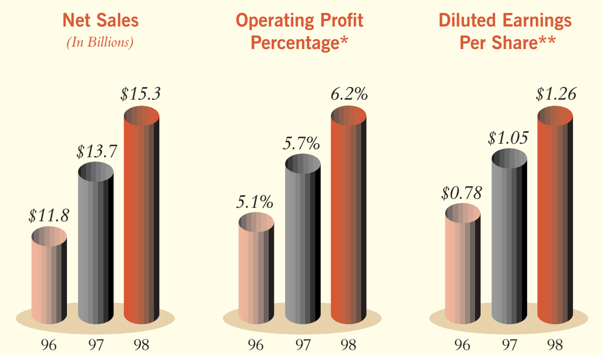
Management's Discussion and Analysis of Financial

We strongly recommend that you read our audited consolidated financial statements and footnotes found on pages 22 through 38 of this Annual Report along with this important discussion and analysis.

1998 Financial Highlights



* Percent of net sales before nonrecurring charges and gain.
** Earnings from continuing operations before nonrecurring charges and gains.

Introduction

1998 was an excellent year for CVS. We are pleased to report that despite the significant challenges our company faced in integrating the operations of Arbor Drugs, Inc. and Revco D.S., Inc., we achieved another record year in terms of net sales, operating profit and diluted earnings per share, excluding the effect of the nonrecurring charges and gain.

Our strong performance in 1998 translated into a 72.7% return to our shareholders. This compares to a total return of 18.1% for the Dow Jones Industrial Average and 28.6% for the S&P 500. While we are extremely proud of this accomplishment, we cannot guarantee that our future performance will result in similar returns to shareholders. Our total market capitalization grew to more than $21 billion at December 31, 1998.

As a result of the significant increase in our stock price, on May 13, 1998, the Board of Directors approved a two-for-one common stock split, effective June 15, 1998. At that time, the Board also approved an increase in our annual post-split cash dividend to $0.23 per share, underscoring their continued optimism in our prospects for future growth.

Mergers

As you review our consolidated financial statements and footnotes, you should carefully consider the impact of the following merger transactions and the nonrecurring charges that we recorded:

CVS/Arbor Merger
On March 31, 1998, we completed a merger with Arbor pursuant to which 37.8 million shares of CVS common stock were exchanged for all the outstanding common stock of Arbor. We also converted Arbor's stock options into options to purchase 5.3 million shares of our common stock. The merger of CVS and Arbor was a tax-free reorganization, which we treated as a pooling of interests under Accounting Principles Board Opinion No. 16, "Business Combinations." Accordingly, we have restated our historical consolidated financial statements and footnotes to include Arbor as if it had always been owned by CVS.

The merger with Arbor made us the market share leader in metropolitan Detroit, the nation's fourth largest retail drugstore market, and strengthened our position as the nation's top drugstore retailer in terms of store count and retail prescriptions dispensed. We believe that we can achieve cost savings from the combined operations of approximately $30 million annually. This will come primarily from closing Arbor's corporate headquarters, achieving economies of scale in advertising, distribution and other operational areas, and spreading our investment in information technology over a larger store base. Please read the "Cautionary Statement Concerning Forward-Looking Statements" section below.

CVS/Revco Merger
On May 29, 1997, we completed a merger with Revco pursuant to which 120.6 million shares of CVS common stock were exchanged for all the outstanding common stock of Revco. We also converted Revco's stock options into options to purchase 6.6 million shares of our common stock. The merger of CVS and Revco was also a tax-free reorganization that we treated as a pooling of interests. Accordingly, we have restated our historical consolidated financial statements and footnotes to include Revco as if it had always been owned by CVS.

The merger with Revco was a milestone event for our company in that it more than doubled our revenues and made us the nation's number one drugstore retailer in terms of store count. The merger brought us into high-growth, contiguous markets in the Mid-Atlantic, Southeast and Midwest regions of the United States.

Condition and Results of Operations

Merger Charges
During the second quarter of 1998, we recorded a $158.3 million charge to operating expenses for direct and other merger-related costs pertaining to the CVS/Arbor merger transaction and related restructuring activities. At that time, we also recorded a $10.0 million charge to cost of goods sold to reflect markdowns on noncompatible Arbor merchandise.

During the second quarter of 1997, we recorded a $411.7 million charge to operating expenses for direct and other merger-related costs pertaining to the CVS/Revco merger transaction and related restructuring activities. At that time, we also recorded a $75.0 million charge to cost of goods sold to reflect markdowns on noncompatible Revco merchandise.

