

management's discussion and analysis

The following is a discussion of the consolidated financial condition and results of operations of Shoppers Drug Mart Corporation (“Shoppers” or the “Company”) for the periods indicated and of certain factors that the Company believes may affect its prospective financial condition, cash flows and results of operations. This discussion and analysis should be read in conjunction with the consolidated financial statements of the Company and the notes thereto for the 52 week period ended December 28, 2002. The fiscal year of the Company consists of a 52 or 53 week period ending on the Saturday closest to December 31.

OVERVIEW

The Company is the licensor of full-service retail drug stores operating under the name Shoppers Drug Mart® (Pharmaprix® in Québec), which constitute the largest drug store group in Canada based on number of stores and system sales. Shoppers Drug Mart/Pharmaprix is the only national drug store group and holds the number one or two market share position in prescription sales in most of Canada’s major metropolitan areas. As at December 28, 2002, there were 844 Shoppers Drug Mart/Pharmaprix retail drug stores owned and operated by the Company’s licensees (“Associates”).

In addition, Shoppers owns and operates 46 Shoppers Home Health Care® stores, making it the largest Canadian retailer of home health care products and services.

The Company’s business strategies are designed to drive system sales growth, maximize gross margin dollars and operating cash flow, leverage cost reduction opportunities and build customer loyalty. The Company believes that proper execution of its strategies will strengthen its position as the licensor of Canada’s leading drug store group, thereby generating increased revenue and profitability, and will provide superior returns to its shareholders.

The following table presents a summary of certain selected operating data and consolidated financial information for the Company and its store network.

(\$000's)	2002	2001	\$ Change	% Change
System sales	5,438,700	4,996,360	442,340	8.9%
Revenue	4,019,401	3,634,567	384,834	10.6%
EBITDA ⁽¹⁾	501,110	436,591	64,519	14.8%
Net earnings	208,584	7,179	201,405	n.m.

⁽¹⁾ Earnings before interest, taxes, depreciation and amortization and excluding the staff restructuring charge of \$19,500 in fiscal 2001.
n.m. – Not meaningful.

Management's Discussion and Analysis

System sales represent the combined sales to external customers of the stores owned by the Associates and of the stores owned by the Company. System sales, other than sales of the stores owned by the Company, do not form part of the Company's revenue. (See note 1 to the consolidated financial statements of the Company.)

The Company earns revenue from selling products and charging for services rendered to its network of Associate-owned drug stores and from sales at its Shoppers Home Health Care® stores. These activities are described below.

Distribution

A significant portion of the Company's revenue is generated from the sale of goods to Associate-owned drug stores. In 2002, 82% of all merchandise sold in Associate-owned drug stores was purchased from the Company's distribution centres, a penetration rate that is unchanged from the prior year.

Associate Operations

The Company also earns revenue from its licensing arrangements with Associates. An Associate is a pharmacist and the owner of a corporation that is licensed to operate a retail drug store at a specific location using the Company's trademarks. Under the licensing arrangement, the Company provides the capital to enable Associates to operate Shoppers Drug Mart/Pharmaprix stores without any initial investment. The Company also provides a package of services to facilitate the growth and profitability of each Associate's business. These services include the use of trade marks, operational support, marketing and advertising, purchasing and distribution, information technology and accounting. In return for providing these and other services, Associates pay fees to the Company. Fixtures, leasehold improvements and equipment are purchased by the Company and leased to Associates over three, five and ten year periods, with title retained by the Company. The Company also provides its Associates with assistance in meeting their working capital and long-term financing requirements through the provision of loans and loan guarantees. (See notes 6 and 15 to the consolidated financial statements of the Company.)

Under the licensing arrangement, Shoppers receives a substantial share of Associate store profits. The Company's share of Associate store profits is reflective of its investment in, and commitment to, the operations of the Associates' stores. The Company recognizes its share of Associate store profits throughout the year by way of a service fee that is based on store profitability.

Shoppers operates in Québec under the Pharmaprix® trade name. Under Québec law, profits generated from the sale of prescription and non-prescription medications may only be earned by a pharmacist or a corporation controlled by a pharmacist. As a result of these restrictions, the licence agreement used for Québec Associates differs from the Associate agreement used in other provinces. Pharmaprix® stores and their Associates benefit from the same infrastructure and support provided to all other Shoppers Drug Mart® stores and Associates.

