

Overview

The Company is the licensor of full-service retail drug stores operating under the name Shoppers Drug Mart® (Pharmaprix® in Québec). As at January 3, 2004, there were 870 Shoppers Drug Mart/Pharmaprix retail drug stores owned and operated by the Company's licensees ("Associates"). An Associate is a pharmacist-owner of a corporation that is licensed to operate a retail drug store at a specific location using the Company's trademarks. The Company's licensed stores are located in prime locations in each province and two territories, making Shoppers stores among the most convenient retail outlets in Canada.

In addition, Shoppers owns and operates 48 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 continue to 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)	2003	2002	\$ Change	% Change
	(53 weeks)	(52 weeks)		
System sales	6,056,571	5,438,700	617,871	11.4%
Revenue	4,415,202	4,019,401	395,801	9.8%
EBITDA ⁽¹⁾	570,179	501,110	69,069	13.8%
Net earnings	257,670	208,584	49,086	23.5%

⁽¹⁾ Earnings before interest, taxes, depreciation and amortization. (See reconciliation to most directly comparable GAAP measure under "Results of Operations".)

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 2003, 83% of all merchandise sold in Associate-owned drug stores was purchased from the Company's distribution centres compared to 82% in 2002.

Associate Operations

The Company also earns revenue from its licensing arrangements with Associates. Under the licensing arrangement, the Company provides the capital and financial support to enable Associates to operate Shoppers Drug Mart 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 trademarks, 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 5 and 14 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 prescription area or dispensary may only be earned by a pharmacist or a corporation controlled by a pharmacist. As a result of these restrictions, the license 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®

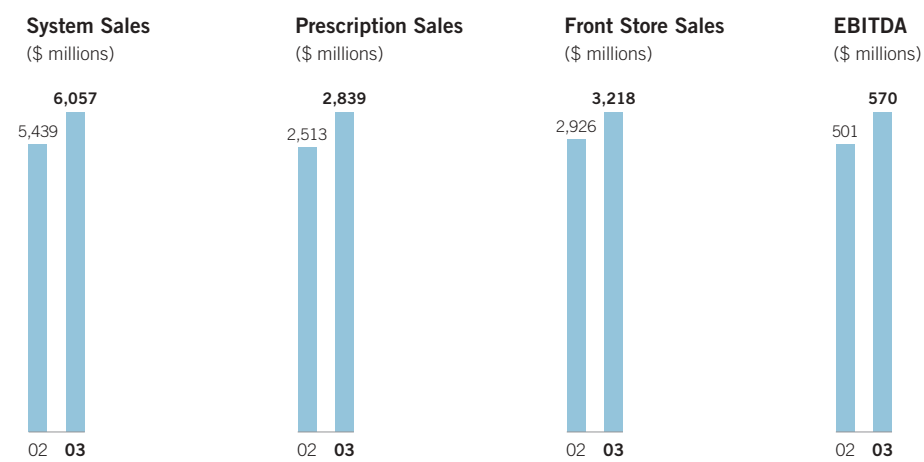
The Company earns revenue from its 48 Shoppers Home Health Care® stores. These stores sell medical equipment and assisted-living devices to institutional and retail customers.

Operating Performance and Investing and Financing Activities

The following provides an overview of the Company's operating performance and investing and financing activities in fiscal 2003:

- System sales of \$6.1 billion, an increase of 11.4%.
- Total comparable store sales growth (52 week basis) of 6.9%.
 - > Comparable store prescription sales growth of 9.9%.
 - > Comparable store front store sales growth of 4.3%.
- Drug store sales per square foot (52 week basis) of \$1,001, an increase of 5.7%.
- EBITDA of \$570 million, an increase of 13.8%.
- EBITDA margin⁽¹⁾ of 9.41%, an increase of 20 basis points.
- Net earnings of \$258 million, an increase of 23.5%.
 - > Earnings per share (diluted) of \$1.20 versus \$0.98 in the prior year.
- Capital expenditure program of \$179 million.
 - > 58 new drug stores opened or acquired, 26 of which were relocations.
 - > 41 drug stores expanded and/or renovated.
 - > 8.6% increase in drug store selling square footage to over 6.3 million square feet.
 - > Six new home health care stores opened, four of which were relocations.
- \$1.2 billion of secured bank credit facilities refinanced with a combination of new unsecured bank credit facilities, medium-term notes and a commercial paper program.
- \$118 million of debt repaid, reducing the Company's net debt to equity ratio to 0.44:1 at year-end compared to 0.59:1 at the end of the prior year.

