NEIGHBORCARE INC
Form 8-K
May 03, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): April 30, 2004

NEIGHBORCARE, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**0-33217**	**06-1132947**
(State or other jurisdiction of incorporation	(Commission File Number)	(I.R.S. Employer Identification No.)

601 East Pratt Street, 3rd Floor, Baltimore, Maryland 21202
(Address of principal executive offices/Zip Code)
Registrant's telephone number, including area code: **410-528-7300**

7 East Lee Street, Baltimore, Maryland 21202
(Former name or former address, if changed since last report)

Item 5. Other Events and Regulation FD Disclosure

On December 1, 2003, NeighborCare, Inc. ("NeighborCare" or the "Company") completed the distribution (the "spin-off") of the common stock of Genesis HealthCare Corporation ("GHC") by way of a pro-rata tax free distribution of the common stock of GHC to holders of NeighborCare common stock at a rate of 0.5 shares of GHC common stock for each share of NeighborCare common stock owned as of October 15, 2003. Subsequent to the spin-off, NeighborCare continues to own and operate its pharmacy services and group purchasing businesses and GHC owns and operates what was formerly NeighborCare's inpatient services business, as well as NeighborCare's former rehabilitation therapy, diagnostic, respiratory and management services businesses.

On November 4, 2003, in anticipation of the spin-off, NeighborCare issued $250 million aggregate principal amount of 6.875% senior subordinated notes due 2013. On April 30, 2004, in satisfaction of its obligations under such issuance, the Company filed a registration statement on Form S-4 in connection with its offer to exchange up to $250 million aggregate principal amount of 6.875% senior subordinated notes due 2013, which have been registered under the Securities act of 1933, as amended, for up to $250 aggregate principal amount of 6.875% senior subordinated notes due 2013 issued in November 2003.

As a result of the spin-off and the filing of such registration statement, NeighborCare is filing updated consolidated financial statements as of September 30, 2003 and 2002 and for each of the years in the three-year period ended September 30, 2003 to reflect GHC as discontinued operations under the provisions of Statement of Financial Accounting Standards No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets"* ("SFAS 144").

Additionally, NeighborCare has revised its Selected Financial Data and Management's Discussion and Analysis of Financial Condition and Results of Operations for such periods to reflect such updated consolidated financial statements as set forth below.

This Current Report on Form 8-K updates Items 6, 7 and 15(a)(1) and (2) of the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2003, as filed with the Securities and Exchange Commission on December 24, 2003 and amended on December 29, 2003, and reflects the spin-off of GHC as discontinued operations. All other Items of the Annual Report on Form 10-K remain unchanged.

Contemporaneous with this Current Report on Form 8-K, NeighborCare is filing an amendment to its Quarterly Report on Form 10-Q for the three months ended December 31, 2003 in order to (i) reflect the exclusion of intersegment revenues with GHC previously reported in continuing operations for the three months ended December 31, 2003; (ii) present GHC's assets and liabilities as held and used by NeighborCare until the completion of the spin-off, as permitted by SFAS 144; and (iii) account for GHC's assets and liabilities as held and used until the completion of the spin-off, as reported in the consolidated statements of cash flows for the periods presented. Initially, the Company reported the intersegment revenues from GHC as a component of revenue from continuing operations such that the periods presented would be comparable and consistent with current and future periods. However, based upon the Company's interpretation of SFAS No. 144, the intersegment revenues from GHC should be included as a component of income from discontinued operations.

SELECTED FINANCIAL DATA

The selected financial data presented below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the notes thereto included elsewhere in this Current Report on Form 8-K. Our consolidated statement of operations data for the years ended September 30, 2003, 2002 and 2001 and our consolidated balance sheet data as of September 30, 2003 and 2002 have been derived from our audited consolidated financial statements included elsewhere in this Current Report on Form 8-K, which have been audited by KPMG LLP, whose report is included elsewhere in this Current Report on Form 8-K. Our statement of operations data for the three months ended December 31, 2003 and 2002 and our balance sheet data as of December 31, 2003 have been derived from our unaudited condensed consolidated financial statements included elsewhere in this Current Report on Form 8-K. Our statement of operations data for the years ended September 30, 2000 and 1999 and our balance sheet data as of September 30, 2001, 2000 and 1999 have been derived from our unaudited consolidated financial statements, which are not presented in this Current Report on Form 8-K.

On December 1, 2003, we completed the spin-off of GHC. Under Statement of Financial Accounting Standards No. 144, *"Accounting for the Impairment or Disposal of Long-Lived Assets,"* referred to as "SFAS 144," discontinued businesses, including assets held for sale or distributed to shareholders, are removed from the results of continuing operations. The results of operations of GHC have been reclassified as discontinued operations in the audited and unaudited consolidated statements of operations for all periods presented. Businesses sold or closed prior to the adoption of SFAS 144 continue to be reported in the results of continuing operations.