Shoppers Home Health Care®

The Company earns revenue from its 46 Shoppers Home Health Care® stores. These stores sell medical equipment and mobility and home-assist devices to institutional and retail customers.

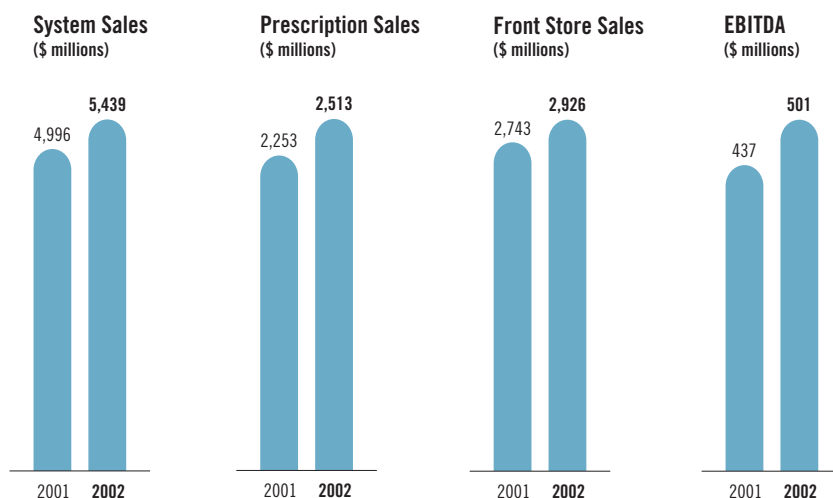
OPERATING PERFORMANCE

The following provides an overview of the Company's operating performance in fiscal 2002:

- System sales of \$5.439 billion, an increase of 8.9%.
- Total comparable store sales growth of 7.0%.
 - Comparable store prescription sales growth of 10.8%.
 - Comparable store front store sales growth of 3.9%.
- Drug store sales per square foot of \$947, an increase from \$920 in 2001.
- EBITDA of \$501 million, an increase of 14.8%.⁽¹⁾
- EBITDA margin⁽²⁾ of 9.21%, an increase of 47 basis points.⁽¹⁾
- Earnings per share (diluted) of \$0.98.
- Completed a \$129 million capital expenditure program.
 - Introduced new large format prototype store.
 - Opened or acquired 57 new drug stores, 31 of which were relocations.
 - Opened or acquired 13 new home health care stores, 3 of which were relocations.
 - Renovated and/or expanded 36 drug stores.
 - Increased drug store selling square footage by approximately 7% to nearly 5.9 million square feet.
- Achieved investment grade credit ratings from Standard & Poor's and Dominion Bond Rating Service.
- Repaid \$160 million of long-term debt, reducing the Company's net debt to equity ratio to 0.59:1 at year-end compared to 0.80:1 at the end of the prior year.

⁽¹⁾ EBITDA and EBITDA margin for the prior year have been adjusted to exclude the impact of a \$20 million staff restructuring charge.

⁽²⁾ EBITDA divided by system sales.



RESULTS OF OPERATIONS

The following table presents a summary of certain selected operating data and consolidated financial information for the Company and its store network.

(\$000's, except per share data)	2002	2001	\$ Change	% Change
System sales	\$ 5,438,700	\$ 4,996,360	\$ 442,340	8.9%
Revenue	\$ 4,019,401	\$ 3,634,567	\$ 384,834	10.6%
Cost of goods sold and other operating expenses	3,518,291	3,217,476 ⁽¹⁾	(300,815)	(9.3%)
EBITDA ⁽²⁾	501,110	417,091	84,019	20.1%
Amortization	77,827	72,967	(4,860)	(6.7%)
Operating income	423,283	344,124	79,159	23.0%
Interest expense ⁽³⁾	79,011	209,119	130,108	62.2%
Earnings before income taxes and goodwill amortization	344,272	135,005	209,267	155.0%
Income taxes	135,688	74,538	(61,150)	(82.0%)
Earnings before goodwill amortization	208,584	60,467	148,117	245.0%
Goodwill amortization	—	53,288	53,288	n.m.
Net earnings	\$ 208,584	\$ 7,179	\$ 201,405	n.m.
Per common share				
– Basic net earnings	\$ 1.00	\$ 0.04	\$ 0.96	n.m.
– Diluted net earnings	\$ 0.98	\$ 0.04	\$ 0.94	n.m.

