management of risks arising from financial instruments to which the entity is exposed.

Except for the adoption of new standards described above, the Company has not changed any accounting policies since August 31, 2008.

## **FUTURE ACCOUNTING PRONOUNCEMENTS**

Effective September 1, 2009 the Company will be required to adopt CICA Section 3064, "Goodwill and Intangible Assets. This section will supersede sections 3062, "Goodwill and Other Intangible Assets" and 3450, "Research and Development Costs", and establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets. Section 1000, "Financial Statement Concepts", was also amended to provide consistency with this new standard to clarify the criteria for recognition of an asset and the timing of expense recognition. As a result of adopting this policy effective September 1, 2009, the Company will write off deferred opening costs which will be charged against opening deficit.

Effective September 1, 2012, the Company will be required to adopt new accounting standards concerning Business Combinations and Consolidated Financial Statements which are based on International Financial Reporting Standards "IFRS" 3 and 27. The new requirements replace existing guidance on accounting for Business Combinations, the preparation of consolidated financial statements and accounting for non-controlling interests.

The Company expects to assess the impact of the new standard as part of its overall review of the convergence of Canadian GAAP with IFRS.

The Canadian Accounting Standards Board ("AcSB") has now confirmed that the use of IFRS will be required commencing in 2011 for publicly accountable, profit-orientated enterprises. IFRS will replace Canadian GAAP currently followed by the Company. The Company will be required to begin under IFRS for its fiscal year ended August 31, 2012 and will be required to provide information that conforms to IFRS for the comparative periods presented.

At this time, the Company has not formalized an IFRS changeover plan. The Company expects to develop such a plan in the coming year. The key elements of the plan will include reviewing the accounting policies permitted under IFRS and assessing the capability of the information systems to capture the necessary information. The plan will also set out processes to evaluate existing internal and disclosure controls and recommend any required changes.

## **DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings requires the Chief Executive Officer ("CEO") and the Director of Finance and Administration of the Company to file annual and quarterly certificates certifying that they are responsible for establishing and maintaining controls and procedures for the Company, and that they have designed such disclosure controls and procedures, or have caused them to be designed under their supervision, to provide reasonable assurance that material information relating to the Company is made known to them by others within the Company during the period in which the interim filings are being prepared.

Based on that evaluation and in light of the control weaknesses discussed below, the CEO and the Director of Finance and Administration concluded that the disclosure controls and procedures as at the end of the period covered by the interim filings are effective in providing reasonable assurance that material information relating to the Corporation and its consolidated subsidiaries, that is required to be disclosed in reports filed or submitted under applicable securities law, is made known to them by others within these entities.

## Management's Discussion and Analysis *(continued)*

Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls become inadequate because of changes in conditions or personnel, or that the degree of compliance with the policies or procedures may deteriorate.

In compliance with Multilateral Instrument 52-109, management must disclose in its MD&A any material weakness found to exist within its system of internal control over financial reporting. As reported last year, management had identified a material weakness in lack of segregation of duties. The management group of the Company is small and full segregation of all duties has not been possible. Management believes this is a typical issue for smaller companies.

Notwithstanding the above control weaknesses, the CEO and Director of Finance and Administration have satisfied themselves that the control environment and reporting practices are such that reasonable assurance exists that material information related to the corporation and its subsidiaries has been made known to them.

The Board of Directors together with the Audit Committee have direct oversight responsibilities for the review and approval of the quarterly and annual financial disclosures.