NEIGHBORCARE INC
Form 10-Q
May 09, 2005

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

# FORM 10-Q

**(Mark One)**

| | |
|---|---|
| **ý** | **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** |
| | **For the quarterly period ended March 31, 2005** |
| | **or** |
| **o** | **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** |
| | **For the transition period from to** |

**Commission File Number: 000-33217**

# NEIGHBORCARE, INC.

(Exact name of registrant as specified in its charter)

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

**(410) 528-7300**

(Registrant s telephone number, including area code)

**N/A**

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

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

YES ý NO o

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

YES ý NO o

As of May 5, 2005, 44,132,566 shares of the registrant s common stock were outstanding and 259,360 shares are to be issued in connection with the registrant s joint plan of reorganization confirmed by the Bankruptcy Court on September 20, 2001.

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

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

YES ý NO o

**TABLE OF CONTENTS**

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Part I: FINANCIAL INFORMATION

Item 1. Financial Statements
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Item 3. Quantitative and Qualitative Disclosures About Market Risk
Item 4. Controls and Procedures

Part II: OTHER INFORMATION

Item 1. Legal Proceedings
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Item 3. Defaults Upon Senior Securities
Item 4. Submission of Matters to a Vote of Security Holders
Item 5. Other Information
Item 6. Exhibits

SIGNATURES

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

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

Statements made in this report and in our other public filings and releases, which are not historical facts, contain forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995) that involve risks and uncertainties and are subject to change at any time. These forward-looking statements may include, but are not limited to:

certain statements in Management s Discussion and Analysis of Financial Condition and Results of Operations, and the notes to our consolidated financial statements, such as our ability to meet our liquidity needs, scheduled debt and interest payments, and expected future capital expenditure and business acquisition requirements; the expected effects of government regulation on our business including the Medicare Prescription Drug, Improvement and Modernization Act of 2003; our ability to successfully implement our strategic objectives, including the effects of the spin-off of Genesis HealthCare Corporation ( GHC ) and the achievement of certain performance improvement initiatives within our institutional pharmacy segment, in order to improve current pharmacy profitability; costs associated with an unsolicited offer to acquire the Company; and estimates in our significant accounting policies, including our allowance for doubtful accounts, the valuation of our deferred tax assets and the anticipated impact of long-lived asset impairments;

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

certain statements in Legal Proceedings regarding the effects of litigation.

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

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

our ability, and the ability of our customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;

changes in the reimbursement rates or methods of payment from Medicare and Medicaid, or the implementation of other measures to reduce the reimbursement for our services and the impact of the Medicare Prescription Drug, Improvement and Modernization Act of 2003;

changes in pharmacy legislation and payment formulas;

the impact of federal and state regulations;

competition in our businesses;

the impact of Omnicare, Inc. s unsolicited tender offer to acquire all of our outstanding common stock and nomination of an alternative slate of directors;

competition for qualified management and pharmacy professionals;

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

changes in the acuity of patients, payor mix and payment methodologies;

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 pharmaceutical manufacturers rebate programs;

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

3

the impact of acquisitions, and our ability to integrate acquired businesses, on our operations and finances;

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;

our covenants and restrictions contained in financing agreements which limit our discretion in the operation of our business;

our charter documents and the Pennsylvania Business Corporation Law of 1988, as amended, which could delay or prevent a change of control;

income tax liabilities and indemnification obligations related to the spin-off of GHC; and

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

Certain of these risks are described in more detail in our Annual Report on Form 10-K for the fiscal year ended September 30, 2004 filed with the Securities and Exchange Commission on December 10, 2004, as amended on Form 10-K/A filed with the Securities and Exchange Commission on December 14, 2004.

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

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

4

## PART I: FINANCIAL INFORMATION

### Item 1. Financial Statements

**NEIGHBORCARE, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(unaudited, in thousands)**

| | March 31, 2005 | September 30, 2004 |
|---|---|---|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | $ 27,316 | $ 81,923 |
| Accounts receivable, net of allowance of $18,174 and $13,608, respectively | 265,557 | 230,903 |
| Inventories | 69,779 | 64,111 |
| Prepaid expenses and other current assets | 43,906 | 40,046 |
| Total current assets | 406,558 | 416,983 |
| Property, plant and equipment, net of accumulated depreciation of $74,659 and $61,904, respectively | 95,600 | 84,215 |
| Other long-term assets | 21,343 | 19,353 |
| Identifiable intangible assets, net | 16,824 | 12,737 |
| Goodwill | 347,097 | 316,120 |
| Total assets | $ 887,422 | $ 849,408 |
| | | |
| LIABILITIES and SHAREHOLDERS EQUITY | | |
| Current liabilities | | |
| Current portion of long-term debt | $ 9,035 | $ 4,263 |
| Accounts payable and accrued expenses | 119,604 | 116,965 |
| Income taxes payable | 14,878 | 4,747 |
| Total current liabilities | 143,517 | 125,975 |
| Long-term debt excluding current portion | 255,648 | 258,008 |
| Deferred income taxes | 62,607 | 62,607 |
| Other long-term liabilities | 10,442 | 8,158 |
| Total liabilities | 472,214 | 454,748 |
| Minority interest | 7,893 | 7,880 |
| SHAREHOLDERS EQUITY | 407,315 | 386,780 |
| Total liabilities and shareholders equity | $ 887,422 | $ 849,408 |

See accompanying notes to unaudited condensed consolidated financial statements.

**NEIGHBORCARE, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(unaudited, in thousands except per share amounts)**

| | Three Months Ended March 31, 2005 | Three Months Ended March 31, 2004 |
|---|---|---|
| Net revenues | $ 404,706 | $ 356,646 |
| Cost of revenues | 321,329 | 282,285 |
| Gross profit | 83,377 | 74,361 |
| Selling, general and administrative | 60,518 | 51,599 |
| Strategic planning, severance and other operating items | (64) | 2,037 |
| Takeover defense expenses | 785 | |
| Operating income | 22,138 | 20,725 |
| Interest expense, net | 4,498 | 4,553 |
| Other expense | 1,173 | 1,225 |
| Income before income tax provision | 16,467 | 14,947 |
| Income tax provision | 6,782 | 6,731 |
| Net income | $ 9,685 | $ 8,216 |
| | | |
| Per common share data | | |
| Basic | | |
| Net income | $ 0.22 | $ 0.19 |
| Weighted average shares outstanding | 43,838 | 43,640 |
| Diluted | | |
| Net income | $ 0.22 | $ 0.19 |
| Weighted average shares outstanding | 44,688 | 43,957 |

See accompanying notes to unaudited condensed consolidated financial statements.

**NEIGHBORCARE, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(unaudited, in thousands except per share amounts)**

| | Six Months Ended March 31, 2005 | | Six Months Ended March 31, 2004 | |
|---|---|---|---|---|
| Net revenues | $ | 796,706 | $ | 695,040 |
| Cost of revenues | | 631,063 | | 544,256 |
| Gross profit | | 165,643 | | 150,784 |
| Selling, general and administrative | | 120,164 | | 108,635 |
| Strategic planning, severance and other operating items | | 455 | | 42,701 |
| Takeover defense expenses | | 1,557 | | |
| Operating income (loss) | | 43,467 | | (552) |
| Interest expense, net | | 8,529 | | 10,207 |
| Other expense | | 2,301 | | 2,317 |
| Income (loss) before income tax provision (benefit) | | 32,637 | | (13,076) |
| Income tax provision (benefit) | | 13,250 | | (7,143) |
| Income (loss) from continuing operations | | 19,387 | | (5,933) |
| Income from discontinued operations, net of taxes | | | | 8,435 |
| Net income | $ | 19,387 | $ | 2,502 |
| | | | | |
| Per common share data | | | | |
| Basic | | | | |
| Income (loss) from continuing operations | $ | 0.44 | $ | (0.14) |
| Income from discontinued operations | $ | | $ | 0.20 |
| Net income | $ | 0.44 | $ | 0.06 |
| Weighted average shares outstanding | | 43,823 | | 42,010 |
| Diluted | | | | |
| Income (loss) from continuing operations | $ | 0.43 | $ | (0.14) |
| Income from discontinued operations | $ | | $ | 0.20 |
| Net income | $ | 0.43 | $ | 0.06 |
| Weighted average shares outstanding | | 44,649 | | 42,010 |

See accompanying notes to unaudited condensed consolidated financial statements.

**NEIGHBORCARE, INC**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(unaudited, in thousands)**

| | Six Months Ended March 31, 2005 | | Six Months Ended March 31, 2004 | |
|---|---|---|---|---|
| Cash flows from operating activities | | | | |
| Net income | $ | 19,387 | $ | 2,502 |
| Net charges included in operations not requiring funds | | 28,159 | | 26,412 |
| Changes in operating assets and liabilities, excluding the impact of business acquisitions | | | | |
| Change in accounts receivable, net | | (34,504) | | (39,986) |
| Change in accounts payable and accrued expenses | | 10,475 | | 79,671 |
| Other, net | | (8,330) | | (33,384) |
| Net cash provided by operating activities | | 15,187 | | 35,215 |
| Cash flows from investing activities | | | | |
| Capital expenditures | | (23,133) | | (16,545) |
| Pharmacy business acquisitions, net of cash acquired | | (46,900) | | (3,969) |
| Other, net | | (2,004) | | (33,432) |
| Net cash used by investing activities | | (72,037) | | (53,946) |
| Cash flows from financing activities | | | | |
| Repayment of long-term debt | | (2,399) | | (556,285) |
| Net borrowings against revolving credit facility | | 4,000 | | |
| Proceeds from issuance of long-term debt, net of debt issuance costs | | | | 465,804 |
| Distributions of cash to GHC | | | | (63,154) |
| Funds received from GHC for debt financing | | | | 135,885 |
| Other | | 642 | | (4,907) |
| Net cash provided (used) by financing activities | | 2,243 | | (22,657) |
| Net decrease in cash and cash equivalents | $ | (54,607) | $ | (41,388) |
| Cash and cash equivalents at beginning of period | | 81,923 | | 132,726 |
| Cash and cash equivalents at end of period | $ | 27,316 | $ | 91,338 |
| | | | | |
| Non-cash investing and financing activities | | | | |
| Distribution of net assets to GHC | | | $ | (662,419) |
| Conversion of preferred stock to common stock | | | | (46,831) |

See accompanying notes to unaudited condensed consolidated financial statements.

