SHOPPERS DRUG MART CORPORATION

2011 SECOND QUARTER REPORT TO SHAREHOLDERS

SHOPPERS DRUG MART CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS

As at July 14, 2011

The following is a discussion of the consolidated financial condition and results of operations of Shoppers Drug Mart Corporation (the "Company") for the periods indicated and of certain factors that the Company believes may affect its prospective financial condition, cash flows and results of operations. This discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements of the Company and the notes thereto for the 12 and 24 week periods ended June 18, 2011. The Company's unaudited condensed consolidated financial statements and the notes thereto have been prepared in accordance with International Financial Reporting Standards ("IFRS") and are reported in Canadian dollars. (See "Transition to International Financial Reporting Standards" under "New Accounting Pronouncements" in this Management's Discussion and Analysis.) These financial statements do not contain all disclosures required by IFRS for annual financial statements and, accordingly, should also be read in conjunction with the most recently prepared annual consolidated financial statements for the 52 week period ended January 1, 2011, which have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

FORWARD-LOOKING INFORMATION AND STATEMENTS

This document contains forward-looking information and statements which constitute "forward-looking information" under Canadian securities law and which may be material regarding, among other things, the Company's beliefs, plans, objectives, estimates, intentions and expectations. Forward-looking information and statements are typically identified by words such as "anticipate", "believe", "expect", "estimate", "forecast", "goal", "intend", "plan", "will", "may", "should", "could" and similar expressions. Specific forward-looking information in this document includes, but is not limited to, statements with respect to the Company's future operating and financial results, its capital expenditure plans, its dividend and shareholder distribution policies and the ability to execute on its future operating, investing and financing strategies.

The forward-looking information and statements contained herein are based on certain factors and assumptions, certain of which appear proximate to the applicable forward-looking information and statements contained herein. Inherent in the forward-looking information and statements are known and unknown risks, uncertainties and other factors beyond the Company's ability to control or predict, which give rise to the possibility that the Company's predictions, forecasts, expectations or conclusions will not prove to be accurate, that its assumptions may not be correct and that the Company's plans, objectives and statements will not be achieved. Actual results or developments may differ materially from those contemplated by the forward-looking information and statements.

The material risk factors that could cause actual results to differ materially from the forward-looking information and statements contained herein include, without limitation: the risk of adverse changes to laws and regulations relating to prescription drugs and their sale, including pharmacy reimbursement programs and the availability of manufacturer allowances, or changes to such laws and regulations that increase compliance costs; the risk that the Company will be unable to implement successful strategies to manage the impact of the regulations enacted in 2010 in the Province of Ontario to amend the Ontario drug system, along with the impact of the Pharmacy Services Agreement that came into effect in 2010 in the Province of British Columbia, as well as the impact of the proposed and/or announced drug system reform initiatives in these and other jurisdictions of Canada, principally the provinces of Alberta, Saskatchewan, Québec, Nova Scotia and Newfoundland and Labrador; the risk of adverse changes in economic and financial conditions in Canada and globally; the risk of increased competition from other retailers; the risk of an inability of the Company to manage growth and maintain its profitability; the risk of exposure to fluctuations in interest rates; the risk of material adverse changes in foreign currency exchange rates; the risk of an inability to attract and retain pharmacists and key employees; the risk of an inability of the Company's information technology systems to support the requirements of the Company's business; the risk of changes to estimated contributions of the Company in respect of its pension plans or post-employment benefit plans which may adversely impact the Company's financial performance; the risk of changes to the relationships of the Company with third-

party service providers; the risk that the Company will not be able to lease or obtain suitable store locations on economically favourable terms; the risk of adverse changes to the Company's results of operations due to seasonal fluctuations; risks associated with alternative arrangements for sourcing generic drug products, including intellectual property and product liability risks; the risk that new, or changes to current, federal and provincial laws, rules and regulations, including environmental and privacy laws, rules and regulations, may adversely impact the Company's business and operations; the risk that violations of law, breaches of Company policies or unethical behaviour may adversely impact the Company's financial performance; property and casualty risks; the risk of injuries at the workplace or health issues; the risk that changes in tax law, or changes in the way that tax law is expected to be interpreted, may adversely impact the Company's business and operations; the risk that new, or changes to existing, accounting pronouncements may adversely impact the Company; the risks associated with the performance of the Associate-owned store network; the risk of material adverse effects arising as a result of litigation; the risk of damage to the reputation of brands promoted by the Company, or to the reputation of any supplier or manufacturer of these brands; and the risk that events or series of events may cause business interruptions.

This is not an exhaustive list of the factors that may affect any of the Company's forward-looking information and statements. Investors and others should carefully consider these and other factors and not place undue reliance on the forward-looking information and statements. Further information regarding these and other factors is included in the Company's public filings with provincial securities regulatory authorities including, without limitation, the sections entitled "Risks and Risk Management" and "Risks Associated with Financial Instruments" in this document and in the Company's Management's Discussion and Analysis for the 52 week period ended January 1, 2011 and for the 12 week period ended March 26, 2011. The forward-looking information and statements contained in this discussion of the consolidated financial condition and results of operations of the Company represent the Company's views only as of the date hereof. Forward-looking information and statements contained in this document about prospective results of operations, financial position or cash flows that are based upon assumptions about future economic conditions and courses of action are presented for the purpose of assisting the Company's shareholders in understanding management's current views regarding those future outcomes and may not be appropriate for other purposes. While the Company anticipates that subsequent events and developments may cause the Company's views to change, the Company does not undertake to update any forward-looking information and statements, except to the extent required by applicable securities laws.

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

OVERVIEW

The Company is the licensor of full-service retail drug stores operating under the name Shoppers Drug Mart® (Pharmaprix® in Québec). As at June 18, 2011, there were 1,189 Shoppers Drug Mart/Pharmaprix retail drug stores owned and operated by the Company's licensees ("Associates"). An Associate is a pharmacist-owner of a corporation that is licensed to operate a retail drug store at a specific location using the Company's trademarks. The Company's licensed stores are located in prime locations in each province and two territories, making Shoppers Drug Mart/Pharmaprix stores among the most convenient retail outlets in Canada. The Company also licenses or owns 60 medical clinic pharmacies operating under the name Shoppers Simply Pharmacy® (Pharmaprix Simplement Santé® in Québec) and eight luxury beauty destinations operating as Murale™.

The Company has successfully leveraged its leadership position in pharmacy and its convenient store locations to capture a significant share of the market in front store merchandise. Front store merchandise categories include over-the-counter medications, health and beauty aids, cosmetics and fragrances (including prestige brands), everyday household needs and seasonal products. The Company also offers a broad range of high-quality private label products marketed under the trademarks Life Brand®, Quo®, Etival™, Balea®, Everyday Market®, Bio-Life®, Nativa®, Simply Food™ and Easypix®, among others, and value-added services such as the HealthWATCH® program, which offers patient counselling and advice on medications, disease management and health and wellness, and the Shoppers Optimum® program, one of the largest retail loyalty card programs in Canada. In fiscal 2010, the Company recorded consolidated sales of approximately $10.2 billion.

