

NEIGHBORCARE INC
Form 10-Q
August 11, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2004

or

**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

(State or other jurisdiction of incorporation or
organization)

06-1132947

(I.R.S. Employer Identification No.)

601 East Pratt Street, 3rd Floor

Baltimore, Maryland

(Address of principal executive offices)

21202

(Zip code)

(410) 528-7300

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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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 NO

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

YES NO

As of August 12, 2004, 43,964,464 shares of the registrant's common stock were outstanding and 259,612 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 BANKRUPTCY 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 NO

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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; costs associated with an unsolicited offer to acquire the Company; estimates in our significant accounting policies, including our allowance for doubtful accounts and the anticipated impact of long-lived asset impairments;

certain statements in Quantitative and Qualitative Disclosures About Market Risk; and

certain statements in Legal Proceedings regarding the effects of litigation.

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;

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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;

regulations;
the impact of investigations and audits relating to alleged violations of federal and/or state

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;

stock;
the impact of Omnicare, Inc.'s unsolicited tender offer to acquire all of our outstanding common

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

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

competition for qualified management and pharmacy professionals;

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

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

products; the impact of our reliance on one supplier to provide a significant portion of our pharmacy

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

matters beyond our control. acts of God or public authorities, war, civil unrest, terrorism, fire, floods, earthquakes and other

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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, as reclassified in the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 3, 2004.

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

Item 1. Financial Statements

NEIGHBORCARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

	June 30, 2004		September 30, 2003	
ASSETS				
Current assets				
Cash and cash equivalents	\$	70,144	\$	132,726
Restricted investments in marketable securities				29,320
Accounts receivable, net of allowance of \$12.8 million and \$48.6 million, respectively		225,480		366,886
Inventories		66,170		66,747
Prepaid expenses and other current assets		36,355		89,918
Total current assets		398,149		685,597
Property, plant and equipment, net		80,251		751,996
Restricted investments in marketable securities				61,271
Notes receivable and other investments				19,252
Other long-term assets		21,272		62,052
Identifiable intangible assets, net		13,852		20,866
Goodwill		356,776		337,695
Total assets	\$	870,300	\$	1,938,729
LIABILITIES and SHAREHOLDERS' EQUITY				
Current liabilities				
Current portion of long-term debt	\$	4,275	\$	20,135
Accounts payable and accrued expenses		106,430		214,689
Income taxes payable				4,116
Total current liabilities		110,705		238,940
Long-term debt		258,921		591,484
Other long-term liabilities		31,742		134,952
Total liabilities		401,368		965,376
Minority interest		9,596		10,359
Redeemable preferred stock				46,831
SHAREHOLDERS' EQUITY		459,336		916,163
Total liabilities and shareholders' equity	\$	870,300	\$	1,938,729

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See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

NEIGHBORCARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME (LOSS)

(unaudited, in thousands except per share amounts)

	Three Months Ended June 30,	
	2004	2003
Net revenues	\$ 371,094	\$ 318,886
Cost of revenues	294,061	246,360
Gross profit	77,033	72,526
Selling, general and administrative	48,807	54,600
Depreciation and amortization	7,107	7,785
Strategic planning, severance and other operating items	792	11,474
Takeover defense expenses	16,751	
Operating income (loss)	3,576	(1,333)
Interest expense, net	4,492	3,419
Other expense	1,137	1,151
Loss before income tax provision (benefit)	(2,053)	(5,903)
Income tax provision (benefit)	4,720	(11,851)
Income (loss) from continuing operations	(6,773)	5,948
Income from discontinued operations, net of taxes		1,184
Net income (loss)	(6,773)	7,132
Preferred stock dividends		660
Net income (loss) available to common shareholders	\$ (6,773)	\$ 6,472
Other comprehensive income:		
Unrealized gain on marketable securities		240
Fair value change of derivative instruments, net		(1,869)
Comprehensive income (loss)	\$ (6,773)	\$ 4,843
Per common share data		
Basic		
Income (loss) from continuing operations	\$ (0.16)	\$ 0.13
Income from discontinued operations	\$	\$ 0.03
Net income (loss) available to common shareholders	\$ (0.16)	\$ 0.16
Weighted average shares outstanding	43,682	40,097
Diluted		
Income (loss) from continuing operations	\$ (0.16)	\$ 0.13
Income from discontinued operations	\$	\$ 0.03
Net income (loss) available to common shareholders	\$ (0.16)	\$ 0.16
Weighted average shares outstanding	43,682	40,097

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

NEIGHBORCARE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME (LOSS)

(unaudited, in thousands except per share amounts)

	Nine Months Ended June 30,	
	2004	2003
Net revenues	\$ 1,066,134	\$ 920,924
Cost of revenues	838,317	710,817
Gross profit	227,817	210,107
Selling, general and administrative	145,286	163,507
Depreciation and amortization	19,263	23,048
Strategic planning, severance and other operating items	43,494	9,603
Takeover defense expenses	16,751	
Operating income	3,023	13,949
Interest expense, net	14,699	10,636
Other expense	3,454	3,281
Income (loss) before income tax benefit	(15,130)	32
Income tax benefit	(2,423)	(4,404)
Income (loss) from continuing operations	(12,707)	4,436
Income from discontinued operations, net of taxes	8,435	20,646
Net income (loss)	(4,272)	25,082
Preferred stock dividends		2,009
Net income (loss) available to common shareholders	\$ (4,272)	\$ 23,073
Other comprehensive income (loss):		
Unrealized gain on marketable securities		211
Fair value change of derivative instruments, net		(3,430)
Comprehensive income (loss)	\$ (4,272)	\$ 19,854
Per common share data		
Basic		
Income (loss) from continuing operations	\$ (0.30)	\$ 0.06
Income from discontinued operations	\$ 0.20	\$ 0.50
Net income (loss) available to common shareholders	\$ (0.10)	\$ 0.56
Weighted average shares outstanding	42,565	41,135
Diluted		
Income (loss) from continuing operations	\$ (0.30)	\$ 0.06
Income from discontinued operations	\$ 0.20	\$ 0.50
Net income (loss) available to common shareholders	\$ (0.10)	\$ 0.56
Weighted average shares outstanding	42,565	41,135

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

NEIGHBORCARE, INC

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

	Nine Months Ended June 30,	
	2004	2003
Cash flows from operating activities		
Net income (loss) available to common shareholders	\$ (4,271)	\$ 23,073
Net charges included in operations not requiring funds	40,408	106,836
Changes in operating assets and liabilities		
Change in accounts receivable, net	(52,884)	(23,835)
Change in accounts payable and accrued expenses	81,785	(16,606)
Cash paid for debt restructuring costs		(1,677)
Other, net	(21,723)	(6,673)
Net cash provided by operating activities	43,315	81,118
Cash flows from investing activities		
Capital expenditures	(21,866)	(42,496)
Business acquisitions, net of cash acquired	(26,309)	
Other, net	(33,432)	50,258
Net cash (used in) provided by investing activities	(81,607)	7,762
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	(557,918)	(66,617)
Proceeds from issuance of long-term debt, net of debt issuance costs	240,804	
Repurchase of common stock		(36,207)
Other	11,984	
Net cash used in financing activities	(24,290)	(102,824)
Net decrease in cash and cash equivalents	(62,582)	(13,944)
Cash and cash equivalents at beginning of period	132,726	148,030
Cash and cash equivalents at end of period	\$ 70,144	\$ 134,086
Non-cash investing and financing activities		
Distribution of net assets to GHC	(437,157)	
Conversion of preferred stock to common 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 June 30, 2004, NeighborCare provided pharmacy services for approximately 263,000 beds in long-term care facilities in 32 states and the District of Columbia. The Company's pharmacy operations consist of 66 institutional pharmacies (five are jointly-owned), 32 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. As a result of the spin-off, the Company's consolidated 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 relationship 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.

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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 Annual Report on Form 10-K for the fiscal year ended September 30, 2003, as reclassified in the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 3, 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, Including Vendor Rebates;

Revenue Recognition / Contractual Allowances; and

Valuation of Long-Lived Assets.

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 prior periods 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 the intrinsic value method as defined in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, in accounting for its stock option and restricted stock plans. The intrinsic value of the restricted stock awards granted during fiscal 2004 is equal to the fair value as defined by SFAS 123, therefore, there is no pro forma impact to the financial statements. Had the Company determined compensation cost of outstanding stock options based on the fair value at the grant date consistent with the provisions of SFAS 123, the Company's net income (loss) would have been changed to the pro forma amounts indicated below (in thousands):

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	Three months ended		Nine months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Net income (loss) available to common shareholders-as reported	\$ (6,773)	\$ 6,472	\$ (4,272)	\$ 23,072
Add stock-based compensation expense included in net income				
(loss) as reported, net of tax effect	271		485	
Deduct stock-based compensation expense determined under the fair-value-based method for all awards, net of tax effect	(626)	(1,260)	(4,471)	(2,463)
Net income (loss) available to common shareholders-pro forma	\$ (7,128)	\$ 5,212	\$ (8,258)	\$ 20,609
Earnings per share:				
Basic as reported	\$ (0.16)	\$ 0.16	\$ (0.10)	\$ 0.56
Basic pro forma	(0.16)	0.13	(0.19)	0.50
Diluted as reported	(0.16)	0.16	(0.10)	0.56
Diluted pro forma	(0.16)	0.13	(0.19)	0.50

At June 30, 2004, 2,281,904 options to purchase NeighborCare common stock were outstanding with exercise prices ranging from \$10.73 to \$21.50. Of the outstanding options, 1,259,796 are vested and fully exercisable and 1,022,108 remain unvested at June 30, 2004. The fair value of stock options granted during the three and nine month periods ended June 30, 2004 and 2003, respectively, is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions for 2004 and 2003:

	Three months ended		Nine months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Volatility	120.66%	25.61%	80.75%	41.83%
Expected life (in years)	5	3.3	5	3.3
Rate of return	3.1%	2.54%	3.1%	2.54%
Dividend yield	0%	0%	0%	0%

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. Under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), discontinued businesses, including assets held for sale or distributed to shareholders, 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.

