

UNIT PRICE
\$3.72
PER 100 SOFT

YOU PAY
\$11.99

36

S4



04200096402

0312471 03-11-12

QUILTD NORTHERN
BATHROOM TISSUE

12PK

with wellness+ CARD

**NOT AS
ADVERTISED**

3/11/12 - 3/17/12 pg 12

8013318



**Out-of-Stock Sale Items and Rite
Aid's Bid for Customer Loyalty**

Missing Products Undermine Customer Loyalty

By making membership in the Wellness+ loyalty program a precondition to access weekly sales, Rite Aid has tightly tied the success of its much-touted branding initiative to its regular promotional activity. The program combines a tiered points system with targeted rebates on particular products or brands, known as +UPs. These promotional offers are an important part of Rite Aid's new approach to its weekly sale offerings and management has identified +UPs as a traffic driver. We believe that, given this focus on regular promotions in the program's design, any customer frustration with the weekly sales experience diminishes the success of Wellness+ and the perception of Rite Aid's brand.

A 2009 IBM Global Business Services report based on a survey of 30,000 U.S. consumers identified product availability as an important factor in establishing trust, warning that shoppers "can become frustrated and lose trust when a product is not available," especially when it comes to special promotions.⁷ Another study found that when shoppers cannot find a product they are looking for, the retailer loses that sale 40% of the time, with the customer making the purchase at another store (31%) or not purchasing the item at all (9%).⁸

In the highly competitive drugstore industry, with the leading chains sometimes located directly across the street from each other, having the right product in the right place at the right time can be the difference between a sale and a lost customer. As Rite Aid seeks to rebrand itself through its loyalty program and the remodeling of some stores in a new "wellness" format, we believe that customer satisfaction remains tied to creating an easy-in, easy-out shopping experience where the products of daily living are affordable and on-hand.

Rite Aid Struggling to Improve Inventory Position

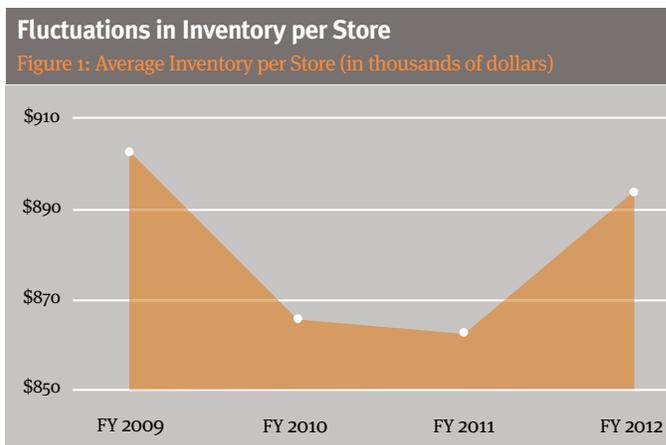
Compared to its primary competitors, Rite Aid has slower inventory turnover and lower sales per store (see table 1). To address this deficiency, the highly leveraged retailer has been trying to rationalize its overall inventory levels, increase efficiency and integrate systems that were strained by the acquisition of 1,850 stores in the Brooks and Eckerd drug chains in 2007.

Rite Aid Sales/Square Foot Lags Competitors		
Table 1: Measures of Efficiency in Drugstore Companies		
	Inventory Turnover	Sales per Square Foot
Rite Aid Drugstores	4.5	\$544
Walgreens	6.7	\$843
CVS	n/a	\$834

Source: Company Data and Guggenheim Securities, LLC. All figures are for the most recent four quarters available.

The Company achieved savings through a 4.2% reduction in total inventory per store in the first two full years after the acquisition (see figure 1). In the midst of that reduction, management identified out-of-stock sale items as a problem requiring attention, saying, "We are very focused right now on improving our add-in stocks [sic], making sure that those featured items are where we want them to be."⁹ By June 2011 management said that it was reaching the "tail end" of an initiative "reducing the inventory, [getting] unproductive inventory out of the system,"¹⁰ yet it remains far behind its pure play drugstore competitor Walgreens in the speed at which it moves inventory through the system and out the door.

