



## PARAGON PHARMACIES LIMITED

### MANAGEMENT'S DISCUSSION & ANALYSIS FOR THE THREE AND SIX MONTH PERIODS ENDED FEBRUARY 28, 2011

As at April 21, 2011

The following is a discussion of the consolidated financial condition and results of operations of Paragon Pharmacies Limited (the "Company") for the three and six month periods ended February 28, 2011. This discussion and analysis should be read in conjunction with the Company's interim unaudited consolidated financial statements and accompanying notes for the three and six month periods ended February 28, 2011. 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.helloparagon.com](http://www.helloparagon.com) or [www.sedar.com](http://www.sedar.com).

#### FORWARD LOOKING STATEMENTS

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

#### NON-GAAP FINANCIAL MEASURES

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

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

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

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

### OVERVIEW

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

### STRATEGIES AND OUTLOOK

The pharmacy industry continues to change in response to the ongoing adjustments that are occurring to generic drug pricing models, shifting consumer needs and aging demographics. This transitioning environment provides growth opportunity for participants that have the ability to adapt to these current trends. Paragon's experienced management team and growing operating income provides the Company with the resources to successfully adapt and grow in this changing market.

The Company continues to focus on business strategies designed to support revenue growth, build customer loyalty, develop its management team, improve profitability and expand brand awareness. This includes measures to improve our existing core business, while also working on initiatives that will evolve our retail model in response to emerging market trends.

The Company has improved service and processes through the adoption of innovative technology in its long term care operations. In the future, the Company will also begin to automate certain processes in its retail pharmacies to enhance quality control and improve efficiencies of those operations.

Using careful recruitment, and through the ongoing development of suitable employee policies, the Company continues to concentrate on building a team of executive and staff that provide sound management and progressive vision for the Company's future.

The hard work and dedication to customer service by the Company's pharmacy, front store, and post office employees are primary contributors to the Company establishing itself as a community pharmacy of choice in the markets in which it competes. To further improve customer service the Company will continue strengthening its training and development programs for employees. Recent changes to pharmacy regulations will allow the Company to expand its professional service offerings to its customers in support of their health and wellness goals, and the Company is actively moving forward on these opportunities.

To improve profitability the Company has put significant effort into improving its supply chain process and relationships in order to optimize gross margin rates over the past two quarters. As a part of that effort, the Company has entered into a number of new supply arrangements for both front store and pharmacy products. In addition, wholesale and distribution processes have been updated to provide the Company with direct control over purchasing programs and closer ties to its key vendors. The Company believes it will see a steady increase in gross margins and profitability over the next four quarters.

### SUMMARY

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

The following provides a summary of the Company's performance for the three and six month periods ended February 28, 2011 compared to the three and six month periods ended February 28, 2010.

- Second quarter revenue of \$20.034 million (2010: \$20.865 million), a decrease of 4.0%.
  - Six month revenue of \$39.769 million (2010: \$41.878 million), a decrease of 5.0%. (Refer to page 5 for further explanation)
- Second quarter comparable store revenue decline of 4.1%; comparable store pharmacy revenue reduction of 6.2%; comparable front store revenue<sup>1</sup> decline of 0.8%.
  - Six month comparable store pharmacy revenue reduction of 6.0%
  - Six month comparable front store revenue<sup>1</sup> reduction of 3.1%. (Refer to page 5 for further explanation)
- Second quarter gross margin<sup>2</sup> as a percentage of revenue of 38.9% (2010: 36.9%), an increase of 2.0%.
  - Six month gross margin<sup>2</sup> as a percentage of revenue of 39.0% (2010: 36.7%), an increase of 2.3%. (Refer to page 6 for further explanation)
- Second quarter operating income<sup>3</sup> of \$2.229 million (2010: \$2.008 million), an increase of 11.0%.
  - Six month operating income<sup>3</sup> of \$4.392 million (2010: \$4.020 million), an increase of 9.3%. (Refer to page 6 for further explanation)
- Second quarter EBITDA of \$0.813 million (2010: \$0.976 million), a decrease of 16.7%.
  - Six month EBITDA of \$1.615 million (2010: \$2.037 million), a decrease of 20.7%. (Refer to page 7 for further explanation)

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

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

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

#### ***Second Quarter***

Second quarter activities included:

- The start of the construction of the Company's largest medical clinic to date, a 5,500 square foot clinic adjacent to one its locations in Calgary, Alberta. The clinic is scheduled to open

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

in early June 2011. As well as having a staff of six full time doctors, the clinic will include an aesthetics clinic that will create significant synergy with the pharmacy's existing strong Botox practice.

