

RITE AID CORP  
Form 10-K  
April 30, 2007

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-K

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

For The Fiscal Year Ended March 3, 2007

OR

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

For The Transition Period From To

Commission File Number 1-5742

## RITE AID CORPORATION

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)  
**30 Hunter Lane, Camp Hill, Pennsylvania**  
(Address of principal executive offices)

**23-1614034**  
(I.R.S. Employer  
Identification No.)  
**17011**  
(Zip Code)

Registrant's telephone number, including area code: (717) 761-2633

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

Title of each class	Name of each exchange on which registered
Common Stock, \$1.00 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to section 13 or section 15(d) of the Exchange Act. Yes  No

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of Accelerated Filer and Large Accelerated Filer in Rule 12b-2 of the Exchange Act. Large Accelerated  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate market value of the voting and non-voting common stock of the registrant held by non-affiliates of the registrant based on the closing price at which such stock was sold on the New York Stock Exchange on September 1, 2006 was approximately \$2,293,456,926. For purposes of this calculation, executive officers, directors and 5% shareholders are deemed to be affiliates of the registrant.

As of April 20, 2007 the registrant had outstanding 538,408,486 shares of common stock, par value \$1.00 per share.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the proxy statement for the registrant's annual meeting of shareholders to be held on June 27, 2007 are incorporated by reference into Part III.

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**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This report, as well as our other public filings or public statements, include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are often identified by terms and phrases such as anticipate, believe, intend, estimate, expect, continue, should, could, may, plan, project, predict, will and similar expressions and include references to our future prospects, developments and business strategies.

Factors that could cause actual results to differ materially from those expressed or implied in such forward-looking statements include, but are not limited to:

- our high level of indebtedness;
- our ability to make interest and principal payments on our debt and satisfy the other covenants contained in our senior secured credit facility and other debt agreements;
- our ability to improve the operating performance of our existing stores in accordance with our long term strategy;
- our ability to hire and retain pharmacists and other store personnel;
- our ability to open or relocate stores according to our real estate development program;
- the efforts of private and public third party payors to reduce prescription drug reimbursement and encourage mail order;
- competitive pricing pressures and continued consolidation of the drugstore industry;
- changes in state or federal legislation or regulations;
- the outcome of lawsuits and governmental investigations;
- general economic conditions and inflation, interest rate movements and access to capital;
- our ability to consummate the pending acquisition of Jean Coudu, USA and realize the benefits of the pending acquisition; and
- other risks and uncertainties described from time to time in our filings with the Securities and Exchange Commission ( the SEC ).

We undertake no obligation to update or revise the forward-looking statements included in this report, whether as a result of new information, future events or otherwise, after the date of this report. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Such factors are discussed in the sections entitled Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations Overview and Factors Affecting Our Future Prospects included in this annual report on Form 10-K.

## PART I

### Item 1. Business

#### Overview

We are the third largest retail drugstore chain in the United States based on revenues and number of stores. We operate our drugstores in 27 states across the country and in the District of Columbia. As of March 3, 2007, we operated 3,333 stores.

In our stores, we sell prescription drugs and a wide assortment of other merchandise, which we call front-end products. In fiscal 2007, prescription drug sales accounted for 63.7% of our total sales. We believe that our pharmacy operations will continue to represent a significant part of our business due to favorable industry trends, including an aging population, increased life expectancy, the federally funded prescription drug benefit program ( Medicare Part D ), the discovery of new and better drug therapies and our on-going program of purchasing prescription files from independent pharmacies. We offer approximately 26,000 front-end products, which accounted for the remaining 36.3% of our total sales in fiscal 2007. Front end products include over-the-counter medications, health and beauty aids, personal care items, cosmetics, household items, beverages, convenience foods, greeting cards, seasonal merchandise and numerous other everyday and convenience products, as well as photo processing. We attempt to distinguish our stores from other national chain drugstores, in part, through our private brands and our strategic alliance with GNC, a leading retailer of vitamin and mineral supplements. We offer approximately 3,000 products under the Rite Aid private brand, which contributed approximately 12.6% of our front-end sales in the categories where private brand products were offered in fiscal 2007.

The overall average size of each store in our chain is approximately 12,800 square feet. The average size of our stores is larger in the western United States. As of March 3, 2007, approximately 56% of our stores are freestanding; approximately 43% of our stores include a drive-thru pharmacy; approximately 67% include one-hour photo shops; and approximately 38% include a GNC store-within-Rite Aid-store.

