

FREDs INC
Form 10-Q
September 13, 2007

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934.**

For the quarterly period ended August 4, 2007.

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 001-14565

FRED S, INC.

(Exact name of registrant as specified in its charter)

Tennessee
(State or other jurisdiction of
incorporation or organization)

62-0634010
(I.R.S. Employer
Identification No.)

4300 New Getwell Rd., Memphis, Tennessee
(Address of principal executive offices)

38118
(zip code)

(901) 365-8880

(Registrant's telephone number, including area code)

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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒.

The registrant had 40,177,050 shares of Class A voting, no par value common stock outstanding as of September 7, 2007.

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	August 4, 2007 (unaudited)	February 3, 2007
ASSETS:		
Current assets:		
Cash and cash equivalents	\$ 2,302	\$ 2,475
Inventories	347,594	304,969
Receivables, less allowance for doubtful accounts of \$767 and \$719, respectively	26,349	29,097
Other non-trade receivables	18,476	18,953
Prepaid expenses and other current assets	10,604	12,224
Total current assets	405,325	367,718
Property and equipment, at depreciated cost	139,070	138,031
Equipment under capital leases, less accumulated amortization of \$4,725 and \$4,578, respectively	242	390
Other noncurrent assets, net	9,060	9,570
Total assets	\$ 553,697	\$ 515,709
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 67,117	\$ 64,349
Current portion of indebtedness	849	385
Current portion of capital lease obligations	276	352
Accrued expenses and other	39,552	42,159
Deferred income taxes	14,635	16,396
Income taxes payable		4,188
Total current liabilities	122,429	127,829
Long-term portion of indebtedness	32,883	2,216
Deferred income taxes	11,550	12,425
Capital lease obligations, long term portion		115
Other noncurrent liabilities	11,072	3,856
Total liabilities	177,934	146,441

Commitments and Contingencies

Shareholders equity:

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Preferred stock, nonvoting, no par value, 10,000,000 shares authorized, none outstanding		
Preferred stock, Series A junior participating nonvoting, no par value, 224,594 shares authorized, none outstanding		
Common stock, Class A voting, no par value, 60,000,000 shares authorized, 40,131,686 and 40,068,953 shares issued and outstanding, respectively	137,649	135,803
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding		
Retained earnings	237,063	232,382
Accumulated other comprehensive income	1,051	1,083
Total shareholders' equity	375,763	369,268
Total liabilities and shareholders' equity	\$ 553,697	\$ 515,709

See accompanying notes to condensed consolidated financial statements.

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FRED S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(in thousands, except share and per share amounts)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	August 4, 2007	July 29, 2006	August 4, 2007	July 29, 2006
Net sales	\$ 424,640	\$ 406,925	\$ 866,902	\$ 823,803
Cost of goods sold	303,157	291,881	618,418	588,915
Gross profit	121,483	115,044	248,484	234,888
Depreciation and amortization	7,408	7,013	14,635	14,122
Selling, general and administrative expenses	108,373	101,826	216,990	203,513
Operating income	5,702	6,205	16,859	17,253
Interest income	(158)	(15)	(291)	(62)
Interest expense	395	235	432	277
Income before income taxes	5,465	5,985	16,718	17,038
Provision for income taxes	2,407	1,662	6,222	5,417
Net income	\$ 3,058	\$ 4,323	\$ 10,496	\$ 11,621
Net income per share				
Basic	\$.08	\$.11	\$.26	\$.29
Diluted	\$.08	\$.11	\$.26	\$.29
Weighted average shares outstanding				
Basic	39,864	39,753	39,851	39,732
Effect of dilutive stock options	118	96	123	99
Diluted	39,982	39,849	39,974	39,831
Dividends per common share	\$.02	\$.02	\$.04	\$.04

Comprehensive income:

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Net income	\$ 3,058	\$ 4,323	\$ 10,496	\$ 11,621
Other comprehensive income (expense), net of tax				
Postretirement plan adjustment	(16)		(32)	
Comprehensive income	\$ 3,042	\$ 4,323	\$ 10,464	\$ 11,621

See accompanying notes to condensed consolidated financial statements.

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FRED S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Twenty-six Weeks Ended	
	August	July 29,
	4,	2006
	2007	
Cash flows from operating activities:		
Net income	\$ 10,496	\$ 11,621
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	14,635	14,122
Net loss on asset disposition	48	15
Stock-based compensation	1,117	1,086
Provision for (recovery of) uncollectible receivables	48	(40)
LIFO reserve increase	921	1,632
Deferred income tax expense (benefit)	(2,636)	647
Provision for postretirement medical	(32)	
Excess tax benefits (charges) from stock-based compensation	7	(56)
(Increase) decrease in assets:		
Trade receivables	1,545	(8,284)
Insurance receivables	982	2,410
Inventories	(43,546)	(35,152)
Other assets	1,620	1,723
Increase (decrease) in liabilities:		
Accounts payable and accrued expenses	161	7,709
Income taxes payable	(4,195)	(6,140)
Other noncurrent liabilities	3,003	392
Net cash used in operating activities	(15,826)	(8,315)
Cash flows from investing activities:		
Capital expenditures	(12,770)	(11,373)
Proceeds from asset dispositions	280	98
Insurance recoveries for replacement assets	650	282
Asset acquisitions, net (primarily intangibles)	(695)	(2,861)
Net cash used in investing activities	(12,535)	(13,854)
Cash flows from financing activities:		
Payments of indebtedness and capital lease obligations	(575)	(665)
Proceeds from revolving line of credit, net of payments	30,068	22,811
Excess tax benefits from stock-based compensation	(7)	56
Proceeds from exercise of stock options and issuances under employee stock purchase plan	305	901
Cash dividends paid	(1,603)	(1,596)

