NEIGHBORCARE INC
Form 10-Q/A
May 03, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

(Amendment No. 1)

(Mark One)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended December 31, 2003

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to
Commission File Number: 000-33217

NEIGHBORCARE, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**06-1132947**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
601 East Pratt Street, 3rd Floor Baltimore, Maryland	**21202**
(Address of principal executive offices)	(Zip code)

(410) 528-7300
(Registrant's telephone number, including area code)
7 East Lee Street, Baltimore Maryland 21202
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined by Rule 12b-2 of the Act).

Yes ý No o

As of April 29, 2004, 43,672,232 shares of the registrant's common stock were outstanding and 259,580 shares are to be issued in connection with the registrant's joint plan of reorganization confirmed by the Bankruptcy Court on September 20, 2001.

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS.

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes ý No o

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Explanatory Note

NeighborCare, Inc. (the "Company") is filing this amendment to its Quarterly Report on Form 10-Q for the three months ended December 31, 2003 filed by the Company with the Securities and Exchange Commission on February 17, 2004 in order to amend Part I, Item 1, "Financial Information," and Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of such Quarterly Report. The purposes of the amendment are (i) to reflect the exclusion of intersegment revenues with Genesis Healthcare Corporation ("GHC") previously reported in continuing operations for the three months ended December 31, 2003; (ii) to present GHC's assets and liabilities as held and used by the Company until the consummation of the spin-off of GHC, i.e., December 1, 2003, as permitted by Statement of Financial Accounting Standards ("SFAS") No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets;*" and (iii) to account for GHC's assets and liabilities as held and used until the consummation of the spin-off, as reported in the consolidated statements of cash flows for the periods presented. Initially, the Company reported the intersegment revenues from GHC as a component of revenue from continuing operations such that the periods presented would be comparable and consistent with current and future periods. However, based upon the Company's interpretation of SFAS No. 144, the intersegment revenues from GHC should be included as a component of income from discontinued operations. See Note 1 of the Condensed Consolidated Financial Statements for a discussion of the Company's spin-off of GHC.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

As used herein, unless the context otherwise requires, "NeighborCare," the "Company," "we," "our" or "us" refers to NeighborCare, Inc. and our subsidiaries.

Statements made in this report and in our other public filings and releases, which are not historical facts, contain "forward-looking" statements (as defined in the Private Securities Litigation Reform Act of 1995) that involve risks and uncertainties and are subject to change at any time. These forward-looking statements may include, but are not limited to certain statements in "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the notes to our unaudited condensed consolidated financial statements, such as our ability to meet our liquidity needs, scheduled debt and interest payments, and expected future capital expenditure requirements; the expected effects of government regulation on our business including the Medicare Prescription Drug, Improvement and Modernization Act of 2003; our ability to successfully implement our strategic objectives, including the effects of the spin-off of Genesis Healthcare Corporation ("GHC") and the achievement of certain performance improvement initiatives within our institutional pharmacy segment, in order to improve current pharmacy profitability; the expected strategic planning, severance and other operating items for the remainder of fiscal 2004 and the foreseeable future; the anticipated overhead costs of being a stand-alone company; estimates in our significant accounting policies, including our allowance for doubtful accounts and the anticipated impact of long-lived asset impairments.

The forward-looking statements involve known and unknown risks, uncertainties and other factors that are, in some cases, beyond our control. You are cautioned that these statements are not guarantees of future performance, and that actual results and trends in the future may differ materially.

Factors that could cause actual results to differ materially include, but are not limited to the following:

- our ability, and the ability of our customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;
- changes in the reimbursement rates or methods of payment from Medicare and Medicaid, or the implementation of other measures to reduce the reimbursement for our services;
- changes in pharmacy legislation and payment formulas;
- the impact of federal and state regulations;
- the impact of investigations and audits relating to alleged violations of federal and/or state regulations;
- changes in the acuity of patients, payor mix and payment methodologies;
- our ability, and the ability of our subsidiary guarantors, to fulfill debt obligations;
- the ability of GHC, as our largest customer, to operate as a separate entity;
- further consolidation of managed care organizations and other third party payors;
- competition in our businesses;

the effect of the expiration or termination of certain service and supply contracts;

an increase in insurance costs and potential liability for losses not covered by, or in excess of, our insurance;

competition for qualified management and pharmacy professionals;

our ability to control operating costs and generate sufficient cash flow to meet operational and financial requirements;

an economic downturn or changes in the laws affecting our business in those markets in which we operate;

- the impact of our reliance on one supplier to provide a significant portion of our pharmacy products;
- the impact of future acquisitions on our operations;
- availability of financial and other resources to us after the spin-off of GHC;
- federal income tax liabilities and indemnification obligations related to the spin-off of GHC;
- conflicts of interest as a result of our continuing relationship with GHC after the spin-off;
- the ability to implement and achieve certain strategic objectives; and
- acts of God or public authorities, war, civil unrest, terrorism, fire, floods, earthquakes and other matters beyond our control.

Certain of these risks are described in more detail in our Annual Report on Form 10-K for the fiscal year ended September 30, 2003.

In addition to these factors and any risks and uncertainties specifically identified in the text surrounding forward-looking statements, any statements in this report or the reports and other documents filed by us with the SEC that warn of risks or uncertainties associated with future results, events or circumstances also identify factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements.

All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except as may be required under applicable securities law.

PART I: FINANCIAL INFORMATION

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NEIGHBORCARE, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 2003	September 30, 2003
	(unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 92,761	$ 132,726
Restricted investments in marketable securities		29,320
Accounts receivable, net of allowance of $16,200 and $48,600, respectively	206,686	366,886
Inventory	67,176	66,747
Prepaid expenses and other current assets	40,726	89,918
Total current assets	407,349	685,597
Property, plant and equipment, net	74,085	751,996
Restricted investments in marketable securities		61,271
Other long-term assets	18,632	81,304
Identifiable intangible assets, net	12,813	20,866
Goodwill	334,742	337,695
Total assets	$ 847,621	$ 1,938,729
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Current portion of long-term debt	$ 4,300	$ 20,135
Accounts payable and accrued expenses	104,577	214,689
Income tax payable		4,116
Total current liabilities	108,877	238,940
Long-term debt	254,332	591,484
Deferred income taxes	12,084	50,022
Other long-term liabilities	10,684	84,930
Total liabilities	385,977	965,376
Minority interest	9,267	10,359
Redeemable preferred stock		46,831
Shareholders' equity	452,377	916,163
Total liabilities and shareholders' equity	$ 847,621	$ 1,938,729

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

NEIGHBORCARE, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
(in thousands, except per share amounts)

	Three Months Ended December 31,	
	2003	**2002**
	(unaudited)	
Net revenues	$ 338,394	$ 297,104
Cost of revenues	261,967	230,563
Gross profit	76,427	66,541
Selling, general and administrative	50,797	53,622
Depreciation and amortization	6,244	7,772
Strategic planning, severance and other operating items	40,664	(3,935)
Operating income (loss)	(21,278)	9,082
Interest expense, net	5,654	3,674
Other expense	1,091	1,039
Income (loss) before income tax provision (benefit)	(28,023)	4,369
Income tax provision (benefit)	(13,874)	5,483
Income (loss) from continuing operations	(14,149)	(1,114)
Income from discontinued operations, net of taxes	8,435	13,734
Net income (loss)	(5,714)	12,620
Preferred stock dividends		683
Net income (loss) available to common shareholders	$ (5,714)	$ 11,937
Other comprehensive income (loss):		
Unrealized loss on marketable securities		(127)
Termination and fair value change of derivative instruments, net	4,402	(922)
Comprehensive income (loss)	$ (1,312)	$ 10,888
Per common share data:		
Basic		
Income (loss) from continuing operations	$ (0.35)	$ (0.04)
Income from discontinued operations	$ 0.21	$ 0.33
Net income (loss) available to common shareholders	$ (0.14)	$ 0.29

