Paragon Pharmacy

PARAGON PHARMACIES LIMITED

MANAGEMENT'S DISCUSSION & ANALYSIS
FOR THE THREE AND NINE MONTH PERIODS ENDED MAY 31, 2010

As at July 22, 2010

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited (the "Company" or "Paragon") for the three and nine month periods ended May 31, 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 or www.sedar.com.

FORWARD LOOKING STATEMENTS

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

NON-GAAP FINANCIAL MEASURES

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

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 improve operations, support revenue growth, build customer loyalty, improve profitability and expand brand awareness.

The pharmacy industry continues to face ongoing regulatory change that will alter the way generic drugs are priced and pharmacy allowances are charged. These changes are being driven by the ongoing increases of health care costs, which will be impacted by the significant number of new generic drugs coming into the market.

To date the Alberta regulatory changes have not adversely affected Paragon's profitability. The recent announced changes in British Columbia are being assessed to determine their impact on both the Company's profitability and future strategy. As the Company works with its supply chain partners on the practical ramifications of the regulatory change in British Columbia it will be able to fully assess the impact of those changes. (Refer to page 15 for further explanation)

The Company's success in achieving its objectives is dependent on its ability to adapt to these regulatory changes. While regulatory changes do pose significant risks to the Company's economic model, they also provide for new and alternative revenue stream opportunities. The Company is currently working to expand its scope of pharmacy practice to take advantage of these additional funding programs that are being simultaneously introduced. Companies such as Paragon with capital to implement changes to take advantage of these opportunities are positioned to succeed.

The hard work and dedication to customer service by Paragon employees are primary contributors as the Company works to establish itself as a 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 includes 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. The recent changes to pharmacy regulations discussed above 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 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.

SUMMARY

Key Operating, Investing and Financial Metrics

The following provides a summary of the Company's performance for the three and nine month periods ended May 31, 2010 compared to the three and nine month periods ended May 31, 2009.

- Third quarter revenue of $20.947 million (2009: $21.615 million), a decrease of 3.1%.
    - Nine month revenue of $62.658 million (2009: $65.602 million), a decrease of 4.5%. (Refer to page 6 for further explanation)

- Third quarter comparable store revenue reduction of (2.6%) (excluding tobacco); comparable store pharmacy revenue reduction of (0.3%); comparable front store revenue[1] reduction of (7.3%) (excluding tobacco).
    - Nine month comparable store pharmacy revenue reduction of (1.2%)
    - Nine month comparable front store revenue[1] reduction of (14.9%) (excluding tobacco). (Refer to page 6 for further explanation)

- Third quarter gross margin[2] as a percentage of revenue of 38.1% (2009: 38.1%), which is comparable to the same period last year.
    - Nine month gross margin[2] as a percentage of revenue of 37.0% (2009: 36.0%), an increase of 1.0%. (Refer to page 6 for further explanation)

- Third quarter operating income[3] of $2.151 million (2009: $2.685 million), a decrease of 19.9%.
    - Nine month operating income[3] of $6.343 million (2009: $6.248 million), an increase of 1.5%. (Refer to page 7 for further explanation)

- Third quarter EBITDA of $0.890 million (2009: $1.529 million), a decrease of 41.8%.
    - Nine month EBITDA of $2.927 million (2009: $2.942 million), a decrease of 0.5%. (Refer to page 8 for further explanation)

[1] Front store revenue includes all non-pharmacy revenue.

[2] Gross margin is defined as revenue minus cost of sales

[3] 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 item.

Third Quarter

- Mr. R. Gordon Gooding, CA commenced his position as Chief Executive Officer effective April 1, 2010. Mr. Gooding brings 25 years of business experience to Paragon, including his last 12 years with a retailer in California, where he was the President and CEO of an early stage retail company that grew from 3 to 50 stores during his tenure.

- During the quarter, the Company continued its implementation phase of its new point-of-sale system and rolled out the system at its first location in mid-June. All locations will be using the new system before the end of the fiscal year. 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 secured a new three year credit facility with a $5.0 million operating line, a $5.0 million term loan and a $15.0 million acquisition facility. This facility replaces the existing $3.0 million operating line and $9.6 million term loan, both of which were repaid upon opening this new facility. This funding will help support the Company's long term growth strategy.