**NeighborCare, Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements**

## 1. Background and Basis of Presentation

NeighborCare, Inc. (NeighborCare or the Company), formerly named Genesis Health Ventures, Inc., provides pharmacy services nationwide through its NeighborCare® integrated pharmacy operation that serves approximately 289,000 institutional beds in long-term care settings. NeighborCare also operates 32 community-based retail pharmacies and a group purchasing organization. Prior to December 1, 2003, the Company also operated an inpatient services business, which was then spun-off as Genesis HealthCare Corporation (GHC). For additional information, see the Company s Form 10-K, as amended, for the fiscal year ended September 30, 2004 (Form 10-K).

The accompanying condensed consolidated financial statements are unaudited and have been prepared on a basis that is substantially consistent with the accounting principles applied in the Form 10-K. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Form 10-K.

In the opinion of NeighborCare s management, the unaudited condensed consolidated financial statements include all necessary adjustments consisting of normal recurring accruals and adjustments for a fair presentation of the financial position and results of operations for the periods presented. Certain reclassifications have been made to the prior year s financial statements to conform to the current year s presentation.

## 2. Significant Accounting Policies

***Management s Use of Estimates***

An accounting policy is considered to be significant if it is important to the Company s financial condition and results of operations, and requires significant judgment and estimates on the part of management in its application. Significant accounting estimates and the related assumptions are evaluated periodically as conditions warrant, and changes to such estimates are recorded as new information or changed conditions require revision. Application of certain accounting policies requires management s significant judgments, often as the result of the need to make estimates of matters that are inherently uncertain. If actual results were to differ materially from the estimates made, the reported results could be materially affected. The Company s significant estimates include allowance for doubtful accounts, allowance for inventories, revenue recognition and contractual allowances, and the valuation of long-lived assets.

Senior management has reviewed these significant accounting policies and estimates with the Company s audit committee. During the current quarter, there were no material changes made to the estimates or methods by which estimates are derived with regard to the significant accounting policies of the Company. See the Form 10-K for more detail regarding the Company s significant accounting policies.

9

***Stock Based Compensation***

As permitted by the Financial Accounting Standards Board (FASB) SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS 148), the Company applies the intrinsic value method as defined in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, in accounting for its stock option and restricted stock plans. Had the Company determined compensation cost of outstanding stock options based on the fair value at the grant date consistent with the provisions of SFAS 123 *Accounting for Stock Based Compensation*, the Company s net income would have been changed to the pro forma amounts indicated below (in thousands):

| | Three months ended | | Six months ended | |
|---|---|---|---|---|
| | **March 31, 2005** | **March 31, 2004** | **March 31, 2005** | **March 31, 2004** |
| Net income as reported | $ 9,685 | $ 8,216 | $ 19,387 | $ 2,502 |
| Add stock-based compensation expense included in net income as reported, net of tax effect | 677 | 147 | 1,279 | 262 |
| Deduct stock-based compensation expense determined under the fair-value-based method for all awards, net of tax effect | (1,096) | (842) | (2,121) | (6,162) |
| Net income (loss) pro forma | $ 9,266 | 7,521 | $ 18,545 | (3,398) |
| | | | | |
| Earnings (loss) per share: | | | | |
| Basic as reported | $ 0.22 | $ 0.19 | $ 0.44 | $ 0.06 |
| Basic pro forma | $ 0.21 | $ 0.17 | $ 0.42 | $ (0.08) |
| Diluted as reported | $ 0.22 | $ 0.19 | $ 0.43 | $ 0.06 |
| Diluted pro forma | $ 0.21 | $ 0.17 | $ 0.42 | $ (0.08) |

There were no stock options granted during the six months ended March 31, 2005. The fair value of stock options granted during the three and six months ended March 31, 2004 was estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions:

| | |
|---|---|
| Volatility | 35% |
| Expected life (in years) | 5.0 |
| Rate of return | 2.2% |
| Dividend yield | 0% |

On December 16, 2004, the FASB issued Statement No. 123R, *Share Based Payment* (SFAS 123R), which is a revision of SFAS 123, *Accounting for Stock-Based Compensation.* SFAS 123R requires that all share-based payments to employees, including stock options, be recognized in the financial statements based on their fair values on the date of grant and eliminates the disclosure-only provisions permitted under SFAS 148. SFAS 123R was to be effective for fiscal periods beginning after June 15, 2005. However, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R will be postponed until October 1, 2005 for the Company. The Company does not expect that the adoption of SFAS 123R will have a significant adverse effect on its results of operations.

## 3. Acquisitions

In the ordinary course of business, the Company makes strategic acquisitions to enhance its geographical market presence and to create beneficial operating synergies through acquisitions in locations that it has an existing market presence. On January 1, 2005, the Company purchased all of the assets of UniScripts, LTC.  On December 1, 2004, the Company completed the acquisition of Belville Pharmacy Services, Inc. (Belville) by purchasing certain of the assets of Belville. As of October 1, 2004, the Company acquired certain of the assets and assumed certain liabilities of Quest Total Care, L.P. These acquisitions were accounted for under the purchase method of accounting for business combinations in accordance with SFAS No. 141   *Business Combinations.*

Results of these completed acquisitions are included in the Company   s consolidated statements of operations from the date of the respective acquisition.  Pro-forma financial information has not been prepared because the acquisitions are not material to the consolidated operations and financial position of the Company.  The Company   s preliminary purchase price allocation, which is based on fair-value estimates, is as follows (in thousands):

| | | |
|---|---|---|
| Accounts receivable, net | $ | 8,185 |
| Inventories | | 1,628 |
| Property, plant and equipment | | 642 |
| Goodwill | | 29,945 |
| Identifiable intangible assets | | 6,649 |
| Other assets | | 27 |
| Total liabilities assumed | | (176) |
| Net assets acquired through acquisitions | $ | 46,900 |

The Company expects to complete its independent third-party valuation of Belville during the third quarter of fiscal 2005.

## 4. Discontinued Operations

Effective December 1, 2003, NeighborCare completed its plan of disposition for GHC through a distribution of GHC common stock to NeighborCare s shareholders of record as of October 15, 2003 in the form of a tax-free spin-off as described in Note 1. Under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), discontinued businesses, including assets held for sale or distributed to shareholders, are removed from the results of continuing operations. Consolidated interest expense in periods prior to the spin-off has been allocated to discontinued operations using a basis of net assets of each of the continuing and discontinued operating segments for the six months ended March 31, 2004.

The following table sets forth the components of income from discontinued operations for the six months ended March 31, 2004 related to the operations of GHC for periods prior to the spin off (in thousands):

| | | |
|---|---|---|
| Net revenues of GHC | $ | 250,927 |
| Net operating income of GHC | | 16,450 |
| Interest expense allocation | | 2,467 |
| Income tax expense | | 5,548 |
| Income from discontinued operations, net of taxes | $ | 8,435 |

## 5. Certain Significant Transactions and Events

***Strategic Planning, Severance and Other Operating Items***

NeighborCare has incurred costs that are directly attributable to the Company s transforming to a pharmacy-based business and certain of its short-term strategic objectives. These costs are segregated in the unaudited condensed consolidated statements of operations as Strategic planning, severance and other operating items. A summary of these costs for the six months ended March 31, 2005 follows (in thousands):

| | Accrued as of September 30, | Six months Ended March 31, 2005 | Accrued as of March 31, |
|---|---|---|---|

| | 2004 | Provision | Paid | 2005 |
|---|---|---|---|---|
| Employee contract termination, transaction completion bonuses, severance and related costs | $ 2,304 | $ 455 | $ 1,009 | $ 1,750 |
| Strategic planning and other items | 655 | | 195 | 460 |
| Total | $ 2,959 | $ 455 | $ 1,204 | $ 2,210 |

Strategic planning, severance and other operating items for the six months ended March 31, 2005 are primarily attributable to the consolidation of pharmacy operations. For the three months ended March 31, 2005, the Company recognized a $64,000 reduction in total strategic planning, severance and other operating items resulting from the adjustment of prior periods accruals.

Strategic planning, severance and other operating items for the six months ended March 31, 2004 relate primarily to legal, professional and other fees incurred to complete the spin-off transaction of $17.5 million; costs incurred pursuant to the termination provisions of employment contracts and transaction completion bonuses with NeighborCare and GHC executives of $9.0 million; costs incurred to extinguish long-term debt and related obligations in connection with the spin-off of $14.5 million; and severance and related costs incurred pursuant to our corporate and regional consolidation in the second quarter of fiscal 2004 of $1.7 million. Debt extinguishment costs represent the write-off of unamortized deferred financing costs of $5.9 million, consent fees required to eliminate our commitments under GHC debt of $5.0 million and other related debt settlements of $3.6 million.