⁽¹⁾ Includes a staff restructuring charge of \$19,500.

⁽²⁾ Earnings before interest, taxes, depreciation and amortization.

⁽³⁾ Includes the write-off of deferred financing costs of \$18,983 in 2002 and \$29,324 in 2001.

n.m. – Not meaningful.

System Sales

System sales in 2002 were \$5.439 billion compared to \$4.996 billion in 2001, an increase of \$443 million or 8.9%, with strong growth in all regions of the country. On a same-store basis, system sales increased by 7.0% during 2002.

Prescription sales were \$2.513 billion in 2002 compared to \$2.253 billion in 2001, an increase of \$260 million or 11.5%. On a same-store basis, prescription sales increased by 10.8% during 2002. In 2002, prescription sales accounted for 46.2% of the Company's system sales mix compared to 45.1% in 2001.

Front store sales were \$2.926 billion in 2002 compared to \$2.743 billion in 2001, an increase of \$183 million or 6.6%. On a same-store basis, front store sales increased by 3.9% during 2002. In 2002, the Company experienced sales increases in all front store categories, on both an absolute and a comparable store basis, in all regions of the country. The effects of a strengthened value proposition, including the Company's Shoppers Optimum™ loyalty card program which had in excess of 6.7 million members at year-end, combined with new operating standards, contributed to these gains in front store sales.

Revenue

Revenue was \$4.019 billion in 2002 compared to \$3.635 billion in 2001, an increase of \$384 million or 10.6%. This increase is largely attributable to higher distribution centre revenue, as shipments to Associate-owned drug stores increased with the corresponding growth in system sales and expansion of the store network.

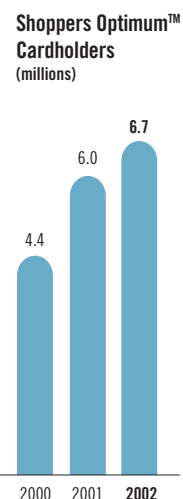
Cost of Goods Sold and Other Operating Expenses

Cost of goods sold is comprised of the cost of goods sold through the Company's distribution centres and Shoppers Home Health Care® stores. Other operating expenses include corporate selling, general and administrative expenses, and operating expenses at the Company's distribution centres and the Shoppers Home Health Care® stores.

Total cost of goods sold and other operating expenses were \$3.518 billion in 2002 compared to \$3.217 billion in 2001, an increase of \$301 million or 9.3%. Other operating expenses for the prior year included a \$20 million staff restructuring charge. (See note 3 to the consolidated financial statements of the Company.) After adjusting for the impact of this one-time charge in the comparative period, total cost of goods sold and other operating expenses in 2002 increased by \$321 million or 10.0% over the prior year. This increase is largely attributable to an increase in the volume of goods sold through the Company's distribution centres to Associate-owned drug stores, a reflection of the growth in system sales and expansion of the store network. Savings in other operating expenses served to partially offset this volume-related increase in cost of goods sold. Other operating expenses amounted to 6.3% of system sales in 2002. This compares to 7.6% in 2001, after adjusting for the impact of the one-time charge. In addition to the efficiencies provided by the increase in sales, this improvement can also be attributed to ongoing savings in administration expenses, largely the result of the prior year's restructuring activities, as well as savings in marketing expenses.

Amortization

Amortization of capital assets was \$78 million in 2002 compared to \$73 million in 2001, an increase of \$5 million or 6.7%. This increase is directly related to the Company's stepped-up capital investment program.



Operating Income

Operating income was \$423 million in 2002 compared to \$344 million in 2001, an increase of \$79 million or 23.0%. Operating income for the prior year was reduced by the \$20 million staff restructuring charge referred to above. After adjusting for the impact of this one-time charge in the comparative period, operating income in 2002 increased by \$60 million or 16.4% over the prior year. As a percentage of system sales, operating margin improved to 7.78% in 2002 from 7.28%, as adjusted, in 2001. The Company's EBITDA margin was 9.21% in 2002, a 47 basis point improvement over the adjusted EBITDA margin of 8.74% posted in 2001.