Integration Update
We are pleased to report that the integration of Arbor is well underway. We have already converted Arbor to CVS' accounting and store systems and closed the Troy, Michigan corporate headquarters facility. With respect to merger synergies, we achieved approximately $20 million of cost savings in 1998 and we believe we are on track to realize at least $30 million of cost savings in 1999 from the Arbor merger. Please read the "Cautionary Statement Concerning Forward-Looking Statements" section below. We are further pleased to report that the integration of Revco is now complete and we have accomplished our goal of achieving at least $100 million of annual cost savings from the Revco merger.

Where You Can Find More Information About the Mergers
Please read the "Results of Operations" and "Cautionary Statement Concerning Forward-Looking Statements" sections below and Notes 2 and 3 to the consolidated financial statements for other important information about the mergers and the nonrecurring charges that we recorded.

Results of Operations

Net sales increased 11.1% in 1998 to $15.3 billion. This compares to increases of 16.2% in 1997 and 12.5% in 1996. Same store sales, consisting of sales from stores that have been open for more than one year, rose 10.8% in 1998, 9.7% in 1997 and 8.9% in 1996. Pharmacy same store sales increased 16.5% in 1998, 16.5% in 1997 and 13.5% in 1996. Our pharmacy sales as a percentage of total sales were 58% in 1998, 55% in 1997 and 52% in 1996. Our third party prescription sales as a percentage of total pharmacy sales were 84% in 1998, 81% in 1997 and 80% in 1996.

As you review our sales performance, we believe you should consider the following important information:

- Our pharmacy sales growth continued to benefit from our ability to attract and retain managed care customers, our ongoing program of purchasing prescription files from independent pharmacies and favorable industry trends. These trends include an aging American population; many "baby boomers" are now in their fifties and are consuming a greater number of prescription drugs. The increased use of pharmaceuticals as the first line of defense for healthcare and the introduction of a number of successful new prescription drugs also contributed to the growing demand for pharmacy services.

- Our front store sales growth was driven by solid performance in categories such as cosmetics, private label, seasonal, vitamins/nutrition, greeting cards, skin care, film and photofinishing, and convenience foods.

- The increase in net sales in 1998 was positively affected by our efforts to improve the performance of the Revco stores. To do this, we converted the retained Revco stores to the CVS store format and relocated certain stores. We are pleased to report that we are seeing improvements, especially in front store sales. However, the improved performance has been aided by temporary promotional events and the rate of progress has varied. We expect it to continue to vary, on a market-by-market basis.

- The increase in net sales in 1997 was positively affected by our acquisition of Big B, Inc., effective November 16, 1996. Excluding the positive impact of the Big B acquisition, net sales increased 11.3% in 1997 when compared to 1996. Please read Note 2 and Note 3 to the consolidated financial statements for other important information about the Big B acquisition.

- We have an active program in place to relocate our existing shopping center stores to larger, more convenient, freestanding locations. Historically, we have achieved significant improvements in customer count and net sales when we do this. The resulting increase in net sales has typically been driven by an increase in front store sales, which normally have a higher gross margin. We believe that our relocation program offers a significant opportunity for future growth, as 23% of our existing stores are freestanding. We currently expect to have 35% of our stores in freestanding locations by the end of 1999. Our long-term goal is to have 70-80% of our stores located in freestanding sites.

Management's Discussion and Analysis of Financial

We cannot, however, guarantee that future store relocations will deliver the same results as those historically achieved. Please read the "Cautionary Statement Concerning Forward-Looking Statements" section below.

Gross margin as a percentage of net sales was 27.0% in 1998. This compares to 27.0% in 1997 and 27.9% in 1996. As you review our gross margin performance, please remember to consider the impact of the $10.0 million charge we recorded in 1998 to reflect markdowns on noncompatible Arbor merchandise and the $75.0 million charge we recorded in 1997 to reflect markdowns on noncompatible Revco merchandise. If you exclude the effect of these nonrecurring charges, our comparable gross margin as a percentage of net sales was 27.1% in 1998, 27.6% in 1997 and 27.9% in 1996.

Why has our comparable gross margin rate been declining?

- Pharmacy sales are growing at a faster pace than front store sales. On average, our gross margin on pharmacy sales is lower than our gross margin on front store sales.

- Sales to customers covered by third party insurance programs have continued to increase and, thus, have become a larger part of our total pharmacy business. Our gross margin on third party sales has continued to decline largely due to the efforts of managed care organizations and other pharmacy benefit managers to reduce prescription drug costs. To address this trend, we have dropped a number of third party programs that fell below our minimum profitability standards. In the event this trend continues and we elect to drop additional programs and/or decide not to participate in future programs that fall below our minimum profitability standards, we may not be able to sustain our current rate of sales growth.