***Takeover Defense Expenses***

On May 24, 2004, Omnicare, Inc. announced its intention to purchase all of the outstanding shares of NeighborCare, Inc. common stock for $30 per share in cash. On May 25, 2004, NeighborCare announced that its Board of Directors unanimously rejected the proposal. On June 3, 2004, Omnicare, Inc. announced its intention to commence a tender offer to purchase all of the outstanding shares of NeighborCare, Inc. common stock for $30 per share in cash. The tender offer formally commenced on June 4, 2004 and was originally stated to expire on July 7, 2004 but has been subsequently extended on several occasions, most recently to June 3, 2005. In any event, Omnicare, Inc. has announced an agreement with the Federal Trade Commission that it will not close any transaction to acquire NeighborCare prior to 12:01 a.m. on June 16, 2005. On June 14, 2004, NeighborCare, Inc. announced that the Board of Directors had unanimously recommended that shareholders reject the tender offer and not tender shares pursuant to the offer. On December 23, 2004, Omnicare, Inc. nominated three directors to the Company s eight member Board of Directors. Further information relating to the tender offer, including the Board s recommendation and reasons therefore, can be found in the Company s Solicitation/Recommendation Statement on Schedule 14D-9 filed with the Securities and Exchange Commission on June 14, 2004, and in subsequent amendments filed with Securities and Exchange Commission.

The Company has incurred various expenses as a result of the tender offer including legal, investment banking and other fees. During the three and six months ended March 31, 2005, $0.8 million and $1.6 million, respectively, of takeover defense expenses were incurred. The Company anticipates that additional takeover defense expenses will continue to be incurred through the duration of the tender offer; however, the impact of these expenses cannot be reasonably estimated.

## 6. Certain Significant Risks, Uncertainties and Business Concentrations

At March 31, 2005, the Company had contracts to provide services to approximately 289,000 residents in long-term care facilities in 34 states and the District of Columbia. Many of these contracts, as is typical in the industry, are for a period of one year but can be terminated by either party for any reason upon thirty to sixty days written notice.

For the three months ended March 31, 2005 and 2004, net revenues from GHC were 11% and 12%, respectively of consolidated net revenues. Net revenues from HCR Manor Care, Inc. (Manor Care) in the both of the three months ended March 31, 2005 and 2004 were 10% of consolidated net revenues. For the six months ended March 31, 2005 and 2004, net revenues from GHC were 11% of total consolidated net revenues. Net revenues from Manor Care in the six months ended March 31, 2005 and 2004 were 10% of consolidated net revenues. No other individual customer or market group represented more than 5% of the Company s consolidated net revenues.

The Company currently has a $34.3 million deposit with its primary pharmaceutical wholesaler. The deposit is fully refundable at the request of the Company.

## 7. Long-Term Debt

Long-term debt as of March 31, 2005 and September 30, 2004 consists of the following (in thousands):

| | March 31, 2005 | September 30, 2004 |
|---|---|---|
| Senior Subordinated Notes due 2013 | $ 250,000 | $ 250,000 |
| Borrowings under revolving credit facility | 4,000 | |
| Capital lease obligations and other debt, inclusive of fair market value adjustments | 10,683 | 12,271 |
| Total debt | 264,683 | 262,271 |
| Less: | | |
| Current portion of long-term debt | (9,035) | (4,263) |
| Long-term debt | $ 255,648 | $ 258,008 |

In order to effectively convert $125 million of its $250 million fixed-rate debt into variable-rate debt, the Company entered into an interest rate swap agreement with a notional amount of $125 million, which expires November 15, 2013, in which the Company receives a fixed-rate of 6.875% and pays a floating rate based on the six-month London InterBank Offered Rate (LIBOR) plus 1.8475% with measurement and settlement performed semiannually. The swap is designated as a fair value hedge, as the critical terms of the interest rate swap and the hedged item are designed to match thereby satisfying the criteria for short-cut method of accounting as defined by SFAS No. 133, as amended. Accordingly, the swap and the underlying debt obligation are recorded on the balance sheet at their fair value, with the changes in fair value of the derivative and the related debt being recorded in the consolidated statement of operations. Based upon valuations provided by third party financial institutions, the fair values of the interest rate swap were $(2.4) million as of March 31, 2005 and $0.3 million as of September 30, 2004. The fair value of the hedged portion of the debt is recorded as a reduction to the carrying value of the Senior Subordinated Notes due 2013 included in capital lease obligations and other debt, inclusive of fair market value adjustments. A corresponding liability is recorded in other long-term liabilities at March 31, 2005 to reflect the fair market value of the interest rate swap derivative instrument. At September 30, 2004, the fair value of the hedged debt was recorded as an increase to the carrying value of the Senior Subordinated Notes due 2013 being hedged through capital lease obligations and other debt, inclusive of fair market value adjustments. A corresponding asset was recorded in other long-term assets at September 30, 2004 reflecting the fair market value of the interest rate swap at that date. The fair value of the 6.875% Senior Subordinated Notes due 2013 on March 31, 2005 and September 30, 2004 was $264.4 million and $250.8 million, respectively, and was determined using quoted market rates on those dates.

During the six months ended March 31, 2004, the Company repaid substantially all of its existing long-term debt using the proceeds of the Company s $250 million senior subordinated notes offering and GHC s $225 million senior subordinated notes offering.

## 8. Guarantor Subsidiaries and Condensed Consolidated Financial Statements

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

**Condensed Consolidating Balance Sheets**

**March 31, 2005**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Accounts receivable, net | $ 166,301 | $ 225,778 | $ 18,447 | $ (144,969) | $ 265,557 |
| Other current assets | 48,121 | 71,145 | 21,735 | | 141,001 |
| Property, plant and equipment, net | 19,388 | 69,227 | 6,985 | | 95,600 |
| Investment in subsidiaries | 24,783 | 1,556 | | (23,697) | 2,642 |
| Goodwill | 287,789 | 56,017 | 3,291 | | 347,097 |
| Other long-term assets | 24,208 | 11,282 | 35 | | 35,525 |
| | $ 570,590 | $ 435,005 | $ 50,493 | $ (168,666) | $ 887,422 |
| | | | | | |
| **Liabilities and Shareholders Equity** | | | | | |
| Accounts payable and accrued expenses | $ 92,366 | $ 171,746 | $ 15,339 | $ (144,969) | $ 134,482 |
| Current portion of long-term debt | 8,543 | | 492 | | 9,035 |
| Long-term debt less current portion | 252,195 | 228 | 3,225 | | 255,648 |
| Other non-current liabilities | 80,942 | | | | 80,942 |
| Shareholders equity | 136,544 | 263,031 | 31,437 | (23,697) | 407,315 |
| | $ 570,590 | $ 435,005 | $ 50,493 | $ (168,666) | $ 887,422 |

**Condensed Consolidating Balance Sheets**

**September 30, 2004**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Accounts receivable, net | $ 146,197 | $ 195,364 | $ 18,365 | $ (129,023) | $ 230,903 |
| Other current assets | 108,879 | 63,787 | 13,414 | | 186,080 |
| Property, plant and equipment, net | 18,685 | 58,069 | 7,461 | | 84,215 |
| Investment in subsidiaries | 20,209 | 1,381 | | (21,034) | 556 |
| Goodwill | 287,142 | 26,720 | 2,258 | | 316,120 |
| Other long-term assets | 25,795 | 5,676 | 63 | | 31,534 |
| | $ 606,907 | $ 350,997 | $ 41,561 | $ (150,057) | $ 849,408 |
| | | | | | |
| **Liabilities and Shareholders Equity** | | | | | |
| Accounts payable and accrued expenses | $ 82,876 | $ 155,346 | $ 12,513 | $ (129,023) | $ 121,712 |
| Current portion of long-term debt | 4,263 | | | | 4,263 |
| Long-term debt less current portion | 256,240 | 254 | 1,514 | | 258,008 |
| Other non-current liabilities | 78,645 | | | | 78,645 |
| Shareholders equity | 184,883 | 195,397 | 27,534 | (21,034) | 386,780 |
| | $ 606,907 | $ 350,997 | $ 41,561 | $ (150,057) | $ 849,408 |

**Condensed Consolidating Statements of Operations**

**Three months ended**

**March 31, 2005**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Consolidated |
|---|---|---|---|---|
| Net revenues | $ | $ 366,874 | $ 37,832 | $ 404,706 |
| Cost of revenues | | 293,490 | 27,839 | 321,329 |
| Gross profit | | 73,384 | 9,993 | 83,377 |
| Operating expenses | 14,967 | 40,934 | 5,338 | 61,239 |
| Interest expense (income), net | 3,991 | 445 | 62 | 4,498 |
| Other expense (income) | 1,370 | (197) | | 1,173 |
| Income (loss) before income tax provision | (20,328) | 32,202 | 4,593 | 16,467 |
| Income tax provision | 6,782 | | | 6,782 |
| Net income (loss) | $ (27,110) | $ 32,202 | $ 4,593 | $ 9,685 |

**Condensed Consolidating Statements of Operations**

**Three months ended**

**March 31, 2004**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Consolidated |
|---|---|---|---|---|
| Net revenues | $ | $ 318,715 | $ 37,931 | $ 356,646 |
| Cost of revenues | | 254,730 | 27,555 | 282,285 |
| Gross profit | | 63,985 | 10,376 | 74,361 |
| Operating expenses | 12,945 | 35,244 | 5,447 | 53,636 |
| Interest expense (income), net | 4,383 | 121 | 49 | 4,553 |
| Other expense (income) | 1,410 | (185) | | 1,225 |
| Income (loss) before income tax provision (benefit) | (18,738) | 28,805 | 4,880 | 14,947 |
| Income tax provision (benefit) | 6,731 | | | 6,731 |
| Net income (loss) | $ (25,469) | $ 28,805 | $ 4,880 | $ 8,216 |

