

Guidance Cut but Not So RADical

Higher Generic Costs, Lower Reimbursements Impact Margin Outlook but FCF Story Still Intact

- Citi's Take** — Rite Aid Corp. (RAD) reported 2Q results that were ahead of our expectations but overshadowed by lower guidance for the 2H of the year. SSS increased 4.1% YoY, led by pharmacy SSS growth of 5.6% and front end SSS growth of 1.1%. Script count was up 3.7% reflecting higher utilization, particularly in Medicaid expansion states. Adjusted EBITDA came in \$364.2mm, beating our estimate of \$308mm and consensus of \$294mm. The increase was primarily driven by front-end & pharmacy gross profit, but also benefitted from a \$40mm inventory valuation from its McKesson agreement that should be offset in 2H15.
- 2H14 Guidance Lowered** — Management highlighted continued reimbursement rate pressure, delays in generic equivalent Nexium coming to market, higher than expected costs on generics that recently lost exclusivity, and the McKesson transition (that had impacted 1Q; largely one-time) as the drivers of FY15 guidance reduction. SSS guidance was narrowed to a range of 3.0%-4.0% vs. the prior 2.5%-4.5%. Full-year EBITDA guidance was lowered to \$1.2bn-\$1.275b vs. its prior \$1.275bn-\$1.35bn and consensus estimates of \$1.3bn. Free cash flow is still expected to remain healthy at \$325mm-\$375mm.
- Recommendation(s)** — We keep our Marketweight on RAD but affirm our Buy on the company's 6.75% Sr. Notes '21, 7.7% Sr. Notes '27, and 2nd Lien Term Loan due 2020. We think the market's reaction yesterday (stock down 18.5%) was not reflective of a change in the credit story. At 4.5x LTM gross leverage, RAD is one of the most moderately levered retailers in our universe with a relatively stable top line and gross margin vs. HY retail peers. With a midpoint of \$350mm of free cash flow guided for the year and ongoing debt repayment efforts (RAD plans to ultimately take out the 10.25% notes with cash from operations) we think the company is postured to further delever within an already manageable balance sheet. Further, we believe that nearly half of the EBITDA revision reflects a delay into FY16, not a permanent loss in dollars. We also take comfort in management's efforts around in store initiatives and focus on "wellness" branding, which have supported positive front end sales. In the context of the HY market (5.8% YTW) we think RAD's bonds are attractive given their pickup in yield despite the company's solid credit profile.

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Rite Aid Corp (RAD) (Marketweight)

Issue	Rating	Amt Outstanding (\$mm)	Rating	Price	YTW	OAS	Next Call Date	Next Call Price	3-Month Total Return	YTD Total Return
L + 475; 1.0% 2L Gld Sr. Secd 8/21/2020	Buy (1)	\$470.0	B2 / B	\$101.25	4.8%	NA	2/21/2015	101	0.3%	2.3%
8% 1st Lien 8/15/2020	Neutral (2)	\$650.0	Ba3 / BB-	\$107.50	3.8%	343	8/15/2015	104	-0.2%	0.9%
10.25% 2nd Lien 10/15/2019	Neutral (2)	\$270.0	B2 / B	\$105.38	5.6%	378	10/15/2014	105	0.2%	0.9%
9.25% Sr Unsecured 3/15/2020	Neutral (2)	\$902.0	Caa1 / CCC+	\$110.75	5.0%	424	3/15/2016	105	-0.7%	2.4%
6.75% Sr Unsecured 6/15/2021	Buy (1)	\$810.0	Caa1 / CCC+	\$102.75	6.1%	391	6/15/2016	105	-2.5%	3.1%
7.7% Sr Unsecured 2/15/2027	Buy (1)	\$295.0	Caa1 / CCC+	\$108.25	7.1%	452	NC	NC	-3.1%	9.0%
6.875% Sr Unsecured 12/15/2028	Neutral (2)	\$128.0	Caa1 / CCC+	\$97.50	7.2%	452	NC	NC	-1.2%	9.2%

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Key Conference Call Takeaways

Transition with McKesson Complete

RAD completed the implementation of its new drug purchasing and distribution process with McKesson in the quarter, which now provides pharmacies with direct to store delivery 5 days per week. The net benefit will ultimately provide RAD with greater purchasing savings, working capital benefits and better in stock positions.