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

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	Three months ended		Nine months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Net revenues of GHC	\$	\$ 349,773	\$ 250,927	\$ 1,064,800
Net operating income of GHC		16,498	16,450	51,724
Net operating loss of other units		(291)		(804)
Income from discontinued operations before interest and taxes		16,207	16,450	50,920
Interest expense allocation		4,807	2,467	14,939
Income tax expense		10,216	5,548	15,335
Net income from discontinued operations	\$	\$ 1,184	\$ 8,435	\$ 20,646

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 nine months ended June 30, 2004 follows (in thousands):

	Accrued at September 30, 2003	Nine Months Ended June 30, 2004			Accrued at June 30, 2004
		Provision	Paid	Non-Cash	
Employee contract termination, transaction completion bonuses, severance and related costs	\$ 1,000	\$ 12,311	\$ 10,601	\$ 833	\$ 1,877
Strategic planning and other items	2,160	31,183	27,203	6,112	28
Total	\$ 3,160	\$ 43,494	\$ 37,804	\$ 6,945	\$ 1,905

Strategic planning, severance and other operating items for the nine months ended June 30, 2004 relate primarily to legal, professional and other fees incurred to complete the spin-off transaction of \$16.7 million; costs incurred pursuant to the termination provisions of employment contracts and transaction completion bonuses with NeighborCare and GHC executives of \$10.2 million, including severance incurred due to the resignation of the Company's former Chief Financial Officer; costs incurred to extinguish long-term debt and related obligations in connection with the spin-off of \$14.5 million; and severance and related costs incurred pursuant to the Company's corporate and regional consolidations in the second and third quarter of fiscal 2004 of \$2.1 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. The majority of the amounts accrued at June 30, 2004 are expected to be paid during the fourth quarter of fiscal 2004.

Strategic planning, severance and other operating items for the nine months ended June 30, 2003 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 \$16.6 million of strategic planning and other operating items for the period primarily relate to consulting and other professional fees.

5. Takeover Defense Expenses

On May 24, 2004, Omnicare, Inc. announced its intention to purchase all of the outstanding shares of NeighborCare common stock for \$30 per share in cash. On May 25, 2004, the Company announced that the board of directors unanimously rejected the proposal. On June 3, 2004, Omnicare, Inc. announced its intention to commence a tender offer to purchase all of the outstanding shares of NeighborCare common stock for \$30 per share in cash. The tender offer formally commenced on June 4, 2004 and was originally stated to expire on July 7, 2004. On June 25, 2004, Omnicare, Inc. amended its offer extending the expiration date to July 30, 2004. On July 31, 2004, Omnicare, Inc. further amended its offer extending the expiration date to August 31, 2004. For further information relating to the tender offer, refer to the Company's Schedule 14D-9 filed with the Securities Exchange Commission on June 14, 2004, and subsequent amendments thereof.

As a result of the tender offer, the Company incurred various expenses in connection with its defense of the tender offer including legal, investment banking and other fees aggregating \$16.8 million as of June 30, 2004. These amounts remain accrued at June 30, 2004.

6. Long-Term Debt

Long-term debt at June 30, 2004 and September 30, 2003 consists of the following (in thousands):

	June 30, 2004	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	13,196	56,406
Total debt	263,196	611,619
Less:		
Current portion of long-term debt	(4,275)	(20,135)
Long-term debt	\$ 258,921	\$ 591,484

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

7. Guarantor Subsidiaries and Condensed Consolidated Financial Statements

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The Company's \$250 million senior subordinated notes due 2013 are fully and unconditionally guaranteed on a joint and several basis by certain 100% owned subsidiaries of the Company (Guarantors). Those subsidiaries that 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 (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:

Condensed Consolidating Balance Sheets
June 30, 2004
(in thousands)

	Parent	Guarantors	Non- Guarantors	Eliminations	Consolidated
Assets					
Accounts receivable, net	\$ 166,467	\$ 194,275	\$ 18,212	\$ (153,474)	\$ 225,480
Other current assets	93,112	67,947	11,610		172,669
Property, plant and equipment, net	17,765	54,831	7,655		80,251
Investment in subsidiaries	24,334	1,299		(25,133)	500
Goodwill	331,024	23,494	2,258		356,776
Other long-term assets	28,197	6,354	73		34,624
	\$ 660,899	\$ 348,200	\$ 39,808	\$ (178,607)	\$ 870,300
Liabilities and Shareholders Equity					
Accounts payable and accrued expenses	\$ 72,352	\$ 182,702	\$ 4,850	\$ (153,474)	\$ 106,430
Current portion of long-term debt	4,262		13		4,275
Long-term debt less current portion	256,537	893	1,491		258,921
Other non-current liabilities	41,338				41,338
Shareholders equity	286,410	164,605	33,454	(25,133)	459,336
	\$ 660,899	\$ 348,200	\$ 39,808	\$ (178,607)	\$ 870,300

Condensed 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

Condensed Consolidating Statements of Operations
Three months ended
June 30, 2004
(in thousands)

	Parent	Guarantors	Non- Guarantors	Consolidated	
Net revenues	\$	\$	332,189	\$ 38,905	\$ 371,094
Cost of revenues			265,603	28,458	294,061
Gross profit			66,586	10,447	77,033
Operating expenses	32,491	35,270	5,696		73,457
Interest expense (income), net	4,463	(24)	53		4,492
Other expense (income)	1,280	(143)			1,137
Income (loss) before income tax provision	(38,234)	31,483	4,698		(2,053)
Income tax provision	4,720				4,720
Income (loss) from continuing operations and net income (loss)	\$ (42,954)	\$ 31,483	\$ 4,698	\$	\$ (6,773)

Condensed Consolidating Statements of Operations
Three months ended
June 30, 2003
(in thousands)

	Parent	Guarantors	Non- Guarantors	Consolidated	
Net revenues	\$	\$	284,291	\$ 34,595	\$ 318,886
Cost of revenues			221,713	24,647	246,360
Gross profit			62,578	9,948	72,526
Operating expenses	33,109	35,438	5,312		73,859
Interest expense (income), net	3,393	(41)	67		3,419
Other expense (income)	1,314	(163)			1,151
Income (loss) before income tax provision (benefit)	(37,816)	27,344	4,569		(5,903)
Income tax provision (benefit)	(12,029)	178			(11,851)
Income (loss) from continuing operations	(25,787)	27,166	4,569		5,948
Income from discontinued operations, net of taxes	1,184				1,184
Net income (loss)	\$ (24,603)	\$ 27,166	\$ 4,569	\$	\$ 7,132

Condensed Consolidating Statements of Operations
Nine months ended
June 30, 2004
(in thousands)

	Parent	Guarantors	Non- Guarantors	Consolidated
Net revenues	\$	\$	952,053	\$ 1,066,134
Cost of revenues		755,185	83,132	838,317
Gross profit		196,868	30,949	227,817
Operating expenses	99,777	108,291	16,726	224,794
Interest expense, net	14,392	147	160	14,699
Other expense (income)	3,945	(491)		3,454
Income (loss) before income taxes	(118,114)	88,921	14,063	(15,130)
Income tax benefit	(2,423)			(2,423)
Income (loss) from continuing operations	(115,691)	88,921	14,063	(12,707)
Income from discontinued operations, net of taxes	8,435			8,435
Net income (loss)	\$ (107,256)	\$ 88,921	\$ 14,063	\$ (4,272)

Condensed Consolidating Statements of Operations
Nine months ended
June 30, 2003
(in thousands)

	Parent	Guarantors	Non- Guarantors	Consolidated
Net revenues	\$	\$	821,027	\$ 920,924
Cost of revenues		639,569	71,248	710,817
Gross profit		181,458	28,649	210,107
Operating expenses	72,592	108,048	15,518	196,158
Interest expense (income), net	10,685	(221)	172	10,636
Other expense (income)	3,720	(439)		3,281
Income (loss) before income tax provision (benefit)	(86,997)	74,070	12,959	32
Income tax provision (benefit)	(5,175)	771		(4,404)
Income from continuing operations	(81,822)	73,299	12,959	4,436
Income from discontinued operations, net of taxes	20,646			20,646
Net income (loss)	\$ (61,176)	\$ 73,299	\$ 12,959	\$ 25,082

Condensed Consolidating Statements of Cash Flows
Nine months ended
June 30, 2004
(in thousands)

	Parent	Guarantors	Non- Guarantors	Consolidated
Cash flow from operating activities	\$ (15,626)	\$ 121,272	\$ (62,331)	\$ 43,315
Cash flow from investing activities	(77,573)	(970)	(3,064)	(81,607)
Cash flow from financing activities	(34,239)	534	9,415	(24,290)

Condensed Consolidating Statements of Cash Flows
Nine months ended
June 30, 2003
(in thousands)

	Parent	Guarantors	Non- Guarantors	Consolidated
Cash flow from operating activities	\$ (2,329)	\$ 59,592	\$ 23,855	\$ 81,118
Cash flow from investing activities	(27,656)	(6,416)	41,834	7,762
Cash flow from financing activities	(131,523)	224	28,475	(102,824)

8. Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share for the three month and nine month periods ended June 30, 2004 and 2003 (in thousands, except per share data):

	Three months ended		Nine months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Earnings:				
<i>Basic and diluted calculation:</i>				
Income (loss) from continuing operations, net of preferred dividends	\$ (6,773)	\$ 5,288	\$ (12,707)	\$ 2,426
Income from discontinued operations		1,184	8,435	20,646
Net income (loss) available to common shareholders	\$ (6,773)	\$ 6,472	\$ (4,272)	\$ 23,072
Shares:				
Weighted average shares outstanding basic	43,682	40,097	42,565	41,135
Assumed conversion of preferred stock				
Weighted average shares outstanding diluted	43,682	40,097	42,565	41,135
Per common share data:				
<i>Basic:</i>				
Income (loss) from continuing operations	\$ (0.16)	\$ 0.13	\$ (0.30)	\$ 0.06
Income from discontinued operations		0.03	0.20	0.50
Net income available to common shareholders	(0.16)	0.16	(0.10)	0.56
<i>Diluted:</i>				
Income (loss) from continuing operations	\$ (0.16)	\$ 0.13	\$ (0.30)	\$ 0.06
Income from discontinued operations		0.03	0.20	0.50
Net income available to common shareholders	(0.16)	0.16	(0.10)	0.56

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 for the current quarter and year to date periods are approximately 260,000 shares to be issued in connection with the joint plan of reorganization confirmed by the bankruptcy court.