⁽¹⁾ 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)	2003 (53 weeks)	2002 (52 weeks)	\$ Change	% Change
System sales	\$ 6,056,571	\$ 5,438,700	\$ 617,871	11.4%
Revenue	\$ 4,415,202	\$ 4,019,401	\$ 395,801	9.8%
Cost of goods sold and other operating expenses	3,845,023	3,518,291	(326,732)	(9.3%)
EBITDA ⁽¹⁾	570,179	501,110	69,069	13.8%
Amortization	83,369	77,827	(5,542)	(7.1%)
Operating income	486,810	423,283	63,527	15.0%
Interest expense	76,329⁽²⁾	79,011 ⁽³⁾	2,682	3.4%
Earnings before income taxes	410,481	344,272	66,209	19.2%
Income taxes	152,811	135,688	(17,123)	(12.6%)
Net earnings	\$ 257,670	\$ 208,584	\$ 49,086	23.5%
Per common share				
– Basic net earnings	\$ 1.25	\$ 1.00	\$ 0.25	
– Diluted net earnings	\$ 1.20	\$ 0.98	\$ 0.22	

⁽¹⁾ Earnings before interest, taxes, depreciation and amortization.

⁽²⁾ Includes a non-cash charge of \$9,520 in respect of a write-off of deferred financing costs and a charge of \$1,122 to exit currency derivative agreements.

⁽³⁾ Includes non-cash charges of \$18,983 in respect of the write-off of deferred financing costs and a foreign currency translation gain of \$10,599.

System Sales

System sales in 2003 were \$6.057 billion compared to \$5.439 billion in 2002, an increase of \$618 million or 11.4%. In 2003, the Company experienced strong sales growth in all departments, across all regions of the country. The Company's stepped-up capital investment program, a significant portion of which has been allocated to the store network, has had a positive impact on system sales growth. By adding new stores, relocating and expanding existing stores and through acquisitions, the Company increased the selling square footage of its drug store network by 8.6% during 2003. The additional week in fiscal 2003 also contributed to the year-over-year increase in system sales. On a same-store (52 week) basis, system sales increased 6.9% during 2003.

Prescription sales were \$2.839 billion in 2003 compared to \$2.513 billion in 2002, an increase of \$326 million or 13.0%. On a same-store (52 week) basis, prescription sales increased 9.9% during 2003. The Company believes that it is well positioned to benefit from favourable demographic trends which continue to drive prescription sales growth. In 2003, prescription sales accounted for 46.9% of the Company's system sales mix compared to 46.2% in 2002.

Front store sales were \$3.218 billion in 2003 compared to \$2.926 billion in 2002, an increase of \$292 million or 10.0%. On a same-store (52 week) basis, front store sales increased 4.3% during 2003. The Company's strengthened value proposition, which includes its Shoppers Optimum™ loyalty card program, combined with improved merchandising and marketing initiatives, including the addition of new categories and services and enhanced seasonal programs, contributed to these gains in front store sales.

Revenue

Revenue was \$4.415 billion in 2003 compared to \$4.019 billion in 2002, an increase of \$396 million or 9.8%. 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. A portion of this increase can also be attributed to increased sales at the Company's home health care stores, which benefitted from a full year of sales from eight stores that were acquired in the fourth quarter of the prior year.

