RITE AID CORP
Form 10-K/A
April 06, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

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

For The Fiscal Year Ended February 28, 2004
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	**23-1614034**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
30 Hunter Lane, Camp Hill, Pennsylvania	**17011**
(Address of principal executive offices)	(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

Common Stock, $1.00 par value

Name of each exchange on which registered

New York Stock Exchange
Pacific Exchange

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

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 an accelerated filer (as defined in Exchange Act Rule 12b-2). 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 August 29, 2003 was approximately $2,590,972,917. For purposes of this calculation, executive officers, directors and 5% shareholders are deemed to be affiliates of the registrant.

As of April 19, 2004 the registrant had outstanding 518,649,806 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 24, 2004 are incorporated by reference into Part III.

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EXPLANATORY STATEMENT

As previously disclosed in our Current Report on Form 8-K dated March 18, 2005, on March 17, 2005, our management and audit committee of the Board of Directors have determined that our financial statements for each of the three years in the period ended February 28, 2004 and for the first three quarters of fiscal 2005 should be restated.

On February 7, 2005, a letter was issued by the Office of the Chief Accountant of the Securities and Exchange Commission ("SEC") to the American Institute of Certified Public Accountants that clarified the application of generally accepted accounting principles ("GAAP") for lease accounting. This letter led to our review of certain leasing transactions. As a result of our review, we have determined that our methods of accounting for rent during construction periods and amortization of leasehold improvements for a small number of stores were not consistent with GAAP. Historically, we recorded rent expense on stores at the time that the store began operations. We have now determined that we should have recorded rent expense at the time that we had the right to use the property, which typically is when we begin construction on the property. We also had leasehold improvements at a small number of stores that were being depreciated over lives longer than the minimum lease term of the related ground lease. We have now determined that we should be amortizing these improvements over a life that is no longer than the minimum lease term of the related lease.

These non-cash adjustments, which are similar to others recently announced by several restaurant and retail companies, have no impact on historical or future cash flows or the timing of payments under our operating leases. Also they have no impact on our financial covenants under our senior secured credit facility.

This Amendment No. 1 on Form 10-K/A ("Form 10-K/A") to our Annual Report on Form 10-K for the fiscal year ended February 28, 2004, initially filed with the SEC on April 26, 2004 (the "Original Filing") is being filed to reflect the restatement of our consolidated financial statements for the fiscal years ended February 28, 2004, March 1, 2003 and March 2, 2002, and the notes related thereto as discussed in Note 21, "Restatement of Financial Statements," to the accompanying audited consolidated financial statements and the section entitled "Restatement" in Management's Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-K/A.

For the convenience of the reader, this Form 10-K/A sets forth the Original Filing in its entirety. However, this Form 10-K/A only amends and restates certain information in Items 1, 6, 7, 8, 9A and 15 of the Original Filing, in each case, solely as a result of, and to reflect the restatement, and no other information in the original filing is amended hereby. The foregoing items have not been updated to reflect other events occurring after the Original Filing or to modify or update those disclosures affected by subsequent events. In addition, pursuant to the rules of the SEC, Item 15 of Part IV of the Original Filing has been amended to include a currently dated consent of our independent registered public accounting firm and currently dated certifications from our Chief Executive Officer and Chief Financial Officer, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002. The consent of the independent registered public accounting firm and the certifications of our Chief Executive Officer and Chief

Financial Officer are attached to this Form 10-K/A as exhibits 23, 31.1, 31.2 and 32, respectively.

Except for the foregoing amended information, this Form 10-K/A continues to describe conditions as of the date of the Original Filing, and we have not updated the disclosures contained herein to reflect events that occurred at a later date. Other events occurring after the filing of the Original Filing or other disclosures necessary to reflect subsequent events have been or will be addressed in our amended Quarterly Reports on Form 10-Q/A for the quarterly periods ended May 29, 2004, August 28, 2004 and November 27, 2004, which are being filed concurrently with the filing of this Form 10-K/A, and any reports filed with the SEC subsequent to the date of this filing.

We have not amended and do not intend to amend our previously filed Annual Reports on Form 10-K or our Quarterly Reports on Form 10-Q for the periods affected by the restatement that ended prior to February 28, 2004. For this reason, the consolidated financial statements, auditors reports and related financial information for the affected periods contained in such reports should no longer be relied upon.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are 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 assumptions and relate 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;
- the outcomes of pending lawsuits and governmental investigations;
- competitive pricing pressures and continued consolidation of the drugstore industry; and
- the efforts of third-party payors to reduce prescription drug reimbursements, changes in state or federal legislation or regulations, the success of planned advertising and merchandising strategies, general economic conditions and inflation, interest rate movements, access to capital, and our relationships with our suppliers.

We undertake no obligation to revise the forward-looking statements included or incorporated by reference in this report to reflect any future events or circumstances. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Factors that could cause or contribute to such differences are discussed in the section entitled "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/A.

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 28 states across the country and in the District of Columbia. We have a first or second market position in approximately 60% of the 124 major U.S. metropolitan markets in which we operate. As of February 28, 2004, we operated 3,382 stores.

In our stores, we sell prescription drugs and a wide assortment of other merchandise, which we call "front-end" products. In fiscal 2004, our pharmacists filled more than 200 million prescriptions which accounted for 63.6% 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 and the discovery of new and better drug therapies. We offer approximately 24,000 front-end products, which accounted for the remaining 36.4% of our total sales in fiscal 2004. 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 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 2,100 products under the Rite Aid private brand, which contributed approximately 11.4% of our front-end sales in the categories where private brand products were offered in fiscal 2004.

Our stores range in size from approximately 5,000 to 40,000 square feet. The overall average size of each store in our chain is approximately 12,700 square feet. The larger stores are concentrated in the western United States. Approximately 53% of our stores are freestanding; 38% of our stores include a drive-thru pharmacy; 72% include one-hour photo shops; and 29% 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 and the Pacific Exchange under the trading symbol of "RAD". We were incorporated in 1968 and are a Delaware corporation.

Strategy

Our strategy is to focus on improving the productivity of our existing store base, which are in good locations, often in major metropolitan areas. We believe that improving the sales of existing stores is important to improving profitability and cash flow. We believe that in the past year, the execution of this strategy has driven a 5.1% increase in revenues, from $15.8 billion in fiscal 2003 to $16.6 billion in fiscal 2004. We believe that the execution of our strategy has also led to a significant improvement in our operating results, which improved from a net loss of $112.5 million in fiscal 2003 to net income of $83.4 million in fiscal 2004.

We believe the productivity of our existing store base will be improved by continuing to (i) grow our pharmacy sales and attract more customers; (ii) grow front end sales; (iii) contain expenses and (iv) improve customer satisfaction with focus on service and selection in our stores. Moreover, we estimate that pharmacy sales in the United States will increase at least 30% over the next three years based upon studies published by pharmacy benefit management companies and the Congressional Budget Office. This anticipated growth is expected to be driven by the "baby boom" generation entering their fifties, the increasing life expectancy of the American population, the introduction of several new successful drugs and inflation. We believe this growth will also help increase the sales productivity of our existing store base.

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

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Grow Our Pharmacy Sales and Attract More Customers.   We are currently installing our next generation pharmacy system and have implemented e-prescription applications in approximately 1,200 of our stores, which will further enable our pharmacists to work directly with customers and doctors and adjudicate and fill prescriptions in a more efficient manner. We also drive pharmacy sales growth via our automatic refill program, prescription file buys, in-store immunization programs, fully integrated diabetes program, a specialty pharmacy program, a workers compensation program and several initiatives aimed at managed care providers and doctors. We believe these activities and our focus on generic prescription drugs and direct marketing efforts will attract new customers to our stores and increase profitability. We also continue to develop and implement programs designed to improve customer satisfaction. We believe that by executing our "With us, it's personal" program that is aimed at delivering more personalized service along with faster prescription delivery to our customers, our growth will continue. Although we are already an industry leader in dispensing generic drugs, which have a higher gross margin compared to branded drugs, we continue to take additional steps to further improve our generic efficiency, including adding functionality to our proprietary pharmacy information system to aid our pharmacists in dispensing generic prescriptions whenever possible. We are increasing customer loyalty by establishing a strong community presence through health expositions and not-for-profit activities, focusing on the attraction and retention of managed care customers, partnering with several Medicare endorsed card programs to provide discounts to senior citizens and participating in almost all of Medicare endorsed prescription cards for senior citizens.

Grow Front-End Sales.   We intend to grow front-end sales through continued emphasis on core drugstore categories, 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 a continued strengthening of our collaborative relationship with our suppliers, an emphasis on our Rite Aid brand products, which provide better value for our customers and higher margins for us, ethnic products targeted to selected markets and a conversion of our one-hour photo development to digital technology.

Contain Expenses.   We continue to execute our cost management programs. Our emphasis is on targeted expense areas that are subject to specific work plans for improvement that are continuously monitored. Some examples of targeted expense areas, include (i) workers compensation expense; (ii) utility expense and (iii) repair and maintenance expense. We plan to contain worker's compensation expense through improving workplace safety at our stores and distribution centers and actively managing open claims. We plan to contain utility expense through development and implementation of energy management procedures and systems and through analysis of energy data to facilitate lowest cost bidding for services. We plan to contain repair and maintenance expense by consolidating contracts where applicable, and consistently seeking out lowest cost bidders for preventive maintenance services.

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, frequent customer surveys by an independent third party, and mystery shoppers. We also have several programs in place that enhance customer satisfaction, examples of which are the maintenance of a customer support center that centrally receives and processes all customer calls and our "never out of stock" program. We continue to develop and implement associate training programs 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 who provide customers with excellent service and who improve our corporate culture. We believe that these steps further enable and motivate our associates to deliver a superior customer service.

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Products and Services

During fiscal 2004, sales of prescription drugs represented approximately 63.6% of our total sales, an increase from 63.2% in fiscal 2003 and 61.4% in fiscal 2002. In fiscal years 2004, 2003 and 2002, prescription drug sales were $10.5 billion, $9.9 billion, and $9.3 billion, respectively.

We sell approximately 24,000 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 2004 although certain front-end product classes contributed notably to our sales. Our principal classes of products in fiscal 2004 were the following:

Product Class	Percentage of Sales
Prescription drugs	63.6%
Over-the-counter medications and personal care	10.2
Health and beauty aids	4.8
General merchandise and other	21.4

We offer approximately 2,100 products under the Rite Aid private brand, which contributed approximately 11.4% of our front-end sales in the categories where private brand products were offered in fiscal 2004. During fiscal 2004, we added 217 products under our private brand. We intend to continue to increase the number and the sales of our private label brand products.

We have a strategic alliance with GNC under which we operate GNC "stores-within-Rite Aid-stores". GNC is a leading nationwide retailer of vitamin and mineral supplements and personal care, fitness and other health-related products. As of February 28, 2004, we operated 989 GNC stores-within-Rite Aid-stores.

Technology

All of our stores are integrated into a common information system, which enables our pharmacists to fill prescriptions more accurately and efficiently reduces chances of adverse drug interactions and which can be expanded to accommodate new stores. This common information system enables a customer to fill their prescription in any of our stores. 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. As of February 28, 2004 we had installed ScriptPro automated pharmacy dispensing units, which are linked to our pharmacists' computers and fill and label prescription drug orders, in 883 stores. 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 2004, we developed and implemented several new technologies and applications, including electronic signature capture, loss prevention analytics, some computer based training modules, and transportation management systems. We continued to focus on vendor collaboration, through the development of category management workstations which integrate and coordinate the many different data sources. We continued to enhance category management applications through the development of promotional price optimization and market basket analysis, all of which support decisions for front-end selection, assortment, pricing, promotion and product placement.

In fiscal 2005, we are focusing on technology initiatives such as the roll-out of our next generation pharmacy dispensing system, expansion of e-prescribing and enhancing our automated refill system. We believe our next generation pharmacy system is state of the art and will enhance workflow. 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

During fiscal 2004, we purchased approximately 90% of the dollar volume of our prescription drugs from a single supplier, McKesson Corp ("McKesson"), under a contract, which runs through March 2009. Under the contract, McKesson has agreed to sell to us all the branded pharmaceutical products we require. 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 prescriptions until we found a replacement supplier, which could negatively affect our business. We purchase generic (non-brand name) pharmaceuticals from a variety of sources. 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 2004, our stores served an average of 1.8 million customers per day. The loss of any one customer would not have a material adverse impact on our results of operations. No single customer or health plan contract accounted for more than 10% of our total sales in fiscal 2004.

In fiscal 2004, 93.3% of our pharmacy sales were to customers covered by pharmacy benefit plans which are provided by third-party payors (such as an 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 2004, the top five third-party payors accounted for approximately 30% of our total sales, the largest of which represented 10.2% of our total sales. During fiscal 2004, state sponsored Medicaid agencies accounted for approximately 11.3% of our total sales, the largest of which was less than 3% of our total sales. Any significant loss of third-party payor business could have a material adverse effect on our business and results of operations.

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 mandatory mail order will further increase competitive pressures in the industry.