- The Company successfully recruited Mark Leibel as Retail District Manager for its Alberta Operations. Mr. Leibel brings 22 years of retail experience, including more than 16 years as district manager for multiple large retailers. The Company expects to make further select additions to the management team over the coming months that will allow it to better implement the initiatives to improve store performance as outlined on page 6.

- During the quarter the Company successfully worked with its distribution partner to refine its buying process in a manner that will allow its buying group to better react to the assortment and promotional requirements of its customers. Paragon also initiated changes to its marketing program to take advantage of the changes to the Company's buying process, and to better support the Company's brand position.

RESULTS OF OPERATIONS

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

	3 Months Ended		9 Months Ended	
(Thousands of dollars except per share amounts)	May 31, 2010 $	May 31, 2009 $	May 31, 2010 $	May 31, 2009 $
Revenue	20,947	21,615	62,658	65,602
Gross Margin	7,972	8,232	23,189	23,631
Operating Expenses[1]	5,821	5,547	16,846	17,383
Operating Income	2,151	2,685	6,343	6,248
Corporate and other costs	1,261	1,156	3,416	3,306
EBITDA[2]	890	1,529	2,927	2,942
Stock-based compensation	1	14	2	60
Amortization	1,298	950	3,737	3,087
Interest and accretion expense[3]	198	316	714	6,357
Other Items[4]	(23)	78	5	226
Net (loss) income	(584)	171	(1,531)	(6,788)
EBITDA per common share				
- Basic	$0.01	$0.02	$0.03	$0.04
- Diluted	$0.01	$0.02	$0.03	$0.04
(Loss) income per common share				
- Basic	($0.01)	$0.00	($0.02)	($0.08)
- Diluted	($0.01)	$0.00	($0.02)	($0.08)

[1] Operating expenses include store level selling, general and administration expenses (excludes corporate expenses, amortization, interest expense and stock-based compensation)

[2] EBITDA defined as earnings before interest expense, income taxes, amortization, stock-based compensation and other items as defined.

[3] Interest expense includes bank charges and interest Q3-2010: $0.049 million (Q3-2009: $0.030 million), YTD-2010: $0.114 million (YTD-2009: $0.096 million); interest on long term debt Q3-2010: $0.127 million, (Q3-2009: $0.173 million), YTD-2010: $0.442 million (YTD-2009: $0.638 million); amortization of financing costs Q3-2010: $0.026 million (Q3-2009: $0.132 million), YTD-2010: $0.180 million (YTD-2009: $0.356) and interest income of Q3-2010: $0.004 million (Q3-2009: $0.019 million), YTD-2010: $0.022 million (YTD-2009: $0.146 million). The financing costs on the convertible debenture for fiscal 2009 of $5.413 million are a non-cash item included in the interest and accretion expense.

[4] Other items include loss on equity investments of Q3-2010: $nil (Q3-2009: $0.077 million loss), YTD-2010: $nil (YTD-2009: $0.220 million) and gain/loss on disposal of capital and intangible assets of Q3-2010: $nil million gain (Q3-2009: $0.001 loss), YTD-2010: $0.028 million loss (YTD-2009: $0.006 million loss).

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

	3 Month Ended		9 Month Ended	
(Thousands of dollars)	May 31, 2010 $	May 31, 2009 $	May 31, 2010 $	May 31, 2009 $
Net (loss) income	(584)	171	(1,531)	(6,788)
Add the following:				
Interest and accretion expense	198	316	714	6,357
Amortization	1,298	950	3,737	3,087
Stock based compensation	1	14	2	60
Other items	(23)	78	5	226
EBITDA	890	1,529	2,927	2,942

Revenue

Revenue is comprised of sales to customers of the Company's retail pharmacies and central fill pharmacies. Revenue was $20.947 million in the third quarter compared to $21.615 million in the same period last year, a decrease of $0.668 million or 3.1%. Decreases were a result of a 0.3% decline in comparable store pharmacy revenue and a 7.3% decline in comparable front store revenue.

