

## PARAGON PHARMACIES LIMITED

### MANAGEMENT'S DISCUSSION & ANALYSIS FOR THE THREE MONTH PERIOD ENDED NOVEMBER 30, 2009

As at January 27, 2010

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited (the "Company") for the three month period ended November 30, 2009. This discussion and analysis should be read in conjunction with the Company's interim unaudited consolidated financial statements and accompanying notes for the three month period ended November 30, 2009. The interim unaudited 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

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

standardized meanings prescribed by GAAP and therefore may not be comparable to similar measures presented by other reporting issuers.

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 Company owns and operates 19 retail pharmacies and three 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, improved profitability and expand brand awareness.

The hard work and dedication to customer service 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 and its ability to secure financing 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 has begun to automate certain processes in its pharmacies to increase service, enhance quality control and improve efficiencies.

The Company will continue to search for new acquisitions that support its long term growth strategies. 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 three month period ended November 30, 2009 compared to the three month period ended November 30, 2008.

- Revenue of \$20.926 million (2008: \$21.783 million), a decrease of 3.9%. (Refer to page 5 for further explanation)
- Comparable store revenue reduction of (3.0%) (excluding tobacco)
  - Comparable store pharmacy revenue growth of 0.1%
  - Comparable front store revenue<sup>1</sup> reduction of (15.8%) (excluding tobacco). (Refer to page 5 for further explanation)
- Gross margin<sup>2</sup> as a percentage of revenue of 36.4% (2008: 34.9%), an increase of 4.3%. (Refer to page 5 for further explanation)
- Operating income<sup>3</sup> of \$2.012 million (2008: \$1.479 million), an increase of 36.0%. (Refer to page 6 for further explanation)
- EBITDA of \$1.061 million (2008: \$0.303 million), an increase of 250.2%. (Refer to page 6 for further explanation)

<sup>1</sup> Front store revenue includes all non-pharmacy revenue.

<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

#### ***First Quarter***

- The Company opened a new clinical format 1,000 square foot pharmacy in Kelowna in early September 2009. The location is part of a health focused professional building, including an adjacent medical practice.
- The Company relocated one of its Kelowna locations to a new 9,000 square foot pharmacy within the same shopping centre. The store opened in September 2009.
- During the quarter the Company began development of a medical clinic adjacent to its Airdrie, Alberta store. The clinic is scheduled to open in the second quarter.
- In late October, the Company purchased an independent pharmacy to consolidate the script business with an existing Paragon location in Calgary. This transaction is expected to add a minimum 12,000 additional prescriptions to the Paragon store.
- The Company opened a new Canada Post outlet in one of its existing locations in Calgary, Alberta in November 2009.
- During the quarter, the Company began the process of reorganizing its long term care operations. This included strengthening management in two locations and recruiting a

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

Director of Business Development/Central Fill. The reorganization will continue through its second quarter with a focus on work flow improvements and introduction of new technologies.

- The Company continued with its unified pharmacy platform conversion within its Alberta and Manitoba locations. Three locations were completed during the quarter, with the remaining eight to be complete by the spring of 2010.
- During the quarter, the Company joined RX Canada to participate in helping track and anticipate flu activity for the National Antiviral and OTC Medication Surveillance Program sponsored by the Public Health Agency of Canada. This program also allows the Company to participate in Health Inform medication programs that not only improves patient knowledge and adherence to medication, but improves the Company's professional pharmacy service levels provided to our customers.

### 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)	3 Months Ended		\$ Change	% Change
	Nov 30, 2009 \$	Nov 30, 2008 \$		
Revenue	20,926	21,783	(857)	(3.9%)
Gross Margin	7,608	7,601	7	0.1%
Operating Expenses <sup>1</sup>	5,596	6,122	(526)	(8.6%)
Operating Income	2,012	1,479	533	36.0%
Corporate and other costs	951	1,176	(225)	(19.1%)
EBITDA <sup>2</sup>	1,061	303	758	250.2%
Stock-based compensation	8	17	(9)	(52.9%)
Amortization	1,185	1,081	104	9.6%
Interest and accretion expense <sup>3</sup>	315	5,734	(5,419)	(94.5%)
Other Items <sup>4</sup>	36	29	7	0.24%
Net loss	(483)	(6,558)	6,075	92.6%
EBITDA per common share				
- Basic	\$0.01	\$0.01	-	-
- Diluted	\$0.01	\$0.01	-	-
Loss per common share				
- Basic	(\$0.00)	(\$0.13)	\$0.13	100.0%
- Diluted	(\$0.00)	(\$0.13)	\$0.13	100.0%

<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 2010: \$0.031 million (2009: \$0.052 million); interest on long term debt 2010: \$0.160 million, (2009: \$0.256 million); and interest income of 2010: \$0.007 million (2009: \$0.083 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 loss on equity investments of 2010: \$nil (2009: \$0,023 million loss) and loss on disposal of capital and intangible assets of 2010: \$0.036 million loss (2009: \$0.006 million loss).