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, vesting of restricted stock awards and also the assumed conversion of preferred stock. For the three and nine months ended June 30, 2004 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 would be anti-dilutive. For the three and nine months ended June 30, 2003, the assumed conversion of preferred stock is antidilutive and therefore is not included in calculating diluted shares outstanding. As of June 30, 2004, there were 291,530 shares of restricted stock issued and outstanding of which 59,262 were vested. Also as of June 30, 2004, there were 2,281,904 stock options outstanding of which 1,259,796 are fully vested.

9. Segment Information

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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: (1) institutional pharmacy business and (2) 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

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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.

Summarized financial information concerning the Company's reportable segments is shown in the following table for the current quarter, compared with the same period last year. The table has been reclassified to reflect the spin-off of GHC, the previously reported Inpatient Services segment. The Corporate and Other category of operations represents operating information of business units below the prescribed quantitative thresholds under 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 (in thousands)	Consolidated
Three months ended June 30, 2004			
Net revenues	\$ 317,794	\$ 53,300	\$ 371,094
Gross profit	60,952	16,081	77,033
Operating income (loss)	31,063	(27,487)	3,576
Three months ended June 30, 2003			
Net revenues	\$ 264,035	\$ 54,851	\$ 318,886
Gross profit	54,081	18,445	72,526
Operating income (loss)	24,206	(25,539)	(1,333)
Nine months ended June 30, 2004			
Net revenues	\$ 902,840	\$ 163,294	\$ 1,066,134
Gross profit	176,784	51,033	227,817
Operating income (loss)	86,158	(83,135)	3,023
Nine months ended June 30, 2003			
Net revenues	\$ 760,021	\$ 160,903	\$ 920,924
Gross profit	156,915	53,192	210,107
Operating income (loss)	66,447	(52,498)	13,949
Total assets as of			
June 30, 2004	\$ 194,426	\$ 675,874	\$ 870,300
September 30, 2003	192,149	1,746,580	1,938,729

10. 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 June 30, 2004, 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 certain of these guarantees 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

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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, and as such, no initial liability was recorded. The obligations in the aggregate require the guarantee of future lease payments of \$2.6 million for the remainder of fiscal 2004, \$5.8 million in fiscal 2005, \$5.6 million in fiscal 2006, \$4.6 million in fiscal 2007 and \$4.2 million thereafter. Remaining annual rents for these guaranteed leases and subleases that are not indemnified by GHC aggregate \$1.0 million for the remainder of 2004 and \$4.2 million annually thereafter through March 2, 2009.

11. Acquisitions

On June 1, 2004, the Company completed the acquisition of The Medicine Centre, LLC by purchasing all outstanding ownership interests in The Medicine Centre, LLC. Also on June 1, 2004, the Company acquired all of the outstanding stock of Capitol Home Infusion, Inc. On January 22, 2004, the Company completed the acquisition of certain of the assets of Texas Long-Term Care Pharmacy Services, LLC. The aggregate purchase price for these acquisitions was approximately \$28.8 million including liabilities assumed.

Results of these completed acquisitions are included in the Company's consolidated statements of operations from the date of acquisition. The Company's preliminary purchase price allocation is as follows (in thousands):

Accounts receivable, net	\$	3,883
Inventories		1,789
Other current assets		835
Property, plant and equipment		966
Goodwill		20,225
Other intangible assets		3,036
Total liabilities assumed		(3,549)
Net assets acquired through acquisitions	\$	27,185

12. Income Taxes

The Company's provision (benefit) for income taxes from continuing operations for the three months ended June 30, 2004 and 2003 and the nine months ended June 30, 2004 and 2003 was \$4.7 million, \$(11.9) million, \$(2.4) million and \$(4.4) 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.

13. 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. 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 consolidated balance sheet under redeemable preferred stock.

14. Restricted Stock

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On June 15, 2004, the Company's shareholders approved the 2004 Performance Incentive Plan (the Plan). The aggregate number of shares that may be issued under the Plan is 5,000,000. As of June 30, 2004, 296,946 shares of restricted stock have been issued to NeighborCare employees under the Plan, of which 64,678 are fully vested and 26,647 have been surrendered to fulfill employee income tax obligations resulting from the grants. These restricted stock grants were issued out of the treasury shares held on June 15, 2004. Restrictions on grants to employees typically vest ratably over three years from the date of grant such that the employee cannot sell or trade the restricted stock until it becomes vested. In addition, as of June 30, 2004, 21,232 shares of restricted stock have been issued to members of the Company's board of directors. Restricted shares issued to current board members are restricted such that the holder cannot sell or trade the stock unless the seller's holdings in NeighborCare stock exceed \$285,000 after the sale or trade occurs. The restrictions immediately lapse upon the holder's termination of board membership.

15. 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		(509,687)
Other		10,301
Net loss		(4,272)
Balance at June 30, 2004	\$	459,336

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, or the Company, we, our or us refers to NeighborCare, Inc. and its subsidiaries.

We are the third largest provider of institutional pharmacy services in the United States. As of June 30, 2004, we provided pharmacy services for approximately 263,000 beds in long-term care facilities in 32 states and the District of Columbia. Our pharmacy operations consist of 66 institutional pharmacies (five are jointly-owned), 32 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 business provides 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, total parenteral nutrition, chemotherapy and pain management).

We also own and operate Tidewater Healthcare Shared Services Group, Inc. (Tidewater), one of the largest long-term care group purchasing organizations 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 (the spin-off) of the common stock of Genesis Healthcare Corporation (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

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 (GHC).

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 segregated in the unaudited condensed consolidated statements of operations as Strategic planning, severance and other operating items. A summary of these costs at June 30, 2004 follows (in thousands):

	Accrued at		Nine Months Ended June 30, 2004						Accrued at	
	September 30, 2003		Provision		Paid		Non-Cash		June 30, 2004	
Employee contract termination, transaction completion bonuses, severance and related costs	\$	1,000	\$	12,311	\$	10,601	\$	833	\$	1,877
Strategic planning and other items		2,160		31,183		27,203		6,112		28

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Total	\$	3,160	\$	43,494	\$	37,804	\$	6,945	\$	1,905
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Strategic planning, severance and other operating items for the nine months ended June 30, 2004 relate primarily to legal, professional and other fees incurred to complete the spin-off transaction of \$16.7 million; costs incurred pursuant to the termination provisions of employment contracts and transaction completion bonuses with NeighborCare and GHC executives of \$10.2 million, including severance to our former Chief Financial Officer as a result of his resignation; costs incurred to extinguish long-term debt and related obligations in connection with the spin-off of \$14.5 million; and severance and related costs incurred pursuant to our corporate and regional consolidation in the second and third quarter of fiscal 2004 of \$2.1 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. The majority of the amounts accrued at June 30, 2004 are expected to be paid during the fourth quarter of fiscal 2004.

Strategic planning, severance and other operating items for the nine months ended June 30, 2003 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, we agreed to terminate the merger agreement with NCS and Omnicare agreed to pay us a \$22.0 million break-up fee. On

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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. We 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, our former vice-chairman, of approximately \$4.8 million. The remaining \$16.6 million of strategic planning and other operating items for the period primarily relate to consulting and other professional fees.

Omnicare, Inc. Tender Offer

On May 24, 2004, Omnicare, Inc. announced its intention to purchase all of the outstanding shares of our common stock for \$30 per share in cash. On May 25, 2004, we announced that our board of directors unanimously rejected the proposal. On June 3, 2004, Omnicare, Inc. announced its intention to commence a tender offer to purchase all of the outstanding shares of our common stock for \$30 per share in cash. The tender offer formally commenced on June 4, 2004 and was originally stated to expire on July 7, 2004. On June 25, 2004, Omnicare, Inc. amended its offer extending the expiration date to July 30, 2004. On July 31, 2004 Omnicare, Inc. further amended its offer extending the expiration date to August 31, 2004. For further information relating to the tender offer, refer to our Schedule 14D-9 filed with the Securities and Exchange Commission on June 14, 2004, and subsequent amendments thereof.

As a result of the tender offer, we incurred various expenses in connection with our defense of the tender offer including legal, investment banking and other fees aggregating \$16.8 million as of June 30, 2004. These amounts remain accrued at June 30, 2004.