**Condensed Consolidating Statements of Operations**

**Six months ended**

**March 31, 2005**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Consolidated |
|---|---|---|---|---|
| Net revenues | $ | $ 720,437 | $ 76,269 | $ 796,706 |
| Cost of revenues | | 575,079 | 55,984 | 631,063 |
| Gross profit | | 145,358 | 20,285 | 165,643 |
| Operating expenses | 30,680 | 80,758 | 10,738 | 122,176 |
| Interest expense (income), net | 7,760 | 641 | 128 | 8,529 |
| Other expense (income) | 2,691 | (390) | | 2,301 |
| Income (loss) before income tax provision | (41,131) | 64,349 | 9,419 | 32,637 |
| Income tax provision | 13,250 | | | 13,250 |
| Net income (loss) | $ (54,381) | $ 64,349 | $ 9,419 | $ 19,387 |

**Condensed Consolidating Statements of Operations**

**Six months ended**

**March 31, 2004**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Consolidated |
|---|---|---|---|---|
| Net revenues | $ | $ 619,864 | $ 75,176 | $ 695,040 |
| Cost of revenues | | 489,582 | 54,674 | 544,256 |
| Gross profit | | 130,282 | 20,502 | 150,784 |
| Operating expenses | 67,390 | 72,916 | 11,030 | 151,336 |
| Interest expense (income), net | 9,929 | 171 | 107 | 10,207 |
| Other expense (income) | 2,665 | (348) | | 2,317 |
| Income (loss) before income tax provision (benefit) | (79,984) | 57,543 | 9,365 | (13,076) |
| Income tax provision (benefit) | (7,145) | 2 | | (7,143) |
| Income (loss) from continuing operations | (72,839) | 57,541 | 9,365 | (5,933) |
| Income from discontinued operations | 8,435 | | | 8,435 |
| Net income (loss) | $ (64,404) | $ 57,541 | $ 9,365 | $ 2,502 |

**Condensed Consolidating Statements of Cash Flows**

**Six months ended**

**March 31, 2005**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Consolidated |
|---|---|---|---|---|
| Cash flow from operating activities | $ (60,976) | $ 62,823 | $ 13,340 | $ 15,187 |
| Cash flow from investing activities | (52,500) | (18,604) | (933) | (72,037) |
| Cash flow from financing activities | 2,465 | (83) | (139) | 2,243 |

**Condensed Consolidating Statements of Cash Flows**

**Six months ended**

**March 31, 2004**

**(in thousands)**

| | Parent | Guarantors | Non-Guarantors | Consolidated |
|---|---|---|---|---|
| Cash flow from operating activities | $ (17,567) | $ 29,164 | $ 23,618 | $ 35,215 |
| Cash flow from investing activities | (11,704) | (8,810) | (33,432) | (53,946) |
| Cash flow from financing activities | (32,002) | (70) | 9,415 | (22,657) |

## 9. Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share for the three and six months ended March 31, 2005 and 2004 (in thousands, except per share data):

| | Three months ended | | Six months ended | |
|---|---|---|---|---|
| | March 31, 2005 | March 31, 2004 | March 31, 2005 | March 31, 2004 |
| **Earnings:** | | | | |
| *Basic and diluted calculation:* | | | | |
| Income (loss) from continuing operations | $ 9,685 | $ 8,216 | $ 19,387 | $ (5,933) |
| Income from discontinued operations | | | | 8,435 |
| Net income | $ 9,685 | $ 8,216 | $ 19,387 | $ 2,502 |
| **Shares:** | | | | |
| Weighted average shares outstanding basic | 43,838 | 43,640 | 43,823 | 42,010 |
| Dilutive effect of stock options and restricted stock | 850 | 317 | 826 | |
| Weighted average shares outstanding diluted | 44,688 | 43,957 | 44,649 | 42,010 |
| **Per common share data:** | | | | |
| *Basic:* | | | | |
| Income from continuing operations | $ 0.22 | $ 0.19 | $ 0.44 | $ (0.14) |
| Income from discontinued operations | | | | $ 0.20 |
| Net income | $ 0.22 | $ 0.19 | $ 0.44 | $ 0.06 |
| *Diluted:* | | | | |
| Income (loss) from continuing operations | $ 0.22 | $ 0.19 | $ 0.43 | $ (0.14) |
| Income from discontinued operations | | | | $ 0.20 |
| Net income | $ 0.22 | $ 0.19 | $ 0.43 | $ 0.06 |

Basic earnings per share is calculated by dividing earnings (numerator) by the weighted average number of shares of common stock outstanding during the respective reporting period (denominator). Included in the calculation of basic weighted average shares for the current quarter are approximately 259,000 shares to be issued in connection with the joint plan of reorganization confirmed by the bankruptcy court.

Diluted earnings per share is calculated in a manner consistent with basic earnings per share except, where applicable, the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options and vesting of restricted stock awards. For the six months ended March 31, 2004, the Company reported a net loss from continuing operations for the period, thus the impact of including the effect of unexercised stock options would be anti-dilutive.

## 10. Segment Information

The Company s principal operating segments are identified by the types of products and services from which revenues are derived and are consistent with the reporting structure of the Company s internal organization. The Company has two reportable segments: (1) institutional pharmacy business and (2) corporate and other.

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

Summarized financial information concerning the Company s reportable segments is shown in the following table for the current quarter and same period last year. The Corporate and Other category of operations represents operating information of business units below the prescribed quantitative thresholds under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Revenues from these business units are primarily derived from the Company s community-based professional pharmacy business, home infusion, respiratory and medical equipment business and long-term care group purchasing business

(Tidewater). The Corporate and Other category also consists of the Company s corporate general and administrative function, for which there is generally no revenue generated.

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

| | Institutional Pharmacy | Corporate and Other (in thousands) | Consolidated |
|---|---|---|---|
| **Three months ended March 31, 2005** | | | |
| Net revenues | $ 350,344 | $ 54,362 | $ 404,706 |
| Gross profit | 67,206 | 16,171 | 83,377 |
| Operating income (loss) | 33,344 | (11,206) | 22,138 |
| **Three months ended March 31, 2004** | | | |
| Net revenues | $ 303,256 | $ 53,390 | $ 356,646 |
| Gross profit | 57,704 | 16,657 | 74,361 |
| Operating income (loss) | 28,521 | (7,796) | 20,725 |
| **Six months ended March 31, 2005** | | | |
| Net revenues | $ 688,176 | 108,530 | $ 796,706 |
| Gross profit | 132,705 | 32,938 | 165,643 |
| Operating income (loss) | 66,394 | (22,927) | 43,467 |
| **Six months ended March 31, 2004** | | | |
| Net revenues | $ 585,047 | $ 109,993 | $ 695,040 |
| Gross profit | 115,818 | 34,966 | 150,784 |
| Operating income (loss) | 55,094 | (55,646) | (552) |
| **Total assets as of** | | | |
| March 31, 2005 | $ 282,235 | $ 605,187 | $ 887,422 |
| September 30, 2004 | 217,969 | 631,439 | 849,408 |

## 11. Income Taxes

The Company s provision (benefit) for income taxes from continuing operations for the three months ended March 31, 2005 and 2004 was $6.8 million and $6.7 million, respectively, and was $13.3 million and $(7.1) million for the six months ended March 31, 2005 and 2004, respectively. The income tax benefit generated from the utilization of certain NOL carryforwards will be applied first as a reduction to goodwill and, thereafter, as a direct addition to paid in capital, pursuant to Statement of Position (SOP) No. 90-7, *Financial Reporting by Entities in Reorganization under the Bankruptcy Code*, at such time as it is assured.

## 12. Restricted Stock

On June 15, 2004, the Company s shareholders approved the 2004 Performance Incentive Plan (the Plan). The aggregate number of shares that may be issued under the Plan is 5,000,000. As of March 31, 2005, 441,296 shares of restricted stock have been issued to NeighborCare employees under the Plan, of which 156,830 are fully vested and 57,825 have been surrendered to fulfill employee income tax obligations resulting from the grants. These restricted stock grants were issued out of the treasury shares held as of the respective grant dates. Restrictions on grants to employees typically vest ratably over three years from the date of grant such that the employee cannot sell or trade the restricted stock until it becomes vested. In addition, as of March 31, 2005, 46,921 shares of restricted stock have been issued to members of the Company s board of directors. Restricted shares issued to current board members are restricted such that the holder cannot sell or trade the stock unless the seller s holdings in NeighborCare stock exceed $285,000 after the sale or trade occurs. The restrictions immediately lapse upon the holder s termination of board membership.

## 13. Changes in Shareholders Equity and Other Comprehensive Income

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

| | | |
|---|---|---|
| Balance at September 30, 2004 | $ | 386,780 |
| Stock option exercises and stock-based compensation | | 1,148 |
| Net income | | 19,387 |
| Balance at March 31, 2005 | $ | 407,315 |

As of March 31, 2005 and September 30, 2004, the Company s comprehensive income was equal to net income.

For the six month s ended March 31, 2004, the Company recognized $4.4 million in other comprehensive income as a result of the termination of an interest rate swap as a result of the spin-off of GHC. Additionally, $1.1 million of other comprehensive loss was distributed to GHC in the spin-off. For further information regarding the spin-off and distribution of net assets to GHC, refer to the Form 10-K.

## 14. Commitments and Contingencies

***Financial Commitments***

Requests for providing commitments to extend financial guarantees and extend credit are reviewed and approved by senior management. Management regularly reviews all outstanding commitments, letters of credit and financial guarantees, and the results of these reviews are considered in assessing the need for any provisions for possible credit and guarantee losses.

As of March 31, 2005, the Company had extended letters of credit of $5.2 million. The outstanding letters of credit reduce the Company s $96.0 million borrowing availability under its $100.0 million revolving credit facility to $90.8 million.

