AMERICAS MERGER REPORT

25 April 2016

Deal Terms
1 RAD = $9.00

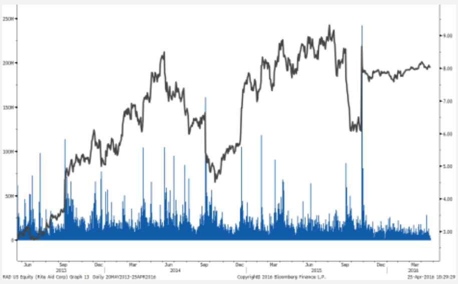
Target: Rite Aid Corp

Country	United States
Bloomberg	RAD
Sector	Drug Stores
Share price ($)	8.03
Market cap ($)	8,403
Free float (%)	100

Acquirer: Walgreens Boots Alliance, Inc.

Country	United States
Bloomberg	WBA
Sector	Drug Stores
Share price ($)	80.00
Market cap (USDm)	86,417
Free float min (%)	100

RAD Price Chart



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Author
Krisztian Szentessy
Senior Event Driven Analyst
krisztian@chainbridgeresearch.com
+44 207 570 0322 (direct line)

Gabor Szabo, CFA
g.szabo@chainbridgeresearch.com
Tomas Stanay
t.stanay@chainbridgeresearch.com
Gabor Kokosy
g.kokosy@chainbridgeresearch.com
Muhammad Daniyal
d.shafiq@chainbridgeresearch.com

Chain Bridge Research
100 Wall Street, 20th Floor
New York, NY 10005
Tel (UK): +44 207 570 0322
Tel (New York): +1 212 796 5769

Rite Aid (RAD) / Walgreens (WBA)

Anti-Trust Analysis

We see the probability of the deal closing at 75% to 80%.

Current report: We have analyzed location data for pharmacies in the U.S.A: RAD, WBA, CVS, WMT, Kroger, Safeway + Albertsons, Good Neighbor, and KMART. We only included stores with pharmacies.

- We have location data for each company: pharmacy stores by state, city, and zip codes.
- We note that our analysis has limitations.
  - We are conducting a frequency analysis based on number of stores by each company in a given geographic location.
  - Econometric analysis of cross-sectional data by the FTC would involve looking at the relationship between drug prices and several variables (incl. number of stores in a geographic market and across geographic markets, store size, density of pharmacy network in a given area, third party payors and number of employers in a given area, consumer characteristics).

Zip code overlaps: We have identified 1,253 zip code overlaps between WBA and RAD (market share is always based on the number of stores).

- By our base case analysis, we have found that altogether ~1,257 stores would have to be divested.

Ultimately, we believe that the key question here is WBA's willingness to complete the deal despite the breach of the DMA threshold.

- We understand that WBA is committed to completing the deal. In our view, the deal is highly strategic for WBA. This is a unique opportunity for WBA to expand its scale with one large acquisition. Given that there are no similar targets in the market, WBA will likely be willing to divest as many stores as necessary to satisfy regulators.
  - A more critical issue may be finding a buyer. Given the interplay between the third payor and the cash retail market, one buyer would likely be required for the divestiture package.
- The most straightforward buyer for the whole portfolio would be a PE buyer. We note that PE has a track record of owning pharmacy chains (Duane Reade in the U.S. and Alliance Boots in the UK, among others).
  - Such an acquisition would not be without complications, however. The divested portfolio for a PE buyer would require rebranding. The most obvious route for a PE buyer would be to continue to use the Rite Aid brand, while WBA would be required to rebrand the acquired Rite Aid store portfolio.
- Overall, we believe that PE buyers would be interested in such an acquisition.
  - A focused and dense drug store portfolio would offer both strategic and non-strategic exit opportunities down the road.
    - If vertical integration picks up then the divested RAD pharmacy portfolio could be acquired by a strategic player in the drug distribution chain.
    - Alternatively, such a large portfolio could also be IPO-d as a unique asset with takeout potential.

IGR view: We estimate an implied deal closing probability of 66%, assuming downside to $6.25 per RAD share and deal close by mid-October 2016.