Discontinued Operations

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 following table sets forth the components of net income (loss) from discontinued operations for the current quarter and year to date periods compared to the same periods last year (in thousands):

	Three months ended				Nine months ended			
	June 30, 2004		June 30, 2003		June 30, 2004		June 30, 2003	
Net revenues of GHC	\$		\$	349,773	\$	250,927	\$	1,064,800
Net operating income of GHC				16,498		16,450		51,724
Net operating loss of other units				(291)				(804)
Income from discontinued operations before interest and taxes				16,207		16,450		50,920
Interest expense allocation				4,807		2,467		14,939
Income tax expense				10,216		5,548		15,335
Net income from discontinued operations	\$		\$	1,184	\$	8,435	\$	20,646

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In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (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 expenses that were incurred for the benefit of both our continuing operations and the spun-off operations of GHC which are included in the continuing operations of our entity. Therefore, our operating results for the periods presented do not necessarily reflect the actual operating expenses of our continuing pharmacy operations. Overhead expenses that were not allocated to discontinued operations primarily included corporate selling, general and administrative expenses including salaries, wages and benefits. For purposes of the following table, we allocated the shared overhead expenses based upon revenue or certain expense categories, whichever was deemed more reflective of the underlying expenses. The allocated expenses may not be representative of our overhead cost reductions as a stand-alone company. The following table outlines our operating income assuming that overhead expenses attributable to our former inpatient services business, as allocated, were included in discontinued operations:

	Three months ended				Nine months ended			
	June 30, 2004		June 30, 2003		June 30, 2004		June 30, 2003	
Operating income (loss) as reported	\$	3,576	\$	(1,333)	\$	3,023	\$	13,949
Overhead expenses allocated to GHC				7,950				23,492
Adjusted operating income	\$	3,576	\$	6,617	\$	3,023	\$	37,441
Income from discontinued operations, net of taxes, as reported	\$		\$	1,184	\$	8,435	\$	20,646
Overhead expenses, net of tax effect				4,770				14,095
Adjusted income (loss) from discontinued operations, net of taxes	\$		\$	(3,586)	\$	8,435	\$	6,551

Agreements with GHC

In furtherance of the spin-off, we and GHC entered into a separation and distribution agreement which sets forth the agreements between us and GHC with respect to the principal corporate transactions required to consummate the spin-off and contains other agreements governing the relationship between us and GHC thereafter. We or our subsidiaries, as applicable, and GHC have also entered into certain mutually beneficial commercial arrangements which govern the current relationship between us and GHC.

These agreements include: (i) a tax sharing agreement which governs the respective rights, responsibilities, and 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; (ii) a transition services agreement which provides for the provision of transitional services by GHC to us, including, without limitation, the provision of information systems, tax services, financial systems and bankruptcy claims processing; (iii) a master agreement for pharmacy, pharmacy consulting and related products and services which provides the terms and conditions on which our subsidiary, NeighborCare Pharmacy Services, Inc. (NCPS), provides pharmacy, pharmacy consulting and medical supply products and services to all long-term care facilities owned or leased by GHC or its affiliates, as amended; (iv) a Tidewater membership agreement which provides the terms and conditions on which Tidewater provides group purchasing and shared services programs to the skilled nursing facilities and assisted living facilities operated by GHC; (v) an employee benefits agreement which provides for our and GHC's responsibilities and obligations regarding certain employee compensation, benefit and labor related matters after the spin-off; (vi) a pharmacy benefit management agreement which provides the terms and conditions under which our subsidiary, CareCard, Inc., provides pharmacy benefit management services, as well as access to retail and mail pharmacy services, to GHC; and (vii) a master agreement for specialty beds and oxygen concentrators which provides the agreements between NCPS and GHC relating to the provision of certain equipment and related services to GHC's skilled nursing and assisted living facilities.

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.

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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 nine 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 pharmaceutical drugs and biologicals currently reimbursed under the average wholesale price methodology. The legislation shifts the payment methodology from average wholesale price to average sales price. DHHS will have the authority to adjust payment rates where the average sales price does not reflect widely available market prices. In addition, the legislation will have a significant impact on reimbursement rates for durable medical equipment by freezing durable medical equipment rates from 2004 through 2006. DHHS will have the authority to adjust rates for the top five most widely used durable medical equipment codes to reflect reimbursement rates paid under the Federal Employee Health Benefit Plan. The Medicare Modernization Act also provides for increased federal resources being available for prescription drug benefits coverage in 2006. Finally, the Medicare Modernization Act authorizes an interim federally sponsored prescription drug discount plan to provide

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group discounts for Medicare beneficiaries between 2004 and 2006.

Because of the recent enactment of the Medicare Modernization Act and its broad scope, we are not in a position to fully assess its impact on our business. The impact of the legislation depends upon a variety of factors, including patient mix. It is not clear at this time whether this new legislation will have an overall negative impact on institutional and long-term care pharmacy services. There are provisions which recognize the unique needs of the long-term care resident contained in the legislation. For example, the Secretary, CMS, is required to review the current standards of practice for pharmacy services provided to long-term care beneficiaries and to prepare a plan for review by the Congress designed to protect the safety and quality of care of nursing facility patients, including the appropriate reimbursement within 18 months of enactment. Nevertheless, this legislation may reduce revenue and impose additional costs to the industry. DHHS has recently promulgated regulations under the Act. It is too soon to evaluate the impact of these regulations. NeighborCare will continue to work closely with CMS directly, as well as through the Long Term Care Pharmacy Alliance, to offer its expertise in pharmaceutical care for the elderly.

Prior to the Medicare Modernization Act, reimbursement for certain products covered under Medicare Part B was limited to 95% of the average wholesale price. The move to a prospective payment system under the Balanced Budget Act of 1997 made pricing a more important consideration in the selection of pharmacy providers. Also, Congress included provisions in the Balanced Budget Act of 1997 that would require nursing facilities to submit all claims for Medicare-covered services that their residents receive, both Medicare Part A and Medicare Part B, even if such services are provided by outside suppliers, including but not limited to pharmacy and rehabilitation therapy providers, except for certain excluded services. The Benefits Improvement and Protection Act, enacted in December 2000, repealed this provision, except for therapy services as discussed below.

The reimbursement rates for pharmacy services under Medicaid are determined on a state by state basis subject to review by CMS and applicable federal law. 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. Certain states have lowest charge legislation or most favored nation provisions which require our institutional pharmacy and medical supply operation to charge Medicaid no more than its lowest charge to other consumers in the state. Since 2000, federal Medicaid requirements establishing payment caps on certain drugs have been periodically revised. We have participated in the efforts to review and interact with CMS on the revisions. This proactive involvement has helped in modifying the rate structures and thereby minimizing the impact of the new rules on our operations.

Revisions made by the Medicare Modernization Act are expected to provide significant relief to states as Medicare coverage becomes primary to Medicaid assistance for dually eligible individuals. While those provisions making Medicare primary to Medicaid do not become effective until January 1, 2006, the competitive design of the interim drug rx discount card program, which is authorized under the Medicare Modernization Act, is expected to put pricing pressure on all pharmacy services, which may impact outlays for prescription drugs.

It is not possible to quantify fully the effect of legislative changes, the interpretation or administration of such legislation or any other governmental initiatives on our business and the business of our principal customers. Accordingly, there can be no assurance that the impact of any future healthcare legislation will not further adversely affect our business. There can be no assurance that payments under governmental and private third-party payor programs will be timely, will remain at levels comparable to present levels or will, in the future, be sufficient to cover the costs allocable to patients eligible for reimbursement pursuant to such programs. Our financial condition and results of operations may be affected by the reimbursement process, which in the healthcare industry is complex.

We belong, with other leading multi-state institutional pharmacy companies, to the Long Term Care Pharmacy Alliance, or LTCPA, an industry trade group established to influence the outcomes of both federal and state-specific legislative and regulatory activities. In this collaboration, LTCPA provides leadership to responding to specific issues. Presently, LTCPA has engaged representation in 23 states and the District of Columbia. Such efforts are augmented by the government relations specialists of the various companies and by active grassroots efforts of pharmacy professionals. These proactive steps have been successful in a number of instances, but given the budgetary concerns of both federal and state governments, there can be no assurance that changes in payment formulas and delivery requirements will not have a negative impact going forward.

While Congress has, through the Medicare Modernization Act, expanded Medicare coverage of certain costs of outpatient pharmaceutical services, the federal government and state governments continue to focus on efforts to curb spending on healthcare programs such as Medicare and Medicaid. We cannot at this time predict the extent to which these proposals will be adopted or, if adopted and implemented, what effect, if any, such proposals and existing new legislation will have on us. Efforts to impose reduced allowances, greater discounts and more stringent cost controls by government and other payors are expected to continue.

Results of Operations

Reasons for Non-GAAP Financial Disclosure

The following discussion contains non-GAAP financial measures. For purposes of SEC Regulation G, a non-GAAP financial measure is a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable financial measure calculated and presented in accordance with GAAP in the statement of operations, balance sheet or statement of cash flows (or equivalent statements) of the registrant; or includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable financial measure so calculated and presented. In this regard, GAAP refers to generally accepted accounting principles in the United States of America. Pursuant to the requirements of Regulation G, we have provided reconciliations of the non-GAAP financial measures to the most directly comparable GAAP financial measures.

EBITDA is a non-GAAP financial measure that is presented in the following discussion. Our management believes that the

presentation of EBITDA provides useful information to investors regarding our results of operations because it is useful for trending, analyzing and benchmarking the performance and value of our business as well as for evaluating our capacity to incur and service debt, fund capital expenditures and expand our business. We use EBITDA primarily as a performance measure, and believe that the GAAP financial measure most directly comparable to EBITDA is net income. We also use EBITDA in our annual budgeting process. We believe EBITDA facilitates internal comparisons to historical operating performance of prior periods and external comparisons to competitors' historical operating performance.

