We strongly recommend that you read our accompanying audited consolidated financial statements and footnotes along with this important discussion and analysis.

Results of Operations

Fiscal 1999, which ended on January 1, 2000, included 53 weeks, while fiscal 1998 and 1997, which ended on December 26, 1998 and December 27, 1997, respectively, included 52 weeks.

Net sales increased 18.5% in 1999 to $18.1 billion. This compares to increases of 11.1% in 1998 and 16.2% in 1997. Same-store sales, consisting of sales from stores that have been open for more than one year, rose 12.5% in 1999, 10.8% in 1998 and 9.7% in 1997. Pharmacy same-store sales increased 19.4% in 1999 and 16.5% in 1998 and 1997. Our pharmacy sales as a percentage of total net sales were 59% in 1999, 58% in 1998 and 55% in 1997. Our third party prescription sales as a percentage of total pharmacy sales were 87% in 1999, 84% in 1998 and 81% in 1997.

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 strong performance in the health and beauty, photo, seasonal, and general merchandise categories.

- The increase in net sales in 1999 was positively affected by the 53rd week. Excluding the positive impact of the 53rd week, net sales increased 16.0% in 1999 when compared to 1998.

- 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. Our performance during the conversion period was positively affected by temporary promotional events.

- 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 3 to the consolidated financial statements for other important information about the Big B acquisition.

- We continued 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 only 33% of our existing stores are freestanding. We currently expect to have approximately 40% of our stores in freestanding locations by the end of 2000. Our long-term goal is to have 80% of our stores located in freestanding sites. 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 26.9% in 1999. This compares to 27.0% in 1998 and 1997. Inventory shrinkage was 0.9% of net sales in 1999, compared to 0.8% of net sales in 1998 and 1997. As you review our gross margin performance, please remember to consider the impact of the following nonrecurring charges:

- During 1998, we recorded a $10.0 million charge to cost of goods sold to reflect markdowns on noncompatible Arbor merchandise, which resulted from the CVS/Arbor merger transaction. Please read Notes 2 and 3 to the consolidated financial statements for other important information about the CVS/Arbor merger.

- During 1997, we recorded a $75.0 million charge to cost of goods sold to reflect markdowns on noncompatible Revco merchandise, which resulted from the CVS/Revco merger transaction. Please read Notes 2 and 3 to the consolidated financial statements for other important information about the CVS/Revco merger.

If you exclude the effect of these nonrecurring charges, our comparable gross margin as a percentage of net sales was 26.9% in 1999, 27.1% in 1998 and 27.6% in 1997.

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 and/or renegotiated 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 20.6% of net sales in 1999. This compares to 22.1% in 1998 and 25.0% in 1997. As you review our performance in this area, please remember to consider the impact of the following nonrecurring charges:

- During 1998, we recorded a $147.3 million charge to operating expenses for direct and other merger-related costs pertaining to the CVS/Arbor merger transaction and related restructuring activities. In addition, we incurred $31.3 million of nonrecurring costs in connection with eliminating Arbor's information technology systems and Revco's noncompatible store merchandise fixtures. Please read Notes 2 and 3 to the consolidated financial statements for other important information about the CVS/Arbor merger.

- During 1997, we recorded a $337.1 million charge to operating expenses for direct and other merger-related costs pertaining to the CVS/Revco merger transaction and related restructuring activities. In addition, we incurred $54.3 million of nonrecurring costs in connection with eliminating Revco's information technology systems and removing Revco's noncompatible store merchandise fixtures. We also recorded a $31.0 million charge for certain costs associated with the restructuring of Big B, Inc. Please read Notes 2 and 3 to the consolidated financial statements for other important information about the CVS/Revco merger and Big B acquisition.

If you exclude the effect of the nonrecurring charges we incurred in 1998 and 1997, comparable operating expenses as a percentage of net sales were 20.6% in 1999, 20.9% in 1998 and 21.9% in 1997.

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

- 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.

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

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 $383.6 million to $1.1 billion in 1999. This compares to $751.9 million in 1998 and $281.7 million in 1997. If you exclude the effect of the nonrecurring charges we recorded in gross margin and in total operating expenses, our comparable operating profit increased $195.0 million (or 20.7%) to $1.1 billion in 1999. This compares to $940.5 million in 1998 and $779.1 million in 1997. Comparable operating profit as a percentage of net sales was 6.3% in 1999, 6.2% in 1998 and 5.7% in 1997.

