NEIGHBORCARE INC
Form 10-K
December 24, 2003
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2003

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 0-33217

NEIGHBORCARE, INC.
(Exact name of Registrant as specified in its charter)

Pennsylvania	**7 East Lee Street Baltimore, MD 21202**	**06-1132947**
(State or other jurisdiction of incorporation or organization)	(Address of principal executive offices including zip code)	(I.R.S. Employer Identification Number)

(410) 752-2600
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

NONE

Securities registered pursuant to Section 12(g) of the Act:

Title of each class

Common Stock, par value $.02 per share
Preferred Share Purchase Rights, no par value per share

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (subsection 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by

reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of voting and non-voting common stock held by non-affiliates of the registrant is $499,529,659[(1)]. As of December 17, 2003, 43,093,682 shares of the registrant s common stock were outstanding and 260,493 shares are to be issued in connection with the registrant s joint plan of reorganization confirmed by the Bankruptcy Court on September 20, 2001.

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

YES NO

APPLICABLE ONLY TO REGISTRANTS 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 Section 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

DOCUMENTS INCORPORATED BY REFERENCE

NONE

(1) The aggregate market value of the voting and non-voting common stock set forth above equals the number of shares of the registrant s common stock outstanding, reduced by the number of shares of common stock held by officers, directors and shareholders owning in excess of 10% of the registrant s common stock, multiplied by the last reported sale price for the registrant s common stock on the last business day of the registrant s most recently completed second fiscal quarter (i.e., March 31, 2003) ($14.86). The information provided shall in no way be construed as an admission that any officer, director or 10% shareholder of the registrant may or may not be deemed an affiliate of the registrant or that he/it is the beneficial owner of the shares reported as being held by him/it, and any such inference is hereby disclaimed. The information provided herein is included solely for record keeping purposes of the Securities and Exchange Commission.

INDEX

		Page
Cautionary Statements Regarding Forward-Looking Statements		1
Risk Factors		2
	PART I	
ITEM 1:	BUSINESS	12
ITEM 2:	PROPERTIES	34
ITEM 3:	LEGAL PROCEEDINGS	36
ITEM 4:	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	37
ITEM 4A:	EXECUTIVE OFFICERS OF THE REGISTRANT	37
	PART II	
ITEM 5:	MARKET FOR THE REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS	38
ITEM 6:	SELECTED FINANCIAL DATA	40
ITEM 7:	MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	42
ITEM 7A:	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	70
ITEM 8:	FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA	72
ITEM 9:	CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE	120
ITEM 9A:	CONTROLS AND PROCEDURES	120
	PART III	
ITEM 10:	DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT	121
ITEM 11:	EXECUTIVE COMPENSATION	125
ITEM 12:	SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS	133
ITEM 13:	CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS	136
	PART IV	
ITEM 14:	PRINCIPAL ACCOUNTING FEES AND SERVICES	136
ITEM 15:	EXHIBITS, FINANCIAL STATEMENT SCHEDULE AND REPORTS ON FORM 8-K	137

Back to Index

Cautionary Statements 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:

- statements contained in Risk Factors;
- certain statements in Management s Discussion and Analysis of Financial Condition and Results of Operations, and our notes to our 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 reimbursement for services provided, including the Medicare Prescription Drug, Improvement and Modernization Act of 2003; and our ability to successfully implement our strategic objectives and achieve certain performance improvement initiatives; the expected financial impact of severance and related costs; the expected spin-off costs in fiscal 2004 and the foreseeable future; and estimates in our critical accounting policies, including our allowance for doubtful accounts, the anticipated impact of long-lived asset impairments and our ability to provide for loss reserves for self-insured programs;
- certain statements contained in Business concerning strategy, corporate integrity programs, insurance coverage, environmental matters, government regulations and the Medicare and Medicaid programs, and reimbursement for services provided; 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, which are discussed more fully in Risk Factors:

- our ability, and the ability of our customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;
- changes in the reimbursement rates or methods of payment from Medicare and Medicaid, or the implementation of other legislation or measures to reduce the reimbursement for our services;
- the expiration or phase out of enactments providing for additional governmental funding;
- changes in pharmacy legislation and/or payment formulas;
- the impact of federal and state regulations;
- the impact of investigations and audits relating to alleged violations of federal and/or state regulations;
- changes in the acuity of our customer s patients, payor mix and payment methodologies;
- further consolidation of managed care organizations and other third-party payors;
- the effect of the expiration or termination of certain service and supply contracts;
- changes in or our failure to satisfy our manufacturer s rebate programs;
- competition in our business;
- competition for qualified management and pharmacy professionals;
- an economic downturn or changes in the laws affecting our business in those markets in which we operate;

Back to Index

the impact of any acquisitions on our operations;

availability of financial and other resources to us after the spin-off of Genesis HealthCare Corporation (GHC);

operating inefficiencies and higher costs 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 of GHC, as our largest customer, to act as a separate entity;

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

our ability, and the ability of our subsidiary guarantors, to fulfill debt obligations;

the enforceability or limitations of the guarantees on our senior subordinated notes;

the liquidity of our senior subordinated notes as a new issue of securities;

our ability to repurchase or fulfill our obligations on our senior subordinated notes; and

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

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.

RISK FACTORS

If we or our client institutions fail to comply with Medicare or Medicaid reimbursement regulations, our revenue could be reduced, we could be subject to penalties and we could lose our eligibility to participate in these programs.

For the year ended September 30, 2003, approximately 44% of our pharmacy services billings were directly reimbursed by government-sponsored programs, including Medicaid and, to a lesser extent, Medicare. The Medicare and Medicaid programs are highly regulated. Our failure to comply with applicable reimbursement regulations could adversely affect the reimbursement we receive and our ability to participate in Medicare and Medicaid. Our failure to comply with these regulations could subject us to other civil and criminal penalties. Moreover, the Medicaid program is significantly dependent upon federal rules. Any limitation of federal funding to states under their Medicaid program could negatively affect our business.

Continuing efforts to contain healthcare costs may reduce our future revenue.

Our sales and profitability are affected by the efforts of healthcare payors to contain or reduce the cost of healthcare by lowering reimbursement rates, limiting the scope of covered services, and negotiating reduced or

Back to Index

capitated pricing arrangements. Any changes that lower reimbursement levels under Medicare, Medicaid or private pay programs, including managed care contracts, could reduce our future revenue. Furthermore, other changes in these reimbursement programs or in related regulations could reduce our future revenue. These changes may include modifications in the timing or processing of payments and other changes intended to limit or decrease the growth of Medicare, Medicaid or third-party expenditures.

Healthcare-related legislation has significantly impacted our business, and future legislation and regulations may negatively affect our financial condition and results of operations.

In recent years, Congress has passed a number of federal laws that have effected major changes in the healthcare system, including, without limitation, changes under the Medicare and Medicaid programs. Our business is directly affected by changes in reimbursement rates and methodologies for pharmaceutical services and indirectly affected through the changes that negatively impact our healthcare clients. Several of these changes have had a significant impact on us.

It is not possible to quantify fully the effect of potential legislative changes, the interpretation or administration of such legislation or any other governmental initiatives on our business. 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 is complex and can result in delays between the time that revenue is recognized and the time that reimbursement amounts are settled.

The recent legislation, titled the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, referred to as the Medicare Modernization Act, passed by Congress on November 25, 2003 and signed by the President on December 8, 2003, may have a significant impact on long-term care pharmacy services with respect to Medicare coverage and payment rates to facilities and individual suppliers. The Medicare Modernization Act constitutes a significant overhaul of the Medicare system, including provisions which add a prescription drug benefit under Medicare starting in 2006, provide subsidies to insurers and managed care organizations and establish mechanisms to allow private health care coverage plans to compete with Medicare initially on a pilot basis. In addition, the Medicare Modernization Act phases out the average wholesale price reimbursement system related to certain outpatient pharmaceutical drugs and biologicals. For discussion of the Medicare Modernization Act, see Part I, Item 1, Business NeighborCare, Inc. Medicare and Medicaid, of this Form 10-K.