	Three Months Ended December 31,	
Weighted average shares outstanding	40,397	41,458
Diluted		
Income (loss) from continuing operations	$ (0.35)	$ (0.04)
Income from discontinued operations	$ 0.21	$ 0.33
Net income (loss) available to common shareholders	$ (0.14)	$ 0.29
Weighted average shares outstanding	40,397	41,458

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

NEIGHBORCARE, INC
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended December 31,	
	2003	2002
	(unaudited)	
Cash flows from operating activities		
Net income (loss) attributed to common shareholders	$ (5,714)	$ 11,937
Charges included in operations not requiring funds	20,227	30,372
Changes in operating assets and liabilities		
Change in accounts receivable, net	(37,974)	(16,825)
Change in accounts payable and accrued expenses	84,618	(11,119)
Other, net	(34,209)	(1,356)
Net cash provided by operating activities	26,948	13,009
Cash flows from investing activities		
Capital expenditures	(9,573)	(12,829)
Other, net	(33,478)	(12,667)
Net cash used in investing activities	(43,051)	(25,496)
Cash flows from financing activities		
Distributions of cash to GHC	(72,161)	
Funds received from GHC for debt financing	353,001	
Repayment of long-term debt	(555,213)	(43,369)
Proceeds from issuance of long-term debt, net of debt issuance costs	240,804	
Other	9,707	2,000
Net cash used in financing activities	(23,862)	(41,369)
Net decrease in cash and cash equivalents	$ (39,965)	$ (53,856)
Cash and cash equivalents at beginning of period	132,726	148,030
Cash and cash equivalents at end of period	$ 92,761	$ 94,174
Non-cash investing and financing activities		
Distribution of net assets to GHC	$ (437,157)	
Conversion of preferred stock	(46,831)	

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

NeighborCare, Inc.
Notes to Unaudited Condensed Consolidated Financial Statements

1. Background and Basis of Presentation

NeighborCare, Inc. (formerly named Genesis Health Ventures, Inc.) was incorporated in May 1985 as a Pennsylvania corporation. As used herein, unless the context otherwise requires, "NeighborCare," or the "Company," "we," "our" or "us" refers to NeighborCare, Inc. and its subsidiaries.

NeighborCare is the third largest provider of institutional pharmacy services in the United States. As of December 31, 2003, NeighborCare provided pharmacy services for approximately 250,000 beds in long-term care facilities in 32 states and the District of Columbia. The Company's pharmacy operations consist of 64 institutional pharmacies (five are jointly-owned), 33 community-based professional retail pharmacies (two are jointly-owned) and 20 on-site pharmacies which are located in customers' facilities and serve only customers of that facility. In addition, NeighborCare operates 16 home infusion, respiratory and medical equipment distribution centers (four are jointly-owned). Jointly-owned facilities and the operations conducted therein are part of joint ventures which are owned by NeighborCare and at least one other unaffiliated party.

On December 1, 2003, the Company completed the distribution (the "spin-off") of the common stock of Genesis Healthcare Corporation ("GHC"), previously reported as the inpatient services division of the Company. On December 2, 2003, the Company changed its name to NeighborCare, Inc. The spin-off was effected by way of a pro-rata tax free distribution of the common stock of GHC to holders of NeighborCare's common stock on December 1, 2003 at a rate of 0.5 shares of GHC stock for each share of NeighborCare, Inc. common stock owned as of October 15, 2003.

In general, pursuant to the terms of the separation and distribution agreement between NeighborCare and GHC, all assets of the inpatient services business prior to the date of the spin-off became assets of GHC. The separation and distribution agreement also provides for assumptions of liabilities and cross-indemnities arising out of or in connection with the inpatient services business to GHC and all liabilities arising out of or in connection with the pharmacy services business to NeighborCare. In addition, GHC will indemnify NeighborCare for liabilities relating to the past inpatient services business. Adjustments, if any, are not expected to have a material effect on the consolidated financial statements. As a result of the spin-off, the Company's financial statements have been reclassified to reflect GHC as discontinued operations in the condensed consolidated statements of operations for all periods presented.

On November 4, 2003, in anticipation of the spin-off, the Company refinanced all of its remaining long-term debt through the issuance of $250 million aggregate principal amount of its 6.875% senior subordinated notes due 2013 and through proceeds received from GHC in accordance with its issuance in October 2003 of $225 million aggregate principal amount of 8% senior subordinated notes due 2013.

In order to facilitate the transition to two separate publicly traded companies, NeighborCare and GHC have entered into certain agreements that, among other things, will govern the ongoing relations between NeighborCare and GHC. These agreements include a tax sharing agreement, a transition services agreement, a pharmacy services agreement, a Tidewater membership agreement, employee benefit and pharmacy management agreements, and a master agreement for specialty beds and oxygen concentrators. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Certain Transactions and Events Agreements with GHC" for more detail regarding the Company's agreements with GHC.

The accompanying condensed consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of NeighborCare's management, the unaudited condensed consolidated financial

statements include all necessary adjustments consisting of normal recurring accruals and adjustments for a fair presentation of the financial position and results of operations for the periods presented. Certain reclassifications have been made to the prior year's financial statements to conform to the current year's presentation.

For further information, refer to the audited consolidated financial statements and notes included in the Company's Form 8-K filed on April 30, 2004.

2. Significant Accounting Policies

Management's Use of Estimates

An accounting policy is considered to be significant if it is important to the Company's financial condition and results of operations, and requires significant judgment and estimates on the part of management in its application. Significant accounting estimates and the related assumptions are evaluated periodically as conditions warrant, and changes to such estimates are recorded as new information or changed conditions require revision. Application of certain accounting policies requires management's significant judgments, often as the result of the need to make estimates of matters that are inherently uncertain. If actual results were to differ materially from the estimates made, the reported results could be materially affected. The following represent significant accounting policies requiring the use of estimates:

- Allowance for Doubtful Accounts;
- Inventories;
- Manufacturer Rebates;
- Revenue Recognition / Contractual Allowances; and
- Long-lived Asset Impairments.

Senior management has reviewed these significant accounting policies and estimates with the Company's audit committee. During the current quarter, there were no material changes made to the estimates or methods by which estimates are derived with regard to the significant accounting policies of the Company. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Significant Accounting Policies" for more detail regarding the Company's significant accounting policies.

Cost of Revenues

Costs of revenues include the net product costs of pharmaceuticals sold and direct charges attributable to providing revenue-generating services. This presentation is applicable to NeighborCare, Inc. as all of the revenues generated from operations are derived from pharmacy services. This presentation was not applicable in periods prior to the spin-off as the revenues from operations were inclusive of both pharmacy and inpatient services and a gross profit presentation was not indicative of the Company's gross margin. As such, prior periods have been reclassified to reflect this presentation.

