



Australian Pharmaceutical Industries Limited

Annual General Meeting

Address by the Chairman, Mr Peter Robinson

18 December 2007

The last quarter of calendar 2007 has marked a new start for API. Today I am pleased to report that the new management team has been able to rebuild the business and we are well on the way to restoring value to shareholders.

This is not to gloss over the past 18 months, this period has provided API with a substantial test and, unfortunately, that has not been at all fruitful for shareholders.

Before we move onto the future I believe we should cover off some of the past events so that you have a clearer understanding of our position. The events since last September's AGM have been many and varied, so it is best to cover them in sequence to provide you with a sense of the actions and strategies that were pursued. Some of these items were discussed at last year's AGM, from which I can assure you the Board considered your feedback and has acted in response where appropriate.

The last AGM dealt largely with the unreconciled balance of \$17.2 million which the company reported in its 2006 financial year. The directors continued to investigate this matter after the AGM. However the Board noted the feedback from shareholders that if the directors did not believe that there was a reasonable prospect of resolving this issue, it would be best to draw the matter to a conclusion.

After the Board consulted further with both external and internal investigative accounting teams, the most likely reasons for the discrepancy were established, whilst not being able to identify the specific accounting entries.

Additionally, advice to the Board concluded that there was only a remote, if any, chance of being able reverse the adjustment.

As such, after taking into account all information and advice, and then being satisfied that there was nothing further that could be done to resolve the issue even by incurring further significant expense, in December 2006 the Board decided that it was satisfied that the cause of the discrepancy was not due to any deliberate act, but mainly to the legacy IT system that was replaced.

The Board believes that treatment of the issue as a profit and loss adjustment was appropriate.

At the time of the Board decision to end the investigation process, the half-year results were being completed and reviewed by API's external auditor, KPMG, and no further unreconciled discrepancies were identified. Further, the findings of Ernst and Young, who were engaged to assist with the investigation, did not indicate any repetition of the issues experienced and nor have we seen any since. While we were pleased that there was no repetition and expect none, the whole matter was clearly unsatisfactory for the Board and for shareholders.

Shortly after the last AGM, API received an unsolicited and unexpected “proposal to make a takeover offer” from Sigma Pharmaceuticals Limited. At the time, our view was that this proposal would only further disrupt API’s business and make it more difficult to recover our position in the industry due to its incomplete and highly conditional nature. The Board needed to maintain API’s longer term integrity with its industry partners and proceeding with an incomplete and non-binding approach would not have been in the interests of shareholders as it would have meant allowing a competitor access to API’s confidential information as part of due diligence without a firm takeover offer being in place. In all considerations the Board was conscious that there was never actually a takeover offer made, only a proposal to make one, which gave no certainty to shareholders and left API exposed.

In January this year the company finally received some clear space in which to make operational progress without distraction.

Prior to and during the transition to new management, the Board and management agreed to revisit a number of processes that the company had been using in stock control. This review led to a number of significant items being recorded in the first six months of the financial year, resulting in a net loss for the financial year to the end of April 2007. While the Board had reviewed these processes previously we did not expect to uncover the level of significant items, and as such we have now addressed these procedures.

As an example, the Retail division had relied on cycle counts for calculating inventory levels, and as a result of a full stocktake being undertaken there was some stock values that had to be written down. The level of stock shrinkage led us to believe that some portion of the total amount may have related to other periods, as we have not seen that level of shrinkage before or since, however without being able to accurately identify in which period it falls the accounting standards require it to be taken in the same period in which it is identified. Cycle counts are used by many retail operations and it had worked well for this business previously. It was confirmed as part of the due diligence API undertook less than two years previously when it purchased these assets from New Price Retail. In reflecting on this matter the Board believes that the rapid growth over a very short period of time, particularly in the retail business with the roll out of Priceline Pharmacy stores, contributed to this situation. We took corrective action, we continue to monitor it and we have not seen this event recur.