***Legal Proceedings***

The Company is a party to litigation arising in the ordinary course of business. The Company accrues for legal proceedings when an unfavorable outcome is probable and reasonably estimable. With exception to the discussion which follows, the Company does not believe the results of such litigation, even if the outcome is unfavorable, would have a material adverse effect on its financial position. While the outcome of the cases discussed below could have a material effect if decided adversely, the Company s management considers this result unlikely. See Cautionary Statements Regarding Forward-Looking Statements.

The following reflects developments in legal proceedings during the reporting quarter. For information regarding other Legal Proceedings, see the Form 10-K and the Company s Form 10-Q for the quarter ended December 31, 2004.

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

This action was brought January 27, 2004 in the Supreme Court of New York, County of New York, by 275 former investors who collectively held over $205 million in subordinated debentures prior to the filing of the Company s Chapter 11 bankruptcy petition in 2000. The case was subsequently removed to federal court and then to the U.S. Bankruptcy Court for the District of Delaware. The plaintiffs allege fraud and grossly negligent misrepresentation by the defendants in connection with the Bankruptcy Court s approval of the Company s plan of reorganization confirmed by the Bankruptcy Court in 2001, canceling the subordinated debentures. The defendants, in addition to NeighborCare, Inc., are Goldman Sachs & Co., Mellon Bank, N.A., Highland Capital Management, LP, and George V. Hager, Jr., the Company s chief financial officer during the period in question. The plaintiffs seek to recover $200 million plus interest costs and fees. The defendants made a motion to dismiss, which has been granted by the U.S. Bankruptcy Court. Meanwhile, Mellon Bank N.A. filed a cross claim for indemnification against the Company. NeighborCare filed a motion to dismiss this claim and Mellon filed a motion for summary judgment. The court ruled that the Company will be obligated to reimburse Mellon s losses in the case, except for those resulting from Mellon s gross negligence or willful misconduct. The Company will not be required to indemnify Mellon until the court s judgment becomes final.

## 15. Subsequent Event

On May 4, 2005, the Company signed a definitive agreement to acquire Primecare Pharmacy in Los Angeles, CA. The acquisition is expected to close during the third quarter of fiscal 2005.

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

### Overview

As of March 31, 2005, NeighborCare, Inc. (formerly named Genesis Health Ventures, Inc) provided pharmacy services for approximately 289,000 beds in long-term care facilities in 34 states and the District of Columbia. Our pharmacy operations consist of 70 institutional pharmacies (five are jointly owned), 32 community-based professional retail pharmacies (two are jointly owned) and 20 on-site pharmacies which are located in customers facilities and serve only customers of that facility. In addition, we operate 16 home infusion, respiratory and medical equipment distribution centers (three are jointly owned) and Tidewater Healthcare Shared Services Group, Inc. ( Tidewater ), one of the largest long-term care group purchasing organizations in the country. Prior to December 1, 2003, the Company also operated an inpatient services business, which was then spun off as Genesis HealthCare Corporation ( GHC ).

The following discussion provides management s analysis of our financial condition and results of operations for the quarter and year-to-date period ended March 31, 2005 and should be read in conjunction with the consolidated financial statements and notes thereto included herein and with our annual report on Form 10-K for the fiscal year ended September 30, 2004, as amended (the Form 10-K ).

Key strategic issues facing our pharmacy operations include industry trends and regulatory changes such as increasing pharmaceutical costs, lower Medicaid reimbursement rates, consolidation within the industry, competitive pricing pressure, and the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the MMA ). Our near-term strategies to address these exposures are to drive down service and product cost while retaining and improving customer service levels, to grow our pharmacy operations through acquisitions and organically, and to implement programs to become a leading long-term care pharmacy provider for MMA Part D enrollees in 2006. More detail on the MMA is provided under Laws Affecting Revenues below and in our Form 10-K. We also continue to face costs and uncertainties associated with Omnicare s pending unsolicited tender offer for all of its outstanding shares.

### Certain Transactions and Events

#### *Omnicare, Inc. Tender Offer*

On May 24, 2004, Omnicare, Inc. announced its intention to purchase all of the outstanding shares of our common stock for $30 per share in cash. On May 25, 2004, we announced that our Board of Directors unanimously rejected the proposal. On June 3, 2004, Omnicare, Inc. announced its intention to commence a tender offer to purchase all of the outstanding shares of our common stock for $30 per share in cash. The tender offer formally commenced on June 4, 2004 and was originally stated to expire on July 7, 2004 but has been subsequently extended, most recently to June 3, 2005. In any event, Omnicare, Inc. has announced an agreement with the Federal Trade Commission that it will not close any transaction to acquire us prior to 12:01 a.m. on June 16, 2005. On June 14, 2004, we announced that our Board of Directors had unanimously recommended that shareholders reject the tender offer and not tender shares pursuant to the offer. On December 23, 2004, Omnicare, Inc. nominated three directors to our eight member Board of Directors. Further information relating to these matters can be found in our Solicitation/Recommendation Statement on Schedule 14D-9 filed with the Securities and Exchange Commission on June 14, 2004, and in subsequent amendments we have filed with the Securities and Exchange Commission.

These events have had an adverse effect on our business and results of operations. The tender offer will continue to impact our ability to attract and retain customers, management personnel and pharmacy professionals. We will also continue to incur advisory fees and other expenses which will negatively impact our results of operations.

We have incurred various expenses as a result of the tender offer including legal, investment banking and other fees. During the three and six months ended March 31, 2005, $0.8 million and $1.6 million, respectively, of takeover defense expenses were incurred. We anticipate that additional takeover defense expenses will continue to be incurred through the duration of the tender offer; however, the impact of these expenses cannot be reasonably estimated.

***Strategic Planning, Severance and Other Operating Items***

We have incurred costs that are directly attributable to the transformation to a pharmacy-based business and certain of our short-term strategic objectives. These costs are segregated in the unaudited condensed consolidated statements of operations as Strategic planning, severance and other operating items. A summary of these costs for the six months ended March 31, 2005 follows (in thousands):

| | Accrued as of September 30, 2004 | Six months Ended March 31, 2005 Provision | Six months Ended March 31, 2005 Paid | Accrued as of March 31, 2005 |
|---|---|---|---|---|
| Employee contract termination, transaction completion bonuses, severance and related costs | $ 2,304 | $ 455 | $ 1,009 | $ 1,750 |
| Strategic planning and other items | 655 | | 195 | 460 |
| Total | $ 2,959 | $ 455 | $ 1,204 | $ 2,210 |

Strategic planning, severance and other operating items for the six months ended March 31, 2005 relate primarily to the consolidation of our pharmacy operations. For the three months ended March 31, 2005, we recognized a $64,000 reduction in total strategic planning, severance and other operating items resulting from the adjustment of prior periods accruals.

Strategic planning, severance and other operating items for the six months ended March 31, 2004 relate primarily to legal, professional and other fees incurred to complete the spin-off transaction of $17.5 million; costs incurred pursuant to the termination provisions of employment contracts and transaction completion bonuses with NeighborCare and GHC executives of $9.0 million; costs incurred to extinguish long-term debt and related obligations in connection with the spin-off of $14.5 million; and severance and related costs incurred pursuant to our corporate and regional consolidation in the second quarter of fiscal 2004 of $1.7 million. Debt extinguishment costs represent the write-off of unamortized deferred financing costs of $5.9 million, consent fees required to eliminate our commitments under GHC debt of $5.0 million and other debt-related settlements of $3.6 million.

***Acquisitions***

In the ordinary course of business, we make strategic acquisitions to enhance our geographical market presence and to create beneficial operating synergies through acquisitions in locations we have an existing market presence. On January 1, 2005 we acquired all of the assets of UniScripts LTC. On December 1, 2004, we completed the acquisition of Belville Pharmacy Services, Inc. ( Belville ) by purchasing certain of the assets of Belville. As of October 1, 2004, we acquired certain assets and assumed certain liabilities of Quest Total Care, L.P. These acquisitions were accounted for under the purchase method for accounting for business combinations in accordance with SFAS No. 141 Business Combinations.

Results of these completed acquisitions are included in our consolidated statements of operations from the date of acquisition. Our preliminary purchase price allocations, which were based upon fair-value estimates, are as follows (in thousands):

| | | |
|---|---|---|
| Accounts receivable, net | $ | 8,185 |
| Inventories | | 1,628 |
| Property, plant and equipment | | 642 |
| Goodwill | | 29,945 |
| Identifiable intangible assets | | 6,649 |
| Other assets | | 27 |
| Total liabilities assumed | | (176) |
| Net assets acquired through acquisitions | $ | 46,900 |

We expect to complete our independent third-party valuation of Belville during the third quarter of fiscal 2005.

***Discontinued Operations***

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

The following table sets forth the components of net income from discontinued operations for the six months ended March 31, 2004 related to the operations of GHC for periods prior to the spin off (in thousands):

| | | |
|---|---|---|
| Net revenues of GHC | $ | 250,927 |
| Net operating income of GHC | | 16,450 |
| Interest expense allocation | | 2,467 |
| Income tax expense | | 5,548 |
| Net income from discontinued operations | $ | 8,435 |

Consolidated interest expense in periods prior to the spin-off has been allocated to discontinued operations using a basis of net assets of each of the continuing and discontinued operating segments for the six months ended March 31,2004.

**Laws Affecting Revenues**

The recently enacted MMA affects the health care industry. However, the overall impact of this new legislation on long-term care pharmacy services is not yet clear. The MMA is more fully described in the Form 10-K, but among other things, it establishes a new federal prescription drug benefit program. The new drug benefit increases federal Medicare resources for prescription drugs beginning in 2006, but also ends Medicaid prescription coverage for most nursing home residents at the same time. The MMA also authorizes an interim federally sponsored prescription drug discount plan to provide group discounts for Medicare beneficiaries between 2004 and 2006.