Stock Option Accounting

In December 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 148, "*Accounting for Stock-Based Compensation Transition and Disclosure"* (SFAS 148). SFAS 148 amends the transition and disclosure requirements of SFAS No. 123, *"Accounting for Stock-Based Compensation"* (SFAS 123). As permitted by SFAS 148, the Company applies APB Opinion No. 25, *"Accounting for Stock Issued to Employees*," in accounting for its plans. Had the Company determined compensation cost based on the fair value at the grant date consistent with the provisions of SFAS 123, the Company's net income (loss) available to common shareholders would have been changed to the pro forma amounts indicated below (in thousands):

	Three months ended	
	December 31, 2003	**December 31, 2002**
Net income (loss) available to common shareholders as reported	$ (5,714)	$ 11,937
Add stock-based compensation expense included in net income (loss) as reported, net of tax effect	126	240
Deduct stock-based compensation expense determined under the fair-value-based method for all awards, net of tax effect	(2,049)	(907)
Net income (loss) available to common shareholders pro forma	$ (7,637)	$ 11,270
Earnings per share:		
Basic as reported	$ (0.14)	$ 0.29
Basic pro forma	(0.19)	0.27
Diluted as reported	(0.14)	0.29
Diluted pro forma	(0.19)	0.27

The fair value of stock options granted during the three month period ended December 31, 2003 and 2002, respectively, is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions for 2003 and 2002:

	Three months ended	
	December 31, 2003	**December 31, 2002**
Volatility	36.92%	39.18%
Expected life (in years)	5.0	4.2
Rate of return	3.80%	2.75%
Dividend yield	0.00%	0.00%

3. Discontinued Operations

Effective December 1, 2003, NeighborCare completed its plan of disposition for GHC through a distribution of GHC common stock to NeighborCare's shareholders of record as of October 15, 2003 in the form of a tax-free spin-off as described in note 1.

In the normal course of business, NeighborCare evaluates the performance of its operating units, with an emphasis on selling or closing under-performing or non-strategic assets. On September 30, 2001, the Company adopted the provisions of SFAS No. 144, *"Accounting for the Impairment or Disposal*

of Long-Lived Assets" (SFAS 144). Under SFAS 144, discontinued businesses, including assets held for sale or distribution, are removed from the results of continuing operations. The results of operations in both the current and prior year periods are classified as discontinued operations in the unaudited condensed consolidated statements of operations.

The following table sets forth the components of income from discontinued operations for the current quarter compared to the same period last year (in thousands):

	Three months ended	
	December 31, 2003	**December 31, 2002**
Net revenues of GHC	$ 250,927	$ 372,407
Net operating income of GHC	16,450	23,325
Net operating loss of other units		(1,012)
Income from discontinued operations before interest and taxes	16,450	22,313
Interest expense allocation	2,467	5,267
Income tax expense	5,548	3,312
Net income from discontinued operations	$ 8,435	$ 13,734

Consolidated interest expense has been allocated to discontinued operations based on the ratio of net assets of GHC to consolidated net assets of the Company. Discontinued operations have not been segregated in the consolidated statements of cash flows.

4. Strategic Planning, Severance and Other Operating Items

NeighborCare has incurred costs that are directly attributable to the Company's transforming to a pharmacy-based business and certain of its short-term strategic objectives. These costs are segregated in the unaudited condensed consolidated statements of operations as "Strategic planning, severance and other operating items." A summary of these costs for the three months ended December 31, 2003 follows (in thousands):

		Three Months Ended December 31, 2003			
	Accrued at September 30, 2003	**Provision**	**Paid**	**Non-Cash**	**Accrued at December 31, 2003**
Employee contract termination, transaction completion bonuses, severance and related costs	$ 1,000	$ 9,760	$ 1,000	$ 833	$ 8,927
Strategic planning and other items	2,160	30,904	12,955	6,112	13,997
Total	$ 3,160	$ 40,664	$ 13,955	$ 6,945	$ 22,924

Strategic planning, severance and other operating items for the three months ended December 31, 2003 relate primarily to legal, professional and other fees incurred to complete the spin-off transaction of $17.4 million; costs incurred pursuant to the termination provisions of employment contracts and transaction completion bonuses with NeighborCare and GHC executives of $8.8 million; and costs

incurred to extinguish long-term debt and related obligations in connection with the spin-off of $14.5 million. Debt extinguishment costs represent the write-off of unamortized deferred financing costs of $5.9 million, consent fees required to eliminate the Company's commitments under GHC debt of $5.0 million and the settlement of interest rate swap arrangements related to debt extinguishment of $3.6 million. Amounts accrued as of December 31, 2003 are expected to be paid during the second quarter of fiscal 2004.

Strategic planning, severance and other operating items for the three months ended December 31, 2002 are primarily attributable to the Company entering into a termination and settlement agreement with Omnicare, Inc. whereby the Company agreed to terminate a merger agreement it had entered into with NCS Healthcare, Inc., a provider of institutional pharmacy services. Pursuant to the termination and settlement agreement, the Company agreed to terminate the merger agreement with NCS and Omnicare agreed to pay the Company a $22.0 million break-up fee. On December 16, 2002, the Company terminated the merger agreement. The Company recognized the break-up fee net of $11.8 million of financing, legal and other costs directly attributable to the proposed merger with NCS. The Company collected $6.0 million of the break-up fee in December 2002, with the remaining $16.0 million received in January 2003. The net gain was offset by severance and related costs associated with the resignation of Richard R. Howard, the Company's former vice-chairman, of approximately $4.8 million. The remaining $1.5 million of strategic planning and other operating items for the period primarily relate to consulting and other professional fees.

5. Long-Term Debt

Long-term debt at December 31, 2003 and September 30, 2003 consists of the following (in thousands):

	December 31, 2003	September 30, 2003
Secured debt		
Senior Credit Facility		
Term Loan	$	$ 246,875
Delayed Draw Term Loan		68,162
Total Senior Credit Facility		315,037
Senior Secured Notes		240,176
Senior Subordinated Notes due 2013	250,000	
Capital leases and other secured debt	8,632	56,406
Total debt	258,632	611,619
Less:		
Current installments of capital leases and other secured debt	(4,300)	(20,135)
Long-term debt	$ 254,332	$ 591,484

During the quarter ended December 31, 2003, the Company repaid substantially all of its existing long-term debt using available cash and the proceeds of the Company's $250 million senior subordinated notes offering and GHC's $225 million senior subordinated notes offering.