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Net cash provided by financing activities	28,188	21,507
Increase (decrease) in cash and cash equivalents	(173)	(662)
Beginning of period cash and cash equivalents	2,475	3,145
End of period cash and cash equivalents	\$ 2,302	\$ 2,483
Supplemental disclosures of cash flow information:		
Interest paid	\$ 442	\$ 207
Income taxes paid	\$ 14,200	\$ 13,141
Non-cash investing and financial activities:		
Assets acquired with term loan	\$ 1,447	\$ 100
Common stock issued for purchase of capital assets	\$ 432	\$

See accompanying notes to condensed consolidated financial statements.

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FRED S. INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: BASIS OF PRESENTATION

Fred's and its subsidiaries (We , Our , Us or Company) operate, as of August 4, 2007, 701 discount general merchandise stores, including 24 franchised Fred's stores, in 15 states in the southeastern United States. 294 of the stores have full service pharmacies.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and are presented in accordance with the requirements of Form 10-Q and therefore do not include all information and notes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with GAAP. The statements do reflect all adjustments (consisting of only normal recurring accruals), which are, in the opinion of management, necessary for a fair presentation of financial position in conformity with GAAP. The statements should be read in conjunction with the Notes to the Consolidated Financial Statements for the fiscal year ended February 3, 2007 incorporated into our Annual Report on Form 10-K.

The results of operations for the twenty-six week period ended August 4, 2007 are not necessarily indicative of the results to be expected for the full fiscal year.

NOTE 2: RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements , (SFAS No. 157) which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. This statement is effective for our 2008 fiscal year, although early adoption is permitted. The Company is in the process of determining the effect, if any, that the adoption of SFAS 157 will have on its results of operations or financial position.

In February 2007, the Financial Accounting Standards Board issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 , (SFAS No. 159). SFAS No. 159 allows companies the choice to measure many financial instruments and certain other items at fair value. This gives a company the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently reviewing the impact of SFAS No. 159, if any, on our Consolidated Financial Statements and expect to complete this evaluation in 2007.

In March 2007, the Emerging Issues Task Force (EITF) reached a consensus on issue number 06-10, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements, (EITF 06-10). EITF 06-10 provides guidance to help companies determine whether a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement should be recorded in accordance with either SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions (if, in substance, a postretirement benefit plan exists), or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract). EITF 06-10 also provides guidance on how a company should recognize and measure the asset in a collateral assignment split-dollar life insurance contract. EITF 06-10 is effective for fiscal years beginning after December 15, 2007, although early adoption is permitted. The Company is in the process of determining the effect, if any, that the adoption of EITF 06-10 will have on its results of operations or financial position.

Table of Contents**NOTE 3: INVENTORIES**

Merchandise inventories are valued at the lower of cost or market using the retail first-in, first-out (FIFO) method for goods in our stores and the cost FIFO method for goods in our distribution centers. The retail inventory method is a reverse mark-up, averaging method which has been widely used in the retail industry for many years. This method calculates a cost-to-retail ratio that is applied to the retail value of inventory to determine the cost value of inventory and the resulting cost of goods sold and gross margin. The assumption that the retail inventory method provides for valuation at lower of cost or market and the inherent uncertainties therein are discussed in the following paragraphs. In order to assure valuation at the lower of cost or market, the retail value of our inventory is adjusted on a consistent basis to reflect current market conditions. These adjustments include increases to the retail value of inventory for initial markups to set the selling price of goods or additional markups to adjust pricing for inflation and decreases to the retail value of inventory for markdowns associated with promotional, seasonal or other declines in the market value. Because these adjustments are made on a consistent basis and are based on current prevailing market conditions, they approximate the carrying value of the inventory at net realizable value (market value). Therefore, the cost value of our inventory is stated at the lower of cost or market as is prescribed by U.S. GAAP.

Because the approximation of net realizable value (market value) under the retail inventory method is based on estimates such as markups, markdowns and inventory losses (shrink) there exists an inherent uncertainty in the final determination of inventory cost and gross margin. In order to mitigate that uncertainty, the Company has a formal review by product class which considers such variables as current market trends, seasonality, weather patterns and age of merchandise to ensure that markdowns are taken currently, or a markdown reserve is established to cover future anticipated markdowns. This review also considers current pricing trends and inflation to ensure that markups are taken if necessary. The estimation of inventory losses is a significant element in approximating the carrying value of inventory at net realizable value, and as such the following paragraph describes our estimation method as well as the steps we take to mitigate the risk of this estimate in the determination of the cost value of inventory.