Because of the recent enactment of the MMA and its broad scope, we are not in a position to fully assess its impact on our business. CMS only announced final regulations relating to MMA on January 21, 2005, with additional administrative guidance to follow. In addition, CMS is in the process of conducting a study on long-term care pharmacy in regards to the rule-making process. The final regulations specifically require the new Prescription Drug Plans and Medicare Advantage Plans that offer prescription drug coverage to provide convenient access to long term care pharmacies and to offer standard contracting terms to all long-term care pharmacies within the plans service areas that meet performance standards to be specified by CMS. Thus, the final regulatory scheme will increase the opportunity for qualified long-term care pharmacies to participate as network pharmacies when the new benefit becomes effective, January 1, 2006. On March 16, 2005, CMS issued regulatory guidance to assist Prescription Drug Plans in formulating policies to implement CMS requirements regarding long-term care pharmacies. However, the impact of the legislation depends upon a variety of factors, including our patient mix; additional administrative guidance to be issued by CMS; results of negotiations with Prescription Drug Plans and Medicare Advantage Plans, which are at risk under the relationship created by MMA; and evolutionary changes in the marketplace caused by MMA. This legislation may reduce revenue and impose additional costs on the industry. We will continue to work closely with CMS directly, as well as through the Long Term Care Pharmacy Alliance, to offer our expertise in pharmaceutical care for the elderly.

**Results of Operations**

***Reasons for Non-GAAP Financial Disclosure***

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

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

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

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

The following table sets forth selected information about our results of continuing operations for the three and six month periods ended March 31, 2005 and 2004:

| | Three months ended March 31, 2005 | Three months ended March 31, 2004 | Six months ended March 31, 2005 | Six months ended March 31, 2004 |
|---|---|---|---|---|
| Net revenues | $ 404,706 | $ 356,646 | $ 796,706 | $ 695,040 |
| Gross profit | 83,377 | 74,361 | 165,643 | 150,784 |
| Income (loss) from continuing operations | 9,685 | 8,216 | 19,387 | (5,933) |
| Income from discontinued operations, net of taxes | | | | 8,435 |
| Net income | $ 9,685 | $ 8,216 | $ 19,387 | $ 2,502 |
| | | | | |
| Gross Margin % | 20.6% | 20.9% | 20.8% | 21.7% |
| | | | | |
| EBITDA | $ 30,320 | $ 26,637 | $ 59,346 | $ 11,604 |
| EBITDA % | 7.5% | 7.5% | 7.4% | 1.7% |
| | | | | |
| **Diluted EPS Data** | | | | |
| Income (loss) from continuing operations | $ 0.22 | $ 0.19 | $ 0.43 | $ (0.14) |
| Income from discontinued operations, net | | | | $ 0.20 |
| Net income | $ 0.22 | $ 0.19 | $ 0.43 | $ 0.06 |
| Weighted average shares outstanding | 44,688 | 43,957 | 44,649 | 42,010 |

The following table reconciles net to our non-GAAP measure of EBITDA:

| | Three months ended March 31, 2005 | Three months ended March 31, 2004 | Six months ended March 31, 2005 | Six months ended March 31, 2004 |
|---|---|---|---|---|
| **EBITDA Reconciliation** | | | | |
| Net income | $ 9,685 | $ 8,216 | $ 19,387 | $ 2,502 |
| Subtract: | | | | |
| Income from discontinued operations, net of taxes | | | | (8,435) |

| | | | | |
|---|---|---|---|---|
| Add back: | | | | |
| Other expense | 1,173 | 1,225 | 2,301 | 2,317 |
| Income tax provision (benefit) | 6,782 | 6,731 | 13,250 | (7,143) |
| Interest Expense | 4,498 | 4,553 | 8,529 | 10,207 |
| Depreciation and amortization expense | 8,182 | 5,912 | 15,879 | 12,156 |
| EBITDA | $ 30,320 | $ 26,637 | $ 59,346 | $ 11,604 |

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

| | Three months ended March 31, 2005 | | |
|---|---|---|---|
| | Institutional Pharmacy | Corporate & Other | Consolidated |
| Operating income (loss) | $ 33,344 | $ (11,206) | $ 22,138 |
| Add back: | | | |
| Depreciation and amortization expense | 4,081 | 4,101 | 8,182 |
| EBITDA | $ 37,425 | $ (7,105) | $ 30,320 |

| | Three months ended March 31, 2004 | | |
|---|---|---|---|
| | Institutional Pharmacy | Corporate & Other | Consolidated |
| Operating income (loss) | $ 28,521 | $ (7,796) | $ 20,725 |
| Add back: | | | |
| Depreciation and amortization expense | 3,090 | 2,822 | 5,912 |
| EBITDA | $ 31,611 | $ (4,974) | $ 26,637 |

| | Six months ended March 31, 2005 | | |
|---|---|---|---|
| | Institutional Pharmacy | Corporate & Other | Consolidated |
| Operating income (loss) | $ 66,394 | $ (22,927) | $ 43,467 |
| Add back: | | | |
| Depreciation and amortization expense | 7,744 | 8,135 | 15,879 |
| EBITDA | $ 74,138 | $ (14,792) | $ 59,346 |

| | Six months ended March 31, 2004 | | |
|---|---|---|---|
| | Institutional Pharmacy | Corporate & Other | Consolidated |
| Operating income (loss) | $ 55,094 | $ (55,646) | $ (552) |
| Add back: | | | |
| Depreciation and amortization expense | 6,157 | 5,999 | 12,156 |
| EBITDA | $ 61,251 | $ (49,647) | $ 11,604 |

***Three months ended March 31, 2005 compared to the three months ended March 31, 2004***

***Consolidated Overview***

We reported consolidated net income of $9.7 million, or $0.22 per diluted share, for the second quarter of fiscal 2005, compared to consolidated net income of $8.2 million, or $0.19 per diluted share, in the second quarter of fiscal 2004. This increase in consolidated net income is largely the result of increased gross profit of $9.0 million and strategic planning, severance and other operating items incurred in the second quarter of fiscal 2004 resulting from charges incurred as a result of our spin-off of GHC. These increases in consolidated net income were offset by increased selling, general and administrative expenses of $8.9 million. Total beds served by our institutional pharmacy segment increased approximately 33,000, or 13%, to approximately 289,000 as of March 31, 2005 reflecting growth both organically and through acquisitions.

For the current quarter, net revenues reached $404.7 million, up $48.1 million, or 13.5%, over the same period in the prior year. The growth was primarily attributed to growth in revenue of our institutional pharmacy segment of approximately $47.1 million, or 15.5% over the same period in the prior year. At March 31, 2005, our institutional pharmacy segment served approximately 289,000 beds generating average revenue per bed per month of $415 compared to $406 in the same period of prior year. The increase in net revenues in the institutional pharmacy segment was due to bed growth, favorable changes in bed mix, higher patient acuity, and drug price inflation. Included in the current quarter is a $1.4 million reduction in revenue predominately related to state Medicaid audits related to prior periods which resulted in direct charges against current period revenue. Additionally, revenues from our corporate and other operating segment increased $1.0 million for the three months ended March 31, 2005 compared to the same period in the prior year due growth in our community-based businesses.

Cost of revenues, which includes cost of service and cost of goods sold, increased by approximately $39.0 million, or 13.8%, for the current quarter to $321.3 million from $282.3 million. As a percentage of net revenues, cost of revenues increased slightly to 79.4% of net revenues compared to 79.1% in the same quarter of the prior year. Cost of service, which includes direct labor and direct expenses, increased to 14.1% of net revenues for the quarter ended March 31, 2005 compared to 13.9% in the prior year quarter. The direct labor component of cost of revenues decreased from the same quarter in prior year from pharmacy consolidations and process improvements while direct expenses increased as a result of higher product delivery costs. Cost of goods sold as a percentage of revenues remained relatively flat at 65.3% for the three months ended March 31, 2005 compared to 65.2% for the three months ended March 31, 2004. Increases in rebates earned offset additional costs incurred from drug price inflation and the commencement of operations at our new repackaging facility. The overall decline in gross profit as a percentage of revenues in the current quarter when compared to the same quarter of the prior year is also the result of lower Medicaid reimbursement rates, competitive pricing pressures and changes in product mix.

Selling, general and administrative expenses increased $8.9 million, or 17.3%, for the current quarter to $60.5 million compared to $51.6 million in the same period of the prior year. The increase in selling, general and administrative expenses is due primarily to the incremental expenses resulting from acquisitions, the vesting of restricted stock awards, accounting and consulting fees incurred in connection with compliance with the Sarbanes-Oxley Act of 2002 and increases in depreciation and amortization expense. We will continue to see similar levels of spending related to compliance with the Sarbanes-Oxley Act for the remainder of the fiscal year. Depreciation and amortization expense included in selling, general and administrative expenses for the quarter ended March 31, 2005 increased $2.3 million resulting from the addition of $44.1 million of depreciable assets compared to the respective amount at March 31, 2004 as a result of capital expenditures, acquisitions and the construction and development of our repackaging facility.

For the quarter ended March 31, 2005, we recognized $(0.1) million in strategic planning, severance and other operating items. These primarily relate to adjustments to our previous accruals of severance costs incurred as a result of our continued consolidations of smaller pharmacies. In addition, we incurred $0.8 million related to our takeover defense, including legal, investment banking and other fees. See Certain Transactions and Events.

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

***Segment Results***

NeighborCare s operating segments include (i) institutional pharmacy and (ii) corporate and other.