6. Guarantor Subsidiaries and Condensed Consolidated Financial Statements

The Company's $250 million senior subordinated notes due 2013 as previously discussed are fully and unconditionally guaranteed on a joint and several basis by certain 100% owned subsidiaries of the Company (Guarantors). Those subsidiaries who do not guarantee the notes consist of the joint ventures in which NeighborCare has a greater than 50% share in the equity and earnings thereof and GHC (Non-Guarantors). Separate financial statements of the guarantor subsidiaries have not been prepared because management believes it would not be material to investors. The following tables present the condensed consolidating financial statements of NeighborCare, Inc. (Parent), the guarantor subsidiaries and the non-guarantor subsidiaries:

Consolidating Balance Sheets
December 31, 2003
(in thousands)

	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Assets					
Accounts receivable, net	$ 133,584	$ 165,769	$ 18,129	$ (110,796)	$ 206,686
Other current assets	123,832	66,920	9,911		200,663
Property, plant and equipment, net	14,863	51,303	7,919		74,085
Investment in subsidiaries	23,579	1,151		(24,288)	442
Goodwill	330,975	1,509	2,258		334,742
Other long-term assets	27,225	3,696	82		31,003
	$ 654,058	$ 290,348	$ 38,299	$ (135,084)	$ 847,621
Liabilities and shareholders' equity					
Accounts payable and accrued expenses	$ 24,375	$ 186,379	$ 4,619	$ (110,796)	$ 104,577
Current portion of long-term debt	4,263		37		4,300
Long-term debt less current portion	252,697	321	1,314		254,332
Other non-current liabilities	32,035				32,035
Shareholders' equity	340,688	103,648	32,329	(24,288)	452,377
	$ 654,058	$ 290,348	$ 38,299	$ (135,084)	$ 847,621

Consolidating Balance Sheets
September 30, 2003
(in thousands)

	Parent	Guarantors	Non-Guarantors	Eliminations	Consolidated
Assets					
Accounts receivable, net	$ 777,592	$ 155,782	$ 213,111	$ (779,599)	$ 366,886
Other current assets	186,884	61,069	70,758		318,711
Property, plant and equipment, net	14,687	51,682	685,627		751,996
Investment in subsidiaries	25,435	1,088	10,058	(27,759)	8,822
Goodwill	330,975	1,509	5,211		337,695
Other long-term assets	64,300	3,604	86,715		154,619
	$ 1,399,873	$ 274,734	$ 1,071,480	$ (807,358)	$ 1,938,729
Liabilities and shareholders' equity					
Accounts payable and accrued expenses	$ 29,786	$ 117,386	$ 851,232	$ (779,599)	$ 218,805
Current portion of long-term debt	18,069		2,066		20,135
Long-term debt less current portion	545,224	340	45,920		591,484
Other non-current liabilities	152,918	9,856	29,368		192,142
Shareholders' equity	653,876	147,152	142,894	(27,759)	916,163
	$ 1,399,873	$ 274,734	$ 1,071,480	$ (807,358)	$ 1,938,729

Consolidating Statements of Operations
Three months ended
December 31, 2003
(in thousands)

	Parent	Guarantors	Non- Guarantors	Consolidated
Net revenues	$ 246	$ 301,805	$ 36,343	$ 338,394
Cost of revenues		234,848	27,119	261,967
Gross profit	246	66,957	9,224	76,427
Operating Expenses	54,451	37,672	5,582	97,705
Interest expense, net	5,545	51	58	5,654
Other expense (income)	1,253	(162)		1,091
Income before income taxes	(61,003)	29,396	3,584	(28,023)
Income tax provision (benefit)	(13,877)	3		(13,874)
Income from discontinued operations	8,435			8,435
Net income (loss)	$ (38,691)	$ 29,393	$ 3,584	$ (5,714)

Consolidating Statements of Operations
Three months ended
December 31, 2002
(in thousands)

	Parent	Guarantors	Non-Guarantors	Consolidated
Net revenues	$ 24	$ 264,786	$ 32,294	$ 297,104
Cost of revenues		207,036	23,527	230,563
Gross profit	24	57,750	8,767	66,541
Operating Expenses	16,189	36,423	4,847	57,459
Interest expense, net	3,823	(198)	49	3,674
Other expense (income)	1,167	(128)		1,039
Income before income taxes	(21,155)	21,653	3,871	4,369
Income tax provision (benefit)	5,135	348		5,483
Income from discontinued operations	13,734			13,734
Net income	(12,556)	21,305	3,871	12,620

Consolidating Statements of Cash Flows
Three months ended
December 31, 2003
(in thousands)

	Parent	Guarantors	Non-Guarantors	Consolidated
Cash flow from operating activities	$ (12,501)	$ 32,575	$ 6,874	$ 26,948
Cash flow from investing activities	(4,520)	(3,899)	(34,632)	(43,051)
Cash flow from financing activities	(33,258)	(19)	9,415	(23,862)

Consolidating Statements of Cash Flows
Three months ended
December 31, 2002
(in thousands)

	Parent	Guarantors	Non-Guarantors	Consolidated
Cash flow from operating activities	$ (19,120)	$ 30,307	$ 1,822	$ 13,009
Cash flow from investing activities	(3,951)	(1,960)	(19,585)	(25,496)
Cash flow from financing activities	(40,999)	(20)	(350)	(41,369)

7. Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share for the three month periods ended December 31, 2003 and 2002 (in thousands, except per share data):

	Three months ended	
	December 31, 2003	December 31, 2002
Earnings (loss) used in computation:		
Income (loss) from continuing operations	$ (14,149)	$ (1,797)
Income from discontinued operations	8,435	13,734
Net income (loss) available to common shareholders	(5,714)	11,937
Shares used in computation:		
Weighted average shares outstanding basic and diluted	40,397	41,458
Per common share data:		
Basic and diluted:		
Income (loss) from continuing operations	$ (0.35)	$ (0.04)
Income from discontinued operations	0.21	0.33
Net income (loss) available to common shareholders	(0.14)	0.29

Basic earnings per share is calculated by dividing earnings (numerator) by the weighted average number of shares of common stock outstanding during the respective reporting period (denominator). Included in the calculation of basic weighted average shares of 40,397,346 for the current quarter are approximately 260,000 shares to be issued in connection with the joint plan of reorganization confirmed by the bankruptcy court and the effect of the conversion of preferred stock to common stock from the date of conversion to December 31, 2003.

Diluted earnings per share is calculated in a manner consistent with basic earnings per share except, where applicable, the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options and also the assumed conversion of preferred stock. For the three months ended December 31, 2003 and 2002, basic and diluted shares outstanding are the same because the Company reported a net loss from continuing operations for the periods; thus, the effect of including the additional shares from such assumed exercise and conversion would be anti-dilutive.

8. Segment Information

The Company's principal operating segments are identified by the types of products and services from which revenues are derived and are consistent with the reporting structure of the Company's internal organization. The Company has two reportable segments: institutional pharmacy business and corporate and other.

The institutional pharmacy business provides prescription and non-prescription pharmaceuticals, infusion therapy and medical supplies and equipment to the elderly, chronically ill and disabled in long-term care facilities, including skilled nursing facilities, assisted living facilities, residential and independent living communities and other institutional healthcare facilities. The pharmacy services provided in these settings are tailored to meet the needs of the institutional customer. These services include highly specialized packaging and dispensing systems, computerized medical records processing

and 24-hour emergency services. The Company also provides pharmacy consulting services to assure proper and effective drug therapy, including monitoring and reporting on prescription drug therapy and assisting the facility in compliance with applicable federal and state regulations.

The "Corporate and Other" category of operations represents operating information of business units below the prescribed quantitative thresholds under the SFAS No. 131, *"Disclosures about Segments of an Enterprise and Related Information*." Revenues from these business units are primarily derived from the Company's community-based professional pharmacy business, home infusion, respiratory and medical equipment business and long-term care group purchasing business (Tidewater). The "Corporate and Other" category also consists of the Company's corporate general and administrative function, for which there is generally no revenue generated.