Under the licensing arrangements with Associates, the Company provides the capital and financial support to enable Associates to operate Shoppers Drug Mart®, Pharmaprix®, Shoppers Simply Pharmacy® and Pharmaprix Simplement Santé® stores without any initial investment. The Company also provides a package of services to facilitate the growth and profitability of each Associate's business. These services include the use of trademarks, operational support, marketing and advertising, purchasing and distribution, information technology and accounting. In return for being provided these and other services, Associates pay fees to the Company. Fixtures, leasehold improvements and equipment are purchased by the Company and leased to Associates over periods ranging from two to 15 years, with title retained by the Company. The Company also provides its Associates with assistance in meeting their working capital and long-term financing requirements through the provision of loans and loan guarantees.

Under the licensing arrangements, the Company receives a substantial share of Associate store profits. The Company's share of Associate store profits is reflective of its investment in, and commitment to, the operations of the Associates' stores.

The Company operates in Québec primarily under the Pharmaprix® and Pharmaprix Simplement Santé® trade names. Under Québec law, profits generated from the prescription area or dispensary may only be earned by a pharmacist or a corporation controlled by a pharmacist. As a result of these restrictions, the licence agreement used for Québec Associates differs from the Associate agreement used in other provinces. Pharmaprix® and Pharmaprix Simplement Santé® stores and their Associates benefit from the same infrastructure and support provided to all other Shoppers Drug Mart® and Shoppers Simply Pharmacy® stores and Associates.

Associate-owned stores comprise the majority of the Company's store network. The Associate-owned stores are separate legal entities and the Company does not have any direct or indirect shareholdings in these Associate-owned stores. The Company consolidates the Associate-owned stores in accordance with International Accounting Standard 27, "Consolidated and Separate Financial Statements" ("IAS 27") based on the concept of control under IAS 27, determined primarily through the licensing arrangements that govern the relationship between the Company and the Associates. However, as the Associate-owned stores remain separate legal entities from the Company, consolidation of these stores has no impact on the underlying risks facing the Company.

The Company also owns and operates 63 Shoppers Home Health Care® stores. These retail stores are engaged in the sale and service of assisted-living devices, medical equipment, home-care products and durable mobility equipment to institutional and retail customers.

In addition to its retail store network, the Company owns Shoppers Drug Mart Specialty Health Network Inc., a provider of specialty drug distribution, pharmacy and comprehensive patient support services, and MediSystem Technologies Inc., a provider of pharmaceutical products and services to long-term care facilities in Ontario and Alberta.

The majority of the Company's sales are generated from its retail drug store network and the majority of the Company's assets are used in the operations of these stores. As such, the Company presents one operating segment in its consolidated financial statement disclosures. The revenue generated by Shoppers Drug Mart Specialty Health Network Inc. and by MediSystem Technologies Inc. is included with the prescription sales of the Company's retail drug stores. The revenue generated by the Shoppers Home Health Care® stores and the Murale™ stores is included with the front store sales of the Company's retail drug stores.

OVERALL FINANCIAL PERFORMANCE

Key Operating, Investing and Financial Metrics

The following provides an overview of the Company's operating performance for the 12 and 24 week periods ended June 18, 2011 compared to the 12 and 24 week periods ended June 19, 2010[1], as well as certain other metrics with respect to investing activities for the 12 and 24 week periods ended June 18, 2011 and financial position as at that same date.

- Second quarter sales of $2.394 billion, an increase of 1.4%.
  - First half sales of $4.741 billion, an increase of 2.1%.
- Second quarter comparable store total sales growth of 0.8%, comprised of a comparable prescription sales decrease of 0.8%, offset by comparable front store sales growth of 2.4%.
  - First half comparable store total sales growth of 1.4%, comprised of a comparable prescription sales decrease of 0.6%, offset by comparable front store sales growth of 3.4%.
- Second quarter prescription count growth of 4.1% and comparable store prescription count growth of 4.3%.
  - First half prescription count growth of 4.0% and comparable store prescription count growth of 4.0%.
- Second quarter EBITDA[2] of $289 million, an increase of 1.1%.
  - First half EBITDA of $536 million, an increase of 1.9%.
- Second quarter EBITDA margin [3] of 12.06%, a decrease of 4 basis points.
  - First half EBITDA margin of 11.30%, a decrease of 2 basis points.
- Second quarter net earnings of $148 million or $0.68 per share (diluted), an increase of 1.3% compared to net earnings of $146 million or $0.67 per share (diluted) in the second quarter of 2010.
  - First half net earnings of $265 million or $1.22 per share (diluted), an increase of 2.2% compared to adjusted net earnings[4] of $260 million or $1.19 per share (diluted) in the first half of 2010.
- Second quarter capital expenditure program of $90 million compared to $110 million in the same period of the prior year. Opened 13 new drug stores, eight of which were relocations, completed seven major drug store expansions and remodelled/converted 11 drug stores to smaller prototype formats.
  - First half capital expenditure program of $161 million compared to $209 million in the same period of the prior year. Opened or acquired 31 new drug stores, 19 of which were relocations, completed 11 major drug store expansions and remodelled/converted 23 drug stores to smaller prototype formats.
  - Year-over-year increase in retail selling square footage of 4.2%.
- Maintained desired capital structure and financial position.
  - Net debt to equity ratio of 0.28:1 at June 18, 2011 compared to 0.36:1 a year ago.
  - Net debt to total capitalization ratio of 0.22:1 at June 18, 2011 compared to 0.26:1 a year ago.

[1] In preparing its 2010 comparative information, the Company has adjusted amounts reported previously in financial statements prepared in accordance with Canadian Generally Accepted Accounting Principles ("Canadian GAAP"). (See Note 12 to the accompanying unaudited condensed consolidated financial statements of the Company.)

(2) Earnings before finance expenses, income taxes and depreciation and amortization. (See reconciliation to the most directly comparable IFRS measure under "Results of Operations" in this Management's Discussion and Analysis and note 7 to the accompanying unaudited condensed consolidated financial statements of the Company.)

(3) EBITDA divided by sales.

(4) Net earnings, excluding the after-tax impact of a gain on disposal of $12 million (pre-tax) in respect of a first quarter sale-leaseback transaction involving certain of the Company's retail properties.

Results of Operations

The following table presents a summary of certain selected consolidated financial information for the Company for the periods indicated.

($000s, except per share data)	12 Weeks Ended June 18, 2011	12 Weeks Ended June 19, 2010[1]	24 Weeks Ended June 18, 2011	24 Weeks Ended June 19, 2010[1]
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Sales	$ 2,394,145	$ 2,360,887	$ 4,741,166	$ 4,645,320
Cost of goods sold	1,462,858	1,464,652	2,922,764	2,891,234
Gross profit	931,287	896,235	1,818,402	1,754,086
Operating and administrative expenses	711,037	677,298	1,420,260	1,347,249
Operating income	220,250	218,937	398,142	406,837
Finance expenses	14,798	13,997	29,439	27,874
Earnings before income taxes	205,452	204,940	368,703	378,963
Income taxes	57,527	58,973	103,237	110,744
Net earnings	$ 147,925	$ 145,967	$ 265,466	$ 268,219
Net earnings per common share				
- Basic	$ 0.68	$ 0.67	$ 1.22	$ 1.23
- Diluted	$ 0.68	$ 0.67	$ 1.22	$ 1.23
EBITDA[2]	$ 288,838	$ 285,690	$ 535,754	$ 526,004

[1] In preparing its 2010 comparative information, the Company has adjusted amounts reported previously in financial statements prepared in accordance with Canadian GAAP. (See Note 12 to the accompanying unaudited condensed consolidated financial statements of the Company.)