Our headquarters are located at 30 Hunter Lane, Camp Hill, Pennsylvania 17011, and our telephone number is (717) 761-2633. Our common stock is listed on the New York Stock Exchange under the trading symbol of RAD . We were incorporated in 1968 and are a Delaware corporation.

#### Acquisition of Jean Coudu, USA

On August 23, 2006, we entered into a Stock Purchase Agreement (the Agreement ) with the Jean Coudu Group (PJC), Inc. ( Jean Coudu Group ) to acquire all of the membership interests of JCG (PJC) USA, LLC ( Jean Coudu USA ), a wholly-owned subsidiary of Jean Coudu Group and the holding company for the Brooks and Eckerd drugstore chains. As consideration for the pending acquisition of Jean Coudu USA, we will issue 250 million shares of our common stock to Jean Coudu Group in accordance with the terms of the stock purchase agreement and pay Jean Coudu Group \$2.3 billion in cash (subject to a working capital adjustment) which will be funded by the issuance of new debt. We had previously considered assuming 8.5% senior secured notes due 2014 held by Jean Coudu Group as a component of the consideration for the acquisition. Jean Coudu Group has initiated a tender offer for these notes and therefore we will not assume them. This has increased the amount of consideration that we intend to fund by the issuance of new debt from \$1.45 billion to \$2.3 billion.

**Following the completion of the pending acquisition, Jean Coudu Group will be our largest shareholder, owning approximately 32.0% of our common stock, which will represent approximately 30.2% of the voting power of our voting securities then outstanding. Upon the completion of the pending acquisition, we will expand our Board of Directors to 14 members, with four of the seats being held by members designated by Jean Coudu Group. In connection with entering into the stock purchase agreement, on August 23, 2006, we entered into a stockholder agreement with Jean Coudu Group and**

certain Coutu family members that will become effective upon consummation of the acquisition and will govern, among other matters, Jean Coutu Group's ownership interest in Rite Aid. The stockholder agreement contains provisions relating to board and board committee composition, corporate governance, stock ownership, stock purchase rights, transfer restrictions, voting arrangements and other matters. We also entered into a registration rights agreement with Jean Coutu Group giving Jean Coutu Group certain rights with respect to the registration under the Securities Act of 1933, as amended, of the shares of our common stock to be issued to Jean Coutu Group or acquired by Jean Coutu Group pursuant to certain stock purchase rights or open market purchase rights under the stockholder agreement.

Jean Coutu, USA, as of March 3, 2007, employed approximately 46,000 people and, operated six distribution centers and 1,856 stores located in 18 states of the Northeastern, mid-Atlantic and Southeastern United States. The overall average size of each store is approximately 11,000 square feet. Approximately 1,720 of the stores are leased.

We believe that our pending acquisition of Jean Coutu USA provides several strategic benefits, including the following:

- a significant increase in the footprint and operating scale of our business, with increased presence in key strategic markets;
- the creation of the leading drugstore retailer in the Eastern United States, which we believe will allow us to achieve the scale necessary to remain competitive with our major competitors;
- long-term value creation through net reductions in costs and expenses, achievement of meaningful synergies, including additional operational efficiencies, greater economies of scale and revenue enhancements resulting in higher operating cash flow and a decrease in our leverage ratio;
- better positioning to capture additional growth in a sector where growth is projected over the next 5 years and;
- an opportunity to apply our scaleable infrastructure, including our programs, best practices and management capabilities, across a larger store network, which we believe will improve profitability through cost savings and sales growth.

#### **Industry Trends**

We believe pharmacy sales in the United States will grow between 5% and 8% each year over the next four years based upon studies published by a pharmaceutical market intelligence firm. This anticipated growth is expected to be driven by greater drug utilization, an aging population caused by the baby boom generation entering their sixties, the increasing life expectancy of the American population, the Medicare Part D drug benefit program, the introduction of new drugs and the rate of inflation.

Generic prescription drugs help lower overall costs for customers and third party payors. We believe the utilization of existing generic pharmaceuticals is expected to continue to increase for several years. Further, we believe a significant number of new generics are expected to be introduced in the next couple of years. The gross profit from a generic drug prescription in the retail drugstore industry is greater than the gross profit from a brand drug prescription.

