

FREDS INC  
Form 10-Q  
September 11, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**<sup>x</sup> QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the quarterly period ended August 2, 2014.

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                      62-0634010  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification Number)

**4300 New Getwell Road**

**Memphis, Tennessee 38118**

(Address of Principal Executive Offices)

(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 has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes  No .

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

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 36,882,261 shares of Class A voting, no par value common stock outstanding as of September 5, 2014.

**FRED'S, INC.**

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**Part I – FINANCIAL INFORMATION****Item 1. Financial Statements**

FRED'S, INC.

**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except for number of shares)

	August 2, 2014 (unaudited)	February 1, 2014
<b><u>ASSETS</u></b>		
Current assets:		
Cash and cash equivalents	\$ 8,088	\$ 6,725
Receivables, less allowance for doubtful accounts of \$3,337 and \$2,097, respectively	36,767	35,161
Inventories	341,976	361,993
Other non-trade receivables	41,382	39,108
Prepaid expenses and other current assets	12,344	13,245
Total current assets	440,557	456,232
Property and equipment, at depreciated cost	146,283	153,363
Equipment under capital leases, less accumulated amortization of \$5,129 and \$5,111, respectively	11	29
Intangibles	65,426	54,580
Other noncurrent assets, net	11,006	3,582
Total assets	\$ 663,283	\$ 667,786
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 121,383	\$ 125,925
Current portion of indebtedness	2,024	1,640
Accrued expenses and other	46,095	46,236
Deferred income taxes	24,570	24,446
Total current liabilities	194,072	198,247
Long-term portion of indebtedness	15,181	3,578
Other noncurrent liabilities	15,172	14,413
Total liabilities	224,425	216,238

Commitments and Contingencies (See Note 9 - Legal 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, 36,868,943 and 36,791,279 shares issued and outstanding, respectively	104,569	102,524
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding	-	-
Retained earnings	333,586	348,321
Accumulated other comprehensive income	703	703
Total shareholders' equity	438,858	451,548
Total liabilities and shareholders' equity	\$ 663,283	\$ 667,786

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(in thousands, except per share amounts)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 2, 2014	August 3, 2013	August 2, 2014	August 3, 2013
Net sales	\$491,185	\$482,176	\$989,449	\$983,671
Cost of goods sold	377,516	346,191	733,306	696,667
Gross profit	113,669	135,985	256,143	287,004
Depreciation and amortization	10,210	10,527	20,049	20,828
Selling, general and administrative expenses	129,600	120,245	252,206	243,179
Operating income (loss)	(26,141 )	5,213	(16,112 )	22,997
Interest expense	163	129	298	264
Income (loss) before income taxes	(26,304 )	5,084	(16,410 )	22,733
Provision (benefit) for income taxes	(9,870 )	1,754	(6,094 )	7,992
Net income (loss)	\$ (16,434 )	\$ 3,330	\$ (10,316 )	\$ 14,741
Net income (loss) per share				
Basic	\$ (0.45 )	\$ 0.09	\$ (0.28 )	\$ 0.40
Diluted	\$ (0.45 )	\$ 0.09	\$ (0.28 )	\$ 0.40
Weighted average shares outstanding				
Basic	36,635	36,521	36,611	36,525
Effect of dilutive stock options	147	164	188	139
Diluted	36,782	36,685	36,799	36,664
Dividends per common share	\$0.06	\$0.06	\$0.12	\$0.12

FRED'S, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

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(in thousands)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 2, 2014	August 3, 2013	August 2, 2014	August 3, 2013
Net income (loss)	\$ (16,434 )	\$ 3,330	\$ (10,316 )	\$ 14,741
Other comprehensive income (expense), net of tax postretirement plan adjustment	-	-	-	-
Comprehensive income	\$ (16,434 )	\$ 3,330	\$ (10,316 )	\$ 14,741

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Twenty Six Weeks Ended	
	August 2, 2014	August 3, 2013
Cash flows from operating activities:		
Net income (loss)	\$ (10,316 )	\$ 14,741
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	20,049	20,828
Net gain on asset disposition	(2,707 )	(663 )
Provision (benefit) for store closures and asset impairment	14,922	(34 )
Stock-based compensation	1,364	1,214
Provision for uncollectible receivables	1,240	171
LIFO reserve increase	2,111	2,516
Deferred income tax benefit	(7,414 )	(822 )
Income tax (charge) benefit upon exercise of stock options	(58 )	32
Changes in operating assets and liabilities:		
(Increase) decrease in operating assets:		
Trade and non-trade receivables	1,668	1,400
Insurance receivables	-	(62 )
Inventories	5,932	2,460
Other assets	901	601
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	(5,247 )	(10,884 )
Income taxes payable	(6,022 )	(1,265 )
Other noncurrent liabilities	729	804
Net cash provided by operating activities	17,152	31,037
Cash flows from investing activities:		
Capital expenditures	(11,300 )	(13,953 )
Proceeds from asset dispositions	3,807	2,245
Asset acquisition, net (primarily intangibles)	(16,545 )	(7,790 )
Net cash used in investing activities	(24,038 )	(19,498 )
Cash flows provided by (used in) financing activities:		
Payments of indebtedness and capital lease obligations	(992 )	(1,152 )
Proceeds from revolving line of credit	304,154	170,645
Payments on revolving line of credit	(291,175 )	(177,639 )
Excess tax charges from stock-based compensation	58	(32 )

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Proceeds from exercise of stock options and employee stock purchase plan	622	856
Cash dividends paid	(4,418 )	(4,409 )
Net cash provide by (used in) financing activities	8,249	(11,731 )
Increase (decrease) in cash and cash equivalents	1,363	(192 )
Cash and cash equivalents:		
Beginning of year	6,725	8,129
End of period	\$ 8,088	\$ 7,937
Supplemental disclosures of cash flow information:		
Interest paid	\$ 298	\$ 264
Income taxes paid	\$ 8,021	\$ 9,912

See accompanying notes to consolidated financial statements.

**FRED'S, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**NOTE 1: BASIS OF PRESENTATION**

Fred's, Inc. and subsidiaries ("Fred's", "We", "Our", "Us" or "Company") operates, as of August 2, 2014, 704 discount general merchandise stores, including 21 franchised Fred's stores, in 15 states in the southeastern United States. There are 357 full service pharmacy departments located within our discount general merchandise stores.

The accompanying unaudited condensed 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 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 1, 2014 incorporated into Our Annual Report on Form 10-K.

Certain prior year amounts have been reclassified to conform to the 2014 presentation (for changes in the balance sheet for state and franchise tax receivables in accrued expenses).

The results of operations for the thirteen week and twenty-six week periods ended August 2, 2014 are not necessarily indicative of the results to be expected for the full fiscal year.