Cost of Goods Sold and Other Operating Expenses

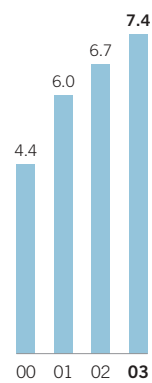
Cost of goods sold is comprised of the cost of goods sold through the Company's distribution centres and Shoppers Home Health Care® stores. Other operating expenses include corporate selling, general and administrative expenses and operating expenses at the Company's distribution centres and the Shoppers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

Total cost of goods sold and other operating expenses were \$3.845 billion in 2003 compared to \$3.518 billion in 2002, an increase of \$327 million or 9.3%. 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 and increased sales at the Company's home health care stores, both of which reflect the growth in system sales and expansion of the store network. Other operating expenses amounted to 5.9% of system sales in 2003, compared to 6.3% in 2002. System sales growth and an ongoing commitment to cost control continue to provide the Company with opportunities to leverage its cost base and increase profitability.

Amortization

Amortization of capital assets was \$83 million in 2003 compared to \$78 million in 2002, an increase of \$5 million or 7.1%, which is reflective of the Company's increased capital investment program.

**Shoppers Optimum™
Cardholders**
(millions)



Operating Income

Operating income was \$487 million in 2003 compared to \$423 million in 2002, an increase of \$64 million or 15.0%. Operating margin (operating income divided by system sales) improved by 26 basis points to 8.04% in 2003 from 7.78% in 2002. The Company's EBITDA margin was 9.41% in 2003, a 20 basis point improvement over the EBITDA margin of 9.21% posted in 2002.

Interest Expense

Interest expense was \$76 million in 2003 compared to \$79 million in 2002, a decrease of \$3 million or 3.4%. Interest expense in 2003 included a non-cash charge of \$10 million stemming from a fourth quarter write-off of certain remaining deferred financing costs related to the termination and refinancing of the Company's previously existing credit facilities. In conjunction with this refinancing, the Company also incurred a charge of \$1 million to exit all of its currency derivative agreements under which it had exchanged a notional principal amount of U.S. \$345 million of previously existing debt for Canadian dollar denominated debt. As the refinancing was funded entirely in Canadian dollars, the Company is no longer exposed to any fluctuation in currency exchange rates by virtue of its borrowings and, accordingly, no longer requires the use of currency derivatives to manage this exposure. Interest expense in the prior year included non-cash charges of \$19 million, largely related to a refinancing of the Company's U.S. dollar denominated debt under its senior bank credit facility in the second quarter of that year. (See notes 3, 10 and 15 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 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 that year. (See note 3 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 the prior year, 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 further such gains or losses. (See notes 2 and 15 to the consolidated financial statements of the Company.)

If interest expense in each of 2002 and 2003 was adjusted to exclude, where applicable, the net impact resulting from the implementation of accounting standard 1650, the non-cash charges associated with the write-offs of deferred financing costs and the charge incurred to exit all currency derivative agreements, interest expense in 2003 would have been \$66 million compared to \$71 million in 2002, a decrease of \$5 million or 7.0%. A portion of this decrease can be attributed to a reduction in net debt in 2003 versus the prior year, as the Company continued to use free cash flow to strengthen its balance sheet. The Company also benefitted from lower spreads and interest rates, particularly in the final quarter of the year once it had completed the refinancing of its previously existing credit facilities.

Interest expense also includes amortization of deferred financing costs of \$4 million in 2003 compared to \$5 million in 2002. (See note 3 to the consolidated financial statements of the Company.)

Income Taxes

The Company's effective income tax rate in 2003 was 37.2% compared to 39.4% in 2002. The decrease in the effective tax rate can be largely attributed to a reduction in statutory rates in various jurisdictions.

Net Earnings

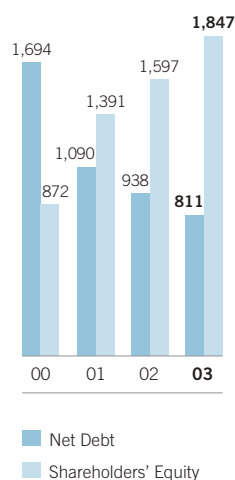
Net earnings in 2003 were \$258 million compared to \$209 million in 2002, an increase of \$49 million or 23.5%. On a diluted basis, earnings per share in 2003 were \$1.20 compared to \$0.98 in 2002. Excluding the impact of the fourth quarter charges to write off deferred financing costs and exit currency derivative agreements, adjusted net earnings were \$265 million in 2003. This compares to adjusted net earnings of \$210 million in 2002, an increase of \$55 million or 26.0%. Adjusted net earnings for the prior year exclude the net impact resulting from the implementation of accounting standard 1650 and the write-off of deferred financing costs that occurred in the second quarter of that year. On a diluted basis, adjusted earnings per share were \$1.24 in 2003 compared to \$0.98 in 2002.

