

PARAGON PHARMACIES LIMITED**MANAGEMENT DISCUSSION & ANALYSIS
FOR THE 3 MONTH PERIOD ENDED NOVEMBER 30, 2008****As at January 29, 2009**

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited (the “Company”) for the three month period ended November 30, 2008. This discussion and analysis should be read in conjunction with the Company’s interim unaudited consolidated financial statements and accompanying notes for the three month period ended November 30, 2008. The presentation in the interim consolidated financial statements for the three month period ended November 30, 2008 conforms to that used for the year ended August 31, 2008. Certain accounts for the three month period ended November 30, 2007 have been reclassified to conform to this. 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.

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

Management's Discussion and Analysis *(continued)*

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

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

OVERVIEW

Paragon is headquartered in Kelowna, British Columbia and currently employs over 450 full and part time staff in its stores and offices. The Corporation owns and operates 18.5 community pharmacies, 3 central fill pharmacies and 1 home healthcare store in British Columbia, Alberta and Manitoba.

STRATEGY AND OUTLOOK

During the quarter, there were two major developments that position the company for the future. The first was the closing of the previously announced equity conversion and private placement transaction with Canterbury Park Capital L.P. and Canterbury Park Capital (US) L.P. (collectively "Canterbury"). With the closing, the debenture obligation to Canterbury, including accrued interest, was eliminated and approximately \$13.8 million of cash previously in escrow was released to Paragon. The availability of this cash combined with amendments to the existing bank lending agreements significantly strengthens the financial position of the Company and its ability to execute its business plan.

The second development was the appointment of a new leadership team. Lorraine McGrath became President after serving as a director of the company since March 2008. Ms. McGrath brings extensive experience in financial services, having most recently served as Executive Vice President and COO for Equity Development Bank of Canada. She is joined by Ron Lane, as President of Store Operations. Mr. Lane was previously responsible for pharmacy and health and beauty care operations for a large Western Canadian based retailer and has many years of pharmacy and retail experience.

The new leadership is undertaking a corporate-wide review where it will focus on gross margin improvement through the streamlining of operations. In this regard, Paragon management is focused on five key areas. They are:

- Managing the bottom line – Responding to the economic climate, management will focus on cost containment and revenue growth. This includes looking at how the company is resourced across its network with an aim to reducing staff levels, driving revenue from existing operations, new stores and completing the rebranding and integration of the Alberta network of stores;
- Inventory management – Integrating the company's buying models and pricing strategies and moving to a one company model will allow the company to better manage its inventory;

Management's Discussion and Analysis *(continued)*

- Organizational restructuring – Aligning the company's resources to improve efficiencies, focus on core business activities, streamline operations and effective deployment of resources;
- Information Technology – Integrating operating systems and building a technology platform that allows for growth is a key priority;
- Processes –Standardizing, integrating and streamlining Paragon's operating processes company-wide will eliminate duplication inefficiencies and waste, and improve controls.

With the current, global economic crisis, it will be important for the company to be structured in such a way that it builds resilience to future economic volatility and prepares the organization for growth.

SUMMARY

Key Operating, Investing and Financials Metrics

The following provides a summary of the Company's performance for the three month period ended November 30, 2008 compared to the three month period ended November 30, 2007.

- Revenue of \$21.783 million (2007: \$17.677 million), an increase of 23.2%
- Same store revenue growth of 0.2%
 - Same store pharmacy revenue growth of 3.1%
 - Same store front store revenue¹ decline of (5.6%)
- Gross margin² as a percentage of revenue of 35.1% (2007: 32.9%), an increase of 2.2%
- Operating income³ of \$1.772 million (2007: \$1.260 million), an increase of 40.7%
- EBITDA⁴ of \$0.476 million (2007: \$0.350 million), an increase of 51.0%

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

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 items

⁴ EBITDA defined as earnings before interest expense, income taxes, amortization, stock-based compensation and other items as defined.

First Quarter

- A new 12,000 square foot retail pharmacy opened in October in Kelowna, BC bringing total retail square footage to approximately 130,000 square feet. The pharmacy includes a third party medical clinic which opened in November 2008.
- In October 2008, the Company completed the closing of its Aldergrove location with remaining assets being distributed amongst other pharmacies.