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

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

(Thousands of dollars)	3 Month Ended	
	November 30, 2009 \$	November 30, 2008 \$
Net loss	(483)	(6,558)
Add the following:		
Interest and accretion expense	315	5,734
Amortization	1,185	1,081
Stock based compensation	8	17
Other items	36	29
EBITDA	1,061	303

### Revenue

Revenue is comprised of sales to customers of the Company's retail pharmacies and central fill pharmacies. Revenue was \$20.926 million in the first quarter compared to \$21.783 million in the same period last year, a decrease of \$0.857 million or 3.9%. Decreases were a result of a decline in comparable 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.

### 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 and central fill pharmacies. Gross margin was \$7.608 million in the first quarter compared to \$7.601 million in the same period last year, an increase of \$0.007 million or 0.1%. This is due to a 0.8% improvement in pharmacy margin to 40.2% over 39.4% margin for the same period last year.

Front store gross margin dollars are down \$0.286 million. This resulted from front store sales in Alberta being impacted by a shift from direct buying to consolidating purchasing through a wholesaler. This change resulted in the Company achieving certain efficiencies in distribution costs; however, access to certain high volume special merchandise promotions were impacted.

Gross margin percentage is up 4.3% overall. Gross margin as a percentage of revenue increased to 36.4% from 34.9% in the same period last year due to the revenue mix changing to a greater percentage of sales coming from higher margin pharmacy revenues.

### **Operating Expenses**

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

Operating expenses were \$5.596 million in the first quarter compared to \$6.122 million in the same period last year, a decrease of \$0.526 million or 8.6%. This was primarily a result of decreased operating wages and operating administration costs relating to distribution and retail stores partially offset by an increase in occupancy costs over the same period last year. Operating expenses as a percentage of revenue were 26.7% compared to 28.1% for the same period last year.

### **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 \$2.012 million in the first quarter compared to \$1.479 million in the same period last year, an increase of \$0.533 million or 36.0%. This increase is a result of cost containment initiatives that were implemented during fiscal 2009 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, administration, and public company costs but excluding stock based compensation. Corporate and other costs were \$0.951 million in the first quarter compared to \$1.176 million in the same period last year, a decrease of \$0.225 million or 19.1%. This decrease is the net effect of lower corporate wage and administration costs partially offset by higher information technology spending.

### **EBITDA**

EBITDA was \$1.061 million in the first quarter compared to \$0.303 million in the same period last year, an increase of \$0.758 million or 250.2%. The increase in EBITDA was primarily a result of the reduction in operating labour and distribution expenses and well as a reduction in corporate costs over the same period last year.

### **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.

Interest and accretion expense, excluding amounts related to the convertible debenture, were \$0.315 million in the first quarter compared to \$0.321 million in the same period last year, a decrease of \$0.006 million. Bank charges and interest were \$0.031 million (2008 - \$0.052 million); interest and amortization of related financing costs on long-term debt was \$0.291 million (2008 - \$0.352 million) due to lower debt levels; and interest income was \$0.007 million (2008 - \$0.083 million). Interest income declined due to falling interest rates.

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

Financing costs on the convertible debenture comprised of accretion, accrued interest, and amortization of financing costs. Total financing costs on the convertible debenture were \$nil in the first quarter compared to \$5.413 in the same period last year which included accretion of \$1.711 million, accrued interest of \$1.272 million, \$1.056 million of amortization of financing costs, and \$1.374 million inducement fee.

### Amortization

Amortization of capital and intangible assets were \$1.185 million in the first quarter compared to \$1.081 million in the same period last year, an increase of \$0.104 million or 9.6%. This increase is due to amortization on the capital and intangible asset additions.

### Stock based compensation

Stock based compensation was \$0.008 million in the first quarter compared to \$0.017 million in the same period last year, a decrease of \$0.009 million or 52.9%.

### Net loss

The net loss was \$0.483 million in the first quarter compared to a net loss of \$6.558 million in the same period last year, an improvement of \$6.075 million or 92.6%. This change is primarily due to an increase in operating income and a reduction in corporate expenses over the prior year together with a reduction in financing costs.

## 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	November 30, 2009 \$	August 31, 2009 \$
Cash and cash in escrow	(13,335)	(14,980)
Current portion of long-term debt and capital leases	10,250	10,640
Long-term debt and capital leases	3,375	3,550
Net debt <sup>1</sup>	290	(790)
Shareholders' equity	32,872	33,572
Total capitalization	33,162	32,782
Net debt: Shareholders' equity	0.01:1	(0.02:1)
Net debt: Total capitalization	0.01:1	(0.02:1)
EBITDA: Cash interest expense <sup>2</sup>	5.77:1	5.16:1

<sup>1</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>2</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

As of November 30, 2009 the Company had 96.9 million common shares. This reduction in common shares is the result of cancellation of 0.7 million through a normal course issuer bid initiated in October 2009. Further details are available in Note 8 of the unaudited consolidated financial statements as at November 30, 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 November 30, 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 November 30, 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.

At November 30, 2009 the Company has on deposit \$13.3 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 the first quarter increased to \$0.312 million from (\$0.072) million in the same period last year.

