

## Rite Aid

### Encouraging 1Q Keeps Us Overweight

### Overweight

Moody's: Ca; Outlook,Negative  
S&P: CCC; Outlook,Negative  
Fitch: CC; Outlook,Stable

Ticker  
**RAD**

**We maintain our Overweight on Rite Aid, after it reported stronger than expected cash flow in 1Q.** We are upgrading the first lien (9.75% due 2016, B3/B+) and second lien (10 3/8% due 2016 and 7.5% due 2017, Caa2/B-) notes to Buy and from Neutral maintain our Buy on the remaining guaranteed (Caa3/CCC) and unsecured notes (ratings shown above right). With yields ranging from 10% on the first lien notes to 20% on the unsecured notes, we believe investors are getting adequately paid for the risk that leverage is high and the turn-around is still in progress.

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#### HY Consumer, Food, Retail

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- We like the quality of earnings and significantly better cash flow than expected. EBITDA came in at \$249 million, up from \$244 million a year ago, and just shy of our \$253 million target (we were at high end of street). Importantly, RAD generated \$345 million of cash flow (operating cash less investing cash). We had anticipated a normal seasonal cash outflow during the quarter. LTM EBITDA is now \$992 million, and we continue to target \$1.05 billion for FY 2010 (within management's guidance).
- Management maintained its sales and EBITDA guidance, and targets \$325 million of free cash flow, but reduced net income due to the refinancing transactions during 2Q.
- The strong cash flow pushed up liquidity: \$901 million of revolver availability plus \$137 million of cash on hand vs. \$723 available at year end. The liquidity improvement and recent new first lien bond and term loan issues should reduce market refi fears. RAD is in the process of refinancing its revolver (it has \$960 million of commitments on a proposed \$1 billion facility), and anticipates refinancing its AR facilities (1st and 2nd lien) later this year or in early 2010.
- Our key concerns are the increasing number of stores categorized as low-volume stores, the \$100 million dark store rent, and the risk that reduced capex is starving stores. We worry that the store base is still considerably weaker than the competition. We believe RAD is trying to address this by tailoring its merchandise, staffing, and delivery to reduce costs at low volume stores (now 1,245 stores or ~26% of the store base), but it will take time to tell if this works.
- If Rite Aid shows another quarter or 2 of performance like this quarter, we would anticipate the rating agencies increasing the outlooks to Stable.

See page 5 for analyst certification and important disclosures.

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## Capitalization & liquidity

Liquidity is solid, with \$901 million of revolver availability plus \$137 million of cash on hand. After quarter end, Rite Aid issued a \$525 million new tranche 4 Term Loan and \$410 million of 9.75% first lien bonds due 2016. Proceeds were used to repay bank debt that matures in 2010.

The company is currently in the process of refinancing its revolver (it has \$960 million of commitments on a proposed \$1 billion facility due 2012), and anticipates refinancing its AR facilities (1st and 2nd lien) later this year or in early 2010. The second lien AR facility is callable beginning August 2009. We assume that the company will call this high-cost facility at that time, using excess cash to pay it down. It could refinance it, and bring it back on-balance sheet by doing a more traditional ABL type financing (we already include it on balance sheet in our model). We believe refinancing would be viewed positively as it would likely reduce the total cost of the facility (currently L+325 on the first lien, but L+1200 on the second lien).