Although we use EBITDA as a financial measure to assess the performance of our business, as well as the employees responsible for operating our business, the use of EBITDA is limited because it does not consider certain material costs necessary to operate our business. These costs include the cost to service our debt, the non-cash depreciation and amortization associated with our long-lived assets, the cost of our federal and state tax obligations, our share of the earnings or losses of our less than 100% owned operations and the operating results of our discontinued businesses. Because EBITDA does not consider these important elements of our cost structure, a user of our financial information who relies on EBITDA as the only measure of our performance or financial condition could draw an incomplete or misleading conclusion regarding our financial performance or condition. Consequently, a user of our financial information should consider net income an important measure of our financial performance because it provides the most complete measure of such performance. EBITDA should be considered in addition to, and not as a substitute for, or superior to, the comparable GAAP financial measure or an indicator of operating performance.

We define EBITDA as earnings from continuing operations before preferred stock dividends, equity in net income (loss) of unconsolidated affiliates, minority interests, interest, taxes, depreciation and amortization. Other companies may define EBITDA differently and, as a result, our measure of EBITDA may not be directly comparable to EBITDA of other companies. EBITDA does not represent net income or cash flow from operations, as defined by GAAP.

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The following table sets forth selected information about our results of continuing operations for the three and nine month periods ended June 30, 2004 and 2003:

	Three months ended June 30,		Nine months ended June 30,	
	2004	2003	2004	2003
Net revenues	\$ 371,094	\$ 318,886	\$ 1,066,134	\$ 920,924
Gross profit	77,033	72,526	227,817	210,107
Income (loss) from continuing operations	(6,773)	5,948	(12,707)	4,436
Income from discontinued operations, net		1,184	8,435	20,646
Net income (loss)	(6,773)	7,132	(4,272)	25,082
Preferred dividends		660		2,009
Net income (loss) available to common shareholders	\$ (6,773)	\$ 6,472	\$ (4,272)	\$ 23,073
Gross margin	\$ 77,033	\$ 72,526	\$ 227,817	\$ 210,107
Gross margin%	20.8%	22.7%	21.4%	22.8%
EBITDA	\$ 10,683	\$ 6,452	\$ 22,286	\$ 36,997
EBITDA%	2.9%	2.0%	2.1%	4.0%
Basic EPS Data				
Income (loss) from continuing operations	\$ (0.16)	\$ 0.13	\$ (0.30)	\$ 0.06
Income from discontinued operations, net of taxes	\$	\$ 0.03	\$ 0.20	\$ 0.50
Net income (loss) available to common shareholders	\$ (0.16)	\$ 0.16	\$ (0.10)	\$ 0.56
Weighted average shares outstanding	43,682	40,097	42,565	41,135
Diluted EPS Data				
Income (loss) from continuing operations	\$ (0.16)	\$ 0.13	\$ (0.30)	\$ 0.06
Income from discontinued operations, net of taxes	\$	\$ 0.03	\$ 0.20	\$ 0.50
Net income available to common shareholders	\$ (0.16)	\$ 0.16	\$ (0.10)	\$ 0.56
Weighted average shares outstanding	43,682	40,097	42,565	41,135

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The following table reconciles net income (loss) available to common shareholders to our non-GAAP measure of EBITDA:

	Three months ended June 30,				Nine months ended June 30,			
	2004		2003		2004		2003	
EBITDA Reconciliation								
Net income available to common shareholders	\$	(6,773)	\$	6,472	\$	(4,272)		23,073
Subtract:								
Income from discontinued operations, net of taxes				(1,184)		(8,435)		(20,646)
Add back:								
Preferred dividends				660				2,009
Minority interest and equity in income of unconsolidated affiliates		1,137		1,151		3,454		3,281
Income tax provision (benefit)		4,720		(11,851)		(2,423)		(4,404)
Interest expense, net		4,492		3,419		14,699		10,636
Depreciation and amortization expense		7,107		7,785		19,263		23,048
EBITDA	\$	10,683	\$	6,452	\$	22,286	\$	36,997

The following table reconciles our consolidating operating income by segment to our non-GAAP measure of EBITDA:

	Three months ended June 30, 2004					
	Institutional Pharmacy		Corporate & Other		Consolidated	
Operating income (loss)	\$	31,063	\$	(27,487)	\$	3,576
Add back:						
Depreciation and amortization expense		3,601		3,506		7,107
EBITDA	\$	34,664	\$	(23,981)	\$	10,683

	Three months ended June 30, 2003					
	Institutional Pharmacy		Corporate & Other		Consolidated	
Operating income (loss)	\$	24,206	\$	(25,539)	\$	(1,333)
Add back:						
Depreciation and amortization expense		3,076		4,709		7,785
EBITDA	\$	27,282	\$	(20,830)	\$	6,452

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	Nine months ended June 30, 2004					
	Institutional Pharmacy		Corporate & Other		Consolidated	
Operating income (loss)	\$	86,158	\$	(83,135)	\$	3,023
Add back:						
Depreciation and amortization expense		9,758		9,505		19,263
EBITDA	\$	95,916	\$	(73,630)	\$	22,286

	Nine months ended June 30, 2003					
	Institutional Pharmacy		Corporate & Other		Consolidated	
Operating income (loss)	\$	66,447	\$	(52,498)	\$	13,949
Add back:						
Depreciation and amortization expense		9,033		14,015		23,048
EBITDA	\$	75,480	\$	(38,483)	\$	36,997

Three months ended June 30, 2004 compared to the three months ended June 30, 2003

Consolidated Overview

When comparing current quarter results to the results for the same period in the prior year, it is important to note that the prior year results include shared overhead costs. 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, in compliance with GAAP, could not be allocated to discontinued operations. For more information, see [Certain Transactions and Events](#) [Discontinued Operations](#).

Net income available to common shareholders for the current quarter was a loss of \$(6.8) million compared to net income of \$6.5 million for the same quarter of the prior year. The decrease in net income available to common shareholders is primarily attributed to the \$16.8 million of costs incurred in our defense of the unsolicited tender offer by one of our largest competitors, offset by a reduction in strategic planning, severance and other costs of \$10.7 million. Also contributing to the decrease in net income available to common shareholders is an increase in income tax provision of \$16.6 million resulting from non-deductible expenses incurred resulting from our transition to a pharmacy-based business.

EBITDA for the current quarter was \$10.7 million compared to EBITDA of \$6.5 million in the same quarter of the prior year. The increase in EBITDA is primarily attributable to the reduction of selling, general and administrative expenses of \$5.8 million and an increase in gross profit of \$4.5 million when comparing the third quarter of fiscal 2004 to the third quarter of fiscal 2003. The reduction in strategic planning, severance and other operating items of \$10.7 million was offset by charges incurred related to the takeover defense of \$16.8 million during the quarter.

For the current quarter, revenues were \$371.1 million, an increase of \$52.2 million, or 16.4%, over the same period in the prior year. This growth was primarily attributed to growth in revenue of our institutional pharmacy segment of approximately \$53.8 million, or 20.4% over the

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same period in the prior year. Net revenues in the same quarter of the prior year do not include intersegment revenues from GHC of \$19.1 million. The remaining increase in net revenues in the institutional pharmacy segment was due to bed growth, favorable changes in bed mix, higher patient acuity, and drug price inflation.

Cost of revenues increased by approximately \$47.7 million, or 19.4%, for the current quarter to \$294.1 million from \$246.4 million. Of this growth, \$40.3 million was attributed to revenue volume growth. As a percentage of net revenues, cost of revenues was 79.2% for the current quarter compared to 77.3% for the same quarter in the prior year. The decline in gross profit as a percentage of revenue in the current quarter when compared to the same quarter of the prior year is the result of reduced pricing to GHC facilities effective after the spin-off of GHC, lower Medicaid reimbursement rates, and changes in product mix. The gross profits presented do not

include gross profit on intersegment revenues from GHC prior to the spin-off of \$3.9 million for the three months ended June 30, 2003. The impact of these gross profits is included in discontinued operations for the respective period.

Selling, general and administrative expenses decreased \$5.8 million, or 10.6%, for the current quarter to \$48.8 million compared to \$54.6 million in the same period of the prior year. Selling, general and administrative expenses for the second quarter of 2003 includes shared overhead costs of approximately \$7.9 million that, in accordance with SFAS 144, could not be allocated to discontinued operations. The resulting increase in selling, general and administrative expenses is due primarily to the vesting of restricted stock awards and increased legal and bad debt expense. Depreciation and amortization expense for the quarter ended June 30, 2004 was approximately \$7.1 million compared with \$7.8 million in the quarter ended June 30, 2003. The decrease in depreciation and amortization expense is mainly attributable to depreciation related to shared corporate assets prior to the spin-off.

For the quarter ended June 30, 2004, we recognized \$0.8 million in strategic planning, severance and other operating items. These primarily relate to severance costs incurred as a result of the restructuring of our field organization, consolidating certain regional functions including several smaller pharmacies, centralizing certain overhead functions and the resignation of our former Chief Financial Officer. In addition, we incurred \$16.8 million related to our takeover defense, including legal, investment banking and other fees.

Interest expense increased by approximately \$1.1 million for the current quarter to \$4.5 million compared to \$3.4 million in the same quarter of the prior year. Interest expense for the prior year was based on an allocation of the net assets of the continuing operations and the discontinued segment. The overall increase is mainly attributable to the interest on our senior subordinated notes and related amortization of deferred financing costs thereon.