[2] Earnings before finance expenses, income taxes and depreciation and amortization. (See note 7 to the accompanying unaudited condensed consolidated financial statements of the Company.)

Sales

Sales represent the combination of sales of the retail drug stores owned by the Associates, sales at Murale™ and sales of the home health care business, Shoppers Drug Mart Specialty Health Network Inc. and MediSystem Technologies Inc. The majority of the Company's sales are generated from its retail drug store network and the majority of the Company's assets are used in the operations of these stores. As such, the Company presents one operating segment in its consolidated financial statement disclosures. Sales at Murale™ and sales of the home health care business are included with front store sales of the Company's retail drug stores. Sales of Shoppers Drug Mart Specialty Health Network Inc. and MediSystem Technologies Inc. are included with prescription sales of the Company's retail drug stores.

Sales are recognized as revenue when the goods are sold to the customer. Revenue is net of returns and award credits. Where a sales transaction includes points awarded under the Shoppers Optimum® loyalty card program (the "Program"), revenue allocated to the Program points is deferred based on the fair value of the award credits and recognized as revenue when the Program points are redeemed and the Company fulfills its obligations to supply the awards.

Revenue is measured at the fair value of the consideration received or receivable from the customer for products sold or services supplied. However, for certain products or services, such as the sale of lottery tickets, third-party prepaid phone cards, third-party gift cards, postal products and services and public transportation tickets, the Company acts as an agent and, consequently, records only the amount of commission income in its sales.

Sales in the second quarter of 2011 were $2.394 billion compared to $2.361 billion in the same period last year, an increase of $33 million or 1.4%, driven by sales growth in the front of the store in all regions of the country. On a same-store basis, sales increased 0.8% during the second quarter of 2011. Year-to-date, sales were $4.741 billion, an increase of 2.1% over the same period last year. On a same-store basis, sales increased 1.4% during the first half of 2011.

Prescription sales were $1.154 billion in the second quarter of 2011 compared to $1.166 billion in the second quarter of 2010, a decrease of $12 million or 1.0%. During the second quarter of 2011, prescription sales accounted for 48.2% of the Company's sales mix compared to 49.4% in the same period last year. On a same-store basis, prescription sales decreased 0.8% during the second quarter of 2011, as continued growth in the number of prescriptions filled was offset by a reduction in average prescription value. During the second quarter of 2011, total prescription counts increased 4.1% compared to the same period last year and were up 4.3% on a same-store basis. The decrease in average prescription value can be attributed to a reduction in generic prescription reimbursement rates, the result of recently implemented drug system reform initiatives in certain jurisdictions of Canada, principally Ontario, British Columbia, Alberta and Québec, combined with increasing generic prescription utilization rates. In the second quarter of 2011, generic molecules represented 56.2% of prescriptions dispensed compared to 52.5% of prescriptions dispensed in the second quarter of 2010. Year-to-date, prescription sales decreased 0.7% to $2.305 billion and accounted for 48.6% of the Company's sales mix compared to 50.0% in the same period last year. On a same store basis, prescription sales decreased 0.6% during the first half of 2011. Year-to-date, prescription counts increased 4.0% on both a total and a same-store basis compared to the same period last year.

Front store sales were $1.240 billion in the second quarter of 2011 compared to $1.195 billion in the second quarter of 2010, an increase of $45 million or 3.8%, led by continued strength and sales growth in over-the-counter medications, cosmetics and food and confection. The Company's store network development program, which resulted in a 4.2% increase in retail selling space compared to a year ago, continues to have a positive impact on sales growth, particularly in the front of the store. Front store sales growth was also aided by continued investments in pricing and promotional activities. On a same-store basis, front store sales increased 2.4% during the second quarter of 2011. Year-to-date, front store sales were $2.437 billion, an increase of 4.8% over the same period last year. On a same-store basis, front store sales increased 3.4% during the first half of 2011.

Cost of Goods Sold

Cost of goods sold is comprised of the cost of goods sold at the retail drug stores owned by the Associates, the cost of goods sold at Murale™ and the cost of goods sold at the home health care business, Shoppers Drug Mart Specialty Health Network Inc. and MediSystem Technologies Inc.

Cost of goods sold was $1.463 billion in the second quarter of 2011 compared to $1.465 billion in the same period last year, a decrease of $2 million or 0.1%. Expressed as a percentage of sales, cost of goods sold declined by 94 basis points in the second quarter of 2011 versus the same period last year reflecting cost reductions in generic prescription molecules, largely the result of the above referenced drug system reform initiatives, along with improved purchasing synergies, partially offset by continued investments in promotional activities.

Year-to-date, cost of goods sold increased by 1.1% to $2.923 billion. Expressed as a percentage of sales, cost of goods sold declined by 59 basis points in the first half of 2011 versus the comparative prior year period.

Operating and administrative expenses

Operating and administrative expenses include corporate selling, general and administrative expenses, operating expenses at the retail drug stores owned by the Associates, including Associates' earnings, operating expenses at Murale™ and operating expenses at the home health care business, Shoppers Drug Mart Specialty Health Network Inc. and MediSystem Technologies Inc. Operating and administrative expenses also include depreciation and amortization expenses. (See note 7 to the accompanying unaudited condensed consolidated financial statements of the Company.)

Operating and administrative expenses, excluding depreciation and amortization expense, were $642 million in the second quarter of 2011 compared to $611 million in the same period last year, an increase of $31 million or 5.2%. This increase can be largely attributed to higher expenses at store-level, primarily occupancy, Associate earnings, wages and benefits tied to the Company's network growth and expansion initiatives, partially offset by the benefits from cost reduction initiatives and further gains in productivity and efficiency at identical stores, particularly in the dispensary. Marketing expenses were also higher in the second quarter of 2011 compared to the same period of the prior year, primarily due to additional promotional events and an increase in flyer costs. Expressed as a percentage of sales, operating and administrative expenses, excluding depreciation and amortization expense, increased by 97 basis points in the second quarter of 2011 versus the comparative prior year period, an increase that also reflects, in part, the impact of top-line deflation stemming from the above referenced drug system reform initiatives and greater generic prescription utilization.

Year-to-date, operating and administrative expenses, excluding depreciation and amortization expense, increased by 4.4% to $1.283 billion. Expressed as a percentage of sales, operating and administrative expenses, excluding depreciation and amortization expense, increase by 61 basis points in the first half of 2011 versus the comparative prior year period.

Depreciation and amortization expense was $69 million in the second quarter of 2011 compared to $67 million in the same period last year, an increase of $2 million or 2.7%. Expressed as a percentage of sales, depreciation and amortization expense increased by 3 basis points in the second quarter of 2011 versus the comparative prior year period, an increase which can be attributed to continued investments in the store network and supporting infrastructure, along with top-line deflation as a result of the above referenced drug system reform initiatives.