The situation with the 2006 accounts also prompted the Board to take a more conservative view of all stock controls. In consultation with management we made a decision to change internal assessment methodologies, which again had an impact on our Pharmacy provision for obsolete stock. This change was taken after considerable deliberation, however we believed it would ultimately result in a better system for the company and benefit API in the long term. This change was something the Board saw as a more conservative approach and it felt these changes were also encouraging best practice in stock control for staff.

A number of initiatives taken by the Board and management provide us with confidence that the stock issues will be well managed in future. For example, the IT system we implemented in early 2006 provides us with greater transparency of inventory, allowing management access to more immediate information thereby allowing them to handle matters more quickly. Similarly, management has half their individual performance measured against meeting working capital targets, which is of course tied to inventory. The Board and management agree that these initiatives are the right course for API.

The Board was of the view that the significant items taken at the half year were necessary and once taken would allow management to proceed with restoring the business and shareholder value.

Prior to moving onto the progress of API's business I would like to cover one issue which has been raised directly with me.

This is in relation to the termination payment made to the previous Managing Director, Mr Jeff Sher. Mr Sher had total service with the company of more than 15 years and he had been an important part of our retail development. The agreement reached with Mr Sher was that his employment was terminated through resignation, and reflected his time of service, his contract with the company and other entitlements. It was a decision reached by both parties due to a particular personal health issue for Mr Sher, that I was not able to share with you last year due to confidentiality and I do not wish to add to that reason in this forum. I can assure shareholders that the Board took extensive legal advice and did not enter into this agreement without satisfying itself that Mr Sher's personal situation was as he described it. As we have stated before, there is absolutely no link to Mr Sher and the unreconciled balance of \$17.2 million. I believe that the action the Board took at a time of distress for the company has now been vindicated by the subsequent restoration of performance.

The improvement in API's business was only really able to gather momentum once the distraction of the Sigma proposal had gone, the half-year results were finalised and management had made changes to the organisation structure that allowed it to move forward with a focus on maximising each of our key assets.

These early plans were shared with you at the Annual General Meeting last year, but our business improvement reflects planning and the commitment of the business to listen and learn during the year.

Last year at the AGM we spoke about increasing the visibility and relationships with our pharmacy customers. Shareholders after the meeting came forward with their ideas, some met with Stephen and myself. They encouraged, prompted and promoted the same style of ideas – and that plan has been implemented with far greater contact from senior API management with customers throughout NSW. We see this process continuing in future because the message was clear – we had to get back to basics and the results have been positive.

While this activity benefited the company, there were a range of other planned strategies that brought us back into the market. Late in 2006, and early this year, the management team for Pharmacy was boosted with experienced industry managers and together they set about providing the consistency and reliability that pharmacists need to be confident in their biggest trading partner. We also continued to build our product and service offering to our independent pharmacy partners. As early as February this year, we started to see signs of improvement and that has continued through until today.

In the four months to August the Pharmacy division grew at 9.0%, which was above market growth and I can confirm that this growth has continued through the first three months of this current financial year. We have recorded sales for the first quarter of \$597.7 million, 19.0% up on the same period last year. While the industry growth has been strong we are above that level – even excluding the positive impact of the partnership with Alphapharm. The Board is confident that this division is now tracking well and we expect to, at least, stay at the rate of overall market growth in future.



During the same period our Retail division has also experienced considerable change and growth. In regard to Priceline Pharmacy, this is the fastest growing retail format in Australia. We still open almost one store each week and the demand remains strong for further stores. The company views the growth of Priceline Pharmacy as an integral part of our future and we intend to maintain the roll out of the brand at these high levels. Priceline Pharmacy is working well with the average like-for-like growth at more than 14.0% in the first quarter.

In Priceline corporate stores the management team has reinvigorated the brand with in-store changes and a renewed marketing approach that is broadening the brand's market appeal. This was being developed by the management team from late last year, but softer than expected sales during the earlier part of this calendar year propelled this project forward and the recovery from September has seen sales increase by 6.0% on a like-for-like basis. The sales result for entire Retail division for the first quarter is up 7.0% on the prior year at \$161.6 million.