- The Company initiated a restructuring of its front store business with the development of systems to facilitate the comprehensive management of its pricing strategy, category management, merchandising strategy, and in-store execution.
- The Company continued to increase the resources allocated to the search for potential acquisition and development targets, and currently has several sites under evaluation, some of which are under negotiation.

### RESULTS OF OPERATIONS

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

(Thousands of dollars except per share amounts)	3 Months Ended		6 Months Ended	
	Feb 28, 2011	Feb 28, 2010	Feb 28, 2011	Feb 28, 2010
	\$	\$	\$	\$
Revenue	20,034	20,865	39,769	41,878
Gross Margin	7,800	7,689	15,502	15,384
Operating Expenses <sup>1</sup>	5,571	5,681	11,110	11,364
Operating Income	2,229	2,008	4,392	4,020
Corporate and other costs	1,416	1,032	2,777	1,983
EBITDA <sup>2</sup>	813	976	1,615	2,037
Stock-based compensation	3	(7)	3	1
Amortization	1,371	1,254	2,695	2,439
Interest expense <sup>3</sup>	196	201	422	516
Other Items <sup>4</sup>	(117)	(8)	(100)	28
Net loss	(640)	(464)	(1,405)	(947)
EBITDA per common share				
- Basic	\$0.01	\$0.01	\$0.02	\$0.02
- Diluted	\$0.01	\$0.01	\$0.02	\$0.02
Loss per common share				
- Basic	(\$0.01)	(\$0.01)	(\$0.02)	(\$0.01)
- Diluted	(\$0.01)	(\$0.01)	(\$0.02)	(\$0.01)

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

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

<sup>3</sup> Interest expense includes bank charges and interest Q2-2011: \$0.027 million (Q2-2010: \$0.034 million), YTD-2011: \$0.058 million (YTD-2010: \$0.065 million); interest and amortization of related financing costs on long term debt Q2-2011: \$0.174 million, (Q2-2010: \$0.178 million), YTD-2011: \$0.372 million (YTD-2010: \$0.469 million) and interest income of Q2-2011: \$0.005 million (Q2-2010: \$0.011 million), YTD-2011: \$0.008 million (YTD-2010: \$0.018 million).

<sup>4</sup> Other items include gain (loss) on disposal of capital and intangible assets of Q2-2011: \$0.116 million (Q2-2010: \$0.008 million), YTD-2011: \$0.099 million (YTD-2010 - \$0.028 million).

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

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

(Thousands of dollars)	3 Months Ended		6 Months Ended	
	February 28, 2011	February 28, 2010	February 28, 2011	February 28, 2010
	\$	\$	\$	\$
Net loss	(640)	(464)	(1,405)	(947)
Add the following:				
Interest expense	196	201	422	516
Amortization	1,371	1,254	2,695	2,439
Stock based compensation	3	(7)	3	1
Other items	(117)	(8)	(100)	28
EBITDA	813	976	1,615	2,037

### Revenue

Revenue is comprised of sales to customers of the Company's retail pharmacies and central fill pharmacies. Revenue was \$20.034 million in the second quarter compared to \$20.865 million in the same period last year, a decrease of \$0.831 million or 4.0%.

Pharmacy revenue was impacted by reductions in generic prescription reimbursement rates, primarily due to regulatory reform implemented in British Columbia in the first quarter of 2011, combined with increased generic prescription utilization rates. Pharmacy revenues also declined due to a decline in script volumes in some regions.

Front store revenue experienced a 0.8% decrease over the second quarter of 2010. The Company recognizes the need for more effective category management, improved pricing strategies, and stronger in-store execution. Management will continue to focus on improving these areas.