Growth in pharmacy revenue was impacted by changes to pricing structures of generic drugs in Alberta due to regulations that came into effect in April 2010, along with the increased availability of lower priced generic drugs in the market.

The Company is working on several initiatives to compete more effectively in the future, including: working to improve its merchandising and promotions; working to elevate the competency of its store personnel; improving the Company's physical store infrastructure both in design and routine maintenance; improving asset protection to reduce shrinkage and increase margin; and continuing its focus on customer service.

Revenue for the nine month period ending May 31, 2010 was $62.658 million compared to $65.602 million for the same period last year, a decrease of $2.944 million or 4.5%. Same store Rx revenue declined by 1.2% year over year. Front store revenues excluding tobacco declined year over year by 14.9% due to increased competition 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 $7.972 million in the third quarter compared to $8.232 million in the same period last year, a decrease of $0.260 million or 3.2%. 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 $0.100 million due primarily to a drop in revenues, offset slightly by a small increase in gross margin percentage. Gross margin as a percentage of revenue remained constant at 38.1% compared to 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 $23.189 million for the nine month period compared to $23.631 million for the same period last year, a decrease of $0.442 million or 1.9%. 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 37.0% from 36.0% 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 $5.821 million in the third quarter compared to $5.547 million in the same period last year, an increase of $0.274 million or 4.9%. This was primarily a result of an increase in occupancy costs partially offset by decreased operating wages and operating administration costs relating to distribution and retail stores over the same period last year. Operating expenses as a percentage of revenue were 27.8% compared to 25.7% for the same period last year.

Operating expenses were $16.846 million for the nine month period compared to $17.383 million for the same period last year, a decrease of $0.537 million or 3.1%. 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 26.5% 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 $2.151 million in the third quarter compared to $2.685 million in the same period last year, a decrease of $0.534 million or 19.9%. The decrease in operating income is a result of the reduction in front store and pharmacy revenue, and an increase in operating expenses of $0.274 million over the same period in the prior year.

Operating income was $6.343 million for the nine month period compared to $6.248 million for the same period last year, an increase of $0.095 million or 1.5%. The year to date increase in operating income is a result of improved pharmacy and front store margins as well as the reduction of operating expenses by 3.7% 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 $1.261 million in the third quarter compared to $1.156 million in the same period last year, an increase of $0.105 million or 9.1%. This increase is the net effect of higher marketing and information technology spending partially offset by lower corporate wage and administration costs.

Corporate expenses for the nine month period were $3.416 million compared to $3.306 million for the same period last year, an increase of $0.110 million or 3.3%.

EBITDA

EBITDA was $0.890 million in the third quarter compared to $1.529 million in the same period last year, a decrease of $0.639 million or 41.8%. The decrease in EBITDA in the third quarter was primarily a result of the reduction in front store revenue, increased operating expenses and an increase in corporate costs over the same period last year.

EBITDA was $2.927 million for the nine month period compared to $2.942 million for the same period last year, a decrease of $0.015 million or 0.5%. The decrease in EBITDA was largely a result of lower revenues recognized in the period which was offset by decreased operating expenses and stronger gross margins realized in the period.

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 $0.198 million in the third quarter compared to $0.316 million in the same period last year, a decrease of $0.118 million. Bank charges and interest were $0.049 million (2009 - $0.030 million); interest and amortization of related financing costs on long-term debt was $0.153 million (2009 - $0.305 million) due to lower debt levels; and interest income was $0.004 million (2009 - $0.019 million). Interest income declined due to falling interest rates.

Bank charges and interest were $0.114 million for the nine month period (2009: $0.096 million); interest and amortization of related financing costs on long-term debt was $0.622 million (2009: $0.994 million) due to lower debt levels; and interest income of $0.022 million (2009: $0.146 million) due to decline in interest rates.

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 nine 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 $1.298 million in the third quarter compared to $0.950 million in the same period last year, an increase of $0.348 million or 36.6%. This increase is due to amortization on capital and intangible asset additions.