Other expense was \$1.1 million for the current quarter and \$1.2 million for the same quarter in the prior year. Other expense primarily consists of minority interest and our proportionate share of the net earnings of businesses in which we have invested, which are recorded under the equity method of accounting. The operating results of joint ventures in which we have a controlling interest are included in our consolidated financial statements. Minority interest expense represents the non-controlling owners' share of the joint ventures' operating profit.

Segment Results

NeighborCare's operating segments include institutional pharmacy and corporate and other.

Institutional Pharmacy Segment

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.

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Institutional pharmacy revenue increased \$53.8 million, or 20.4%, to \$317.8 million for the current quarter compared to \$264.0 million in the same period in the prior year. Of the \$53.8 million increase, \$34.7 million is attributed to an increase in the number of beds served as well as favorable changes in the bed mix, higher patient acuity and drug price inflation. Net revenues of the institutional pharmacy segment do not include intersegment revenues with GHC prior to the spin-off of \$19.1 million for the three months ended June 30, 2003.

Operating income of the institutional pharmacy segment increased \$6.9 million, or 28.5%, to \$31.1 million in the current quarter from \$24.2 million for the same period in the prior year. EBITDA of the institutional pharmacy segment increased \$7.4 million, or 27.1%, to \$34.7 million in the current quarter from \$27.3 million for the same period in the prior year. EBITDA margin increased to 10.9% from 10.3% for the same period. The gross profit presented does not include gross profit on intersegment revenues from GHC prior to the spin-off of \$3.9 million for the three months ended June 30, 2003. The impact of these gross profits is included in discontinued operations for the respective period.

Corporate and Other

Corporate and other consists of our community-based professional pharmacy business, home infusion, respiratory and medical equipment business and our Tidewater group purchasing organization. The corporate and other category includes of corporate general and administrative expenses that are not allocated to the segments for internal reporting purposes. Revenues for this segment decreased \$1.6 million to \$53.3 million in the current quarter from \$54.9 million in the same period of the prior year. Operating loss for the corporate and other segment increased \$2.0 million, or 7.8%, to a loss of \$27.5 million compared to a loss of \$25.5 million in the same period of prior year. This increase in operating loss is primarily the result of takeover defense charges incurred in the period offset by a reduction of selling general and administrative costs and depreciation.

Nine months ended June 30, 2004 compared to the nine months ended June 30, 2003

Consolidated Overview

When comparing current results to the results for the same period in the prior year, it is important to note that the prior year results include shared overhead costs. 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, in compliance with GAAP, could not be allocated to discontinued operations. For more information, see [Certain Transactions and Events](#) Discontinued Operations.

Net income available to common shareholders for the current year to date period was a loss of \$(4.3) million compared to income of \$23.1 million for the same period of the prior year. The decline in net income available to common shareholders is primarily attributed to strategic planning, severance and other operating items of \$43.5 million incurred primarily as a result of the spin-off of GHC compared to expenses of \$9.6 million in the prior year period. Contributing to the decrease are costs incurred in our takeover defense of approximately \$16.8 million and an increase in interest expense of \$4.1 million. Income from discontinued operations for the current nine month period declined principally due to the inclusion of only two months of discontinued operations prior to the spin-off of GHC compared to nine months included in the prior year period. The aggregate decrease in net income available to common shareholders was offset by decreases in selling, general and administrative expenses of \$18.2 million and decreased depreciation expense of \$3.8 million in addition to the relief of preferred dividend requirements of \$2.0 million.

EBITDA for the nine months ended June 30, 2004 was \$22.3 million compared to EBITDA of \$37.0 million in the same period of the prior year. The decrease in EBITDA is primarily attributable to strategic planning, severance and other operating items of \$43.5 million incurred principally as a result of the spin-off of GHC plus the takeover defense charges incurred of \$16.8 million. In the same period of the prior year, \$9.6 million was recorded in strategic planning, severance and other operating items. This was partially offset by an increase in gross profit of \$17.7 million and decreases in selling, general and administrative expenses of \$18.2 million in the nine months ended June 30, 2004 when compared to the same period of the prior year.

For the current year to date period, revenues were \$1,066.1 million, an increase of \$145.2 million, or 15.8%, over the same period in the prior year. This growth was primarily attributed to growth in revenue of our institutional pharmacy segment of approximately \$142.8 million, or 18.8% over the same period in the prior year. Net revenues do not include intersegment revenues with GHC prior to the spin-off of \$13.0 million and \$58.8 million for the nine months ended June 30, 2004 and 2003, respectively. The remaining increase in net revenues in the institutional pharmacy segment was due to bed growth, favorable changes in bed mix, higher patient acuity and drug price inflation. Approximately \$2.4 million of the increase in total revenues is attributable to growth in our corporate and other operating segment revenue.

Cost of revenues increased by approximately \$127.5 million, or 17.9%, for the current period to \$838.3 million from \$710.8 million. Of this growth, \$112.1 million was attributed to revenue volume growth. As a percentage of net revenues, cost of revenues was 78.6% for the current year to date period compared to 77.2% for the same period in the prior year. The decline in gross profit as a percentage of revenue in the current year when compared to the prior year is the result of reduced pricing to GHC facilities effective after the spin-off of GHC, lower Medicaid reimbursement rates, and price increases in key pharmaceuticals that we purchase. The gross profits presented do not include gross profits on intersegment revenues from GHC prior to the spin-off of \$2.7 million and \$12.1 million for the nine months ended June 30, 2004 and 2003, respectively. The impact of these gross profits is included in discontinued operations in the respective periods.

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Selling, general and administrative expenses decreased \$18.2 million, or 11.1%, for the current year to date period to \$145.3 million compared to \$163.5 million in the same period of the prior year. Selling, general and administrative expenses for the nine months of fiscal 2003 include shared overhead costs of approximately \$23.6 million that, in accordance with SFAS 144, could not be allocated to discontinued operations. The resulting increase in selling, general and administrative costs is primarily due to increases in legal and accounting fees, additional board of directors expenses incurred as a result of the unsolicited tender offer and the grants of restricted stock with vesting dates in the third quarter. Depreciation and amortization expense for the period was approximately \$19.3 million compared with \$23.0 million in the nine months ended June 30, 2003. The decrease in depreciation and amortization expense is mainly attributable to depreciation related to shared corporate assets prior to the spin-off.

For the nine months ended June 30, 2004, we recognized \$43.5 million in strategic planning, severance and other operating items. These costs include legal, professional and other fees incurred to complete the spin-off transaction of \$16.7 million; costs incurred pursuant to the termination provisions of employment contracts and transaction completion bonuses with NeighborCare and GHC executives of \$10.2 million; costs incurred to extinguish long-term debt and related obligations in connection with the spin-off of \$14.5 million; and \$2.1 million of severance costs incurred related to the restructuring of our field organization, consolidating certain regional functions including several

smaller pharmacies and centralizing certain overhead functions. For more information, see [Certain Transactions and Events](#) [Strategic Planning](#), [Severance and Other Operating Items](#).

Interest expense increased by approximately \$4.1 million for the current period to \$14.7 million compared to \$10.6 million in the same period of the prior year. Interest expense for the prior year was based on an allocation of the net assets of the continuing operations and the discontinued segment.

Other expense was \$3.5 million for the current period and \$3.3 million for the same period in the prior year. Other expense primarily consists of minority interest and our proportionate share of the net earnings of businesses in which we have invested, which are recorded under the equity method of accounting. The operating results of joint ventures in which we have a controlling interest are included in our consolidated financial statements. Minority interest expense represents the non-controlling owners' share of the joint ventures' operating profit.

Segment Results

NeighborCare's operating segments include institutional pharmacy and corporate and other.

Institutional Pharmacy Segment

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.

Institutional pharmacy revenue increased \$142.8 million, or 18.8%, to \$902.8 million for the current year to date period compared to \$760.0 million in the same period in the prior year. Net revenues of the institutional pharmacy segment do not include intersegment revenues with GHC prior to the spin-off of \$13.0 million and \$58.8 million for the nine months ended June 30, 2004 and 2003, respectively. The remaining increase is attributed to an increase in the number of beds served as well as favorable changes in the bed mix, higher patient acuity and drug price inflation.

Operating income of the institutional pharmacy segment increased \$19.8 million, or 29.8%, to \$86.2 million in the current period from \$66.4 million for the same period in the prior year. EBITDA of the institutional pharmacy segment increased \$20.4 million, or 27.0%, to \$95.9 million in the current period from \$75.5 million for the same period in the prior year. The gross profits presented do not include gross profit on intersegment revenues from GHC prior to the spin-off of \$2.7 million and \$12.1 million for the nine months ended June 30, 2004 and 2003, respectively. The impact of these gross profits is included in discontinued operations in the respective periods.

Corporate and Other

Corporate and other consists of our community-based professional pharmacy business, home infusion, respiratory and medical equipment business and our Tidewater group purchasing organization. The corporate and other includes corporate general and administrative expenses that are not allocated to the segments for internal reporting purposes. Revenues for this segment increased \$2.4 million to \$163.3 million in the current quarter from \$160.9 million in the same period of the prior year. Operating loss for the corporate and other segment increased \$30.6 million from a loss of \$52.5 million to a loss of \$83.1 million for the nine months ended June 30, 2004 compared to the same period in prior year. Profits declined principally due to \$43.5 million of costs incurred in connection with the spin-off compared to \$9.6 million of expense in the prior year period plus takeover defense charges of \$16.8 million in the current period. See Certain Transaction and Events Strategic Planning, Severance and Other Operating Items and Omnicare, Inc. Tender Offer. This increase in strategic planning and other operating items in fiscal 2004 was partially offset by declines in selling, general and administrative costs of \$17.2 million and depreciation expense of \$3.3 million related to shared overhead costs that, in accordance with SFAS 144, could not be allocated to discontinued operations.