Reimbursement Rate Pressure Persists

Management commented that the reimbursement rate environment seems a little tougher in 2H15 than they anticipated; driven by migration within plans and among plans, as well as regular contract negotiations. Management indicated that about one-third to one-half of the lowered EBTIDA guidance for the year was attributable to rate pressure.

Generic Inflation Should Moderate into 2015

A reason for the guidance reduction was the impact of newer generics that recently lost exclusivity, but were not picked up by new manufacturers as quickly as expected, keeping costs on these drugs higher than anticipated. That said, new FDA applications and the expectation that these manufacturers will come online in FY16 should help generic costs come down into next year. Further, RAD expects ongoing benefits from its purchasing arrangement with McKesson.

Focus on Wellness, Health Continues

Management is focused on transforming the company into a healthcare and wellness center, evidenced by programs such as Rite Aid Health Alliance and the opening of RediClinics in select Rite Aid stores. Educated, active pharmacists, flu immunization services, and programs such as Quit For You are part of these initiatives. Further, RAD continues to implement its Wellness Store Program, with RAD Wellness Stores representing now over 31% of its store base. RAD is focused on its wellness+ customer loyalty program and capturing the loyalty of the senior population via its wellness65+ program.

Ongoing Investment in Growth

The company affirmed its \$525mm capex guidance for the year, inclusive of \$90mm of file buys, which could increase if "opportunities arise". Of the budget, \$225mm will be allocated toward store remodels.

Other Key Takeaways

(1) Nexium should start to benefit them in 1Q to 2Q of next year (2) Expect full year working capital benefit of \$250mm from McKesson (3) Private label increased 30bp YoY to 18.3% of front end sales (4) RAD plans to call its 10.25% notes with revolver availability, to be later paid down with cash generated from operations.