**NOTE 2: 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 assumptions 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, after applying the cost to retail ratio, the cost value of our inventory is stated at the lower of cost or market as is prescribed by 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 (shrink) 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 methodology that we have applied in estimating shrink has resulted in variability that is not material to our financial statements.

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 \$38.4 million and \$40.4 million at August 2, 2014 and February 1, 2014, respectively, cost was determined using the retail last-in, first-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 \$37.3 million at August 2, 2014 and \$35.2 million at February 1, 2014.

The Company has historically included an estimate of inbound freight and certain general and administrative costs in merchandise inventory as prescribed by GAAP. These costs include activities surrounding the procurement and storage of merchandise inventory such as merchandise planning and buying, warehousing, accounting, information technology and human resources, as well as inbound freight. The total amount of procurement and storage costs and inbound freight, inclusive of the accelerated recognition of freight capitalization expense, included in merchandise inventory at August 2, 2014 is \$18.3 million, with the corresponding amount of \$21.6 million at February 1, 2014.

In the second quarter of 2014, the Company established a reserve for inventory clearance of product that management identified as low-productive and does not fit our go-forward convenience/pharmacy-centric store model. The Company recorded a below-cost inventory adjustment in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 330, "Inventory," of approximately \$11.6 million (including \$1.6 million, for the accelerated recognition of freight capitalization expense) in cost of goods sold to value inventory at the lower of cost or market on inventory identified as low-productive, which the Company will be liquidating in accordance with our new strategy.

The following table illustrates the inventory markdown reserve activity related to the low-productive inventory discussed in the previous paragraph (in millions):

	Balance at February 1, 2014	Additions	Utilization	Ending Balance August 2, 2014
Inventory markdown on low-productive inventory	\$ -	\$ 10.0	\$ -	\$ 10.0
Inventory provision for freight capitalization expense	\$ -	\$ 1.6	\$ -	\$ 1.6
Total:	\$ -	\$ 11.6	\$ -	\$ 11.6

#### NOTE 3: STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation plans in accordance with the FASB ASC 718 “Compensation – Stock Compensation”. Under FASB ASC 718, 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.

FASB ASC 718 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 FASB ASC 718. 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 2, 2014	August 3, 2013	August 2, 2014	August 3, 2013
Stock option expense	\$ 259	\$ 154	\$ 461	\$ 317
Restricted stock expense	386	432	793	793
ESPP expense	55	52	110	104
Total stock-based compensation	\$ 700	\$ 638	\$ 1,364	\$ 1,214
Income tax benefit on stock-based compensation	\$ 183	\$ 183	\$ 359	\$ 342

The fair value of each option granted during the thirteen and twenty-six week periods ended August 2, 2014 and August 3, 2013 is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 2, 2014	August 3, 2013	August 2, 2014	August 3, 2013
<u>Stock Options</u>				
Expected volatility	36.6%	38.8 %	36.7%	39.0 %
Risk-free interest rate	1.8 %	1.0 %	1.8 %	1.0 %
Expected option life (in years)	5.84	5.84	5.84	5.84
Expected dividend yield	1.55%	1.34 %	1.55%	1.28 %
Weighted average fair value at grant date	\$5.40	\$ 4.47	\$5.39	\$ 4.61
<u>Employee Stock Purchase Plan</u>				
Expected volatility	32.5%	31.2 %	36.8%	29.3 %
Risk-free interest rate	0.2 %	0.2 %	0.2 %	0.2 %
Expected option life (in years)	0.50	0.50	0.38	0.38
Expected dividend yield	0.90%	0.90 %	0.68%	0.68 %

Weighted average fair value at grant date \$4.31 \$ 3.24 \$4.23 \$ 3.02

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 shareholders, 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 26,409 shares issued during the twenty-six weeks ended August 2, 2014. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of August 2, 2014, there were 832,156 shares available.

### *Stock Options*

The following table summarizes stock option activity during the twenty-six weeks ended August 2, 2014:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (Thousands)
Outstanding at February 1, 2014	1,142,429	\$ 12.63	3.0	\$ 5,539
Granted	31,500	\$ 17.18		
Forfeited / Cancelled	(18,310 )	\$ 12.30		
Exercised	(31,822 )	\$ 11.80		
Outstanding at August 2, 2014	1,123,797	\$ 12.79	3.3	\$ 3,524
Exercisable at August 2, 2014	481,514	\$ 10.74	1.9	\$ 2,440

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between Fred's closing stock price on the last trading day of the period ended August 2, 2014 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 2, 2014, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately \$1.2 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 2, 2014 was \$234.1 thousand.

*Restricted Stock*

The following table summarizes restricted stock activity during the twenty-six weeks ended August 2, 2014:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested Restricted Stock at February 1, 2014	551,013	\$ 13.53
Granted	111,272	\$ 17.67
Forfeited / Cancelled	(87,604)	) \$ 13.31
Vested	(19,578)	) \$ 13.24
Non-vested Restricted Stock at August 2, 2014	555,103	\$ 12.81

The aggregate pre-tax intrinsic value of restricted stock outstanding as of August 2, 2014 is \$8.8 million with a weighted average remaining contractual life of 5.3 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding stock is approximately \$4.9 million, which is expected to be recognized over a weighted average period of approximately 7.1 years. The total fair value of restricted stock awards that vested during the twenty-six weeks ended August 2, 2014 was \$266.8 thousand.

## NOTE 4 — FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy, as defined below, gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

Level 1, defined as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

Level 2, defined as inputs other than quoted prices included within Level 1, that are observable for the asset or liability, either directly or indirectly.

Level 3, defined as unobservable inputs for the asset or liability.

Due to their short-term nature, the Company's financial instruments, which include cash and cash equivalents, receivables and accounts payable, are presented on the Condensed Consolidated Balance Sheet at a reasonable estimate of their fair value as of August 2, 2014 and February 1, 2014. The fair value of the revolving line of credit is consistent with the carrying amount because it is a floating rate obligation. The fair value of the revolving line of credit and our mortgage loans are estimated using Level 2 inputs based on the Company's current incremental borrowing rate for comparable borrowing arrangements.

The table below details the fair value and carrying values for the revolving line of credit and mortgage loans as of the following dates:

(in thousands)	August 2, 2014		February 1, 2014	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Revolving line of credit	\$12,878	\$ 12,878	\$ -	\$ -
Mortgage loans on land & buildings	4,327	4,582	5,319	5,581

## NOTE 5: PROPERTY AND EQUIPMENT

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 as a component of selling, general and administrative expenses.