Management's Discussion and Analysis *(continued)*

- The company announced in November 2008, the completion of the note conversion and share subscription agreement that eliminated the \$20-million convertible debenture and resulted in an increase in available cash of approximately \$13.8 million.
- The Company embarked on a corporate wide evaluation of revenues, gross margins and operating and corporate costs. Over the next number of months the results of this review are expected to result in Company performance improvements.

RESULTS OF OPERATIONS

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

| Thousands except per share amounts | 3 Months Ended | | \$ Change | % Change |
|------------------------------------|-------------------|-------------------|-----------|------------|
| | November 30, 2008 | November 30, 2007 | | |
| Revenue | 21,783 | 17,677 | 4,106 | 23.2% |
| Gross Margin | 7,644 | 5,824 | 1,820 | 31.3% |
| Operating Expenses ¹ | 5,872 | 4,564 | 1,308 | 28.7% |
| Operating Income | 1,772 | 1,260 | 512 | 40.7% |
| Corporate and other costs | 1,296 | 910 | 386 | (42.4%) |
| EBITDA ² | 476 | 350 | 126 | 36.0% |
| Stock-based compensation | 17 | 35 | (18) | 51.4% |
| Interest and accretion expense | 4,360 | 1,586 | 2,774 | (174.9%) |
| Other Items | 1,403 | 59 | 1,344 | (2,278.0%) |
| Net loss and comprehensive loss | (6,392) | (1,893) | (4,499) | (237.7%) |
| EBITDA per common share | | | | |
| Basic | \$0.01 | \$0.01 | - | |
| Diluted | \$0.01 | \$0.01 | - | |
| Loss per common share | | | | |
| Basic | (\$0.13) | (\$0.05) | (\$0.08) | |
| Diluted | (\$0.13) | (\$0.05) | (\$0.08) | |

¹ Operating expenses include store level selling, general and administration expenses (excluding corporate and other costs, amortization, interest expense, and stock-based compensation expense)

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

Management's Discussion and Analysis *(continued)*

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

| Thousands | 3 Months Ended | |
|--------------------------------|-------------------|-------------------|
| | November 30, 2008 | November 30, 2007 |
| Net loss | \$ (6,392) | \$ (1,893) |
| Add the following: | | |
| Interest and accretion expense | 4,360 | 1,586 |
| Amortization | 1,088 | 563 |
| Stock based compensation | 17 | 35 |
| Other items | 1,403 | 59 |
| EBITDA | \$ 476 | \$ 350 |

Revenue

Revenue is comprised of sales to customers of the Company's retail pharmacies, home health care store and central fill pharmacies. Revenue was \$21.783 million in the first quarter compared to \$17.677 million in the same period last year, an increase of \$4.106 million or 23.2%. Increases were a result of growth in same store pharmacy revenue of 3.1%, revenue from the acquisitions of Alentex, Teulon, and Central Fill in 2008 offset by a reduction in same store front store revenues of 5.6% due in part to the general economic slowdown resulting in decreased consumer spending across the front stores. As a result of these market conditions, management is focused on its merchandising strategies to enhance consumer spending at its retail outlets.

Gross Margin

Gross margin is calculated as revenue less cost of sales. Cost of sales is comprised of the cost of goods sold through the Company's retail pharmacies, home health care store and central fill pharmacies. Gross margin was \$7.644 million in the first quarter compared to \$5.824 million in the same period last year, an increase of \$1.820 million or 31.3%. This was primarily a result of the acquisition of the Alentex, Teulon and Central Fill acquisitions in the prior year. Gross margin as a percentage of revenue increased to 35.1% from 32.9% in 2007 due to higher margin pharmacy revenues.

Operating Expenses

Operating expenses include all store level selling, general and administration expenses (which include wages and benefits), store occupancy costs, marketing 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 \$5.872 million in the first quarter compared to \$4.564 million in the same period last year, an increase of \$1.308 million or 28.7%. Same store operating expenses declined by 1.8% over the comparable period. Operating expenses as a percentage of revenue were 27.0% compared to 25.8% for 2007.

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 \$1.772 million in the first quarter compared to \$1.260 million in the same period last year, an increase of \$0.512 million or 40.7% for the reasons noted above.