During the year the Board and management agreed that the most important two strategies for the company were continuing the growth of Priceline Pharmacy and rebuilding the underlying Pharmacy and Priceline businesses. This meant that other areas were considered non-core to the company. A number of these businesses have under performed, and it was important that if we did not see a realistic short term turnaround, a decision to divest would be required. As such the company has sold the Price Attack and House franchise brands, sold its PBL joint venture in New Zealand, consolidated the Making Life Easy joint venture into our Pharmacy division and new management has been appointed in the Clifford Hallam Healthcare business. We expect the Clifford Hallam Healthcare business to improve its performance in future.

Our industry sector has seen a high level of potential merger or acquisition activity during the past year and API reiterates that if there is an opportunity for consolidation, particularly in infrastructure sharing, we are open to the concept and willing to engage with industry and regulatory stakeholders. If we can provide a more efficient service to pharmacists, without compromising service standards, then all parties will benefit. When margins are consistently being squeezed from the industry by external factors it is an oddity that extensive and costly product delivery infrastructure is replicated by three publicly listed companies for a population of only 21 million people. There are better solutions, and API is committed to pursuing this strategy to enhance shareholder value.

All the activities undertaken during the year have placed the company in a better position for the future and the early results we have seen for the current financial year are encouraging. I wish to stress to shareholders that the Board is bitterly disappointed with the company's performance in the recent past and it is ultimately the Board that is accountable for the issues we have encountered and for their resolution. As the improvement in performance continues the Board's next priority is to reinstate a dividend at the earliest practical opportunity and the current six-month period will be vital in determining that outcome.

The optimism of the Board in our performance is demonstrated by the improving results and the strategic position of the company. The importance of our strategic position has been underlined by API's recent agreement with Australia's largest generic pharmaceutical provider Alphapharm. This agreement sees API become their preferred distributor and partner to our retail brands. Alphapharm supplies approximately 20% of products to the Pharmaceutical Benefits Scheme by volume. The partnership was an excellent outcome for API, conveying the confidence in the company and our place in the industry. This agreement was achieved due to



the strong position of our pharmacy brands and our distribution capability. This partnership is expected to be accretive to our earnings margins and to add approximately \$7.5 million in annualised earnings before interest and tax, or a lift of a little more than 10%.

One of the critical issues for the company at present is the cost of funding such high growth levels. The Board is exploring all its capital management options, including a range of possible funding alternatives. Better management in this area will add value to shareholders and keep the company well placed to participate in any potential growth activities. Increasing interest rates and the low levels of liquidity in our shares do provide some obstacles that we need to address. The Board will keep shareholders apprised of any developments in this regard, however it is an immediate priority for us.

I would like to conclude with some comments regarding the Board. At last year's AGM I committed to reviewing the Board and its composition. To that end the Board has appointed two new members in the past year, Carol Holley and Miles Hampton, while after the April 2007 financial year was completed two directors resigned, John Murphy and David Fairfull. The skills that Carol and Miles bring to the Board complement the existing Board and have particular expertise that will assist us in future. Effectively half the Board has been renewed in the past two years.

During the coming year it is the intention of the Board to invite our shareholders to a less formal meeting than this to update you on our performance and progress – while also giving you a chance to discuss issues during the year. We intend to hold the meeting at our Camellia office in Sydney. What is apparent to the Board is that with the number of changes that have occurred in the past year keeping shareholders up to date is not always best achieved through written communication. We did take into account your feedback from last year's meeting of the need for more regular communication and since then we have communicated with you on many more occasions.

In summary, the past year has been dedicated to rebuilding API which has meant a period of under-performance for our shareholders, however with the leadership provided by Stephen Roche and his team the Board is confident that the business is heading in the right direction and the early indications for this financial year support that view.

Before handing over to Stephen I would like to thank the members of the board who have given a considerable amount of time and energy over the past sixteen months.

I would also like to thank the management and staff for their tireless efforts during a difficult period in restoring the business, in particular, the work done in the second half of the 2007 financial year to return the company to profitability and their continued efforts during the transitional four month period which has led to a very good start to our 2008 year.

I would now like to hand over to Stephen to discuss with you in some more detail the strategic direction and operational performance of the Company.