- We believe that the discount to the deal price is driven by the relatively large downside and the expected divestiture clause breach (more than 1,000 stores to be divested).
- Our view remains by large unchanged since our October 2015 report. We see the probability of the deal closing at 75% to 80%.
- We would start a position long RAD at or close to $8.0 per RAD share.
  - We would look to unwind the position at an implied deal closing probability of 80% (unless there is positive news flow on the divestiture process).

RAD antitrust analysis

LEGAL ASPECTS

IGR comment: From an antitrust perspective, we believe that the key issue is how the FTC will settle on the required divestitures across two product markets that, in turn, imply two different geographic market definitions.

- We believe that the key issue here is the interplay of the third payor and cash retail markets. The two are interconnected as there is overlap between the two geographic markets with the third party payor market having a larger radius vs. the cash retail market. In addition, a third payor participant pharmacy chain requires sufficient scale and density.
- This means that the divestitures may have to be deeper in certain geographic markets than what a cash retail overlap analysis imply.
    - And also, participation in the third payor market would also mean that the FTC will likely prefer one buyer.
    - One buyer could have the necessary scale and geographic presence to sufficiently compete in the affected geographic markets
- On this basis, WBA would likely have to go to the limit to meet these two standards.
    - We believe the strategic rationale is there and therefore we believe that WBA will go to the limit to satisfy the FTC.
    - In this report, we intend to analyze what the expected divestiture package could look like.

Limit on divestitures under the DMA:

- (i) with respect to any sale, transfer, disposition, divestiture or hold separate of any retail stores of WBA, Rite Aid or any of their respective subsidiaries, neither WBA nor any of its subsidiaries will be required to (x) sell, transfer, dispose of, divest or hold separate, or (y) proffer, propose, negotiate, offer to effect or consent, commit or agree to any sale, transfer, disposal, divestiture or hold separate, in each case before or after the effective time of the merger, **more than an aggregate of 1,000 retail stores of WBA and its subsidiaries and Rite Aid and its subsidiaries**; and
- (ii) with respect to any divestiture action not described in the preceding paragraph, WBA will not be required to take such other divestiture action other than (A) certain actions set forth in WBA's confidential disclosure schedules and (B) such divestiture actions as would not, individually or in the aggregate, result in an impact exceeding **$100 million** in the aggregate (without taking into account any impact arising from or relating to any action set forth on WBA's confidential disclosure schedules pursuant to the foregoing clause (A)) as a result of (x) the divestiture of non-earnings generating assets, properties or businesses, in each case with such impact calculated as the **fair market value of such assets, properties or businesses so divested** ***or*** (y) the divestiture of earnings-generating assets, properties or businesses, or any other adverse impact on the assets, businesses, liabilities or financial condition of WBA, Rite Aid or their respective subsidiaries, in each case ***with such impact calculated by multiplying any reduction of Adjusted EBITDA (as such term is defined in the merger agreement) on an annual basis resulting therefrom by twelve (12).***

Relevant product market: We believe that the FTC may focus on two aspects of the merger: third party payors (and PBMs) and cash customers. Before Revco/Rite Aid, the FTC had defined the relevant product market as the sale of prescription drugs in retail stores.

- George S. Cary, ex-Deputy Director for Mergers at the FTC: "We found that the third party payor market works quite differently from the cash paying customer market. Let me explain. First, whereas an individual cash paying customer can choose from the stores near his home or work, third party payers must offer a network of pharmacies geographically dispersed throughout the area where the employer's covered workforce lives. This kind of extensive coverage can only be provided cost effectively by chains with multiple locations in various geographic areas. Second, prices to third party payers and their PBMs are effectively established by competition between the lowest cost suppliers, which are inevitably the larger chain drug stores who benefit from economies of scale. Only after a price level is set through this competition do smaller, higher cost retail operations join the third party payor's network. However, these higher cost independents would not themselves compete prices down to that same level in the absence of chain store competition. Consequently, if the low cost chain is large enough so that it represents such a large percentage of the pharmacy counters in the area where the employer needs coverage that it becomes indispensable to the network, it can hold out for a higher price."
    - "Similarly, if the largest two competitors merge, leaving only smaller less cost effective competitors, the merged entity can also withhold its participation in the network except at higher prices than each would have been willing to participate at premerger. The network simply will not get enough participation at a low price because higher-cost stores will not participate; the network will therefore have to increase the price it is offering in order to induce the participation of the large merged chain, or higher cost competitors."
- In the failed Revco/Rite Aid merger, however, the relevant product market was defined as the retail sale of pharmacy services through PBMs.
    - The FTC had applied a similar market definition framework—(1) out-of-pocket customers and (2) third-party payors like health insurance plans and pharmacy benefit managers—to the Thrifty/PayLess proposed merger.
        - The FTC found anticompetitive effects in the retail customer market required divestitures in some geographic areas, but did not find anything of concern with the impact of the proposed combination of the two drugstores in the third-party payor market.
- In Jean Coutu/Rite Aid, the FTC defined the relevant product market as "the retail sale of pharmacy services to cash customers in local markets".