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 this 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 long-term care pharmacy services. This legislation may reduce revenue and impose additional costs to the industry. Moreover, the United States Department of Health and Human Services, referred to as DHHS, has not yet promulgated any regulations under the Act, as the Act requires it to do. The impact of these regulations when promulgated, including those regulations relating to the prescription drug discount plan discussed above, is unclear.

We have described only certain provisions of the Medicare Modernization Act applicable to our business. There may be other provisions of the legislation that may impact our business by decreasing revenues or increasing operational expenses. We can make no assurance as to the effect of these provisions on our business.

The phase out of the average wholesale price reimbursement system related to certain outpatient pharmaceutical drugs and biologicals under the Medicare Modernization Act could adversely affect our business. In addition, a second initiative under consideration at the federal level is a program to further reduce reimbursement for specific types of drugs. These initiatives have focused on certain therapies that are not extensively utilized in long-term care facilities. However, if this program were to be expanded, such a decision could have an adverse impact on our business.

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Back to Index

State Medicaid program reimbursement is directly affected by the Medicare Modernization Act and may have a material adverse effect on our operating results.

The reimbursement rates for pharmacy services under Medicaid are determined on a state-by-state basis subject to applicable federal law and review by the Centers for Medicare and Medicaid Services, the agency within DHHS that is responsible for the Medicare and Medicaid programs. 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 us 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. The Medicare Modernization Act s phase out of the use of average wholesale price related to certain outpatient pharmaceutical drugs and biologicals might impact these current payment methodologies.

State Medicaid programs generally have long-established programs for reimbursement which have been revised and refined over time and have not had a material adverse effect on the pricing policies or receivables collection for long-term care facility pharmacy services. Any future changes in such 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.

In order to control healthcare costs, we anticipate that federal and state governments will continue to review and assess alternate healthcare delivery systems, payment methodologies and operational requirements for healthcare providers, including long-term care facilities and pharmacies. Given the continuous debate regarding the cost of healthcare, managed care and other healthcare issues, we cannot predict with any degree of certainty what additional healthcare initiatives, if any, will be implemented or the effect any future legislation or regulation will have on our business.

While Congress has expanded Medicare to cover certain costs of outpatient pharmaceutical services, the federal and state governments continue to focus on efforts to curb spending on healthcare programs such as Medicare and Medicaid. A number of states have enacted or are considering cost containment initiatives. Many of these initiatives focus on reducing the amount that the state Medicaid program will pay for drug acquisition costs. Some have attempted to impose more stringent pricing standards. Institutional pharmacies are often paid a dispensing fee over and above the payment for the drug. To the extent that changes in the payment for drugs are not accompanied by an increase in the dispensing fee, margins could erode. Some states have explored efforts to restrict utilization by requiring the use of preferred drug lists, prior-authorization and formularies. A few states have attempted to extend the preferred Medicaid pricing to all Medicare beneficiaries. 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 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.

Healthcare reform and legislation may reduce payments to our skilled nursing facility customers, which may negatively impact our ability to fund our working capital needs.

Healthcare reform and legislation has an indirect effect on our business through decreasing funds available to our skilled nursing facility customers. Limitations or restrictions on Medicare and Medicaid payments to skilled nursing facilities could adversely impact the liquidity of our pharmacy and other service related business customers, resulting in their inability to pay us, or to pay us timely, for our products and services. This factor could require us to borrow in order to fund our working capital needs, and, in turn, cause us to become more highly leveraged.