Marketing and Advertising

In fiscal 2004, marketing and advertising expense was $255.7 million, which was spent primarily on nationwide weekly advertising circulars. We have implemented various programs that are designed to improve our image with customers. These include several customer events, including our Rite Aid Health and Beauty Expos. Our front-end and prescription suppliers are invited to participate in these events by displaying, demonstrating and providing samples of their products and services in exhibit booths. We continue to implement programs that are specifically directed to our pharmacy business. These include direct marketing programs, displaying and distributing printed materials educating customers about various diseases and treatment for these diseases, displaying both pharmacy and front end products that are related and partnering with several Medicare endorsed card programs to

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provide a discount card to senior citizens. Also, commencing in fiscal 2005, we intend to launch a television advertising compaign focused on our "With us, it's personal" message in 33 markets that represent 74% of our pharmacy sales.

Associates

We believe that our relationships with our associates are good. As of February 28, 2004, we had approximately 72,500 associates, 12% of which were pharmacists, 50% of which were part-time and 38% 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. We have also expanded our efforts in recruitment of pharmacists through an increase in the number of recruiters, a successful pharmacist intern program and good relations with pharmacy schools.

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 allows 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 fourth fiscal quarter as the result of the concentration of the 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 quarter may fluctuate based upon the timing and severity of the cold and flu season, both of which are unpredictable.

Regulation

Our business is subject to various federal and state regulations. For example, 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.

In recent years, an increasing number of legislative proposals have been introduced or proposed in Congress and in some state legislatures that would effect major changes in the healthcare system,

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either nationally or at the state level. The legislative initiatives include drug importation and a prescription drug benefit for Medicare participants, changes in qualified participants and changes in reimbursement rates. Although we believe we are well positioned to respond to these developments and near-term the senior discount drug cards are not expected to have a significant impact, we cannot predict the long-term outcome or effect of legislation resulting 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 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 Securities and Exchange Commission 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 and our Code of Ethics and Business Conduct are posted on the corporate governance section of our website at 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 practical after we file these reports with the SEC.

Item 2. Properties

As of February 28, 2004, we operated 3,382 retail drugstores. The overall average selling square feet of each store in our chain is 11,100 square feet. The overall average total square feet of each store in our chain is 12,700. The stores in the eastern part of the U.S. average 8,700 selling square feet per store (9,700 average total square feet per store). The stores in the central part of the U.S. average 9,500 selling square feet per store (10,200 average total square feet per store). The stores in the western part of the U.S. average 16,800 selling square feet per store (20,500 average total square feet per store).

The table below identifies the number of stores by state as of February 28, 2004:

State	Store Count
Alabama	116

Arizona	3
California	579
Colorado	29
Connecticut	36
Delaware	24
District of Columbia	8
Georgia	49
Idaho	20
Indiana	9
Kentucky	117
Louisiana	85
Maine	80
Maryland	138
Michigan	321
Mississippi	31
Nevada	36
New Hampshire	39
New Jersey	167
New York	385
Ohio	237
Oregon	70
Pennsylvania	349
Tennessee	47
Utah	26
Vermont	12
Virginia	132
Washington	134
West Virginia	103
Total	3,382

Our stores have the following attributes at February 28, 2004:

Attribute	Number	Percentage
Freestanding	1,806	53%
Drive through pharmacy	1,288	38%
One-hour photo development department	2,430[(1)]	72%
GNC stores-within a Rite Aid-store	989	29%

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(1)1,137 of these have digital capabilities.

We own our corporate headquarters, which is located in a 205,000 square foot building at 30 Hunter Lane, Camp Hill, Pennsylvania 17011. We lease a 100,000 square foot building near Harrisburg, Pennsylvania for use by additional administrative personnel. We lease 3,106 of our operating drugstore facilities under non-cancelable leases, many of which have original terms of 10 to 22 years. In addition to minimum rental payments, which are set at competitive market rates, certain leases require additional payments based on sales volume, as well as reimbursement for taxes, maintenance and insurance. Most of our leases contain renewal options, some of which involve rent increases.

We operate the following distribution centers and overflow storage locations, which we own or lease as indicated:

Location	Owned or Leased	Approximate Square Footage
Rome, New York	Owned	291,000
Utica, New York(1)	Leased	172,000
Poca, West Virginia	Owned	264,000
Dunbar, West Virginia(1)	Leased	109,000
Perryman, Maryland	Owned	885,000
Tuscaloosa, Alabama	Owned	238,000
Cottondale, Alabama(1)	Leased	155,000
Pontiac, Michigan	Owned	362,000
Woodland, California	Owned	521,300
Woodland, California(1)	Leased	200,000
Wilsonville, Oregon	Leased	518,000
Lancaster, California	Owned	917,000

(1)Overflow storage locations.

The original terms of the leases for our distribution centers range from five to 22 years. In addition to minimum rental payments, certain distribution centers require tax reimbursement, maintenance and insurance. Most leases contain renewal options, some of which involve rent increases. Although from time to time, we may be near capacity at some of our distribution facilities, particularly at our older facilities, we believe that the capacity of our facilities is adequate for the foreseeable future.

We also own a 52,200 square foot ice cream manufacturing facility located in El Monte, California.

On a regular basis and as part of our normal business, we evaluate store performance and may reduce in size, close or relocate a store if the store is redundant, under performing or otherwise deemed unsuitable. When we reduce in size, close or relocate a store, we often continue to have leasing obligations or own the property. We attempt to sublease this space. As of February 28, 2004, we have 7,669,442 square feet of excess space, of which 4,772,545 square feet was subleased.

Item 3. Legal Proceedings

Federal investigations

There are currently pending federal governmental investigations, both civil and criminal, by the United States Attorney, involving various matters related to prior management's business practices. We are cooperating fully with the United States Attorney. We have begun settlement discussions with the United States Attorney for the Middle District of Pennsylvania. The United States Attorney has proposed that the government would not institute any criminal proceeding against us if we enter into a consent judgement providing for a civil penalty payable over a period of years. The amount of the civil penalty has not been agreed to and there can be no assurance that a settlement will be reached or that the amount of such penalty will not have a material adverse effect on our financial condition and results of operations. We have recorded an accrual of $20.0 million in fiscal 2003 in connection with the resolution for these matters; however, we may incur charges in excess of that amount and we are unable to estimate the possible range of loss. We will continue to evaluate our estimate and to the extent that additional information arises or our strategy changes, we will adjust our accrual accordingly.

These investigations and settlement discussions are ongoing and we cannot predict their outcomes. If we were convicted of any crime, certain licenses and government contracts such as Medicaid plan reimbursement agreements that are material to our operations may be revoked, which

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would have a material adverse effect on our results of operations, financial condition or cash flows. In addition, substantial penalties, damages or other monetary remedies assessed against us, including a settlement, could also have a material adverse effect on our results of operations, financial condition or cash flows.

Reimbursement Matters

Multiple state attorneys general are investigating us for our reimbursement practices relating to partially filled prescriptions and fully filled prescriptions that are not picked up by ordering customers. We are supplying similar information with respect to these matters to the United States Department of Justice. We believe that these investigations are similar to investigations that were, and are being, undertaken with respect to the practices of others in the retail drug industry. We also believe that our existing policies and procedures fully comply with the requirements of applicable law and intend to fully cooperate with these investigations. We cannot, however, predict their outcomes at this time. An individual acting on behalf of the United States of America, has filed a lawsuit in the United States District Court for the Eastern District of Pennsylvania under the Federal False Claims Act alleging that we defrauded federal healthcare plans by failing to appropriately issue refunds for partially filled prescriptions and prescriptions which were not picked up by customers. The United States Department of Justice has intervened in this lawsuit, as is its right under the law. We have reached an agreement to settle these investigations and the lawsuit filed by the private individual for $7.2 million, which is subject to court approval. We have accrued $7.2 million for this potential liability.

Other

We, together with a significant number of major U.S. retailers, have been sued by the Lemelson Foundation in a complaint that alleges that portions of the technology included in our point-of-sale system infringe upon a patent held by the plaintiffs. The amount of damages sought is unspecified and may be material. We cannot predict the outcome of this litigation or whether it could result in a material adverse effect on our results of operations, financial conditions or cash flows.

We are subject from time to time to lawsuits arising in the ordinary course of business. In the opinion of our management, these matters are adequately covered by insurance or, if not so covered, are without merit or are of such nature or involve amounts that would not have a material adverse effect on our financial conditions, results of operations or cash flows if decided adversely.

Item 4. Submission of Matters to a Vote of Security Holders

No matter was submitted to a vote of our security holders, through the solicitation of proxies or otherwise, during the fourth quarter of our fiscal year covered by this report.

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PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Our common stock is listed on the New York and Pacific Stock Exchanges under the symbol "RAD." On April 19, 2004, we had approximately 15,421 record shareholders. Quarterly high and low stock prices, based on the New York Stock Exchange composite transactions, are shown below.

Fiscal Year	Quarter	High	Low
2005 (through April 19, 2004)	First	$ 5.75	$ 5.11
2004	First	3.90	2.17
	Second	5.05	3.67
	Third	6.30	4.73
	Fourth	6.40	5.25
2003	First	4.22	3.01
	Second	3.24	1.75
	Third	2.65	1.79
	Fourth	3.05	2.02

We have not declared or paid any cash dividends on our common stock since the third quarter of fiscal 2000 and we do not anticipate paying cash dividends in the foreseeable future. Our senior secured credit facility does not allow us to pay cash dividends. Some of the indentures that govern our other outstanding indebtedness also restrict our ability to pay dividends. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

We have not sold any unregistered equity securities during the period covered by this report, nor have we repurchased any equity securities during the period covered by this report.

Item 6. Selected Financial Data

Such consolidated financial statements have been adjusted to give effect to the restatement as discussed in Note 21 to the Consolidated Financial Statements.

The following selected financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the audited consolidated financial statements and related notes appearing on pages 44-85.

	Fiscal Year Ended				
	February 28, 2004 (52 weeks)	March 1, 2003 (52 weeks)	March 2, 2002 (52 weeks)	March 3, 2001 (53 weeks)(1)	February 26, 2000 (52 weeks)(1)
	(Dollars in thousands, except per share amounts)				
Summary of Operations:					
Revenues	$ 16,600,449	$ 15,791,278	$ 15,166,170	$ 14,516,865	$ 13,338,947
Costs and expense:					
Cost of goods sold, including occupancy costs	12,568,729	12,036,003	11,695,871	11,152,285	10,219,168
Selling, general and administrative expenses	3,594,405	3,471,573	3,422,383	3,412,442	3,651,248
Stock-based compensation expense (benefit) (2)	29,821	4,806	(15,891)	45,865	(43,438)
Goodwill amortization	—	—	21,007	20,670	24,457
Store closing and impairment charges	22,074	135,328	251,617	388,078	139,448
Interest expense	313,498	330,020	396,064	649,926	542,028
Interest rate swap contracts	—	278	41,894	—	—

	Fiscal Year Ended				
	February 28, 2004 (52 weeks)	March 1, 2003 (52 weeks)	March 2, 2002 (52 weeks)	March 3, 2001 (53 weeks)(1)	February 26, 2000 (52 weeks)(1)
	(Dollars in thousands, except per share amounts)				
Loss (gain) on debt modifications and retirements, net (3)	35,315	(13,628)	221,054	100,556	—
Share of loss from equity investments	—	—	12,092	36,675	15,181
Loss(gain) on sale of assets and investments, net	2,023	(18,620)	(42,536)	(6,030)	(80,109)
Total cost and expenses	16,565,865	15,945,760	16,003,555	15,800,467	14,467,983
Income (loss) from continuing operations before income taxes and cumulative effect of accounting change	34,584	(154,482)	(837,385)	(1,283,602)	(1,129,036)
Income tax (benefit) expense	(48,795)	(41,940)	(11,745)	148,957	(8,375)
Income (loss) from continuing operations before cumulative effect of accounting change	83,379	(112,542)	(825,640)	(1,432,559)	(1,120,661)
	—	—	—	11,335	9,178

Income (loss) from discontinued operations, net of income tax expense of $13,846, and $30,903										
Loss on disposal of discontinued operations, net of income tax benefit of $734		—		—		—		(168,795)		—
Cumulative effect of accounting change, net of income tax benefit of $18,200		—		—		—		—		(27,300)
Net income (loss)	$	83,379	$	(112,542)	$	(825,640)	$	(1,590,019)	$	(1,138,783)
Basic and diluted net income (loss) per share:										
Income (loss) from continuing operations	$	0.11	$	(0.28)	$	(1.81)	$	(5.15)	$	(4.36)
(Loss) income from discontinued operations		—		—		—		(0.50)		.04
Cumulative effect of accounting change		—		—		—		—		(0.11)
Net income (loss) per share	$	0.11	$	(0.28)	$	(1.81)	$	(5.65)	$	(4.43)
Year-End Financial Position:										
Working capital	$	1,894,247	$	1,676,889	$	1,580,218	$	1,955,877	$	752,657
Property, plant and equipment, net		1,882,763		1,867,830		2,095,552		3,040,790		3,445,863
Total assets		6,245,634		6,132,766		6,491,281		7,913,693		9,845,601
Total debt (4)		3,891,666		3,862,628		4,056,468		5,894,548		6,612,868
Redeemable preferred stock (5)		—		19,663		19,561		19,457		19,457
Stockholders' (deficit) equity		(8,277)		(129,938)		(7,527)		(373,619)		414,120
Other Data:										
Cash flows from continuing operations provided by (used in):										
Operating activities	$	227,515	$	305,383	$	16,343	$	(704,554)	$	(623,098)
Investing activities		(242,150)		(72,214)		342,531		677,653		(504,112)
Financing activities		(15,931)		(211,903)		(107,109)		(64,324)		905,091
Capital expenditures		267,373		116,154		187,383		141,504		641,070
Cash dividends declared per common share	$	0	$	0	$	0	$	0	$	.3450
Basic weighted average shares		515,822,000		515,129,000		474,028,000		314,189,000		259,139,000
Diluted weighted average shares (6)		525,831,000		515.129,000		474,028,000		314,189,000		259,139,000
Number of retail drugstores		3,382		3,404		3,497		3,648		3,802
Number of associates		72,500		72,000		75,000		75,500		77,300

(1)PCS was acquired on January 22, 1999. On October 2, 2000, we sold PCS. Accordingly, our Pharmacy Benefit Management ("PBM") segment was reported as a discontinued operation in the fiscal years ended March 3, 2001 and February 26, 2000.