The Company continues to work on several initiatives to improve store competitiveness, including: working to improve its merchandising and promotions; 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 six month period ending February 28, 2011 was \$39.769 million compared to \$41.878 million for the same period last year, a decrease of \$2.109 million or 5.0%. Same store pharmacy revenue declined by 6.0% year over year, mainly due to British Columbia regulatory reimbursement reform and a decline in the number of prescriptions filled. Front store revenues declined year over year by 3.1% and continues to be the focus for improvement by the Company.

### 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 and central fill pharmacies. Gross margin was \$7.800 million in the second quarter compared to \$7.689 million in the same period last year, an increase of \$0.111 million or 1.4%. This is the result of greater utilization of higher margin

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

generic prescriptions compared to prior year combined with a 0.6% improvement in front store margin.

The front store margin improvement is the result of a shift to direct buying of high volume special merchandise, as well as the Company's continued focus on improved front store product offering, inventory management and in-store sales and promotions.

Gross margin as a percentage of revenue increased to 38.9% from 36.9% in the same period last year partially due to an increasing trend of pharmacy revenue sales coming from higher margin generic prescriptions combined with a 1.4% increase in front store margin over the same period last year.

Gross margin was \$15.502 million for the six month period compared to \$15.384 million for the same period last year, an increase of \$0.118 million or 0.8%. This was primarily a result of improved pharmacy margins due to increased availability of higher margin generic drugs combined with a 2.3% improvement in gross margin as a percentage of front store sales. Overall gross margin increased to 39.0% from 36.7% 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 expense, amortization, stock based compensation and other items as defined.

Operating expenses were \$5.571 million in the second quarter compared to \$5.681 million in the same period last year, a decrease of \$0.110 million or 1.9%. This was primarily a result of decreased marketing and occupancy costs which were slightly offset by increased operating wages over the same period last year. Operating expenses as a percentage of revenue were 27.8% compared to 27.2% for the same period last year.

Operating expenses were \$11.110 million for the six month period compared to \$11.364 million for the same period last year, a decrease of \$0.254 million or 2.2%. This was primarily a result of decreased marketing and occupancy costs over the same period last year, which was slightly offset by increased operating wages. Operating expenses as a percentage of revenue were 27.9% compared to 27.1% for the same period last year.

### **Operating Income**

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

Operating income was \$2.229 million in the second quarter compared to \$2.008 million in the same period last year, an increase of \$0.221 million or 11.0%. This increase is a result of improved gross margin over the same quarter of the prior year and cost containment initiatives over marketing and operating wages.

Operating income was \$4.392 million for the six month period compared to \$4.020 million for the same period last year, an increase of \$0.372 million or 9.3%. This increase is a result of improved pharmacy and front store margins as well as the reduction of operating expenses by 2.2% 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 \$1.416 million in the second quarter compared to \$1.032 million in the same period last year, an increase of \$0.384 million or 37.2%. This increase is due to increased personnel and information technology spending, offset by decreased management fees and marketing expenses.

Corporate expenses for the six month period were \$2.777 million compared to \$1.983 million for the same period last year, an increase of \$0.794 million or 40.0%. This is due to expanding the senior management team to have adequate capabilities to focus on improving and growing the business. .

### **EBITDA**

EBITDA was \$0.813 million in the second quarter compared to \$0.976 million in the same period last year, a decrease of \$0.163 million or 16.7%. The decrease in EBITDA was primarily a result of decreased revenue and increased corporate costs offset by a stronger gross margin over the same period last year.

EBITDA was \$1.615 million for the six month period compared to \$2.037 million for the same period last year, a decrease of \$0.422 million or 20.7%. The increase in EBITDA was a result of decreased operating and corporate costs over the period, and increased overall margin percentage from prior year.

### **Interest expense**

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

Interest expense was \$0.196 million in the second quarter compared to \$0.201 million in the same period last year, a decrease of \$0.005 million. Bank charges and interest were \$0.027 million (2010 - \$0.034 million); interest and amortization of related financing costs on long-term debt was \$0.174 million (2010 - \$0.178 million); and interest income was \$0.005 million (2010 - \$0.011 million).