*Institutional Pharmacy*

The institutional pharmacy business provides prescription and non-prescription pharmaceuticals, infusion therapy and medical supplies and equipment to the elderly, chronically ill and disabled in long-term care facilities, including skilled nursing facilities, assisted living facilities, residential and independent living communities and other institutional healthcare facilities.

Institutional pharmacy revenue increased $47.1 million, or 15.5%, to $350.3 million for the current quarter compared to $303.2 million in the same period in the prior year. The increased revenues are primarily attributed to an increase in the number of beds served as well as favorable changes in the bed mix, higher patient acuity and drug price inflation offset by competitive pricing pressures and lower Medicaid reimbursement rates.

Operating income of the institutional pharmacy segment increased $4.8 million, or 16.9%, to $33.3 million in the current quarter from $28.5 million for the same period in the prior year. EBITDA of the institutional pharmacy segment increased $5.8 million, or 18.4%, to $37.4 million in the current quarter from $31.6 million for the same period in the prior year. EBITDA margin increased to 10.7% from 10.4% for the same period.

*Corporate and Other*

Corporate and other consists of our community-based professional pharmacy business, home infusion, respiratory and medical equipment business and our Tidewater group purchasing organization. The corporate and other category includes corporate general and administrative expenses that are not allocated to the segments for internal reporting purposes. Revenues for this segment increased $1.0 million to $54.4 million in the current quarter from $53.4 million in the same period of the prior year due to increases in our community based businesses. Operating loss for the corporate and other segment increased $3.4 million, to a loss of $11.2 million compared to a loss of $7.8 million in the same period of the prior year. This increase in operating loss is primarily the result of increased selling, general and administrative expenses in the current quarter resulting from consulting and accounting fees incurred in connection with compliance with the Sarbanes-Oxley Act of 2002 and the vesting of restricted stock awards, in addition to Medicare Part B reimbursement changes.

***Six months ended March 31, 2005 compared to the Six months ended March 31, 2004***

***Consolidated Overview***

We reported consolidated net income of $19.4 million, or $0.43 per diluted share, for the six months ended March 31, 2005 compared to a $5.9 million net loss from continuing operations for the same period a year ago.  Total beds served by our institutional pharmacy segment increased approximately 33,000, or 13%, to approximately 289,000 as of March 31, 2005 reflecting organic growth and acquisitions.

For the current six month period, net revenues were $796.7 million, an increase of $101.7 million, or 14.6%, over the same period in the prior year. Net revenues in the same period of the prior year do not include intersegment revenues from GHC of $13.0 million, which were included in the results of discontinued operations, prior to the spin-off. The growth was primarily attributed to growth in revenue of our institutional pharmacy segment of approximately $103.1 million, or 17.6% over the same period in the prior year.  The increase in net revenues in the institutional pharmacy segment was due to bed growth, favorable changes in bed mix, higher patient acuity, and drug price inflation. The gain in institutional pharmacy revenue was offset by a decline in our corporate and other operating segment revenues of $1.5 million for the six months ended March 31, 2005 compared to the same period in the prior year due to the wind down of our medical supply business line during fiscal 2004.

Cost of revenues, which includes cost of service and cost of goods sold, increased by approximately $86.8 million, or 15.9%, for the current year to date period to $631.1 million from $544.3 million. As a percentage of net revenues, cost of revenues was 79.2% for the current year to date period compared to 78.3% for the same period in the prior year. Cost of service, which includes direct labor and direct expenses, declined to 14.0% of net revenues for the six month period ended March 31, 2005 compared to 14.2% in the prior year due to declines in direct labor resulting from pharmacy consolidations and process improvements while direct expenses increased slightly to 1.8% of net revenues from 1.6% in the prior year resulting from higher product delivery costs.  Cost of goods sold as a percentage of revenues increased to 65.3% for the six months ended March 31, 2005 compared to 64.1% for the same period in prior year and is the result of drug price inflation. The decline in gross profit as a percentage of revenues in the current six month period when compared to the same period of the prior year is also the result of lower Medicaid reimbursement rates, competitive pricing pressures and changes in product mix. The gross profits presented do not include gross profit on intersegment revenues from GHC prior to the spin-off of $2.7 million for the six months ended March 31, 2004. The impact of these gross profits is included in discontinued operations for the respective period.

Selling, general and administrative expenses increased $11.5 million, or 10.6%, for the current period to $120.2 million compared to $108.6 million in the same period of the prior year. This increase is due primarily to the vesting of restricted stock awards, consulting fees incurred in connection with compliance with the Sarbanes-Oxley Act of 2002 and increased depreciation expense. We will continue to see an increase in these fees related to compliance with the Sarbanes-Oxley Act of 2002 for the remainder of the fiscal year. Depreciation and amortization expense included in selling, general and administrative expenses for the six months ended March 31, 2005 increased $3.7 million increase resulting from the increase of $44.1 million of depreciable assets compared to the respective amount at March 31, 2004 as a result of capital expenditures, acquisitions and the construction and development of our repackaging facility.

For the six months ended March 31, 2005, we recognized $0.5 million in strategic planning, severance and other operating items. These primarily relate to severance costs incurred as a result of our continued consolidations of smaller pharmacies. In addition, we incurred $1.6 million related to our takeover defense, including legal, investment banking and other fees. See Certain Transactions and Events.

Interest expense, net of interest income, decreased by approximately $1.7 million for the six months ended March 31, 2005 to $8.5 million compared to $10.2 million in the same period of the prior year. The decline in interest expense net of interest income is mainly due to interest expense incurred on our shared debt with GHC in the first quarter of fiscal 2004 prior to our refinancing of those borrowing arrangements that was not allocable to discontinued operations and the impact of our interest rate swap.

Other expense was $2.3 million for the current year to date period and for the same period in the prior year. Other expense primarily consists of minority interest and our proportionate share of the net earnings of businesses in which we have invested, which are recorded under the equity method of accounting. The operating results of joint ventures in which we have a controlling interest are included in our consolidated financial statements. Minority interest expense represents the non-controlling owners share of the joint ventures operating profit.

***Segment Results***

NeighborCare s operating segments include (i) institutional pharmacy and (ii) corporate and other.

*Institutional Pharmacy*

The institutional pharmacy business provides prescription and non-prescription pharmaceuticals, infusion therapy and medical supplies and equipment to the elderly, chronically ill and disabled in long-term care facilities, including skilled nursing facilities, assisted living facilities, residential and independent living communities and other institutional healthcare facilities.

Institutional pharmacy revenue increased $103.1 million, or 17.6%, to $688.2 million for the current six month period compared to $585.0 million in the same period in the prior year. Of the $103.1 million increase, $90.1 million is attributed to an increase in the number of beds served from organic growth and acquisitions, as well as favorable changes in the bed mix, higher patient acuity and drug price inflation offset by competitive pricing pressures and lower Medicaid reimbursement rates. The remaining increase in net revenues of the institutional pharmacy segment are attributable to intersegment revenues with GHC prior to the spin-off of $13.0 million that were excluded for the six months ended March 31, 2004.

Operating income of the institutional pharmacy segment increased $11.3 million, or 20.5%, to $66.4 million in the current quarter from $55.1 million for the same period in the prior year. EBITDA of the institutional pharmacy segment increased $12.9 million, or 21.0%, to $74.1 million in the current quarter from $61.2 million for the same period in the prior year. EBITDA margin increased to 10.8% from 10.5% for the same period. The gross profit presented does not include gross profit on intersegment revenues from GHC prior to the spin-off of $2.7 million for the six months ended March 31, 2004. The impact of these gross profits is included in discontinued operations for the period.

*Corporate and Other*

Corporate and other consists of our community-based professional pharmacy business, home infusion, respiratory and medical equipment business and our Tidewater group purchasing organization. The corporate and other category includes corporate general and administrative expenses that are not allocated to the segments for internal reporting purposes. Revenues for this segment decreased $1.5 million to $108.5 million in the current period from $110.0 million in the same period of the prior year due to the wind down of our medical supply business line during fiscal 2004 and Medicare Part B reimbursement changes. Operating loss for the corporate and other segment decreased $32.7 million, to a loss of $22.9 million compared to a loss of $55.6 million in the same period of the prior year. This decrease in operating loss is primarily the result of strategic planning, severance and other operating items incurred in the prior year period.

**Liquidity and Capital Resources**

***Working Capital and Cash Flows***

At March 31, 2005 we had cash and equivalents of $27.3 million, net working capital of $263.0 million and long-term debt of

$255.6 million.  Also at that date we had $4.0 million of borrowings under our revolving credit facility, leaving $90.8 million of available borrowings under the credit facility.

Our net cash provided by operating activities during the six months ended March 31, 2005 aggregated $15.2 million compared to cash provided by operations of $35.2 million in the same period in the prior year. The decline in the current year is primarily due to the timing of payments made to our primary pharmaceutical supplier, the payment of strategic planning, severance and other operating items accrued in the prior year period and the payment of $8.8 million of takeover defense expenses in the current period.  Cash flows from operations for the six months ended March 31, 2004 include the operating activities of GHC for the period prior to the spin-off.

Our net cash used in investing activities during the current period was $72.0 million. Capital expenditures were $23.1 million and are mainly attributable to expenditures related to our drug repackaging facility, investments in computer hardware and software, furniture and equipment used in operations and medical equipment rented to customers. Acquisitions of three pharmacy businesses during the current period resulted in net cash outflows of $46.9 million.  Our cash flows from investing activities also include $2.0 million of expenditures related to an investment in the common stock of a privately-held pharmacy dispensing technology provider.

Our financing activities for the six months ended March 31, 2005 resulted in a net cash inflow of $2.2 million, and is mainly attributable to our net borrowings under our revolving credit facility of $4.0 million.