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(2)Stock based compensation expense for the year ended February 28, 2004 was determined using the fair value method set forth in Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock Based Compensation". Stock based compensation expense (benefit) for the fiscal years ended March 1, 2003, March 2, 2002, March 3, 2001 and February 26, 2000 was determined using the intrinsic method set forth in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees".

(3)Amounts related to the early extinguishment of debt that were previously recognized as an extraordinary item outside of results from continuing operations were reclassified as a gain or loss on debt retirements and modifications, which is a component of income or loss from continuing operations.

(4)Total debt included capital lease obligations of $183.2 million, $176.2 million, $182.6 million, $1.1 billion, and $1.1 billion, as of February 28, 2004, March 1, 2003, March 2, 2002, March 3, 2001, and February 26, 2000, respectively.

(5)Redeemable preferred stock was included in "Other Non-current liabilities" as of February 28, 2004.

(6)Diluted weighted average shares for the year ended February 28, 2004 included the impact of stock options, as calculated under the treasury stock method.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Net income for fiscal 2004 was $83.4 million, compared to a net loss of $112.5 million in fiscal 2003 and $825.6 million in fiscal 2002. Reasons for the substantial improvement in our results in fiscal 2004 are described in more detail in the Results of Operations and Liquidity and Capital Resources sections of this Item 7. However, some of the key factors that impacted this improvement are summarized as follows:

Productivity of Existing Store Base. Our strategy is to focus on improving the productivity of our existing store base. We have focused our efforts on improving the productivity of our stores by implementing programs to drive pharmacy sales growth, improving our product categories to offer more personalized products and service to our customers, increasing our mix of private brand and generic drug sales, developing programs that are specifically directed toward improving our pharmacy service and implementing associate programs that create compensatory and other incentives for associates to provide customers with better service. We believe that our improvements in revenues, gross margin as a percentage of revenues and selling, general and administrative costs (SG&A) as a percent of revenues that are detailed in the Results of Operations section are a direct result of our success in implementing this strategy of improving the productivity of our stores, evidenced by a rise in average revenue per store from $4.3 million in fiscal 2002 to $4.9 million in fiscal 2004.

Debt Refinancing. In fiscal 2002 and again in fiscal 2004, we took several steps to improve our leverage and extend the terms of a substantial amount of our debt. In fiscal 2004, we replaced our senior secured credit facility with a new credit facility, issued new senior notes, and repurchased portions of several existing notes prior to maturity. These activities resulted in a loss of $43.2 million related to the termination of the old senior secured credit facility and the issuance of the new senior secured credit facility, offset by net gains of $7.9 million related to the note repurchases described above. Our fiscal 2002 refinancing, extended the maturity of the majority of our debt, converted a portion of our debt to equity and rescinded purchase options on certain sale-leaseback leases, resulting in their reclassification from capital leases to operating leases. These activities resulted in aggregate charges of $221.1 million in fiscal 2002. These steps have enabled us to reduce our debt from $6.6 billion as of February 26, 2000 to $3.9 billion as of February 28, 2004, and to extend the maturity of the majority of our debt to 2008 and beyond. These transactions are discussed in more detail in the Liquidity and Capital Resources section below.

Closure of Under-Performing Stores. We performed a rigorous review of underperforming stores, and, based on these reviews, decided to close 5, 40 and 116 stores in fiscal 2004, 2003 and 2002, respectively. As a result of these closures and our annual review of our stores' operating performance for potential impairment, we have recorded store closing and related impairment charges of $22.1 million, $135.3 million, and $251.6 million in fiscal 2004, 2003 and 2002, respectively. We believe that these closures were necessary to improve the productivity of our remaining store base and to eliminate underperforming stores. As part of our ongoing business activities, we will continue to assess

stores for potential closure. There can be no assurance that other such actions may not be required in the future, or that such actions would not have a material adverse effect on our operating results for the period in which we take those actions.

Substantial Investigation Expenses. We have incurred substantial expenses in connection with defense against litigation related to prior management's business practices and the defense of prior management. We incurred $15.1 million in fiscal 2004, $20.7 million in fiscal 2003, and $17.5 million in fiscal 2002. We expect to incur approximately $5.0 million in fiscal 2005, and expect to continue to incur significant legal and other expenses until the resolution of the U.S. Attorney's case against certain of our former executive officers and the investigation of certain other matters.

Stock-Based Compensation Expense. We recorded stock-based compensation expense (benefit) of $29.8 million, $4.8 million and $(15.9) million in fiscal 2004, 2003, and 2002, respectively. The expense recorded in fiscal 2004 resulted primarily from the application of the fair value method of accounting for stock-based compensation expense, which we adopted as of the beginning of fiscal 2004. The expense (benefit) recorded in fiscal 2003 and 2002 resulted primarily from the impact of applying variable plan accounting to several of our stock-based compensation plans and the vesting of restricted stock grants.

Dilutive Equity Issuances. At February 28, 2004, 516.5 million shares of common stock were outstanding and an additional 176.4 million shares of common stock were issuable related to outstanding stock options, convertible notes and preferred stock.

Our 176.4 million shares of potentially issuable common stock consist of the following:

(Shares in thousands)

Strike price	Outstanding Stock Options (a)	Convertible Notes (b)	Preferred Stock	Total
	(Shares in thousands)			
$5.50 and under	52,986	—	75,964	128,950
$5.51 to $7.50	2,307	38,462	—	40,769
$7.51 and over	6,702	—	—	6,702
Total issuable shares	61,995	38,462	75,964	176,421

(a)The exercise of these options would provide cash of $292.6 million

(b)The conversion of these notes to equity would reduce the principal amount of debt by $250.0 million

Working Capital. We generally finance our inventory and capital expenditure requirements with internally generated funds and borrowings under our senior credit facility. We expect to use cash from operations and, when necessary borrowings under our revolving credit facility to finance inventories and to support our continued growth. The majority of our front-end sales are in cash. Third-party payors, which typically settle in fewer than 30 days, accounted for 93.3% of our pharmacy sales and 59.3% of our revenues in fiscal 2004.

Industry Trends We believe pharmacy sales in the United States will increase at least 30% over the next three years based on studies provided by pharmacy benefit management companies and the Congressional Budget Office. This rate of increase is lower than it has been in the past five years. The anticipated increase of 30% over the next three years is expected to be driven by the "baby boom" generation entering their fifties, the increasing life expectancy of the American population, the introduction of several new drugs, the rate of inflation and expanded consumer access to drug benefits under the recent Medicare program modifications.

The retail drugstore industry is highly competitive and has been experiencing consolidation. We believe that continued consolidation of the drugstore industry, continued new store openings, increased mandatory mail order and drug importation 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.

The retail drugstore industry relies significantly on third party payors at an increasing rate. Third party payors, especially state sponsored Medicaid agencies, have recently evaluated and reduced

certain reimbursement levels. Also, modifications to the Medicare program are being implemented that will provide discount cards to senior citizens in the near term and will expand coverage of prescription drugs. If third-party payors, including state sponsored Medicaid agencies, reduce their reimbursement levels, or if Medicare covers prescription drugs at lower reimbursement levels, sales and margins in the industry could be reduced, and the profitability of the industry could be adversely effected.

Restatement

Following a review of our lease-related accounting practices, we have determined that our previous methods of accounting for straight-line rent expense and the related deferred rent liability and our computation of leasehold improvement depreciation for a small number of stores were not in conformity with GAAP. As a result, our financial statements for each of the three years in the period ended February 28, 2004 and for the first three quarters of fiscal 2005 have been restated.

Historically, we recorded rent expense on operating leases on a straight-line basis over the minimum lease term at the time that the store began operations. We have now determined that we should have recorded rent expense at the time that we had the right to use the property, which typically is when we begin construction on the property. We also had leasehold improvements at a small number of stores that were being depreciated over lives longer than the minimum lease term of the related ground lease. We have now determined that we should be amortizing these improvements over a life that is no longer than the minimum lease term.

These non-cash adjustments, which are similar to others recently announced by several restaurant and retail companies, have no impact on historical or future cash flows or the timing of payments under our operating leases. Also, they have no impact on our financial covenants under our senior secured credit facility.

The financial statement impact of the restatement is to accelerate the depreciation on leasehold improvement assets on ground leases so that the asset is fully depreciated over the remaining minimum lease term and to recognize rent expense on operating leases on a straight-line method beginning at the time we have the right to use the property. The cumulative effect of the restatement as of February 28, 2004 is to decrease net property plant and equipment by $1.0 million, to increase non-current liabilities by $16.5 million and to increase the accumulated deficit by $17.5 million. The impact of the restatement is an increase in net income of $0.1 million for fiscal 2004, an increase in net loss of $0.5 million for fiscal 2003 and a decrease in net loss of $2.0 million in fiscal 2002, from amounts previously reported. The restatement has no effect on diluted earnings per share for fiscal years 2004 and 2003, and results in a decrease in diluted loss per share of $.01 for fiscal 2002. The cumulative effect of the restatement for all years prior to fiscal 2002 is $19.2 million, which is recorded as an increase in opening stockholders' deficit at March 4, 2001.

The following Management's Discussion and Analysis gives effect to the restatement.

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Results of Operations

Revenue and Other Operating Data

	Year Ended		
	February 28, 2004 (52 Weeks)	March 1, 2003 (52 Weeks)	March 2, 2002 (52 Weeks)
	(Dollars in thousands)		
Revenues	$ 16,600,449	$ 15,791,278	$ 15,166,170
Revenue growth	5.1%	4.1%	4.5%
Same store sales growth	5.7%	6.7%	8.3%
Pharmacy sales growth	5.8%	7.1%	9.6%
Same store pharmacy sales growth	6.4%	9.7%	11.4%
Pharmacy sales as a % of total sales	63.6%	63.2%	61.4%
Third-party sales as a % of total pharmacy sales	93.3%	92.7%	92.0%
Front-end sales growth (decline)	3.9%	(0.5)%	1.9%
Same store front-end sales growth	4.6%	1.9%	3.6%
Front-end sales as a % of total sales	36.4%	36.8%	38.6%
Store data:			
Total stores (beginning of period)	3,404	3,497	3,648
New stores	2	3	7
Closed stores	(26)	(97)	(168)
Store acquisitions, net	2	1	10

Total stores (end of period)	3,382	3,404	3,497
Remodeled stores	170	138	64
Relocated stores	7	12	22

Revenues

The 5.1% growth in revenues for fiscal 2004 was driven by pharmacy sales growth of 5.8%, and front-end sales growth of 3.9%. Sales growth in both pharmacy and front end was driven by same store sales, which are discussed in more detail in the paragraphs below. We include in same store sales all stores that have been open in each comparable fiscal year. Stores in liquidation are considered closed. Relocated stores are not considered new stores in our calculation.

Fiscal 2004 pharmacy same store sales increased by 6.4%, due primarily to increases in price per prescriptions and, to a lesser extent, increases in the number of prescriptions filled. The increase in price per prescription was driven by inflation, partially offset by an increase in generic sales mix. The increase in the number of prescriptions filled was aided by prescription file purchases, a more severe flu season, and favorable industry trends. Favorable industry trends include an aging population, the use of pharmaceuticals to treat a growing number of healthcare problems, and the introduction of a number of successful prescription drugs. Partially offsetting increases in the number of prescriptions filled was an increase in third-party payors requiring customers to use mail order for certain prescriptions and a reduction in hormone replacement therapy and non-sedating antihistamine prescriptions.

Fiscal 2004 front-end same store sales increased 4.6%, primarily as a result of improvement in most core categories, such as over-the-counter items, consumables and vitamins and improved assortments. Also contributing to front-end same store sales increases was the switch of certain prescriptions to over-the-counter products.

Pharmacy and front-end same store sales increases in fiscal 2004 benefited from increased business in our Southern California stores, driven by the migration of customers impacted by a union strike at several grocery store chains. The union strike ended the beginning of March 2004. Early indications are we will be successful in retaining a significant amount of these customers in both the pharmacy and front-end parts of our business.