Bank charges and interest were \$0.058 million for the six month period (2010: \$0.065 million); interest and amortization of related financing costs on long-term debt was \$0.372 million (2010: \$0.469 million); and interest income of \$0.008 million (2010: \$0.018 million).

### **Amortization**

Amortization of capital and intangible assets was \$1.371 million in the second quarter compared to \$1.254 million in the same period last year, an increase of \$0.117 million or 8.5%. This increase is due to amortization on capital and intangible asset additions.

Amortization of capital and intangible assets was \$2.695 million for the six month period compared to \$2.439 million for the same period last year, an increase of \$0.256 million or 10.5%. This increase is due to amortization on capital and intangible asset additions.

### **Stock based compensation**

Stock based compensation was \$0.003 million in the second quarter compared to (\$0.007) million in the same period last year, an increase of \$0.010 million.

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

Stock based compensation was \$0.003 million for the six month period compared to \$0.001 million for the same period last year, an increase of \$0.002 million.

### Net loss

The net loss was \$0.640 million in the second quarter compared to a net loss of \$0.464 million in the same period last year, an increase in the loss of \$0.176 million or 37.9%. This change is primarily due to the reasons described above in EBITDA along with an increase in amortization.

The net loss was \$1.405 million for the six month period compared to a net loss of \$0.947 for the same period last year, an increase in the loss of \$0.458 million or 48.4%. This change is primarily due to decreasing revenues and increased corporate costs offset by improved gross margins and decreased operating expenses.

### FINANCIAL POSITION

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

Thousands of dollars	February 28, 2011 \$	August 31, 2010 \$
Cash and cash equivalents	(1,588)	(4,285)
Current portion of long-term debt and capital leases	945	952
Long-term debt	6,390	7,008
Net debt <sup>1</sup>	5,747	3,675
Shareholders' equity	27,295	29,523
Total capitalization	33,042	33,198
Net debt: Shareholders' equity	0.21:1	0.12:1
Net debt: Total capitalization	0.17:1	0.11:1
EBITDA: Cash interest expense <sup>2</sup>	4.66:1	5.30:1

<sup>1</sup> Net debt is defined as total bank indebtedness, long term debt (including current portion), capital leases (including current portion), and is net of cash and cash equivalents.

<sup>2</sup> Cash interest expense excludes amortization of financing costs and is net of interest income.

### OUTSTANDING SHARE DATA

As of February 28, 2011 the Company had 91.4 million issued common shares outstanding compared to 93.3 million at August 31, 2010. This reduction in common shares is the result of cancellation of 1.9 million shares through a normal course issuer bid initiated in October 2009 and renewed in October 2010. Further details are available in Note 7 of the unaudited consolidated financial statements as at February 28, 2011.

## LIQUIDITY AND CAPITAL RESOURCES

The Company has a three year credit facility which includes a \$5.0 million operating line which bears interest at prime plus 1% to prime plus 2% which is adjusted each quarter dependent on Company specific covenants outlined in the agreement. 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 February 28, 2011, the Company had issued letters of credit aggregating \$0.5 million (August 31, 2010 - \$0.5 million) leaving \$4.5 million (August 31, 2010 - \$4.5 million) of the \$5.0 million (August 31, 2010 - \$5.0 million) facility available. The Company was in compliance with its financial covenants as at February 28, 2011 and for the period then ended.

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 has been obtained through a combination of cash, debt financing and the issuance of common shares.

At February 28, 2011 the Company had, in addition to its bank facilities, on deposit \$1.6 million available to fund capital projects relating to existing stores as well as for working capital and acquisitions.

### Operating Activities

Cash flow used in operating activities in the second quarter decreased to \$0.377 million from \$0.501 million in the same period last year. The decrease is largely due to a reduction realized by the Company in relation to working capital investment.

For the six month period, net cash flow generated from operating activities was \$0.015 million compared to cash flow used in operating activities of \$0.159 million in the same period last year.