Interest Expense

Interest expense was \$79 million in 2002 compared to \$209 million in 2001, a decrease of \$130 million or 62.2%. Interest expense in 2001 included a non-cash charge of \$29 million in respect of a write-off of deferred financing costs related to the repayment of the Company's senior subordinated debt facility. Interest expense in 2002 included similar non-cash charges, largely related to the second quarter refinancing of the Company's U.S. dollar denominated debt under its senior bank credit facility. However, the amount of this year's charges, at \$19 million, was \$10 million less than what was incurred in 2001. (See notes 4 and 11 to the consolidated financial statements of the Company.)

In 2002, the Company adopted the new accounting standard 1650 "Foreign Currency Translation," which required retroactive restatement. (See note 2 to the consolidated financial statements of the Company.) The new standard eliminates the deferral and amortization method of accounting for unrealized translation gains and losses on non-current monetary assets and liabilities. Instead, the new standard requires all foreign exchange gains and losses to be included in net earnings each reporting period. As a result, interest expense in 2001 included an unrealized translation loss of \$21 million, stemming from the impact of a weaker Canadian dollar on the carrying value of the unhedged amount of the Company's U.S. dollar denominated debt during that year. In contrast, interest expense in 2002 included a translation gain of \$11 million, reflecting the relative strength of the Canadian dollar on the carrying value of the unhedged amount of the Company's U.S. dollar denominated debt during the first half of the year. (See note 4 to the consolidated financial statements of the Company.) In conjunction with the aforementioned refinancing of its U.S. dollar denominated debt in the second quarter of 2002, the Company took steps to manage its exposure to fluctuations in currency rates by entering into cross-currency basis swap agreements to exchange the entire notional principal amount of its U.S. dollar denominated debt for Canadian dollar denominated debt. As a result of the effectiveness of this hedging program, the Company did not incur any such gains or losses during the second half of 2002. (See notes 2 and 16 to the consolidated financial statements of the Company.)

Excluding the net impact resulting from the implementation of the new accounting standard 1650 and the non-cash charges associated with the write-offs of deferred financing costs, interest expense in 2002 would have been \$70 million compared to \$159 million in 2001, a decrease of 56.3%. Much of this decrease can be attributed to reduced levels of debt, the result of applying the net proceeds from the November 2001 initial public offering, together with free cash flow, to the repayment of long-term debt. A small amount of additional savings was also generated as a result of lower interest rates. Interest expense also included amortization of deferred financing costs of \$5 million in 2002 compared to \$11 million in 2001. (See note 4 to the consolidated financial statements of the Company.)

Income Taxes

The Company's effective income tax rate in 2002 was 39.4% compared to an effective tax rate before goodwill amortization of 55.2% in 2001. The decrease in the effective tax rate can be attributed to a reduction in statutory rates, which also resulted in an expense being recorded in the prior year as future tax assets were reduced at that time, and to the non-taxable component of the translation gains/losses resulting from the implementation of the new accounting standard 1650, as described above. (See note 5 to the consolidated financial statements of the Company.)

Goodwill Amortization

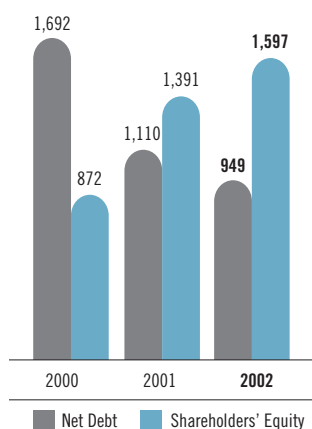
Commencing this year, the Company adopted the new accounting standard 3062 "Goodwill and Other Intangible Assets" on a prospective basis. (See note 2 to the consolidated financial statements of the Company.) As a result, goodwill and other intangible assets with an indefinite life are no longer amortized, but instead, are tested for impairment at least annually. If it is determined, based on the results of such tests, that the carrying value of these assets is in excess of their fair value, the excess amount is charged to earnings. The Company determined that no charge was required in 2002 against the carrying value of goodwill. The results for 2001 included \$53 million of goodwill amortization.