Amortization of capital and intangible assets was $3.737 million for the nine month period compared to $3.087 million for the same period last year, an increase of $0.650 million or 21.1%. This increase is primarily a result of amortization resulting from acquisitions and additions to capital and intangible assets.

Stock based compensation

Stock based compensation was $0.001 million in the third quarter compared to $0.014 million in the same period last year, a decrease of $0.013 million.

Stock based compensation was $0.002 million for the nine month period compared to $0.060 million for the same period last year, a decrease of $0.058 million.

Net (loss) income

The net loss was $0.584 million in the third quarter compared to net income of $0.171 million in the same period last year, an increase in the net loss of $0.755 million. This change is primarily due to a decline in revenue from that of prior year.

The net loss was $1.531 million for the nine month period compared to a net (loss) of $6.788 for the same period last year, an improvement of $5.257 million or 77.4%. 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	May 31, 2010 $	August 31, 2009 $
Cash and cash equivalents	(6,945)	(14,980)
Current portion of long-term debt and capital leases	971	10,640
Long-term debt and capital leases	7,260	3,550
Net debt[1]	1,286	(790)
Shareholders' equity	30,911	33,572
Total capitalization	32,197	32,782
Net debt: Shareholders' equity Net debt: Total capitalization EBITDA: Cash interest expense[2]	0.04:1 0.04:1 5.26:1	(0.02:1) (0.02:1) 5.16:1

[1] 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.
[2] 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 May 31, 2010 the Company had 94.5 million issued and outstanding common shares compared to 97.6 million at August 31, 2009. This reduction in common shares is the result of cancellation of 3.1 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 May 31, 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 May 31, 2010 the Company has on deposit $6.9 million available to fund capital projects relating to existing stores as well as for working capital and acquisitions.

Operating Activities

Cash flow from operating activities in the third quarter decreased to $1.293 million from $4.398 million in the same period last year due to an increase in inventory, prepaid expenses and accounts receivable.

> For the nine month period, net cash flow generated from operating activities was $1.134 million compared to $5.031 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 ($5.411) million in the third quarter compared to ($0.670) million in the same period last year. The increase in net cash used in financing activities was due to the repayment of $4.7 million in long-term debt in connection with the refinancing, and $0.498 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 nine month period, net cash expenditures used in financing activities was ($7.273) million compared to net cash expenditures used in financing activities of ($4.111) million in the same period last year. This change was due primarily to the Company's reduction of long-term debt of $3.952 million compared to prior year, and $1.132 million spent on repurchasing shares under the Normal Course Issuer Bid. This was slightly offset by the elimination of advances to related parties compared to $0.311 million and $0.826 million in changes in non-cash working capital in prior year.

Investing Activities

Net investment from investing activities was ($0.192) million in the third quarter compared to a net cash flow of ($0.515) million in the same period last year. The current year relates entirely to the purchase of capital and intangible assets.

For the nine month period, net investment from investing activities was ($1.896) million compared to cash injected from investing activities of $13.198 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 $1.472 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 $1.004 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. 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.

The Company has 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 with interest rates of prime plus 1% to prime plus 2% dependent on Company specific covenants outlined in the agreement and revalued every quarter. The term loan is payable in quarterly principal installments amortized over five years from advance date. Advances under the acquisition facility are payable in quarterly principal installments amortized over five years from each advance date. The facility 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.

The Company expects these replacement facilities will provide the Company with financing to fund future acquisitions on reasonable terms and conditions.

TRANSACTIONS WITH RELATED PARTIES

For the three and nine months ended May 31, 2010, the Company expensed $0.10 million and $0.33 million respectively for advisory and executive services fees due to Canterbury Park Management Inc. (three and nine months ended May 31, 2009 $0.03 million and $0.08 million respectively). Canterbury Park Management Inc. provides management services as a shareholder.