We derive a significant portion of our revenue from state Medicaid programs and the recent economic downturn in the states in which we operate could have a material adverse effect on our operating results.

There are numerous reports affirming that the recent economic downturn has had a detrimental effect on state revenues. Historically, these budget pressures have translated into reductions in state spending. Given that Medicaid outlays are a significant component of state budgets, we expect continuing cost containment pressures on Medicaid outlays for nursing homes and pharmacy services in the states in which we operate.

Back to Index

If we, or our long-term care customers, fail to comply with licensure requirements or other applicable laws, we may need to curtail operations, and could be subject to significant penalties.

Our pharmacy services business is subject to extensive and often changing federal, state and local regulations, and our pharmacies are required to be licensed in the states in which they are located or do business. We continuously monitor the effects of regulatory activity on our operations and we currently have pharmacy licenses for each pharmacy we operate. The failure to obtain or renew any required regulatory approvals or licenses could adversely affect the continued operation of our business. The long-term care facilities that contract for our services are also subject to federal, state and local regulations and are required to be licensed in the states in which they are located. The failure by these long-term care facilities to comply with these or future regulations or to obtain or renew any required licenses could result in our inability to provide pharmacy services to these facilities and their residents.

We conduct business in a heavily regulated industry, and changes in regulations or violations of regulations including fraud and abuse laws may result in increased costs or sanctions.

We are also subject to federal and state laws that prohibit some types of direct and indirect payments between healthcare providers. These laws, commonly known as the fraud and abuse laws, prohibit payments intended to induce or encourage the referral of patients to, or the recommendation of, a particular provider of items or services. Violation of these laws can result in loss of licensure, civil and criminal penalties and exclusion from the Medicare, Medicaid and other federal healthcare programs. We are subject to periodic audits under 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. Rights and remedies available to these programs include repayment of any amounts alleged to be overpayments or in violation of program requirements, or making deductions from future amounts due to us. These programs may also impose fines, criminal penalties or program exclusions. Other third-party payor sources also reserve the right to conduct audits and make monetary adjustments in connection with or exclusive of audit activities.

In the ordinary course of our business, the long-term care facilities we service receive notices of deficiencies for failure to comply with conditions of participation in the Medicare and Medicaid programs. This non-compliance may have a negative effect upon our business.

We are also subject to federal and state laws that govern financial and other arrangements between healthcare providers. These laws often prohibit certain direct and indirect payments or fee-splitting arrangements between healthcare providers that are designed to induce the referral of patients to a particular provider for medical products and services. Possible sanctions for violation of any of these restrictions or prohibitions include loss of eligibility to participate in reimbursement programs and/or civil and criminal penalties.

We have established policies and procedures that we believe are sufficient to ensure that our facilities will operate in substantial compliance with these anti-fraud requirements. While we believe that our business practices are consistent with Medicare and Medicaid criteria, those criteria are often complex and subject to change and interpretation. Aggressive anti-fraud actions, however, could have an adverse effect on our financial condition, results of operations and cash flows.

In addition, a number of states have undertaken enforcement actions against pharmaceutical manufacturers involving pharmaceutical marketing programs, including programs containing incentives to pharmacists to dispense one particular product rather than another. These enforcement actions arose under state consumer protection laws, which generally prohibit false advertising, deceptive trade practices and the like.

New federal medical privacy regulations may increase the costs of operations and expose us to civil and criminal sanctions.

We face additional federal requirements that mandate major changes in the transmission and retention of health information. The Health Insurance Portability and Accountability Act of 1996 was enacted first, to ensure that employees can retain and at times transfer their health insurance when they change jobs, and second, to simplify healthcare administrative processes. This simplification includes expanded protection of the privacy and security of personal medical data and requires the adoption of standards for the exchange of electronic health information.