Year-to-date, depreciation and amortization expense was $138 million compared to $119 million in the same period last year, with last year's amount inclusive of a $12 million (pre-tax) gain in respect of a first quarter sale-leaseback transaction involving certain of the Company's retail properties. Excluding the impact of this gain from the comparative prior year period, the Company's year-to-date depreciation and amortization expense increased by $6 million or 4.7%. Expressed as a percentage of sales, depreciation and amortization expense increased by 7 basis points in the first half of 2011 compared to the adjusted depreciation and amortization expense in the same period of last year.

Operating Income

Operating income was $220 million in the second quarter of 2011 compared to $219 million in the same period last year, an increase of $1 million or 0.6%. As described above, this result was driven by continued strong performance in the front of the store, improved purchasing synergies, cost reduction initiatives and further gains in productivity and efficiency, offset by the negative impact of recently implemented drug system reform initiatives and higher operating costs associated with the Company's strategic growth and expansion initiatives, along with continued investments in marketing and promotional activities. Second quarter operating margin (operating income divided by sales) declined by 7 basis points to 9.20% compared to an operating margin of 9.27% in the second quarter of 2010. The Company's EBITDA margin (EBITDA divided by sales), was 12.06% in the second quarter of 2011, a 4 basis point reduction compared to the EBITDA margin of 12.10% posted in the second quarter of last year.

Year-to-date, operating income was $398 million compared to $407 million in the same period last year. Excluding the impact of last year's $12 million (pre-tax) gain in respect of the first quarter sale-leaseback transaction referred to above, operating income increased by $3 million or 0.9% in the first half of 2011. Excluding the impact of the aforementioned first quarter sale-leaseback transaction from the prior year's results, first half operating margin (operating income divided by sales) declined by 9 basis points to 8.40% compared to an adjusted operating margin of 8.49% in the first half of 2010. During the first half of 2011, the Company's EBITDA margin (EBITDA divided by sales), was 11.30%, a 2 basis point reduction compared to the same period of the prior year.

Finance expenses

Finance expenses are comprised of interest expense arising from borrowings at the Associate-owned stores and from debt obligations of the Company, interest associated with financing leases and the amortization of transaction costs incurred in conjunction with debt transactions.

Finance expenses were $15 million in the second quarter of 2011 compared to $14 million in the same period last year, an increase of $1 million or 5.7%. Interest expense was higher as a result of a market-driven increase in short-term interest rates on the Company's floating rate debt obligations, along with higher bank fees associated with the Company's revolving term credit facility which was refinanced in the fourth quarter of 2010. This higher interest expense was partially offset by interest expense savings due to the Company having a lower average amount of consolidated net debt outstanding during the quarter and from the maturity, in the fourth quarter of 2010, of an interest rate derivative agreement that converted an aggregate notional principal amount of $50 million of floating rate debt into fixed rate debt. Year-to-date, interest expense was $29 million compared to $28 million in the first half of the prior year, an increase of 5.6%.

Income Taxes

The Company's effective income tax rate in the second quarter and first half of 2011 was 28.0% compared to 28.8% and 29.2% in the same respective periods of the prior year. These decreases in the effective income tax rate can be attributed to a reduction in statutory rates.

Net Earnings

Second quarter net earnings were $148 million compared to $146 million in the same period last year, an increase of $2 million or 1.3%. On a diluted basis, earnings per share were $0.68 in the second quarter of 2011 compared to $0.67 in the same period last year.

Year-to-date, net earnings were $265 million compared to $268 million in the same period last year. Excluding the impact of the aforementioned $12 million (pre-tax) gain in respect of the first quarter sale-leaseback transaction from the prior year's results, the Company's net earnings increased by $6 million or 2.2% during the first half of 2011. On a diluted basis, earnings per share were $1.22 in the first half of 2011 compared to adjusted earnings per share of $1.19 in the same period last year.

Capitalization and Financial Position

The following table provides a summary of certain information with respect to the Company's capitalization and consolidated financial position at the dates indicated.

($000s)	June 18, 2011	January 1, 2011[1]
Cash	$ (95,644)	$ (64,354)
Bank indebtedness	246,417	209,013
Commercial paper	-	127,828
Current portion of long-term debt	249,612	-
Long-term debt	694,935	943,412
Financing lease obligations	87,976	79,031
Net debt	1,183,296	1,294,930
Shareholders' equity	4,248,502	4,092,547
Total capitalization	$ 5,431,798	$ 5,387,477
Net debt:Shareholders' equity	0.28:1	0.32:1
Net debt:Total capitalization	0.22:1	0.24:1
Net debt:EBITDA[2]	1.00:1	1.10:1
EBITDA:Cash interest expense[2][3]	18.49:1	18.62:1

(1) In preparing its 2010 comparative information, the Company has adjusted amounts reported previously in financial statements prepared in accordance with Canadian GAAP. (See Note 12 to the accompanying unaudited condensed consolidated financial statements of the Company.)

(2) For purposes of calculating the ratios, EBITDA is comprised of the EBITDA for each of the 52 week periods then ended.

(3) Cash interest expense is comprised of finance expenses for each of the 52 week periods then ended and excludes the amortization of deferred financing costs, but includes capitalized interest.

Financial Ratios and Credit Ratings

The following table provides a summary of the Company's credit ratings at June 18, 2011.

	Standard & Poor's	DBRS Limited
Corporate credit rating	BBB+	-
Senior unsecured debt	BBB+	A (low)
Commercial paper	-	R-1 (low)

There were no changes to any of the Company's credit ratings during the first half of 2011.

Outstanding Share Capital

The Company's outstanding share capital is comprised of common shares. An unlimited number of common shares is authorized and the Company had 217,473,716 common shares outstanding at July 14, 2011. As at this same date, the Company had issued options to acquire 933,117 of its common shares pursuant to its stock-based compensation plans, of which 811,031 were exercisable.

Normal Course Issuer Bid

On February 10, 2011, the Company's Board of Directors authorized the purchase of up to 8,700,000 of its common shares, representing approximately 4.0% of its common shares then outstanding, by way of normal course purchases effected through the facilities of the Toronto Stock Exchange (the "TSX"). The Company was able to commence purchases under this program on February 15, 2011. The program will terminate on February 14, 2012, or on such earlier date as the Company may complete its purchases pursuant to a Notice of Intention filed with the TSX. Purchases will be made by the Company in accordance with the requirements of the TSX and the price which the Company will pay for any such common shares will be the market price of any such common shares at the time of acquisition, or such other price as may be permitted by the TSX. For purposes of the TSX rules, a maximum of 170,759 common shares may be purchased by the Company on any one day under the bid, except where purchases are made in accordance with the "block purchase exception" of the TSX rules. Common shares purchased by the Company will be cancelled. As at July 14, 2011, no purchases had been made under this program.

Liquidity and Capital Resources

Sources of Liquidity

The Company has the following sources of liquidity: (i) cash provided by operating activities; (ii) cash available from a committed $750 million revolving bank credit facility maturing December 10, 2014, less what is currently drawn and/or being utilized to support commercial paper issued and outstanding; and (iii) up to $500 million in availability under its commercial paper program, less what is currently issued. The Company's commercial paper program is rated R-1 (low) by DBRS Limited. In the event that the Company's commercial paper program is unable to maintain this rating, the program is supported by the Company's $750 million revolving bank credit facility. At June 18, 2011, $10 million of the Company's $750 million revolving bank credit facility was utilized, all in respect of outstanding letters of credit, unchanged compared to the end of the first quarter of 2011. At January 1, 2011, $9 million of this facility was utilized, all in respect of outstanding letters of credit. At June 18, 2011, the Company did not have any commercial paper issued and outstanding under its commercial paper program compared to $107 million at the end of the first quarter of 2011 and $128 million at the end of 2010.