The Company calculates inventory losses (shrink) based on actual inventory losses occurring as a result of physical inventory counts during each fiscal period and estimated inventory losses occurring between yearly physical inventory counts. The estimate for shrink occurring in the interim period between physical counts is calculated on a store-specific basis and is based on history, as well as performance on the most recent physical count. It is calculated by multiplying each store's shrink rate, which is based on the previously mentioned factors, by the interim period's sales for each store. Additionally, the overall estimate for shrink is adjusted at the corporate level to a three-year historical average to ensure that the overall shrink estimate is the most accurate approximation of shrink based on the Company's overall history of shrink. The three-year historical estimate is calculated by dividing the book-to-physical inventory adjustments for the trailing 36 months by the related sales for the same period. In order to reduce the uncertainty inherent in the shrink calculation, the Company first performs the calculation at the lowest practical level (by store) using the most current performance indicators. This ensures a more reliable number, as opposed to using a higher level aggregation or percentage method. The second portion of the calculation ensures that the extreme negative or positive performance of any particular store or group of stores does not skew the overall estimation of shrink. This portion of the calculation removes additional uncertainty by eliminating short-term peaks and valleys that could otherwise cause the underlying carrying cost of inventory to fluctuate unnecessarily. The Company has not experienced any significant change in shrink as a percentage of sales from year to year during the subject reporting periods.

Management believes that the Company's retail inventory method provides an inventory valuation which reasonably approximates cost and results in carrying inventory at the lower of cost or market. For pharmacy inventories, which were approximately \$34.3 million and \$36.4 million at August 4, 2007 and February 3, 2007, respectively, cost was determined using the retail last-in, first-

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out (LIFO) method in which inventory cost is maintained using the retail inventory method, then adjusted by application of the Producer Price Index published by the U.S. Department of Labor for the cumulative annual periods. The current cost of inventories exceeded the LIFO cost by approximately \$14.7 million at August 4, 2007 and \$13.8 million at February 3, 2007.

The Company has historically included an estimate of inbound freight and certain general and administrative expenses in merchandise inventory as prescribed by Generally Accepted Accounting Principles. These costs include activities surrounding the procurement and storage of merchandise inventory such as buying, warehousing, and accounting, as well as inbound freight. During the quarter ended August 4, 2007, we revised our estimate to include certain costs internally captured within our Merchandise Planning, Information Technology and Human Resources departments as they relate to the inventory functions and support of procurement and storage. This revision follows growth in the role of these departments in support of the procurement and warehousing functions, including additional personnel hired over the past few quarters. Further, our Merchandise Planning department has evolved from being previously included within the buying function to a stand alone function with responsibility for inbound logistics and commodity procurement. The inclusion of these expenses in the estimate resulted in an additional \$1.1 million pretax or \$.02 of earnings per share being capitalized as part of merchandise inventory. The total amount of expenses and inbound freight included in merchandise inventory as of the end of the second quarter is \$22.7 million.

NOTE 4: EQUITY INCENTIVE PLANS**Incentive stock option plan:**

The Company accounts for its stock-based compensation plans in accordance with Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, (SFAS No. 123(R)). Under SFAS No. 123(R) stock-based compensation expense is based on awards ultimately expected to vest, and therefore has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant based on the Company's historical forfeiture experience and will be revised in subsequent periods if actual forfeitures differ from those estimates.

SFAS 123(R) also requires the benefits of income tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required prior to SFAS 123(R).

A summary of the Company's stock-based compensation (a component of selling, general and administrative expenses) and related income tax benefit is as follows (*in thousands*):

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 4, 2007	July 29, 2006	August 4, 2007	July 29, 2006
Stock option expense	\$ 255	\$ 558	\$ 739	\$ 710
Restricted stock expense	134	115	274	222
ESPP expense	52	65	104	154
Total stock-based compensation	441	738	1,117	1,086
Income tax benefit on stock-based compensation	54	56	168	94

The fair value of each option granted during the periods indicated in the following table (there were no grants for the thirteen weeks ended August 4, 2007) are estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

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	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 4, 2007	July 29, 2006	August 4, 2007	July 29, 2006
Stock Options				
Expected volatility	N/A	41.6%	41.0%	41.5%
Risk-free interest rate	N/A	4.4%	4.4%	4.8%
Expected option life (in years)	N/A	5.84	5.84	5.84
Expected dividend yield	N/A	0.35%	0.40%	0.35%
Weighted average fair value at grant date	N/A	\$6.05	\$6.49	\$6.15
Employee Stock Purchase Plan				
Expected volatility	42.3%	33.5%	37.5%	33.5%
Risk-free interest rate	4.7%	4.8%	4.7%	4.8%
Expected option life (in years)	0.5	0.5	0.38	0.38
Expected dividend yield	0.30%	0.13%	0.23%	0.13%
Weighted average fair value at grant date	\$3.36	\$3.91	\$3.01	\$3.67

The following is a summary of the methodology applied to develop each assumption:

Expected Volatility This is a measure of the amount by which a price has fluctuated or is expected to fluctuate. The Company uses actual historical changes in the market value of our stock to calculate expected price volatility because management believes that this is the best indicator of future volatility. The Company calculates weekly market value changes from the date of grant over a past period representative of the expected life of the options to determine volatility. An increase in the expected volatility will increase compensation expense.