Upon emergence from Chapter 11 bankruptcy proceedings on October 2, 2001, our subsidiaries adopted the American Institute of Certified Public Accountants Statement of Position 90-7, *"Financial Reporting By Entities in Reorganization Under the Bankruptcy Code,"* also referred to as "fresh-start reporting," effective September 30, 2001. In connection with the adoption of fresh-start reporting, a new entity was deemed created for financial reporting purposes, the provisions of the 2001 joint plan of reorganization were implemented, assets and liabilities were adjusted to their estimated fair values and our accumulated owner's deficit was eliminated. Any financial information labeled "predecessor company" refers to periods prior to the adoption of fresh-start reporting, while those labeled "successor company" refers to periods following September 30, 2001. Predecessor company and successor company financial information is generally not comparable and is therefore separated by a vertical line. The lack of comparability within the statement of operations data is most apparent in our capital costs (interest, depreciation and amortization), as well as with income taxes and debt restructuring and reorganization costs. Predecessor company and successor company balance sheet data are not comparable due to the change in accounting basis of long-lived assets to estimated fair value and the discharge of liabilities subject to compromise.

On October 1, 2002, we adopted Statement of Financial Accounting Standards No. 145, "*Recission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections as of April 2002*," referred to as "SFAS 145." The most significant impact of the adoption of SFAS 145 is that effective October 1, 2002, any gains or losses on the extinguishment of debt that were classified as extraordinary items in prior periods that do not meet the new criteria for classification as extraordinary items have been reclassified. This reclassification includes the $1.4 billion gain recognized in fiscal 2001 in connection with the discharge of liabilities subject to compromise upon our subsidiaries' emergence from Chapter 11 proceedings which is now included in income (loss) from continuing operations.

	Successor Company				Predecessor Company		
	Three Months Ended December 31,		Years Ended September 30,		Years Ended September 30,		
	2003	2002	2003	2002	2001	2000	1999
	(in thousands, except operating and per share data)						
Statement of Operations Data (1):							
Net revenues	$ 338,394	$ 297,104	$ 1,243,857	$ 1,136,737	$ 1,047,883	$ 1,001,222	$ 921,642
Gross profit	76,427	66,541	281,879	255,154	230,002	231,780	238,178
Income (loss) from continuing operations	(14,149)	(1,114)	3,956	6,259	920,964	(147,614)	(38,860)
Income (loss) from discontinued operations, net of taxes	8,435	13,734	28,732	66,507	(628,867)	(692,710)	(231,713)
Net income (loss)	(5,714)	12,620	32,688	72,766	292,097	(840,324)	(270,573)
Preferred stock dividends		683	2,701	2,599	45,623	42,596	19,477
Net income (loss) available to common shareholders	(5,714)	11,937	29,987	70,167	246,474	(882,920)	(290,050)
Ratio of Earnings to Fixed Charges(2)			1.11x		21.36x		
Diluted EPS Data:							
Income (loss) from continuing operations	$ (0.35)	$ (0.04)	$ 0.03	$ 0.09	$ 18.00	$ (4.04)	$ (1.64)
Income (loss) from discontinued operations, net	0.21	0.33	0.71	1.61	(12.93)	(14.71)	(6.53)
Net income (loss) available to common shareholders	(0.14)	0.29	0.74	1.68	5.07	(18.75)	(8.17)
Weighted average shares outstanding income (loss) from continuing operations and discontinued operations	40,397	41,458	40,757	41,260	48,641	47,077	35,485
Weighted average shares outstanding income (loss) available to common shareholders	40,397	41,458	40,757	43,351	48,641	47,077	35,485
Other Data:							
Gross Profit	$ 76,427	$ 66,541	$ 281,879	$ 255,154	$ 230,002	$ 231,780	$ 238,178
Gross Profit %	22.6%	22.4%	22.7%	22.4%	21.9%	23.1%	25.8%
EBITDA(3)	$ (15,034)	$ 16,854	$ 52,186	$ 43,847	$ 1,005,096	$	$
EBITDA %	(4.4)%	5.7%	4.2%	3.9%	95.9%		

	Successor Company				Predecessor Company	
	December 31,	September 30,			September 30,	
	2003 (4)	2003	2002	2001	2000	1999
	(dollars in thousands)					
Balance Sheet Data (end of period):						
Working capital	$ 298,472	$ 446,657	$ 449,006	$ 282,016	$ 304,241	$ 235,704
Total assets	847,621	1,938,729	2,010,477	1,839,220	3,081,998	2,429,914
Liabilities subject to compromise					2,446,673	

	Successor Company				Predecessor Company	
Long-term debt, including current portion	258,632	611,619	689,683	644,509	143,441	1,521,636
Redeemable preferred stock		46,831	44,765	42,600	442,820	
Shareholders' equity (deficit)	452,377	916,163	914,123	834,858	(246,391)	587,890

(1) For a discussion of operating results from fiscal 2001 through the three months ended December 31, 2003 and a description of significant events, see "Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations."