Net Earnings

Net earnings in 2002 were \$209 million compared to \$7 million in 2001. On a diluted basis, earnings per share in 2002 were \$0.98 compared to \$0.04 in 2001. Excluding the net impact resulting from the implementation of the new accounting standards 1650 and 3062, the write-offs of deferred financing costs in the second quarter of 2002 and the fourth quarter of 2001, as well as the staff restructuring charge incurred in the third quarter of 2001, adjusted net earnings were \$210 million in 2002 compared to \$110 million in 2001. On a diluted basis, adjusted earnings per share were \$0.98 in 2002 compared to \$0.59 in 2001, an increase of 66%.

SELECTED QUARTERLY FINANCIAL INFORMATION

	Quarter 1 (12 weeks)	Quarter 2 (12 weeks)	Quarter 3 (16 weeks)	Quarter 4 (12 weeks)
(\$000's, except per share data – unaudited)				
2002	March 23	June 15	October 5	December 28
Revenue	853,867	903,586	1,204,519	1,057,429
Net earnings	41,972	40,864	63,847	61,901
Per common share				
– Basic net earnings	\$ 0.20	\$ 0.20	\$ 0.30	\$ 0.30
– Diluted net earnings	\$ 0.20	\$ 0.19	\$ 0.30	\$ 0.29
2001	March 24	June 16	October 6	December 29
Revenue	775,584	819,232	1,080,812	958,939
Net earnings (loss)	(10,197)	17,607	(4,527)	4,296
Per common share				
– Basic net earnings (loss)	\$ (0.06)	\$ 0.10	\$ (0.02)	\$ 0.02
– Diluted net earnings (loss)	\$ (0.06)	\$ 0.10	\$ (0.02)	\$ 0.02

 Net Debt and Shareholders' Equity
 (\$ millions)


FINANCIAL POSITION

The Company maintains a solid financial position which continued to improve in 2002. At the end of 2002, the Company's working capital ratio was 1.01:1 compared to 1.08:1 at the end of the prior year. During 2002, the Company repaid an additional \$160 million of long-term debt, reducing the Company's net debt to equity ratio to 0.59:1 at year-end compared to 0.80:1 at the end of the prior year.

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

(\$000's)	2002	2001
Bank indebtedness	\$ 10,774	\$ 293
Current portion of long-term debt	12,500	—
Long-term debt	926,063	1,109,545
Net debt	949,337	1,109,838
Shareholders' equity	1,597,499	1,390,561
Total capitalization	\$ 2,546,836	\$ 2,500,399
Net debt: Shareholders' equity	0.59:1	0.80:1
Net debt: Total capitalization	0.37:1	0.44:1
Net debt: EBITDA	1.89:1	2.54:1 ⁽¹⁾
EBITDA: Cash interest expense ⁽²⁾	7.68:1	2.95:1 ⁽¹⁾

⁽¹⁾ Fiscal 2001 EBITDA excludes the \$19,500 staff restructuring charge.

⁽²⁾ Cash interest expense excludes the write-off of deferred financing costs, the amortization of deferred financing costs and any unrealized foreign exchange gains or losses.

LIQUIDITY AND CAPITAL RESOURCES

The Company has two principal sources of liquidity: (i) cash provided by operating activities; and (ii) cash available from a committed \$350 million revolving credit facility under its senior bank credit facility. The Company's operating and investing activities are typically financed by cash flow generated from its operations. In 2002, operating activities net of investing activities generated cash flow of \$147 million compared to \$125 million in 2001. At December 28, 2002, \$9 million of the Company's \$350 million revolving credit facility was utilized, all in respect of letters of credit and trade finance guarantees, compared to \$2 million at the end of the prior year. (See note 11 to the consolidated financial statements of the Company.)

Operating Activities

Cash flows from operating activities were \$315 million in 2002 compared to \$244 million in 2001, an increase of \$71 million or 29.4%. This increase is reflective of improved earnings, which is largely attributable to stronger operating performance, reduced leverage and a lower effective tax rate.