The following illustrates the breakdown of the major categories within Property and Equipment (in thousands):

	August 2, 2014	February 1, 2014
Property and equipment, at cost:		
Buildings and building improvements	\$ 115,933	\$ 114,688
Leasehold improvements	78,827	78,101
Automobiles and vehicles	5,597	5,459
Airplane	4,697	4,697
Furniture, fixtures and equipment	270,670	268,771
	475,724	471,716
Less: Accumulated depreciation and amortization	(340,861 )	(328,686 )
	134,863	143,030
Construction in progress	2,816	1,729
Land	8,604	8,604
Total Property and equipment, at depreciated cost	\$ 146,283	\$ 153,363

#### NOTE 6: EXIT AND DISPOSAL ACTIVITIES

##### *Fixed Assets*

The Company's policy is to review the carrying value of all long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. We measure impairment losses of fixed assets and leasehold improvements as the amount by which the carrying amount of a long-lived asset exceeds its fair value as prescribed by FASB ASC 360, "Impairment or Disposal of Long-Lived Assets." If a long-lived asset is found to be impaired, the amount recognized for impairment is equal to the difference between the carrying value and the asset's fair value. The fair value is based on estimated market values for similar assets or other reasonable estimates of fair market value based upon using a discounted cash flow model.

During the second quarter of 2014, in association with the planned closure of approximately 60 stores in the fourth quarter of 2014, we recorded a charge of \$2.9 million in selling, general and administrative expense for the impairment of fixed assets and leasehold improvements.

##### *Inventory*

As discussed in Note 2 - Inventories, we adjust inventory values on a consistent basis to reflect current market conditions. In accordance with FASB ASC 330, "Inventories," we write down inventory to net realizable value in the period in which conditions giving rise to the write-downs are first recognized.

In the fourth quarter of 2013, a reserve in the amount of \$1.7 million, was established for the discontinuance of product categories that the Company has decided to exit in line with the strategies that are part of the Company's reconfiguration plan. Product categories the Company has decided to exit are furniture, electronics, and footwear. During the first half of 2014, the Company recorded additional markdown reserve to cost of goods sold for the discontinuance of the exit categories of \$0.5 million, including \$0.3 million for the accelerated recognition of freight capitalization expense, while utilizing \$0.1 million of the reserve associated with goods sold in 2014.

#### *Lease Termination*

For lease obligations related to closed stores, we record the estimated future liability associated with the rental obligation on the cease use date (when the stores were closed). The lease obligations are established at the cease use date for the present value of any remaining operating lease obligations, net of estimated sublease income, and at the communication date for severance and other exit costs, as prescribed by FASB ASC 420, "Exit or Disposal Cost Obligations". Key assumptions in calculating the liability include the timeframe expected to terminate lease agreements, estimates related to the sublease potential of closed locations, and estimates of other related exit costs. If actual timing and potential termination costs or realization of sublease income differ from our estimates, the resulting liabilities could vary from recorded amounts. These liabilities are reviewed periodically and adjusted when necessary.

A lease obligation still exists for some store closures that occurred in 2008. During the first six months of fiscal 2014, we utilized and added less than \$0.1 million of the remaining lease liability for the fiscal 2008 store closures, leaving \$0.1 million in the reserve at August 2, 2014.

The following table illustrates the exit and disposal reserves related to the store closures and strategic initiatives discussed in the previous paragraphs (in millions):

	Balance at February 1, 2014	Additions	Utilization	Ending Balance August 2, 2014
Inventory markdowns for discontinuance of exit categories	\$ 1.7	\$ 0.2	\$ (0.1 )	\$ 1.8
Inventory provision for freight capitalization expense, exit categories	\$ -	\$ 0.3	\$ -	\$ 0.3
Lease contract termination liability, 2008 closures	\$ 0.1	\$ -	\$ -	\$ 0.1
Total:	\$ 1.8	\$ 0.5	\$ (0.1 )	\$ 2.2

We expect to record additional charges related to the planned closure of approximately 60 stores in fiscal 2014. These charges will be primarily associated with inventory markdowns and lease terminations. Non-cash charges associated with the liquidation of inventory are anticipated to be in the range of \$5.5 million to \$6.5 million. Charges associated with lease terminations are expected to be in the range of \$1.5 million to \$2.5 million. Additional one-time charges to selling, general and administrative expenses associated with going out of business activities are anticipated to be in the range of \$3.5 million to \$4.5 million.

#### NOTE 7: ACCUMULATED OTHER COMPREHENSIVE INCOME

Comprehensive income consists of two components, net income and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that under GAAP are recorded as an element of shareholders' equity but are excluded from net income. The Company's accumulated other comprehensive income includes the unrecognized prior service costs, transition obligations and actuarial gains/losses associated with our postretirement benefit plan.

The following table illustrates the activity in accumulated other comprehensive income:

(in thousands)	Thirteen Weeks Ended August 2, 2014	August 3, 2013	Year Ended February 1, 2014
Accumulated other comprehensive income	\$ 703	\$ 794	\$ 794
Amortization of postretirement benefit	-	-	(91 )
Ending balance	\$ 703	\$ 794	\$ 703

#### NOTE 8: RELATED PARTY TRANSACTIONS

Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, a director of the Company and Chairman of the Board, owns the land and buildings occupied by three Fred's stores. The terms and conditions regarding the leases on these locations are consistent in all material respects with other stores leases of the Company with unrelated landlords. The total rental payments related to related party leases were \$159.4 thousand and \$150.5 thousand for the twenty six weeks ended August 2, 2014 and August 3, 2013, respectively.

#### NOTE 9: LEGAL CONTINGENCIES

In July 2008, a lawsuit styled Jessica Chapman, on behalf of herself and others similarly situated, v. Fred's Stores of Tennessee, Inc. was filed in the United States District Court for the Northern District of Alabama, Southern Division, in which the plaintiff alleges that she and other female assistant store managers are paid less than comparable males and seeks compensable damages, liquidated damages, attorney fees and court costs. The plaintiff filed a motion seeking collective action. On or about March 15, 2013, the Magistrate Judge issued a Report and Recommendation that the case be conditionally certified as a collective action, which the District Court Judge affirmed. As a result, notice of a collective action was sent to the appropriate class as required by the Court. Approximately 194 plaintiffs have opted into the suit. The Company believes that all of its assistant managers have been properly paid and that the matter is not appropriate for collective action treatment. The Company is and will continue to vigorously defend this matter; however, it is not possible to predict whether Chapman will ultimately be able to proceed collectively and no assurances can be given that the Company will be successful in the defense of the action on the merits or otherwise. In accordance with FASB ASC 450, "Contingencies", the Company does not believe at this time that a loss in this matter is probable. For these reasons, the Company is unable to estimate any potential loss or range of loss in the matter. The Company has tendered the matter to its Employment Practices Liability Insurance ("EPLI") carrier for coverage under its EPLI policy. At this time, the Company expects that the EPLI carrier will participate in the defense or resolution of part or all of the potential claims.