Risk-free Interest Rate This is the yield of a U.S. Treasury zero-coupon bond issue effective at the grant date with a remaining term equal to the expected life of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected Lives This is the period of time over which the options granted are expected to remain outstanding and is based on historical experience. Options granted have a maximum term of seven and one-half years. An increase in the expected life will increase compensation expense.

Dividend Yield This is based on the historical yield for a period equivalent to the expected life of the option. An increase in the dividend yield will decrease compensation expense.

Forfeiture Rate This is the estimated percentage of options granted that are expected to be forfeited or cancelled before becoming fully vested. This estimate is based on historical experience. An increase in the forfeiture rate will decrease compensation expense.

Employee stock purchase plan.

The 2004 Employee Stock Purchase Plan (the "2004 Plan"), which was approved by Fred's stockholders, permits eligible employees to purchase shares of our common stock through payroll deductions at the lower of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value at the time of exercise. There were 32,336 shares issued during the twenty-six weeks ended August 4, 2007. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of August 4, 2007, there were 1,262,905 shares available.

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The following table summarizes stock option activity during the twenty-six weeks ended August 4, 2007:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (Thousands)
Outstanding at February 3, 2007	1,103,064	\$16.74	4.2	\$ 298
Granted	17,500	\$14.73		
Forfeited / Cancelled	(26,250)	\$19.60		
Exercised				
Outstanding at August 4, 2007	1,094,314	\$16.64	3.8	\$ 0
Exercisable at August 4, 2007	403,203	\$17.37	2.9	\$ 0

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between Fred's closing stock price of \$11.53 on the last trading day of the period ended August 4, 2007 and the exercise price of the option multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on that date. As of August 4, 2007, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately \$1.43 million, which is expected to be recognized over a weighted average period of approximately 2.8 years. The total fair value of options vested during the twenty-six weeks ended August 4, 2007 was \$.58 million.

Restricted Stock

The following table summarizes restricted stock activity during the twenty-six weeks ended August 4, 2007:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested Restricted Stock at February 3, 2007	229,851	\$15.03
Granted	534	\$14.98
Forfeited / Cancelled	(389)	\$14.46
Vested	(6,619)	\$17.62
Non-vested Restricted Stock at August 4, 2007	223,377	\$15.04

The aggregate pre-tax intrinsic value of restricted stock outstanding as of August 4, 2007 is \$2.6 million with a weighted average remaining contractual life of 6.9 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding stock is approximately \$2.4 million, which is expected to be recognized over a weighted average period of approximately 6.5 years. The total fair value of restricted stock awards that vested during the twenty-six weeks ended August 4, 2007 was \$.11 million.

NOTE 5: Property and Equipment

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Property and Equipment are carried at cost. Depreciation is recorded using the straight-line method over the estimated useful lives of the assets. Improvements to leased premises are amortized using the straight-line method over the shorter of the initial term of the lease or the useful life of the improvement. Leasehold improvements added late in the lease term are amortized over the shorter of the remaining term of the lease (including the upcoming renewal option, if the renewal is reasonably assured) or the useful life of the improvement. Assets under capital leases are amortized in accordance with the Company's normal depreciation policy for owned assets or over the lease term (regardless of renewal options), if shorter, and the charge to earnings is included in depreciation expense in the consolidated financial statements. Gains or losses on the sale of assets are recorded at disposal as a component of operating income. The following illustrates the breakdown of the major categories within Property and Equipment:

	August 4, 2007 (unaudited)	February 3, 2007
Building and building improvements	\$ 80,236	\$ 76,623
Furniture, fixtures and equipment	220,891	216,448
Leasehold improvements	48,311	45,097
Automobiles and vehicles	6,555	6,429
Airplane	4,697	4,697
	360,690	349,294
Less: Accumulated Depreciation and Amortization	(226,792)	(215,879)
	133,898	133,415
Construction in Progress	814	353
Land	4,358	4,263
Total Property and Equipment, at depreciated cost	\$ 139,070	\$ 138,031

During the second quarter of fiscal 2007, the Company acquired the land and building, occupied by three Fred's stores which we had previously leased. In consideration for the three properties, the Company paid cash of \$.425 million, issued 32,578 shares of our common stock valued at \$.432 million and assumed debt of \$.836 million current and \$.611 million long term. The long term debt has a fixed interest rate of 6.90% and matures on February 1, 2015. The Company intends to acquire an additional eleven properties consisting of land and building presently leased by a Fred's store through the issuance of our common stock, assumption of debt and payment of cash.

NOTE 6: Income taxes

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109*. We adopted FIN 48 as of February 4, 2007, the first day of fiscal 2007. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109 and prescribes a minimum recognition threshold of more-likely-than-not to be sustained upon examination that a tax position must meet before being recognized in the financial statements. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

As a result of the adoption of FIN 48, we recognized a cumulative effect adjustment of \$4.2 million decrease to beginning retained earnings and a reclassification of certain amounts between deferred income taxes (\$2.3 million decrease) and other non-current liabilities (\$6.5 million increase, including

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\$1.0 million of interest and penalties) to conform to the balance sheet presentation requirements of FIN 48. During the first six months of 2007, our FIN 48 reserve increased by \$0.2 million, including \$0.1 million of accrued interest. The Company includes potential interest and penalties recognized in accordance with FIN 48 in the financial statements as a component of income tax expense.