The retail drugstore industry is highly competitive and has been experiencing consolidation. We believe that the continued consolidation of the drugstore industry, continued new store openings, increased mail order, increased competition from internet based providers, drug importation and mergers of retail drugstores and pharmaceutical services companies will further increase competitive pressures in the industry. In addition, sales of potential generic pharmaceuticals continue to grow as a percentage of total prescription drug sales, which has a dampening effect on sales growth. The growth rate of

prescription drug sales has also been impacted by slower introductions of successful new prescription drugs and safety concerns sometimes resulting in the recall of some drugs.

The retail drugstore industry relies significantly on third party payors. Third party payors, including the Medicare Part D plans and the state sponsored Medicaid agencies, periodically evaluate and at times change the eligibility requirements to reduce the number of participants or reduce certain reimbursement rates. These evaluations and resulting changes and reductions are expected to continue. When third-party payors, including the Medicare Part D program and the state sponsored Medicaid agencies, reduce the number of participants or reduce their reimbursement rates, sales and margins in the industry could be reduced, and profitability of the industry could be adversely affected. These possible adverse effects can be partially or entirely offset by expense control, by dispensing more higher margin generics or dispensing more prescriptions, which could come from the anticipated growth opportunities mentioned above or from competitors.

## Strategy

Our strategy is to continue to focus on improving the productivity of our existing stores and developing new and relocated stores in our strongest existing markets as well as integrating the stores we acquire from Jean Coutu Group under the Rite Aid banner. We believe that improving the sales of existing stores and growing our existing markets is critical to improving our profitability and cash flow. We believe the consummation of the pending acquisition will broaden and accelerate the implementation of our strategy.

The following paragraphs describe in more detail the components of our strategy:

*Integrate Brooks and Eckerd Stores Under Rite Aid Banner and Develop Stores in Existing Markets.* We intend to convert all Brooks and Eckerd stores to the Rite Aid systems and banner within 16 months following the completion of the pending acquisition. We have assigned senior managers focused exclusively on and fully dedicated to ensuring the successful integration of the Brooks and Eckerd stores, with oversight by our senior executives including our Chief Executive Officer and Chief Operating Officer. Initially, as part of the integration and conversion process, the banners and signs of the Brooks and Eckerd stores will be changed to Rite Aid and all Brooks and Eckerd store systems will be converted to the Rite Aid store systems, including our pharmacy management and dispensing system, Nexgen. Following the store system conversion, the stores will be re-set, re-merchandised and upgraded to the Rite Aid décor package. To ensure successful integration and conversion with minimal disruption to our customers, we intend to launch and complete a pilot store conversion program to test our integration and conversion process over a 4 month period, and then convert all the remaining Brooks and Eckerd stores gradually over a 12 month period. We also expect to continue our new and relocated store and store remodeling program and intend to incorporate the Brooks and Eckerd stores into the program. We expect that some of the Brooks and Eckerd stores will also be remodeled within the first 12 months following the completion of the pending acquisition. We expect that almost all Brooks and Eckerd stores will be remodeled over the next several years. As part of the new and relocated store and store remodeling program, some of the Brooks or Eckerd and Rite Aid stores that are in close proximity to one another may be combined to improve overall productivity.

Our new and relocated store program is focused on our strongest existing markets. Our goal currently and after the pending acquisition, is to open or relocate approximately 800 to 1,000 stores over the next five years, of which we expect that at least 50% will be relocated stores. As part of this program, we also plan to continue remodeling stores. An integral part of the program is a new prototype store. Approximately 150 new or relocated stores have been constructed and opened utilizing the new prototype. We expect that almost all of the planned new and relocated stores will be the new prototype store. We

believe that this program, over the longer term, along with the execution of our near term strategy of improving store productivity, will increase our sales and customer satisfaction.

*Grow our Pharmacy Sales and Attract More Customers.* We believe that customer service and convenience are key factors to growing pharmacy sales. To improve customer service, we are focused on our With Us, It's Personal program that is aimed at delivering more personalized service along with timely delivery to our customers. To help our pharmacists do this, we developed and implemented a new pharmacy management and dispensing system and expect to implement this system in the Brooks and Eckerd stores that we acquire in the pending acquisition. This system, which we call Nexgen, provides our pharmacists with better tools and information to meet our customers' needs. In addition, Nexgen provides management with important information about the performance of each pharmacy in critical operating areas that drive customer service. We provide our customers with an easy and convenient way to order refills over the telephone or the internet using our automatic refill program. To provide better value to our customers we recommend, when appropriate, the utilization of generic drugs. Generic drugs, which often cost our customers significantly less than a branded drug, are also more profitable for us. Our generic penetration continues to increase every year, and we are setting our goals even higher in future years to take advantage of the substantial number of new generics expected to come to market.