In addition to the matters disclosed above, the Company is party to several pending legal proceedings and claims arising in the normal course of business. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the Company is of the opinion that these proceedings and claims should not have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. Future developments could cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole.

#### NOTE 10: CUMULATIVE EFFECT OF A CORRECTION OF AN ERROR IN THE CASH FLOW STATEMENT

In the second quarter of 2013, the Condensed Consolidated Statements of Cash Flows (Cash Flows Statement) was changed to correct the presentation of proceeds received and net gain resulting from the sale of pharmacy department prescription files. From time-to-time, the Company closes an underperforming pharmacy department and sells the related prescription files. In previous filings, the proceeds received and gain resulting from the sale of pharmacy department prescription files were neither presented on the face of the Cash Flows Statement as an addition to cash flows provided by investing activities nor as a reduction to cash flows provided by operating activities. Going forward, the proceeds received from the sale of pharmacy prescription files will be shown on the face of the Cash Flows Statement as part of proceeds from asset dispositions in investing activities, and the net gain from the sale will be presented as a part of net loss (gain) on asset disposition in operating activities.

In accordance with Staff Accounting Bulletin 99, quantifying the impact of the corrected presentation on our Cash Flows Statement, we have determined that the quantitative impact on the Cash Flows Statement was immaterial to both the net cash provided by operating activities and the net cash used by investing activities. In addition, qualitatively, this misstatement had no effect on the Consolidated Income Statements or Consolidated Balance Sheets presented in our filed Form 10-Qs or Form 10-Ks from fiscal year 2011 through the first quarter of 2013. Additionally, there was no impact on our debt covenant requirements or our previous Liquidity and Capital Resources disclosures.

#### NOTE 11: NEW PRIME VENDOR AGREEMENT WITH PRIMARY PHARMACEUTICAL WHOLESALER

On August 6, 2014, the Company entered into a Prime Vendor Agreement (the "Agreement") with Cardinal Health, Inc., one of the nation's largest healthcare services companies. Cardinal Health will serve as Fred's new primary wholesale supplier for branded and generic pharmaceuticals under a multi-year agreement beginning on October 1, 2014. The agreement with Cardinal Health will replace the current Prime Vendor Agreement the Company has with AmerisourceBergen Drug Corporation, which will expire in accordance with the contract on September 30, 2014.

Under the Agreement, Fred's and Cardinal Health will establish a mutually beneficial strategic alliance designed to support Fred's key initiative of rapid pharmacy growth, and build on a foundation of premier supply chain and asset management tools. The initial term of the Agreement will commence on October 1, 2014 and shall continue through the longer of 1) March 31, 2018 or 2) the date upon which the Company's net aggregate generic purchases reach a certain purchase requirement, provided that date is not before September 30, 2017.

**Item 2:**

**Management's Discussion and Analysis of Financial**

**Condition and Results of Operations**

GENERAL

**Executive Overview**

Fred's, Inc. and subsidiaries ("Fred's", "We", "Our", "Us" or "Company") operates, as of August 2, 2014, 704 discount general merchandise stores, including 21 franchised Fred's stores, in 15 states in the southeastern United States. There are currently 357 full service pharmacies in our stores. Our mission is to be the hometown pharmacy and discount store that provides a fast, fun and friendly low-price place to shop. Approximately 84% of our stores are located in markets with populations of 15,000 or less, where Fred's provides often the only, or one of only two, pharmacies in town.

Fred's is a unique combination of pharmacy, dollar store and mass merchant. We offer a broader assortment than traditional dollar stores and pharmacies with greater convenience than big box retailers. We offer different product categories to drive shopping frequency (including consumables such as tobacco, food and beverage, prescription pharmaceuticals, paper and cleaning supplies, pet supplies, health and beauty aids) and to drive higher profitability (including discretionary products such as home décor, seasonal merchandise, auto and hardware and lawn and garden). Our general merchandise selection includes a diverse array of brand name and private label staple and discretionary products at value prices. We operate in the discount retail variety sector and approximately 90% of the products offered in our stores retail between \$1 and \$10.

Fred's caters to value-oriented, budget-conscious, primarily female shoppers who prefer convenience over the hassles of big-box shopping. Similar to the other retailers in this sector, our customers have continued to be negatively impacted by the pressures of the current macroeconomic environment. Those primary pressures include employment challenges, the rising costs of food, gasoline and energy, increasing payroll taxes and the uncertainty of medical expenses just as the deadline to sign up for the Affordable Care Act ended on March 31, 2014. While some of these key factors have shown signs of improvement, the uncertainty about the length of time it will take for the economy to recover and the strength of that recovery has left consumers wary and understandably conservative. As a percent of total sales, spending in our discretionary merchandise categories, which we classify as Household Goods and Apparel and Linens, declined to 26.1% of net sales at the end of the second quarter of 2014 as compared to 28.3% at the end of the first quarter of 2013.

In the first quarter of 2013, the Company announced the launch of our three-year reconfiguration plan to regain the momentum we had in the prior three years in driving toward our 4% operating margin goal. In 2009, 2010 and 2011 our operating income as a percent of sales was 2.1%, 2.5% and 2.7%, respectively. The main focus of our reconfiguration plan is to improve our overall store productivity and space efficiency while enhancing the product selection in stores with pharmacies. The plan has two fundamental principles: to aggressively accelerate our pharmacy department presence and to improve our general merchandise space efficiency and productivity.

In our first quarter press release filed Thursday, May 29, 2014, the Company announced updates to our reconfiguration plan in fiscal 2014. We have learned through extensive research that customers use Fred's for their "need it now" convenience trips. We see this as an opportunity to further leverage non-consumable, higher margin "immediate need" convenience departments which include Bed, Bath, Kitchen, Home Improvement (which includes Hardware), Seasonal and Pet.

Also as an outcome of the extensive research performed in the first half of the year, during the second quarter of 2014, the Company embarked on a promotional program to reduce low-productive inventory that does not fit the go-forward convenience/pharmacy-centric store model and its gross margin return-on-investment (GMROI) objectives. An \$11.9 million lower of cost or market write-down of this promotional inventory was recorded in the second quarter. The reduction of these SKUs will make way for our improved convenience/pharmacy-centric store model. In addition, the Company plans to close approximately 60 under-performing stores by the end of the fourth quarter of 2014. As a result, a write-down of the fixed assets also was recorded in the second quarter, which totaled \$2.9 million. The stores selected for closure contribute less than the Company's average return on invested capital and do not have pharmacy departments. The closures are in line with the reconfiguration plan launched in the first quarter of 2013 and the capital previously spent to operate these locations will be used to invest in pharmacy acquisitions. The closures will take place primarily in the fourth quarter of 2014, during which time the Company will also record the write down of inventory, the closed stores' lease liability, and additional one-time charges in the range of \$10.5 million to \$13.5 million.