The Company had approximately \$8.0 million of unrecognized tax benefits as of August 4, 2007. If recognized, approximately \$5.9 million of the unrecognized tax benefits would affect the Company's effective income tax rate. We are subject to U.S. federal income tax as well as the income tax of multiple state jurisdictions. The Company is open to federal and state tax audits until the applicable statutes of limitation expire. The tax years 2000 through 2006 remain open to examination by the major taxing jurisdictions to which we are subject.

NOTE 7: Exit and disposal activities

During the year ended February 3, 2007, the Company recorded a below-cost inventory adjustment of approximately \$1.2 million associated with the discontinuance of the boys and girls apparel departments. Also the Company recorded an additional below-cost inventory adjustment of \$0.9 million for planned store closings. Both adjustments were recorded in cost of goods sold in the consolidated statements of income for the year ended February 3, 2007.

The Company also recorded approximately \$0.9 million in selling, general and administrative expense in the consolidated statements of income for the year ended February 3, 2007 to reflect impairment charges for furniture and fixtures and leasehold improvements relating to the planned store closures mentioned above. Liability balances related to activities discussed above for stores closed during the first six months ended August 4, 2007 are as follows (in millions):

	Beginning Balance February 3, 2007	Utilized during first 6 months 2007	Ending Balance August 4, 2007
Inventory markdowns for discontinuance of boys & girls apparel	\$1.2	\$ 0.8	\$ 0.4
Inventory markdowns for planned store closings	0.9	0.7	0.2
Asset impairment for planned store closings	0.9	0.5	0.4
	\$3.0	\$ 2.0	\$ 1.0

During the current year, the Company has incurred or expects to incur the following pretax costs associated with said store closings (in millions):

	Estimated Total	Incurred in 2007	Remaining
Lease contract termination costs	\$1.7	\$ 1.4	\$ 0.3
Total	\$1.7	\$ 1.4	\$ 0.3

In addition to those stores that might be closed in the ordinary course of business, the Company is planning approximately 20 store and pharmacy closings during the course of 2007 (16 of which have been closed as of August 4, 2007).

NOTE 8: Accumulated other comprehensive income

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Accumulated Other Comprehensive Income

(in thousands)	Twenty-Six Weeks Ended		Year Ended
	August 4, 2007	July 29, 2006	February 3, 2007
Accumulated other comprehensive income	\$ 1,083	\$ 0	\$ 0
Adjustment to initially apply SFAS No. 158 (net of tax)			1,083
Amortization of postretirement benefit	(32)	0	
Ending balance	\$ 1,051	\$ 0	\$ 1,083

Effective February 3, 2007, the Company began recognizing the funded status of its postretirement benefits plan in accordance with SFAS No. 158. SFAS No. 158 requires the Company to display the net over-or under funded position of a defined benefit postretirement plan as an asset or liability, with any unrecognized prior service costs, transition obligations or actuarial gains/losses reported as a component of accumulated other comprehensive income in stockholders' equity. The activity within accumulated other comprehensive income in the first six months of 2007 represents the amortization of prior service cost and net actuarial gains and losses through net periodic benefit cost.

Item 2:

**Management's Discussion and Analysis of Financial
Condition and Results of Operations**

GENERAL**Executive Overview**

During the first six months of 2007, we continued our strategy of refreshing and revitalizing our stores and capitalizing on our 60 years of experience in the discount retail sector. Our Merchandise Refresher Program continued in the second quarter, reaching completion in approximately 65% of our stores as of August 4, 2007. This program refreshes the look and feel of our stores with new paint and flooring, updated signage and the expansion and relocation of several departments. Additionally, our new branding and advertising campaign, which focuses on our 60 year history while emphasizing the new look and feel of Fred's continued throughout the quarter. During the second quarter of 2007 we embarked on two additional strategies to enhance our customers experience when visiting our stores. The first involves a new extensive market research program to determine customer preferences and expectations in a visit to a Fred's store and the second involves a new site selection and real estate program to determine which locations best suit our customers.

The integration of the aforementioned strategies coupled with our unique store layout allows us to offer our customers all the attractive elements of a discount dollar store, drug store and mass merchant under one roof. By offering elements of all three types of businesses, we are able to provide our customers with a ten minute Superstore experience in a smaller, easier and more convenient store layout.

As discussed in our Form 10-K for the fiscal year ended February 3, 2007, we slowed our new store growth in the first six months and will continue to do so through the remainder of the year. This slow down in growth, coupled with the closing of unproductive stores, should have a positive impact on the Company's operating margin over time. In the first six months of 2007, the Company opened 16 new stores and closed 16 stores. The majority of our new store openings were in Alabama, Texas, and Mississippi. We did not enter into any new states during the quarter. Additionally, we opened nine new pharmacies and closed four pharmacies during the first six months of 2007. The Company continued during the first six months to see paybacks on productivity improvements and key technology initiatives. Some of these include continuing enhancement of our point of sale and radio frequency (RF) store systems, refinement and upgrades to our merchandise planning and allocation systems and process and

productivity standards improvements in our distribution centers. Pharmacy system improvements that enhance customer service also continue to be a key initiative.