### Financing Activities

Net cash expenditures used in financing activities was \$0.802 million in the second quarter compared to \$0.941 million in the same period last year. The Company repaid \$0.347 million of long term debt obligations during the second quarter compared to \$0.508 million during the same period last year. The Company repurchased shares for \$0.458 million in the quarter under the Normal Course Issuer Bid that commenced October 9, 2009 and was extended October 12, 2010, compared to \$0.409 for the same period last year.

For the six month period, net cash expenditures used in financing activities was \$1.519 million compared to net cash expenditures used in financing activities of \$1.862 million in the same period last year. The Company repaid \$0.731 million of long term debt obligations compared to \$1.189 million during the same period last year. The Company repurchased shares for \$0.826 million under the Normal Course Issuer Bid that commenced October 9, 2009 and was extended October 12, 2010, compared to \$0.634 for the same period last year.

### **Investing Activities**

Net investment from investing activities was \$0.646 million in the second quarter compared to a \$0.638 million in the same period last year. The current year investing activities relates to the purchase of capital assets of \$0.718 million including pharmacy equipment upgrades, computer equipment and leasehold improvements and the purchase of intangible assets \$0.116 million which is comprised mainly of computer software acquisitions.

For the six month period, net investment from investing activities was \$1.193 million compared to \$1.704 million in the same period last year. The current year relates primarily to the purchase of additional capital assets of \$1.206 million which includes additional leaseholds at a number of the Company's locations, pharmacy equipment upgrades and computer equipment. There were also intangible assets additions of \$0.188 million for the current year which is comprised mainly of computer software acquisitions. The prior year relates primarily the acquisition of the prescription file of a pharmacy in Calgary, Alberta, for \$0.500 million and capital and intangible asset expenditures of \$1.226 million on additional leaseholds as well as computer hardware and software.

### **Future Liquidity**

The Company estimates that sufficient means exist to satisfy the Company's working capital needs, a limited number of acquisitions or greenfield developments and debt-service requirements for the coming fiscal year. Further acquisitions or greenfield developments may require additional debt and equity financing to ensure compliance with credit facility covenants. The Company remains subject to future impact of pharmacy reform and how it impacts the Company's ability to raise new debt or equity financing, or refinance existing debt.

The Company has a three year credit facility that comprises a \$5.0 million operating line, a \$5.0 million term loan and a \$15.0 million acquisition facility with interest rates of prime plus 1% to prime plus 2% which is adjusted every quarter dependent on Company specific covenants outlined in the agreement. The term loan is payable in quarterly principal instalments 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.

### **TRANSACTIONS WITH RELATED PARTIES**

During the three and six month periods ended February 28, 2011, the Company expensed \$0.05 million and \$0.10 million (February 28, 2010 - \$0.11 million and \$0.23 million) for advisory and executive services fees due to Canterbury Park Management Inc. Canterbury Park Management Inc. provides management services as a shareholder.

The Company also paid \$0.05 million and \$0.10 million, respectively, for the three and six month periods ended February 28, 2011 (February 28, 2010 - \$0.05 million and \$0.10 million) in rent for premises leased under operating leases to one director.

These transactions are in the normal course of operations and have been recorded at the exchange amount, which is the amount agreed to by the related parties.

## QUARTERLY INFORMATION

### Summary of Quarterly Information

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

Thousands (except per share amounts)	Second Quarter		First Quarter		Fourth Quarter		Third Quarter	
	2011	2010	2011	2010	2010	2009	2010	2009
Revenue	20,034	20,865	19,735	21,013	20,339	20,620	21,026	21,706
EBITDA	813	976	802	1,061	632	965	890	1,529
- EBITDA per share - Basic	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.02
- EBITDA per share - Diluted	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01	\$0.02
Net (loss) income	(640)	(464)	(765)	(483)	(1,063)	(469)	(584)	171
- Net loss per share - Basic	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.00)	(\$0.01)	(\$0.01)	(\$0.01)	\$0.00
- Net loss per share - Diluted	(\$0.01)	(\$0.01)	(\$0.01)	(\$0.00)	(\$0.01)	(\$0.01)	(\$0.01)	\$0.00

## 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

General economic conditions have resulted in reduced consumer spending and have impacted the Company's profitability. Should these conditions continue to prevail, there will be further pressure on the Company's profitability.