Table 1: RAD capitalization and liquidity

	30-May-09	Pro forma	Leverage	Market value		
				Price	MV	Leverage
LTM EBITDA		992.4			992.4	
LTM EBITDAR		1,992.4			1,992.4	
Cash	136.5	361.5			361.5	
Revolver (\$1,750 million max due 9/2010) L+175	535.0	0.0			0.0	
Term loans - Tranche 1 due 9/30/10 L+175	145.0	0.0			0.0	
Term loans - Tranche 2 due 6/4/14 L+175	1,094.0	1,094.0			1,094.0	
Term loans - Tranche 3 6/4/14 L+300	321.9	321.9			321.9	
Term loans - Tranche 4 due 2015 L+650		525.0				
9.75% first lien notes due 2016		400.0				
Capital leases	169.4	169.4	2,265.3		169.4	
AR securitization facility (\$345mn due 1/22/10, backstop 9/10) L+ 325	294.4	294.4	2,510.3		294.4	
2nd lien AR securitization L+1200 (9/2010)	<u>225.0</u>	<u>225.0</u>			<u>225.0</u>	
<b>Total bank debt, cap leases, and AR facility</b>	<b>2,784.7</b>	<b>3,029.7</b>	<b>2.7 x</b>	<b>26-May-09</b>	<b>2,104.7</b>	<b>1.8 x</b>
8.125% senior secured (2nd lien) notes due 2010	11.1	11.1		100.00	11.1	784.3
7.5% senior secured (2nd lien) notes due 2017	500.0	500.0		76.25	381.3	
10.375% senior secured (2nd lien) notes due 2016	434.5	434.5		89.25	387.8	
Other	<u>4.2</u>	<u>4.2</u>			<u>4.2</u>	
<b>Total senior secured notes</b>	<b>949.8</b>	<b>949.8</b>			<b>784.3</b>	<b>Rent Adj:</b>
<b>Total senior secured notes and bank debt</b>	<b>3,734.5</b>	<b>3,979.5</b>	<b>3.6 x</b>		<b>2,889.0</b>	<b>5.3 x</b>
9.25% senior notes due 2013	6.0	6.0			5.0	1,114.5
8.625% senior notes due 2015	500.0	500.0		65.50	327.5	
9.375% senior notes due 2015	405.2	405.2		65.25	264.4	
9.5% senior notes due 2017	<u>799.3</u>	<u>799.3</u>		64.75	<u>517.5</u>	
<b>Total guaranteed notes</b>	<b>1,710.5</b>	<b>1,710.5</b>	<b>Rent Adj:</b>		<b>1,114.5</b>	
<b>Total debt through senior notes with guarantees</b>	<b>5,445.0</b>	<b>5,690.0</b>	<b>6.7 x</b>		<b>4,003.5</b>	<b>5.8 x</b>
6.875% senior debentures due 2013	184.8	184.8		66.50	122.9	
7.7% notes due 2027	295.0	295.0		41.00	121.0	
6.875% fixed-rate senior notes due 2028	128.0	128.0		39.00	49.9	
8.5% convertible notes due 2015	158.0	158.0		70.75	111.8	
<i>Total unsecured debt</i>	<i>765.8</i>	<i>765.8</i>			<i>405.5</i>	
<b>Total debt through unsecured</b>	<b>6,210.8</b>	<b>6,455.8</b>	<b>7.1 x</b>		<b>4,409.0</b>	<b>6.0 x</b>
Market value of equity	<u>1,151.9</u>	<u>1,151.9</u>			<u>1,151.9</u>	
<b>Total Enterprise Value</b>	<b>7,362.7</b>	<b>7,607.7</b>	<b>7.7 x</b>		<b>5,560.9</b>	<b>6.6 x</b>
<b>RAD Liquidity</b>	<b>30-May-09</b>	<b>PF</b>				
Cash on hand	136	361				
+ R/C or Sec Debt Availability	901	812				
+ AR securitization Availability	51	51				
- Next yr maturities	(16.6)	(16.6)				
<b>Excess liquidity</b>	<b>1,071</b>	<b>1,207</b>				

Source: Company reports and J.P. Morgan estimates.