Selected Quarterly Financial Information

(\$000's, except per share data – unaudited)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2003	(12 weeks)	(12 weeks)	(16 weeks)	(13 weeks)
Revenue	917,611	992,700	1,305,439	1,199,452
Net earnings	51,484	57,988	78,772	69,426
Per common share				
– Basic net earnings	\$ 0.25	\$ 0.28	\$ 0.38	\$ 0.33
– Diluted net earnings	\$ 0.24	\$ 0.27	\$ 0.37	\$ 0.32
2002	(12 weeks)	(12 weeks)	(16 weeks)	(12 weeks)
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

Net Debt and Shareholders' Equity

(\$ millions)



Financial Position

The Company maintains a solid financial position which was further improved in 2003. During 2003, the Company repaid an additional \$118 million of debt, reducing the Company's net debt to equity ratio to 0.44:1 at year-end compared to 0.59:1 at the end of the prior year. Shareholders' equity was \$1.847 billion at the end of 2003 compared to \$1.597 billion at the end of 2002, an increase of \$250 million or 15.6%.

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)	2003	2002
Cash	\$ (8,813)	\$ —
Bank indebtedness	—	10,774
Commercial paper	170,000	—
Current portion of long-term debt	—	12,500
Long-term debt	650,000	926,063
Currency swap receivable	—	(11,438)
Net debt	811,187	937,899
Shareholders' equity	1,847,398	1,597,499
Total capitalization	\$ 2,658,585	\$ 2,535,398
Net debt:Shareholders' equity	0.44:1	0.59:1
Net debt:Total capitalization	0.31:1	0.37:1
Net debt:EBITDA	1.42:1	1.87:1
EBITDA:Cash interest expense ⁽¹⁾	9.09:1	7.68:1

⁽¹⁾ 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 three principal sources of short-term liquidity: (i) cash provided by operating activities; (ii) cash available from a committed \$250 million revolving bank credit facility maturing February 2, 2007; and (iii) up to \$300 million in availability under its commercial paper program, less what is currently issued. The Company's commercial paper program is supported by a \$300 million 364-day extendible revolving bank credit facility.

The Company has obtained its long-term financing from a \$350 million non-revolving bank credit facility maturing January 26, 2007 and through the issuance of \$300 million of medium-term notes.

The Company's operating and investing activities are typically financed by cash flow generated from its operations. In 2003, operating activities net of investing activities generated cash flow of \$128 million compared to \$147 million in 2002. At January 3, 2004, \$9 million of the Company's \$250 million revolving credit facility (2002 – \$350 million) was utilized, all in respect of letters of credit and trade finance guarantees, an amount which is unchanged from the prior year. (See note 10 to the consolidated financial statements of the Company.) As at this same date, the Company had \$170 million of commercial paper issued and outstanding under its commercial paper program.

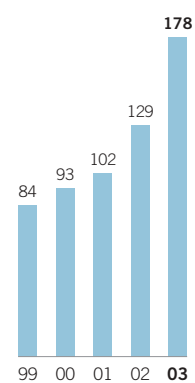
Operating Activities

Cash flows from operating activities were \$364 million in 2003 compared to \$315 million in 2002, an increase of \$49 million or 15.6%. This increase can be primarily attributed to the year-over-year increase in net earnings.