The 4.1% growth in revenues for fiscal 2003 was driven by pharmacy sales growth of 7.1%, offset slightly by a front-end sales decline of 0.5%. The decline in front-end sales was a direct result of closing 97 stores in fiscal 2003, partially offset by same store sales growth of 1.9%.

Fiscal 2003 pharmacy same store sales increased by 9.7%, due to increases in both the number of prescriptions filled and sales price per prescription. Factors contributing to our pharmacy same store sales increases include inflation, improved attraction and retention of managed care customers, our increased focus on pharmacy initiatives, such as predictive refill, and favorable industry trends. These favorable factors were partially offset by the increase in generic sales mix, a reduction in hormone replacement therapy prescriptions and the impact of a less severe flu season than in the prior year.

Fiscal 2003 front-end same store sales increased 1.9%, primarily as a result of improvement in most core categories, such as over-the-counter items, consumables and vitamins, and improved assortments.

Fiscal 2002 (52 weeks) revenues increased 4.5% over fiscal 2001 (53 weeks). Excluding the extra week, revenues would have increased 6.5%, driven by increases of 1.9% in front-end and 9.6% in pharmacy. Same store sales growth for fiscal 2002 was 8.3% (pharmacy of 11.4% and front-end of 3.6%). As fiscal 2001 was a 53 week year, same store sales are calculated by comparing the 52 week period ended March 2, 2002 with the 52 week period ended March 3, 2001.

Fiscal 2002 pharmacy sales led sales growth due to an increase in both the number of prescriptions filled (on a comparable 52-week basis) and sales price per prescription. Factors contributing to our pharmacy same store sales increases include inflation, improved attraction and retention of managed care customers, our reduced cash pricing, our increased focus on pharmacy initiatives, such as predictive refill, and favorable industry trends.

Front-end fiscal 2002 sales also increased. The increase was primarily a result of increased sales volume due to improved assortments, lower prices on key items and distributing a nationwide weekly advertising circular.

Costs and Expenses

	Year Ended		
	February 28, 2004 (52 Weeks)	March 1, 2003 (52 Weeks)	March 2, 2002 (52 Weeks)
	(Dollars in thousands)		
Costs of goods sold, including occupancy costs	$ 12,568,729	$ 12,036,003	$ 11,695,871
Gross profit	$ 4,031,720	$ 3,755,275	$ 3,470,299
Gross margin	24.3%	23.8%	22.9%
Selling, general and administrative expenses	$ 3,594,405	$ 3,471,573	$ 3,422,383
Selling, general and administrative expenses as a percentage of revenues	21.7%	22.0%	22.6%
Stock-based compensation expense (benefit)	$ 29,821	$ 4,806	$ (15,891)
Goodwill amortization	—	—	21,007
Store closing and impairment charges	22,074	135,328	251,617
Interest expense	313,498	330,020	396,064
Interest rate swap contracts	—	278	41,894
Loss (gain) on debt modifications and retirements, net	35,315	(13,628)	221,054
Share of loss from equity investments	—	—	12,092
Loss (gain) on sale of assets and investments, net	2,023	(18,620)	(42,536)

Cost of Goods Sold

Gross margin was 24.3% for fiscal 2004 compared to 23.8% in fiscal 2003. Gross margin was positively impacted by improvements in both pharmacy and front-end margin. Improvement in pharmacy margin was driven by improved generic product mix and reduced inventory costs resulting from purchasing improvements, partially offset by lower reimbursement rates. Front-end gross margin improved due to more efficient promotional markdowns and lower inventory costs due to improvements in purchasing. Overall gross margin was negatively impacted by an increase in pharmacy sales mix. Gross margin was also positively impacted by lower occupancy and depreciation and amortization charges and lower LIFO related charges.

Gross margin was 23.8% for fiscal 2003 compared to 22.9% in fiscal 2002. Gross margin was positively impacted by improvements in both pharmacy and front-end margin. Improvement in pharmacy margin was driven by improved generic product mix and improved third party reimbursements. Front-end gross margin improved due to more efficient promotional markdowns. Overall gross margin was negatively impacted by an increase in pharmacy sales mix. Gross margin was also positively impacted by a decrease in the LIFO provision due to a lower rate of inflation and lower occupancy and depreciation and amortization charges.

We use the last-in, first-out (LIFO) method of inventory valuation. The LIFO charge was $19.9 million in fiscal 2004, $19.7 million in fiscal 2003, and $69.3 million in fiscal 2002.

Selling, General and Administrative Expenses

Total selling, general and administrative expenses ("SG&A") for fiscal 2004 was 21.7% as a percentage of revenues, compared to 22.0% for fiscal 2003. SG&A expenses for fiscal 2004 include $15.1 million incurred primarily to defend against litigation related to prior management's business practices and to defend prior management. Offsetting these charges are credits of $20.7 million related to favorable litigation settlements.

SG&A expenses for fiscal 2003 includes $20.7 million incurred primarily to defend against litigation related to prior management's business practices and to defend prior management. SG&A for fiscal 2003 also includes a charge of $20.0 million for an investigation by the United States Attorney into various matters related to former management, a credit of $10.9 million related to favorable litigation settlements and a credit of $27.7 million related to the elimination of severance liabilities for former executives.

After considering the items described in the previous paragraphs, SG&A was lower in fiscal 2004 than fiscal 2003 due to decreased depreciation and amortization charges resulting from certain store equipment and intangible assets becoming completely depreciated and amortized, reduction in professional fees and better leveraging of our fixed costs resulting from higher sales volume, partially offset by higher associate benefit costs.

Total SG&A expenses for fiscal 2003 were 22.0% as a percentage of revenues, compared to 22.6% for fiscal 2002. SG&A expenses for fiscal 2002 included $17.5 incurred to defend against litigation related to prior management's business practices and to defend prior management and a charge of $8.8 million to terminate an exclusivity contract with a certain vendor. Offsetting these items were net receipts of $32.0 million related to litigation and $7.1 million of expense reduction resulting primarily from senior executives releasing their rights to their non-qualified defined benefit arrangements.

After considering the items described in the previous paragraphs, SG&A was lower in fiscal 2003 than fiscal 2002 due to decreased depreciation and amortization charges resulting from certain store equipment and intangible assets becoming completely depreciated and amortized, reduced professional fees and better leveraging of our fixed costs resulting from higher sales volume, partially offset by higher associate benefit costs.

Store Closing and Impairment Charges

Store closing and impairment charges consist of:

Year Ended

	February 28, 2004	March 1, 2003	March 2, 2002
	(Dollars in thousands)		
Impairment charges	$ 24,914	$ 69,508	$ 157,962
Store and equipment lease exit (credits) charges	(2,840)	65,820	93,303
Impairment of investments	—	—	352
	$ 22,074	$ 135,328	$ 251,617

Impairment Charges

In fiscal 2004, 2003 and 2002, store closing and impairment charges include non-cash charges of $24.9 million, $69.5 million and $158.0 million, respectively, for the impairment of long-lived assets

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(including allocable goodwill for fiscal 2002) at 208, 262 and 365 stores, respectively. These amounts include the write-down of long-lived assets to estimated fair value at stores that were assessed for impairment as part of our on-going review of the performance of our stores or management's intention to relocate or close the store.

Store and Equipment Lease Exit (Credits) Charges

In fiscal 2004, 2003 and 2002, we recorded charges for 5, 40 and 116 stores, respectively, to be closed or relocated under long-term leases. Effective January 1, 2003, charges to close a store, which principally consist of lease termination costs, were recorded at the time the store is closed and all inventory is liquidated, pursuant to the guidance set forth in SFAS No. 146, "Accounting for Costs Associated with Exit of Disposal Activities." Prior to January 1, 2003, charges incurred to close a store were recorded at the time management committed to closing the store. We calculate our liability for closed stores on a store-by-store basis. The calculation includes the future minimum lease payments and related ancillary costs, from the date of closure to the end of the remaining lease term, net of estimated cost recoveries that may be achieved through subletting properties or through favorable lease terminations. This liability is discounted using a risk-free rate of interest. We evaluate these assumptions each quarter and adjust the liability accordingly. The effect of adjustments to the risk-free rate of interest and the reversal of reserves established for stores that were previously committed for closure by management, but ultimately were not closed, resulted in a net credit for fiscal 2004.

Interest Expense

Interest expense was $313.5 million in fiscal 2004 compared to $330.0 million in fiscal 2003. Interest expense for fiscal 2004 decreased from fiscal 2003 due to a decrease in debt issue cost amortization and the reclassification of closed store interest expense, which, pursuant to SFAS No. 146, is classified as a component of store closing and impairment charges.

Interest expense was $330.0 million in fiscal 2003 compared to $396.1 million in fiscal 2002. Interest expense for fiscal 2003 decreased from fiscal 2002 due to the reduction of debt resulting from the retirement and repurchase of certain notes, and a reduction in LIBOR rates, which reduced our interest rate on the senior secured credit facility.

The annual weighted average interest rates on our indebtedness in fiscal 2004, fiscal 2003 and fiscal 2002 were 6.8%, 7.3%, and 8.2% respectively.

Interest Rate Swap Contracts

We entered into two year interest rate swap contracts in June and July of 2000 to hedge the exposure to increasing rates with respect to our variable rate debt. As a result of the June 2001 refinancing, the interest rate swap contracts no longer qualified for hedge accounting treatment, and therefore the changes in fair value of these interest rate swap contracts were required to be recorded as components of net loss. Accordingly, we recognized an initial charge of $31.0 million and subsequent changes in the market value of the interest rate swaps of $10.4 million, inclusive of cash payments, which resulted in a charge of $41.9 million for fiscal 2002. Changes in market value of the interest rate swaps in fiscal 2003 were not significant. These contracts expired and were fully funded during fiscal 2003 and have not been renewed.

Income Taxes

Tax benefits of $48.8 million, $41.9 million and $11.7 million have been recorded for fiscal 2004, fiscal 2003 and fiscal 2002, respectively. The fiscal 2004 benefit is comprised of a federal tax benefit of $54.6 million offset by a state tax expense of $5.8 million. The federal benefit is related to the conclusion of the Internal Revenue Service examination for fiscal years 1996 through 2000, representing recoverable federal and state income taxes and interest, as well as a reduction of previously recorded liabilities. The state tax expense of $5.8 million is the result of the provision from

operations for state income taxes for which the use of net operating losses were temporarily suspended by certain jurisdictions. The fiscal 2003 benefit resulted primarily from the federal tax law change, enacted on March 9, 2002, which increased the carryback period of net operating losses incurred in fiscal 2001 and 2002 from two years to five. The fiscal 2002 benefit is primarily due to the favorable outcome of federal income tax litigation. The benefit of the net operating loss carryforwards ("NOLs") and net deferred tax assets generated in each period have been fully offset by a valuation allowance as a result of management's determination that, based on available evidence, it is more likely than not that the deferred tax assets will not be realized. We regularly review our deferred tax assets for recoverability considering historical profitability, projected taxable income, the expected timing of the reversals of existing temporary differences and tax planning strategies. If and when our operations in some jurisdictions were to become sufficiently profitable to recover previously reserved deferred tax assets, we would reduce all or a portion of the applicable valuation allowance in the period that such determination is made. This would result in an increase to reported earnings in such period.

We have undergone an ownership change for statutory tax purposes during fiscal 2002, which resulted in a limitation on the future use of net operating loss carryforwards. We believe that this limitation does not further impair the net operating loss carryforwards because they are fully reserved.

During fiscal 2003, we received federal income tax refunds in the amount of $68.7 million based on the favorable outcome of federal income tax litigation and tax law changes permitting the five-year carryback of NOLs.

Liquidity and Capital Resources

General

We have three primary sources of liquidity: (i) cash equivalent investments, (ii) cash provided by operations and (iii) the revolving credit facility under our senior secured credit facility. Our principal uses of cash are to provide working capital for operations, service our obligations to pay interest and principal on debt, to provide funds for capital expenditures, including prescription file purchases, and to provide funds for repurchases of our publicly traded debt.

Our ability to borrow under the senior secured credit facility is based on a specified borrowing base consisting of eligible accounts receivable, inventory and prescription files. On February 28, 2004, we had $584.8 million in additional available borrowing capacity under the revolving credit facility net of outstanding letters of credit of $115.2 million.

2004 Transactions

On May 28, 2003, we replaced our senior secured credit facility with a new senior secured credit facility. The new facility consists of a $1.15 billion term loan and a $700.0 million revolving credit facility which will mature on April 30, 2008. The proceeds of the loans made on the closing of the new credit facility were, among other things, used to repay the outstanding amounts under the old facility and to purchase the land and buildings at our Perryman, MD and Lancaster, CA distribution centers, which had previously been leased through a synthetic lease arrangement. On August 4, 2003, we amended and restated the senior secured credit facility, which reduced the interest rate on term loan borrowings under the senior secured credit facility by 50 basis points.

