

**PARAGON PHARMACIES LIMITED**

**MANAGEMENT'S DISCUSSION & ANALYSIS  
FOR THE THREE AND SIX MONTH PERIODS ENDED FEBRUARY 28, 2010**

**As at April 22, 2010**

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited (the "Company") for the three and six month periods ended February 28, 2010. This discussion and analysis should be read in conjunction with the Company's interim unaudited consolidated financial statements and accompanying notes for the same period. 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 revenue growth, build customer loyalty, improve profitability and expand brand awareness.

The pharmacy industry is facing significant change that will impact prices of generic drugs and pharmacy allowances. These changes are being driven by the increasing cost of health care as well as the significant number of new generic drugs coming into the market. The Company is working to expand its pharmacy scope of practice to take advantage of additional funding programs that are being introduced in connection with these changes to minimize the impact of newly effective Alberta regulation changes, as well as the pending changes in British Columbia expected later this year. The Alberta government strategy includes transitional initiatives to mitigate the initial impact and allow for restructuring.

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 are well positioned to succeed. The Company's success in achieving its objectives is dependent on its ability to adapt to these regulatory changes.

The hard work and dedication to customer service of the 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 its internal systems to enhance the service offering to its customers. This included implementing a new point-of-sale system that will improve the Company's ability to manage front store operations and enhanced training and development programs focused on improved customer service.

The aging population and general shift of Canadians to live healthier, more active lives will support the Company's growth strategies. 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, prescription files 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.

### SUMMARY

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

The following provides a summary of the Company's performance for the three and six month periods ended February 28, 2010 compared to the three and six month periods ended February 28, 2009.

- Second quarter revenue of \$20.785 million (2009: \$22.204 million), a decrease of 6.4%.
  - Six month revenue of \$41.711 million (2009: \$43.987 million), a decrease of 5.2%. (Refer to page 6 for further explanation)
- Second quarter comparable store revenue reduction of (6.0%) (excluding tobacco); comparable store pharmacy revenue reduction of (4.3%); comparable front store revenue<sup>1</sup> reduction of (15.0%) (excluding tobacco).
  - Six month comparable store pharmacy revenue reduction of (2.1%)
  - Six month comparable front store revenue<sup>1</sup> reduction of (15.4%) (excluding tobacco). (Refer to page 6 for further explanation)
- Second quarter gross margin<sup>2</sup> as a percentage of revenue of 36.6% (2009: 35.1%), an increase of 1.5%.
  - Six month gross margin<sup>2</sup> as a percentage of revenue of 36.5% (2009: 35.2%), an increase of 1.3%. (Refer to page 6 for further explanation)
- Second quarter operating income<sup>3</sup> of \$2.008 million (2009: \$2.084 million), a decrease of 3.6%.
  - Six month operating income<sup>3</sup> of \$4.192 million (2009: \$3.919 million), an increase of 7.0%. (Refer to page 7 for further explanation)
- Second quarter EBITDA of \$0.976 million (2009: \$1.110 million), a decrease of 12.1%.
  - Six month EBITDA of \$2.037 million (2009: \$1.586 million), an increase of 28.4%. (Refer to page 8 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

### **Second Quarter**

- During the quarter, the Board of Directors appointed Mr. R. Gordon Gooding, CA, as Chief Executive Officer effective April 1, 2010. Mr. Gooding brings extensive experience in the retail sector having served as CEO, President and Chief Financial Officer of a U.S. retail organization he established and grew to a 50-store chain.
- During the quarter, the Company finalized its point-of-sale system vendor selection and began the implementation phase of the project. Standardizing its systems across all locations will allow for improved customer service, loyalty program additions, and more efficient reporting tools for the Company.
- The Company continued with its unified pharmacy platform conversion within its Alberta and Manitoba locations. Seven locations were completed during the quarter, with one remaining to be complete by the spring of 2010.
- The Company opened a new medical clinic adjacent to its Airdrie, Alberta store. The benefit of this will begin impacting store results in the third quarter.
- During the quarter, the Company continued the process of reorganizing its long term care operations. This included work flow improvements and information technology upgrades that will increase efficiency and eliminate down time. The Company also introduced new technology to one of its sites that improves patient safety and increases efficiencies within the operation.

