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October 13, 2006

Re: Premature vote on Brooks/Eckerd deal threatens Rite Aid shareholder value

Dear Rite Aid Corporation shareholder:

We write to share our concern with the Rite Aid board of directors' plan to seek shareholder approval for the company's $3.4 billion acquisition of the Brooks and Eckerd drugstore chains in early December, presumably before the transaction clears federal and state antitrust review. The acquisition of over 1800 stores may make strategic sense, but the purchase price appears high and the downside risks considerable. While shareholders must weigh these risks in determining whether to vote in favor of the deal, shareholders should not have to make this decision before knowing how many store divestitures the government may require to satisfy antitrust concerns, and how much cash flow will be lost because of those divestitures.

We therefore urged the Rite Aid board, in a September 28th letter to Chairman Robert Miller, to schedule the shareholder vote after regulatory review. On October 2nd, however, Rite Aid filed a preliminary proxy statement that seemed to confirm the board's intent to schedule the vote before that time. And today we received a letter, dated October 10th, from Robert Sari, Rite Aid Executive Vice President and General Counsel, confirming the company's plan to seek shareholder approval "as soon as practicable." According Mr. Sari, "The EBITDA threshold in the [Stock Purchase] Agreement should adequately protect your concerns." Our analysis, however, suggests otherwise.

We have therefore decided to share our concerns, which are detailed below, with Rite Aid shareholders. We would be happy to discuss our concerns further with interested investors.

1. Rite Aid is asking shareholders to approve the deal even if it requires divestiture of some 300 stores. However, divestitures of that magnitude will substantially alter its financial logic.

The Rite Aid board contemplated the possibility of large-scale divestitures when it negotiated a provision in the Stock Purchase Agreement with the Jean Coutu Group (PJC), Inc. whereby it is not obligated to close if antitrust authorities require divestitures generating store-level adjusted EBITDA of up to an aggregate of $60 million, which we estimate equals about 300 stores.[1]

Rite Aid and Brooks/Eckerd compete in over 80 metropolitan markets in some 14 states, placing over 500 stores under the authorities' antitrust microscope. Long-term shareholders can't help but remember Rite Aid's failed effort to acquire Revco, which it abandoned in April 1996 after the FTC and four state Attorneys General rejected Rite Aid's offer to shed 340 stores and instead sought divestiture of about twice that number. Accordingly, the number of required divestitures could substantially exceed even the 300 contemplated by Rite Aid.

The Stock Purchase Agreement defines the $60 million EBITDA threshold as "not materially adverse" to Rite Aid. In our view, this is a high threshold of materiality given Rite Aid's limited financial flexibility and the fact that $60 million constitutes over 16% of Brooks/Eckerd's fiscal 2006 adjusted EBITDA of $369 million[2]. The $60 million EBITDA threshold appears even more risky given the purchase price and Rite Aid's high debt. We detail these concerns below.

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[1] $60 mil equals 16.3% of Brooks/Eckerd's fiscal 2006 adjusted EBITDA of $369 mil reported in PJC Form 6-K filed with the SEC on 8/4/06 and in Rite Aid's 8-K filed with the SEC on 8/29/06; 16.3% of 1858 stores equals 302 stores.
[2] See footnote 1.

2. The $3.4 billion purchase price, which equals $1.8 million per store acquired, appears high; required divestitures could push the effective per store cost even higher.

Morgan Stanley reports that $1.8 million is far more than the estimated $1 million per store CVS paid for its Eckerd stores in 2004; it's also well above the $1.5 million per store PJC paid for over 1500 Eckerd stores the same year. Credit Suisse also believes the price is high; in response to press reports that a Rite Aid-PJC deal was imminent, the firm issued a report on August 22nd projecting a purchase price of $2.3 – 2.5 billion based on "an acquisition value of roughly $1.3 million per store and 7.1x EBITDA." After the $3.4 billion deal was announced, Credit Suisse issued a follow-up report in which it called the deal positive for Rite Aid, but noted that it was paying "about $1 billion more than we expected."

In the event that Rite Aid is required to divest 300 stores, we estimate that the effective cost per net store acquired would increase from $1.8 million to almost $2.2 million, before taking into account the proceeds from the sale of divested stores.[3] Store divestitures are likely to be at fire sale prices given the circumstances (i.e. government-mandated markets and timeline). But even assuming an average sales price equal to the $1 million per store that CVS paid for its Eckerd stores, we estimate the effective cost per net store acquired would be $2 million.