This approach to segment reporting is consistent with the Company's internal financial reporting and the information used by the chief operating decision makers regarding the performance of the reportable and non-reportable segments. The accounting policies of the segments are the same as those of the consolidated organization.

	Institutional Pharmacy	Corporate and Other	Consolidated
		(in thousands)	
Three months ended December 31, 2003			
Net revenues	$ 281,792	$ 56,602	$ 338,394
Gross profit	58,114	18,313	76,427
Operating income (loss)	26,573	(47,851)	(21,278)
Three months ended December 31, 2002			
Net revenues	$ 238,117	$ 58,987	$ 297,104
Gross profit	47,827	18,714	66,541
Operating income (loss)	17,682	(8,600)	9,082
Total assets as of			
December 31, 2003	$ 243,253	$ 604,368	$ 847,621
September 30, 2003	192,149	1,746,580	1,938,729

A reconciliation of consolidated operating income to consolidated income from continuing operations:

	Three months ended December 31,	
	2003	2002
Consolidated operating income	$ (21,278)	$ 9,082
Interest expense, net	5,654	3,674
Other expense	1,091	1,039
Income tax provision (benefit)	(13,874)	5,483
Income from continuing operations	$ (14,149)	$ (1,114)

9. Guarantees

In December 2002, the FASB issued Interpretation No. 45, "*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*." FIN 45 requires that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under that guarantee. As of December 31, 2003, the Company had guaranty obligations related to various leases and subleases entered into by GHC, the former inpatient services business of NeighborCare. These obligations remained with NeighborCare following the spin-off and were not assigned under the separation and distribution agreement. The guarantees secure the payment of annual rents due to lessors for various long-term care facilities and specialized nursing centers. The nature of the guarantees only require cash payment in the event of default by GHC and does not guarantee residual values of the leased properties. The majority of the guarantees have been indemnified by GHC as of the date of the spin-off. Remaining annual rents for the guaranteed leases and subleases not indemnified by GHC aggregate $4.2 million annually through March 2, 2009.

10. Derivative Financial Instruments

The Company follows the provisions of SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*," and SFAS No. 138, "*Accounting for Certain Derivative Instruments and Certain Hedging Activities an Amendment of FASB Statement No. 133*." The Company utilizes derivative financial instruments, such as interest rate swaps and caps, to manage changes in market conditions related to debt obligations. As a component of interest expense, the Company recorded $0.8 million and $1 million of net interest expense in the quarters ended December 31, 2003 and 2002, respectively, for the variable interest rate swaps and amortization of the rate cap.

In connection with the spin-off and the repayment of senior indebtedness, the Company transferred its $75 million interest rate cap to GHC and terminated its $75 million and $125 million interest rate swaps that were to expire September 13, 2005 and 2007, respectively. As a result of the terminations, the Company recognized a charge of approximately $3.6 million that is recorded as a component of "Strategic planning, severance and other operating items."

11. Income Taxes

The Company's provision (benefit) for income taxes from continuing operations for the three months ended December 31, 2003 and 2002 was $(13.9) million and $5.5 million, respectively. The income tax benefit of any NOL carryforward utilization will be applied first as a reduction to goodwill and, thereafter, as a direct addition to paid in capital, pursuant to Statement of Position (SOP) No. 90-7, "*Financial Reporting by Entities in Reorganization under the Bankruptcy Code*," at such time it is assured.

12. Preferred Stock Conversion

Effective December 16, 2003, the Company's board of directors exercised its option for mandatory conversion of the Series A preferred stock, at a per share conversion price of $12.60 (as adjusted from $20.33 in connection with the spin-off), into 3,464,255 shares of NeighborCare, Inc. common stock pursuant to the terms of the Company's amended and restated articles of incorporation, as amended. Prior to December 16, 2003, 38,377 shares of Series A preferred stock were voluntarily converted into

293,643 shares of the Company's common stock. The Series A preferred stock is reflected in the September 30, 2003 balance sheet under redeemable preferred stock.

13. Changes in Shareholders' Equity

The rollforward of shareholders' equity is as follows (in thousands):

Balance at September 30, 2003	$916,163
Conversion of Preferred Stock	46,831
Distribution to shareholders of common stock of GHC	(509,318)
Other	4,415
Net loss	(5,714)
Balance at December 31, 2003	452,377

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

General

NeighborCare, Inc. (formerly named Genesis Health Ventures, Inc.) was incorporated in May 1985 as a Pennsylvania corporation. As used herein, unless the context otherwise requires, "NeighborCare," the "Company," "we," "our" or "us" refers to NeighborCare, Inc. and its subsidiaries and "GHC" refers to Genesis HealthCare Corporation together with its subsidiaries.

We are the third largest provider of institutional pharmacy services in the United States. As of December 31, 2003, we provided pharmacy services for approximately 250,000 beds in long-term care facilities in 32 states and the District of Columbia. Our pharmacy operations consist of 64 institutional pharmacies (five are jointly-owned), 33 community-based professional retail pharmacies (two are jointly-owned) and 20 on-site pharmacies which are located in customers' facilities and serve only customers of that facility. In addition, we operate 16 home infusion, respiratory and medical equipment distribution centers (four are jointly-owned). Jointly-owned facilities and the operations conducted therein are part of joint ventures which are owned by NeighborCare and at least one other unaffiliated party.

Our institutional pharmacy business provides prescription and non-prescription pharmaceuticals, infusion therapy and medical supplies and equipment to the elderly, chronically ill and disabled in long-term care facilities, including skilled nursing facilities, assisted living facilities, residential and independent living communities and other institutional healthcare facilities. The pharmacy services provided in these settings are tailored to meet the needs of the institutional customer. These services include highly specialized packaging and dispensing systems, computerized medical records processing and 24-hour emergency services. We also provide pharmacy consulting services to assure proper and effective drug therapy, including monitoring and reporting on prescription drug therapy and assisting the facility in compliance with applicable federal and state regulations.

Our community-based professional pharmacies are retail operations branded under the NeighborCare® name that are located in or near medical centers, hospitals and physician office complexes which provide prescription and non-prescription medications and certain medical supplies, as well as personal service and consultation by licensed pharmacists.

Our home infusion, respiratory and medical equipment distribution centers provide a wide array of products and services to support the home care needs of a range of individuals of all ages. We work with physicians, hospital discharge planners, case managers and managed care organizations who refer these individuals to us. Services include respiratory and medical equipment (such as oxygen, hospital beds, wheelchairs and respiratory medications), as well as home infusion (such as antibiotics, TPN, chemotherapy and pain management).

We also own and operate Tidewater Healthcare Shared Services Group, Inc., or "Tidewater," one of the largest long-term care group purchasing companies in the country. Tidewater provides purchasing and shared service programs specially designed to meet the needs of eldercare centers and other long-term care facilities.

On December 1, 2003, we completed the distribution, or the "spin-off," of the common stock of GHC, previously reported as our inpatient services division. On December 2, 2003, we changed our name to NeighborCare, Inc. The spin-off was effected by way of a pro rata tax-free distribution of the common stock of GHC to holders of our common stock on December 1, 2003 at a rate of 0.5 shares of GHC stock for each share of our common stock owned as of October 15, 2003. On November 4, 2003, in anticipation of the spin-off, we refinanced all of our remaining long-term debt through the issuance of $250 million aggregate principal amount of our 6.875% senior subordinated notes due 2013 and through proceeds received from GHC in accordance with its issuance in October 2003 of $225 million aggregate principal amount of 8% senior subordinated notes due 2013.