Corporate and Other Costs

Corporate and other costs include all costs related to the corporate and administration offices including wages, benefits, occupancy, marketing, administration, and public company costs but excluding stock based compensation. Corporate and other costs were \$1.296 million in the first quarter compared to \$0.910 million in the same period last year, an increase of \$0.386 million or 42.4%. This level of corporate costs was comparable to the fourth quarter of 2008. Corporate costs have increased over the same period in 2007 due to an increase in consulting of \$0.166 million and an increase in recruitment expense of \$0.080 million.

EBITDA

EBITDA was \$0.476 million in the first quarter compared to \$0.350 million in the same period last year, an increase of \$0.126 million or 51.0%. The increase in EBITDA was primarily a result of the improved store operating income contributed by the stores acquired in the prior year offset by the increase in corporate costs.

Interest and accretion expense

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

Financing costs on the convertible debenture consist of accretion, accrued interest, and amortization of financing costs. Total financing costs on the convertible debenture were \$4.039 million in the first quarter compared to \$1.622 in the same period last year and included accretion of \$1.711 million, accrued interest of \$1.272 million, and \$1.056 million of amortization of financing costs. The significant increase in the financing costs is attributable to the acceleration of accretion and the finalization of certain interest adjustments in connection with the conversion of the debenture in November, 2008.

Bank charges and interest were \$0.052 million (2007 - \$0.039 million); interest and amortization of related financing costs on long-term debt was \$0.352 million (2007 - \$0.153 million) due to bank financing relating to the acquisitions in the prior year; and interest income was \$0.083 million (2007 - \$0.227 million). Interest income declined due to lower investable assets and falling interest rates.

Amortization

Amortization of capital and intangible assets were \$1.088 million in the first quarter compared to \$0.563 million in the same period last year, an increase of \$0.525 million or 93.3%. This increase is primarily a result of the amortization of capital and intangible assets acquired in the Alentex, Teulon and Central Fill acquisitions in the prior year.

Other items

Other items consist primarily of a \$1.374 million fee paid to the debenture holder as an inducement to convert the debenture prior to its maturity date.

Net loss

The net loss was \$6.392 million in the first quarter compared to a net loss of \$1.893 million in the same period last year, an increased loss of \$4.499 million or 237.7%. The increase is

Management's Discussion and Analysis *(continued)*

principally due to the increased interest and accretion expense on the convertible debenture together with the inducement fee paid to the debenture holder.

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

| | November 30, 2008 | August 31, 2008 |
|--|----------------------|--------------------|
| Cash and cash in escrow | (\$12,296) | (\$14,269) |
| Bank indebtedness | - | 921 |
| Current portion of long-term liabilities | 2,457 | 2,459 |
| Convertible debenture | - | 17,233 |
| Long-term liabilities ¹ | 13,290 | 13,899 |
| Net debt ² | 3,451 | 20,243 |
| Shareholders' equity ³ | 34,386 | 18,313 |
| Total capitalization | 37,837 | 38,556 |
| Net debt: Shareholders' equity | 0.10:1 | 1.11:1 |
| Net debt: Total capitalization | 0.09:1 | 0.52:1 |
| EBITDA: Cash interest expense ⁴ | 2.12:1 | 3.97:1 |

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

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

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

⁴ Cash interest expense excludes financing costs on the convertible debenture and amortization of other financing costs and is net of interest income

OUTSTANDING SHARE DATA

The Company had outstanding 97.6 million common shares and 1.2 million options and 4.7 million warrants to acquire its common shares. Further details are available in Note 15 of the unaudited interim consolidated financial statements as at November 30, 2008.

LIQUIDITY AND CAPITAL RESOURCES

The Company currently has an operating line of credit facility of a maximum of \$3 million, bearing interest at prime plus 1.25% per annum. The operating line is secured by a general security agreement representing a first charge on all the assets and undertakings of the Company and its subsidiaries, unlimited guarantees of advances by the Company and its subsidiaries, subordination/priority agreements with a certain supplier and an assignment of fire insurance over assets of the Company and its subsidiaries. At November 30, 2008, the Company had issued letters of credit aggregating \$0.5 million leaving \$2.5 million of the \$3 million facility available.

Management's Discussion and Analysis *(continued)*

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 debt financing and the issuance of common shares.