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During the remainder of 2007, we intend to continue with capital improvements in infrastructure, including new store expansion, distribution center upgrades and further development of our information technology capabilities.

As previously reported, the Company expects an increase of 6 % to 12% in earnings per diluted share for 2007. The Company bases this increase in estimated earnings for fiscal 2007 on the following assumptions:

Comparable store sales are anticipated to increase in the range of 1% to 3% in the third and fourth quarter.

The Company expects to open 14 to 19 more new stores, and 3 to 6 more new pharmacies, and expects to close 4 to 9 more stores during the remainder of fiscal 2007, netting growth in selling square footage in the range of 1% to 3% for the year.

Minimum wage legislation which went into effect on July 24, 2007 should benefit our customers, thereby increasing our sales, which offset expenses of increased labor costs.

We anticipate additional expenses of approximately \$0.3 million associated with previously announced store closings.

Key factors that will be critical to the Company's future success include managing the growth strategy for new stores and pharmacies, including the ability to open and operate efficiently, maintaining high standards of customer service, maximizing efficiencies in the supply chain, controlling working capital needs through improved inventory turnover, controlling the effects of inflation, especially in regard to occupancy costs, increasing operating margin through improved gross margin and leveraging operating costs, and generating adequate cash flow to fund the Company's expansion.

Other factors that will affect Company performance in 2007 include the continuing management of the impacts of the changing regulatory environment in which our pharmacy department operates, especially the anticipated implementation of the federally approved change in pricing of generic pharmaceuticals to Average Manufacturer's Price (AMP), which could negatively affect gross margin. Also, the Company experienced an initial negative impact in selling, general and administrative expenses from the recent raising of the Federal minimum wage; however, the increase should be a positive factor over time because it will directly impact the disposable income of our primary customer base.

Our business is subject to seasonal influences, but has tended to experience less seasonal fluctuation than many other retailers due to the mix of everyday basic merchandise and pharmacy business. Our fiscal fourth quarter is typically the most profitable quarter because it includes the Christmas selling season. The overall strength of the fourth quarter is partially mitigated, however, by the inclusion of the month of January, which is generally the least profitable month of the year.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The critical accounting matters that are particularly important to the portrayal of the Company's financial condition and results of operations and require some of management's most difficult, subjective and complex judgments are described in detail in the Company's Annual Report on Form 10-K for the fiscal year ended February 3, 2007. The preparation of condensed financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to inventories, income taxes, insurance reserves, contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The only material changes in critical

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accounting policies during the twenty-six weeks ended August 4, 2007, was the adoption of FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No.109, which was discussed in detail in Note 6 of the financial statements included elsewhere in this document.

The only material change in estimate during the twenty-six weeks ended August 4, 2007 was the addition of certain Merchandise Planning, Information Technology and Human Resource costs to the calculation used to estimate the costs capitalized as part of merchandise inventory. Previously, these costs have not been included in the calculation used to estimate the costs capitalized as part of merchandise inventory and the Company believes that their inclusion provides a more complete and comprehensive merchandise inventory value. This change is discussed in more detail in Note 3 of the financial statements included elsewhere in this document.

RESULTS OF OPERATIONS**Thirteen Weeks Ended August 4, 2007 and July 29, 2006**

Net sales increased to \$424.6 million in 2007 from \$406.9 million in 2006, an increase of \$17.7 million or 4.3%. The increase was attributable to comparable store sales increases of 0.8% (\$3.2 million) and sales by stores not yet included as comparable stores (\$14.1 million). Sales to franchisees increased \$.4 million in 2007 compared to the same quarter last year. The sales mix for the period was 32.6% Pharmaceuticals, 23.8% Household Goods, 10.0% Apparel and Linens, 14.1% Food and Tobacco, 9.2% Paper and Cleaning Supplies, 8.2% Health and Beauty Aids, and 2.1% Franchise. This compares with 33.0% Pharmaceuticals, 22.5% Household Goods, 12.4% Apparel and Linens, 12.8% Food and Tobacco, 8.2% Health and Beauty Aids, 9.0% Paper and Cleaning Supplies, and 2.1% Franchise for the same period last year.

Gross profit increased to 28.6% of sales in 2007 compared with 28.3% of sales in the prior-year period. The improvement is primarily a result of controlling shrink in the general merchandise and pharmacy departments, as well as pharmacy department benefits gained through the shift from branded drugs to generics, which have a larger profit margin.

Selling, general and administrative expenses increased to \$115.8 million in 2007 from \$108.8 million in 2006. The increase in the quarter is primarily attributed to lease termination costs related to store closings (0.20%), store expenses related to our store refresher program (0.15%), additional advertising expenses related to our branding campaign (0.10%), and insurance cost (0.05%). As a percentage of sales, expenses increased to 27.2% of sales compared to 26.8% of sales last year.

For the second quarter of 2007, the Company incurred net interest expense of \$0.2 million, the same as in 2006.

For the second quarter of 2007, the effective income tax rate was 44.0%, as compared to 27.8% in the second quarter of last year. The increase in the tax rate in the second quarter resulted from a higher overall state income tax rate this year as well as the post-implementation effect of FIN 48, Accounting for Uncertainty in Income Taxes .