Substantially all of Rite Aid Corporation's wholly owned subsidiaries guarantee the obligations under the new senior secured credit facility. The subsidiary guarantees are secured by a first priority lien on, among other things, the inventory, accounts receivable and prescription files of the subsidiary guarantors. Rite Aid Corporation is a holding company with no direct operations and is dependent upon dividends, distributions and other payments from its subsidiaries to service payments under the new senior secured credit facility. Rite Aid Corporation's direct obligations under the new senior secured credit facility are unsecured.

The new senior secured credit facility allows for the issuance of up to $150.0 million in additional term loans or additional revolver availability. We may request the additional loans at any time prior to

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the maturity of the senior secured credit facility, provided we are not in default of any terms of the facility, nor are in violation of any financial covenants. The new senior secured credit facility allows us to have outstanding, at any time, up to $1.0 billion in secured debt in addition to the senior secured credit facility. Accordingly, at February 28, 2004, the remaining additional permitted secured debt under the new senior credit facility is $198.0 million. We have the ability to incur an unlimited amount of unsecured debt, if the terms of such unsecured indebtedness comply with certain terms set forth in the credit agreement and subject to our compliance with certain financial covenants. If we issue unsecured debt that does not meet the credit agreement restrictions, it reduces the amount of available permitted secured debt. The new senior secured credit facility also allows for the repurchase of any debt with a maturity prior to April 30, 2008, and for a limited amount of debt with a maturity after April 30, 2008, based upon outstanding borrowings under the revolving credit facility and available cash at the time of the repurchase.

The new senior secured credit facility contains customary covenants, which place restrictions on incurrence of debt, the payment of dividends, mergers, liens and sale and leaseback transactions. The new senior secured credit facility also requires us to meet various financial ratios and limits capital expenditures. For the twelve months ending February 26, 2005, the covenants require us to maintain a maximum leverage ratio of 6.05:1. Subsequent to February

26, 2005, the ratio gradually decreases to 3.8:1 for the twelve months ending March 1, 2008. We must also maintain a minimum interest coverage ratio of 2.05:1 for the twelve months ending February 26, 2005. Subsequent to February 26, 2005, the ratio gradually increases to 3.25:1 for the twelve months ending March 1, 2008. In addition, we must maintain a minimum fixed charge ratio of 1.10:1 for the twelve months ending February 26, 2005. Subsequent to February 26, 2005, the ratio gradually increases to 1.25:1 for the twelve months ending March 1, 2008. Capital expenditures are limited to $386.1 million for the fiscal year ending February 26, 2005, with the allowable amount increasing in subsequent years.

We were in compliance with the covenants of the new senior secured credit facility and our other debt instruments as of February 28, 2004. With continuing improvements in operating performance, we anticipate that we will remain in compliance with our debt covenants. However, variations in our operating performance and unanticipated developments may adversely affect our ability to remain in compliance with the applicable debt covenants.

The new senior secured credit facility provides for customary events of default, including nonpayment, misrepresentation, breach of covenants and bankruptcy. It is also an event of default if any event occurs that enables, or which with the giving of notice or the lapse of time would enable, the holder of our debt to accelerate the maturity of debt having a principal amount in excess of $25.0 million.

On October 1, 2003, we paid, at maturity, our remaining outstanding balance of $58.1 million on the 6.0% dealer remarketable securities.

In May 2003, we issued $150.0 million aggregate principal amount of 9.25% senior notes due 2013. These notes are unsecured and effectively subordinate to our secured debt. The indenture governing the 9.25% senior notes contains customary covenant provisions that, amount other things, include limitations on our ability to pay dividends, make investments or other restricted payments, incur debt, grant liens, sell assets and enter into sale lease-back transactions.

In April 2003, we issued $360.0 million aggregate principal amount of 8.125% senior secured notes due 2010. The notes are unsecured, unsubordinated obligations to Rite Aid Corporation and rank equally in right of payment with all other unsecured, unsubordinated indebtedness. Our obligations under the notes are guaranteed, subject to certain limitations, by subsidiaries that guarantee the obligations under our new senior secured credit facility. The guarantees are secured, subject to the permitted liens, by shared second priority liens, with the holders of our 12.5% senior notes and our 9.5% senior secured notes, granted by subsidiary guarantors on all of their assets that secure the obligations under the new senior secured credit facility, subject to certain exceptions. The indenture governing the 8.125% senior secured notes contains customary covenant provisions that, among other things, include limitations on our ability to pay dividends, make investments or other restricted payments, incur debt, grant liens, sell assets and enter into sales lease-back transactions.

During fiscal 2004 we repurchased the following securities (in thousands):

Debt Repurchased	Principal Amount Repurchased	Amount Paid	(Gain)/ loss
6.0% fixed rate senior notes due 2005	$ 37,848	$ 36,853	$ (865)

7.125% notes due 2007		124,926		120,216		(4,314)
6.875% senior debentures due 2013		15,227		13,144		(1,981)
7.7% notes due 2027		5,000		4,219		(715)
6.875% fixed rate senior notes due 2028		10,000		7,975		(1,895)
12.5% senior secured notes due 2006		10,000		11,275		1,888
Total	$	203,001	$	193,682	$	(7,882)

2003 Transactions

In February 2003, we issued $300.0 million aggregate principal amount of 9.5% senior secured notes due 2011. The notes are unsecured, unsubordinated obligations to Rite Aid Corporation, and rank equally in right of payment with all other unsecured, unsubordinated indebtedness. Our obligations under the notes are guaranteed, subject to certain limitations, by subsidiaries that guarantee the obligations under our new senior secured credit facility. The guarantees are secured, subject to the permitted liens, by shared second priority liens, with the holders of our 12.5% senior notes and our 8.125% senior secured notes, granted by subsidiary guarantors on all of their assets that secure the obligations under the new senior secured credit facility, subject to certain exceptions. The indenture governing the 9.5% senior secured notes contains customary covenant provisions that, among other things, include limitations on our ability to pay dividends, make investments or other restricted payments, incur debt, grant liens, sell assets and enter into sales lease-back transactions.

We retired $150.5 million of our 5.25% convertible subordinated notes due 2002 and $20.9 million of our 10.5% senior secured notes due 2002 at maturity in fiscal 2003. In addition, we repurchased $25.4 million of our 6.0% dealer remarketable securities, $118.6 million of our 6.0% fixed rate senior notes due 2005 and $15.0 million of our 7.125% notes due 2007 during fiscal 2003. The fiscal 2003 transactions resulted in a gain of $13.6 million.

2002 Refinancing and Other Transactions

On June 27, 2001, we completed a major refinancing that extended the maturity dates of the majority of our debt to 2005 or beyond, provided additional equity, converted a portion of our debt to equity and reclassified capital leases to operating leases. The components of the refinancing are described in detail in the notes to the consolidated financial statements. Major components of the refinancing are summarized below:

Senior Secured Credit Facility: We entered into a new $1.9 billion syndicated senior secured credit facility. The new facility matured on June 27, 2005 unless more than $20.0 million of our 7.625% senior notes due April 15, 2005 were outstanding on December 31, 2004, in which event the maturity date was March 15, 2005. The new facility consisted of a $1.4 billion term loan facility and a $500.0 million revolving credit facility. The term loan was used to prepay various outstanding debt balances. This facility was repaid and replaced with our new senior secured credit facility on May 28, 2003, as described above.

High Yield Notes: We issued $150.0 million of 11.25% senior notes due July 2008. These notes are unsecured and are effectively subordinate to our secured debt.

Debt for Debt Exchange: We exchanged $152.0 million of our existing 10.50% senior secured notes for an equal principal amount of 12.50% senior secured notes due September 15, 2006. The 12.50% notes are secured by a second priority lien on the collateral of the senior secured credit facility. In addition, holders of these notes received warrants to purchase 3.0 million shares of our common stock at $6.00 per share. On June 29, 2001, the warrant holders elected to exercise these warrants, on a cashless basis and as a result 1.0 million shares of common stock were issued.

Tender Offer: On May 24, 2001, we commenced a tender offer for the 10.50% senior secured notes due 2002 at a price of 103.25% of the principal amount. The tender offer was closed on June 27,

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2001, at which time $174.5 million principal was tendered. We incurred a tender offer premium of $5.7 million as a result of the transaction. We used proceeds from the new senior secured credit facility to pay for the tender offer.

Debt Repurchases: We repurchased $24.2 million of our 6.0% dealer remarketable securities due 2003, $1.0 million of our 10.50% notes due 2002 and $1.5 million of our 5.25% convertible subordinated notes due 2002 during fiscal 2002.

Debt for Equity Exchanges: We completed exchanges of $588.7 million of debt for 86.4 million shares of common stock.

Sales of Common Stock: We issued 80.1 million shares of our common stock for net proceeds of $528.4 million.

Lease Obligations: We relinquished certain renewal options which had been available under the terms of certain real estate leases on property previously sold and leased back and accordingly, we reclassified the related leases as operating leases thereby reducing outstanding capital lease obligations by $850.8 million.

Impact on Results of Operations for Fiscal 2002: As a result of the fiscal 2002 refinancing, we: i) recognized a loss of $66.6 million related to the early retirement of debt; ii) recognized a loss of $21.8 million related to debt and lease conversions and modifications and iii) recognized a charge of $132.7 million related to debt for equity exchanges.

Other Transactions

On December 22, 2003, we entered into a contract with McKesson, the supplier of our pharmaceutical products. The terms of the contract require that McKesson serve as our supplier through March 2009. In exchange for better pricing, we agreed to reduce the payment terms under the McKesson contract by five calendar days. This change in payment terms will not have a significant impact on our liquidity or working capital.

Other

As of February 28, 2004, the company had no material off balance sheet arrangements.

The following table details the maturities of our indebtedness and lease financing obligations as of February 28, 2004, as well as other contractual cash obligations and commitments.

Contractual Obligations and Commitments

	Less Than 1 Year	1 to 3 Years	4 to 5 Years	After 5 Years	Total
			(Dollars in thousands)		
Contractual Cash Obligations					
Long term debt	$ 11,145	$ 856,783	$ 1,416,545	$ 1,424,024	$ 3,708,497
Capital lease obligations	12,831	16,972	17,350	136,016	183,169
Operating leases	543,922	997,562	870,800	3,521,944	5,934,228

Open purchase orders	265,676	—	—	—	265,676
Other, primarily self-insurance and retirement plan obligations	121,692	154,463	23,870	51,929	351,954
Total contractual cash obligations	$ 955,266	$ 2,025,780	$ 2,328,565	$ 5,133,913	$10,443,524
Commitments					
Lease guarantees	$ 20,480	$ 36,340	$ 34,438	$ 146,928	$ 238,186
Outstanding letters of credit	115,196	—	—	—	115,196
Total commitments	$ 135,676	$ 36,340	$ 34,438	$ 146,928	$ 353,382

Net Cash Provided By (Used In) Operating, Investing and Financing Activities

Cash provided by operations was $227.5 million in fiscal 2004. Cash was provided primarily through improved operating results, which more than offset $295.4 million in interest payments and increases in accounts receivable and inventory.

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Cash provided by operations was $305.4 million in fiscal 2003. Cash was provided primarily through improved operating results, income tax refunds of $68.7 million and decreases in accounts receivable and inventory, which more than offset $288.0 million in interest payments and a decrease in accounts payable.

Cash provided by operations was $16.3 million in fiscal 2002. Cash was provided primarily through improved operating results, a significant reduction in interest payments and a reduction in inventory levels net of a decrease in accounts payable.

Cash used in investing activities was $242.2 million in fiscal 2004. Cash of $106.9 million was used to purchase land and buildings at our Perryman, MD and Lancaster, CA distribution centers, which had previously been held under a synthetic lease arrangement. Cash of $143.8 million was used for the purchase of other fixed assets and cash of $16.7 million was used for the purchase of prescription files. Cash of $25.2 million was provided by the disposition of fixed assets and other investments.

Cash used in investing activities was $72.2 million in fiscal 2003. Cash of $104.5 million was used for the purchase of fixed assets and cash of $11.6 million was used for the purchase of prescription files. Cash of $43.9 million was provided by the disposition of fixed assets and other investments.

Cash provided by investing activities was $342.5 million for fiscal 2002. Cash was provided from the sale of our investment in AdvancePCS, less expenditures for fixed assets and prescription file purchases.

Cash used in financing activities was $15.9 million in fiscal 2004. Cash usage related to the change in our credit facility, the early redemption of several bonds and payments on certain bonds at maturity was largely offset by proceeds from bond issuances.

Cash used in financing activities was $211.9 million in fiscal 2003. The cash used consisted of the repayments of long term debt and deferred financing fees, offset with proceeds from the issuance of bonds.

Cash used in financing activities was $107.1 million for fiscal 2002. The cash used consisted of repayments of long-term debt of $2.3 billion and payments of deferred financing costs of $83.1 million, offset with new borrowing of $1.4 billion, bond proceeds of $392.5 million and $530.6 million of proceeds from the issuance of common stock.

Capital Expenditures

We plan to make total capital expenditures of approximately $300 million to $350 million during fiscal 2005, consisting of approximately $200 to $230 million related to new store construction, store relocation and store remodel projects, $70 to $80 million related to technology enhancements, improvements to distribution centers, and other corporate requirements, and $30 to $40 million related to the purchase of prescription files from independent pharmacies. Management expects that these capital expenditures will be financed primarily with cash flow from operations and borrowings under the revolving credit facility available under our senior secured facility.