Beginning in the second quarter, we implemented marketing and branding changes to emphasize those "need it now" trips and drive customer traffic. We began relaying our stores with a new front-end configuration for a faster checkout and a realignment of category adjacencies to highlight and brand our in-store convenience centers. The front end of our stores will be re-laid with power displays and pallets, along with a faster check-out configuration, all focused on ease of shopping and designed to become the convenient, small-box store of choice.

Fred's stores with pharmacy departments outperform our retail locations without pharmacy departments. Our pharmacy department is a key differentiating factor from other small-box discount retailers. Pharmacy department penetration was 50% at the end of 2012 and 52% at the end of 2013 and the second quarter of 2014. Under the reconfiguration plan, we are increasing pharmacy department penetration to 65% to 70% by the end of 2015. To achieve this goal, we will concentrate on adding pharmacies to existing stores without pharmacy departments, open all new stores with a pharmacy department and make opportunistic acquisitions that will operate as Xpress pharmacy locations until they become a future full-service location. Our pharmacy departments should continue to benefit from the aging U.S. population, an expected increase in patient prescription compliance and newly insured customers under the Affordable Care Act.

This growth in pharmacy department locations positions us to expand our other pharmacy offerings such as our specialty pharmacy program, our customer-centric clinical services offerings and an improved over-the-counter offering in health and beauty aids. Specialty pharmacy is the fastest-growing segment of the pharmacy industry. During 2012, we entered into an agreement with Diplomat Specialty Pharmacy to provide clinical and patient administration services necessary to manage our patients who are receiving specialty medications. Specialty medications are high cost drugs that are used to treat chronic or rare conditions such as hepatitis, cancer, multiple sclerosis, rheumatoid arthritis and other complex diseases. We are pleased with the initial progress surrounding the execution of our specialty pharmacy initiative, including the on-going relationship with Diplomat Specialty Pharmacy and the launch of our internal specialty pharmacy facility, EIRIS Health Services, which opened late in the third quarter of 2013. Fred's clinical services offerings are focused on driving increased immunizations, assisting our customers with medication therapy management, rolling out "Time My Meds", which is focused on prescription adherence, and expanding our disease management services, beginning with diabetes management.

In the second quarter of 2014, the Company announced the execution of a new prime vendor multi-year agreement with pharmacy wholesaler Cardinal Health to serve as Fred's new primary wholesale supplier for branded and generic pharmaceuticals beginning on October 1, 2014. Under the prime vendor agreement, Fred's and Cardinal Health will establish a mutually beneficial strategic alliance designed to support Fred's key initiative of rapid pharmacy growth, and build on a foundation of premier supply chain and asset management tools.

### *Second Quarter 2014 Financial Results*

As reported in our earnings release published on August 28, 2014, sales in the second quarter of 2014 increased 2% to \$491.2 million from \$482.2 million in the second quarter of 2013. Comparable store sales for the quarter declined 0.1% as compared to an increase of 2.2% in the same quarter last year. For the first six months of 2014, sales increased 1% to \$989.4 million from \$983.7 million in the year earlier period. Comparable store sales for the first half of the year decreased 1.0% as compared to an increase of 0.5% in the year earlier period. As a percent of sales, pharmacy department sales increased to 40.4% of sales in the second quarter and 40.1% of sales in the first six months, continuing to rank as the top department in our stores.

Fred's gross profit for the second quarter of 2014, including the provision for inventory reserve, decreased 16% to \$113.7 million from \$136.0 million in the prior-year period. Gross margin for the quarter decreased to 23.1% from 28.2% in the same quarter last year. Excluding the impact of the inventory provision, gross margin was 25.6%, 260 basis points below last year. The decrease is attributable to vendor-related cost pressures on pharmacy department sales and the aggressive advertising to kick off the new marketing programs.

Gross profit for the first half of 2014, including the provision for inventory reserve, decreased to \$256.1 million from \$287.0 million in the prior-year period. Gross margin for the six-month period decreased to 25.9% compared with 29.2% in the prior-year period. Excluding the impact of the inventory provision, gross margin was 27.1%, 210 basis points below last year.

For the second quarter ended August 2, 2014, Fred's net loss totaled (\$16.4) million or (\$0.45) per share compared with net income of \$3.3 million or \$0.09 per share for the second quarter ended August 3, 2013. Excluding the provision for inventory reserve and impairment of closed stores' fixed assets, Fred's net loss for the second quarter was (\$7.1) million or (\$0.19) per share. Fred's net loss for the first six months of fiscal 2014 was (\$10.3) million or (\$0.28) per share versus net income of \$14.7 million or \$0.40 per share in the year-earlier period. Excluding the provision for inventory reserve and impairment of closed stores' fixed assets, net loss for the first half of the year was (\$1.0) million or (\$0.03) per share.

We expect the investments and changes made in 2014 will bring stronger financial performance in 2015 and beyond, while allowing us to continue our growth. Our customers have already seen a difference, and the reaction is positive as measured by improved customer transactions throughout the second quarter. Our model of stores with pharmacies continues to achieve strong operating profit and margins. Growth in pharmacy toward the 65% to 70% penetration target and improving the general merchandise financial performance continue to be the core goals for the future success of Fred's.

At August 2, 2014, the balance sheet remained strong with cash and cash equivalents at \$8.1 million up from \$7.9 million at the same time last year. The inventory balance at the end of the second quarter decreased 1.8% to \$342.0 million from \$348.3 million at the same time last year. Excluding the provision for inventory reserve, the inventory balance at August 2, 2014 increased 1.6% to \$353.8 million. The increase was driven by the accelerated pharmacy department growth in line with our reconfiguration plan as well as inflation experienced in the pharmacy department. At the end of the second quarter of 2014, there were borrowings of \$13.0 million under our revolving line of credit and total indebtedness related to mortgage liabilities totaled \$4.3 million as compared to \$5.2 million at the end of the second quarter of 2013.

In our sales release dated January 9, 2014, the Company announced that we have engaged financial advisors Bank of America Merrill Lynch and Peter J. Solomon to review strategic opportunities to enhance shareholder value. The Board of Directors, with the assistance of its financial advisors, will consider a range of options, which may include a sale or merger of the Company, a strategic alliance with another company, a recapitalization of the Company or none of the foregoing. No decision has been made to enter into a transaction at this time, and there can be no assurance that we will enter into a transaction in the future. The Company does not intend to comment further regarding this process until such time as its Board of Directors has determined the outcome of the process or otherwise determined that disclosure is required or appropriate.

## **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 1, 2014. 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.