The Medicare Part D program provides prescription drug coverage to senior citizens, including those who previously were not covered by any drug benefit program. We communicate information on the Medicare Part D program to senior citizens. We also offer senior citizens newsletters and prescription discounts through our Living More program, a customer loyalty program. We have also expanded our home health category to target senior citizens with products like wheelchairs, canes, electric scooters and products that enhance bath safety. We believe that programs like these will help us to grow prescription sales in this important market.

To help grow sales and script count, we acquire pharmacy files from other drug stores and have initiatives designed to attract and retain those customers. Other initiatives that we expect to grow our pharmacy sales include the opening of in-store health clinics such as those in the Los Angeles, California and Sacramento, California areas, and the continuing pilot of a medication therapy management program, a fee for service arrangement, in conjunction with physicians and the University of Pittsburgh. We believe these initiatives have been effective at growing sales in their target markets and have scalable, replicable potential for future expansion.

We also have the capability to provide pharmacy benefit management ("PBM") services to employers, health plans and insurance companies. We intend to offer, through our PBM capabilities, a 90 day at retail alternative to mail order. We believe that providing PBM services will create opportunities to direct customers to our stores.

*Grow Front-End Sales.* We intend to grow front-end sales through continued emphasis on core drugstore categories, a commitment to health and wellness products to enhance our pharmacy position, a focus on seasonal and cross-merchandising, offering a wider selection of products and services to our customers and effective promotions in our weekly advertising circulars. Our focus for expanding our products and services includes several fully integrated health condition marketing programs, e.g., diabetes, allergy, vitamins, heart health, skincare and pain management, a continued strengthening of our collaborative relationship with our suppliers, an emphasis on our Rite Aid private brand products, which provide better value for our customers and higher margins for us, offering ethnic products targeted to selected markets, expansion of the number of GNC store-within-Rite Aid-store, and utilizing digital technology in our one-hour photo development. We believe that the new store and relocation program described earlier will also contribute to an increase in our front-end sales.

The average front-end sales per store for the Rite Aid stores are approximately 35% more than the average front-end sales per store for the Brooks and Eckerd stores located in the same markets, even



though the average square footage of such Rite Aid stores is slightly less than the average square footage of such Brooks and Eckerd stores. Our goal is to increase the average Brooks and Eckerd front-end sales per store to the level of the average Rite-Aid front-end sales per store. We believe that following the consummation of the pending acquisition, the implementation of the Rite Aid best practices described in the previous paragraph will increase the average Brooks and Eckerd front-end sales per store to a level similar to the average Rite Aid front-end sales per store.

*Focus on Customers and Associates.* Our With Us, It's Personal commitment encourages associates to provide customers with a superior customer service experience. We obtain feedback on our customer service performance by utilizing an automated survey system that collects store specific information from customers shortly after the point of sale and from independent third party customer surveys. We also have programs in place that are designed to enhance customer satisfaction, an example of which is the maintenance of a customer support center that centrally receives and processes all customer calls. We continue to develop and implement associate training programs such as our Take 10 program to improve customer satisfaction and educate our associates about the products we offer. We have implemented programs that create compensatory and other incentives for associates to provide customers with excellent service. We believe that these steps further enable and motivate our associates to deliver superior customer service.

*Expense Control and Cost Savings Through Synergies.* In our existing stores, and in the combined company upon completion of the pending acquisition, our goal is to either reduce costs, lower expense or contain expense in order to leverage the pharmacy and front end sales growth strategies described earlier, which will allow for more investment in the strategies important for our future. We budget and monitor all areas of expense and have also targeted areas of spending for continuous improvement. Our targeted expense areas are subject to analysis of the processes involved, with an emphasis on collaboration between areas in the company and vendors, utilization of competition between vendors and consolidation of spending volumes to achieve economies of scale. Examples of expense areas that are targeted for continuous improvement include: (i) inventory returns, (ii) utility expense and (iii) temporary labor. We have begun to implement strategies to reduce the volume of merchandise returns and thereby reduce the labor expense and inventory valuation losses related to returns. We also have taken steps to better control utility expense by focusing on improving the energy management practices, replacing certain equipment to lower consumption and accessing alternative energy sources for a lower cost. We have begun the process of consolidating the various temporary labor arrangements throughout our business to achieve economies of scale.