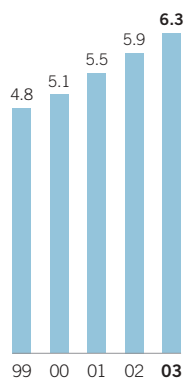
Investing Activities

Cash flows used in investing activities were \$236 million in 2003 compared to \$169 million in 2002, an increase of \$67 million or 39.8%. Of these totals, capital asset expenditures amounted to \$161 million in 2003 compared to \$109 million in 2002, reflecting the Company's stepped-up store development program. In 2003, approximately 82% of the amount invested in capital assets was allocated to the store network, compared to 80% in the prior year. During 2003, the Company invested a further \$18 million in business acquisitions, as it continues to pursue attractive opportunities in the marketplace. The Company invested an additional \$58 million in long-term receivables in 2003 compared to \$40 million in 2002, which is reflective of the additional amount of financial support the Company provided to its Associates as it expanded its store network, opened more large-format stores and introduced new merchandising programs to its network of Associate-owned drug stores.

Capital Asset Expenditures and Business Acquisitions
(\$ millions)



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



During 2003, 58 new drug stores were opened or acquired, 26 of which were relocations, six drug stores were closed and 41 drug stores were expanded and/or renovated. Also in 2003, six new home health care stores were opened, four of which were relocations, and five home health care stores were expanded and/or renovated. At the end of 2003 there were 918 stores in the system, comprised of 870 drug stores and 48 home health care stores. Drug store selling square footage increased 8.6% during 2003 to in excess of 6.3 million square feet at year-end.

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

	2003		2002	
	Drug Stores	Total Stores	Drug Stores	Total Stores
Store count – beginning of year	844	890	827	864
Stores opened	32	34	26	36
Stores closed	6	6	9	10
Store count – end of year	870	918	844	890
Stores relocated	26	30	31	34
Stores renovated/expanded	41	46	36	42

Financing Activities

On October 24, 2003, the Company completed a refinancing of all of its approximately \$1.2 billion of previously existing senior secured bank credit facilities with a combination of new senior unsecured bank credit facilities, medium-term notes and a commercial paper program. (See note 10 to the consolidated financial statements of the Company.)

The Company's new bank credit facilities consist of a \$350 million term facility maturing January 26, 2007, a \$250 million revolving credit facility maturing February 2, 2007 and a 364-day extendible revolving credit facility in the amount of \$300 million. The term facility and a portion of the revolving facility were applied to the repayment of existing bank indebtedness. The revolving facility and the 364-day extendible revolving facility are available for general corporate purposes, including backstopping the Company's new commercial paper program. The Company's initial credit spread on BA borrowings under the new bank credit facilities is 75 basis points.

As part of this refinancing the Company issued \$300 million of 5-year medium-term notes maturing October 24, 2008, which bear interest at a fixed rate of 4.97% per annum (the "Notes"). The Notes were issued pursuant to a short form base shelf prospectus dated October 10, 2003 (the "Prospectus"), as supplemented by a pricing supplement dated October 20, 2003, and filed by the Company with Canadian securities regulators in all of the provinces of Canada. The Prospectus qualifies the distribution of medium-term notes of the Company at any time and from time to time during the next 25 months having an aggregate principal amount of up to \$500 million. The Notes were assigned ratings of A (low) from Dominion Bond Rating Service and BBB from Standard & Poor's.

A component of the refinancing also included the establishment of a commercial paper program of up to \$300 million. This program has been assigned a rating of R-1 (low) by Dominion Bond Rating Service.

In conjunction with this refinancing, the Company incurred a non-cash charge of \$10 million stemming from a write-down of certain remaining deferred financing costs associated with the termination of its previously existing credit facilities. The Company also incurred a charge of \$1 million to exit all of its currency derivative agreements under which it had exchanged a notional principal amount of U.S. \$345 million of previously existing debt for Canadian dollar denominated debt. As the refinancing was funded entirely in Canadian dollars, the Company is no longer exposed to any fluctuations in currency exchange rates by virtue of its borrowings and, accordingly, no longer requires the use of currency derivatives to manage this exposure. These charges were expensed in the fourth quarter of fiscal 2003.

In addition to the aforementioned refinancing activities, the Company repaid an additional \$118 million of debt during 2003.