In May, 2007 the Company issued a \$20.0 million convertible debenture, the proceeds of which were restricted for future acquisitions and which required matching senior debt. In fiscal 2008, the Company secured a \$7.5 million loan facility to be used for acquisitions to be matched with the convertible debenture funds on a dollar for dollar basis. Advances under this facility totaled \$7.060 million.

On November 14, 2008, the Company announced that it had concluded with the debenture holder a note conversion and share subscription agreement. The agreement provided the Company with approximately \$13.8 million of cash proceeds and eliminated the Company's \$20 million debenture. Shares issued under the agreement had a combined average issuance price of approximately \$0.40 per share. The agreement resulted in:

- 1) a conversion of \$11,550,000 million principal convertible notes ("the Converted Notes") that Canterbury held to Paragon common shares at \$0.8028 per share for an aggregate of 14,387,145 Paragon common shares;
- 2) accrued interest and accrued interest adjustment on the Converted Notes in the aggregate of \$2,159,055, convertible at \$0.35 per share for an aggregate of 6,168,729 Paragon common shares;
- 3) a conversion inducement fee equal to forgone interest for early conversion at the rate otherwise payable to the scheduled maturity of May 2, 2009 and an agreed interest adjustment amount, in the aggregate of \$1,374,170, convertible at \$0.35 per share for an aggregate of 3,926,200 Paragon common shares; and
- 4) a repayment to Canterbury of \$8,450,000 million principal in respect to the convertible notes plus accrued interest of \$316,486 with an immediate reinvestment in Paragon common shares of these amounts by way of private placement at \$0.26 per common share, resulting in issuance of an aggregate of 33,717,264 Paragon common shares.

As a result of the agreement, the debenture holder increased its ownership in Paragon from 25.6% (undiluted) to approximately 70% (undiluted) of the outstanding common shares.

In conjunction with the aforementioned transaction the Company also renegotiated certain terms of its credit facilities included revised financial covenants and, in certain circumstances, accelerated repayments based on the EBITDA of the Company. The \$7.500 million loan facility was capped at the amount then advanced being \$7.060 million. The amendments also altered the pricing on the Company's bank debt of the facility. Amounts outstanding on the term loan and revolving facility will now bear interest at prime plus 1.50% and amounts outstanding under the operating line will bear interest at prime plus 1.25%.

Management's Discussion and Analysis *(continued)*

As a result of the repayment and conversion of all outstanding debentures, the previously restricted cash became available for general corporate purposes. These funds have been applied against the bank operating line and the balance is invested in short term investments. These funds are available to the Company to fund operating and capital requirements, payments required under the long term debt and are available to assist in financing acquisitions.

The Company anticipates holding a significant portion of these funds in reserve until such time as the bank facilities, which come due in December 2009, are renewed.

Operating Activities

Cash flow from operating activities in the first quarter increased to \$0.101 million from \$0.094 million in the same period last year. The increase was primarily due to cash flow generated from a reduction in non cash working capital.

Financing Activities

Cash flow expended on financing activities in the first quarter increased to \$1.906 million from \$0.764 million in 2007. The principal financing activities related to a partial repayment of the convertible debenture which was then reinvested in common shares of the Company. In addition the convertible debenture holder converted the remaining portion of the debenture and accrued interest into common shares. These transactions are more fully described in Note 12 to the consolidated financial statements. In addition the Company paid down approximately \$1.5 million of bank and other debt compared to approximately \$0.9 million in the comparable period last year.

Investing Activities

Cash flow from investing activities in 2008 was \$13,560 million compared to a net investment of \$2.712 million in 2007. As a result of the conversion of the debenture the Company received \$13.8 million in 2008 of funds previously held in escrow. In the prior year the Company had also received \$1.7 million of funds that were previously held in escrow. The latter were released to the Company to assist in the financing of the Teulon acquisition. The investment activities in the quarter related to leasehold improvements for a new store together with related preopening costs. In 2007, the investment activities related to a store redevelopment and the acquisition of Duncan.

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. Any future acquisitions or green field developments may require additional debt and equity financing to ensure compliance with credit facility covenants. As with all businesses today, the Company is subject to the potential impact the recent global credit and financial crisis may have on its ability to raise debt or equity financing at reasonable rates or at all.