**In addition to the focus and activities described in the previous paragraph, following consummation of the pending acquisition which we expect to happen at the end of our first quarter of fiscal 2008, we estimate that net reductions in costs and expenses of approximately \$155 million (which is net of assumed loss of store level EBITDA due to store disposals as mandated by regulatory authorities and additional labor and benefit expense), will be realized in the area of merchandise purchasing, advertising, distribution and administration. Beginning in fiscal 2009, we estimate that annual net reductions in costs and expenses of approximately \$225 million (which is net of an assumed loss of \$15 million of store-level EBITDA and \$50 million of additional labor and benefit expense) will be realized. The general categories of anticipated cost and expense reduction opportunities are cost of product, corporate administrative expenses, advertising expenses and other expense reduction opportunities. We estimate cost of product reductions of approximately \$155 million, primarily from purchasing certain products for all stores at lower costs and increases in vendor support. We also estimate corporate administrative expense reductions of approximately \$55 million, related to the consolidation of the Brooks and Eckerd headquarter functions into the Rite Aid headquarter functions. We estimate advertising expense reductions of approximately \$45 million, from eliminating advertising expense that is duplicated in common markets. We also expect other expense reduction opportunities of approximately \$35 million in areas such as energy management,**

physical inventory processes and supply procurement processes. We also expect other benefits and synergies to result from additional operational efficiencies, greater economies of scale and revenue enhancement opportunities. However, the timing and size of these other benefits and synergies cannot be currently determined. We can provide no assurance that the anticipated benefits and synergies from the pending acquisition described herein will be realized upon consummation of the pending acquisition.

**Products and Services**

Sales of prescription drugs represented approximately 63.7%, 63.2%, and 63.6% of our total sales fiscal years 2007, 2006 and 2005, respectively. In fiscal years 2007, 2006 and 2005, prescription drug sales were \$11.1 billion, \$10.9 billion, and \$10.7 billion, respectively. See Item 7 Management’s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements.

We sell approximately 26,000 different types of non-prescription, or front-end products. The types and number of front-end products in each store vary, and selections are based on customer needs and preferences and available space. No single front-end product category contributed significantly to our sales during fiscal 2007, although certain front-end product classes contributed in excess of 10% to our sales. Our principal classes of products in fiscal 2007 were the following:

Product Class	Percentage of Sales
Prescription drugs	63.7 %
Over-the-counter medications and personal care	21.5 %
Health and beauty aids	4.7 %
General merchandise and other	10.1 %

We offer approximately 3,000 products under the Rite Aid private brand, which contributed approximately 12.6% of our front-end sales in the categories where private brand products were offered in fiscal 2007. During fiscal 2007, we added approximately 244 products under our private brand. We intend to continue to increase the number of private brand products.

We have a strategic alliance with GNC under which we have opened 1,270 GNC stores-within-Rite Aid-stores. We have incorporated the GNC store-within-Rite Aid store into our new and relocated stores and intend to incorporate the GNC store-within-RiteAid-store concept into the Brooks Eckerd stores that we acquire where appropriate.

**Technology**

All of our stores are integrated into a common information system, which enables our customers to fill or refill prescriptions in any of our stores throughout the country, reduces chances of adverse drug interactions, and enables our pharmacists to fill prescriptions more accurately and efficiently. This system can be expanded to accommodate new stores. We expect to integrate all of the Brooks Eckerd stores that we acquire into our information system following the consummation of the pending acquisition. Our customers may also order prescription refills over the Internet through www.riteaid.com powered by drugstore.com, or over the phone through our telephonic rapid automated refill systems, which we also expect to be made available at all of the Brooks and Eckerd stores that we acquire. As of March 3, 2007 we had installed ScriptPro automated pharmacy dispensing units, which are linked to our pharmacists’ computers and fill and label prescription drug orders, in 966 stores, and we expect to extend this technology to the Brooks and Eckerd stores where appropriate. The efficiency of ScriptPro units allows our pharmacists to spend an increased amount of time consulting with our customers. Additionally, each of our stores employs point-of-sale technology that supports sales analysis and recognition of customer

trends. This same point-of-sale technology facilitates the maintenance of perpetual inventory records which together are the basis for our automated inventory replenishment process.