We have resumed the activities of a new store and store relocation program. Initially, the program will start out slowly and will not have a significant impact on operating results or the profile of our store base. In fiscal 2005, our goal is to open or relocate between 40 and 50 stores by the end of fiscal 2005 and an additional 100 stores by the end of fiscal 2006. Approximately 50% of the stores will be relocated stores and the remaining 50% will be new stores. The program is focused on our strongest existing markets. It also includes a significant number of remodels. We believe that this program over the longer term, along with the execution of the near term strategy of improving store productivity, will continue to increase our sales and operating profits.

Future Liquidity

We are highly leveraged. Our high level of indebtedness: (i) limits our ability to obtain additional financing; (ii) limits our flexibility in planning for, or reacting to, changes in our business and the

industry; (iii) places us at a competitive disadvantage relative to our competitors with less debt; (iv) renders us more vulnerable to general adverse economic and industry conditions; and (v) requires us to dedicate a substantial portion of our cash flow to service our debt. Based upon current levels of operations and planned improvements in our operating performance, management believes that cash flow from operations together with cash equivalent investments and available borrowings under the senior credit facility and other sources of liquidity will be adequate to meet our anticipated annual requirements for working capital, debt service and capital expenditures for the next twelve months. We will continue to assess our liquidity position and potential sources of supplemental liquidity in light of our operating performance and other relevant circumstances. Should we determine, at any time, that it is necessary to obtain additional short-term liquidity, we will evaluate our alternatives and take appropriate steps to obtain sufficient additional funds. Obtaining any such supplemental liquidity through the increase of indebtedness or asset sales may require the consent of the lenders under one or more of our debt agreements. There can be no assurance that any such supplemental funding, if sought, could be obtained or that our lenders would provide the necessary consents, if required.

Recent Accounting Pronouncements

We have several stock option plans. Prior to fiscal 2004, we accounted for these plans under the recognition and measurement provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related Interpretations. Effective March 2, 2003 we adopted the fair value recognition provisions of Statement of Financial

Accounting Standards ("SFAS") No. 123, "Accounting for Stock Based Compensation". Under the modified prospective method of adoption selected by us under the provision of SFAS No. 148, "Accounting for Stock Based Compensation — Transition and Disclosure", compensation cost recognized in fiscal 2004 is the same as that which would have been recognized had the recognition provisions of SFAS No. 123 been applied from its original effective date. Results for prior periods have not been restated.

In May 2003, the Financial Accounting Standards Board ("FSAB") issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liability and Equity." SFAS No. 150 requires that certain instruments that were previously classified as equity on a company's statement of financial position now be classified as liabilities. SFAS No. 150 is effective, except for certain provisions that have been deferred, for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We have adopted the provisions of SFAS No. 150. As a result of the adoption of SFAS No. 150, our redeemable preferred stock balance of $19.8 million is included in "Other Non-Current Liabilities" as of February 28, 2004.

In January of 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities." FIN 46 requires the consolidation of entities that cannot finance their activities without the support of other parties and that lack certain characteristics of a controlling interest, such as the ability to make decisions about the entity's activities via voting or similar rights. An entity that consolidates a variable interest entity is the primary beneficiary of the entity's activities. FIN 46 applied immediately to variable interest entities created after January 31, 2003, and required application in the first period ending after December 15, 2003 for entities in which an enterprise holds a variable interest entity that it acquired before February 1, 2003. The adoption of FIN 46 did not have a material impact on our financial position or results of operations. In December of 2003, the FASB revised FIN 46 ("FIN 46R"), which delayed the required implementation date for variable interest entities until the end of the first reporting period that ends after March 15, 2004. FIN 46R applies to our financial statements for the period ending May 29, 2004. We do not believe the adoption of FIN 46R will have a material impact on our financial position or results of operations.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements

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requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to allowance for uncollectible receivables, inventory shrink, impairment, self insurance liabilities, pension benefits, lease exit liabilities, income taxes and litigation. We base our estimates on historical experience, current and anticipated business conditions, the condition of the financial markets and various other assumptions that are believed to be reasonable under existing conditions. Actual results may differ from these estimates.

The following critical accounting policies require the use of significant judgements and estimates by management:

Allowance for uncollectible receivables: The majority of our prescription sales are made to customers that are covered by third party payors, such as insurance companies, government agencies and employers. We carry receivables that represent the amount owed to us for sales made to customers or employees of those payors that have not yet been paid. We maintain a reserve for the amount of these receivables deemed to be uncollectible. This reserve is calculated based upon historical collection activity adjusted for current conditions. If the financial condition of the payors were to deteriorate, resulting in an inability to make payments, then an additional reserve would be required.

Inventory: Included in our valuation of inventory are estimates of the losses related to shrink, which occurs during periods between physical inventory counts. When estimating these losses, we consider historical loss results at specific locations as well as overall loss trends. Should actual shrink losses differ from the estimates that our reserves are based on, our operating results will be impacted.

Impairment: We evaluate long-lived assets, including stores and excluding goodwill, for impairment annually, or whenever events or changes in circumstances indicate that the assets may not be recoverable. The impairment is measured by calculating the estimated future cash flows expected to be generated by the store, and comparing this amount to the carrying value of the store's assets. Cash flows are calculated utilizing individual store forecasts and total Company projections for the remaining estimated lease lives of the stores being analyzed. Should actual results differ from those forecasted and projected, we may incur future impairment charges related to these facilities.

Goodwill Impairment: As disclosed in the consolidated financial statements, we have unamortized goodwill in the amount of $684.5 million. In connection with the provisions of SFAS No. 142, we perform an annual impairment test of goodwill. Our test as of February 28, 2004, resulted in no impairment being identified. However, the process of evaluating goodwill for impairment involves the determination of the fair value of our company. Inherent in such fair value determinations are certain judgements and estimates, including the interpretation of economic indicators and market valuations and assumptions about our strategic plans. To the extent that our strategic plans change, or that economic and market conditions worsen, it is possible that our conclusion regarding goodwill impairment could change and result in a material effect on our financial position or results of operations.

Self insurance liabilities: We record estimates for self-insured medical, dental, worker's compensation and general liability insurance coverage with assistance from actuaries. Should a greater amount of claims occur compared to what was estimated, or medical costs increase beyond what was anticipated, reserves recorded may not be sufficient, and additional expense may be recorded.

Benefit plan accrual: We have several defined benefit plans, under which participants earn a retirement benefit based upon a formula set forth in the plan. We record expense related to these plans using actuarially determined amounts that are calculated under the provisions of SFAS No. 87, "Employer's Accounting for Pensions". Key assumptions used in the actuarial valuations include the discount rate, the expected rate of return on plan assets and rate of increase in future compensation levels. These rates are based on market interest rates, and therefore fluctuations in market interest rates could impact the amount of pension expense recorded for these plans.

The accumulated benefit obligation of the defined benefit plans is a discounted amount calculated using the market interest rates described above. Market interest rates at the end of fiscal 2004 are at

historically low levels. Accordingly, we believe the market interest rates will not significantly decrease further. An increase in the market interest rates, assuming no other changes in the estimates, reduces the amount of the accumulated benefit obligation and the related required expense.

Lease exit liabilities: We record reserves for closed stores based on future lease commitments, anticipated ancillary occupancy costs, anticipated future subleases of properties and current risk free interest rates. If interest rates or the real estate leasing markets change, reserves may be increased or decreased.

Income taxes: We currently have net operating loss ("NOL") carryforwards that can be utilized to offset future income for federal and state tax purposes. These NOLs generate a significant deferred tax asset. However, we have recorded a valuation allowance against this deferred tax asset as we have determined that it is more likely than not that we will not be able to fully utilize the NOLs. Should our assumptions regarding the utilization of these NOLs change, we may reduce some or all of this valuation allowance, which would result in the recording of an income tax benefit.

Litigation reserves: We are involved in litigation on an on-going basis. We accrue our best estimate of the probable loss related to legal claims. Such estimates are developed in consultation with in-house and outside counsel, and are based upon a combination of litigation and settlement strategies. To the extent additional information arises or our strategies change, it is possible that our best estimate of the probable liability may also change.

Factors Affecting our Future Prospects

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 February 28, 2004, $3.9 billion of outstanding indebtedness and stockholders' equity of $9.3 million. We also had additional borrowing capacity under our revolving credit facility of $584.8 million at that time, net of outstanding letters of credit of $115.2 million. 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 2005, 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 our fixed charges for fiscal 2004 by $2.6 million.

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 and industry conditions; and
- require us to dedicate a substantial portion of our cash flow to service our debt.

Our ability to make payments on our debt depends upon our ability to substantially improve our operating performance, which is 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 earn enough to pay our debts or to successfully undertake any of these actions could have a material adverse effect on us.

Some of our debt, including borrowings under our senior secured credit facility, is based upon variable rates of interest, which could result in higher interest expense in the event of increases in interest rates.

Approximately $1.15 billion of our outstanding indebtedness as of February 28, 2004 bears an interest rate that varies depending upon LIBOR. If we borrow additional amounts under our senior secured credit facility, the interest rate on those borrowings will vary depending upon LIBOR. If LIBOR rises, the interest rates on this outstanding debt will also increase. Therefore an increase in LIBOR would increase our interest payment obligations under these outstanding loans and have a negative effect on our cash flow and financial condition. We currently do not maintain any hedging contracts that would limit our exposure to variable rates of interest.

The covenants in our outstanding indebtedness impose restrictions that may limit our operating and financial flexibility.

The covenants in the instruments that govern our outstanding indebtedness restrict our ability to:

- incur liens and debt;
- pay dividends;
- make redemptions and repurchases of capital stock;
- make loans, investments and capital expenditures;
- prepay, redeem or repurchase debt;
- engage in mergers, consolidations, assets dispositions, sale-leaseback transactions and affiliate transactions;
- change our business;
- amend certain debt and other material agreements;
- issue and sell capital stock of subsidiaries;
- restrict distributions from subsidiaries; and
- grant negative pledges to other creditors.

If we are unable to meet the terms of the financial covenants or if we breach any of these covenants, a default could result under one or more of these agreements. A default, if not waived by our lenders, could result in the acceleration of our outstanding indebtedness and cause our debt to become immediately due and payable. If acceleration occurs, we would not be able to repay our debt and it is unlikely that we would be able to borrow sufficient additional funds to refinance such debt. Even if new financing is made available to us, it may not be available on terms acceptable to us.

If we obtain modifications of our agreements, or are required to obtain waivers of defaults, we may incur significant fees and transaction costs. In fiscal 2004, 2003, 2002 and 2001, we modified certain covenants contained in our then existing senior secured credit facility and loan agreements. In fiscal 2000, we obtained waivers of compliance contained in our then existing credit facilities and public indentures. In connection with obtaining these modifications and waivers, we paid significant fees and transaction costs.

Our new store development program requires entering into construction and development commitments and occasionally purchasing land that will not be utilized for several years which may limit our financial flexibility.

Construction and development commitments are entered into as part of our new store development program that must be completed. Also, capital expenditures are occasionally made for

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land that may not be used for several years. If there are significant negative economic or competitive developments, these commitments must still be met. Further, the net book value of the purchased land may not be realizable.

Risks Related to Our Operations

We need to continue to improve our operations in order to improve our financial condition, but our operations will not improve if we cannot continue to effectively implement our business strategy or if our strategy is negatively affected by general economic conditions.

Although we have had significant improvement in the sales productivity of our store base, we have not yet achieved the sales productivity level of our major competitors. We believe that improving the sales of existing stores is important to achieving profitability and continuing to improve operating cash flow. If we are not successful in implementing our strategy, or if our strategy is not effective, we may not be able to continue to improve our operations. In addition, any adverse change in general economic conditions can adversely affect consumer buying practices and reduce our sales of front-end products, which are our higher margin products, and cause a proportionately greater decrease in our profitability. Failure to continue to improve operations or a decline in general economic conditions would adversely affect our results of operations, financial condition and cash flows and our ability to make principal or interest payments on our debt.

We are dependent on our management team, and the loss of their services could have a material adverse effect on our business and the results of our operations or financial condition.

The success of our business is materially dependent upon the continued services of our executive management team. The loss of key personnel could have a material adverse effect on the results of our operations, financial condition or cash flows. Additionally, we cannot assure you that we will be able to attract or retain other skilled personnel in the future.

There are currently pending both civil and criminal investigations by the United States Attorney. In addition to any fines or damages that we might have to pay, any criminal conviction against us may result in the loss of licenses and contracts that are material to the conduct of our business, which would have a negative effect on our results of operations, financial condition and cash flows.

There are currently pending both civil and criminal governmental investigations by the United States Attorney involving matters related to prior management's business practices. Settlement discussions have begun with the United States Attorney of the Middle District of Pennsylvania, who has proposed that the government would not institute any criminal proceeding against us if we enter into a consent judgment providing for a civil penalty payable over a period of years. The amount of the civil penalty has not been agreed to and there can be no assurance that a settlement will be reached or that the amount of such penalty will not have a material adverse effect on our financial condition and results of operations. We recorded an accrual of $20.0 million in fiscal 2003 in connection with the resolution of these matters; however, we may incur charges in excess of that amount and we are unable to estimate the possible range of loss. We will continue to evaluate our estimate and to the extent that additional information arises or our strategy changes, we will adjust our accrual accordingly.