We believe the reduction in inventory may have undermined the effort to improve in-stock conditions. Over the first three quarters of FY2012, the Company built up its inventory by an average of 3.6% per store, almost completely eliminating the previous gains in efficiency in order to make sure products were on the shelf. During the FY2012 third quarter earnings call in December 2011, CFO Frank Vitrano again honed in on the issue of out-of-stock sale items when explaining the factors behind the increased inventory levels, which included "initiatives to reduce out-of-stocks, whereby we increased the minimum stock quantities on certain items as well as increased the amount of inventory for add items [sic]."¹¹



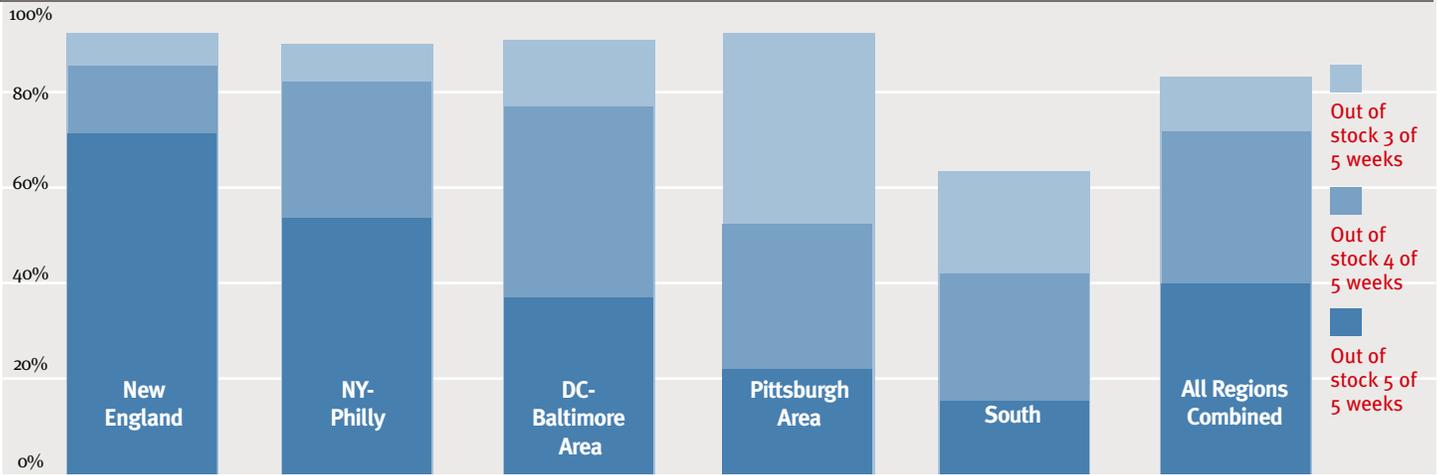
Source: Company Data and Guggenheim Securities.

The Company's seesawing inventory levels and persistent out-of-stock issues call into doubt management's ability to maximize the efficiency of working capital and regain competitive standing. Even with the recent inventory buildup, CtW found a significant pattern of missing sale items.

CtW Findings: Persistent Inventory Holes

CtW researchers made 1,100 visits to Rite Aid stores in 13 states and the District of Columbia.¹² A set of 220 stores was surveyed five times in the Fall of 2011 and Spring of 2012, with the last review conducted in March 2012, to determine

Figure 2: Proportion of Rite Aid stores with out-of-stock sale items per store visit, by region



whether a basket of selected sale items advertised in the weekly circular were present on Rite Aid shelves. Each survey's basket of items – which ranged in number from 20 to 25 – included food, household products and over-the-counter medication; pet care and baby-related products were also included in most rounds of the survey. The survey included both name brand items as well as products marketed under Rite Aid's private label brands including Tuga-bo, Simplify, Rite Aid and Rite Aid Home.

In total, 40% of Rite Aid stores visited were out-of-stock of at least one of the advertised sale items every time the store was surveyed (see figure 2). Seventy percent of all stores had at least one of the advertised items missing four out of five times surveyed, and 86% had something missing three out of five times surveyed. None of the 220 stores surveyed had every item in stock for all five survey visits.

The out-of-stock issues were most prominent in New England, where over 70% of stores visited had at least one missing sale item all five times surveyed. And in the NYC-Philadelphia corridor, over half of visited stores were out of stock of at least one item every time they were surveyed.

The items surveyed are the types of products that consumers regularly purchase for their health and daily household needs (see table 2). For example, many over-the-counter medications were out of stock during the course of the survey: A 42-count bottle of Prilosec was missing in 27% of stores during the week it was advertised, a Theraflu Value Pack was missing a full 46% of the time in a week during the flu season, and a 70-count Zyrtec Allergy Relief was out of stock in 23% of stores surveyed during Spring allergy season.