In fiscal 2005, we completed the roll-out of our next generation pharmacy dispensing system, and expanded e-prescribing services to all of our stores. We expect to integrate all of the Brooks and Eckerd stores that we acquire into our next generation pharmacy dispensing system and to extend e-prescribing services to all of the Brooks and Eckerd stores that we acquire. We believe our next generation pharmacy system has enhanced management of customers' prescription orders, assignment of responsibilities within the pharmacy, quality control and measurement and monitoring of each of our pharmacies' key performance indicators, which include timeliness, completeness, and backlog. Our next generation pharmacy system was designed with optimal ease of use in mind so as to further enable our pharmacists to work directly with customers and doctors.

### **Suppliers**

We purchase almost all of our generic (non-brand name) pharmaceuticals directly from manufacturers. During fiscal 2007, we purchased brand pharmaceuticals and some generic pharmaceuticals, which amounted to approximately 94% of the dollar volume of our prescription drugs, from a single wholesaler, McKesson Corp ( McKesson ), under a contract, which runs through March 2009. We expect to continue to purchase a significant volume of our prescription drugs from McKesson subsequent to the pending acquisition. Under the contract, with limited exceptions, we are required to purchase all of our branded pharmaceutical products from McKesson. If our relationship with McKesson was disrupted, we could temporarily have difficulty filling brand drug prescriptions until we executed a replacement strategy, which could negatively affect our business.

We purchase our non-pharmaceutical merchandise from numerous manufacturers and wholesalers. We believe that competitive sources are readily available for substantially all of the non-pharmaceutical merchandise we carry and that the loss of any one supplier would not have a material effect on our business.

We sell private brand and co-branded products that generally are supplied by numerous competitive sources. The Rite Aid and GNC co-branded PharmAssure vitamin and mineral supplement products and the GNC branded vitamin and mineral supplement products that we sell in our stores are developed by GNC, and along with our Rite Aid brand vitamin and mineral supplements, are manufactured by GNC.

### **Customers and Third Party Payors**

During fiscal 2007, our stores served an average of 1.7 million customers per day. The loss of any one customer would not have a material adverse impact on our results of operations.

In fiscal 2007, 95.4% of our pharmacy sales were to customers covered by health plan contracts which typically contract with third parties payors (such as insurance companies, prescription benefit management companies, governmental agencies, private employers, health maintenance organizations or other managed care providers) that agree to pay for all or a portion of a customer's eligible prescription purchases and negotiate with us for reduced prescription rates. During fiscal 2007, the top five third party payors accounted for approximately 31.2% of our total sales, the largest of which represented 9.4% of our total sales. During fiscal 2007, Medicaid related sales were approximately 6.8% of our total sales, of which the largest single Medicaid payor was less than 2% of our total sales.

### **Competition**

The retail drugstore industry is highly competitive. We compete with, among others, retail drugstore chains, independently owned drugstores, supermarkets, mass merchandisers, discount stores, dollar stores

and mail order pharmacies. We compete on the basis of store location and convenient access, customer service, product selection and price. We believe continued consolidation of the drugstore industry, continued new store openings and increased mail order will further increase competitive pressures in the industry.

### **Marketing and Advertising**

In fiscal 2007, marketing and advertising expense was \$295.2 million, which was spent primarily on weekly circular advertising. We have implemented various programs that are designed to support our health and wellness vision and improve our image with customers by delivering upon our With Us, It's Personal brand promise. These include health condition marketing platforms focused on specific health conditions, increased GNC presence through expanded locations and promotional activity, continuation of our Rite Aid Health and Beauty Expos, and marketing and merchandising strategies that capitalize on emerging beauty trends such as men's grooming, spa products, proprietary cosmetics and skincare. We continue to implement programs that are specifically directed to our pharmacy business. These include promotions that provide incentives for customers that transfer their prescriptions to us, a card-based loyalty program for senior citizens called Living More that provides meaningful discounts and targeted newsletters and offers, direct marketing programs, comprehensive health condition management programs, and other educational materials to help customers with their healthcare decisions. We are creating a more inviting store environment for our Hispanic customers through tailored product assortments and bi-lingual signing and advertising in stores with large Hispanic customer bases.