#### **Financing Activities**

Net cash expenditures used in financing activities was (\$0.891) million in the first quarter compared to (\$1.906) million in the same period last year. The Company repaid \$0.681 million of long term debt obligations during the first quarter compared to \$0.583 million during the same period last year. The Company repurchased shares for \$0.225 million in the quarter under the Normal Course Issuer Bid that commenced October 9, 2009, compared to \$nil for the same period last year. The Company repaid bank indebtedness of \$nil in the first quarter of 2009, compared to \$0.921 million in the same period in 2008. The prior year financing activities primarily related to a partial repayment of the convertible debenture which was then reinvested in common shares of the Company. In addition the convertible debenture holder converted the remaining portion of the debenture and accrued interest into common shares.

#### **Investing Activities**

Net investment from investing activities was (\$1.066) million in the first quarter compared to a net cash flow of \$13.733 million in the same period last year. The current year relates primarily to the acquisition of the prescription file of a pharmacy in Calgary, AB, for \$0.500 million and capital and intangible asset expenditures of \$0.588 million. The pharmacy acquisition is

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

discussed further under Note 4 of the unaudited consolidated financial statements as at November 30, 2009. The prior 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 \$0.602 million.

### **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 that was originally set to expire in December 2009, and now been extended to April 6, 2010. Based on information currently available, the Company expects that replacement facilities will be secured that will include providing the Company with financing to fund future acquisitions on reasonable terms and conditions.

### **TRANSACTIONS WITH RELATED PARTIES**

For the quarter ended November 30, 2009, the Company expensed \$0.13 million (2008 - \$0.025 million) for advisory and executive services fees due to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services as a shareholder.

For the quarter ended November 30, 2009, the Company expensed \$nil million (2008 - \$0.135 million) to one member of the Board of Directors for consulting services. The Company also paid \$0.050 million for the quarter ended November 30, 2009 (2008 - \$0.050 million) in rent for premises leased under operating leases to one director. 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.

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

Thousands (except per share amounts)	First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
	2010	2009	2009	2008	2009	2008	2009	2008
Revenue	20,926	21,783	20,537	22,094	21,615	22,357	22,204	21,590
EBITDA	1,061	303	964	(984)	1,425	957	1,110	1,105
- EBITDA per share - Basic	\$0.01	\$0.01	\$0.01	(\$0.03)	\$0.01	\$0.02	\$0.01	\$0.03
- EBITDA per share - Diluted	\$0.01	\$0.01	\$0.01	(\$0.03)	\$0.01	\$0.02	\$0.01	\$0.03
Net (loss) income	(483)	(6,558)	(452)	(4,028)	67	(2,405)	(401)	(1,796)
- Net loss per share - Basic	(\$0.01)	(\$0.13)	(\$0.01)	(\$0.09)	\$0.00	(\$0.06)	(\$0.01)	(\$0.04)
- Net loss per share - Diluted	(\$0.01)	(\$0.13)	(\$0.01)	(\$0.09)	\$0.00	(\$0.06)	(\$0.01)	(\$0.04)

\* Prior quarters adjusted for Goodwill and intangible assets Section 3064 accounting policy change noted in the unaudited consolidated financial statements

### 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 required to meet its capital requirements for current and future operations.

#### 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 has allowed 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 now expected to take effect later this year.

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 initially was to expire on December 31, 2009. The agreement has now been extended to June 30, 2010. 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

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

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 expected in the summer of 2010. The interim agreement impacted revenues and margins by an estimated \$0.600 million since inception and \$0.175 million of that estimated to have impacted the first quarter of 2010.

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 three to five years, the Alberta government wants to reduce spending 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 now expected to be announced in early 2010.

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. Ontario's review includes reductions to pharmacy allowances, expanding scope of pharmacy services and the reimbursement for such services, alternative drug distribution channels and pricing mechanisms and reduced drug costs. The discussions between Ontario and the pharmacy industry are ongoing with implementation of reform expected in 2010.

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.

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

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 provided an allowance of \$0.200 million in the fourth quarter of 2009 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

The Company adopted a new accounting standard Handbook Section 3064 "Goodwill and Intangible Assets". This section replaces the existing guidance on goodwill and other intangible assets and research and development costs, and provides additional guidance on measuring the cost of goodwill and 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.

Following the adoption of Section 3064, the Company reclassified the net carrying value of computer software that met the definition of intangible assets from capital assets to intangible assets on the consolidated balance sheet. The Company also wrote-off pre-operating costs through opening deficit. The prior year's net loss for the three-month period November 30, 2008 was restated to recognize pre-operating costs relating to new store openings as operating expenses and to eliminate the amortization of pre-operating costs in the interim consolidated statement of operations.

Cumulative adjustments, following the adoption of Section 3064, to the consolidated balance sheet as at August 31, 2009 and to the interim consolidated statements of earnings and cash flows for the three months ended November 30, 2008, are disclosed in Note 3 of the November 30, 2009 unaudited financial statements.

### FUTURE ACCOUNTING PRONOUNCEMENTS

Effective September 1, 2011, 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 will 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 begun to develop an IFRS changeover plan. This includes analyzing the key differences between IFRS requirements and Canadian GAAP. 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.

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.