Figure 1. Rite Aid Corp (RAD) Summary Financial Model

RITE AID CORP																
	FY12	FY13	FY14	LTM	FY15	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15E	4Q15E			
\$ Millions	3/3/12	3/2/13	3/1/14	8/31/14	3/1/15	6/1/13	8/31/13	11/30/13	3/1/14	6/1/14	8/31/14	12/1/14	3/1/15			
Total Revenues	26,121	25,392	25,526	25,943	26,140	6,293	6,278	6,358	6,597	6,466	6,523	6,455	6,697			
Cost of Goods Sold	19,328	18,074	18,203	18,559	18,759	4,472	4,462	4,557	4,712	4,663	4,628	4,680	4,789			
Gross Profit	6,793	7,318	7,324	7,384	7,381	1,821	1,816	1,801	1,886	1,803	1,895	1,775	1,909			
SG&A	6,531	6,601	6,561	6,634	6,592	1,609	1,603	1,632	1,717	1,644	1,641	1,633	1,674			
D&A	441	414	404	408	408	101	99	101	102	103	101	101	101			
Adjusted EBITDAR	1,884	1,953	2,239	2,225	2,174	567	578	537	557	506	601	487	580			
Co. Adj. EBITDA	943	1,128	1,325	1,285	1,238	345	342	282	356	283	364	249	342			
- Capex	(215)	(316)	(334)	(357)	(444)	(81)	(90)	(84)	(79)	(94)	(99)	(125)	(125)			
- Interest	(529)	(482)	(415)	(383)	(407)	(89)	(130)	(94)	(101)	(91)	(97)	(110)	(110)			
- Taxes	(5)	1	(3)	(4)	(1)	1	(1)	(3)	(1)	(1)	-	-	-			
- Changes in Working Cap.	(135)	223	(124)	48	204	(28)	(151)	62	(6)	96	(103)	70	141			
Basic Free Cash Flow	59	554	449	590	590	148	(31)	163	170	192	65	85	248			
+ Dispositions	23	30	28	25	15	7	3	16	3	2	4	4	4			
- Acquisitions	(35)	(67)	(87)	(92)	(90)	(12)	(24)	(29)	(23)	(20)	(20)	(25)	(25)			
Net Free Cash Flow	47	517	391	523	515	142	(51)	150	150	175	49	64	227			
% Growth, YoY																
Same-Store Sales		-0.3%	0.7%	2.9%	2.6%	-2.5%	1.0%	2.3%	2.1%	3.1%	4.1%	1.5%	1.5%			
Total Revenue		-2.8%	0.5%	0.0%	2.4%	-2.7%	0.8%	1.9%	2.2%	2.7%	3.9%	1.5%	1.5%			
Adj. EBITDA		19.7%	17.4%	0.0%	-6.6%	25.7%	56.2%	-4.4%	4.7%	-18.0%	6.6%	-11.7%	-4.1%			
% Margin																
Gross Profit % of Sales	26.0%	28.8%	28.7%	28.5%	28.2%	28.9%	28.9%	28.3%	28.6%	27.9%	29.0%	27.5%	28.5%			
SG&A % of Sales	25.0%	26.0%	25.7%	25.6%	25.2%	25.6%	25.5%	25.7%	26.0%	25.4%	25.2%	25.3%	25.0%			
EBITDA % of Sales	3.6%	4.4%	5.2%	5.0%	4.7%	5.5%	5.4%	4.4%	5.4%	4.4%	5.6%	3.9%	5.1%			
Capex % of Sales	0.8%	1.2%	1.3%	1.4%	1.7%	1.3%	1.4%	1.3%	1.2%	1.5%	1.5%	1.9%	1.9%			
Liquidity & Balance Sheet																
Cash	162.3	129.5	146.4	185.8	121.9	108.9	144.2	183.2	146.4	166.0	185.8	185.8	121.9			
Revolver Availability	910.8	1,015.0	1,315.1	885.1	1,728.0	1,140.5	885.1	916.8	1,315.1	1,366.2	1,323.0	1,386.9	1,728.0			
Total Liquidity	1,073.1	1,144.5	1,461.5	1,070.9	1,849.9	1,249.4	1,029.3	1,100.0	1,461.5	1,532.2	1,508.8	1,572.6	1,849.9			
Secured Debt	3,914.1	3,835.1	3,553.6	3,548.5	3,143.5	3,713.0	3,847.9	3,748.1	3,553.6	3,501.3	3,548.5	3,484.7	3,143.5			
Total Debt	6,328.2	6,033.5	5,756.8	5,751.6	5,346.6	5,911.5	6,051.6	5,951.7	5,756.8	5,704.4	5,751.6	5,687.8	5,346.6			
Net Debt	6,165.9	5,904.1	5,610.4	5,565.9	5,224.7	5,802.6	5,907.4	5,768.5	5,610.4	5,538.4	5,565.9	5,502.0	5,224.7			
Credit Statistics																
EBITDA / Interest	1.8x	2.3x	3.2x	3.4x	3.0x	3.9x	2.6x	3.0x	3.5x	3.1x	3.8x	2.3x	3.1x			
Secured Leverage	4.2x	3.4x	2.7x	2.8x	2.5x	2.9x	2.9x	2.7x	2.7x	2.8x	2.8x	2.8x	2.5x			
Total Leverage	6.7x	5.3x	4.3x	4.5x	4.3x	4.6x	4.5x	4.3x	4.3x	4.5x	4.5x	4.5x	4.3x			
Net Leverage	6.5x	5.2x	4.2x	4.3x	4.2x	4.5x	4.4x	4.2x	4.2x	4.4x	4.3x	4.4x	4.2x			
Rent Adjusted Leverage	7.5x	7.0x	6.0x	6.1x	6.0x	6.1x	6.1x	6.1x	6.0x	6.1x	6.1x	6.2x	6.0x			
Valuation																
Book Value	(2,587)	(2,459)	(2,114)	(1,907)	(1,783)	(2,358)	(2,318)	(2,229)	(2,114)	(2,046)	(1,907)	(1,885)	(1,783)			
Share Price	\$ 1.7	\$ 1.7	\$ 6.6	\$ 6.6	\$ 6.6	\$ 2.9	\$ 6.6	\$ 6.6	\$ 6.6	\$ 8.3	\$ 6.6	\$ 6.6	\$ 6.6			