Back to Index

Among the standards that the Secretary of Health and Human Services has adopted pursuant to the Health Insurance Portability and Accountability Act are standards for electronic transactions and code sets, and it may adopt unique identifiers for providers, employers, health plans and individuals, security and electronic signatures, privacy and enforcement. Although the Health Insurance Portability and Accountability Act was intended to ultimately reduce administrative expenses and burdens faced within the healthcare industry, we believe that implementation of this law will result in additional costs. Failure to comply with the Health Insurance Portability and Accountability Act could result in fines and penalties that could have a material adverse effect on us.

Possible changes in the acuity of patients as well as payor mix and payment methodologies may significantly affect our profitability.

The sources and amounts of our revenues will be determined by a number of factors, including licensed bed capacity and occupancy rates of the centers we supply, the acuity of patients and the rates of reimbursement among payors. Changes in the acuity of the patients as well as payor mix among private pay, Medicare and Medicaid in the centers we supply will significantly affect our profitability. Particularly, any significant increase in the Medicaid population in such facilities could have a material adverse effect on our financial condition, results of operations and cash flows, especially if states operating these programs continue to limit, or more aggressively seek limits on, reimbursement rates.

Further consolidation of managed care organizations and other third-party payors may adversely affect our profits.

Managed care organizations and other third-party payors have continued to consolidate in order to enhance their ability to influence the delivery of healthcare services. Consequently, the healthcare needs of a large percentage of the U.S. population are increasingly served by a small number of managed care organizations. These organizations generally enter into service agreements with a limited number of providers for needed services. To the extent that such organizations terminate us as a preferred provider and/or engage our competitors as a preferred or exclusive provider, our business could be materially and adversely affected. In addition, private payors, including managed care payors, increasingly are demanding discounted fee structures.

We purchase a significant portion of our pharmaceutical products from one supplier.

We obtain approximately 98% of our pharmaceutical products from one supplier pursuant to contracts that are terminable by either party on 90 days notice. If these contracts are terminated, there can be no assurance that our operations would not be disrupted or that we could obtain the products at similar cost. In this event, failure to satisfy our customers requirements could materially and adversely affect our business, results of operations and financial condition.

Possible changes in or our failure to satisfy our manufacturers rebate programs could adversely affect our results of operations.

We currently earn rebates from certain manufacturers of pharmaceutical products for meeting targeted purchase volumes on a quarterly basis. There can be no assurance that our pharmaceutical manufacturers will continue to offer these rebates or that we will continue to satisfy the targeted purchase volumes. The termination of such programs or our failure to satisfy the targeted volumes may have an adverse affect on our cost of sales and inventory costs.

We face intense competition in our business.

We compete with a variety of other companies in providing pharmacy services, many of which have greater financial and other resources than we do and may be more established in their respective communities than we are. Competing companies may offer newer or different services than we do and may thereby attract customers who are presently our customers or are otherwise receiving our services.

The provision of pharmacy services in the long-term care industry is highly competitive. In the 32 states and in the District of Columbia where we sell pharmacy products and services, we compete with multiple national, regional and local institutional pharmacies. Institutional pharmacies compete principally on the basis of service, integrity, clinical expertise, fair pricing and the ability to form strong relationships with key personnel.

Back to Index

We are dependent on our senior management team and our pharmacy professionals.

We are highly dependent upon the members of our senior management team, our pharmacists and other pharmacy professionals. Our business is managed by a small number of key management personnel, including John J. Arlotta, who became our chairman, president and chief executive officer after the spin-off. If we were unable to retain these persons, we might be adversely affected. Our industry is small and there is a limited pool of senior management personnel with significant experience in our industry. Accordingly, we believe we could experience significant difficulty in replacing key management personnel. Although we have employment contracts with our key management personnel, these contracts generally may be terminated without cause by either party.

In addition, our continued success depends on our ability to attract and retain pharmacists and other pharmacy professionals. Competition for qualified pharmacists and other pharmacy professionals is intense. The loss of pharmacy personnel or the inability to attract, retain or motivate sufficient numbers of qualified pharmacy professionals could adversely affect our business. Although we generally have been able to meet our staffing requirements for pharmacists and other pharmacy professionals in the past, our inability to do so in the future could have a material adverse effect on us.