3. Divestitures that would not be deemed material under the Stock Purchase Agreement could nevertheless push the effective purchase price/EBITDA multiple above the reference ranges that Rite Aid's own advisors used to prepare their fairness opinions.

Citigroup Global Markets Inc. and Rothschild, Inc. each provided fairness opinions to the Rite Aid board. Given that both firms' fees are largely contingent on the deal closing, we do not consider these opinions to be independent affirmation that the purchase price is reasonable to Rite Aid. Notwithstanding our concerns, however, the analyses of firm value as a multiple of EBITDA used to prepare the opinions suggest that divestitures affecting less than $60 million of EBITDA could have a substantial impact on investors' evaluation of the purchase price.[4]

The following table summarizes the reference ranges for firm value as a multiple of EBITDA based on the two advisors' analyses of both comparable companies and precedent transactions:

Summary of Firm Value/EBITDA Analyses Prepared by Rite Aid Advisors

	Comparable Companies		Precedent Transactions	
	Low	Hi	Low	Hi
Citigroup	8.5x	9.5x	8.5x	10.0x
Rothschild	8.0x	10.0x	8.0x	10.0x

The $3.4 billion purchase price translates to a multiple of 9.2x Brooks/Eckerd's fiscal 2006 adjusted EBITDA of $369 million, which is within the above reference ranges. As the following table illustrates, however, a mere divestment of stores generating $30 million in EBIDTA—equivalent to roughly 150 stores—would place the price/EBITDA multiple at the highest end of the reference ranges before taking into account proceeds from the sale of divested stores.[5]

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[3] Assumes Rite Aid divests 302, equal to 16.3%, of stores acquired per footnote 1.
[4] Citigroup received $2 mil upon delivery its opinion and will receive an additional $10 mil (less any amounts paid) upon consummation of the transaction. Rothschild receives portions of its potential $10 mil fee upon delivery of fairness opinion and upon shareholder approval, and a significant portion upon consummation of the transaction.
[5] See footnote 2 above.

Impact of Store Divestitures on EBITDA Multiple for $3.4 Billion Transaction

EBITDA Divested ($mil)	0	10	20	30	40	50	60	70
Estimated # of Stores Affected	0	50	101	151	201	252	302	352
EBITDA - net ($mil)	369	359	349	339	329	319	309	299
Implied EBITDA Multiple								
Assuming no divestiture proceeds	9.2x	9.5x	9.7x	10.0x	10.3x	10.7x	11.0x	11.4x
Assuming $0.75 mil per store proceeds	n.a.	9.4x	9.5x	9.7x	9.9x	10.1x	10.3x	10.5x
Assuming $1.0 mil per store proceeds	n.a.	9.3x	9.5x	9.6x	9.7x	9.9x	10.0x	10.2x

If Rite Aid is required to divest stores generating $60 million in EBITDA, it would end up paying 11.0x EBITDA for net stores acquired–well above the maximum multiple paid in similar transactions—before taking into account divestiture proceeds. Assuming Rite Aid divests stores for an average price of $1 million, it would still end up paying 10.0x EBITDA, the high end of the reference ranges and well above Citigroup's 9.5x maximum based on comparable companies.

4. Rite Aid's ability to obtain financing on reasonable terms, service that debt and create value for its shareholders is uncertain and will require improved operations. Divestitures could exacerbate these challenges by stripping away needed earnings and cash flow.

Rite Aid's total debt will jump by approximately $2.4 billion to $5.75 billion as a result of the acquisition based on pro forma financials in the preliminary proxy statement.[6] This includes $1.55 million in new debt plus the assumption of $850 million of PJC's 8.5% Senior Subordinated Notes. The added debt would increase pro forma leverage (net debt/adjusted EBITDA) to 5.3x as of June 3, 2006 assuming no divestitures.[7] In the event that required divestitures reach the $60 million EBITDA threshold, pro forma leverage would increase to 5.6x. Citing leverage and integration risks from the deal, Fitch, Moody's and Standard & Poor's placed Rite Aid debt—which is already below investment grade—on watch for a possible downgrade.