Household items that were advertised as on sale but found to be out of stock in numerous stores CtW surveyed included Charmin Ultra Bath Tissue 24-packs, which were missing in 25% of stores surveyed during the week advertised, 8-oz packages of Maxwell House Instant Regular Coffee, which were out 47% of the time, and a 14-lb package of Rite Aid brand cat litter, out 17% of the time during the week it was

What's Missing at Rite Aid
 Table 2: Selected Out-of-Stock Items

Sale Item	Percent of Stores Missing Item
Maxwell House Instant Regular Coffee 8 oz.	47%
Theraflu Value Pack Warming Relief: 2x 8.3 fl. Oz	46%
Diet 7-UP, 12 pack	30%
Prilosec OTC 42 ct.	27%
Charmin Ultra Bath Tissue 24 pack	25%
St. Joseph Aspirin 120 ct.	24%
Zyrtec Allergy Relief 70 ct.	23%
Bounty Paper Towels 15 pack	23%
Rite Aid Loratadine (Generic Claritin) 120 tablets	22%
Rite Aid Fabric Refresher 16.9 fl. Oz	20%



Sale item missing in a Pennsylvania store.



New York store with missing inventory.

surveyed. Our researchers found a significant number of Rite Aid private label products to be out-of-stock, reflecting a missed opportunity for the company to make sales of its profitable in-house brands.

Consumers look for particular products because they are advertised in the circular and out-of-stock conditions may lead shoppers to ask for a rain check, opt for a more expensive, non-sale item or leave the store empty-handed if the promised item is not on the shelf.

On average, 9.3% of the Rite Aid sale products for which CtW surveyed were out of stock in the stores visited. In certain markets, the incidence was significantly higher, with the highest rate in the important New York City market where the average out-of-stock rate was 20.4% over five sets of store visits. Several other states reached above ten percent out-of-stock rates for the basket of goods CtW surveyed: DC (11.9%), Virginia (11.8%), Connecticut (11.3%) and Massachusetts (10.7%). Despite Rite Aid's focus on improving its inventory position for promotional offerings, CtW's findings suggest the retailer's systems and execution may pose a threat to the success of the Wellness+ initiative, which promises industry-leading value for consumers.

Conclusion:

A Need for Improvement and Disclosure

As retailers adopt ever more sophisticated RFID inventory track-

ing software and point-of-sale replenishment systems, Rite Aid itself has acknowledged an ongoing need to improve inventory management. As it worked to rationalize inventory levels, management commented in June of 2010 that with more than twenty thousand SKUs, there were some areas in which they could further reduce inventory and others in which they "came out a little tighter on inventory... than we wanted it to be."

Given the recent history of problems with inventory management and Rite Aid's lagging performance compared to its competitors, we believe management should refocus on this area of operations and discuss with investors what it is doing to address persistent challenges. Specifically, investors would benefit from information about the company's goals for out-of-stock rate reduction and the success in meeting those goals over time. Additionally, the apparent limitations of the manual inventory-checking system currently in place demonstrate the need for management to describe the technological capacity of its inventory management systems and whether there are plans and resources available to upgrade.

The company must improve its overall inventory management capabilities and performance if it is to restore investor confidence. By working towards greater consistency in its in-stock levels and providing investors with more insight into this challenging area, we believe Rite Aid could make headway in its effort to remake its image with both customers and shareholders.

Notes

¹ CEO John Standley, Rite Aid Corporation, Q3 FY2012 Earnings Call.

² CEO John Standley, Rite Aid Corporation, Q1 FY2012 Earnings Call Q&A.

³ Rite Aid Corporation, Q3 FY2012 Earnings Call.

⁴ Thomas W. Gruen, Ph.D. and Dr. Daniel Corsten, "A Comprehensive Guide To Retail Out-of-Stock Reduction In the Fast-Moving Consumer Goods Industry," Grocery Manufacturers Association (GMA), Food Marketing Institute (FMI), National Association of Chain Drug Stores (NACDS), The Procter & Gamble Company (P&G) and the University of Colorado at Colorado Springs, 2007, at 1. PDF available at: <http://bit.ly/HhLk5Z>.

⁵ Ibid. at 7-8.

⁶ Ibid. at 7, 27, 29.

⁷ IBM Institute for Business Value, "Shopper advocacy: Building consumer trust in the new economy," 2009, at 11. Available at: <http://ibm.co/7e8INY>.

⁸ Gruen and Corsten, *supra* n4, at 10.

⁹ CEO John Standley, Rite Aid Corporation, Q1 FY2011 Earnings Call Q&A.

¹⁰ CFO Frank Vitrano, Rite Aid Corporation, Q1 FY2012 Earnings Call Q&A.

¹¹ Rite Aid Corporation, Q3 FY2012 Earnings Call.

¹² The 13 states in which Rite Aid stores were surveyed: Connecticut, Delaware, Georgia, Maryland, Massachusetts, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Virginia and West Virginia.

¹³ CEO John Standley, Rite Aid Corporation, Q1 FY2011 Earnings Call Q&A.

To learn more about the Rite Aid Disclosure Watch initiative, go to www.RiteToKnow.org