Liquidity and Capital Resources

Working Capital and Cash Flows

At June 30, 2004 we had cash and equivalents of \$70.1 million and net working capital of \$287.4 million.

On November 4, 2003, in anticipation of the spin-off, we issued \$250 million aggregate principal amount of 6.875% senior subordinated notes due 2013. On April 30, 2004, we filed a registration statement on Form S-4 with the Securities and Exchange Commission in connection with our offer to exchange the initial notes issued in November 2003 for registered notes. As of July 20, 2004, the expiration of the exchange offer, all of the outstanding initial notes were exchanged for newly registered notes. We also entered into a

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\$100 million revolving credit facility, none of which was drawn at June 30, 2004, exclusive of \$2.4 million required for outstanding letters of credit. The revolving credit facility matures in 2008 and bears interest at LIBOR plus 2% on borrowings and includes a commitment fee of 0.50% on any unused commitment. See *New Financing Arrangements* below.

Our cash flow from operations generated cash of \$43.3 million for the first nine months of fiscal 2004 and we used \$81.6 million in our investing activities for the purchase of capital items and acquisitions.

During the first nine months of fiscal 2004, we used \$24.3 million in our financing activities. The net proceeds from the sale of our 6.875% senior subordinated notes, funds transferred from GHC and cash on hand were used to repay the following indebtedness:

approximately \$247.1 million of indebtedness outstanding under the term loan portion of the senior credit facility that was to mature on October 2, 2006;

approximately \$240.2 million of indebtedness outstanding under senior secured notes that were to mature on April 2, 2007; and

approximately \$68.9 million of indebtedness outstanding under the delayed draw term loan portion of the senior credit facility that was to mature on April 2, 2007.

We currently have a \$32.9 million deposit with our primary pharmaceutical wholesaler. The deposit is fully refundable to us at our request. This, combined with our contractual ability to elect 15-day payment terms with our primary pharmaceutical wholesaler, provides us the ability to use these funds as an additional resource to meet our working capital requirements, debt service and other cash needs over the next year, if needed.

We believe that the net cash provided by our operating activities will provide sufficient resources to meet our working capital requirements, debt service and other cash needs over the next year. We also believe that such funds, together with funds available through the revolving line of credit, will provide the necessary resources to expand and grow our business either through internal growth or acquisitions.

New Financing Arrangements

The agreements and instruments governing our senior subordinated notes and our revolving credit facility contain various restrictive covenants that, among other things, require us to comply with or maintain certain financial tests and ratios and restrict our ability to:

incur more debt;

pay dividends, redeem stock or make other distributions;

make certain investments;

create liens;

enter into transactions with affiliates;

make acquisitions;

merge or consolidate; and

transfer or sell assets.

Our new financing arrangements require us to maintain compliance with certain financial and non-financial covenants, including minimum earnings before interest, taxes, depreciation and amortization; limitations on capital expenditures, maximum leverage ratios, minimum fixed charge coverage ratios and minimum net worth.

Under the terms of our senior subordinated notes, the notes are not redeemable until on or after November 15, 2008. We may, however, use the net proceeds from one or more equity offerings to redeem up to 35% of the aggregate principal amount of the notes issued on or before November 15, 2006 at 106.875% of the principal amount thereof, plus accrued and unpaid interest to the redemption date, subject to the terms of the notes.

Non-Derivative Off-Balance Sheet Arrangements

Financial Commitments

We have future obligations for debt repayments and future minimum rentals under operating leases. These obligations as of June 30, 2004 have not materially changed from those amounts previously reported in our financial statements for the three months ended December 31, 2003.

Our debt and certain of our lease obligations require us to maintain compliance with financial and non-financial covenants, including minimum earnings before interest, taxes, depreciation, amortization and rent, limitations on capital expenditures, maximum leverage ratios, minimum fixed charge coverage ratios and minimum net worth. Failure to meet these covenants or the occurrence of other defaults, such as non-payment, could result in the acceleration of the maturity of such obligations.

In accordance with our credit agreement entered into on December 1, 2003, certain letters of credit reduce the available funds under our revolving credit facility. As discussed in Note 10 in the notes to the condensed consolidated financial statements, we have a guarantee obligation that collateralizes the payments of certain properties that are leased and subleased by GHC. As the surviving entity after the spin-off, we have assumed this guarantee as a result of the transaction and the respective guarantees have not been assigned in accordance with the separation and distribution agreement. GHC has agreed to indemnify us for the majority of the guarantees to the extent that we remain the guarantor for annual lease payments approximating \$4.2 million.

Effective December 16, 2003, we exercised our option for the 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 our common stock pursuant to the terms of our amended and restated articles of incorporation, as amended.

Significant Accounting Policies

Management's discussion and analysis of financial condition and results of operations are based upon our unaudited condensed consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. Such financial statement preparation requires management to make judgments and use estimates regarding significant accounting policies. We consider an accounting policy to be significant if it is important to our financial condition and results, and requires significant judgment and estimates on the part of management in its application. Our 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 the critical 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. We believe that the following represents our critical accounting policies, which are described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2003 and our related Current Report on Form 8-K filed with the Securities and Exchange Commission on May 3, 2004:

Allowance for Doubtful Accounts

We utilize the Aging Method to evaluate the adequacy of our allowance for doubtful accounts. This method is based upon applying estimated standard allowance requirement percentages to each accounts receivable aging category for each type of payor. We have developed estimated standard required allowance percentages by utilizing historical collection trends and our understanding of the nature and collectibility of receivables in the various aging categories and the various segments of our business. The standard allowance percentages are developed by payor type as the accounts receivable from each payor type have unique characteristics. The allowance for doubtful accounts is determined utilizing the Aging Method described above while also considering accounts specifically identified as uncollectible. Accounts receivable that we specifically estimate to be uncollectible, based upon the age of the receivables, the results of collection efforts or other circumstances, are reserved for in the allowance for doubtful accounts until they are written-off.

We continue to refine our assumptions and methodologies underlying the Aging Method. However, because the assumptions underlying the Aging Method are based upon historical collection data, there is a risk that our current assumptions are not reflective of more recent collection patterns. Changes in market conditions and/or budgetary constraints of government funded programs such as Medicare and Medicaid can cause changes in overall collection patterns. Such changes can adversely impact the collectibility of receivables, but may not be addressed in a timely fashion when using the Aging Method, until updates to our periodic historical collection studies are completed and implemented.

At least annually, we update our historical collection studies in order to evaluate the propriety of the assumptions underlying the Aging Method. Any changes to the underlying assumptions are implemented immediately. Changes to these assumptions can have a

material impact on our bad debt expense, which is reported in the consolidated statements of operations as a component of selling, general and administrative expenses.

Inventory

Inventories for all business units consist primarily of purchased pharmaceuticals and medical supplies and equipment and are stated at acquisition cost. Counts of inventories on hand are performed at least quarterly at all sites. Because we do not utilize a perpetual inventory system, cost of revenues is estimated during non-inventory months and is adjusted to actual by recording the results of the count of actual physical inventories. We utilize the following criteria in developing estimated cost of revenues during non-inventory months:

historical cost of revenues trends based on the two most recent physical inventory counts; and

consideration and analysis of changes in customer base, product mix, or other issues that may impact cost of revenues.

There are no significant obsolescence reserves recorded since we have not historically experienced (nor do we expect to experience) significant levels of inventory obsolescence.

Manufacturer Rebates

Certain of our manufacturers of pharmaceutical products offer rebates for meeting a targeted volume of purchases on a quarterly basis. These rebate agreements are contractually binding. We recognize these rebates as a reduction of inventory costs in the quarter in which they are earned when they are reasonably estimable and payment is probable.

Revenue Recognition/Contractual Allowance

Revenue is recognized on a monthly basis for products or services provided to customers during that month. The revenue cycle ends on the last day of the month. We receive payments from state Medicaid programs, long-term care facilities, individual residents (private pay), private third-party insurers and Medicare programs. The state Medicaid programs are highly regulated. Our failure to comply with applicable reimbursement regulations could adversely affect our business. We report revenues at the net realizable amount expected to be received from third-party payors and monitor our receivables from state Medicaid programs and other third-party payor programs.

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An estimated contractual allowance is recorded against third-party sales and accounts receivable (Medicaid and insurance) to reduce the net revenues and accounts receivable reported in our financial statements to the amount expected to be received from the third-party payor. Contractual allowances are adjusted to actual as cash is received and applied and claims are reconciled. We utilize the following criteria in developing the estimated contractual allowance percentages each month:

historical contractual allowance trends on actual claims paid by third-party payors;

review of contractual allowance information reflecting current contract terms; and

consideration and analysis of changes in customer base, product mix, reimbursement levels or other issues that may impact contractual allowances.

Valuation of Long-Lived Assets

We account for long-lived assets, other than goodwill with an indefinite useful life, in accordance with the provisions of SFAS No. 144. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparison of the carrying amount of an asset to the future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized to the extent the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or the fair value less costs to sell.

With regard to goodwill, we adopted SFAS No. 142, *Goodwill and Other Intangible Assets*, (SFAS 142) on September 30, 2001 in accordance with the early adoption provisions of SOP 90-7. SFAS 142 provides that goodwill no longer be amortized on a recurring basis but rather is subject to periodic impairment testing. Prior to adopting SFAS 142, we amortized goodwill over periods not exceeding 40 years. The impairment test requires us to compare the fair value of our businesses to their carrying value including assigned goodwill. SFAS 142 requires an impairment test annually. Our assessments to date have indicated that goodwill has not been impaired. Events may occur in the future that could result in an impairment of our goodwill, and any resulting impairment charge could be material to our financial position, results of operations or cash flows.