- "Pharmacy services include the provision of prescription medications by a licensed pharmacist who is able to provide usage advice and other relevant information as may be required by law."
- "Cash customers are consumers of pharmacy services that do not pay a price negotiated by or paid through a third party (such as an insurance plan or a pharmacy benefits."
- "Cash customers generally pay the full posted or list price set by a pharmacy for a prescription drug or some discounted amount of a posted or list price set by a pharmacy."
- The FTC alleged that many customers viewed RAD and Brooks/Eckerd pharmacies as their first and second choices.
  - The merger "likely would allow Rite Aid to unilaterally exercise market power … increasing the likelihood that the combined Rite Aid/Brooks-Eckerd will unilaterally exercise market power in the relevant markets".

Relevant geographic market: The relevant geographic market for retail pharmacies under third party payor contracts may not be the same as the geographic markets for cash paying customers.

- The geographic market analysis is also different for third party payers than for cash paying customers:
  - "The geographic market analysis is also different for third party payers than for cash paying customers. For third party payers, the geographic market quite literally is the area that each employer offering a prescription benefits plan must cover for his or her employees. Of course, the map for each employer would be a different amoeba-shaped service area representing the residential pattern of each employer. The pharmacy benefit plan managers that organize the networks would need to contract with pharmacies covering the overlapping areas of each of its third party payers."
  - "Obviously, defining such geographic markets with any precision is impossible. For pleading purposes, we settled on numerous representative Standard Metropolitan Statistical Areas ("SMSA's") and states. We used SMSA's because many employers in a metropolitan area have employees throughout the area. We used states because there are many state-wide employers that contract statewide: for example, public school teachers, Blue Cross, and the state government employees health plan. Because most employers are focused in one metropolitan area, we do not believe this shorthand does violence to the underlying economics of the market."
- "The numerous geographic markets and the fact that some of the markets overlapped others made it very difficult for the parties to propose a settlement that gave us any confidence that the anticompetitive problems identified could be resolved. A few local divestitures along the pattern of previous drugstore mergers simply would not solve the problem. Even if the parties had divested within an SMSA, the competitive problems would not have been solved because many statewide employers (and their third.
  - *"Finally, the impact on competition of proposed divestitures could not be known unless we could know exactly who the purchaser was in various markets, and what the competitive situation would look like after the divestiture. Unlike in many markets, the specific identity of the competitor and its size in various markets was relevant to judging the competitive results of the divestiture."*

RAD/WBA OVERLAP ANALYSIS

Current report: We have analyzed location data for pharmacies in the U.S.A: RAD, WBA, CVS, WMT, Kroger, Safeway + Albertsons, Good Neighbor, and KMART. We only included stores with pharmacies.

- We have location data for each company: pharmacy stores by state, city, and zip codes.
- We would highlight that the data sets are not of the same date, although we note that all of the data sets are from the past six months.
  - There are ongoing store closures and openings as part of the normal course of the businesses; however, we do not believe that the scale of the activity over the past three months would materially affect our analysis and results.
- The data set had to be cleaned, mainly because some of the city denominations were different for the four data sets.
  - We believe that any potential (and similar) remaining inconsistencies would not have a material effect on the analysis and the results.
- We note that our analysis has limitations.
  - We are not doing an econometric analysis. We are conducting a frequency analysis based on number of stores by each company in a given geographic location.
  - Econometric analysis of cross-sectional data would involve looking at the relationship between drug prices and several variables (number of stores in a geographic market and across geographic markets, store size, density of pharmacy network in a given area, third party payors and number of employers in a given area, consumer characteristics).
  - Nonetheless, we believe that our analysis is a fairly good approximation of the FTC's analysis.
    - We note that whatever our final results are, there are arguments for both overestimating and underestimating the actually required divestiture package.
- We are using city overlaps and zip code overlaps to approximate the relevant geographic markets for the merger.
  - We note that for cash retail markets zip code overlaps are likely to be a good approximation, while city overlaps are likely to be a good approximation for the third payor market,.
  - In any case, the actual geogr. market definition may differ somewhat from our analysis.