Table 2: RAD summary forecast

	1Q09A	2Q09A	3Q09A	4Q09A	FY09A	1Q10A	2Q10E	3Q10E	4Q10E	FY10E	RAD '10	FY11E
Date	31-May-08	30-Aug-08	29-Nov-08	28-Feb-09	28-Feb-09	30-May-09	29-Aug-09	28-Nov-09	27-Feb-10	27-Feb-10	guidance	26-Feb-11
<b>Income Statement</b>												
Total Revenue	6,612.9	6,500.2	6,468.6	6,707.6	26,289.3	6,531.2	6,470.9	6,508.2	6,790.1	26,300.3	26.3-26.7	26,895.2
CGS, including occupancy costs	4,804.6	4,722.1	4,743.1	4,983.8	19,253.6	4,757.1	4,704.3	4,705.4	4,936.4	19,103.2		19,472.1
Gross Profit	1,808.2	1,778.2	1,725.5	1,723.7	7,035.7	1,774.1	1,766.5	1,802.8	1,853.7	7,197.1		7,423.1
SG&A expenses	1,779.6	1,768.4	1,697.0	1,689.6	6,934.7	1,689.8	1,682.4	1,686.5	1,697.5	6,756.2		6,858.3
Stock-based comp benefit	8.7	7.5	9.7	5.5	31.4	6.4	6.4	6.4	6.7	25.8	25-20	40.3
Lease termination & impairment	36.3	51.8	101.6	104.0	293.7	67.0	32.4	19.5	6.8	125.7	242-204	26.9
Total Operating Expenses	1,824.6	1,827.8	1,808.4	3,609.4	9,070.1	1,763.2	1,721.1	1,712.4	1,711.0	6,907.7		6,925.5
Operating EBIT	(16.3)	(49.6)	(82.9)	(1,885.7)	(2,034.5)	10.9	45.4	90.4	142.7	289.4		497.6
Depreciation and Amortization	145.0	150.9	145.4	144.9	586.2	138.2	138.1	140.1	138.9	555.5	565-545	557.5
Stock based comp benefit	8.7	7.5	9.7	5.5	31.4	6.4	6.4	6.4	6.7	25.8	25-20	40.3
Lease termination & impairment	36.3	51.8	101.6	104.0	293.7	67.0	32.4	19.5	6.8	125.7		26.9
Legal Costs - ongoing, nonop	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0
Other Non-cash & non-recurring	55.7	44.2	23.4	1,802.8	1,926.1	11.9	0.0	0.0	0.0	11.9	11-(15)	0.0
<b>EBITDA</b>	<b>229.3</b>	<b>204.8</b>	<b>197.3</b>	<b>171.6</b>	<b>803.0</b>	<b>234.4</b>	<b>222.3</b>	<b>256.4</b>	<b>295.1</b>	<b>1,008.2</b>		<b>1,122.3</b>
Margin	3.5%	3.2%	3.1%	2.6%	3.1%	3.6%	3.4%	3.9%	4.3%	3.8%		4.2%
EBITDA Growth	34.5%	-17.3%	-9.6%	-44.4%	-16.3%	2.2%	8.5%	30.0%	72.0%	25.6%	70-50	11.3%
LIFO Provision	15.1	15.1	59.8	94.6	184.6	14.8	12.0	10.0	5.0	41.8		20.0
<b>EBITDA before LIFO Chg</b>	<b>244.4</b>	<b>219.9</b>	<b>257.1</b>	<b>266.1</b>	<b>987.6</b>	<b>249.2</b>	<b>234.3</b>	<b>266.4</b>	<b>300.1</b>	<b>1,050.0</b>	1.025-1.125bn	<b>1,142.3</b>
Margin	3.7%	3.4%	4.0%	4.0%	3.8%	3.8%	3.6%	4.1%	4.4%	4.0%		4.2%
Rentals	245.0	248.0	250.0	252.0	995.0	250.0	258.8	260.3	271.6	1,040.8		1,075.8
<b>EBITDAR before LIFO Chg</b>	<b>489.4</b>	<b>467.9</b>	<b>507.1</b>	<b>518.1</b>	<b>1,982.6</b>	<b>499.2</b>	<b>493.1</b>	<b>526.8</b>	<b>571.7</b>	<b>2,090.8</b>		<b>2,218.1</b>
Interest Expense	118.2	118.6	126.6	114.2	477.6	109.5	141.4	134.7	134.8	520.4	585-570	476.8
Securitization cost	4.7	4.7	5.1	4.7	19.2	14.4	14.7	6.0	6.0	41.1	561.5	19.9
<b>Summary B/S and CF</b>												
Cash	152.2	170.3	148.9	152.0	152.0	136.6	281.6	114.1	123.9	123.9		230.8
Secured Debt (bank and bonds)	4,068.1	4,241.3	4,416.9	4,083.8	4,083.8	3,734.5	3,981.6	3,758.6	3,760.7	3,760.7		3,592.0
AR Securitized	505.0	500.0	545.0	548.4	548.4	519.4	519.4	294.4	294.4	294.4		294.4
Senior guaranteed notes	1,851.8	1,709.5	1,710.0	1,710.5	1,710.5	1,710.5	1,710.5	1,710.5	1,710.5	1,710.5		1,710.5