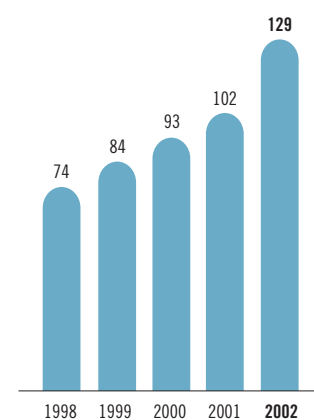
Investing Activities

Cash flows used in investing activities were \$169 million in 2002 compared to \$119 million in 2001, an increase of \$50 million or 42.2%. Of these totals, capital asset expenditures amounted to \$109 million in 2002 compared to \$100 million in 2001. In 2002, approximately 80% of the amount invested in capital assets was allocated to the store network. In 2002, the Company also invested \$20 million in business acquisitions compared to \$2 million in 2001, reflecting its increased commitment to pursue attractive acquisition opportunities. The Company invested an additional \$40 million in long-term receivables in 2002 compared to \$17 million in 2001. This increase is reflective of the additional amount of financial support the Company provided to its Associates, as it opened more large format stores and introduced new merchandising programs to its network of Associate-owned drug stores.

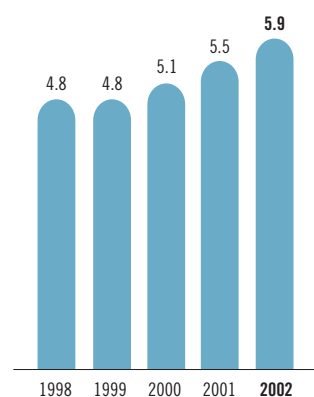
During 2002, 26 drug stores (2001 – 41) and 10 home health care stores (2001 – one) were opened or acquired and nine drug stores (2001 – 11) and one home health care store (2001 – one) were closed. Also in 2002, 31 drug stores (2001 – 23) and three home health care stores were relocated and 36 drug stores (2001 – 76) and six home health care stores were renovated and/or expanded.

At the end of 2002, there were 890 stores (2001 – 864) in the Company's system, comprised of 844 drug stores (2001 – 827) and 46 home health care stores (2001 – 37). At the end of 2002, total drug store selling square footage was approximately 5.9 million square feet (2001 – 5.5 million square feet).

Capital Asset Expenditures and Business Acquisitions
(\$ millions)



Total Selling Space – Drug Stores
(millions ft.²)



Management's Discussion and Analysis

The following table provides a summary of the Company's store network, and changes thereto, for the periods indicated.

	2002		2001	
	Drug Stores	Total Stores	Drug Stores	Total Stores
Store count – beginning of year	827	864	797	834
Stores opened	26	36	41	42
Stores closed	9	10	11	12
Store count – end of year	844	890	827	864
Stores relocated	31	34	23	23
Stores renovated/expanded	36	42	76	76

Financing Activities

During 2002, the Company successfully negotiated an amendment to the terms of its senior bank credit facility to borrow an additional U.S. \$425 million under a new Tranche F term loan. The proceeds of the Tranche F loan were applied to the repayment of the amounts outstanding under the Tranche C and E term loans under the same credit facility. The Tranche F loan has a final maturity date of February 4, 2009. The minimum repayment terms of the Tranche F loan required six annual payments equal to 1% of the original principal amount of the loan, along with a final payment equal to the remaining principal amount outstanding at maturity. The Tranche F loan bears interest at a fixed margin of base rate plus 0.75% or LIBOR plus 2.0%. The Tranche F term loan is subject to all of the covenants and has the benefit of all of the security given in connection with the Company's senior bank credit facility. (See note 11 to the consolidated financial statements of the Company.)

During 2002, the Company repaid an additional \$160 million of long-term debt. At year-end, the Company's senior bank credit facility was comprised of a revolving credit facility of up to Cdn. \$350 million maturing February 2, 2007; a non-revolving, reducing Tranche A term loan in the amount Cdn. \$350 million maturing January 26, 2007; and a non-revolving, reducing Tranche F term loan in the amount of U.S. \$375 million maturing February 4, 2009. (See note 11 to the consolidated financial statements of the Company.)

During 2002, the Company provided an additional \$98 million of guarantees to various banks in respect of borrowings by Associates. At December 28, 2002, the Company's maximum obligation in respect of such guarantees was \$429 million. As of this same date, an aggregate amount of \$379 million in available lines of credit had been allocated to Associates by the various banks, against which an aggregate amount of \$307 million was drawn. (See note 15 to the consolidated financial statements of the Company.)