Shares Outstanding	898	904	967	980	967	905	980	980	967	975	980	980	980			
Market Cap	1,500	1,518	6,369	6,507	6,369	2,659	6,507	6,507	6,369	8,096	6,507	6,507	6,507			
TEV / EBITDA	8.1x	6.6x	9.0x	9.4x	9.4x	6.1x	9.1x	10.9x	8.4x	12.1x	8.3x	12.0x	8.6x			
Bank Facilities & Pricing						Capitalization								3/1/2014	9/1/2014	x LTM EBITDA
Facility	Asset Based Revolver					Sr. Secured Revolver due 2018								400.0	405.0	
Facility Size	\$1,795															
Maturity	2/21/2018					Tranche 6 1st Lien Term Loan due February 2020								1,152.0	1,152.0	
Rate	Libor + 225; No Floor					8.0% 1st Lien Notes due August 2020								650.0	650.0	
Lead Arranger	Citigroup					Other Secured Debt								5.3	5.0	
BB Advance Rates:	85% A/R + 90% Pharma & Other Inventory + 30% Scripts List + 85% Credit Card A/R					Total 1st Lien								2,207.3	2,212.0	1.7x
						Tranche 1 2nd Lien Term Loan due August 2020								470.0	470.0	
						Tranche 2 2nd Lien Term Loan due June 2021								500.0	500.0	
						10.25% 2nd Lien Notes due October 2019								268.8	269.0	
Facility	Term Loan, Tranche 6					Total 2nd Lien								1,238.8	1,239.0	2.7x
Priority	1st Lien															
Maturity	2/21/2020					9.25% Sr. Notes due March 2020								906.0	906.0	
Rate	L + 300; 1.0% Floor					6.75% Sr. Notes due June 2021								810.0	810.0	
						Guaranteed Unsecured								1,716.0	1,716.0	4.0x
Facility	Term Loan, Tranche 1					8.5% Convert Notes due May 2015								64.2	64.2	
Priority	2nd Lien					7.7% Notes due February 2027								295.0	295.0	
Maturity	8/21/2020					6.875% Sr. Notes due December 2028								128.0	128.0	
Rate	L + 475; 1.0% Floor					Unsecured Unsecured Debt								487.2	487.2	
Amort						Lease Financing Obligations								107.1	97.0	
Facility	Term Loan, Tranche 2					Total Debt								5,756.5	5,751.2	4.5x
Priority	2nd Lien					Net Debt								5,573.3	5,565.4	4.3x
Maturity	6/21/2021					Market Capitalization								6,506.5	6,369.4	
Rate	L + 387.5; 1.0% Floor					TEV								12,079.8	11,934.8	9.3x
Debt Maturity Schedule						Management						Equity Ownership		Apr-14		
Year	Debt	Lease Fin.	Op. Leases	Total	%	Name	Since			Vanguard		5.8%				
2015	16.9	40.0	996.5	1,053.5	7.8%	John T Standley, Chairman & CEO	June-10			Blackrock		5.5%				
2016	75.8	21.2	953.6	1,050.6	7.7%	Kenneth Martindale; President & COO	June-10			T Rowe		4.9%				
2017	11.6	19.3	892.3	923.2	6.8%	Darren Karst	July-14			Arrowstreet		2.8%				
2018	411.6	13.5	810.3	1,235.4	9.1%					DE Shaw		2.2%				
2019	11.6	12.4	713.9	737.9	5.4%					Top 5 Holders		21.1%				
Thereafter	5,121.8	33.7	3,405.1	8,560.5	63.1%											
Total	5,649.4	140.1	7,771.6	13,561.1	100.0%											

Appendix A-1

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% of companies in each rating category that are investment banking clients	70%	66%	43%
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Rite Aid Corp (RAD) — Issuer Portfolio Weighting and Issue Rating History

High Yield Credit Research

Analyst: Jenna Giannelli

Issuer		Issue			
Weighting	Date	Coupon	Description	Maturity	Date
UW	15-Oct-12	8.000%	Sec Nts	15-Aug-20	15-Oct-12
MW	20-Dec-12				01-May-14
UW	28-Oct-13	7.500%	2nd Lien Nts	01-Mar-17	15-Oct-12
MW	01-May-14				20-Dec-12
					20-Aug-13
		9.250%	Guaran Nts	15-Mar-20	15-Oct-12
					20-Dec-12
					15-Mar-13
					01-May-14
		6.750%	Sr Nts	15-Jun-21	28-Oct-13
					01-May-14
		10.250%	2nd Lien Nts	15-Oct-19	28-Oct-13
					01-May-14
		7.700%	Sr Nts	15-Feb-27	28-Oct-13
					01-May-14
		6.875%	Sr Nts	15-Dec-28	28-Oct-13
					01-May-14
		L+475bp	2nd Lien TL	21-Aug-20	04-Sep-14

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