Certain Transactions and Events

Spin-off and Discontinued Operations of GHC

On December 1, 2003, we completed the plan of disposition of GHC through a distribution of GHC common stock to our shareholders of record as of October 15, 2003 in the form of a tax-free spin-off as previously described.

The spin-off was motivated by two business purposes: (1) to allow each business to pursue strategies and focus on objectives appropriate to that business, and to assume only those risks inherent in the respective businesses; and (2) to resolve problems that our pharmacy services segment had with existing or potential customers who object to our association with the inpatient services segment that competes with those customers. The inpatient services segment and pharmacy services segment are distinct businesses with significant differences in their markets, products, investment needs and plans for growth. Our board of directors believes that the separation into two independent public companies will enhance the ability of each to focus on strategic initiatives and new business opportunities, and to improve cost structures and operating efficiencies. The operations of our former inpatient services segment, rehabilitation therapy business, management services and certain other ancillary service businesses are operating under the name Genesis Healthcare Corporation.

The following tables set forth the components of net income (loss) from discontinued operations for the three months ended December 31, 2003 compared to the same period last year (in thousands):

	Three Months ended December 31,	
	2003	**2002**
Net revenues of GHC	$ 250,927	$ 372,407
Net operating income of GHC	16,450	23,325
Net operating loss of other units		(1,012)
Income from discontinued operations before interest and taxes	16,450	22,313
Interest expense allocation	2,467	5,267
Income tax expense	5,548	3,312
Net income from discontinued operations	$ 8,435	$ 13,734

In accordance with SFAS 144, only those overhead costs that are solely attributable to the discontinued business segment can be allocated to discontinued operations. As a result, prior periods include significant overhead charges that were incurred for the benefit of both our continuing operations and the spun-off operations of GHC that are now included in the continuing operations of our Company. Therefore, our operating results for the periods presented do not necessarily reflect the actual operating expenses of our continuing pharmacy operations.

Change in Strategic Direction and Objectives

Since our inception, our principal business plan was to build networks of skilled nursing and assisted living centers in concentrated geographic markets and broaden our array of higher margin specialty medical services; principally institutional pharmacy and rehabilitation services. By offering a broad array of services, we sought to create an integrated delivery system connecting our eldercare centers and ancillary service capabilities to hospitals, physicians, managed care plans and other providers in a seamless delivery network. Through acquisitions of both eldercare facilities and pharmacy operations in the 1990's, we fulfilled our stated business plan and operated under the mission to "redefine how eldercare is delivered."

In 2000, we and certain of our direct and indirect subsidiaries filed for voluntary relief under Chapter 11 of the United States Code with the United States Bankruptcy Court for the District of Delaware. We emerged from bankruptcy in late 2001 and constituted a new board of directors who evaluated our current business portfolio and identified strategies to optimize the performance of our operations. The new board of directors initially decided to focus on expanding the growth and margins of our pharmacy services segment and to maintain the current market position of our inpatient services segment. This was primarily the result of our inpatient services segment suffering from significant cuts in funding sources, nursing labor cost increases in excess of inflation, intensified regulatory oversight and intervention and increases in the cost of medical malpractice insurance. The new board of directors also implemented a short-term strategy to reduce overhead costs to pursue operational efficiencies with the intent of absorbing the financial performance of the inpatient services business.

After the short-term objectives of the board of directors were achieved, we continued to evaluate strategic alternatives to enhance shareholder value and improve market performance. Such evaluations led to exploration of separating our business into two distinct businesses. In late 2002, the board of directors retained independent consultants to evaluate the impact of potentially separating the pharmacy business and the eldercare business by way of a spin-off. By February 2003, the board of directors approved a plan to spin-off the inpatient services segment into a separate legal operating entity under the name Genesis HealthCare Corporation.

Strategic Planning, Severance and Other Operating Items

We have incurred costs that are directly attributable to the transformation to a pharmacy-based business and certain of our short-term strategic objectives. These costs are expected to continue for the foreseeable future and are segregated in the unaudited condensed consolidated statements of operations as "Strategic planning, severance and other operating items." A summary of these costs as of December 31, 2003 follows (in thousands):

Three Months Ended December 31, 2003

	Accrued at September 30, 2003	Three Months Ended December 31, 2003			Accrued at December 31, 2003
		Provision	Paid	Non-Cash	
Employee contract termination, transaction completion bonuses, severance and related costs	$ 1,000	$ 9,760	$ 1,000	$ 833	$ 8,927
Strategic planning and other items	2,160	30,904	12,955	6,112	13,997
Total	$ 3,160	$ 40,664	$ 13,955	$ 6,945	$ 22,924

Strategic planning, severance and other operating items for the three months ended December 31, 2003 relate primarily to legal, professional and other fees incurred to complete the spin-off transaction of $17.4 million; costs incurred pursuant to the termination provisions of employment contracts and transaction completion bonuses with NeighborCare and GHC executives of $8.8 million; and costs incurred to extinguish long-term debt and related obligations in connection with the spin-off of $14.5 million. Debt extinguishment costs represent the write-off of unamortized deferred financing costs of $5.9 million, consent fees required to eliminate our commitments under GHC debt of $5.0 million and the settlement of interest rate swap arrangements related to debt extinguishment of $3.6 million. Amounts accrued as of December 31, 2003 are expected to be paid during the second and third quarters of fiscal 2004.

Strategic planning, severance and other operating items for the three months ended December 31, 2002 are primarily attributable to us entering into a termination and settlement agreement with

Omnicare, Inc. whereby we agreed to terminate a merger agreement we had entered into with NCS Healthcare, Inc., a provider of institutional pharmacy services. Pursuant to the termination and settlement agreement dated December 15, 2002, we agreed to terminate the merger agreement with NCS and Omnicare agreed to pay us a $22.0 million break-up fee. On December 16, 2002, we terminated the merger agreement and we and Omnicare each agreed to release the other from any claims arising from the merger agreement and not to commence any action against one another in connection therewith. We recognized the break-up fee net of $11.8 million of financing, legal and other costs directly attributable to the proposed merger with NCS. The net gain was offset by severance and related costs associated with the resignation of Richard R. Howard, our former vice chairman, of approximately $4.8 million. The remaining $1.5 million of strategic planning and other operating items for the period primarily relate to consulting and other professional fees.

Agreements with GHC

Tax Sharing Agreement

For periods prior to the spin-off, GHC will be included in our U.S. federal consolidated income tax group, and GHC's tax liability thus will be included in our and our subsidiaries' consolidated federal income tax liability. GHC also will be included with us or certain of our subsidiaries in consolidated, combined or unitary income tax groups for state and local tax purposes for periods prior to the spin-off.

The tax sharing agreement governs the respective rights, responsibilities, and the obligations of us and GHC after the spin-off with respect to tax liabilities and benefits, tax attributes, tax contests and other matters regarding income taxes, other taxes and related tax returns.