During 2003, the Company provided an additional \$20 million of guarantees to various banks in respect of borrowings by Associates. At January 3, 2004, the Company's maximum obligation in respect of such guarantees was \$449 million. As of this same date, an aggregate amount of \$413 million in available lines of credit had been allocated to Associates by the various banks, against which an aggregate amount of \$355 million was drawn. As recourse in the event that any payments are made under the guarantees, the Company holds a floating or non-specific security interest on all assets of Associate-owned stores. As at January 3, 2004, the Company estimates the net proceeds from secured assets would exceed the amount of any payments required in respect of the guarantees. (See note 14 to the consolidated financial statements of the Company.)

Future Liquidity

The Company believes that its current credit facilities and commercial paper program, 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 2003:

	Standard & Poor's	Dominion Bond Rating Service
Corporate credit rating	BBB	A (low)
Medium-term notes	BBB	A (low)
Commercial paper	—	R-1 (low)

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, 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 pharmacy services and controlling increasing drug costs, there has not been any recent expansion of these initiatives. In fact, the Company believes that there is continued interest by governments for pharmacy services to play an expanded role in the delivery of health care services to Canadians. Examples of this include recent discussions in Alberta to consider providing pharmacists with limited prescribing authority, as well as involvement in influenza awareness and immunization programs in Ontario. The Company is an active proponent of pharmacy playing an expanded role 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 2004, the Company will continue to make 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 Fluctuations

The Company is exposed to fluctuations in interest rates by virtue of its borrowings under its bank credit facilities and commercial paper program. Increases in interest rates 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. (See note 2 to the consolidated financial statements of the Company.)

As at January 3, 2004, 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 15 to the consolidated financial statements of the Company.)

Changes in the underlying interest rates of the Company's interest rate 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 fulfil 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.

New Accounting Pronouncements

Revenue Recognition

In January 2004, the Emerging Issues Committee (the "EIC") of the Canadian Institute of Chartered Accountants (the "CICA") issued EIC-144, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor" (the "EIC Abstract"). The EIC Abstract requires a customer to record cash consideration received from a vendor as a reduction in the price of the vendor's products and reflect it as a reduction to cost of goods sold and related inventory when recognized in the income statement and balance sheet. Certain exceptions apply where the cash consideration received is either a reimbursement of incremental selling costs incurred by the reseller, or is a payment for assets or services delivered to the vendor. The EIC Abstract must be applied retroactively for annual and interim periods ending after August 15, 2004.

The Company receives allowances from certain of its merchandise vendors, which it records as a reduction to cost of goods sold. This new guidance will change the timing of recognition of some vendor allowances. The Company is assessing the impact of this new guidance.

Consolidation of Variable Interest Entities

In June 2003, the CICA issued Accounting Guideline 15 (“AcG-15”), “Consolidation of Variable Interest Entities”, requiring the consolidation of variable interest entities (“VIEs”). In September 2003, the Accounting Standards Board of the CICA delayed the effective date of the implementation of AcG-15 until annual and interim periods beginning on or after November 1, 2004. A VIE is any type of legal structure in which control is determined through contractual or other financial arrangements, as opposed to traditional voting rights, if certain conditions exist.

While the Company is currently assessing the impact of AcG-15, it is possible that the individual Associate-owned drug stores that comprise the Company’s Associate store network may be deemed to be VIEs and if so, may be subject to consolidation by the Company. As the Associate-owned drug stores are separate legal entities, consolidation of the Associate-owned drug stores will have no impact on the underlying risks facing the Company.

Outlook

The Company believes that it is well positioned to continue 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, a continued focus on operational excellence and through 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 \$220 million to capital expenditures in 2004, which will be funded entirely from internally generated cash flow.

Non-GAAP Financial Measures

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

These 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 drug store industry. Management believes that non-GAAP financial measures assist in identifying underlying operating trends. Management believes that presenting adjusted earnings calculations is helpful in making year-over-year comparisons as they eliminate the effect of certain accounting changes and/or non-operational transactions.

These non-GAAP financial measures, particularly EBITDA and EBITDA margin, 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.

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.

Additional information about the Company, including the Annual Information Form, can be found at www.sedar.com.