A significant portion of our business is concentrated in certain markets, and an economic downturn or changes in the laws affecting our business in those markets could have a material adverse effect on our operating results.

We receive approximately 62% of our revenue from operations in the states of Maryland, New Jersey, Pennsylvania, Virginia, Ohio and West Virginia. The economic condition of these markets could affect the ability of our patients and third-party payors to reimburse us for our services through a reduction of disposable household income or the ultimate reduction of the tax base used to generate state funding of their respective Medicaid programs. An economic downturn in these markets and in surrounding markets or changes in the laws affecting our business could have a material adverse effect on our financial condition, results of operations and cash flows.

We may make acquisitions that could subject us to a number of operating risks.

We anticipate that we may make acquisitions of, investments in and strategic alliances with complementary businesses to enable us to capitalize on our strong position in the geographic markets in which we operate and to expand our businesses in new geographic markets. However, implementation of this strategy entails a number of risks, including:

- inaccurate assessment of undisclosed liabilities;
- entry into markets in which we may have limited or no experience;
- diversion of management s attention from our core business;
- difficulties in assimilating the operations of an acquired business or in realizing projected efficiencies and cost savings;
- increase in our indebtedness and a limitation on our ability to access additional capital when needed; and
- difficulties in obtaining anticipated revenue synergies or cost reductions.

In addition, certain changes may be necessary to integrate the acquired businesses into our operations, assimilate many new employees and implement reporting, monitoring, compliance and forecasting procedures.

Back to Index

We have no history operating as an entity without our eldercare businesses.

Historically, our operations were conducted as part of a consolidated entity with GHC and not as a separate entity. As a result of the spin-off, we own and operate the pharmacy services business and GHC owns and operates the inpatient services business and other ancillary businesses. Neither of these businesses has an operating history as a separate company. The spin-off may result in some temporary dislocation and inefficiencies to our business operations, as well as impact the overall management of our company. In addition, operating these businesses independently may be more expensive, more complicated or more difficult than operating them together.

Since we and our subsidiaries emerged from bankruptcy on October 2, 2001, there is limited operating and financial data available from which to analyze our operating results and cash flows.

Financial information related to our and our subsidiaries operations after our emergence from bankruptcy is limited and therefore, it is difficult to compare such post-bankruptcy financial information with that of prior periods. Additionally, this information reflects the results of fresh-start reporting which also makes comparison of results of operations and financial condition after our emergence from bankruptcy to the results of prior periods difficult. For additional information, see Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of this Form 10-K.

Our historical financial information and our pro forma financial information may not be representative of our results as a separate company.

Historically, our operations were conducted as part of a consolidated entity with GHC and not as a separate entity. Accordingly, the pro forma financial information included in the notes to our consolidated financial statements may not reflect the results of operations and financial condition that would have been achieved had our company been operated independently during the period and as of the dates presented. In addition, the historical pharmacy services segment information contained herein may not be indicative of how our business would have performed had the spin-off occurred during the periods presented. Such segment information does not, for example, reflect general and administrative and other corporate overhead expenses.

Costs related to our corporate functions, including legal support, treasury administration, insurance administration, human resource management, information systems, internal audit and corporate accounting and income tax administration, which are not directly and solely related to our operations, have been allocated for purposes of preparing pro forma financial information based upon various methodologies deemed reasonable by management. Although our management believes that the methods used to allocate and estimate such expenses are reasonable, there can be no assurance that our actual costs will not be higher, perhaps substantially.

Furthermore, our historical consolidated financial statements do not reflect the costs to us of borrowing funds as a separate entity.

We may be responsible for federal income tax liabilities that relate to our distribution of GHC common stock.