In general, we will prepare and file the federal consolidated return, and any combined, consolidated or unitary tax returns that include both us or one of our subsidiaries and GHC or one of its subsidiaries and will be responsible for all income taxes and other taxes with respect to such returns. GHC will prepare and file any tax return required to be filed by GHC or any of its subsidiaries that does not include us or any entity that is our subsidiary after the spin-off and will be responsible for all income taxes or other taxes with respect to any such tax return. In general, we will be responsible for any increase (and will receive the benefit of any decrease) in the income tax of any entity that is or was reflected on a tax return filed by us and we will control all audits and administrative matters relating to such tax returns.

GHC generally may not (i) take or fail to take any action that would cause any representations, information or covenants in the spin-off documents or documents relating to the private letter ruling request to be untrue, (ii) take or fail to take any action that would cause the spin-off to lose its tax-free status, (iii) sell, issue, redeem or otherwise acquire its equity securities for a period of two years following the spin-off, except in certain specified transactions, and (iv) sell or otherwise dispose of a substantial portion of its assets, liquidate, merge or consolidate with any other person for a period of two years following the spin-off. During that two-year period, GHC may take certain actions prohibited by the covenants if, for example, we obtain a supplemental private letter ruling or an unqualified opinion of counsel to the effect that these actions will not affect the tax-free nature of the spin-off, in each case satisfactory to us in our sole and absolute discretion. Notwithstanding the receipt of any such private letter ruling or opinion, GHC must indemnify us for any taxes and related losses resulting from (i) any act or failure to act described in the covenants above, (ii) any acquisition of GHC's equity securities or assets (or equity securities or assets of any member of GHC's group) and (iii) any breach by GHC or any member of GHC's group of certain representations in the spin-off documents or the documents relating to the private letter ruling.

In addition, the tax sharing agreement provides for cooperation and information sharing with respect to taxes.

Transition Services Agreement

The transition services agreement provides for the provision of certain transitional services by GHC to us. The services include the provision of information systems (e.g., access to computer systems that are owned by GHC), tax services, financial systems, bankruptcy claims processing and certain additional services identified by the parties. The transition services agreement provides for a term of 18 months. In addition, we may extend the transition services agreement for an additional six months with adequate notice. The pricing is based on actual costs incurred by GHC in rendering the services.

Master Agreement for Pharmacy, Pharmacy Consulting and Related Products and Services

GHC and our subsidiary NeighborCare Pharmacy Services, Inc., or "NCPS," entered into a master agreement for pharmacy, pharmacy consulting and related products and services, referred to as the "pharmacy services agreement." The pharmacy services agreement has an initial term of ten years, plus a renewal term of five years if NCPS matches third-party bids for comparable services. The pharmacy services agreement provides the terms and conditions on which NCPS and its affiliates provide pharmacy, pharmacy consulting and medical supply products and services to all long-term care facilities owned or leased by GHC and its affiliates. These services include the provision of all of the needed prescription and non-prescription medications, pharmacy consulting services, Medicare Part B supplies and services, Medicare Part B claim filing services, enteral nutrition products, durable and disposable medical supplies and equipment, and related services as required by applicable law and as reasonably requested by each facility. The agreement imposes restrictions on GHC's ability to purchase pharmaceutical products and supplies from other suppliers.

Each of GHC's eldercare facilities entered into an individual services agreement with NCPS that reflects the terms of the pharmacy services agreement. The individual services agreements govern the terms under which pharmacy, pharmacy consulting and medical supply products and services will be provided to each eldercare facility by NCPS.

Pricing under the pharmacy services agreement is at pre-negotiated prices or formulas consistent with market pricing for the applicable services and are set forth in the individual service agreements. NCPS has the right to adjust prices, other than those that are determined by formula, not more than once per year to account for increases in its costs in providing the services (including inflation). GHC is eligible for a pricing reduction at specified percentages for certain specified products and services if and so long as the aggregate number of skilled nursing facility beds served by NCPS increases to specified targets over a baseline amount. In addition, GHC and NCPS will negotiate in good faith to enter into arrangements whereby GHC will contract directly with certain manufacturers of enteral nutrition products, durable medical equipment and other non-pharmaceutical products historically purchased from NCPS to receive "end user pricing," and NCPS will distribute enteral nutrition products and durable medical equipment to GHC's facilities for a fee priced at the fair market value of such distribution services. In addition, after five years, pricing may be reset depending upon NCPS's pricing to its other customers of similar size.

GHC may terminate the pharmacy services agreement with respect to any facility in connection with a sale of the facility to a third party or the closing of the facility so long as GHC uses its best efforts to persuade the buyer or successor of the facility, if any, to assume the applicable service agreement. This right is limited to five facilities through the first year, 10 facilities through the second year, 20 facilities through the third year, and a maximum of 30 facilities over the 10-year term of the pharmacy services agreement.

If the pharmacy services agreement or any individual service agreement is terminated by GHC, then NCPS will be entitled to recover a specified amount per facility based on the remaining number

of months in the term. Each of GHC and NCPS will indemnify the other against all claims, losses and liabilities arising out of the acts or omissions of the other party in connection with the pharmacy services agreement.

The pharmacy services agreement provides that GHC will not compete with NCPS or solicit NCPS's employees or customers until 2015 or, if later, two years following termination of the pharmacy services agreement.

Either party may assign the pharmacy services agreement, or any individual services agreement, upon receipt of written consent of the other (which consent may not be unreasonably withheld, conditioned or delayed), but NCPS may assign its interest without GHC's consent to an affiliate, joint venture or a provider whose service and/or quality levels are at least comparable to those currently provided by NCPS.

Tidewater Membership Agreement

The Tidewater membership agreement, referred to as the "Tidewater agreement," provides group purchasing and shared service programs to skilled nursing facilities and assisted living facilities operated by GHC. Under the Tidewater agreement, GHC engaged Tidewater, our wholly-owned group purchasing subsidiary, as an independent group purchasing organization, and Tidewater will grant to GHC access to its vendor contracts. The initial term of the Tidewater agreement is ten years. GHC will not make any payments to us under the Tidewater agreement. Instead, Tidewater will receive administrative fees from various suppliers. Such fees are based on a percentage of the volume of purchases made by all of Tidewater's members, including GHC. GHC will remain directly responsible to vendors for purchases through the Tidewater agreement. The Tidewater agreement obligates GHC to purchase certain minimum amounts; however, GHC may be a member of other group purchasing organizations. GHC may earn financial incentives, such as fee sharing, for meeting certain purchasing volumes under the Tidewater agreement.

Employee Benefits Agreement

We and GHC entered into an employee benefits agreement which provides for certain employee compensation, benefit and labor-related matters. In general, after the spin-off, we and GHC are responsible for all obligations and liabilities relating to our respective current and former employees and their dependents and beneficiaries.

As of the date of the spin-off, and except with respect to health and welfare plans and flexible benefit plans as set forth below, GHC ceased its participation in any benefit plan or trust under any such plan sponsored or maintained by us and we ceased participation in any benefit plan or trust under any such plan sponsored or maintained by GHC. With respect to employees who are transferred to or from us or GHC, both parties have mutually recognized and credited service with the other employer.