If we were convicted of any crime, certain licenses and government contracts, such as Medicaid plan reimbursement agreements, that are material to our operations may be revoked, which would have a material adverse effect on our results of operations and financial condition. In addition, substantial penalties, damages or other monetary remedies assessed against us could also have a material adverse effect on our results of operations, financial condition and cash flows.

Given the size and nature of our business, we are subject from time to time to various lawsuits which, depending on their outcome, may have a negative impact on our results of operations, financial condition and cash flows.

We are substantially dependent on a single supplier of pharmaceutical products to sell products to us on satisfactory terms. A disruption in this relationship may have a negative effect on our results of operations, financial condition and cash flow.

We obtain approximately 90% of the dollar value of our prescription drugs from a single supplier, McKesson, pursuant to a contract that runs through March 2009. Pharmacy sales represented approximately 63.6% of our total sales during fiscal 2004, and, therefore, our relationship with McKesson is important to us. Any significant disruptions in our relationship with McKesson may temporarily make it difficult for us to continue to operate our business, until we found a replacement supplier, which could have a material adverse effect on our results of operations, financial condition and cash flows.

Terrorist attacks, such as the attacks that occurred in New York and Washington, D.C. on September 11, 2001, the general instability in the Middle East and the threat of other attacks or acts of war in the United States and abroad may adversely affect the markets in which we operate, our operations and our profitability.

The attacks of September 11, 2001 and subsequent events, have caused instability in the United States and other financial markets and have led, and may continue to lead to, further armed hostilities, prolonged military action in Iraq, or further acts of terrorism in the United States or abroad, which could cause further instability in financial markets and reduced consumer confidence. The threat of terrorist attacks, and other related developments may adversely affect prevailing economic conditions, resulting in reduced consumer spending and reduced sales in our stores. These developments will subject us to increased risks and, depending on their magnitude, could have a material adverse effect on our business.

Risks Related to Our Industry

The markets in which we operate are very competitive and further increases in competition could adversely affect us.

We face intense competition with local, regional and national companies, including other drugstore chains, independently owned drugstores, supermarkets, mass merchandisers, discount stores, dollar stores, mail order pharmacies and drug importation. We may not be able to effectively compete against them because our existing or potential competitors may have financial and other resources that are superior to ours. In addition, we may be at a competitive disadvantage because we are more highly leveraged than our competitors. The ability of our stores to achieve profitability depends on their ability to achieve a critical mass of customers. We believe that the continued consolidation of the drugstore industry will further increase competitive pressures in the industry. As competition increases, a significant increase in general pricing pressures could occur, which would require us to increase our sales volume and to sell higher margin products and services in order to remain competitive. We cannot assure you that we will be able to continue effectively to compete in our markets or increase our sales volume in response to further increased competition.

Changes in third-party reimbursement levels for prescription drugs could reduce our margins and have a material adverse effect on our business.

Sales of prescription drugs, as a percentage of sales, and the percentage of prescription sales reimbursed by third parties, have been increasing and we expect them to continue to increase. In fiscal 2004, sales of prescription drugs represented 63.6% of our sales and 93.3% of all of the prescription drugs that we sold were with third party payors. During fiscal 2004, the top five third-party payors accounted for approximately 30% of our total sales. Any significant loss of third-party payor business could have a material adverse effect on our business and results of operations. Also, these third-party payors could reduce the levels at which they will reimburse us for the prescription drugs that we provide to their members. Furthermore, the passing in December 2003 of the Medicare Prescription Drug, Improvement and Modernization Act will grant a prescription drug benefit to participants. As a

result of this benefit, we may be reimbursed for some prescription drugs at prices lower than our current reimbursement levels. In fiscal 2004, approximately 11.3% of our revenues were from state sponsored Medicaid agencies. There have been a number of recent proposals and enactments by various states to reduce Medicaid reimbursement levels in response to budget problems, some of which propose to reduce reimbursement levels in the applicable states significantly, and we expect other similar proposals in the future. If third-party payors reduce their reimbursement levels or if Medicare or state Medicaid programs cover prescription drugs at lower reimbursement levels, our margins on these sales would be reduced, and the profitability of our business and our results of operations, financial condition or cash flows could be adversely affected.

We are subject to governmental regulations, procedures and requirements; our noncompliance or a significant regulatory change could adversely affect our business, the results of our operations or our financial condition.

Our pharmacy business is subject to federal, state and local regulation. These include local registrations of pharmacies in the states where our pharmacies are located, applicable Medicare and Medicaid regulations and prohibitions against paid referrals of patients. Failure to properly adhere to these and other applicable regulations could result in the imposition of civil and criminal penalties and could adversely affect the continued operation of our business. Furthermore, our pharmacies could be affected by federal and state reform programs, such as healthcare reform initiatives which could, in turn, negatively affect our business. The passing of these initiatives or any new federal or state programs could adversely affect our results of operations, financial condition or cash flows.

Our pharmacy business is subject to the 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 use and disclosures of protected health information, provide a notice of privacy practice to our pharmacy customers and permit pharmacy health 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.

Certain risks are inherent in providing pharmacy services; our insurance may not be adequate to cover any claims against us.

Pharmacies are exposed to risks inherent in the packaging and distribution of pharmaceuticals and other healthcare products, such as with respect to improper filling of prescriptions, labeling of prescriptions and adequacy of warnings. Although we maintain professional liability and errors and omissions liability insurance, from time to time, claims result in the payment of significant amounts, some portions of which are not funded by insurance. We can offer no assurance that the coverage limits under our insurance programs will be adequate to protect us against future claims, or that we will maintain this insurance on acceptable terms in the future. Our results of operations, financial condition or cash flows may be adversely affected if in the future our insurance coverage proves to be inadequate or unavailable or there is an increase in liability for which we self insure or we suffer reputational harm as a result of an error or omission.

We will not be able to compete effectively if we are unable to attract, hire and retain qualified pharmacists.

There is a nationwide shortage of qualified pharmacists. In response, we have implemented improved competitive benefits and training programs in order to attract, hire and retain qualified pharmacists. We have also expanded our pharmacist recruiting efforts, through an increase in the number of recruiters, a succesful pharmacist intern program and improved relations with pharmacy schools. However, we may not be able to attract, hire and retain enough qualified pharmacists. This could adversely affect our operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risks

Our future earnings, cash flow and fair values relevant to financial instruments are dependent upon prevalent market rates. Market risk is the risk of loss from adverse changes in market prices and

interest rates. Our major market risk exposure is changing interest rates. Increases in interest rates would increase our interest expense. We enter into debt obligations to support capital expenditures, acquisitions, working capital needs and general corporate purposes. Our policy is to manage interest rates through the use of a combination of variable-rate credit facilities, fixed-rate long-term obligations and derivative transactions.

The table below provides information about our financial instruments that are sensitive to changes in interest rates. The table presents principal payments and the related weighted average interest rates by expected maturity dates as of February 28, 2004.

	2005	2006	2007	2008	2009	Thereafter	Total	Fair Valu at Februa 28, 2004
ong-term debt, cluding current ortion								
xed rate	$ 2,520	$ 236,474	$ 594,434	$ 915	300,130	1,424,024	2,558,497	2,640,99
verage Interest Rate	11.51%	7.36%	7.51%	8.00%	8.69%	8.20%	8.02%	
ariable Rate	8,625	14,375	11,500	11,500	1,104,000	—	1,150,000	1,150,00

verage Interest Rate	4.10%	4.10%	4.10%	4.10%	4.10%	4.10%

Our ability to satisfy our interest payment obligations on our outstanding debt will depend largely on our future performance, which, in turn, is subject to prevailing economic conditions and to financial, business and other factors beyond our control. If we do not have sufficient cash flow to service our interest payment obligations on our outstanding indebtedness and if we cannot borrow or obtain equity financing to satisfy those obligations, our business and results of operations will be materially adversely affected. We cannot be assured that any replacement borrowing or equity financing could be successfully completed.

The ratings on the new senior secured credit facility as of April 19, 2004 were BB by Standard & Poor's and Ba3 by Moody's. The interest rate on the variable-rate borrowings on this facility are LIBOR plus 3.00% for the term loan and 3.50% for the revolving credit facility.

Downgrades of our credit ratings could have an impact upon the rate on the borrowings under these credit facilities.

Changes in one month LIBOR affect our cost of borrowings because the interest rate on our variable-rate obligations is based on LIBOR. If the market rates of interest for one month LIBOR change by 10% (approximately 11 basis points) as compared to the LIBOR rate of 1.10% as of February 28, 2004 our annual interest expense would change by approximately $1.3 million based upon our variable-rate debt outstanding of approximately $1,150.0 million on February 28, 2004.

A change in interest rates generally does not have an impact upon our future earnings and cash flow for fixed-rate debt instruments. As fixed-rate debt matures, however, and if additional debt is acquired to fund the debt repayment, future earnings and cash flow may be affected by changes in interest rates. This effect would be realized in the periods subsequent to the periods when the debt matures.

Item 8. Financial Statements and Supplementary Data

Our consolidated financial statements and notes thereto are included elsewhere in this Annual Report on Form 10-K/A and are incorporated by reference herein. See Item 15 of Part IV.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable

Item 9A. Controls and Procedures

Disclosure Controls and Procedures. On February 7, 2005, a letter was issued by the Office of the Chief Accountant of the SEC to the American Institute of Certified Public Accountants that clarified the application of GAAP for lease accounting. The SEC letter led to a review of our

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lease-related accounting practices. As a result of our review, we have determined that our previous methods of accounting for straight-line rent expense and the related deferred rent liability and leasehold improvement depreciation for a small number of stores were not in conformity with GAAP.

On March 17, 2005, our management and audit committee determined to restate our financial statements for each of the three years in the period ended February 28, 2004 and for the first three quarters of fiscal 2005 and to file a Form 10-K/A amending our Annual Report on Form 10-K for our fiscal year ended February 28, 2004 with restated consolidated financial statements and Forms 10-Q/A amending our interim condensed consolidated financial statements for the first three quarters of fiscal 2005. The restatement is further discussed in "Explanatory Note" in the forepart of this Form 10-K/A, in the section entitled "Restatement" in Management's Discussion and Analysis of Financial Condition and Results of Operation in this Form 10-K/A and in Note 21, "Restatement of Financial Statements," to the accompanying audited consolidated financial statements.

In connection with the restatement referred to above, our management, including our Chief Executive Officer and Chief Financial Officer, re-evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report (February 28, 2004). Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Form 10-K/A, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, the information relating to us required to be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

In concluding that our disclosure controls and procedures were effective as of February 28, 2004, our management considered, among other things, the circumstances that resulted in the restatement of our previously issued financial statements. We also considered the materiality of the restatement adjustments on our consolidated balance sheet and statement of operations (as more fully set forth in the section entitled "Restatement" in Management's Discussion and Analysis of Financial Condition and Results of Operation in this Form 10-K/A and in Note 21, "Restatement of Financial Statements," to the accompanying audited consolidated financial statements) and that these non-cash adjustments have no effect on historical or future cash flows or the timing of payments under our operating leases.

Changes In Internal Control Over Financial Reporting. There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act), during the most recent fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

We intend to file with the Securities and Exchange Commission a definitive proxy statement for our 2004 Annual Meeting of Stockholders, to be held on June 24, 2004, pursuant to Regulation 14A not later than 120 days after February 28, 2004. The information called for by these Items 10, 11, 12, 13 and 14 are incorporated by reference to that proxy statement.

PART IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) The consolidated financial statements of the Company and report of independent registered public accounting firm identified in the following index are included in this report from the individual pages filed as a part of this report:

1. Financial Statements

The following financial statements and report of independent auditors are included herein:

2. Financial Statement Schedules

Schedule II — Valuation and Qualifying Accounts

All other schedules are omitted because they are not applicable, not required or the required information is included in the consolidated financial statements or notes thereto.

(b) The Company filed a current report on Form 8-K/A with the Securities and Exchange Commission on January 6, 2004 (as to Item 5 only).