In the second quarter of 2014, the Company made a change to the revenue recognition policy concerning gift card breakage. The Company sells gift cards for which the revenue is recognized at time of redemption. The Company has stated in our Form 10-K, filed April 17, 2014, that we will begin to recognize aged liabilities as revenue when the likelihood of the gift card being redeemed is remote ("gift card breakage") and that the Company had not recognized any revenue from gift card breakage since the inception of the program in 2004 and did not intend to record any gift card breakage revenue until there was more certainty regarding our ability to retain such amounts in light of current

consumer protection and state escheatment laws.

Utilizing 10 years of gift card data provided by third party vendor Bank of America, a clear redemption and breakage trend emerged. Fred's gift cards hit their redemption peak of approximately 87% by the end of third year of activation, resulting in a 13% breakage trend. In addition, Fred's gift card liability is governed by Tennessee's escheat laws which state that gift cards issued after 1998 are not considered abandoned property. Therefore, the Company has changed the estimate of gift card breakage revenue during the second quarter of 2014 and recognized \$0.9 million of gift card revenue, or \$0.02 per share. Going forward, the balance on gift cards activated at least 36 months will be considered to represent gift card breakage and the liability balance on those cards will be recognized as part of revenue.

## **RESULTS OF OPERATIONS**

### **Thirteen Weeks Ended August 2, 2014 and August 3, 2013**

#### **Sales**

Net sales for the second quarter of 2014 increased to \$491.2 million from \$482.2 million in 2013, a year-over-year increase of \$9.0 million or 1.9%. On a comparable store basis, sales decreased 0.1% with a 2.2% increase in the same period last year.

General merchandise (non-pharmacy) sales decreased 4.6% to \$285.3 million from \$298.9 million in 2013. We experienced sales decreases in departments such as electronics, bed and window, food, beverage and toys which were partially offset by sales increases in promotional goods, photo, hardware and ladies accessories.

The Company's pharmacy department sales were 40.4% of total sales (\$198.3 million) in 2014 compared to 36.3% of total sales (\$175.2 million) in the prior year and continue to rank as the largest department within the Company. The total sales in this department increased 13.2% over 2013 with third party prescription sales representing approximately 92% of total pharmacy sales, 1% above the prior year. The Company's pharmacy department continues to benefit from an ongoing program of purchasing prescription files from independent pharmacies as well as the addition of EIRIS Specialty Pharmacy and pharmacy departments in existing store locations.

During the quarter, there were no changes to the franchised locations, with 21 franchised locations at August 2, 2014 and August 3, 2013. Sales to our franchised locations during 2014 were \$7.6 million (1.6% of sales) compared to \$8.1 million (1.7% of sales) in the prior year. The Company does not intend to expand its franchise network.

The following table illustrates the sales mix, unadjusted for deferred layaway sales:

	Thirteen Weeks Ended			
	August 2, 2014		August 3, 2013	
Pharmaceuticals	40.4	%	36.4	%
Household Goods	21.9	%	22.6	%
Food and Tobacco	16.9	%	17.8	%
Paper and Cleaning Supplies	8.4	%	8.8	%
Health and Beauty Aids	6.6	%	7.0	%
Apparel and Linens	4.2	%	5.7	%
Franchise	1.6	%	1.7	%
	100.0	%	100.0	%

For the quarter, comparable store customer traffic decreased 2.6% over last year while the average customer ticket increased 2.5% to \$21.14.

### Gross Profit

Gross profit for the second quarter decreased to \$113.7 million in 2014 from \$136.0 million in 2013, a decrease of \$22.3 million or 16.4%. Gross margin, measured as a percentage of sales, was 23.1% in 2014, a decrease of 510 basis

points as compared to 28.2% in the same quarter last year. In the quarter, gross margin was negatively impacted by a reserve for inventory clearance of product that management identified as low-productive and a reserve for inventory markdowns on the discontinuance of product categories that the Company has decided to exit. Gross margin deleveraging was also driven by extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates. The reimbursement adjustments from third parties have not been made at the speed of the manufacturer's rate of price increases. Also contributing to the gross margin deleveraging were lower pharmacy rebates despite a year over year sales increase and aggressive promotional activities.

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses, including depreciation and amortization, increased to \$139.8 million (28.4% of sales) in 2014 from \$130.8 (27.1% of sales) million in 2013, an increase of \$9.0 million. The 130 basis points deleveraging in the second quarter was comprised of an increase in occupancy related costs (56 basis points) and an unfavorable experience in the gain or loss recorded on the disposal of fixed assets (54 basis points) resulting from a reserve for the impairment of fixed assets due to planned store closings in the fourth quarter. Also contributing to the deleveraging were increased payroll expense (23 basis points) driven by pharmacy department growth and higher advertising expense (23 basis points) associated with our new marketing program that began in late May. The deleveraging was partially offset by a reduction in insurance expense (14 basis points) and lower depreciation and amortization expense (10 basis points), primarily the result of extending the useful life of the pharmacy department intangible script files from five to seven years in the fourth quarter of 2013.

### **Operating Income (Loss)**

Operating loss was (\$26.1) million or (5.3%) of sales in 2014 compared to operating income of \$5.2 million or 1.1% of sales in 2013. The \$31.3 million decrease in operating income is attributable to the \$22.3 million decrease in gross profit, driven by inventory reserves for clearance of product and the discontinuance of certain product categories, extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates, lower pharmacy department rebates and aggressive promotional activities. Also decreasing operating income was the \$9.0 million increase in selling, general and administrative expenses as detailed in the Selling, General and Administrative Expenses section above.

### **Interest Expense, Net**

Net interest expense for the second quarter totaled \$0.2 million or less than 0.1% of sales, compared to \$0.1 million or less than 0.1% of sales in the second quarter of 2013.

### **Income Taxes**

The effective income tax rate for the second quarter of 2014 was 37.5% compared to 34.5% in the second quarter of 2013. The increase in the effective income tax rate is primarily the result of the expiration of the federal Work Opportunity Tax Credits (WOTC) at the end of 2013. The federal WOTC are expected to be reinstated in a future quarter in 2014. Income tax benefit for the quarter was (\$9.9) million compared to income tax expense of \$1.8 million in the second quarter of 2013.

### **Net Income (Loss)**

Net loss for the second quarter totaled (\$16.4) million or (\$0.45) per diluted share in 2014 as compared to net income of \$3.3 million or \$0.09 per diluted share in 2013, a decrease of \$19.7 million. The decrease in net income was due to the \$22.3 million decrease in gross profit, driven by inventory reserves for the clearance of product and the discontinuance of certain product categories, extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates, lower pharmacy department rebates and aggressive promotional activities. Net income also decreased due to the \$9.0 million increase in selling, general and administrative expenses as detailed in the Selling, General and Administrative Expenses section above. The decrease in gross profit was partially offset by a decrease in income tax expense of \$11.6 million driven by lower gross profit which more than offset the higher effective tax rate.