Total operating expenses were 22.0% of net sales in 1998. This compares to 25.1% in 1997 and 22.9% in 1996. As you review our performance in this area, please remember to consider the impact of the following nonrecurring charges:

- During 1998, we recorded the $158.3 million charge associated with the Arbor merger.

- During 1997, we recorded the $411.7 million charge associated with the Revco merger. We also recorded a $31.0 million charge for certain costs associated with the restructuring of Big B. Please read Note 3 to the consolidated financial statements for other important information about this charge.

- During 1996, Revco recorded a $12.8 million charge when Rite Aid Corporation announced that it had withdrawn its tender offer to acquire Revco. This event took place before we merged with Revco.

If you exclude the effect of these nonrecurring charges, comparable total operating expenses as a percentage of net sales were 20.9% in 1998, 21.9% in 1997 and 22.8% in 1996.

What have we done to improve our comparable total operating expenses as a percentage of net sales?

- We eliminated most of Arbor's existing corporate overhead in 1998 and most of Revco's in 1997.

- Our strong sales performance has consistently allowed our net sales to grow at a faster pace than total operating expenses.

- Our information technology initiatives have led to greater productivity, which has resulted in lower operating costs and improved sales. Our major IT initiatives include: Supply Chain Management, Rx2000 Pharmacy Delivery Project, and Rapid Refill.

As a result of combining the operations of CVS, Arbor and Revco, we were able to achieve substantial annual operating cost savings in 1998 and 1997. Although we are extremely proud of this accomplishment, we strongly advise you not to rely on the resulting operating expense improvement trend to predict our future performance.

Operating profit increased $510.8 million to $772.2 million in 1998. This compares to $261.4 million in 1997 and $591.9 million in 1996. If you exclude the effect of the nonrecurring charges we recorded in gross margin and in total operating expenses, our comparable operating profit increased $161.4 million (or 20.7%) to $940.5 million in 1998. This compares to $779.1 million in 1997 and $604.7 million in 1996. Comparable operating profit as a percentage of net sales was 6.2% in 1998, 5.7% in 1997 and 5.1% in 1996.

Other expense (income), net consisted of the following for the years ended December 31:

In millions	**1998**	1997	1996
Gain on sale of securities	**$ —**	$ —	$(121.4)
Dividend income	**—**	—	(5.6)
Interest expense	**69.7**	59.1	84.7
Interest income	**(8.8)**	(15.0)	(9.2)
Other expense (income), net	**$60.9**	$ 44.1	$ (51.5)

Condition and Results of Operations *(continued)*

During 1998, our other expense (income), net increased $16.8 million due to higher interest expense and lower interest income. Our interest expense increased because we maintained higher average borrowing levels during 1998 to finance, in part, additional inventory. You should be aware that we purchased the additional inventory to support several initiatives. First we converted the Revco stores to the CVS merchandise mix. We also held promotional name change events in most Revco markets and realigned our stores and distribution centers. In order to properly support these important initiatives, we decided to temporarily increase our inventory levels during 1998. We believe that our inventory levels were back to "normal" at December 31, 1998.

During 1997, our other expense (income), net increased $95.6 million to a net other expense of $44.1 million from a net other income of $51.5 million in 1996. As you review this change, you should consider the impact of the following information:

- During 1997, we recognized interest income on a note receivable that we received when we sold Kay-Bee Toys in 1996. This note was sold in 1997. We also had lower interest expense in 1997 because we retired most of the higher interest rate debt we absorbed as part of the CVS/Revco Merger.
- During 1996, we recognized a $121.4 million gain when we sold certain equity securities that we received when we sold Marshalls in 1995.

Income tax provision ~ Our effective income tax rate was 44.3% in 1998. This compares to 64.8% in 1997 and 42.1% in 1996. Our effective income tax rates were higher in 1998 and 1997 because certain components of the charges we recorded in conjunction with the CVS/Arbor and CVS/Revco merger transactions were not deductible for income tax purposes.

Earnings from continuing operations before extraordinary item increased $319.9 million to $396.4 million (or $0.98 per diluted share) in 1998. This compares to $76.5 million (or $0.16 per diluted share) in 1997 and $372.4 million (or $0.95 per diluted share) in 1996. If you exclude the effect of the nonrecurring charges we recorded in cost of goods sold and total operating expenses and the gain on sale of securities included in other expense (income), net, our comparable earnings from continuing operations before extraordinary item increased 21.7% to $510.1 million (or $1.26 per diluted share) in 1998. This compares to $419.2 million (or $1.05 per diluted share) in 1997 and $306.8 million (or $0.78 per diluted share) in 1996.