Total Debt+ AR sold	6,685.7	6,716.6	6,892.7	6,560.1	6,560.1	6,210.8	6,457.9	6,234.9	6,237.0	6,237.0		6,068.3
EBITDAL/Net Interest inc sec	2.0 x	1.8 x	2.0 x	2.2 x	2.0 x	2.0 x	1.5 x	1.9 x	2.1 x	1.9 x		2.3 x
EBITDAR/Net Interest + Rent	1.3 x	1.3 x	1.3 x	1.4 x	1.3 x	1.3 x	1.2 x	1.3 x	1.4 x	1.3 x		1.4 x
EBITDAL-Capex/Net Interest	0.8 x	0.5 x	1.2 x	1.7 x	1.1 x	1.7 x	1.1 x	1.4 x	1.5 x	1.4 x		1.3 x
Secured debt/EBITDA	3.9 x	4.3 x	4.4 x	4.1 x	4.1 x	3.8 x	4.0 x	3.7 x	3.6 x	3.6 x		3.1 x
Rent adj gtee leverage	7.0 x	7.2 x	7.2 x	7.1 x	7.1 x	6.9 x	6.9 x	6.7 x	6.7 x	6.7 x		6.3 x
Adj. Net Debt/EBITDALR	7.1 x	7.3 x	7.3 x	7.2 x	7.2 x	7.1 x	7.1 x	6.9 x	6.9 x	6.9 x		6.5 x
<b>Summary Oper Stats</b>												
Sales Growth YOY	49.3%	-1.1%	-0.5%	-1.7%	8.1%	-1.2%	-0.5%	0.6%	1.2%	0.0%		2.3%
Gross Margin	27.3%	27.4%	26.7%	25.7%	26.8%	27.2%	27.3%	27.7%	27.3%	27.4%		27.6%
SGA/Total Revenue	26.9%	27.2%	26.2%	25.2%	26.4%	25.9%	26.0%	25.9%	25.0%	25.7%		25.5%
EBIT Margin	-0.2%	-0.8%	-1.3%	-28.1%	-7.7%	0.2%	0.7%	1.4%	2.1%	1.1%		1.9%
Total Stores	5,004	4,930	4,914	4,901	4,901	4,825	4,833	4,860	4,868	4,868		4,893
Same-Store Sales Gains	1.5%	0.6%	1.4%	-0.1%	0.8%	0.6%	0.5%	1.0%	1.0%	0.8%	0.5-1.5%	
<b>Cash Flow</b>												
Net Income	(156.6)	(222.0)	(243.1)	(2,293.7)	(2,915.4)	(98.4)	(114.4)	(54.5)	(3.5)	(270.8)		0.5
Change in working capital	(217.8)	69.1	(40.3)	278.5	89.5	293.0	(97.7)	12.8	(50.7)	157.5		56.0
Disc Ops & other non-recurring	0.0	0.0	0.0	1,810.2	1,810.2	0.0	0.0	0.0	0.0	0.0		0.0
Operating Cash Flow	(105.3)	96.1	44.3	324.8	359.9	357.6	(35.2)	(100.6)	98.2	320.0		681.2
Capital Expenditures	(149.9)	(153.1)	(98.5)	(59.4)	(460.9)	(42.3)	(60.6)	(62.8)	(84.3)	(250.0)	(250.0)	(503.4)
Proceeds from Sale Leasebacks	87.6	73.9	0.0	0.0	161.6	0.0	0.0	0.0	0.0	0.0		100.0
Acquisitions	(36.2)	(25.3)	(14.0)	(5.0)	(80.6)	(2.0)	0.0	0.0	0.0	(2.0)		0.0
Investing Cash Flow	(93.8)	(90.5)	(108.2)	(53.8)	(346.4)	(15.4)	(60.6)	(62.8)	(84.3)	(223.1)		(403.4)
<b>Free-Cash-Flow</b>	<b>(199.1)</b>	<b>5.6</b>	<b>(63.9)</b>	<b>271.0</b>	<b>13.6</b>	<b>342.1</b>	<b>(95.8)</b>	<b>(163.4)</b>	<b>13.9</b>	<b>96.9</b>		<b>277.8</b>
OCF (ex AR fac) - net capex	(237.6)	22.0	(99.2)	270.5	(44.3)	345.3	(95.8)	61.6	13.9	325.0	325.0	277.8
Proceeds / repayment of debt	13.2	60.7	(214.1)	(15.9)	8.8	(7.5)	775.9	(4.1)	(4.1)	760.1		(170.9)
Change in revolver	187.0	(22.0)	342.0	(300.0)	42.0	(303.0)	(535.0)	0.0	0.0	(838.0)		0.0
Financing Cash Flow	195.6	12.5	42.5	(267.8)	(17.3)	(357.7)	240.9	(4.1)	(4.1)	(125.2)		(170.9)
Changes in Cash Balances	(3.6)	18.1	(21.4)	3.2	(3.7)	(15.6)	145.0	(167.5)	9.8	(28.3)		106.9
Beginning Cash	155.8	152.2	170.3	148.9	155.8	152.2	136.6	281.6	114.1	152.2		123.9
Ending Cash	152.2	170.3	148.9	152.0	152.0	136.6	281.6	114.1	123.9	123.9		230.8

Source: Company reports and J.P. Morgan estimates.

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24 June 2009

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