**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		6 Months Ended	
	Feb 28, 2010	Feb 28, 2009	Feb 28, 2010	Feb 28, 2009
	\$	\$	\$	\$
Revenue	20,785	22,204	41,711	43,987
Gross Margin	7,609	7,798	15,217	15,490
Operating Expenses <sup>1</sup>	5,601	5,714	11,025	11,571
Operating Income	2,008	2,084	4,192	3,919
Corporate and other costs	1,032	974	2,155	2,333
EBITDA <sup>2</sup>	976	1,110	2,037	1,586
Stock-based compensation	(7)	29	1	46
Amortization	1,254	1,055	2,439	2,153
Interest and accretion expense <sup>3</sup>	201	307	516	6,041
Other Items <sup>4</sup>	(8)	120	28	149
Net loss	(464)	(401)	(947)	(6,803)
EBITDA per common share				
- Basic	\$0.01	\$0.01	\$0.02	\$0.02
- Diluted	\$0.01	\$0.01	\$0.02	\$0.02
Loss per common share				
- Basic	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.07)
- Diluted	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.07)

<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 Q2-2010: \$0.034 million (Q2-2009: \$0.014 million), YTD-2010: \$0.065 million (YTD-2009: \$0.066 million); interest on long term debt Q2-2010: \$0.155 million, (Q2-2009: \$0.209 million), YTD-2010: \$0.315 million (YTD-2009: \$0.465 million); amortization of financing costs Q2-2010: \$0.023 million (Q2-2009: \$0.128 million), YTD-2010: \$0.154 million (YTD-2009: \$0.224) and interest income of Q2-2010: \$0.011 million (Q2-2009: \$0.044 million), YTD-2010: \$0.018 million (YTD-2009: \$0.127 million). The financing costs on the convertible debenture \$5.413 million are a non-cash item included in the interest and accretion expense.

<sup>4</sup> Other items include loss on equity investments of Q2-2010: \$nil (Q2-2009: \$0.120 million loss), YTD-2010: \$nil (YTD-2009: \$0.143 million) and gain/loss on disposal of capital and intangible assets of Q2-2010: \$0.008 million gain (Q2-2009: \$nil loss), YTD-2010: \$0.028 million loss (YTD-2009: \$0.005 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		6 Month Ended	
	February 28, 2010	February 28, 2009	February 28, 2010	February 28, 2009
	\$	\$	\$	\$
Net loss	(464)	(401)	(947)	(6,803)
Add the following:				
Interest and accretion expense	201	307	516	6,041
Amortization	1,254	1,055	2,439	2,153
Stock based compensation	(7)	29	1	46
Other items	(8)	120	28	149
EBITDA	976	1,110	2,037	1,586

### Revenue

Revenue is comprised of sales to customers of the Company's retail pharmacies and central fill pharmacies. Revenue was \$20.785 million in the second quarter compared to \$22.204 million in the same period last year, a decrease of \$1.419 million or 6.4%. Decreases were a result of a 4.3% decline in comparable store pharmacy revenue and a 15.0% decline in comparable front store revenue.

Pharmacy revenue was impacted by reductions 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 decline in front store revenue was in part due to decreased foot traffic caused by the current challenging economic conditions and increased competitive pressure from larger retailers in the industry. The Company recognizes improvement in product assortment is required to compete more effectively. Under the direction of the Company's new CEO, who has extensive knowledge in merchandising and general retail management, advancements are being made which should benefit future front store sales.

Revenue for the six month period ending February 28, 2010 was \$41.711 million compared to \$43.987 million for the same period last year, a decrease of \$2.28 million or 5.2%. Same store Rx revenue declined by 2.1% year over year. Front store revenues excluding tobacco declined year over year by 15.4% due to poor economic conditions and reduced traffic resulting from restrictions on the sale of tobacco products.