### **Associates**

We believe that our relationships with our associates are good. As of March 3, 2007, we had approximately 69,700 associates, 13% of which were pharmacists, 46% of which were part-time and 37% of which were unionized. Associate satisfaction is critical to the success of our strategy. We have surveyed our associates to obtain feedback on various employment-related topics, including job satisfaction and their understanding of our core values and mission.

There is a national shortage of pharmacists. We have implemented various associate incentive plans in order to attract and retain qualified pharmacists, have added a survey to find out how newly hired pharmacists are doing and have an advisory board made up entirely of associates that are pharmacists. We have also expanded our efforts in recruitment of pharmacists through an increase in the number of recruiters, a successful pharmacist intern program, improved relations with pharmacy schools and an international recruiting program.

### **Research and Development**

We do not make significant expenditures for research and development.

### **Licenses, Trademarks and Patents**

The Rite Aid name is our most significant trademark and the most important factor in marketing our stores and private brand products. We hold licenses to sell beer, wine and liquor, cigarettes and lottery tickets. As part of our strategic alliance with GNC we have a license to operate GNC stores-within-Rite Aid-stores. Additionally, we hold licenses granted to us by the Nevada Gaming Commission that allow us to place slot machines in our Nevada stores. We also hold licenses to operate our pharmacies and our distribution facilities. Together, these licenses are material to our operations.

### **Seasonality**

We experience moderate seasonal fluctuations in our results of operations concentrated in the first and fourth fiscal quarters as the result of the concentration of the cough, cold and flu season and the holidays. We tailor certain front-end merchandise to capitalize on holidays and seasons. We increase our inventory levels during our third fiscal quarter in anticipation of the seasonal fluctuations described above. Our results of operations in the fourth and first fiscal quarters may fluctuate based upon the timing and severity of the cough, cold and flu season, both of which are unpredictable.

### **Regulation**

Our business is subject to federal, state, and local government laws, regulations and administrative practices. We must comply with numerous provisions regulating health and safety, equal employment opportunity, minimum wage and licensing for the sale of drugs, alcoholic beverages, tobacco and other products. In addition we must comply with regulations pertaining to product labeling, dating and pricing.

Pursuant to the Omnibus Budget Reconciliation Act of 1990 ( OBRA ) and comparable state regulations, our pharmacists are required to offer counseling, without additional charge, to our customers about medication, dosage, delivery systems, common side effects and other information deemed significant by the pharmacists and may have a duty to warn customers regarding any potential adverse effects of a prescription drug if the warning could reduce or negate such effect.

The appropriate state boards of pharmacy must license our pharmacies and pharmacists. Our pharmacies and distribution centers are also registered with the Federal Drug Enforcement Administration and are subject to Federal Drug Enforcement Agency regulations relative to our pharmacy operations, including regulations governing purchasing, storing and dispensing of controlled substances. Applicable licensing and registration requirements require our compliance with various state statutes, rules and/or regulations. If we were to violate any applicable statute, rule or regulation, our licenses and registrations could be suspended or revoked and we could be subject to fines or penalties.

In recent years, an increasing number of legislative proposals have been enacted, introduced or proposed in Congress and in some state legislatures that effect or would effect major changes in the healthcare system, either nationally or at the state level. The legislative initiatives include drug importation, changes in qualified participants and changes in reimbursement levels. Although we believe we are well positioned to respond to these developments, we cannot predict the long-term outcome or effect of legislation from these efforts.

Our pharmacy business is subject to patient privacy and other obligations, including corporate, pharmacy and associate responsibility imposed by the Health Insurance Portability and Accountability Act. As a covered entity, we are required to implement privacy standards, train our associates on the permitted uses and disclosures of protected health information, provide a notice of privacy practice to our pharmacy customers and permit pharmacy customers to access and amend their records and receive an accounting of disclosures of protected health information. Failure to properly adhere to these requirements could result in the imposition of civil as well as criminal penalties.

We are also subject to laws governing our relationship with our associates, including minimum wage requirements, overtime and working conditions. Increases in the federal minimum wage rate, associate benefit costs or other costs related to associates could adversely affect our results of operations.