Interest expense, net consisted of the following:

		Fiscal Year	
In millions	**1999**	1998	1997
Interest expense	**$ 66.1**	$ 69.7	$ 59.1
Interest income	**(7.0)**	(8.8)	(15.0)
Interest expense, net	**$ 59.1**	$ 60.9	$ 44.1

The decrease in interest expense in 1999 was primarily due to the fact that we replaced $300 million of our commercial paper borrowings with unsecured senior notes that bear a lower interest rate than our commercial paper. The increase in interest expense in 1998 was primarily due to higher average borrowing levels when compared to 1997. The decrease in interest income in 1998 was primarily due to interest income recognized during 1997 on a note receivable that we received when we sold Kay-Bee Toys in 1996. This note was sold in 1997.

Income tax provision ~ Our effective income tax rate was 41.0% in 1999 compared to 44.4% in 1998 and 62.8% in 1997. Our effective income tax rates were higher in 1998 and 1997 because certain components of the nonrecurring 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 $250.6 million to $635.1 million (or $1.55 per diluted share) in 1999. This compares to $384.5 million (or $0.95 per diluted share) in 1998 and $88.4 million (or $0.19 per diluted share) in 1997. If you exclude the effect of the nonrecurring charges we recorded in cost of goods sold and in total operating expenses, our comparable earnings from continuing operations before extraordinary item increased 24.5% to $635.1 million (or $1.55 per diluted share) in 1999. This compares to $510.1 million (or $1.26 per diluted share) in 1998 and $419.2 million (or $1.05 per diluted share) in 1997.

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. During 1997, we sold our remaining investment in Linens 'n Things and recorded, as a component of discontinued operations, an after-tax gain of $38.2 million. In connection with recording this gain, we also recorded, as a component of discontinued operations, an after-tax charge of $20.7 million during 1997 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 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 $635.1 million (or $1.55 per diluted share) in 1999. This compares to $384.5 million (or $0.95 per diluted share) in 1998 and $88.8 million (or $0.19 per diluted share) in 1997.

Liquidity & Capital Resources

Liquidity ~ The Company has three primary sources of liquidity: cash provided by operations, commercial paper and uncommitted lines of credit. We generally finance our inventory and capital expenditure requirements with internally generated funds and commercial paper. We currently expect to continue to utilize our commercial paper program to support our working capital needs. In addition, we may elect to use long-term borrowings in the future to support our continued growth.

Our commercial paper program is supported by a $670 million, five-year unsecured revolving credit facility that expires on May 30, 2002, and a $530 million, 364-day unsecured revolving credit facility that expires on June 21, 2000. We can also obtain up to $35.0 million of short-term financing through various uncommitted lines of credit. As of January 1, 2000, we had $451.0 million of commercial paper outstanding at a weighted average interest rate of 6.2%. There were no borrowings outstanding under the uncommitted lines of credit as of January 1, 2000.

On February 11, 1999, we issued $300 million of 5.5% unsecured senior notes due February 15, 2004. The proceeds from the issuance were used to repay outstanding commercial paper borrowings.

Our credit facilities and unsecured senior notes contain customary restrictive financial and operating covenants. We do not believe that the restrictions contained in these covenants materially affect our financial or operating flexibility.

Capital Resources ~ 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 2000. 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 for at least the next 12 months.

Net Cash Provided by Operations ~ Net cash provided by operations was $658.8 million in 1999. This compares to net cash provided by operations of $221.0 million in 1998 and net cash used in operations of $105.8 million in 1997. The improvement in net cash provided by operations was primarily the result of higher net earnings, improved working capital management and a reduction in cash payments associated with the Arbor and Revco mergers. You should be aware that cash flow from operations will continue to be negatively impacted by future payments associated with the Arbor and Revco mergers and the Company's strategic restructuring program. As of January 1, 2000, the future cash payments associated with these programs totaled $123.0 million. These payments primarily include: (i) $12.1 million for employee severance, which extends through 2000, (ii) $9.0 million for retirement benefits and related excess parachute payment excise taxes, which extend for a number of years to coincide with the future payment of retirement benefits, and (iii) $98.5 million for continuing lease obligations, which extend through 2020.

Capital Expenditures ~ Our capital expenditures totaled $493.5 million in 1999. This compared to $502.3 million in 1998 and $341.6 million in 1997. During 1999, we opened 146 new stores, relocated 299 existing stores and closed 170 stores. During 2000, we currently expect to open 425 stores, including 250 relocations. As of January 1, 2000, we operated 4,098 retail drugstores in 26 states and the District of Columbia.

Recent Accounting Pronouncements

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, which establishes the accounting and financial reporting requirements for derivative instruments, requires companies to recognize derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair value. In May 1999, the Financial Accounting Standards Board delayed the implementation date for this statement by one year. We expect to adopt SFAS No. 133 in 2001. We currently are in the process of determining what impact, if any, this pronouncement will have on our consolidated financial statements.

Cautionary Statement Concerning Forward-Looking Statements

We have made forward-looking statements in this Annual Report that are subject to risks and uncertainties that could cause actual results to differ materially. 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 fiscal year ended January 1, 2000.