State by state analysis: HHI by number of stores

	CVS	GN	KMART	KR	RAD + WBA	ALB + SWY	WMT	Grand Total	Change
AL	888	86	5	13	1,163	0	435	2,591	576
CA	922	74	0	124	1,031	99	53	2,303	514
CO	33	2	2	1,457	636	231	161	2,522	126
CT	2,054	6	0	0	1,852	0	74	3,987	918
DC	3,922	16	0	16	230	123	9	4,317	114
DE	166	2	2	7	4,677	60	34	4,947	2,238
GA	871	78	2	235	903	0	221	2,310	450
ID	12	164	8	246	914	414	211	1,970	343
IN	1,474	9	4	386	550	0	172	2,595	51
KY	119	537	8	451	839	0	165	2,119	415
LA	479	272	3	2	1,292	9	384	2,442	523
MA	2,557	1	0	0	1,503	9	38	4,108	749
MD	1,183	28	4	13	1,400	94	56	2,779	647
ME	338	40	0	0	2,857	74	160	3,469	731
MI	622	119	15	132	1,696	0	58	2,642	840
MS	320	258	0	123	1,011	0	508	2,220	381
NC	883	28	4	144	1,351	0	203	2,613	671
NH	897	0	0	0	2,525	37	174	3,634	1,086
NJ	983	194	1	1	1,750	29	30	2,988	858
NV	1,191	2	7	226	599	89	153	2,269	14
NY	910	28	3	0	3,219	0	28	4,188	1,587
OH	701	64	7	406	1,068	0	102	2,348	533
OR	19	15	0	578	1,111	567	100	2,389	555
PA	796	22	10	243	1,476	5	59	2,610	435
RI	2,178	0	0	0	2,116	0	36	4,331	978
SC	1,221	60	7	34	1,079	0	254	2,655	533
TN	370	31	7	366	1,447	0	236	2,458	532
TX	875	123	0	70	743	31	310	2,150	64
UT	140	60	13	704	793	1	433	2,146	345
VA	1,092	22	4	136	1,041	14	160	2,468	509
VT	190	0	0	0	4,756	74	74	5,095	660
WA	30	11	0	539	1,323	509	74	2,485	660
WV	352	97	24	200	1,558	0	165	2,396	360

Source: IGR.

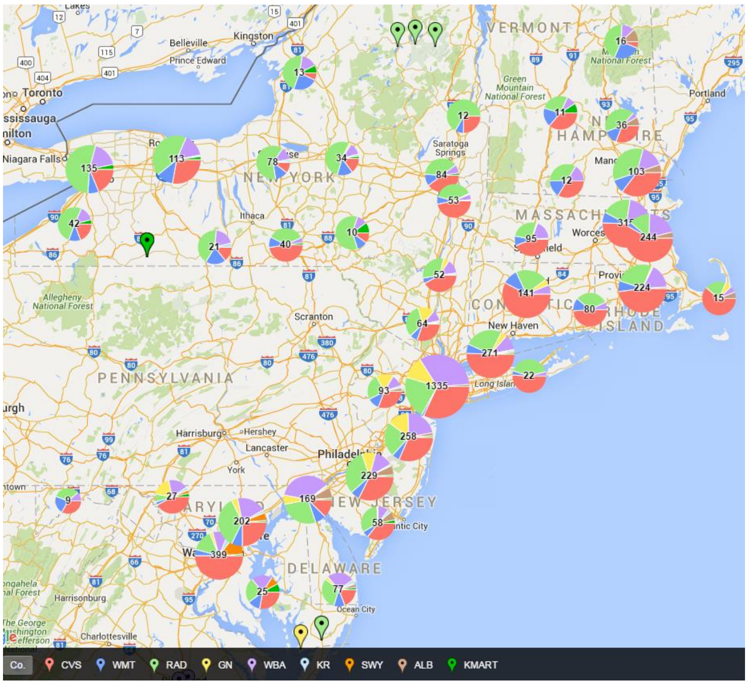
State by state overlaps: We start our analysis by looking at the two companies' geographic overlap state by state. We note that we have looked at the largest pharmaceutical networks by number of pharmacies (there are more pharmacies, however, the network for those pharmacies are even patchier).