We have received a private letter ruling from the Internal Revenue Service to the effect that the spin-off and certain related transactions will qualify as a tax-free distribution to us and our shareholders under Section 355 of the Internal Revenue Code of 1986, as amended. We and GHC have made certain representations in connection with the private letter ruling, and we will agree to restrictions on certain future actions designed to preserve the tax-free status of the spin-off.

If the spin-off were found to be taxable by reason of any act (or failure to act) by GHC described in certain covenants contained in the spin-off documents, any acquisition of our equity securities or assets, or any breach of any of our representations in the spin-off documents or in the private letter ruling request, the spin-off would be taxable to us and may be taxable to holders of our common stock who received shares of GHC common stock in the spin-off. In such case, under the spin-off documents between us and GHC, GHC will be required to indemnify us against any taxes and related losses. The amount of any such indemnification payment could be substantial and we cannot assure you that GHC will have the ability to satisfy those obligations.

Back to Index

We may be required to satisfy certain indemnification obligations to GHC or may not be able to collect on indemnification rights from GHC.

Under the terms of the separation and distribution agreement, we and GHC have agreed to indemnify each other from and after the distribution with respect to the indebtedness, liabilities and obligations that will be retained by our respective companies. These indemnification obligations could be significant, and we cannot presently determine the amount of indemnification obligations for which we will be liable or for which we will seek payment from GHC. Our ability to satisfy these indemnities, if we are called upon to do so, will depend upon our future financial performance. Similarly, GHC s ability to satisfy any such obligations to us will depend on GHC s future financial performance. We cannot assure you that we will have the ability to satisfy any substantial indemnification obligations to GHC. We also cannot assure you that if GHC is required to indemnify us for any substantial obligations, GHC will have the ability to satisfy those obligations.

Our management owns stock in GHC and there continue to be agreements between us and GHC.

As a result of their ownership of our common stock, most of our officers and certain members of our board of directors own GHC stock received in the spin-off distribution to our shareholders. In addition, certain of our subsidiaries entered into a tax sharing agreement, transition services agreement, a group purchasing agreement, an employee benefits agreement, a pharmacy services agreement, a pharmacy benefit management agreement and a durable medical equipment agreement with GHC. Although we believe the charges for services under the group purchasing agreement, the pharmacy services agreement, the pharmacy benefit management agreement and the durable medical equipment services agreement represent fair market value, there can be no assurance that we could not have obtained more favorable terms from an independent third-party. In some cases, the terms of the new agreements are not as favorable to us as the terms in effect prior to the spin-off. Robert H. Fish, the former chairman of our board of directors and chief executive officer, continues to serve as a director of both GHC and NeighborCare. Ownership of GHC common stock by our officers and directors could create, or appear to create, potential conflicts of interest for these officers and directors when faced with decisions that could have implications for both GHC and us.

GHC, our largest customer, will be subject to its own risks as a result of the spin-off and its operation as a separate entity.

Sales to facilities of GHC, our largest customer, represented 14% of our total revenues for the year ended September 30, 2003 after giving effect to the spin-off. As a result of the spin-off, it is operating for the first time as an independent public entity. GHC is also exposed to risks similar to those outlined herein, including initial operation without the support of the former consolidated corporate infrastructure. In addition, GHC will be highly leveraged. The degree to which GHC is leveraged could materially and adversely affect GHC s ability to obtain financing for working capital, acquisitions or other purposes and could make GHC more vulnerable to industry downturns and competitive pressures. GHC s ability to meet its obligations will be dependent upon its future performance, which will be subject to financial, business and other factors affecting GHC s operations. We are bound by a multi-year contractual arrangement with GHC. If GHC is not able to meet its obligations under this arrangement, our financial condition and results of operations could suffer materially.

Our ability to generate cash to service our indebtedness depends on many factors beyond our control.