FUTURE LIQUIDITY

The Company believes that its current credit facilities, together with cash generated from operating activities, will be sufficient to fund its operations, investing activities and commitments for the foreseeable future. The Company does not foresee any difficulty in obtaining long-term financing given its current credit ratings and past experiences in the capital markets.

The following table provides a summary of the Company's credit ratings at the end of 2002:

	Moody's	Standard & Poor's	Dominion Bond Rating Service
Senior secured bank debt	Ba1	BBB+	BBB (high)
Senior implied ⁽¹⁾ /Corporate credit ⁽²⁾ rating	Ba1	BBB	—
Long-term unguaranteed and unsecured senior issuer rating	Ba2	—	—

⁽¹⁾ Moody's terminology.

⁽²⁾ Standard & Poor's terminology.

RISKS AND RISK MANAGEMENT

Regulatory Environment and Factors Affecting the Sale of Prescription Drugs

The Company is reliant on prescription drug sales for a significant and growing portion of its revenues and profits. Prescription drug sales are subject to numerous federal, provincial, territorial and local laws and regulations governing the packaging, disposal, sale, marketing, advertising, handling, distribution and dispensing of pharmaceuticals, as well as the approval of new drugs. Non-compliance with or amendments to any such laws or regulations, particularly those that provide for the licensing and conduct of pharmacists, the regulation and ownership of pharmacies and the advertising of pharmacies and prescription services, could adversely affect the Company. Sales of prescription drugs may be affected by changes in the health care industry, including changes to programs providing for reimbursement of the cost of prescription drugs by third-party payers, such as government and private sources. Federal or provincial legislative changes affecting prescription drug coverage or allowable mark-ups to the cost of a drug or to professional or dispensing fees could also affect the Company's sales and profitability.

While over the past few years certain provincial governments have implemented a number of measures directed towards managing the cost of pharmacy services and controlling increasing drug costs, there has not been any recent expansion of these initiatives. In fact, the Company believes that there has been a shift in government interest toward an expanded role for pharmacy services in the delivery of health care services to Canadians. It is the Company's view that the recently released reports by the Commission on the Future of Health Care in Canada – "Building on Values: The Future of Health Care in Canada" and the Senate Standing Committee on Social Affairs, Science and Technology –

"The Health of Canadians – The Federal Role," confirm this belief. The Company is an active proponent of this position and believes that properly managed pharmacy services are part of the solution to controlling rising health care costs. Accordingly, as a means to managing this risk, the Company has implemented a proactive government relations program in order to build awareness of pharmacy issues and influence the policy-making process.

Certain third-party payers, such as corporate employers and/or their insurers, continue to seek ways to manage the cost of their drug programs. While traditional cost control mechanisms such as the capping of dispensing fees and the sharing of costs with employees are still in use, the Company believes that corporate employers are becoming more aware of the beneficial role that pharmacy can play in improving the health of their employees. The Company's approach to this issue is to demonstrate to employers and/or their insurers that properly managed pharmacy services result in a workforce that is better educated about the importance of disease management and health and wellness, which provides savings to employers in areas such as absenteeism and long-term disability, while increasing productivity.

Ability to Attract and Retain Pharmacists

The Company is dependent on its ability to attract, motivate and retain pharmacists for the stores in its network. Demographic trends and increased competition have led to a shortage of pharmacists in certain markets in Canada. The inability to attract and retain pharmacists could adversely affect the Company's business, financial condition and results of operations.

The Company believes that its Associate Concept provides it with a competitive advantage when recruiting pharmacists. In particular, pharmacy school graduates are attracted to Shoppers because its Associate Concept enables pharmacists to own their own businesses while benefitting from the training and capital provided by the Company. Shoppers has also implemented an aggressive recruitment strategy to increase the number of domestic and foreign trained pharmacists hired each year. Moreover, the Associate-owned stores in the Company's network continue to employ more pharmacy students and interns to ensure a source of supply of new graduates in future years. During 2003, the Company will introduce a number of enhancements to its pharmacist compensation and benefit plans in order to further improve its retention rate of existing pharmacists.

Competition

The Company faces competition from many retailers in the front store merchandise and non-prescription drug categories. 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. These competitors may reduce prices in front store merchandise or reduce dispensing fees to increase market share, which could have an adverse impact on the Company's earnings.