### 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 \$7.609 million in the second quarter compared to \$7.798 million in the same period last year, a decrease of \$0.189 million or 2.4%. This is due to a decline in both pharmacy and front store revenue partially offset by an increase in both pharmacy and front store gross margin as a percentage of sales.

Front store gross margin dollars are down \$0.079 million due primarily to a drop in revenues, offset slightly by a small increase in gross margin percentage.

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

Gross margin percentage is up 4.3% overall. Gross margin as a percentage of revenue increased to 36.6% from 35.1% in the same period last year due to the revenue mix changing to a greater percentage of sales coming from higher margin pharmacy revenues.

Gross margin was \$15.217 million for the six month period compared to \$15.490 million for the same period last year, a decrease of \$0.273 million or 1.8%. This was primarily a result of decreased pharmacy and front store revenue partially offset by an increase in both pharmacy and front store gross margin as a percentage of sales. Gross margin as a percentage of sales increased to 36.5% from 35.2% in the same period last year.

### **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 \$5.601 million in the second quarter compared to \$5.714 million in the same period last year, a decrease of \$0.113 million or 2.0%. 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 26.9% compared to 25.7% for the same period last year.

Operating expenses were \$11.025 million for the six month period compared to \$11,571 million for the same period last year, a decrease of \$0.546 million or 4.7%. 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 26.4% compared to 26.3% 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 \$2.008 million in the second quarter compared to \$2.084 million in the same period last year, a decrease of \$0.076 million or 3.6%. This decrease is a result of the reduction in sales, offset by increased margin percentages and cost containment initiatives that were implemented during fiscal 2009 that reduced labour and product distribution expenses.

Operating income was \$4.192 million for the six month period compared to \$3.919 million for the same period last year, an increase of \$0.273 million or 7.0%. This increase is a result of improved pharmacy and front store margins as well as the reduction of operating expenses by 2.0% over prior year.

### **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 \$1.032 million in the second quarter compared to \$0.974 million in the same period last year, an increase of \$0.058 million or

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

6.0%. This increase is the net effect of higher marketing spend and operating costs associated with pharmacy technology partially offset by lower corporate wage and administration costs.

Corporate expenses for the six month period were \$2.155 million compared to \$2.333 million for the same period last year, a decrease of \$0.178 million or 7.6%.

### **EBITDA**

EBITDA was \$0.976 million in the second quarter compared to \$1.110 million in the same period last year, a decrease of \$0.134 million or 12.1%. The decrease in EBITDA was primarily a result of the reduction in pharmacy and front store revenue and an increase in corporate costs over the same period last year.

EBITDA was \$2.037 million for the six month period compared to \$1.586 million for the same period last year, an increase of \$0.451 million or 28.4%. The increase in EBITDA was a result of decreased operating and corporate costs over the period, and increased overall margin percentage from prior 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 \$0.201 million in the second quarter compared to \$0.307 million in the same period last year, a decrease of \$0.106 million. Bank charges and interest were \$0.034 million (2009 - \$0.014 million); interest and amortization of related financing costs on long-term debt was \$0.178 million (2009 - \$0.337 million) due to lower debt levels; and interest income was \$0.011 million (2009 - \$0.044 million). Interest income declined due to falling interest rates.

Bank charges and interest were \$0.065 million for the six month period (2009: \$0.066 million); interest and amortization of related financing costs on long-term debt was \$0.469 million (2009: \$0.689 million); and interest income of \$0.018 million (2009: \$0.127 million).

Financing costs on the convertible debenture comprised of accretion, accrued interest, and amortization of financing costs. Financing costs on the convertible debenture were \$nil for the six month period compared to \$5.413 million 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 was \$1.254 million in the second quarter compared to \$1.055 million in the same period last year, an increase of \$0.199 million or 18.9%. This increase is due to amortization on the capital and intangible asset additions.

Amortization of capital and intangible assets was \$2.439 million for the six month period compared to \$2.153 million for the same period last year, an increase of \$0.286 million or 13.3%. This increase is primarily a result of amortization resulting from acquisitions and additions to capital and intangible assets.