The Company has also arranged for its Associates to obtain financing to facilitate their inventory purchases and fund their working capital requirements by providing guarantees to various Canadian chartered banks that support Associate loans. At the end of the second quarter of 2011, the Company's maximum obligation in respect of such guarantees was $520 million, unchanged from the end of the first quarter of 2011 and the end of the prior year. At June 18, 2011, an aggregate amount of $446 million in available lines of credit had been allocated to the Associates by the various banks compared to $443 million at the end of the first quarter of 2011 and $440 million at the end of the prior year. At June 18, 2011, Associates had drawn an aggregate amount of $255 million against these available lines of credit compared to $221 million at the end of the first quarter of 2011 and $176 million at the end of the prior year. Any amounts drawn by the Associates are included in bank indebtedness on the Company's consolidated balance sheets. As recourse in the event that any payments are made under the guarantees, the Company holds a first-ranking security interest on all assets of Associate-owned stores, subject to certain prior-ranking statutory claims. As the Company is involved in allocating the available lines of credit to its Associates, it estimates that the net proceeds from secured assets would exceed the amount of any payments required in respect of the guarantees.

The Company has obtained additional long-term financing from the issuance of $450 million of five-year medium-term notes maturing June 3, 2013, which bear interest at a fixed rate of 4.99% per annum (the "Series 2 Notes"), $250 million of three-year medium-term notes maturing January 20, 2012, which bear interest at a fixed rate of 4.80% per annum (the "Series 3 Notes") and $250 million of five-year medium-term notes maturing January 20, 2014, which bear interest at a fixed rate of 5.19% per annum (the "Series 4 Notes"). The Series 2 Notes were issued pursuant to a final short form base shelf prospectus dated May 22, 2008 (the "Prospectus"), as supplemented by a pricing supplement dated May 28, 2008. The Series 3 Notes and Series 4 Notes were issued pursuant to the Prospectus, as supplemented by pricing supplements dated January 14, 2009. The pricing supplements were filed by the Company with Canadian securities regulators in all of the provinces of Canada. At the time of issuance, the medium-term notes were assigned ratings of A (low) from DBRS Limited and BBB+ from Standard & Poor's.

Cash Flows From Operating Activities

Cash flows from operating activities were $253 million in the second quarter of 2011 compared to $240 million in the same period last year. This increase can be largely attributed to a reduction in the amount of income tax paid when compared to the same period last year.

Year-to-date, the Company has generated $396 million of cash from operating activities compared to $388 million in the first half of 2010.

Cash Flows Used in Investing Activities

Cash flows used in investing activities were $86 million in the second quarter of 2011 compared to $109 million in the same period last year, a decrease of $23 million or 21.1%. Of these totals, purchases of property and equipment, net of proceeds from any dispositions, amounted to $74 million in the second quarter of 2011 compared to $98 million in the same period last year, reflecting a step-down in the Company's retail development and network growth and expansion initiatives. During the second quarter of 2011 and consistent with the same period last year, the Company did not invest funds in the acquisition of drug stores and prescription files. The Company invested a combined $11 million in the purchase and development of intangible and other assets during the second quarter of 2011, unchanged when compared to the same period last year.

Year-to-date, cash flows used in investing activities were $161 million compared to $172 million in the first half of 2010, a decrease of $11 million or 6.3%. Of these totals, purchases of property and equipment, net of proceeds from any dispositions, amounted to $133 million in the first half of 2011 compared to $139 million in the same period last year. Included in the net purchases of property and equipment in the first half of 2010 was $37 million of proceeds resulting from dispositions, $35 million of which related to a sale/leaseback transaction involving 13 retail locations. Investments in business acquisitions and in the purchase and development of intangible and other assets were $6 million and $21 million, respectively, in the first half of 2011 compared to $11 million and $22 million, respectively, in the same period last year. Investments in business acquisitions relate primarily to acquisitions of drug stores and prescription files, and while the Company has reduced such investments as of late, it will continue to pursue attractive opportunities in the marketplace.

During the second quarter of 2011, the Company opened 13 new drug stores, eight of which were relocations, closed one smaller drug store and completed seven major drug store expansions. In addition to this activity, 11 existing drug stores were remodeled, converting them to smaller prototype formats. Year-to-date, 31 new drug stores have been opened or acquired, 19 of which were relocations, four smaller drug stores were consolidated or closed, 11 major drug store expansions were completed and 23 existing drug stores were remodelled, converting them to smaller prototype formats. At the end of the first half of 2011, there were 1,320 retail stores in the Company's network, comprised of 1,249 drug stores (1,189 Shoppers Drug Mart®/Pharmaprix® stores and 60 Shoppers Simply Pharmacy®/Pharmaprix Simplement Santé® stores), 63 Shoppers Home Health Care® stores and eight Murale™ stores.

Cash Flows Used in Financing Activities

Cash flows used in financing activities were $142 million in the second quarter of 2011, as cash outflows of $164 million were partially offset by cash inflows of $23 million. Cash outflows were comprised of a $107 million decrease in the amount of commercial paper issued and outstanding by the Company under its commercial paper program, a $1 million repayment of financing lease obligations, a $2 million reduction in the amount of Associate investment and $54 million for the payment of dividends. Cash inflows were comprised of a $23 million increase in bank indebtedness.

In the second quarter of 2011, the net result of the Company's operating, investing and financing activities was an increase in cash balances of $26 million.

Year-to-date, cash flows used in financing activities was $204 million and the net result of the Company's operating, investing and financing activities was an increase in cash of $31 million.

Future Liquidity

The Company believes that its current credit facilities, commercial paper program and financing programs available to its Associates, together with cash generated from operating activities, will be sufficient to fund its operations, including the operations of its Associate-owned store network, investing activities and commitments for the foreseeable future. Historically, the Company has not experienced any major difficulty in obtaining additional short or long-term financing given its investment grade credit ratings. While the Company is committed to maintaining its investment grade credit ratings, credit ratings may be revised or withdrawn at any time by the rating agencies if, in their judgment, circumstances warrant.

NEW ACCOUNTING PRONOUNCEMENTS

Transition to International Financial Reporting Standards

The Company has adopted International Financial Reporting Standards ("IFRS") for its 2011 fiscal year as required by the Accounting Standards Board of the Canadian Institute of Chartered Accountants. The Company provided information on its transition to IFRS in its 2010 Annual Management's Discussion and Analysis. The assessments and impacts discussion in the 2010 Annual Management's Discussion and Analysis remain largely unchanged.

The Company has completed its assessment of lease classifications. For certain leases, this assessment resulted in the recognition of financing leases under IFRS where previously, they had been considered operating leases under Canadian GAAP. Upon implementation of IFRS, the Company recognized an increase in property and equipment of $51.2 million, an increase in accounts payable and accrued liabilities of $1.2 million, an increase in other long-term liabilities of $53.3 million, a decrease in deferred tax liabilities of $1.5 million and an associated after-tax charge to retained earnings of $1.8 million. Prior to adopting IFRS, the Company recognized a future tax asset on the temporary difference between the cost base and the tax base of inventory. This temporary difference relates primarily to consideration received from vendors which is classified as a reduction to the cost of inventory on consolidation. Under IFRS, this reduction to the cost of inventory is not considered a temporary difference and, as such, there is no deferred tax asset. Upon its implementation of IFRS, the Company recognized a decrease in deferred tax assets of $60.7 million and a corresponding decrease in retained earnings.