Except as otherwise provided herein, all liabilities relating to employee benefits incurred by or on behalf of either company's employees or their covered dependents on or before the date of the spin-off remain our liabilities. Liabilities and assets were transferred from our retirement plan to a comparable plan to be established by GHC. Similarly, liabilities and assets were transferred from our union retirement savings plan, the sponsorship of which was assumed by GHC. Liabilities under our deferred compensation plan (a non-qualified plan) and assets relating to such plan held in a rabbi trust were transferred to a comparable plan and trust established by GHC. In the event that we or GHC elect to contribute the full matching amount due to participants covered under each company's respective plan and entitled to a match at the end of the 2003 plan year, each company will reimburse the other for 50% of the amount contributed with respect to specified employees who are transferred between companies in connection with the spin-off. A similar arrangement applies with respect to bonus amounts due for the 2003 fiscal year. In general, all liabilities relating to workers' compensation claims

incurred by or on behalf of either company's employees on or before December 1, 2003, the date of the spin-off, remained liabilities of GHC.

To avoid the administrative inconvenience and expense that would have resulted from our having to establish separate health and welfare plans and flexible benefit plans for the remainder of the calendar year, during the period beginning immediately following the spin-off and ending on December 31, 2003, current and former employees of GHC remained covered under our existing health and welfare plans and flexible benefit plans. GHC reimbursed us for all expenses we incurred as a result of this arrangement. As of January 1, 2004, current and former employees of ours and GHC are covered under their own health insurance plans.

Pharmacy Benefit Management (CareCard) Agreement

GHC and our subsidiary, CareCard, Inc., entered into a pharmacy benefit management agreement, referred to as the "CareCard agreement." The CareCard agreement sets forth the agreements between GHC and CareCard relating to the provision of services to GHC by our "CareCard" business. The term of the CareCard agreement expires on December 31, 2004. Under the CareCard agreement, CareCard provides pharmacy benefit management services to GHC and access to retail and mail pharmacy services. GHC agreed to enroll all of its employees participating in a GHC self-insured health plan in the CareCard program. The CareCard agreement may be assigned by either party upon receipt of the written consent of the other (which consent may not be unreasonably withheld, conditioned or delayed), but CareCard may assign its interest without GHC's consent to a provider whose service and/or quality levels are at least comparable to those currently provided by CareCard.

Master Agreement for Specialty Beds and Oxygen Concentrators

The master agreement for specialty beds and oxygen concentrators, referred to as the "durable medical equipment agreement," sets forth the agreements between GHC and NCPS relating to the provision of certain equipment and related services to GHC's skilled nursing and assisted living facilities. The durable medical equipment agreement provides for an initial five-year term with one-year automatic renewals (unless terminated upon 90 days' notice prior to the expiration of the then-current term). Under the durable medical equipment agreement, NCPS agreed to provide GHC's facilities with durable medical equipment (specialty beds and oxygen concentrators), equipment maintenance and warehousing of equipment at prices set forth in the durable medical equipment agreement. The durable medical equipment agreement provides that, except as otherwise required by law, NCPS will be the exclusive provider of specialty beds and oxygen concentrators to the contracting facilities. Either party may assign the agreement upon receipt of the written consent of the other (which consent may not be unreasonably withheld, conditioned or delayed), but NCPS may assign its interest without GHC's consent to a provider whose service and/or quality levels are at least comparable to those currently provided by NCPS.

Laws Affecting Revenues

The Health Insurance for Aged and Disabled Act (Title XVIII of the Social Security Act), or "Medicare," is a federally funded and administered health insurance program for individuals aged 65 and over or for certain individuals who are disabled. The Medicare program consists of three parts: (i) Medicare Part A, which covers, among other things, inpatient hospital, skilled long-term care, home healthcare and certain other types of healthcare services; (ii) Medicare Part B, which covers physicians' services, outpatient services and certain items and services provided by medical suppliers; and (iii) a managed care option for beneficiaries who are entitled to Medicare Part A and enrolled in Medicare Part B, known as Medicare+Choice or Medicare Part C. Pursuant to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, or the "Medicare Modernization Act," passed by Congress on November 25, 2003 and signed into law by the President on December 8, 2003, the Medicare+Choice program will be subsumed into a new Medicare supplemental product called

Medicare Advantage by 2006. Under Medicare Part B, we are entitled to payment for products that replace a bodily function (i.e., ostomy supplies), home medical equipment and supplies and a limited number of specifically designated prescription drugs. The Medicare program is currently administered by fiscal intermediaries (for Medicare Part A and some Medicare Part B services) and carriers (for Medicare Part B) under the direction of the Centers for Medicare and Medicaid Services, or CMS, the Medicare and Medicaid oversight division of the United States Department of Health and Human Services, or "DHHS."

Medicaid (Title XIX of the Social Security Act) is a federal-state matching fund program, whereby the federal government, under a needs-based formula, matches funds provided by the participating states for medical assistance to "medically indigent" persons. The programs are administered by the applicable state welfare or social service agencies under federal rules. Although Medicaid programs vary from state to state, traditionally they have provided for the payments, up to established limits, at rates determined in accordance with each state's regulations. The federal Medicaid statute specifies a variety of requirements that the state plan must meet, including requirements relating to eligibility, coverage of services, payment and administration. For patients eligible for Medicaid, we bill the individual state Medicaid program or, in certain circumstances, the state designated managed care or other similar organizations. The reimbursement rates for pharmacy services under Medicaid are determined on a state-by-state basis subject to review by the Centers for Medicare and Medicaid Services and applicable federal law. Federal regulations and the regulations of certain states establish "upper limits" for reimbursement for certain prescription drugs under Medicaid. In most states, pharmacy services are priced at the lower of "usual and customary" charges or cost (which generally is defined as a function of average wholesale price and may include a profit percentage) plus a dispensing fee. Most states establish a fixed dispensing fee that is adjusted to reflect associated costs on an annual or less frequent basis. The payment methodology for certain forms of prescription drugs and biologicals reimbursed under the Medicaid program may be subject to changes under the Medicare Modernization Act.

Any future changes in Medicaid reimbursement programs or in regulations relating thereto, such as reductions in the allowable reimbursement levels or the timing of processing of payments, could adversely affect our business. The annual increase in the federal share could vary from state to state based on a variety of factors. Such provisions, if ultimately signed into law, could adversely affect our business. Additionally, any shift from Medicaid to state designated managed care could adversely affect our business due to historically lower reimbursement rates for managed care. Moreover, Medicare and Medicaid are subject to statutory and regulatory changes, retroactive rate adjustments, administrative rulings and government funding restrictions, all of which may materially affect the timing and/or levels of payments to us for our services.

We are subject to periodic audits by the Medicare and Medicaid programs, which have various rights and remedies against us if they assert that we have overcharged the programs or failed to comply with program requirements. These rights and remedies may include requiring the repayment of any amounts alleged to be overpayments or in violation of program requirements, or making deductions from future amounts due to us. Such programs may also impose fines, criminal penalties or program exclusions. Other third-party payor sources also reserve rights to conduct audits and make monetary adjustments.

Congress has enacted laws directly affecting our business and the skilled nursing facilities served by us. Three major laws during the past six years have significantly altered payment for nursing home and medical ancillary services. Healthcare related legislation has significantly impacted our business, and future legislation and regulations are likely to affect us.

The recently enacted Medicare Modernization Act may have a significant impact on our business or the business of our primary customers, nursing facilities. Specifically, the Medicare Modernization Act increases payments to nursing facilities to cover the high costs of care associated with treatment for AIDS patients, subject to applicable sunsets, while potentially reducing payments for certain outpatient