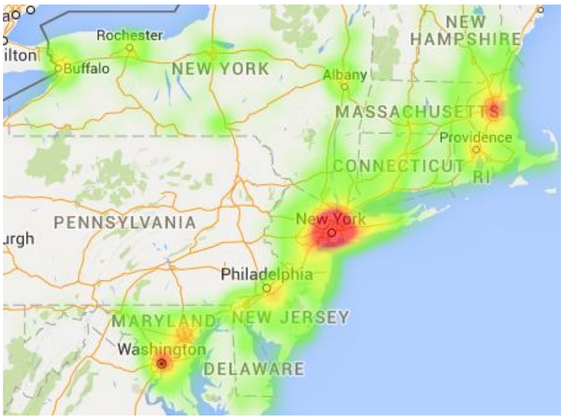
- We note that on a state by state basis where RAD and WBA overlap, the concentration is very high.

Key state overlaps through locations and heat map

Key state overlaps by number of stores in different ZIP code locations (by our HHI analysis)

Heat map of the overlap (intense competition is red)





** Companies included: CVS, RAD, WMT, WBA, KR, SWY, Albertsons, KMART, and Good Neigbor.*

Source: IGR

We note that the key overlaps between the two companies are in the North East. From the heat map above one can see that the competition is more intense where the map is red and less intense where the map is greener.

- This would also confirm the view that apart from metropolitan areas, competition is less intense and therefore, any market definition that is larger than city-wide would be negative for the companies.

City by city overlaps: We have identified 523 city overlaps between WBA and RAD (market share is always based on the number of stores)

- We have done the following analysis.
  - We have looked at the market share of the combined entity and the number of players in a given market.
  - We have considered problematic those cities where the combined market share would be above 30%.
  - Where there was no or only one competitor, we assumed that all of the stores of the smaller of RAD or WBA would have to be divested.
  - For markets where the combined market share would be between 30% and 50% and the number of competitors is more than 1, we assumed that the companies would have to sell down to below 30%.
    - Here, we assume that at least 1 store would have to be divested.
  - Where the market share was between 50% and 100% but there was more than 1 competitor, we assumed that all of the stores of the smaller of RAD or WBA would have to be divested.
- ***We have found that altogether ~591 stores would have to be divested.***
  - ***If we assume that between 30% and 100% where there is more than one competitor, WBA and RAD would have to sell down to a 30% market share (by number of stores), then 640 stores would have to be divested.***
- While the city overlaps look promising we note that the zip code comparison is likely to be more important in terms of size of divestiture and overall store density.

Zip code overlaps: We have identified 1,253 zip code overlaps between WBA and RAD (market share is always based on the number of stores)

- We have done the following analysis.
    - We have looked at the market share of the combined entity and the number of players in a given market.
    - We have considered problematic those zip codes where the combined market share would be above 30%.
    - Where there was no or only one competitor, we assumed that all of the stores of the smaller of RAD or WBA would have to be divested.
    - For markets where the combined market share would be between 30% and 50% and the number of competitors is more than 1, we assumed that the companies would have to sell down to below 30%.
        - Here, we assume that at least 1 store would have to be divested.
    - Where the market share was between 50% and 100% but there was more than 1 competitor, we assumed that all of the stores of the smaller of RAD or WBA would have to be divested.
- ***We have found that altogether ~1,257 stores would have to be divested.***
    - ***If we assume that between 30% and 100% where there is more than one competitor, WBA and RAD would have to sell down to a 30% market share (by number of stores), then 1,385 stores would have to be divested.***
- By our ZIP code analysis, we estimate that approximately 1,300 stores would have to be divested by WBA.