The Company has provided a detailed explanation of the impacts of this transition in Note 13 of the Company's first quarter 2011 unaudited condensed consolidated financial statements ("Note 13"). Note 13 includes reconciliations of the Company's balance sheet and shareholders' equity from Canadian GAAP to IFRS as at January 1, 2011, March 27, 2010 and January 3, 2010, and its fiscal 2010 net earnings and comprehensive income for the 52 weeks ended January 1, 2011 and 12 weeks ended March 27, 2010. Explanations of the individual impacts of adopting IFRS identified in the reconciliations are also provided, as are the Company's elections under IFRS 1 "First-time Adoption of International Financial Reporting Standards". Note 12 of the Company's second quarter 2011 unaudited condensed consolidated financial statements includes reconciliations of the Company's balance sheet and shareholders equity from Canadian GAAP to IFRS as at June 19, 2010 and its net earnings and comprehensive income for the 12 and 24 weeks ended June 19, 2010.

Future Accounting Standards

Financial Instruments – Disclosures

The International Accounting Standards Board (the "IASB") has issued an amendment to IFRS 7, "Financial Instruments: Disclosures" (the "IFRS 7 amendment"), requiring incremental disclosures regarding transfers of financial assets. The IAS 7 amendment is effective for annual periods beginning on or after July 1, 2011 and can be applied prospectively. The Company will apply the amendment at the beginning of its 2012 financial year and does not expect the implementation to have a significant impact on the Company's disclosures.

Deferred Taxes – Recovery of Underlying Assets

The IASB has issued an amendment to IAS 12, "Income Taxes" (the "IAS 12 amendment"), that introduces an exception to the general measurement requirements of IAS 12 in respect of investment properties measured at fair value. The IAS 12 amendment is effective for annual periods beginning on or after January 1, 2012. The Company will apply the amendment at the beginning of its 2012 financial year. The Company is assessing the impact of the IAS 12 amendment on its results of operations, financial position and disclosures.

Financial Instruments

The IASB has issued a new standard, IFRS 9, "Financial Instruments" ("IFRS 9"), which will ultimately replace IAS 39, "Financial Instruments: Recognition and Measurement" ("IAS 39"). The replacement of IAS 39 is a multi-phase project with the objective of improving and simplifying the reporting for financial instruments and the issuance of IFRS 9 is part of the first phase of this project. IFRS 9 uses a single approach to determine whether a financial asset or liability is measured at amortized cost or fair value, replacing the multiple rules in IAS 39. For financial assets, the approach in IFRS 9 is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. IFRS 9 requires a single impairment method to be used, replacing multiple impairment methods in IAS 39. For financial liabilities measured at fair value, fair value changes due to changes in an entity's credit risk are presented in other comprehensive income. IFRS 9 is effective for annual periods beginning on or after January 1, 2013 and must be applied retrospectively. The Company is assessing the impact of the new standard on its results of operations, financial position and disclosures.

SELECTED QUARTERLY INFORMATION

Reporting Cycle

The annual reporting cycle of the Company is divided into four quarters of 12 weeks each, except for the third quarter which is 16 weeks in duration. The fiscal year of the Company consists of a 52 or 53 week period ending on the Saturday closest to December 31. When a fiscal year consists of 53 weeks, the fourth quarter is 13 weeks in duration.

Summary of Quarterly Results

The following table provides a summary of certain selected consolidated financial information for the Company for each of the eight most recently completed fiscal quarters. Except where noted, this information has been prepared in accordance with IFRS.

	Second Quarter		**First Quarter**		**Fourth Quarter**		**Third Quarter**	
($000s, except per share data – unaudited)	**2011** (12 Weeks)	**2010** (12 Weeks)	**2011** (12 Weeks)	**2010** (12 Weeks)	**2010** (12 Weeks)	**2009**[1] (12 Weeks)	**2010** (16 Weeks)	**2009**[1] (16 Weeks)
Sales	$ 2,394,145	$ 2,360,887	$ 2,347,021	$ 2,284,433	$ 2,499,965	$ 2,488,544	$ 3,047,430	$ 3,013,007
Net earnings	$ 147,925	$ 145,967	$ 117,541	$ 122,252	$ 168,906	$ 171,060	$ 154,724	$ 170,894
Per common share								
- Basic net earnings	$ 0.68	$ 0.67	$ 0.54	$ 0.56	$ 0.78	$ 0.79	$ 0.71	$ 0.79
- Diluted net earnings	$ 0.68	$ 0.67	$ 0.54	$ 0.56	$ 0.78	$ 0.79	$ 0.71	$ 0.79

[1] The selected information that is presented for quarterly periods in fiscal 2009 does not reflect the impact of the adoption of IFRS.

The Company experienced growth in sales in each of the four most recent quarters compared to the same quarters of the prior year.

Although not directly comparable, net earnings decreased in the third quarter of 2010 compared to the same quarter of the prior year due in part to the impact of the drug system reform initiatives implemented in certain jurisdictions of Canada, principally Ontario, which negatively impacted pharmacy reimbursement and margin rates, and also due to a charge of $10 million (pre-tax) to settle a long-standing legal dispute related to a commercial arrangement with one of the Company's ancillary businesses. While also not directly comparable, net earnings decreased in the fourth quarter of 2010 compared to the same quarter of the prior year, partly the result of downward pressure on sales and margins in the dispensary, partially offset by strong performance in the front of the store, improved purchasing synergies and continued gains in productivity and efficiency, but also due to the recognition of an impairment charge of $7 million (pre-tax) as a result of the adoption of IFRS. Net earnings decreased in the first quarter of 2011 compared to the same quarter of the prior year, however the prior year's results include a gain on disposal of $12 million (pre-tax) in respect of a sale-leaseback transaction involving certain of the Company's retail properties. Net earnings increased in the second quarter of 2011 compared to the same quarter of the prior year, as continued strong performance in the front of the store served to partially mitigate the downward pressure on sales and margin dollars in the dispensary and the Company realized benefits from cost reduction initiatives and further gains in productivity and efficiency in identical stores.

The Company's core prescription drug operations are not typically subject to seasonal fluctuations. The Company's front store operations include seasonal promotions which may have an impact on comparative quarterly results, particularly when a season, notably Easter, does not fall in the same quarter each year. Also, as the Company continues to expand its front store product and service offerings, including seasonal promotions, its results of operations may become subject to more seasonal fluctuations.

RISKS AND RISK MANAGEMENT

Industry and Regulatory Developments

The Company is exposed to a number of risks in the normal course of its business that have the potential to affect its operating and financial performance, including the risk of adverse drug system reform initiatives which may adversely impact the revenues and profitability that may be derived from prescription drug sales. The Company is reliant on prescription drug sales for a significant portion of its sales and profits.