TRANSACTIONS WITH RELATED PARTIES

In addition to transactions relating to the convertible debenture which are more fully described in note 12, the Company recorded an expense of \$25,000 (2007 - \$50,000) for advisory fees due to Canterbury Park Management Inc. Canterbury Park Management Inc. is the manager of the holders of the Convertible Debenture who are significant shareholders of the Company.

Management's Discussion and Analysis *(continued)*

For the three months ended November 30, 2008, the Company expensed \$135,000 (2007 - \$Nil) paid to a member of the Board of Directors for consulting services. The Company also paid \$0.05 million (2007 - \$0.069 million) in rent for premises leased under operating leases to parties related by virtue of common management and directors. These transactions are in the normal course of operations and have been recorded at the exchange amount, which is the amount agreed to by the related parties.

QUARTERLY INFORMATION

Summary of Quarterly Information

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

| Thousands (except per share amounts) | First Quarter | | Fourth Quarter | | Third Quarter | | Second Quarter | |
|---|---------------|----------|----------------|----------|---------------|----------|----------------|--------|
| | 2009 | 2008 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Revenue | 21,783 | 17,677 | 22,094 | 16,957 | 22,357 | 17,067 | 21,590 | 16,209 |
| EBITDA | 476 | 315 | (984) | (39) | 957 | 380 | 1,105 | 829 |
| - EBITDA per share - Basic | \$0.01 | \$0.01 | (\$0.03) | \$0.00 | \$0.02 | \$0.01 | \$0.03 | \$0.02 |
| - EBITDA per share - Diluted | \$0.01 | \$0.01 | (\$0.03) | \$0.00 | \$0.02 | \$0.01 | \$0.03 | \$0.02 |
| Net (loss) income | (6,392) | (1,893) | (4,029) | (2,513) | (2,406) | (1,058) | (1,797) | 82 |
| - Net loss per share - Basic | (\$0.13) | (\$0.05) | (\$0.09) | (\$0.07) | (\$0.06) | (\$0.03) | (\$0.04) | \$0.00 |
| - Net loss per share - Diluted | (\$0.13) | (\$0.05) | (\$0.09) | (\$0.07) | (\$0.06) | (\$0.03) | (\$0.04) | \$0.00 |

RISKS AND RISK MANAGEMENT

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

Management's Discussion and Analysis *(continued)*

General economic conditions

The Company currently operates in Western Canada but, like all businesses globally, it will be subject to the impact that the current global credit and financial crisis may have on consumers in its areas of operations and the discretionary spending available to them. Should general economic conditions deteriorate in such a way as to reduce consumer spending the Company's profitability may be reduced.

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

Key Personnel

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

Reliance on Information Systems and Technology

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

Industry and Regulatory

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

Internal Control Deficiencies

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

Management's Discussion and Analysis *(continued)*

Financial covenants in lending agreements

The Company's is dependent upon continued access to capital on terms acceptable to the Company, including bank indebtedness and lending facilities. Prior to the amendments to its banking agreement affected this quarter, the Company was in breach of certain financial covenants. There can be no assurance that the Company will be able to comply with any or all such covenants in the future. Should it not be able to meet these covenants or arrange further 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. Any negative events affecting these third-party service providers could, in turn, potentially impact the Company. The Company has entered into contractual arrangements to formalize these relationships and, to minimize operating risks; The Company actively manages its relationships with its third-party service providers.

Real Estate

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

Seasonality

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

Financial Instruments

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

Exposure to Interest Rate Fluctuations

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

Foreign Currency Exchange Risk

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

Credit Risk

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

REGULATORY CHANGES THAT IMPACT THE COMPANY'S INDUSTRY

The British Columbia government has followed the lead of Alberta government by announcing that pharmacists will be able to adapt prescriptions effective January 2009. The move is designed to improve the public's access to drug therapy and reduce medication side-effects and emergency-room visits. Negotiations to establish a funding formula to cover the adaptation services provided by pharmacists are now under way. Additionally, the British Columbia government continues on the path towards introducing other drug program reforms sometime in the next several months. The Ministry of Health Services has already experimented with a tendering approach to procurement of pharmaceuticals and related supplies. Widespread use of tendering could dramatically alter business relationships between pharmacy owners and generic manufacturers, who have traditionally supported pharmacies through professional allowances. Unless the government agrees to significant increases in dispensing fees (which now lag behind actual retailer costs by approximately \$5 per prescription) or begins compensating pharmacists for other services, the economics of the British Columbia pharmacy industry could be severely impacted by a curtailment in such allowances.