(2) The ratio of earnings to fixed charges is computed by dividing fixed charges into income (loss) from continuing operations before income taxes plus fixed charges. Fixed charges include interest (expensed or capitalized), amortization of debt issuance costs and the estimated interest component of rent expense. For the three months ended December 31, 2003 and 2002 and the fiscal years ended September 30, 2002, 2000 and 1999, our earnings were insufficient to cover fixed charges by $28.1 million, $1.2 million, $6.6 million, $175.2 million and $62.1 million, respectively.

(3) The following tables reconcile EBITDA to our net income (loss) available to common shareholders and our consolidating operating income by segments. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Reasons for Non-GAAP Financial Disclosure."

	Three Months Ended	
	December 31, 2003	December 31, 2002
Net income (loss) available to common shareholders	$ (5,714)	$ 11,937
Subtract:		
Income (loss) from discontinued operations, net of taxes	(8,435)	(13,734)
Add back:		
Preferred dividends		683
Minority interest and equity in income of unconsolidated affiliates	1,091	1,039
Income tax provision (benefit)	(13,874)	5,483
Interest expense, net	5,654	3,674
Depreciation and amortization	6,244	7,772
EBITDA	$ (15,034)	$ 16,854

	Three Months Ended December 31, 2003		
	Institutional Pharmacy	Corporate & Other	Consolidated
Operating income (loss)	$ 26,573	$ (47,851)	$ (21,278)
Add back:			
Depreciation and amortization	3,068	3,176	6,244
EBITDA	$ 29,641	$ (44,675)	$ (15,034)

	Three Months Ended December 31, 2002		
	Institutional Pharmacy	Corporate & Other	Consolidated
Operating income (loss)	$ 17,683	$ (8,601)	$ 9,082
Add back:			
Depreciation and amortization	3,014	4,758	7,772
EBITDA	$ 20,697	$ (3,843)	$ 16,854

	Successor Company		Predecessor Company
	Years Ended September 30,		
	2003	2002	2001
Net income available to common shareholders	$ 29,987	$ 70,167	$ 246,474

	Successor Company		Predecessor Company
Subtract:			
Income (loss) from discontinued operations, net of taxes	28,732	66,507	(628,867)
Add back:			
Preferred dividends	2,701	2,599	45,623
Minority interest and equity in income of unconsolidated affiliates	4,289	3,061	1,802
Income tax provision (benefit)	(2,048)	(12,699)	
Interest expense, net	14,358	17,186	45,188
Depreciation and amortization	31,631	30,040	37,142
EBITDA	$ 52,186	$ 43,847	$ 1,005,096

	Successor Company Year Ended September 30, 2003		
	Institutional Pharmacy	Corporate & Other	Consolidated
Operating income (loss)	$ 92,325	$ (71,770)	$ 20,555
Add back:			
Depreciation and amortization	12,386	19,245	31,631
EBITDA	$ 104,711	$ (52,525)	$ 52,186

	Successor Company Year Ended September 30, 2002		
	Institutional Pharmacy	Corporate & Other	Consolidated
Operating income (loss)	$ 67,851	$ (54,044)	$ 13,807
Add back:			
Depreciation and amortization	11,315	18,725	30,040
EBITDA	$ 79,166	$ (35,319)	$ 43,847

	Predecessor Company Year Ended September 30, 2001		
	Institutional Pharmacy	Corporate & Other	Consolidated
Operating income (loss)	$ (30,954)	$ 998,908	$ 967,954
Add back:			
Depreciation and amortization expense	13,062	24,080	37,142
EBITDA	$ (17,892)	$ 1,022,988	$ 1,005,096

(4) Balance sheet data as of December 31, 2003 reflects the distribution and spin-off of GHC. Balance sheet data prior to the spin-off has not been adjusted to give effect to the spin-off of GHC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

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

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

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

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

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

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

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

Certain Transactions and Events

Spin-off and Discontinued Operations of GHC

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

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

The following tables set forth the components of net income (loss) from discontinued operations for the three months ended December 31, 2003 compared to the same period last year (in thousands) and for the years ended September 30, 2003, 2002, and 2001 (in thousands):