Twenty-six Weeks Ended August 4, 2007 and July 29, 2006

Net sales increased to \$866.9 million in 2007 from \$823.8 million in 2006, an increase of \$43.1 million or 5.2%. The increase was attributable to comparable store sales increases of 1.3% (\$10.7 million) and sales by stores not yet included as comparable stores (\$31.7 million). Sales to franchisees increased \$0.7 million in 2007. The sales mix for the period was 32.9% Pharmaceuticals, 23.4% Household Goods, 14.2% Food and Tobacco, 10.2% Apparel and Linens, 9.0% Paper and Cleaning Supplies, 8.2% Health and Beauty Aids, and 2.1% Franchise. This compares with 32.6% Pharmaceuticals, 22.3% Household Goods, 13.0% Apparel and Linens, 13.1% Food and Tobacco, 8.7 % Paper and Cleaning Supplies, 8.2% Health and Beauty Aids, and 2.1% Franchise for the same period last year.

For the twenty-six weeks ended August 4, 2007, we opened 16 new stores and 9 new pharmacies and we closed 16 stores and 4 pharmacies.

Gross profit increased to 28.7% of sales in 2007 compared with 28.5% of sales in the prior-year period. Gross profit margin for the first six months was favorably affected by the same factors as listed for the second quarter.

Selling, general and administrative expenses increased to \$231.6 million in 2007 from \$217.6 million in 2006. As a percentage of sales, expenses increased to 26.7% of sales compared to 26.4% of sales last year. The increase in expenses as a percent to sales results primarily from lease termination costs (.16%) and expenses related to the merchandise refresher program (.10%).

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For the first six months of 2007, we incurred net interest expense of \$0.1 million as compared to net interest expense of \$0.2 million last year. The decrease in interest results from better management of cash flow.

For the first six months of 2007, the effective income tax rate was 37.2%, compared with 31.8% for last year. The increase in the rate resulted primarily from the same issues as mentioned in the quarter. We anticipate the tax rate for the remaining two quarters of 2007 to be in the 36% to 38% range.

LIQUIDITY AND CAPITAL RESOURCES

Due to the seasonality of our business and the continued increase in the number of stores and pharmacies, inventories are generally lower at year-end than at each quarter-end of the following year.

Cash used in operating activities totaled \$15.8 million during the twenty-six week period ended August 4, 2007. Cash was primarily used to increase inventories by approximately \$43.5 million in the first six months of 2007. This increase was primarily attributable to 16 new stores and increases in our basic product inventories to improve in-stock positions, and additional inventories related to the new stationery program and check-out aisle resets.

Cash used in investing activities totaled \$12.5 million, and consisted primarily of capital expenditures associated with the store and pharmacy expansion program (\$6.2 million), acquisition of LLCs owning land and buildings (\$0.4 million), expenditures related to the Store Refresher Program (\$4.9 million) and technology and other corporate expenditures (\$1.2 million). During the first six months of 2007, we opened 16 stores, closed 16 stores, opened 9 pharmacies, and closed 4 pharmacies. We expect to open 8 to 10 stores in the third quarter and approximately 30 to 35 stores for the year. In 2007, the Company is planning capital expenditures totaling approximately \$31.9 million. Expenditures are planned totaling approximately \$24.7 million for upgrades, remodels, or new stores and pharmacies or acquisitions of land and buildings; \$5.2 million for technology upgrades, \$2.0 million for distribution center equipment and capital replacements. In addition, the Company also plans expenditures of \$2.6 million for the acquisition of customer lists and other pharmacy related items. Depreciation expense for 2007 will be approximately \$29 million.

Cash provided by financing activities totaled \$28.2 million and included \$30.1 million of borrowings under the Company's revolving credit agreement for inventory needs. There were \$32.2 million in borrowings against our revolving line of credit outstanding at August 4, 2007 and \$2.2 million in borrowings against our revolving line of credit outstanding at February 3, 2007.

We believe that sufficient capital resources are available in both the short-term and long-term through currently available cash and cash generated from future operations and, if necessary, the ability to obtain additional financing.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Other than statements based on historical facts, many of the matters discussed in this Form 10-Q relate to events which we expect or anticipate may occur in the future. Such statements are defined as forward-looking statements under the Private Securities Litigation Reform Act of 1995 (the Reform Act), 15 U.S.C.A. Sections 77z-2 and 78u-5 (Supp. 1996). The Reform Act created a safe harbor to protect companies from securities law liability in connection with forward-looking statements. We intend to qualify both our written and oral forward-looking statements for protection under the Reform Act and any other similar safe harbor provisions.

The words believe, anticipate, project, plan, expect, estimate, objective, forecast, goal, intend, will, continue and similar expressions generally identify forward-looking statements. All forward-looking statements are inherently uncertain, and concern matters that involve risks and other factors that may cause the

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actual performance of the Company to differ materially from the performance expressed or implied by these statements. Therefore, forward-looking statements should be evaluated in the context of these uncertainties and risks, including but not limited to:

- o Economic and weather conditions which affect buying patterns of our customers and supply chain efficiency.
- o Changes in consumer spending and our ability to anticipate buying patterns and implement appropriate inventory strategies.
- o Continued availability of capital and financing.
- o Competitive factors.
- o Changes in reimbursement practices for pharmaceuticals.
- o Governmental regulation.
- o Increases in fuel and utility rates.
- o other factors affecting business beyond our control, including (but not limited to) those discussed under Part 1, ITEM 1A Risk Factors of the Company's Annual Report on Form 10-K for the fiscal year ended February 3, 2007.