The Company believes that it is well positioned to compete against drug store chains, as well as supermarkets, mass merchandisers and independent drug stores, by concentrating on providing high levels of professional service and focusing on improving patient self-management and outcomes. While mass merchandisers compete aggressively on price, the Company believes that consumers will pay for its value-added pharmacy services such as patient counselling and disease management clinics, and will be attracted by its convenient locations, extended hours of service and broad selection of health, beauty and everyday household essentials.

Exposure to Interest Rate and Currency Fluctuations

The Company is exposed to fluctuations in interest rates and currency exchange rates by virtue of its borrowings under its senior credit facility. (See note 11 to the consolidated financial statements of the Company.) Increases in interest rates and increases in the value of the U.S. dollar in relation to the Canadian dollar will have an adverse effect on the earnings of the Company.

The Company uses interest rate derivatives to manage its exposure to fluctuations in interest rates. The Company also uses currency derivatives to manage its exposure to fluctuations in currency rates. (See note 2 to the consolidated financial statements of the Company.)

As at December 28, 2002, the Company had entered into interest rate derivative agreements converting an aggregate notional principal amount of \$350 million of floating rate debt into fixed rate debt. The fixed rates payable by the Company under these agreements range from 6.07% to 6.10%. These agreements mature on April 14, 2005. (See note 16 to the consolidated financial statements of the Company.)

As at December 28, 2002, the Company had entered into currency derivative agreements to exchange a notional principal amount of U.S. \$375 million of debt for Canadian dollar denominated debt. These agreements mature on June 14, 2004. (See notes 6 and 16 to the consolidated financial statements of the Company.)

Changes in the underlying interest rates and exchange rates of the Company's interest rate and currency derivative agreements will result in market gains and losses. Furthermore, the Company may be exposed to losses should any counterparty to its derivative agreements fail to fulfill its obligations. The Company has sought to minimize counterparty risk by transacting with counterparties that are large international financial institutions.

Property and Casualty Exposures

Certain property and casualty risks and exposures are inherent in the operation of the Company's business. The Company has a number of integrated risk management programs in place, which are designed to reduce its exposures and mitigate any losses. These include self-insuring certain exposures to levels appropriate and customary for a company the size of Shoppers and purchasing excess

insurance coverage from financially stable third-party insurance companies to provide adequate coverage for all normal insurable commercial risks.

OUTLOOK

The Company believes that it is well positioned to capitalize on the projected growth in the retail drug store industry given its strong brand recognition, focus on pharmacy, health care and beauty products and services, convenient locations and the dedication of its Associate-owners. The demographic trends of the aging Canadian population are expected to fuel continued strong growth in the pharmacy and beauty categories. The Company intends to maintain its leadership in pharmacy by investing in technology and, more importantly, in the recruitment and retention of pharmacists. The Company believes that its primary focus on pharmacy products and services will continue to drive customer traffic and provide profitable growth in its beauty and other front store categories. The Company expects that front store sales growth will also be driven by improved merchandising, an increased focus on operational excellence and the introduction of new products and services.

Due to the fragmented nature of the Canadian retail drug store industry, Shoppers believes that it is well positioned to capitalize on consolidation opportunities, given its strong cash flow and steadily improving balance sheet. The Company also intends to continue making significant investments in its store network, particularly by replacing its smaller format stores with larger stores and by opening new stores. The Company plans to allocate approximately \$160 million to capital expenditures in 2003, which will be funded entirely from internally generated cash flow.

NON-GAAP EARNINGS REFERENCES

The foregoing contains references to non-GAAP earnings measures, such as operating margin, EBITDA (earnings before interest, taxes, depreciation and amortization), adjusted EBITDA, EBITDA margin, adjusted EBITDA margin, adjusted net earnings and adjusted earnings per share. Non-GAAP earnings measures do not have standardized meanings prescribed by GAAP and therefore may not be comparable to similar measures presented by other reporting issuers.

FORWARD-LOOKING STATEMENTS

The foregoing contains forward-looking statements related to expected future events and financial results and operating results of the Company that involve risks and uncertainties. Actual results may differ materially from management expectations as projected in such forward-looking statements for a variety of reasons, including market and general economic conditions and the risks and uncertainties discussed above and in other disclosure materials filed from time to time by the Company with Canadian securities regulatory authorities.