Discontinued Operations ~ In November 1997, we completed the final phase of a comprehensive strategic restructuring program, under which we sold Marshalls, Kay-Bee Toys, Wilsons, This End Up and Bob's Stores. As part of this program, we also completed the spin-off of Footstar, Inc., which included Meldisco, Footaction and Thom McAn, completed the initial and secondary public offerings of Linens 'n Things and eliminated certain corporate overhead costs. As part of completing this program, we recorded an after-tax charge of $20.7 million during the second quarter of 1997 and $148.1 million during the second quarter of 1996 to finalize our original liability estimates. Please read Note 4 to the consolidated financial statements for other important information about this program.

Extraordinary item ~ During the second quarter of 1997, we retired $865.7 million of the debt we absorbed when we acquired Revco. As a result, we recorded a charge for an extraordinary item, net of income taxes, of $17.1 million. The extraordinary item included the early retirement premiums we paid and the balance of our deferred financing costs.

Net earnings were $396.4 million (or $0.98 per diluted share) in 1998. This compares to $76.9 million (or $0.16 per diluted share) in 1997 and $208.2 million (or $0.52 per diluted share) in 1996.

Liquidity & Capital Resources

Liquidity ~ The Company has three primary sources of liquidity: cash provided by operations, commercial paper and uncommitted lines of credit. Our commercial paper program is supported by a $670 million, five-year unsecured revolving credit facility that expires on May 30, 2002 and a $460 million, 364-day unsecured revolving credit facility that expires on June 26, 1999. Our credit facilities contain customary financial and operating covenants. We believe that the restrictions contained in these covenants do not materially affect our financial or operating flexibility. We can also obtain up to $35 million of short-term financing through various uncommitted lines of credit. As of December 31, 1998, we had $736.6 million of commercial paper outstanding at a weighted average interest rate of 5.8% and $34.5 million outstanding under our uncommitted lines of credit at a weighted average interest rate of 4.8%.

Capital Resources ~ With a total debt to capitalization ratio of 25.4% at December 31, 1998, we are pleased to report that our financial condition remained strong at year-end. Although there can be no assurance and assuming market interest rates remain favorable, we currently believe that we will continue to have access to capital at attractive interest rates in 1999.

Management's Discussion and Analysis of Financial

We further believe that our cash on hand and cash provided by operations, together with our ability to obtain additional short-term and long-term financing, will be sufficient to cover our future working capital needs, capital expenditures and debt service requirements. Please read the "Cautionary Statement Concerning Forward-Looking Statements" section below.

Capital Expenditures

Our capital expenditures totaled $502.3 million in 1998. This compares to $341.6 million in 1997 and $328.9 million in 1996. During 1998, we opened 184 new stores, relocated 198 existing stores and closed 156 stores. During 1999, we expect that our capital expenditures will total approximately $450-$500 million. This currently includes a plan to open 140 new stores, relocate 300 existing stores and close 130 stores. As of December 31, 1998, we operated 4,122 stores in 24 states and the District of Columbia. This compares to 4,094 stores as of December 31, 1997.

Goodwill

In connection with various acquisitions that were accounted for as purchase transactions, we recorded goodwill, which represented the excess of the purchase price we paid over the fair value of the net assets we acquired. The goodwill we recorded in these transactions is being amortized on a straight-line basis, generally over periods of 40 years.

We evaluate goodwill for impairment whenever events or changes in circumstances suggest that the carrying amount may not be recoverable. Under these conditions, we would compare our estimated future cash flows to our carrying amounts. If our carrying amounts exceeded our expected future cash flows, we would consider the goodwill to be impaired and we would record an impairment loss. We do not currently believe that any of our goodwill is impaired.

Recent Accounting Pronouncements

In March 1998, the American Institute of Certified Public Accountants issued Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," effective for fiscal years beginning after December 15, 1998. This statement defines which costs incurred to develop or purchase internal-use software should be capitalized and which costs should be expensed. We are in the process of determining what impact, if any, this pronouncement will have on our consolidated financial statements.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement requires companies to record derivative instruments on their balance sheet at fair value and establishes new accounting practices for hedge instruments. This statement is effective for years beginning after June 15, 1999. We are in the process of determining what impact, if any, this pronouncement will have on our consolidated financial statements.