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

### Stock based compensation

Stock based compensation was \$(0.007) million in the second quarter compared to \$0.029 million in the same period last year, a decrease of \$0.036 million.

Stock based compensation was \$0.001 million for the six month period compared to \$0.046 million for the same period last year, an increase of \$0.045 million.

### Net loss

The net loss was \$0.464 million in the second quarter compared to a net loss of \$0.401 million in the same period last year, an increase of \$0.063 million or 15.7%. This change is primarily due to a decline in revenue from that of prior year.

The net loss was \$0.947 million for the six month period compared to a net loss of \$6.803 for the same period last year, an improvement of \$5.856 million or 618.4%. This change is primarily due to the interest and accretion costs on the debenture in the prior year.

## 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	February 28, 2010 \$	August 31, 2009 \$
Cash and cash equivalents	(11,255)	(14,980)
Current portion of long-term debt and capital leases	9,757	10,640
Long-term debt and capital leases	3,361	3,550
Net debt <sup>1</sup>	1,863	(790)
Shareholders' equity	31,992	33,572
Total capitalization	33,855	32,782
Net debt: Shareholders' equity	0.06:1	(0.02:1)
Net debt: Total capitalization	0.06:1	(0.02:1)
EBITDA: Cash interest expense <sup>2</sup>	5.63:1	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), 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 February 28, 2010 the Company had 95.8 million issued and outstanding common shares. This reduction in common shares is the result of cancellation of 1.8 million shares 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 February 28, 2010.

## LIQUIDITY AND CAPITAL RESOURCES

The Company secured a new three year credit facility with a \$5.0 million operating line, \$5.0 million term loan and \$15.0 million acquisition facility effective April 6, 2010 that replaced the original facility in place. The facility is secured by 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.

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 February 28, 2010 the Company has on deposit \$11.3 million available to fund capital projects relating to existing stores as well as for working capital and acquisitions. Subsequent to the quarter end, the Company used approximately \$4.8 million of these funds to pay down its existing debt in connection with the refinancing.

### Operating Activities

Cash flow from operating activities in the second quarter decreased to (\$0.501) million from \$0.790 million in the same period last year due to an increase in inventory of \$0.869 million.

For the six month period, net cash flow generated from operating activities was (\$0.159) million compared to \$0.891 million in the same period last year. This difference was primarily from increased investment in working capital items.

### Financing Activities

Net cash expenditures used in financing activities was (\$0.941) million in the second quarter compared to (\$1.528) million in the same period last year. The difference that the Company repaid \$0.283 million less of long term debt obligations during the second quarter compared to the same period last year, and \$0.680 million less financing of non-cash working capital offset by the \$0.409 million spent repurchasing shares in the quarter under the Normal Course Issuer Bid that commenced October 9, 2009, compared to \$nil for the same period last year.

For the six month period, net cash expenditures used in financing activities was (\$1.862) million compared to net cash expenditures used in financing activities of (\$3.434) million in the same period last year. This change was due primarily to the Company's reduction of bank indebtedness of \$0.921 million compared to prior year, the elimination of advances to related parties compared to \$0.246 million in prior year, and the reduction of financing costs of \$0.136 million.

### Investing Activities

Net investment from investing activities was (\$0.638) million in the second quarter compared to a net cash flow of (\$0.112) million in the same period last year. The current year relates entirely to the purchase of capital and intangible assets.

For the six month period, net investment from investing activities was (\$1.704) million compared to cash injected from investing activities of \$13.448 million in the same period

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

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 \$1.226 million. The prior year relates primarily to the conversion of the debenture in the first quarter in which \$13.830 million previously held in escrow was released to the Company net of capital and intangible asset expenditures of \$0.858 million.

### **Future Liquidity**

The Company estimates that sufficient means exist to satisfy the Company's working capital needs and debt-service requirements. Future acquisitions or green field developments may require additional debt and equity financing to ensure compliance with credit facility covenants. The Company remains subject to the potential impact of RX reform and how it impacts the Company's ability to raise new debt or equity financing, or refinance existing debt.