In addition, in connection with the ownership and operations of our stores, distribution centers and other sites, we are subject to laws and regulations relating to the protection of the environment and health and safety matters, including those governing the management and disposal of hazardous substances and the cleanup of contaminated sites. Violations of or liabilities under these laws and regulations as a result of

our current or former operations or historical activities at our sites, such as gasoline service stations and dry cleaners, could result in significant costs.

#### **Corporate Governance and Internet Address**

We recognize that good corporate governance is an important means of protecting the interests of our stockholders, associates, customers, and the community. We have closely monitored and implemented relevant legislative and regulatory corporate governance reforms, including provisions of the Sarbanes-Oxley Act of 2002 ( Sarbanes-Oxley ), the rules of the SEC interpreting and implementing Sarbanes-Oxley, and the corporate governance listing standards of the New York Stock Exchange.

Our corporate governance information and materials, including our Certificate of Incorporation, Bylaws, Corporate Governance Guidelines, the charters of our Audit Committee, Compensation Committee and Nominating and Governance Committee, our Code of Ethics for the Chief Executive Officer and Senior Financial Officers, our Code of Ethics and Business Conduct and our Related Person Transaction Policy are posted on the corporate governance section of our website at [www.riteaid.com](http://www.riteaid.com) and are available in print upon request to Rite Aid Corporation, 30 Hunter Lane, Camp Hill, Pennsylvania 17011, Attention: Corporate Secretary. Our Board will regularly review corporate governance developments and modify these materials and practices as warranted.

Our website also provides information on how to contact us and other items of interest to investors. We make available on our website, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to these reports, as soon as reasonably practicable after we file these reports with, or furnish to, the SEC.

**Item 1A. Risk Factors**

**Factors Affecting our Future Prospects**

Set forth below is a description of certain risk factors which we believe may be relevant to an understanding of us and our business. Security holders are cautioned that these and other factors may affect future performance and cause actual results to differ from those which may, from time to time, be anticipated. See Cautionary Statement Regarding Forward-Looking Statements.

**Risks Related to Our Financial Condition**

**We are highly leveraged. Our substantial indebtedness could limit cash flow available for our operations and could adversely affect our ability to service debt or obtain additional financing if necessary.**

We had, as of March 3, 2007, \$3.1 billion of outstanding indebtedness and stockholders' equity of approximately \$1.66 billion. We also had additional borrowing capacity under our existing \$1.75 billion senior secured revolving credit facility of approximately \$1.33 billion at that time, net of outstanding letters of credit of \$117.1 million. At the time of closing for the pending acquisition, we will fund the \$2.3 billion cash portion of the purchase price with the issuance of additional debt.

Our debt obligations adversely affect our operations in a number of ways and while we believe we have adequate sources of liquidity to meet our anticipated requirements for working capital, debt service and capital expenditures through fiscal year 2008, there can be no assurance that our cash flow from operations will be sufficient to service our debt, which may require us to borrow additional funds for that purpose, restructure or otherwise refinance our debt. Our earnings were insufficient to cover fixed charges for fiscal 2007, 2006, 2004, and 2003 by \$50.8 million, \$23.1 million, \$2.6 million, and \$204.3 million, respectively. Our ratio of earnings to fixed charges for fiscal 2005 was 1.15.

Our high level of indebtedness will continue to restrict our operations. Among other things, our indebtedness will:

- limit our ability to obtain additional financing;
- limit our flexibility in planning for, or reacting to, changes in the markets in which we compete;
- place us at a competitive disadvantage relative to our competitors with less indebtedness;
- render us more vulnerable to general adverse economic, regulatory and industry conditions; and
- require us to dedicate a substantial portion of our cash flow to service our debt.

Our ability to meet our cash requirements, including our debt service obligations, both now and after the consummation of the pending acquisition, will be dependent upon our ability to substantially improve our operating performance, which will be subject to general economic and competitive conditions and to financial, business and other factors, many of which we cannot control. If our cash flow from our operating activities is insufficient, we may take certain actions, including delaying or reducing capital or other expenditures, attempting to restructure or refinance our debt, selling assets or operations or seeking additional equity capital. We may be unable to take any of these actions on satisfactory terms or in a timely manner. Further, any of these actions may not be sufficient to allow us to service our debt obligations or may have an adverse impact on our business. Our existing debt agreements limit our ability to take certain of these actions. Our failure to generate sufficient operating cash flow to pay our debts or to successfully undertake any of these actions could have a material adverse effect on us.