	Successor Company				Predecessor Company
	Three Months ended December 31,		Years Ended September 30,		Year Ended September 30,
	2003	2002	2003	2002	2001
Net revenues of GHC	$ 250,927	$ 372,407	$ 1,405,122	$ 1,349,051	$ 1,279,250
Net operating income of GHC	16,450	23,325	66,680	128,512	(621,858)
Net operating loss of other units		(1,012)	(1,111)	4,211	
Income from discontinued operations before interest and taxes	16,450	22,313	65,569	132,723	(621,858)
Interest expense allocation	2,467	5,267	19,937	23,373	7,009
Income tax expense	5,548	3,312	16,900	42,843	
Net income from discontinued operations	$ 8,435	$ 13,734	$ 28,732	$ 66,507	$ (628,867)

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

Change in Strategic Direction and Objectives

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

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

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

Strategic Planning, Severance and Other Operating Items

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

Three Months Ended December 31, 2003

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

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

Strategic planning, severance and other operating items for the three months ended December 31, 2002 are primarily attributable to us entering into a termination and settlement agreement with Omnicare, Inc. whereby we agreed to terminate a merger agreement we had entered into with NCS Healthcare, Inc., a provider of institutional pharmacy services. Pursuant to the termination and settlement agreement dated December 15, 2002, we agreed to terminate the merger agreement with NCS and Omnicare agreed to pay us a $22.0 million break-up fee. On December 16, 2002, we terminated the merger agreement and we and Omnicare each agreed to release the other from any claims arising from the merger agreement and not to commence any action against one another in connection therewith. We recognized the break-up fee net of $11.8 million of financing, legal and other costs directly attributable to the proposed merger with NCS. The net gain was offset by severance and related costs associated with the resignation of Richard R. Howard, our former vice chairman, of approximately $4.8 million. The remaining $1.5 million of strategic planning and other operating items for the period primarily relate to consulting and other professional fees.

Fiscal 2003 and 2002

In fiscal 2003, we incurred strategic planning, severance and other operating items of approximately $27.2 million, which included: severance and related costs for a former vice chairman (Richard R. Howard) of $4.8 million; expense associated with the offer and exchange all outstanding stock options as of April 1, 2003 of $7.2 million; strategic consulting expense of $12.9 million; and certain executive compensation of $2.2 million. Executive compensation related to the recruitment of John J. Arlotta as the Company's new chief executive officer and incentive compensation paid to Robert H. Fish for services rendered during his term as the interim chief executive officer.

On April 1, 2003, we extended an offer to our employees, including executive officers except for our chief executive officer, to tender all options to purchase shares of our common stock, par value $.02 per share, outstanding under our 2001 Stock Option Plan, for the following consideration: (a) for those holders of options who had received awards of more than 2,000 restricted shares of common stock under our 2001 Stock Incentive Plan, the acceleration of vesting of all such restricted shares plus a cash payment of $2.50 per share underlying the option for options that had an exercise price below $20.00 per share, and (b) with respect to those holders of options who had not received awards of more than 2,000 restricted shares, (i) for those options that had an exercise price of at least $20.00 per share, a cash payment of $2.00 per share underlying the option, and (ii) for those options that had an exercise price below $20.00 per share, a cash payment of $2.50 per share subject to the option. The offer expired on May 12, 2003. We accepted for exchange and cancellation options to purchase 1,724,000 shares of our common stock, which represented all of the eligible outstanding options properly tendered for exchange by eligible option holders, on May 13, 2003. All eligible options held by our employees were tendered in the offer, with the exception of options to purchase 35,000 shares. As a result of this offer and exchange, we expensed $7.2 million in fiscal 2003, of which $1.4 million was disbursed in cash, with the remainder distributed in common stock.

Strategic consulting costs relate to consulting services for several of our new strategic objectives. Initially, these strategic consulting firms were engaged to assist our board of directors and management in the evaluation of our existing business model and the development of our strategic alternatives. Additional services were procured to assist in the evaluation of our pharmacy sales and marketing function, the bid selection process in connection with the potential sale or spin-off of the eldercare business and, more recently, the legal, accounting and other professional fees directly attributed to the spin-off transaction.

In fiscal 2002, we incurred strategic planning, severance and other operating items of approximately $21.5 million, which included: severance and related costs for the termination of 100 individuals of $3.8 million; severance and related costs for a former chief executive officer and vice chairman of $12.6 million; and strategic consulting expense of $5.1 million.

Agreements with GHC

Tax Sharing Agreement

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

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

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

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

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

Transition Services Agreement

The transition services agreement provides for the provision of certain transitional services by GHC to us. The services include the provision of information systems (e.g., access to computer systems that are owned by GHC), tax services, financial systems, bankruptcy claims processing and certain additional services identified by the parties. The transition services agreement provides for a term of

18 months. In addition, we may extend the transition services agreement for an additional six months with adequate notice. The pricing is based on actual costs incurred by GHC in rendering the services.

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

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

Each of GHC's eldercare facilities entered into an individual services agreement with NCPS that reflects the terms of the pharmacy services agreement. The individual services agreements govern the terms under which pharmacy, pharmacy consulting and