Consequently, all forward-looking statements are qualified by this cautionary statement. We undertake no obligation to update any forward-looking statement to reflect events or circumstances arising after the date on which it was made.

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We have no holdings of derivative financial or commodity instruments as of August 4, 2007. We are exposed to financial market risks, including changes in interest rates. All borrowings under our Revolving Credit Agreement bear interest at 1.5% below prime rate or a LIBOR-based rate. An increase in interest rates of 100 basis points would not significantly affect our income. All of our business is transacted in U.S. dollars and, accordingly, foreign exchange rate fluctuations have not had a significant impact on us, and they are not expected to in the foreseeable future.

Item 4.

CONTROLS AND PROCEDURES

(a) Disclosure Controls and Procedures. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer, concluded that, as of the date of their evaluation, the Company's disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company's periodic SEC reports, subject to the effectiveness of the Company's internal control over financial reporting. Consistent with the suggestion of the Securities and Exchange Commission, the Company has formed a Disclosure Committee consisting of key Company personnel designed to review the accuracy and completeness of all disclosures made by the Company.

(b) Changes in Internal Control over Financial Reporting. There have been no changes in the Company's internal control over financial reporting that occurred during the Company's second fiscal quarter that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

The Company is party to several pending legal proceedings and claims arising in the normal course of business including those mentioned in Part I Item 3. Legal Proceedings in the Annual Report on Form 10-K for the fiscal year ended February 3, 2007. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the Company is of the opinion that it is unlikely that these proceedings and claims will have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. There can be no assurance that pending lawsuits will not consume the time and energy of our management, or that future developments will not cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole. We intend to vigorously defend or prosecute each pending lawsuit.

Item 1A. RISK FACTORS

The risk factors listed in Part I Item 1A. Risk Factors in the Annual Report on Form 10-K for the fiscal year ended February 3, 2007, should be considered with the information provided elsewhere in this Quarterly Report on Form 10-Q, which could materially adversely affect the business, financial condition or results of operations. There have been no material changes to the risk factors as previously disclosed in such Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On July 16, 2007 and July 20, 2007, we sold in a private placement an aggregate of 32,578 shares of Class A common stock to Summit Properties, LLC (Summit) pursuant to the exemptions from registration provided in Section 4(2) of the Securities Act of 1933, as amended (the Act), and Rule 506 of Regulation D promulgated thereunder. The shares were issued in connection with our acquisition of the membership interests of certain LLCs and related real estate rights. The shares have subsequently been registered under the Act. We will not receive any proceeds from the sale of these shares.

The private placement that we made in reliance on the exemptions from registration under Section 4(2) of the Act and Rule 506 of Regulation D thereunder did not involve any public offering of common stock. In addition, Summit provided us with written representations that it was an accredited investor within the meaning of Rule 501(e) of Regulation D, that it was a sophisticated investor and that it had the knowledge and experience necessary to evaluate the risks and merits of the investment in our common stock. In addition, Summit was solicited on a private and confidential basis in a manner not involving any general solicitation or advertising in compliance with Regulation D.

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

The Annual Meeting of the Shareholders of Fred's, Inc. was held on June 20, 2007. Michael J. Hayes, John R. Eisenman, Roger T. Knox, John D. Reier, Thomas H. Tashjian, B. Mary McNabb and Michael T. McMillan were elected as directors of the Company. The shareholders also ratified the appointment of BDO Seidman, LLP as our registered public accounting firm for the fiscal year ending February 2, 2008. The shareholders also rejected the shareholder proposal regarding vendor code of conduct.

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The results of the voting were as follows:

	For	Abstain/ Against	Withheld	Broker Non-Vote
Election of Directors:				
Michael J. Hayes	33,434,925		2,863,107	3,769,486
John R. Eisenman	33,921,972		2,376,060	3,769,486
Roger T. Knox	33,919,077		2,378,955	3,769,486
John D. Reier	34,550,402		1,747,630	3,769,486
Thomas H. Tashjian	34,171,572		2,126,460	3,769,486
B. Mary McNabb	34,994,351		1,303,681	3,769,486
Michael T. McMillan	34,997,352		1,300,680	3,769,486

Appointment of BDO Seidman, LLP	36,206,165	91,867	3,769,486
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Shareholder Proposal	2,907,172	29,394,444	7,765,902
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Item 6. Exhibits

Exhibits:

31.1 Certification of Chief Executive Officer.

31.2 Certification of Chief Financial Officer.

32. Certification of Chief Executive Officer and Chief Financial Officer pursuant to rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FRED S, INC.

Date: September 13, 2007

/s/ Michael J. Hayes
Michael J. Hayes
Chief Executive Officer

Date: September 13, 2007

/s/ Jerry A. Shore
Jerry A. Shore
Chief Financial Officer
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