We currently have a $34.3 million deposit with our primary pharmaceutical wholesaler. The deposit is fully refundable to us at our request. This, combined with our contractual ability to elect 15-day payment terms with our primary pharmaceutical wholesaler, provides us the ability to use these funds as an additional resource to meet our working capital requirements, debt service and other cash needs over the next year, if needed.

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

***Non-Derivative Off-Balance Sheet Arrangements***

We have future obligations for debt repayments and future minimum rentals under operating leases. These obligations as of March 31, 2005 have not materially changed from those amounts previously reported in our Form 10-K.

Our debt and certain of our lease obligations require us to maintain compliance with financial and non-financial covenants, including minimum earnings before interest, taxes, depreciation, amortization and rent, limitations on capital expenditures, maximum leverage ratios, minimum fixed charge coverage ratios and minimum net worth. Failure to meet these covenants or the occurrence of other defaults, such as non-payment, could result in the acceleration of the maturity of such obligations. On March 15, 2005, we received a consent letter ( the consent ) from Wachovia Bank, N.A. and the lenders under our credit agreement permitting us to exclude takeover defense expenses from our consolidated statements of operations for the periods in which we incurred such expenses for purposes of calculating our compliance with such covenants that are measured using our statements of operations for the respective trailing twelve month periods. The consent is effective for the fiscal quarters ended June 30, 2004, September 30, 2004 and December 31, 2004. In the absence of the consent, we would still have been in compliance with these debt covenants. The consent is not effective for the fiscal quarter ended March 31, 2005 whereby we cannot include takeover defense expenses incurred in the three months ended March 31, 2005 for purposes of calculating our compliance with these covenants. However, at March 31, 2005 we were in compliance with these covenants.

Requests for providing commitments to extend financial guarantees and extend credit are reviewed and approved by senior management. Management regularly reviews all outstanding commitments, letters of credit and financial guarantees, and the results of these reviews are considered in assessing the need for any reserves for possible credit and guarantee loss.

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

**Critical Accounting Policies**

Management s discussion and analysis of financial condition and results of operations are based upon our unaudited condensed consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. Such financial statement preparation requires management to make judgments and use estimates regarding significant accounting policies. We consider an accounting policy to be significant if it is important to our financial condition and results, and requires significant judgment and estimates on the part of management in its application. A summary of our significant accounting policies is included in Note 1 to our consolidated financial statements for the year ended September 30, 2004, which are included in the Form 10-K. Our significant accounting estimates and the related assumptions are evaluated periodically as conditions warrant, and changes to such estimates are recorded as new information or changed conditions require revision. Application of the critical accounting policies requires management s significant judgments, often as the result of the need to make estimates of matters that are inherently uncertain. If actual results were to differ materially from the estimates made, the reported results could be materially affected. Such policies are summarized in Management s Discussion and Analysis of Financial Condition and Results of Operations contained in the Form 10-K. There have been no significant changes in the application of the critical accounting policies, or in the assumptions or estimates relating thereto, since September 30, 2004.

**New Accounting Pronouncements**

On December 16, 2004, the FASB issued Statement No. 123R, *Share Based Payment* (SFAS 123R), which is a revision of SFAS 123, *Accounting for Stock-Based Compensation.* SFAS 123R requires that all share-based payments to employees, including stock options, be recognized in the financial statements based on their fair values on the date of grant and eliminates the disclosure-only provisions permitted under SFAS 148. SFAS 123R was to be effective for fiscal periods beginning after June 15, 2005. However, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R will be postponed until October 1, 2005 for us. We do not expect that the adoption of SFAS 123R will have a significant adverse effect on our results of operations.

**Seasonality**

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

**Impact of Inflation**

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

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to interest rate changes in the normal course of our business. We use an interest rate swap to hedge our interest rate exposures with the objective of offsetting gains and losses resulting from these exposures with the losses and gains on the derivative instruments used to hedge them, thereby reducing volatility of earnings or protecting fair values of liabilities.

In August 2004, we entered into an interest rate swap agreement with a notional amount of $125 million, which expires November 15, 2013, in which we receive a fixed-rate of 6.875% and pays a floating rate based on the six-month London InterBank Offered Rate ( LIBOR ) plus 1.8475% with measurement and settlement performed semiannually (5.2351% as of March 31, 2005). The swap was designated as a fair value hedge, as the critical terms of the interest rate swap and the hedged item are designed to match thereby satisfying the criteria for short-cut method of accounting as defined by SFAS No. 133, as amended. Accordingly, the swap and the underlying debt obligation are recorded on the balance sheet at their fair value, with the changes in fair value of the derivative and the related debt are recorded in the consolidated statement of operations. Based upon valuations provided by third party financial institutions, the fair value of the interest rate swap as of March 31, 2005 was approximately $(2.4) million.

The existing swap arrangement effectively converts $125 million of our $250 million fixed-rate debt into variable-rate debt. Consequently, a 1.0% change in LIBOR would result in additional annualized interest of $1.25 million.

The fair value of our 6.875% Senior Subordinated Notes due 2013 on March 31, 2005 and September 30, 2004 was $264.4 million and $250.8 million, respectively, and was determined using quoted market rates on those dates. At March 31, 2005, the fair value of the interest rate swap agreement reduced the carrying value of our 6.875% Senior Subordinated Notes due 2013 by $2.4 million. At September 30, 2005, the fair value of the interest rate swap agreement increased the carrying value of our 6.875% Senior Subordinated Notes due 2013 by $0.3 million.

On December 1, 2003, we entered into our new senior credit facility consisting of a $100.0 million revolving credit facility that bears interest based on variable rates. If we were to borrow the $100.0 million available under the revolving credit facility without entering into any derivative financial instruments, a 1% increase in variable rates of interest would result in additional interest expense of $1.0 million annually. There were $4.0 million in borrowings outstanding under the revolving credit facility as of March 31, 2005 as to which the variable interest rate at that date was 5.05%, leaving $90.8 million available for borrowings under the credit facility.

## Item 4. Controls and Procedures

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

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

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

## PART II: OTHER INFORMATION

### Item 1. Legal Proceedings

We are a party to litigation arising in the ordinary course of business. We accrue for legal proceedings when an unfavorable outcome is probable and reasonably estimable. With exception to the discussion which follows, we do not believe the results of such litigation, even if the outcome is unfavorable, would have a material adverse effect on our financial position. While the outcome of the cases discussed below could have a material effect if decided adversely, our management considers this result unlikely. See Cautionary Statement Regarding Forward-Looking Statements.

The following reflects developments in legal proceedings during the reporting quarter. For information regarding other Legal Proceedings, see the Company s Form 10-K, as amended, for the fiscal year ended September 30, 2004 and the Company s Form 10-Q for the quarter ended December 31, 2004.

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

This action was brought January 27, 2004 in the Supreme Court of New York, County of New York, by 275 former investors who collectively held over $205 million in subordinated debentures prior to the filing of our Chapter 11 bankruptcy petition in 2000. The case was subsequently removed to federal court and then to the U.S. Bankruptcy Court for the District of Delaware. The plaintiffs allege fraud and grossly negligent misrepresentation by the defendants in connection with the Bankruptcy Court s approval of our plan of reorganization confirmed by the Bankruptcy Court in 2001, canceling the subordinated debentures. The defendants, in addition to us, are Goldman Sachs & Co., Mellon Bank, N.A., Highland Capital Management, LP, and George V. Hager, Jr., our chief financial officer during the period in question. The plaintiffs seek to recover $200 million plus interest costs and fees. The defendants made a motion to dismiss, which has been granted by the U.S. Bankruptcy Court. Meanwhile, Mellon Bank N.A. filed a cross claim for indemnification against us. We filed a motion to dismiss this claim and Mellon filed a motion for summary judgment. The court ruled that we will be obligated to reimburse Mellon s losses in the case, except for those resulting from Mellon s gross negligence or willful misconduct. We will not be required to indemnify Mellon until the court s judgment becomes final.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds** None

**Item 3. Defaults Upon Senior Securities** None

**Item 4. Submission of Matters to a Vote of Security Holders** None

**Item 5. Other Information** None

**Item 6. Exhibits**

| | Exhibits |
|---|---|
| 10.1 | Amendment to Employment Agreement by and between NeighborCare, Inc. and Robert A. Smith, dated as of February 11, 2005 (incorporated by reference to Exhibit 99.1 to NeighborCare s Current Report on Form 8-K, filed February 17, 2005) |
| 10.2 | Consent, dated as of March 15, 2004, by and among the Company, the domestic subsidiaries of the Company, Wachovia Bank, National Association and the lenders party to the Company s Credit Agreement dated as of December 1, 2003 |
| 31.1 | Certification of John J. Arlotta, Chairman, President and Chief Executive Officer of the Company, dated May 9, 2005, pursuant to Securities Exchange Act Rule 13a 14(a). |
| 31.2 | Certification of Richard W. Hunt, Chief Financial Officer of the Company, dated May 9, 2005 pursuant to Securities Exchange Act Rule 13a 14(a). |
| 32.1 | Certification of John J. Arlotta, Chairman, President and Chief Executive Officer, and Richard W. Hunt, Chief Financial Officer, of the Company dated May 6, 2005 pursuant to 18 U.S.C. Section 1350. |

**SIGNATURES**

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

| | |
|---|---|
| | NeighborCare, Inc. |
| Date: May 9, 2005 | /s/ RICHARD W. HUNT<br>Richard W. Hunt<br>Chief Financial Officer |
| Date: May 9, 2005 | /s/ JOHN J. ARLOTTA<br>John J. Arlotta<br>Chairman, President and Chief Executive Officer |