### **Twenty-Six Weeks Ended August 2, 2014 and August 3, 2013**

### **Sales**

Net sales for the first half of 2014 increased to \$989.4 million from \$983.7 million in 2013, a year-over-year increase of \$5.7 million or 0.6%. On a comparable store basis, sales decreased 1.0% (\$9.4 million) compared with a 0.5% (\$3.9 million) increase in the same period last year.

General merchandise (non-pharmacy) sales decreased 5.8% to \$575.7 million in 2014 from \$611.2 million in 2013. The decrease resulted primarily from categories such as beverages, electronics, bed and window, cleaning supplies and home furnishings which were partially offset by sales increases in promotional inventory, photo, tobacco and ladies apparel.

The Company's pharmacy department sales were 40.2% of total sales (\$397.7 million) in 2014 compared to 36.2% of total sales (\$356.0 million) in the prior year and continue to rank as the largest department within the Company. The total sales in this department increased 11.7% over 2013 with third party prescription sales representing approximately 92% of total pharmacy sales, 1% above the prior year. The Company's pharmacy department continues to benefit from an ongoing program of purchasing prescription files from independent pharmacies as well as the addition of pharmacy departments in existing store locations, in line with our reconfiguration plan.

During the first half of 2014, there were no changes to franchised locations leaving 21 franchised locations as of August 2, 2014 and August 3, 2013. Sales to our franchised locations during 2013 decreased to \$16.0 million (1.6% of sales) from \$16.4 million (1.7% of sales) in 2013. The Company does not intend to expand its franchise network.

The following table illustrates the sales mix unadjusted for deferred layaway sales:

	Twenty-Six Weeks Ended			
	August 2, 2014		August 3, 2013	
Pharmaceuticals	40.1	%	36.1	%
Household Goods	21.6	%	22.6	%
Food and Tobacco	16.9	%	17.7	%
Paper and Cleaning Supplies	8.2	%	8.6	%
Health and Beauty Aids	6.7	%	7.2	%
Apparel and Linens	4.9	%	6.1	%
Franchise	1.6	%	1.7	%
	100.0	%	100.0	%

For the first half, comparable store customer traffic decreased 3.4% over last year and the average customer ticket increased 2.4% to \$21.60.

### **Gross Profit**

Gross profit for the first half of 2014 decreased to \$256.1 million from \$287.0 million in 2013, a year-over-year decrease of \$30.9 million or 10.8%. Gross margin, measured as a percentage of sales was 25.9% in 2014 as compared to 29.2% last year. In the first half of 2014, gross margin deleveraging was negatively impacted by a reserve for inventory clearance of product that management identified as low-productive and a reserve for inventory markdowns on the discontinuance of product categories that the Company has decided to exit. The gross margin deleveraging was also driven by extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates. The reimbursement adjustments from third parties have not been made at the speed of the manufacturer's rate of price increases. Also contributing to the gross margin deleveraging were lower pharmacy rebates despite a year over year sales increase and aggressive promotional activities.

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses, including depreciation and amortization was \$272.3 million in the first half of 2014 (27.5% of sales) as compared to \$264.0 million in 2013 (26.9% of sales). The 60 basis points deleveraging in the first six months of 2014 was comprised of approximately 56 basis points deleveraging due to increased occupancy related costs, increased payroll expense (28 basis points) driven by the year over year pharmacy department growth and an unfavorable experience in the gain or loss recorded on the disposal of fixed assets (16 basis points) resulting from a reserve for the impairment of fixed assets due to planned store closings in the fourth quarter. The deleveraging was partially offset by a reduction in insurance expense (23 basis points) and lower depreciation and amortization expense (9 basis points), primarily the result of extending the useful life of the pharmacy department intangible script files from five to seven years in the fourth quarter of 2013.

### **Operating Income (Loss)**

Operating loss was (\$16.1) million or (1.6%) of sales in 2014 as compared to operating income of \$23.0 million or 2.3% of sales in 2013. The year-over-year decrease of \$39.1 million is attributable to the \$30.9 million decrease in gross profit that was driven by inventory reserves for the clearance of product and the discontinuance of certain product categories, extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates, lower pharmacy department rebates and aggressive promotional activities. Also decreasing operating income was the \$8.3 million increase in selling, general and administrative expenses as detailed in the Selling, General and Administrative Expenses section above.

### **Interest Expense, Net**

Net interest expense for 2014 totaled \$0.3 million or less than 0.1% of sales, unchanged from 2013.

### **Income Taxes**

The effective income tax rate for the year-to-date period was 37.1% in 2014 compared to 35.2% in 2013. The increase in the effective income tax rate is primarily the result of the expiration of the federal Work Opportunity Tax Credits (WOTC) at the end of 2013. The federal WOTC are expected to be reinstated in a future quarter in 2014. Income tax benefit for the year was (\$6.1) million compared to income tax expense of \$8.0 million in 2013. The benefit resulting from an operating loss more than offset the higher effective tax rate.

### **Net Income (Loss)**

Net loss was (\$10.3) million or (\$0.28) per diluted share in 2013 as compared to \$14.7 million or \$0.40 per diluted share in 2013, a decrease of \$25.1 million. The decrease in net income was due to the \$30.9 million decrease in gross profit that was driven by inventory reserves for the clearance of product and the discontinuance of certain product categories, generic pharmaceutical inflation combined with pressure on generic pharmaceutical reimbursement rates, lower pharmacy department rebates and aggressive promotional activities and the \$8.3 million of increased selling, general and administrative expenses as described in the Selling, General and Administrative section above. These increases more than offset the \$14.1 million decrease in income tax expense driven by the operating loss.

### **LIQUIDITY AND CAPITAL RESOURCES**

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

Net cash flow provided by operating activities totaled \$17.2 million during the twenty-six week period ended August 2, 2014 compared to \$31.0 million in the same period of the prior year. Cash generated from operating activities primarily resulted from \$20.0 million in depreciation and amortization expense, driven by pharmacy department growth and an increase in our reserves of \$14.9 million resulting from our promotional inventory strategy and decision to close stores in the fourth quarter. Also contributing to operating cash flow was an inventory decrease of \$5.9 million, an increase to the LIFO reserve of \$2.1 million and an increase in trade and non-trade receivables of \$1.7 million. Offsetting the increases to cash were a net loss of \$10.3 million, a decrease in operating liabilities of \$10.5 million and a deferred income tax benefit of \$7.4 million.