### **TRANSACTIONS WITH RELATED PARTIES**

For the three and six months ended February 28, 2010, the Company expensed \$0.11 million and \$0.23 million respectively for advisory and executive services fees due to Canterbury Park Management Inc. (three and six months ended February 28, 2009 \$0.03 million and \$0.05 million respectively). Canterbury Park Management Inc. provides management services as a shareholder.

For the three and six months ended February 28, 2010, the Company expensed \$nil and \$nil respectively (three and six months ended February 28, 2009 \$nil and \$0.135 million respectively) to one member of the Board of Directors for consulting services. The Company also paid \$0.050 million for the three months ended, and \$0.096 million for the six months ended February 28, 2010 (three and six months ended February 28, 2009 \$0.066 million and \$0.116 million respectively) 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.

Thousands (except per share amounts)	Second Quarter		First Quarter		Fourth Quarter		Third Quarter	
	2010	2009	2010	2009	2009	2008	2009	2008
Revenue	20,785	22,204	20,926	21,783	20,537	22,094	21,615	22,357
EBITDA	976	1,110	1,061	303	964	(984)	1,425	957
- EBITDA per share - Basic	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	(\$0.03)	\$0.01	\$0.02
- EBITDA per share - Diluted	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	(\$0.03)	\$0.01	\$0.02
Net (loss) income	(464)	(401)	(483)	(6,558)	(452)	(4,028)	67	(2,405)
- Net loss per share - Basic	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.13)	(\$0.01)	(\$0.09)	\$0.00	(\$0.06)
- Net loss per share - Diluted	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.13)	(\$0.01)	(\$0.09)	\$0.00	(\$0.06)

\* 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 has been subject to the impact of the recent economic downturn and decrease of discretionary spending available to its customer base. 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 pharmacy industry regulation changes may have on its ability to raise debt or equity financing required to meets 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.

On April 1, 2010 a new Chief Executive Officer (CEO), Mr. Robert Gooding, was appointed for the Company. Mr. Gooding brings extensive experience in the retail sector having served as CEO, President and Chief Financial Officer of a U.S. retail organization he established and grew to a 50-store chain. The Company may be exposed to the risks associated with transition to new leadership such as change of management style and amended strategic focus. The Company expects to recruit or appoint a Chief Financial Officer (CFO) in the coming months once Mr. Gooding and the Board have evaluated the needs of the organization.

### **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. The Company is changing its POS system in all stores in the fourth quarter of 2010 and may be vulnerable to new system issues, such as inadequate training, delays in implementation, or system changeover errors. The Company will manually track results and perform full inventory counts at every store to minimize error risk, as well as ensure adequate support for project implementation.

### **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

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 in British Columbia 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 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 \$0.780 million since inception and \$0.350 million of that estimated to have impacted the six months ended February 28, 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 Alberta 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 individuals 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, added to the Alberta Drug Benefit List after October 1, 2009 at 45% of the brand name product, which was previously set at 75%. Alberta has provided certain transitional and regional relief which will initially mitigate the effect of the changes announced to date.

The Government of Alberta has taken another step to reduce generic drug costs; effective April 1, 2010 the prices of existing generic drugs have been limited to 56% of the brand name product.

Paragon, other pharmacy service providers and pharmacy focused organizations continue to discuss opportunities to better utilize 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 latest announced changes propose a further reduction of generic pricing levels to 25% of brand from

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

the 50% previously announced; private drug plan pricing will be set at 50% for current year, and reduced to 25% over the next two years, and the elimination of professional allowances. If the government is successful, this policy would have a drastic impact of pharmacy operations not only in Ontario, but the rest of the country, and may impact the going-concern of small pharmacies unable to adapt.

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.

### 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 and six months ended February 28, 2009, are disclosed in Note 3 of the February 28, 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. The Company has established an internal work team who has begun a high level assessment of the key differences between IFRS requirements and Canadian GAAP in an effort to identify areas that may have material impact or challenge for the organization.

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

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

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.