### 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.

### **Ability to Manage Growth and Maintain Profitability**

The Company may make acquisitions of other pharmacies or develop greenfield opportunities from time to time. Growth transactions will increase the size of operations, increase the amount of indebtedness that may need to be serviced by the Company, and place additional demands on the Company's management resources. Although the Company has enhanced its systems to effectively manage growth, there is no assurance that the Company will be able to successfully integrate any future acquisitions and failure to do so 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, merchandise management, adjudication of third-party prescriptions in the pharmacy dispensing systems, and real-time debit and credit approval through the point of sales system. 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".

The Company is subject to periodic post reimbursement review of drug costs and dispensing fees by provincial health and third party authorities.

### **Alternative Arrangements for Generic Drug Supply**

As the utilization rate of generic drugs increases, the guaranteed supply from the Company's current providers may be at risk. The Company's inability to source the required generic drug supply could adversely affect the Company's ability to maximize gross margin dollars, operating results and profits.

### **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 exposure to foreign currency risk, credit risk and other price risk is 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.

In British Columbia in 2010, the Ministry of Health Services executed a long term agreement which lowered the cost of generic prescription drugs in the province. The agreement limits the

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

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 \$9.60 per prescription to \$10.50 gradually through April 2, 2012. The British Columbia government has committed to a \$35 million dollar expansion of new clinical pharmacy services effective April 1, 2012.

Further reductions to generic drug pricing were announced in Alberta. Effective April 2010, the prices of existing generic drugs at 75% of the equivalent brand name price have been limited to 56% of such price. Alberta has provided certain transitional and regional relief which will mitigate the effect of the changes announced from April 2010 to March 2013. The Company, 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 Alberta and British Columbia; however, no change has been announced at this time.

The previously announced changes in British Columbia and Alberta have been assessed to determine their impact on both Paragon's profitability and future strategy. The Company is working with its supply chain partners to develop more effective supply chain strategies that may help ensure that there is only moderate impact from these regulatory changes.

While regulatory changes do pose 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.

### **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.

## FUTURE ACCOUNTING PRONOUNCEMENTS

International Financial Reporting Standards will replace Canadian GAAP for Canadian publically accountable enterprises effective for fiscal years beginning on or after January 1, 2011. The Company will implement these standards on September 1, 2011.

In accordance with IFRS, the Company will be required to report its results commencing with its fiscal year ending August 31, 2012, with the quarter ending November 30, 2011 being the first set of consolidated financial statements prepared under IFRS. Comparative figures for the quarter ending November 30, 2010 and year ended August 31, 2011 also need to be restated and presented, including an opening balance sheet as at September 1, 2010 reconciled from current Canadian GAAP to IFRS. For the year ended August 31, 2011 and comparative year ended August 31, 2010, the Company will continue to report its results in accordance with Canadian GAAP.

The Company commenced its process to transition to IFRS and developed an implementation plan of five phases, which in certain cases will be in process concurrently. The five phases are: (1) preliminary diagnostic and scoping; (2) detailed evaluation and design; (3) solution development; (4) integration; and (5) post-implementation review. To date, the Company is progressing according to its implementation plan, has completed the first phase and is continuing to work through the detailed evaluation and design. Below is a summary of the key deliverables for each phase, along with the project status.