Net cash used in investing activities totaled \$24.1 million during the twenty-six week period ended August 2, 2014 compared to \$19.5 million in the same period last year. Capital expenditures in the first half of 2014 totaled \$11.3 million related to existing store and pharmacy expenditures (\$7.2 million), technology and other corporate expenditures (\$2.6 million) and new store and pharmacy expenditures (\$1.5 million). In addition, the Company planned expenditures of approximately \$45.9 million in 2014 for the acquisition of prescription lists and other pharmacy related items of which \$16.5 million has been spent to date. During the first half of 2014, we opened two full-service stores and seven Xpress pharmacy stores. Fred's also closed five full-service stores and four Xpress pharmacy locations during this period. In 2014, the Company is planning capital expenditures, excluding the acquisition of prescription lists, of approximately \$28.5 million. Expenditures are planned totaling \$21.9 million for new and existing stores and pharmacies. Planned expenditures also include approximately \$3.9 million for technology upgrades and approximately \$2.7 million for distribution center equipment and other capital maintenance. Technology upgrades in 2014 will be made in the areas of IT software and hardware and mainframe upgrades. To date, the Company has spent \$1.8 million towards these improvements.

Net cash generated by financing activities totaled \$8.2 million during the twenty-six week period ended August 2, 2014 while net cash used by financing activities was \$11.7 million in the same period last year. During the first half of 2014, we borrowed \$304.2 million and repaid \$291.2 on our revolving line of credit, paid cash dividends of \$4.4 million and paid \$1.0 million on our mortgage debt. There were \$4.3 million in borrowings outstanding at August 2, 2014 related to real estate mortgages compared to \$5.3 million at February 1, 2014. There were \$13.0 million of borrowings under the revolving line of credit at August 2, 2014.

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.

## **FORWARD-LOOKING STATEMENTS**

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. Sections 77z-2 and 78u-5.

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 "outlook", "guidance", "may", "should", "could", "believe", "anticipate", "project", "plan", "expect", "estimate", "objective", "forecast", "goal", "intend", "will likely result", or "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 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:

- Economic and weather conditions which affect buying patterns of our customers and supply chain efficiency;
- Changes in consumer spending and our ability to anticipate buying patterns and implement appropriate inventory strategies;
- Continued availability of capital and financing;
- Competitive factors, and the ability to recruit and retain employees;
- Changes in the merchandise supply chain;
- Changes in pharmaceutical inventory costs;
- Changes in reimbursement practices for pharmaceuticals;
- Governmental regulation;
- Increases in insurance costs;
- Cyber security risks;
- Increases in fuel and utility rates;
- Potential adverse results in the litigation described under Legal Proceedings (see Note 9 - Legal Contingencies);
- 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 1, 2014.

Consequently, all forward-looking statements are qualified by this cautionary statement. Readers should not place undue reliance on any forward-looking statements. 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 2, 2014. We are exposed to financial market risks, including changes in interest rates. There were \$13.0 million of borrowings at August 2, 2014, and no borrowings as of August 3, 2013, under our Revolving Loan and Credit Agreement, which bears interest at our option, on a sliding scale from 1.00% - 1.625% plus LIBOR, or an alternative base rate. The weighted average interest rate on borrowings outstanding at August 2, 2014 was 1.54%. 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) Conclusion Regarding the Effectiveness of 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 and Exchange Act of 1934, as amended (the "Exchange Act")). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Additionally, they concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that the Company is required to file or submit under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

(b) Changes in Internal Control over Financial Reporting. There have been no changes during the quarter ended August 2, 2014 in the Company's internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

In July 2008, a lawsuit styled Jessica Chapman, on behalf of herself and others similarly situated, v. Fred's Stores of Tennessee, Inc. was filed in the United States District Court for the Northern District of Alabama, Southern Division, in which the plaintiff alleges that she and other female assistant store managers are paid less than comparable males and seeks compensable damages, liquidated damages, attorney fees and court costs. The plaintiff filed a motion seeking collective action. On or about March 15, 2013, the Magistrate Judge issued a Report and Recommendation that the case be conditionally certified as a collective action, which the District Court Judge affirmed. As a result, notice of a collective action was sent to the appropriate class as required by the Court. Approximately 194 plaintiffs have opted into the suit. The Company believes that all of its assistant managers have been properly paid and that the matter is not appropriate for collective action treatment. The Company is and will continue to vigorously defend this matter; however, it is not possible to predict whether Chapman will ultimately be able to proceed collectively and no assurances can be given that the Company will be successful in the defense of the action on the merits or otherwise. In accordance with FASB ASC 450, "Contingencies", the Company does not believe that a loss in this matter is probable at this time. For these reasons, the Company is unable to estimate any potential loss or range of loss in the matter. The Company has tendered the matter to its Employment Practices Liability Insurance ("EPLI") carrier for coverage under its EPLI policy. At this time, the Company expects that the EPLI carrier will participate in the defense or resolution of part or all of the potential claims.

In addition to the matters disclosed above, the Company is party to several pending legal proceedings and claims arising in the normal course of business. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the Company is of the opinion that these proceedings and claims should not have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. Future developments could cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole.

## **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 1, 2014, 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 August 27, 2007, the Board of Directors approved a plan that authorized stock repurchases of up to 4.0 million shares of the Company’s common stock. Under the plan, the Company may repurchase its common stock in the open market or through privately negotiated transactions at such times and at such prices as determined to be in the Company’s best interest. On February 16, 2012, Fred's Board authorized the expansion of the Company's existing stock repurchase program by increasing the authorization to repurchase an additional 3.6 million shares or approximately 10% of the current outstanding shares. These repurchases may be commenced or suspended without prior notice depending on then-existing business or market conditions and other factors. No repurchases were made in the first half of 2014, leaving 3.0 million shares available for repurchase at August 2, 2014.

## **Item 6. Exhibits**

### Exhibits

- \*\*\*\*10.29 Prime Vendor Agreement between Fred's Stores of Tennessee, Inc. and Cardinal Health 110, LLC and Cardinal Health 410, LLC as of October 1, 2014.
- \*\*10.30 Amendment to Employment Agreement, dated July 30, 2014, between the Company and Bruce A. Efird
- 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.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema

101.CAL XBRL Taxonomy Extension Calculation Linkbase

101.DEF XBRL Taxonomy Extension Definition Linkbase

101.LAB XBRL Taxonomy Extension Label Linkbase

101.PRE XBRL Taxonomy Extension Presentation Linkbase

\*\* Filed Herewith

\*\*\*\* Confidential treatment requested under Rule 24b-2 under the Securities Exchange Act of 1934. The confidential portions of this exhibit have been omitted and are marked accordingly. The confidential portions have been filed separately with the Securities and Exchange Commission pursuant to the confidential treatment request.

**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 11, 2014 /s/ Bruce A. Efirm  
Bruce A. Efirm  
Chief Executive Officer and President

Date: September 11, 2014 /s/ Jerry A. Shore  
Jerry A. Shore  
Executive Vice President,  
Chief Financial Officer and  
Chief Operating Officer