Our ability to make payments on our existing and future debt and to fund working capital needs and planned capital expenditures will depend on our ability to generate cash in the future. Risks of future cash generation include the ability to sustain an audfit, and utilized, net operating losses for tax purposes. Our ability to generate cash, to a certain extent, is subject to general economic, financial, competitive, regulatory, legislative and other factors that are beyond our control.

Cost containment and lower reimbursement levels relative to inflationary increases in cost by third-party payors, including federal and state governments, have had a significant impact on the healthcare industry and on our

Back to Index

cash flows. Our operating margins continue to be under pressure because of continuing regulatory scrutiny and growth in operating expenses, such as labor costs and insurance premiums.

We cannot assure you that our business will generate sufficient cash flow from operations or that future borrowings will be available to us in amounts sufficient to enable us to pay our indebtedness or to fund our other liquidity needs. If we do not generate or are unable to borrow sufficient amounts of cash to meet these needs, we may need to refinance all or a portion of our indebtedness on or before maturity, sell assets, curtail discretionary capital expenditures or file for bankruptcy protection. We cannot assure you that we will be able to refinance any of our indebtedness on commercially reasonable terms or at all.

The agreements governing our existing debt permit us, subject to specified conditions, to incur a significant amount of additional indebtedness. If we incur additional debt above current levels, the risks associated with our leverage, including our ability to service our debt, would increase.

The agreements governing our existing debt and preferred stock impose, and future debt may impose, significant operating and financial restrictions on us, which may prevent us from capitalizing on business opportunities and taking some corporate actions.

The agreements and instruments governing our existing debt impose, and the agreements and instruments governing our future debt may impose, significant operating and financial restrictions on us. These restrictions, among other things, limit our ability to:

incur additional indebtedness;

issue redeemable preferred stock;

pay dividends or make other distributions to our shareholders;

repurchase our stock;

make certain investments;

create liens;

sell or otherwise dispose of certain assets;

consolidate, merge or sell all of our assets;

prepay, redeem or repurchase debt;

enter into transactions with affiliates; and

engage in certain business activities.

In addition, the agreements and instruments governing our existing debt require us to maintain specified financial ratios and satisfy other financial condition tests. We cannot assure you that these covenants will not adversely affect our ability to finance our future operations or capital needs or to pursue available business opportunities or limit our ability to plan for or react to market conditions or meet capital needs or otherwise restrict our activities or business plans. A breach of any of those covenants or our inability to maintain the required financial ratios could result in a default in respect of the related indebtedness. If a default occurs, the relevant lenders could elect to declare the indebtedness, together with accrued interest and other fees, to be immediately due and payable and proceed against any collateral securing that indebtedness.

Back to Index

The terms of our outstanding preferred stock also contain restrictions on our ability to complete certain types of transactions without the consent of the holders of our preferred stock.

Provisions in Pennsylvania law and our corporate charter documents could delay or prevent a change in control.

As a Pennsylvania corporation, we are governed by the Pennsylvania Business Corporation Law of 1988, as amended, referred to as Pennsylvania corporation law. Pennsylvania corporation law provides that the board of directors of a corporation in discharging its duties, including its response to a potential merger or takeover, may consider the effect of any action upon employees, shareholders, suppliers, customers and creditors of the corporation, as well as upon communities in which offices or other establishments of the corporation are located, and all other pertinent factors. In addition, under Pennsylvania corporation law, subject to certain exceptions, a business combination between us and a beneficial owner of more than 20% of our stock may be accomplished only if certain conditions are met.

Our articles of incorporation contain certain provisions that may affect a person s decision to implement a takeover of us, including the following provisions:

a classified board of directors, with each director having a three-year term;

a provision providing that certain business combinations involving us, unless approved by at least 75% of the board of directors, will require the affirmative vote of at least 80% of our voting stock;

a provision permitting the board of directors to oppose a tender or other offer for our securities in light of the fairness of the price, the impact on our constituents, the reputation of the offeror, the value of the offered securities and any applicable legal or regulatory issues raised by the offer,