Our senior management has reviewed these critical accounting policies and estimates with our audit committee. During the current quarter, we did not make any material changes to our estimates or methods by which estimates are derived with regard to our critical accounting policies.

Seasonality

Our earnings generally fluctuate from quarter to quarter. This seasonality is related to a combination of factors, which include the timing of Medicaid rate changes and payroll tax obligations, seasonal census cycles, weather conditions and the number of calendar days in a given quarter.

Impact of Inflation

Our product costs are sensitive to the impact of inflation. We have implemented cost control measures to limit increases in operating costs and expenses but cannot predict our ability to control such operating cost increases in the future. See Cautionary Statement Regarding Forward-Looking Statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

In the first quarter of fiscal 2004, we entered into a new senior credit facility consisting of a \$100.0 million revolving credit facility that bears interest based on variable rates. We have not yet borrowed against the facility, but at the point that we do borrow against this credit facility, we will be exposed to the impact of interest rate changes. We intend to take steps to mitigate this risk in order to limit the impact of such changes in interest rates on earnings and cash flows and to lower overall borrowing costs. We may manage those risks by entering into derivative financial instruments. We will not enter into such arrangements for trading purposes. If we were to borrow the total \$100 million revolving debt without entering into derivative financial instruments, a 1% increase in the rate of interest would result in additional interest expense of \$1.0 million annually.

As of June 30, 2004, we were not a party to any derivative instrument.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in reaching a reasonable level of assurance that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time period specified in the Securities and Exchange Commission's rules and forms.

Our principal executive officer and principal financial officer also conducted an evaluation of our internal control over financial reporting (Internal Control) to determine whether any changes in Internal Control occurred during the quarter that have materially affected or which are reasonably likely to materially affect Internal Control. Based on that evaluation, there has been no such change during the quarter covered by this report.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. We conduct periodic evaluations to enhance, where necessary our procedures and controls.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

U.S. ex rel Scherfel v. Genesis Health Ventures et al.

In this action, brought in United States District Court for the District of New Jersey on March 16, 2000, the plaintiff alleges that a pharmacy purchased by us failed to process Medicaid credits for returned medications. The allegations are vaguely alleged for other jurisdictions. While the action was under seal in United States District Court, we fully cooperated with the Department of Justice's evaluation of the allegations. On or about March 2001, the Department of Justice declined to intervene in the suit and prosecute the allegations. The United States District Court action is no longer under seal but remains administratively stayed pending resolution of the bankruptcy issues.

The plaintiff filed a proof of claim in our bankruptcy proceedings initially for approximately \$650 million and subsequently submitted an amended claim in the amount of approximately \$325 million. We believe the allegations have no merit and objected to the proof of claim. In connection with an estimation of the proof of claim in the bankruptcy proceeding, we filed a motion for summary judgment urging that the claim be estimated at zero. On or about January 24, 2002, the United States Bankruptcy Court granted our motion and estimated the claim at zero.

On or about February 11, 2002, the plaintiff appealed the Bankruptcy Court's granting of summary judgment to the United States District Court in Delaware and sought an injunction preventing the distribution of assets according to the plan of reorganization. The injunction was subsequently denied by the United States District Court for several reasons, including that the plaintiff was unlikely to succeed on the merits. When the injunction was denied by the United States District Court, the assets previously reserved for the plaintiff's claim were distributed in accordance with the plan of reorganization. On March 27, 2003, the United States District Court denied the plaintiff's appeal and upheld the summary judgment decision rendered by the United States Bankruptcy Court. The plaintiff filed an appeal to the Third Circuit Court of Appeals, which was heard April 13, 2004. A decision is expected by the end of the calendar year.

Haskell et al v. Goldman Sachs & Co. et al.

This action was brought January 27, 2004, in the Supreme Court of New York, County of New York, by 275 former investors who collectively held over \$205 million in subordinated debentures prior to the filing of our Chapter 11 bankruptcy petition in 2000. The case was subsequently removed to federal court and it is now pending in the U.S. District Court for the District of Delaware. The plaintiffs allege fraud and grossly negligent misrepresentation by the defendants in connection with the Bankruptcy Court's approval of our plan of reorganization confirmed by the Bankruptcy Court in 2001, canceling the subordinated debentures. The defendants, in addition to us, are Goldman Sachs & Co., Mellon Bank, N.A., Highland Capital Management, LP, and George V. Hager, Jr., our chief financial officer during the period in question. The plaintiffs seek to recover \$200 million plus interest costs and fees.

Freeport Partners, LLC v. Arlotta et al.

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This action was brought June 8, 2004, against us and our directors in the Supreme Court of New York, County of New York, as a purported class action alleging that our board of directors breached their fiduciary duties to the plaintiff and the class and aided and abetted such breaches in connection with a proposal by Omnicare, Inc. to acquire all of our outstanding common stock.

Item 2. Changes in Securities and Use of Proceeds None

Item 3. Defaults Upon Senior Securities None

Item 4. Submission of Matters to a Vote of Security Holders

The annual meeting of shareholders was held June 15, 2004 in Baltimore, Maryland. Proxies were solicited for the meeting pursuant to Regulation 14A of the Securities and Exchange Act of 1934, as amended.

Pursuant to the election of the three directors listed below, Messrs. Arlotta, Fish and Reimers were each elected as Class I directors to serve until the 2007 Annual Meeting of Shareholders and until their successors are duly elected and qualified. Messrs. Bloem and Dondero and Ms. Yale continue to serve as Class II directors to serve until the 2006 Annual Meeting of Shareholders and Messrs. Dalton and Gerbino continue to serve as Class III directors to serve until the 2005 Annual Meeting of Shareholders, each until their successors are duly elected and qualified.

At the meeting, the following matters were submitted to a vote of shareholders:

1. Election of the following persons to serve as Class I directors of NeighborCare, Inc. until the 2007 Annual Meeting of Shareholders and until their successor are duly elected and qualified:

	Total Vote for Each Director	Total Vote Withheld From Each Director
John J. Arlotta	35,586,975	602,583
Robert H. Fish	35,510,620	678,938
Arthur J. Reimers	35,600,214	589,344

2. Approval of NeighborCare, Inc.'s 2004 Performance Incentive Plan:

For	Against	Abstain	Broker Non-Votes
18,681,843	5,994,574	15,618	11,497,523

3. Ratification of the appointment of KPMG LLP as NeighborCare, Inc.'s independent accountants for the fiscal year ending September 30, 2004:

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For	Against	Abstain	Broker Non-Votes
36,103,448	83,531	2,759	

Item 5. Other Information None

Item 6. Exhibits and Reports on Form 8-K

- (a) Exhibits
- 3.1 (1) Amended and restated bylaws.
 - 10.1 (2) Employment Agreement between Richard W. Hunt and NeighborCare, Inc. dated June 29, 2004.
 - 31.1 Certification of John J. Arlotta, Chairman, President and Chief Executive Officer of the Company, dated August 11, 2004 pursuant to Securities and Exchange Act Rule 13d-14(a)/15d-14(a), as adopted pursuant to Sections 302 and 404 of the Sarbanes-Oxley Act of 2002.
 - 31.2 Certification of Richard W. Hunt, Chief Financial Officer of the Company, dated August 11, 2004 pursuant to Securities and Exchange Act Rule 13d-14(a)/15d-14(a), as adopted pursuant to Sections 302 and 404 of the Sarbanes-Oxley Act of 2002.
 - 32.1 Certification of John J. Arlotta, Chairman, President and Chief Executive Officer, and Richard W. Hunt, Chief Financial Officer, of the Company dated August 11, 2004 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- (1) Incorporated by reference to NeighborCare, Inc.'s Current Report on Form 8-K filed on June 16, 2004.
 - (2) Incorporated by reference to Amendment No. 4 to NeighborCare, Inc.'s Schedule 14D-9 filed on June 30, 2004.
- (b) Reports on Form 8-K
- The following reports on Form 8-K were filed or furnished, as applicable, by NeighborCare, Inc. during the quarterly period ended June 30, 2004:
1. On April 16, 2004, the Company filed a Current Report on Form 8-K under Item 10 announcing the approval and adoption of a combined Code of Business Conduct and Ethics for the Company in satisfaction of both the requirements of the code of ethics definition enumerated in Item 406(b) of Regulation S-K and the NASDAQ corporate governance rules regarding a company's code of conduct.
 2. On April 30, 2004, the Company filed a Current Report on Form 8-K under Items 5 and 7 updating Items 6, 7 and 15(a)(1) and (2) of the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2003, as filed with the Securities and Exchange Commission on December 24, 2003 and amended on December 29, 2003, reflecting the spin-off of GHC as discontinued operations.
 3. On May 12, 2004, the Company filed a Current Report on Form 8-K under Items 7, 9 and 12 reporting its financial results for the fiscal quarter ended March 31, 2004 and announcing the resignation of Richard W. Sunderland, Jr. as Senior Vice President and Chief Financial Officer.
 4. On June 15, 2004, the Company filed a Current Report on Form 8-K under Items 5 and 7 adopting the amended and restated bylaws of the Company and filing the Separation Agreement between NeighborCare and Richard W. Sunderland, Jr.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 11, 2004

NeighborCare, Inc.

/s/ RICHARD W. HUNT
Richard W. Hunt
Chief Financial Officer

Date: August 11, 2004

/s/ JOHN J. ARLOTTA
John J. Arlotta
Chairman, President and Chief Executive Officer