The following is a discussion of significant industry and regulatory developments since the date of the Company's Interim Management's Discussion and Analysis for the 12 week period ended March 26, 2011:

Nova Scotia

On July 1, 2011, Bill 17, *An Act Respecting an Insured Prescription Drug Plan, including Fair Drug Pricing* (the "Fair Drug Pricing Act") became law in Nova Scotia. The Fair Drug Pricing Act creates stand-alone legislation to oversee the public drug plans in Nova Scotia and allows the government to regulate the cost of generic drugs dispensed under the public drug plans. The Fair Drug Pricing Act also allows the government to regulate the activities of providers of pharmacy services in relation to any matters under the legislation and includes the ability to impose rules, terms, restrictions or conditions respecting rebates and professional allowances. The Regulations to support the Fair Drug Pricing Act, the *Drug Plan Regulations*, the *Fair Drug Pricing Regulations*, the *Seniors Pharmacare Program Regulations*, the *Family Pharmacare Program Regulations* and the *Provider Appeals Regulations* also came into force on July 1, 2011. In furtherance of the Nova Scotia government's drug pricing plan announced by the government on April 1, 2011, the *Fair Drug Pricing Regulations* sets a cap on the price of most generic drugs, both new and existing, at a percentage of the price of the equivalent brand name drug as set out below:

July 1, 2011 – generic drugs will be priced at 45 percent of the manufacturer's list price of the equivalent brand name drug as of April 11, 2011;

January 1, 2012 – generic drugs will be priced at 40 percent of the manufacturer's list price of the equivalent brand name drug as of April 11, 2011; and

July 1, 2012 – generic drugs will be priced at 35 percent of the price of the equivalent brand name drug as of April 11, 2011 or as of the date that the notice of compliance is issued for the first product in a new category of interchangeable products.

Also, on July 1, 2011, under a three year agreement reached between the Nova Scotia Department of Health and Wellness and the Pharmacy Association of Nova Scotia, the maximum dispensing fees will be raised from $10.62 to $10.73 and will be further increased at periodic intervals to reach $11.05 on April 1, 2013. In addition to the dispensing fee, beginning on September 1, 2011, a transition fee of $0.10 per prescription will be provided to assist pharmacy operators in the transition period. This transition fee will be increased at periodic intervals to reach $1.05 on April 1, 2013. The maximum permitted mark-up on generic drugs will also increase from 2% to 6% on August 1, 2011, subject to a maximum of $50 per prescription, which will increase to $250 per prescription on September 1, 2011. The Nova Scotia government is also introducing four new payments for services: advanced medication review (maximum special services fee of $150); basic medication review (maximum special services fee of $52.50); prescription adaptation (maximum special services fee of $14.00); and therapeutic substitution (maximum special services fee of $26.25).

Ontario

On May 18, 2010, the Government of Ontario passed amendments to the *Ontario Drug Benefit Act* and the *Drug Interchangeability and Dispensing Fee Act*, and on June 7, 2010, filed amendments to Ontario Regulation 201/96 and Regulation 935 (collectively, the "Ontario Regulatory Amendments"). The Ontario Regulatory Amendments provide that a prescription drug product that falls under the definition of a "private label product" will not be designated as an interchangeable prescription drug product or as a listed drug product for the Ontario Drug Benefit Program. Designation as an interchangeable prescription drug product is generally necessary for market adoption of generic prescription drug products and designation as a listed drug product for the Ontario Drug Benefit Program is necessary for public reimbursement. The Company pursued a legal challenge to the validity of the prohibition under the current legislation. On February 3, 2011, the Ontario Divisional Court released its decision in respect of the Company's application for judicial review of the prohibition on "private label products" under the Ontario Regulatory Amendments. In its decision, the Ontario Divisional Court found in favour of the Company and Katz Group Canada Inc. (the applicant in a parallel application) and declared the regulatory restrictions in respect of "private label products" to be invalid. The Ontario government subsequently sought and obtained leave to appeal the Divisional Court's decision, which appeal was heard by the Court of Appeal for Ontario on June 27, 2011. The Court of Appeal has reserved its decision, and the Company expects the ruling to be released in the coming months.

Saskatchewan

On May 4, 2011, the Saskatchewan government announced that it was implementing a plan to lower generic drug prices in Saskatchewan. A key component of the plan is an agreement with the pharmacy sector to invest a portion of the government savings into pharmacy reimbursement such as increased dispensing fees and expansion of professional pharmacy services. As part of the plan, the price on most existing generic drug products was lowered to 45 percent of the equivalent brand name drug price by June 1, 2011 and will be lowered to 35 percent of the equivalent brand name drug price by April 1, 2012. As of April 1, 2011, prices for new multisource generic drugs are priced at 40 percent of the equivalent brand name drug price and will be lowered to 35 percent of the equivalent brand name drug price by April 1, 2012. As for generic drugs that have been procured under standing offer contracts, certain of those generic drugs will be transitioned out of standing offer contracts and will be priced at 35 percent of the equivalent brand name drug price. Generic drug pricing in Saskatchewan had been in the range of 50 to 70 percent of the equivalent brand name drug price. To recognize the impact of reduced generic prices on Saskatchewan pharmacies, the maximum dispensing fee was increased from $9.43 to $9.85 on May 1, 2011 and the dispensing fee will be further increased to $10.25 on April 1, 2012.

Where legislative or other measures that appear to be effective in reducing prescription drug costs are implemented in one jurisdiction, governments in other provincial jurisdictions are looking or may look to implement similar measures. In some provincial jurisdictions, elements of the laws and regulations that impact pharmacy reimbursement and manufacturer allowances for sales to the public drug plans may be extended by legislation to sales in the private sector. Also, private third-party payers (such as corporate employers and their insurers) are looking or may look to benefit from any measures implemented by government payers to reduce prescription drug costs for public plans by attempting to extend these measures to prescription drug plans they own or manage. Accordingly, changes to pharmacy reimbursement and manufacturer allowances for a public drug plan could also impact pharmacy reimbursement and manufacturer allowances for private sector sales. In addition, private third-party payers could reduce pharmacy reimbursement for prescription drugs provided to their members.

Changes impacting pharmacy reimbursement programs, prescription drug pricing and manufacturer allowance funding, legislative or otherwise, may have a material adverse impact on the Company's business, sales and profitability. In addition, the Company could incur significant costs in the course of complying with any changes in the regulatory regime affecting prescription drugs. Non-compliance with any such existing or proposed laws or regulations, particularly those that provide for the licensing and conduct of wholesalers, the licensing and conduct of pharmacists, the regulation and ownership of pharmacies, the advertising of pharmacies and prescription services, the provision of information concerning prescription drug products, the pricing of prescription drugs and restrictions on manufacturer allowance funding, could result in civil or regulatory proceedings, fines, penalties, injunctions, recalls or seizures, any of which may impact the Company's business, sales or profitability.

RISKS ASSOCIATED WITH FINANCIAL INSTRUMENTS

The Company is exposed to a number of risks associated with financial instruments that have the potential to affect its operating and financial performance. The Company's primary financial instrument risk exposures are interest rate risk and liquidity risk. The Company's exposures to foreign currency risk, credit risk and other price risk are not considered to be material. The Company may use derivative financial instruments to manage certain of these risks but it does not use derivative financial instruments for trading or speculative purposes.