On December 12, 2008, the British Columbia government announced an interim agreement that runs for calendar 2009. The agreement specifies no tendering of generic drugs for the duration of the interim agreement, it reduces the allowances paid on newly approved (approved after January 1, 2009) generic molecules, and it limits the capitation on daily and weekly dispensing fees effective February 1, 2009. Negotiations will begin in the near future to develop a longer term agreement. The interim agreement will negatively impact the Company's revenues and gross margins in 2009. Management estimates that the impact on store operating income for the balance of fiscal 2009 could be \$0.3 to \$0.5 million.

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

Alberta is also in the process of developing a provincial pharmaceutical strategy. Health and Wellness Minister Ron Liepert has not made an announcement affecting the retail business practices. Paragon and other pharmacy service providers are planning a round of grassroots meetings that front-line pharmacists will have with local MLA's to discuss opportunities to better use pharmacists' education and expertise to deliver quality healthcare as well as to outline the potential harm to their financial viability resulting from efforts to reduce generic drug prices. As in British Columbia, community pharmacy stakeholders in Alberta are working to raise compensation rates for dispensing services so that cost-cutting measures such as tendering do not force stores to reduce or eliminate services.

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

Management's Discussion and Analysis *(continued)*

The Company is closely monitoring these developments at the provincial level while seeking opportunities to explore additional pharmacy-related revenue streams to offset the inevitable decline in financial support from generic drug suppliers. It is encouraged by the Alberta government's move to invest \$9 million in short-term demonstration projects of alternate payment models for pharmacists' services that emphasize outcomes of patient care in three areas-medication review, medication management and chronic disease management support.

Effective January 1, 2009, tobacco sales in Alberta will no longer be 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

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

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

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

FUTURE ACCOUNTING PRONOUNCEMENTS

Effective September 1, 2009 the Company will be required to adopt CICA Section 3064, "Goodwill and Intangible Assets. This section will supersede sections 3062, "Goodwill and Other Intangible Assets" and 3450, "Research and Development Costs", and establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets. The Company is assessing the impact of this new standard on its consolidated financial statements and its implications are still under review.

Management's Discussion and Analysis *(continued)*

Effective September 1, 2009, the Company will need to adopt amendments to CICA Section 1000, "Financial Statement Concepts" that clarify the criteria for recognition of an asset and the timing of expense recognition. The implementation of the amendments to Section 1000 is not expected to have an impact on the Company's results of operations, financial position and disclosures because the amendments are clarifications on the application of Section 1000.

Effective September 1, 2012, the Company will be required to adopt new accounting standards concerning Business Combinations and Consolidated Financial Statements which are based on International Financial Reporting Standards "IFRS" 3 and 27. The new requirements replace existing guidance on accounting for Business Combinations, the preparation of consolidated financial statements and accounting for non-controlling interests. The Company expects to assess the impact of the new standard as part of its overall review of the convergence of Canadian GAAP with IFRS.

In January 2006, the CICA Accounting Standards Board adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies are expected to converge with International Financial Reporting Standards ("IFRS") by the end of 2011. The Company is assessing the impact of convergence of Canadian GAAP and IFRS.

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 President and the Interim Chief Financial Officer ("CFO") 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 President and the Interim CFO 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.

Management's Discussion and Analysis *(continued)*

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. This is a typical issue for smaller companies, and while the Company has experienced significant growth in recent quarters, and has added additional staff to strengthen the segregation of duties, there still exists a lack of such segregation of duties.

The Company has had an executive management change and replaced its previous Chief Executive Officer with a newly appointed President. This appointment was made by the Board of Directors in mid November, 2008.

The Company has also experienced turnover of personnel in the finance and accounting department over the last year, including changes at both the Chief Financial Officer and Controller levels. The Company has recruited replacement personnel including Interim Chief Financial Officers to fill these responsibilities.

Lastly, in this challenged personnel environment the company has integrated several new acquisitions that have comprised differing accounting systems and financial operating policies and procedures.

Notwithstanding the above control weaknesses, the President and the Interim CFO 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 Company is currently seeking a Chief Financial Officer on a full-time basis. 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.