Rite Aid expects to raise the new debt by issuing $870 million of senior secured notes and drawing approximately $680 million under a $1.105 billion Term Loan Facility provided by Citigroup. If Rite Aid does not assume the PJC notes, a risk it acknowledges in its preliminary proxy statement, it expects to issue additional secured and/or unsecured notes. In the event Rite Aid is unable to issue new notes, a risk also referenced in the preliminary proxy statement, Citigroup has agreed to provide Rite Aid up to a $1.720 billion senior secured bridge facility. While this insures that Rite Aid will have the financing needed to close the deal, it could come at a high price—the interest rate on the bridge facility escalates from an undisclosed base up to a maximum of 12.50%.

Going forward, Rite Aid expects to incur additional debt to help fund capital expenditures of $900 million in fiscal 2007, including $450 million to transform Brooks and Eckerd stores to the Rite Aid banner.[8] As a result, Rite Aid does not expect its leverage ratio relative to adjusted EBITDA to decline until 12 to 24 months after completing the transaction, a forecast that assumes realization of anticipated synergies totaling $150 million. As Rite Aid warns in its preliminary proxy statement, "Following the completion of the acquisition, our ability to meet our cash requirements, including our debt service obligations, will be dependent upon our ability to substantially improve our operating performance..."[9]

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[6] Net debt equals total debt reported in pro forma balance sheet on p. 156 of preliminary proxy plus $330 million outstanding under Rite Aid's A/R securitization program, less cash of $222 million.
[7] Pro forma adjusted EBITDA of $1.045B includes $369M from Brooks/Eckerd (footnote 1) and $676M from Rite Aid, per its presentation to investors filed with the SEC on 8/29/06.
[8] The $450 million in acquisition-related CapEx referenced in preliminary proxy is $50 million less than the $500 million in acquisition-related CapEx Rite Aid previously projected on an August 24 call with analysts.
[9] Rite Aid preliminary proxy statement filed 10/2/06, p. 28.

5. Because Rite Aid shareholders cannot afford to take a "show me" attitude, antitrust issues can and should be resolved before the shareholder vote.

Proponents of the deal assert that, by dramatically narrowing its store count gap with its two larger competitors (CVS and Walgreens), Rite Aid will be better able it to leverage its distribution and purchasing capabilities. Rite Aid hopes to realize these benefits quickly, projecting the acquisition to generate $150 million in synergies and be accretive to earnings within 12 to 24 months. In the near term, however, Rite Aid expects the deal to be dilutive by $0.03 to $0.07 per diluted share for the first 12 months after closing due to increased interest expense and approximately $87 million of non-recurring integration-related expenses.

A new, bigger Rite Aid, therefore, will remain a turnaround story for the foreseeable future. Noting that neither Rite Aid nor PJC has been successful at executing a meaningful store-level turnaround, Morgan Stanley expects "the market to take a 'show me' attitude to this transaction." Deutsche Bank echoed this concern. Sitting on the sidelines, however, is not an option for long-term Rite Aid shareholders who will have responsibility for approving the acquisition. While shareholders will need to assess significant risks in making this decision, they should not have to undertake this analysis in the dark, without the benefit of knowing the extent to which antitrust regulators will require substantial store divestitures.

Rite Aid filed for Hart Scott Rodino review on September 18th, and doesn't expect to have antitrust approval for the acquisition before the shareholder vote. We believe the antitrust issues can and should be resolved before the vote. If you agree, we urge you to promptly communicate your concern to the Rite Aid board.

6. We will continue to evaluate whether the deal's anticipated benefits outweigh its considerable risks. We encourage you to contact us to discuss these issues further.

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a federation of unions representing over six million workers in the US. Members of Change to Win affiliates participate in public and union-sponsored pension funds with about $1.5 trillion in assets, including $180 billion in plans sponsored by affiliates. These funds are long-term Rite Aid shareholders with responsibility for casting proxy votes on the proposed acquisition in the best long-term interests of their participants and beneficiaries.

We will continue to evaluate the deal's anticipated benefits as well as its regulatory, operating and financial risks. We are also reviewing other key issues raised in Rite Aid's preliminary proxy statement, such as the authorization of 500 million additional shares of common stock, the Stockholder Agreement, and corporate governance issues, including changes to the composition of the board and its key committees.

Please feel free contact my colleague, Michael Garland, at (212) 290-0308 if you wish to discuss these issues further.

Sincerely,

William B Patterson

William Patterson
Executive Director