For the three and nine months ended May 31, 2010, the Company expensed $nil and $nil respectively (three and nine months ended May 31, 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 $0.145 million for the nine months ended May 31, 2010 (three and nine months ended May 31, 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)	Third Quarter		Second Quarter		First Quarter		Fourth Quarter	
	2010	2009	2010	2009	2010	2009	2009	2008
Revenue	20,947	21,615	20,785	22,204	20,926	21,783	20,537	22,094
EBITDA	890	1,529	976	1,110	1,061	303	964	(984)
- EBITDA per share - Basic	$0.01	$0.02	$0.01	$0.01	$0.01	$0.01	$0.01	($0.03)
- EBITDA per share - Diluted	$0.01	$0.02	$0.01	$0.01	$0.01	$0.01	$0.01	($0.03)
Net (loss) income	(584)	171	(464)	(401)	(483)	(6,558)	(452)	(4,028)
- Net loss per share - Basic	($0.01)	$0.00	($0.01)	($0.01)	($0.01)	($0.13)	($0.01)	($0.09)
- Net loss per share - Diluted	($0.01)	$0.00	($0.01)	($0.01)	($0.01)	($0.13)	($0.01)	($0.09)

* 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. R. Gordon 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. Despite Mr. Gooding's extensive knowledge in merchandising and general management and his strong financial background, the Company may be exposed to the risks associated with transition to new leadership such as change of management style and amended strategic focus.

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

The Provincial jurisdictions in which the Company operates have undergone regulatory reform over the past several months.

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 July 28, 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. This agreement has impacted revenues and margins by an estimated $0.935 million since inception and $0.525 million of that estimated to have impacted the nine months ended May 31, 2010.

In British Columbia, on July 9, 2010, the Ministry of Health Services announced a new long term agreement relating to the pricing of generic drugs and a fee schedule for services provided by pharmacists. The British Columbia strategy aims to reduce generic drug prices and make improvements to the drug system to benefit all residents of the province. The agreement limits the price of generic drugs previously set at up to 70% of the brand name equivalent, to 35% in step down phases over the next two year period. To help preserve the future viability of the community pharmacy, an increase in dispensing fee reimbursements by PharmaCare to pharmacies is also included in the agreement. Dispensing fees will increase from current rate of $8.60 per prescription to $10.50 gradually through April 2, 2012. Expansion of clinical pharmacy services is also expected and will be defined over the course of the agreement.

The recently announced changes in British Columbia are being assessed to determine their impact on both Paragon's profitability and future strategy. As the Company works with its supply chain partners on the practical ramifications of the regulatory change in British Columbia it will be able to fully assess the impact of those changes.

While regulatory changes do pose significant risks to Paragon's economic model, they also provide for new and alternative revenue stream opportunities. The Company is currently working to expand its scope of pharmacy practice to take advantage of these additional funding programs that are being simultaneously introduced. Companies such as Paragon with capital to implement changes to take advantage of these opportunities are positioned to succeed.

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.

Further reductions to generic drug pricing were announced; 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.

The Company is also monitoring possible Manitoba regulatory change in reaction to the latest announcements in Ontario and British Columbia; however, no change has been announced at this time.

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 nine-month period ended May 31, 2009 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 nine months ended May 31, 2009, are disclosed in Note 3 of the May 31, 2010 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.

Business combinations and consolidated financial statements

In January 2009, the CICA issued Handbook Section 1582, "Business Combinations", which replaces the existing standard. This section establishes the standards for the accounting of business combinations, and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent considerations and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date and that non-controlling interests would be measured at fair value at the date of acquisition. This standard is applied prospectively to business combinations with acquisition dates on or after January 1, 2011 and earlier adoption is permitted. The Company currently anticipates applying the new accounting standards at the beginning of its 2012 fiscal year. The Company expects to assess the impact of the new standard as part of its overall review of its convergence to IFRS.

Multiple Deliverable Revenue Arrangements

In December 2009, the Emerging Issues Committee ("EIC") of the CICA issued EIC 175 "Multiple Deliverable Revenue Arrangements," which replaces EIC 142 "Revenue Arrangements with Multiple Deliverables." This new EIC addresses some aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue generating activities and is effective for the first annual fiscal period beginning on or after January 1, 2011. The Company is currently evaluating the impact of the new EIC.

International Financial Reporting Standards (IFRS)

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 report 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 detailed 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

National 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 National 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.