Exposure to Interest Rate Fluctuations

The Company, including its Associate-owned store network, is exposed to fluctuations in interest rates by virtue of its borrowings under its bank credit facilities, commercial paper program and financing programs available to its Associates. Increases or decreases in interest rates will negatively or positively impact the financial performance of the Company.

The Company monitors market conditions and the impact of interest rate fluctuations on its fixed and floating rate debt instruments on an ongoing basis and may use interest rate derivatives to manage this exposure. Currently, the Company is not party to interest rate derivative agreements. In 2010, the Company used an interest rate derivative agreement to convert an aggregate notional principal amount of $50 million of floating rate debt into fixed rate debt. The fixed rate payable by the Company under this agreement was 4.18% and contained reset terms of one month. This agreement matured in December 2010.

Furthermore, the Company may be exposed to losses should any counterparty to its derivative agreements fail to fulfill its obligations. The Company seeks to minimize counterparty risk by transacting with counterparties that are large financial institutions. There was no such exposure as at June 18, 2011, as the Company was not party to any interest rate derivative agreements as at that date.

As at June 18, 2011, the Company had $255 million (2010 - $401 million) of unhedged floating rate debt. During the 12 and 24 week periods ended June 18, 2011, the Company's average outstanding unhedged floating rate debt was $409 million and $444 million (2010 - $580 million and $599 million), respectively. Had interest rates been higher or lower by 50 basis points during the 12 and 24 week periods ended June 18, 2011, net earnings would have decreased or increased, respectively, by approximately $0.3 million and $0.7 million (2010 - $0.5 million and $1.0 million), respectively, as a result of the Company's exposure to interest rate fluctuations on its unhedged floating rate debt.

Foreign Currency Exchange Risk

The Company conducts the vast majority of its business in Canadian dollars. The Company's foreign currency exchange risk principally relates to purchases made in U.S. dollars and this risk is tied to fluctuations in the exchange rate of the Canadian dollar vis-à-vis the U.S. dollar. The Company monitors its foreign currency purchases in order to monitor and manage its foreign currency exchange risk. The Company does not consider its exposure to foreign currency exchange rate risk to be material.

Credit Risk

Accounts receivable arise primarily in respect of prescription sales billed to governments and third-party drug plans and, as a result, collection risk is low. There is no concentration of balances with debtors in the remaining accounts receivable. The Company does not consider its exposure to credit risk to be material.

Other Price Risk

The Company uses cash-settled equity forward agreements to limit its exposure to future changes in the market price of its common shares by virtue of its obligations under its long-term incentive plan ("LTIP") and restricted share

unit plan ("RSU Plan"). The income or expense arising from the use of these instruments is included in operating and administrative expenses.

Based on market values of the equity forward agreements in place at June 18, 2011, the Company recognized a liability of $1.7 million, of which $0.4 million is presented in accounts payable and accrued liabilities and $1.3 million is presented in other long-term liabilities. Based on market values of the equity forward agreements in place at June 19, 2010, the Company recognized a liability of $7.6 million, of which $2.4 million was presented in accounts payable and accrued liabilities and $5.2 million was presented in other long-term liabilities. During the 12 and 24 week periods ended June 18, 2011 and June 19, 2010, the Company assessed that the percentages of the equity forward agreements in place related to unearned units under the LTIP and RSU Plan were effective hedges for its exposure to future changes in the market price of its common shares in respect of the unearned units. Market values were determined based on information received from the Company's counterparty to these equity forward agreements.

Capital Management and Liquidity Risk

The Company's primary objectives when managing its capital are to profitably grow its business while maintaining adequate financing flexibility to fund attractive new investment opportunities and other unanticipated requirements or opportunities that may arise. Profitable growth is defined as earnings growth commensurate with the additional capital being invested in the business in order that the Company earns an attractive rate of return on that capital. The primary investments undertaken by the Company to drive profitable growth include additions to the selling square footage of its store network via the construction of new, relocated and expanded stores, including related leasehold improvements and fixtures, the acquisition of sites as part of a land bank program, as well as through the acquisition of independent drug stores or their prescription files. In addition, the Company makes capital investments in information technology and its distribution capabilities to support an expanding store network. The Company also provides working capital to its Associates via loans and/or loan guarantees. The Company largely relies on its cash flow from operations to fund its capital investment program and dividend distributions to its shareholders. This cash flow is supplemented, when necessary, through the borrowing of additional debt. No changes were made to these objectives during the period.

The Company considers its total capitalization to be bank indebtedness, commercial paper, short-term debt, long-term debt (including the current portion thereof), financing leases and shareholders' equity, net of cash. The Company also gives consideration to its obligations under operating leases when assessing its total capitalization. The Company manages its capital structure with a view to maintaining investment grade credit ratings from two credit rating agencies. In order to maintain its desired capital structure, the Company may adjust the level of dividends paid to shareholders, issue additional equity, repurchase shares for cancellation or issue or repay indebtedness. The Company has certain debt covenants and is in compliance with those covenants.

The Company monitors its capital structure principally through measuring its net debt to shareholders' equity ratio and net debt to total capitalization ratio, and ensures its ability to service its debt and meet other fixed obligations by tracking its interest and other fixed charges coverage ratios. (See discussion under "Capitalization and Financial Position" in this Management's Discussion and Analysis.)

Liquidity risk is the risk that the Company will be unable to meet its obligations relating to its financial liabilities. The Company prepares cash flow budgets and forecasts to ensure that it has sufficient funds through operations, access to bank credit facilities and access to debt and capital markets to meet its financial obligations, capital investment program and fund new investment opportunities or other unanticipated requirements as they arise. The Company manages its liquidity risk as it relates to financial liabilities by monitoring its cash flow from operating activities to meet its short-term financial liability obligations and planning for the repayment of its long-term financial liability obligations through cash flow from operating activities and/or the issuance of new debt.

For a complete description of the Company's sources of liquidity, see the discussions under "Sources of Liquidity" and "Future Liquidity" under "Liquidity and Capital Resources" in this Management's Discussion and Analysis.

INTERNAL CONTROL OVER FINANCIAL REPORTING

The Chief Executive Officer and the Chief Financial Officer have designed, or caused to be designed under their supervision, internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. Internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be designed effectively can provide only reasonable assurance with respect to financial reporting and financial statement preparation.

There were no changes in internal control over financial reporting that occurred during the Company's most recent interim period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

NON-IFRS FINANCIAL MEASURES

The Company reports its financial results in accordance with IFRS. However, the foregoing contains references to non-IFRS financial measures, such as adjusted depreciation and amortization, operating margin, EBITDA (earnings before finance expenses, income taxes and depreciation and amortization), EBITDA margin, adjusted earnings, adjusted earnings per share and cash interest expense. Non-IFRS financial measures do not have standardized meanings prescribed by IFRS and, therefore, may not be comparable to similar measures presented by other reporting issuers.

These non-IFRS financial measures have been included in this Management's Discussion and Analysis as they are measures which management uses to assist in evaluating the Company's operating performance against its expectations and against other companies in the retail drug store industry. Management believes that non-IFRS financial measures assist in identifying underlying operating trends.

These non-IFRS financial measures, particularly EBITDA and EBITDA margin, are also common measures used by investors, financial analysts and rating agencies. These groups may use EBITDA, EBITDA margin and other non-IFRS financial measures to value the Company and assess the Company's ability to service its debt.