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(c) **Exhibits**

Exhibit Numbers	Description	Incorporation By Reference To
3.1	Restated Certificate of Incorporation dated December 12, 1996	Exhibit 3(i) to Form 8-K, filed on November 2, 1999
3.2	Certificate of Amendment to the Restated Certificate of Incorporation dated February 22, 1999	Exhibit 3(ii) to Form 8-K, filed on November 2, 1999
3.3	Certificate of Amendment to the Restated Certificate of Incorporation dated June 27, 2001	Exhibit 3.4 to Registration Statement on Form S-1, File No. 333-64950, filed on July 12, 2001
3.4	8% Series D Cumulative Convertible Pay-in-Kind Preferred Stock Certificate of Designation dated	Exhibit 3.5 to Form 10-Q, filed on October 12, 2001

	October 3, 2001	
3.5	By-laws, as amended on November 8, 2000	Exhibit 3.1 to Form 8-K, filed on November 13, 2000
3.6	Amendment to By-laws, adopted January 30, 2002	Exhibit T3B.2 to Form T-3, filed on March 4, 2002
4.1	Indenture, dated August 1, 1993, by and between Rite Aid Corporation, as issuer, and Morgan Guaranty Trust Company of New York, as trustee, related to the Company's 6.70% Notes due 2001, 7.125% Notes due 2007, 7.70% Notes due 2027, 7.625% Notes due 2005 and 6.875% Notes due 2013	Exhibit 4A to Registration Statement on Form S-3, File No. 033-63794, filed on June 3, 1993
4.2	Supplemental Indenture, dated as of February 3, 2000, between Rite Aid Corporation, as issuer, and U.S. Bank Trust National Association as successor to Morgan Guaranty Trust Company of New York, to the Indenture dated as of August 1, 1993, relating to the Company's 6.70% Notes due 2001, 7.125% Notes due 2007, 7.70% Notes due 2027, 7.625% Notes due 2005 and 6.875% Notes due 2013	Exhibit 4.1 to Form 8-K filed on February 7, 2000
4.3	Indenture, dated as of December 21, 1998, between Rite Aid Corporation, as issuer, and Harris Trust and Savings Bank, as trustee, related to the Company's 5.50% Notes due 2000, 6% Notes due 2005, 6.125% Notes due 2008 and 6.875% Notes due 2028	Exhibit 4.1 to Registration Statement on Form S-4, File No. 333-74751, filed on March 19, 1999
4.4	Supplemental Indenture, dated as of February 3, 2000, between Rite Aid Corporation and Harris Trust and Savings Bank, to the Indenture dated December 21, 1998, between Rite Aid Corporation and Harris Trust and Savings Bank, related to the Company's 5.50% Notes due 2000, 6% Notes due 2005, 6.125% Notes due 2008 and 6.875% Notes due 2028	Exhibit 4.4 to Form 8-K, filed on February 7, 2000

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Exhibit Numbers	Description	Incorporation By Reference To
4.5	Indenture, dated as of June 27, 2001, between Rite Aid Corporation, as issuer, and State Street Bank and Trust Company, as trustee, related to the Company's 12.50% Senior Secured Notes due 2006	Exhibit 4.7 to Registration Statement on Form S-1, File No. 333-64950, filed on July 12, 2001
4.6	Indenture, dated as of June 27, 2001 between Rite Aid Corporation, as issuer, and BNY Midwest Trust Company, as trustee, related to the Company's 11¼% Senior Notes due 2008	Exhibit 4.8 to Registration Statement on Form S-1, File No. 333-64950, filed on July 12, 2001
4.7	Indenture, dated as of November 19, 2001, between Rite Aid Corporation, as issuer, and BNY Midwest Trust Company, as trustee, related to the Company's	Exhibit 4.3 to Form 10-Q, filed on January 15, 2002

	4.75% Convertible Notes due December 1, 2006	
4.8	Indenture, dated as of February 12, 2003, between Rite Aid Corporation, as issuer, and BNY Midwest Trust Company, as trustee, related to the Company's 9½% Senior Secured Notes due 2011	Exhibit 4.1 to Form 8-K, filed on March 5, 2003
4.9	Indenture, dated as of April 22, 2003, between Rite Aid Corporation, as issuer, and BNY Midwest Trust Company, as trustee, related to the Company's 8.125% Senior Secured Notes due 2010	Exhibit 4.11 to Form 10-K, filed on May 2, 2003
4.10	Indenture, dated as of May 20, 2003, between Rite Aid Corporation, as issuer, and BNY Midwest Trust Company, as trustee, related to the Company's 9.25% Senior Notes due 2013	Exhibit 4.12 to Form 10-Q, filed on July 3, 2003
10.1	1999 Stock Option Plan*	Exhibit 10.1 to Form 10-K, filed on May 21, 2001
10.2	2000 Omnibus Equity Plan*	Included in Proxy Statement dated October 24, 2000
10.3	2001 Stock Option Plan*	Exhibit 10.3 to Form 10-K, filed on May 21, 2001
10.4	Employment Agreement by and between Rite Aid Corporation and Robert G. Miller dated as of December 5, 1999*	Exhibit 10.1 to Form 8-K, filed on January 18, 2000
10.5	Amendment No. 1 to Employment Agreement by and between Rite Aid Corporation and Robert G. Miller, dated as of May 7, 2001*	Exhibit 10.9 to Form 10-K, filed on May 21, 2001
10.6	Employment Agreement by and between Rite Aid Corporation and Robert G. Miller, dated as of April 9, 2003*	Exhibit 10.7 to Form 10-K, filed on May 2, 2003
10.7	Rite Aid Corporation Restricted Stock and Stock Option Award Agreement, made as of December 5, 1999, by and between Rite Aid Corporation and Robert G. Miller*	Exhibit 4.31 to Form 8-K, filed on January 18, 2000

Exhibit Numbers	Description	Incorporation By Reference To
10.8	Employment Agreement by and between Rite Aid Corporation and Mary F. Sammons, dated as of December 5, 1999*	Exhibit 10.2 to Form 8-K, filed on January 18, 2000
10.9	Amendment No. 1 to Employment Agreement by and between Rite Aid Corporation and Mary F. Sammons, dated as of May 7, 2001*	Exhibit 10.12 to Form 10-K, filed on May 21, 2001
10.10	Amendment No. 2 to Employment Agreement by and between Rite Aid Corporation and Mary F. Sammons, dated as of September 30, 2003*	Exhibit 10.3 to Form 10-Q, filed on October 7, 2003

10.11	Rite Aid Corporation Restricted Stock and Stock Option Award Agreement, made as of December 5, 1999, by and between Rite Aid Corporation and Mary F. Sammons*	Exhibit 4.32 to Form 8-K, filed on January 18, 2000
10.12	Employment Agreement by and between Rite Aid Corporation and John T. Standley, dated as of December 5, 1999*	Exhibit 10.4 to Form 8-K, filed on January 18, 2000
10.13	Rite Aid Corporation Restricted Stock and Stock Option Award Agreement, made as of December 5, 1999, by and between Rite Aid Corporation and John T. Standley*	Exhibit 4.34 to Form 8-K, filed on January 18, 2000
10.14	Employment Agreement by and between Rite Aid Corporation and James Mastrian, dated as of September 27, 1999*	Exhibit 10.20 to Form 10-K, filed on May 21, 2001
10.15	Rite Aid Corporation Special Executive Retirement Plan*	Filed herewith
10.16	Employment Agreement by and between Rite Aid Corporation and Christopher Hall, dated as of January 26, 2000*	Exhibit 10.48 to Form 10-K, filed on May 21, 2001
10.17	Employment Agreement by and between Rite Aid Corporation and Robert B. Sari, dated as of February 28, 2001*	Exhibit 10.49 to Form 10-K filed on May 21, 2001
10.18	Employment Agreement by and between Rite Aid Corporation and Kevin Twomey, dated as of September 30, 2003*	Exhibit 10.4 to Form 10-Q, filed on October 7, 2003
11	Statement regarding computation of earnings per share (see note 4 to the consolidated financial statements)	Filed herewith
12	Statement regarding computation of ratio of earnings to fixed charges	Filed herewith
14	Code of Ethics for the Chief Executive Officer and Senior Financial Officers	Filed herewith
21	Subsidiaries of the Registrant	Filed herewith

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Exhibit Numbers	Description	Incorporation By Reference To
23	Consent of Independent Registered Public Accounting Firm	Filed herewith
31.1	Certification of CEO pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934	Filed herewith
31.2	Certification of CFO pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934	Filed herewith
32	Certification of CEO and CFO pursuant to 18 U.S.C., Section 1350, as adopted pursuant to Section 906 of the	Filed herewith

Sarbanes-Oxley Act of 2002

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*Constitutes a compensatory plan or arrangement required to be filed with this Form 10-K.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Rite Aid Corporation
Camp Hill, Pennsylvania

We have audited the accompanying consolidated balance sheets of Rite Aid Corporation and subsidiaries as of February 28, 2004 and March 1, 2003, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the three years in the period ended February 28, 2004. Our audits also included the financial statement schedule listed in the Table of Contents at Item 15(a)(2). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Rite Aid Corporation and subsidiaries at February 28, 2004 and March 1, 2003, and the results of their operations and their cash flows for each of the three years in the period ended February 28, 2004 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" effective March 2, 2003 and Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" as amended, effective March 4, 2001. Also, as discussed in Note 7 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" effective March 3, 2002.

As discussed in Note 21, the accompanying consolidated financial statements have been restated.

/s/ DELOITTE & TOUCHE LLP

Philadelphia, Pennsylvania
April 23, 2004 (April 6, 2005
as to the effects of the restatement

discussed in Note 21)

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RITE AID CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS (as Restated, see Note 21)

(In thousands, except per share amounts)

	February 28, 2004	March 1, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 334,755	$ 365,321
Accounts receivable, net	670,004	575,518
Inventories, net	2,223,171	2,195,030
Prepaid expenses and other current assets	150,067	108,018
Total current assets	3,377,997	3,243,887
Property, plant and equipment, net	1,882,763	1,867,830
Goodwill	684,535	684,535
Other intangibles, net	176,672	199,768
Other assets	123,667	136,746
Total assets	$ 6,245,634	$ 6,132,766
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Short-term debt and current maturities of convertible notes, long-term debt and lease financing obligations	$ 23,976	$ 103,715
Accounts payable	758,290	755,284
Accrued salaries, wages and other current liabilities	701,484	707,999
Total current liabilities	1,483,750	1,566,998
Convertible notes	246,000	244,500
Long-term debt, less current maturities	3,451,352	3,345,365
Lease financing obligations, less current maturities	170,338	169,048
Other noncurrent liabilities	902,471	917,130
Total liabilities	6,253,911	6,243,041
Commitments and contingencies	—	—
Redeemable preferred stock	—	19,663
Stockholders' deficit:		
Preferred stock, par value $1 per share; liquidation value $100 per share; 20,000 shares authorized; shares issued — 4,178 and 3,937	417,803	393,705
Common stock, par value $1 per share; 1,000,000 shares authorized; shares issued and outstanding 516,496 and 515,115	516,496	515,115
Additional paid-in capital	3,133,277	3,119,619

Accumulated deficit		(4,052,974)		(4,135,728)
Stock based and deferred compensation		—		5,369
Accumulated other comprehensive loss		(22,879)		(28,018)
Total stockholders' deficit		(8,277)		(129,938)
Total liabilities and stockholders' deficit	$	6,245,634	$	6,132,766

The accompanying notes are an integral part of these consolidated financial statements.

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RITE AID CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS (as Restated, see Note 21)

(In thousands, except per share amounts)

			Year Ended			
		February 28, 2004		March 1, 2003		March 2, 2002
Revenues	$	16,600,449	$	15,791,278	$	15,166,170
Costs and expenses:						
Cost of goods sold, including occupancy costs		12,568,729		12,036,003		11,695,871
Selling, general and administrative expenses		3,594,405		3,471,573		3,422,383
Stock-based compensation expense (benefit)		29,821		4,806		(15,891)
Goodwill amortization		—		—		21,007
Store closing and impairment charges		22,074		135,328		251,617
Interest expense		313,498		330,020		396,064
Interest rate swap contracts		—		278		41,894
Loss (gain) on debt modifications and retirements, net		35,315		(13,628)		221,054
Share of loss from equity investments		—		—		12,092
Loss (gain) on sale of assets and investments, net		2,023		(18,620)		(42,536)
		16,565,865		15,945,760		16,003,555
Income (loss) before income taxes		34,584		(154,482)		(837,385)
Income tax benefit		(48,795)		(41,940)		(11,745)
Net income (loss)	$	83,379	$	(112,542)	$	(825,640)
Computation of income (loss) applicable to common stockholders:						
Income (loss)	$	83,379	$	(112,542)	$	(825,640)
Accretion of redeemable preferred stock		(102)		(102)		(104)
Preferred stock beneficial conversion		(625)		—		(6,406)
Cumulative preferred stock dividends		(24,098)		(32,201)		(27,530)
Income (loss) applicable to common stockholders	$	58,554	$	(144,845)	$	(859,680)
Basic and diluted income (loss) per share:						
Net income (loss) per share	$	0.11	$	(0.28)	$	(1.81)

The accompanying notes are an integral part of these consolidated financial statements.

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RITE AID CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIT
For the Years Ended February 28, 2004, March 1, 2003 and March 2, 2002
(In thousands, except per share amounts)

	Preferred Stock		Common Stock						
	Shares	Amount	Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Stock Based and Deferred Compensation	Accumulated Other Comprehensive Income (Loss)	Total
Balance March 4, 2001 (as previously reported)	3,340	$333,974	348,055	$348,055	$2,065,301	$ (3,171,956)	$ 19,782	$50,409	$ (354,435)
Prior year adjustment (see Note 21)	—	—	—	—	—	(19,184)	—	—	(19,184)
Balance March 4, 2001 (as restated, see Note 21)	3,340	333,974	348,055	348,055	2,065,301				