IGR Comment: We believe that the key to the divestiture package will be the narrower market definition. A sufficiently large cash retail divestiture package should provide sufficient density for the third payor market given the distribution of WBA and RAD overlap (as is seen in the heat map above).

- Our results appear to confirm that WBA would have to divest 30% more than what is indicated in the DMA.
- Ultimately, we believe that the key question here is WBA's willingness to complete the deal despite the breach of the DMA threshold.
    - We understand that WBA is committed to completing the deal. We believe that the deal is highly strategic for WBA. This is a unique opportunity for WBA to expand its scale with one large acquisition. Given that there are no similar targets in the market, we believe that WBA will be willing to divest as many stores as necessary to satisfy regulators.
- We believe that a more critical issue would be finding a buyer. Given the interplay between the third payor and the cash retail market, one buyer would be required for the divestiture package.
    - The most straightforward buyer for the whole portfolio would be a PE buyer. We note that PE has a track record owning pharmacy chains (Duane Reade in the U.S. and Alliance Boots in the UK, among others).
        - Such an acquisition would not be without complications, however. The divested portfolio for a PE buyer would require rebranding.
            - The most obvious route for a PE buyer would be to continue to use the Rite Aid brand, while WBA would be required to rebrand the acquired Rite Aid store portfolio.
    - Overall, we believe that PE buyers would be interested in such an acquisition.
        - A focused and dense drug store portfolio would offer both strategic and non-strategic exit opportunities win the road.
            - If vertical integration picks up further than the divested RAD pharmacy portfolio could be acquired by a strategic player in the drug distribution chain.
            - Alternatively, such a large portfolio could also be IPO-ed as a unique asset with potential takeout potential.

RAD valuation and risk-reward

RAD STANDALONE VALUE

Peers

Company	Ticker	Price	O/S	Market cap	FY1 EV/EBITDA	FY2 EV/EBITDA	FY1 EV/Sales	FY2 EV/Sales	FY2/FY1 Sales	FY1 EBITDA margin
Rite Aid	**RAD**	**$8.03**	**1,046**	**$8,403**	**9.9x**	**9.9x**	**0.5x**	**0.4x**	**5.4%**	**4.5%**
CVS	CVS	$101.41	1,092	$110,769	10.3x	9.5x	0.8x	0.7x	8.8%	7.3%
Walgreens	WBA	$79.97	1,080	$86,387	11.0x	9.9x	0.8x	0.8x	8.3%	7.4%
Dollar Tree	DLTR	$80.55	235	$18,944	11.0x	9.7x	1.2x	1.2x	5.8%	11.0%
Dollar General	DG	$81.59	287	$23,389	10.4x	9.6x	1.2x	1.1x	7.4%	11.3%

Source: IGR and Bloomberg.

We estimate a downside to $6.0 to $6.5 per RAD share on a deal break. We assumed 8.5x to 9.0x forward EBITDA.

- We note that RAD has historically traded at a discount to its peers given RAD's lower profitability and lower growth rate.
    - On this basis, we believe that a 15% to 20% discount to the average peer forward EBITDA multiple is warranted (this is also in line with the historical discount to the peer group).

RISK-REWARD

We estimate an implied deal closing probability of 66%, assuming downside to $6.25 per RAD share and deal close by mid-October 2016.

- We believe that the discount to the deal price is driven by the relatively large downside and the expected divestiture clause breach (more than 1,000 stores to be divested).
- Our view remains by large unchanged since our October 2015 report. We see the probability of the deal closing at 75% to 80%.
    - For us, the key issue is finding the buyer for the divested asset portfolio at the right price rather than the actual breach of the divestiture limit clause of the DMA.

Implied deal closing probability.

Assumptions	
Target current share price	$8.04
Bidder current share price	n.a.
Offer price	**$9.00**
Current spread	*-10.7%*
Estimated downside ($/share)	**$6.3**
Target deal closing date	**15 October 2016**
Risk free rate	*1.7%*
Discount factor	*0.99*
Probability of close	**66.6%**
Probability of the deal breaking	**33.4%**
Gross annualized return	**25.4%**

Source: IGR and Bloomberg.

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Chain Bridge Research

100 Wall Street, 20th Floor

New York, NY 10005

Tel (UK): 44 207 570 0322

Tel (New York): 212-796-5769

www.chainbridgeresearch.com

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