1. Preliminary diagnostic and scoping phase. The Company completed this phase in the fourth quarter of fiscal 2010. During this phase, the Company: (1) developed its project structure; (2) established an estimated timeline for the plan completion; (3) created a project team to plan for and achieve a smooth transition to IFRS; (4) engaged a public accounting firm to assist with the high-level assessment of the significant differences between Canadian GAAP and IFRS specific to the Company; and (5) prioritized potentially affected areas based on their financial reporting impact, business impact and overall complexity to the Company.
2. Detailed evaluation and design phase. The Company commenced this phase in the first quarter of fiscal 2011 and plans to: (1) evaluate the IFRS standards, including the transitional provisions of IFRS 1, First-time Adoption of International Financial Reporting Standards; (2) assess policy alternatives allowed under the standards and any resulting impact to the Company; (3) select accounting policies when alternatives are available; and (4) develop draft IFRS consolidated financial statements and note disclosures. Any potential choice of policies and optional exemptions recommended during this phase will be reviewed by the Company's Audit Committee.
3. Solution development phase. The Company will commence this phase concurrent with many of the phase 2 activities in fiscal 2011 and plans to: consider the impact of the IFRS conversion on the Company's business processes, including information technology and data systems, internal control over financial reporting, disclosure control and procedures, financial reporting expertise, and other business activities; (2) develop and document solutions to each business process; and (3) quantify the impact of accounting policies chosen under IFRS at the date of transition and thereafter. Any significant impacts identified during this stage will be reviewed by the Company's Audit Committee.

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

4. Integration phase. The Company will commence this phase after the completion of the second and third phases. This phase of the work plan will include: (1) the approval, testing, and execution of solutions to each business process identified in the third phase; and (2) the collection of financial information necessary to compile IFRS compliant financial statements, including any information required to reconcile Canadian GAAP to IFRS at transition. The Company's Audit Committee will review and approve the IFRS compliant financial statements.
5. Post-implementation review phase. The Company will commence this stage after the changeover to IFRS and completion of the fourth phase. This phase involves assessing and evaluating the overall project performance.

The Company is completing its technical review of identified Canadian GAAP and IFRS differences and is focusing its efforts on the following standards:

### *IAS 36, Impairment of Assets*

The objective of IAS 36, "Impairment of Assets" (IAS 36") is to ensure that assets are carried at no more than their recoverable amount, through use or sale. An asset carried at more than its recoverable amount is considered impaired and an impairment loss must be recognized in income. A previously recognized impairment loss on an asset may be reversed if the factors have changed that were used to determine the asset's recoverable amount. An impairment loss for goodwill may not be reversed.

The requirements in IAS 36 are similar to those that exist in Canadian GAAP however there are differences in identification of cash-generating units, reversals in previously recognized impairment losses and the methodology for calculating the recoverable amount, including the use of discounting. The Company is currently reviewing the implications of IAS 36.

### *IFRS 3, Business Combinations*

The primary effects of adopting IFRS 3, "Business Combinations" ("IFRS 3"), compared to the current Canadian GAAP requirements are: the inability to capitalize acquisition costs which are currently considered part of the purchase price; subsequent acquisition purchase price adjustments (within 12 months) will require retroactive application and a restatement of prior periods; greater limitations exist for establishing restructuring provisions, thereby reducing the number or amount of provisions recognized on acquisition; and intangible assets (liabilities) arising from favourable (unfavourable) operating leases are recognized as a component of the leased asset where they are currently recognized as separate intangible assets or liabilities.

IFRS 1, "First-time adoption of International Financial Reporting Standards" ("IFRS 1"), states that first-time adopters may elect not to apply IFRS 3 retrospectively to business combinations that occurred before the date of transition to IFRS. The Company's current intention is to make election under IFRS 1 and only apply IFRS 3 to business combinations prospectively, or after September 1, 2010.

### *Other Standards*

In addition to the above standards, the Company is also focusing on IAS 12 "Income taxes" and the further options of IFRS 1 beyond those mentioned above. This list should not be regarded as a complete list of the IFRS standards that may have an impact on the Company's results of

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

operations, financial position and disclosures. The list is intended to highlight areas the Company has identified that may be significant. Final conclusions could change as the Company progresses through its implementation plan.

The IASB has ongoing projects, which management is monitoring, that could affect the ultimate differences between Canadian GAAP and IFRS and the impact those differences have on the Company's results of operations, financial position and disclosures.

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

Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings requires the Chief Executive Officer ("CEO") and the 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 CEO and the 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 Company and its consolidated subsidiaries, that is required to be disclosed in reports filed or submitted under applicable securities law, is made known to them by others within these entities.

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

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

Notwithstanding the above control weaknesses, the CEO and 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 Board of Directors together with the Audit Committee have direct oversight responsibilities for the review and approval of the quarterly and annual financial disclosures.