Discriminatory Pricing Litigation Against Drug Manufacturers and Wholesalers

The Company is a party to two lawsuits that have been filed against various pharmaceutical manufacturers and wholesalers:

- The first lawsuit is a class action that alleges that manufacturers and wholesalers conspired to fix and/or stabilize the price of the prescription drugs sold to retail pharmacies in violation of the Sherman Antitrust Act. In this lawsuit, CVS is a member of the plaintiff class.

- The second lawsuit was filed by individual chain pharmacies, including Revco, as plantiffs. This lawsuit alleges unlawful price discrimination against retail pharmacies by manufacturers and wholesalers in violation of the Robinson-Patman Act, and asserts a conspiracy in violation of the Sherman Act. CVS became a party to this lawsuit when it acquired Revco.

With respect to the first lawsuit, fifteen defendants have agreed to settlements totaling $720 million. The class plaintiffs were not able to reach settlements with the four remaining defendants. As a result, a trial of the claims was commenced in September 1998. The trial resulted in a directed verdict in favor of the remaining defendents. The court has yet to approve a formula for distributing the settlement proceeds to class members. While we believe that our portion of the distribution could be significant, we cannot predict an exact dollar amount at this time.

With respect to the second lawsuit, a few settlements have been reached to date and the case is expected to go to trial in the latter part of 1999. Our portion of any settlement or judgment in this lawsuit could also be significant, but we cannot predict an exact dollar amount at this time.

Condition and Results of Operations *(continued)*

Year 2000 Compliance Statement

The "Year 2000 Issue" relates to the inability of certain computer hardware and software to properly recognize and process date-sensitive information for the Year 2000 and beyond. Without corrective measures, our computer applications could fail and/or produce erroneous results. To address this concern, we have a work plan in place to identify the potential issues that could affect our business. The following discussion will provide you with an update on where we stand on this important matter.

Information Technology ("IT") Systems ~ We have completed the assessment phase for each of our critical information technology systems. Our IT business systems include point-of-sale, Rx2000 pharmacy, supply chain management, financial accounting and other corporate office systems. To date, we have modified or replaced approximately 85% of our critical IT business systems. We currently expect to modify or replace the remaining critical business systems by the end of the second quarter of 1999 and complete our systems testing by the end of the third quarter of 1999.

Non-IT Systems ~ We are currently in the process of completing the assessment phase for each of our critical non-IT business systems, including those with embedded chip technology. Our non-IT business systems include distribution center logistics, HVAC, energy management, facility alarms and key entry systems. To date, we have modified or replaced approximately 30% of our critical non-IT business systems. We currently expect to modify or replace the remaining critical non-IT business systems and complete our systems testing by the end of the third quarter of 1999.

Business Partners ~ As part of our project work plan, we have been communicating with our key business partners, including our vendors, suppliers, financial institutions, managed care organizations, pharmacy benefit managers, third party insurance programs and governmental agencies to determine the status of their Year 2000 compliance programs. Although there can be no assurance that we will not be adversely affected by the Year 2000 issues of our business partners, we believe that ongoing communication will continue to minimize our risk.

Potential Risks ~ The potential risks associated with failing to remediate our Year 2000 issues include: temporary disruptions in store operations; temporary disruptions in the ordering, receiving and shipping of merchandise and in the ordering and receiving of other goods and services; temporary disruptions in the billing and collecting of accounts receivable; temporary disruptions in services provided by banks and other financial institutions; temporary disruptions in communication services; and temporary disruptions in utility services.

Incremental Cost ~ We currently estimate that the incremental cost associated with completing our Year 2000 work plan will be approximately $10 million, about half of which had been incurred through December 31, 1998. This estimate could change as additional information becomes available. The cost to resolve our Year 2000 issues will be funded through our operating cash flows.

Contingency Plan ~ We are currently in the process of developing a contingency plan for each area in our organization that could be affected by the Year 2000 issue. Although we currently anticipate minimal business disruption, the failure of either the Company or one or more of our major business partners to remediate critical Year 2000 issues could have a materially adverse impact on our business, operations and financial condition. Please read the "Cautionary Statement Concerning Forward-Looking Statements" section below.

Cautionary Statement Concerning Forward-Looking Statements

We have made forward-looking statements in this Annual Report that are subject to risks and uncertainties. For these statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. We strongly recommend that you become familiar with the specific risks and uncertainties that we have outlined for you under the caption "Cautionary Statement Concerning Forward-Looking Statements" in our Annual Report on Form 10-K for the year ended December 31, 1998.