FREDS INC
Form 10-K
May 03, 2019
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended February 2, 2019

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)

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

4300 NEW GETWELL ROAD

MEMPHIS, TENNESSEE 38118

(Address of Principal Executive Offices)

Registrant's telephone number, including area code (901) 365-8880

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Class	Trading Symbol(s)	Name of exchange on which registered
Class A Common Stock, no par value	FRED	The NASDAQ Global Select Market
Share Purchase Rights		

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (of for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K .

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

If an emerging growth company, indicate by checkmark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the last reported sale price on such date by the NASDAQ Global Select Market, Inc. on August 3, 2018 the last business day of the registrant's most recently completed second fiscal quarter, was approximately $56,477,163. Shares of voting stock held by executive officers, directors and certain significant shareholders have been excluded from this calculation because such persons may be deemed to be affiliates. Exclusion of such shares should not be construed to indicate that any of such persons possess the power, direct or indirect, to control the Registrant, or that such person is controlled by or under common control of the Registrant.

As of May 1, 2019, there were 35,128,881 shares outstanding of the Registrant's Class A no par value voting common stock.

As of May 1, 2019, there were no shares outstanding of the Registrant's Class B no par value non-voting common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the 2019 annual stockholders meeting, to be filed within 120 days of the Registrant's fiscal year end, are incorporated into Part III of this Annual Report on Form 10-K (the "Form 10-K") by reference. With the exception of those portions that are specifically incorporated herein by reference, the aforesaid document is not to be deemed filed as part of this Form 10-K.

FRED'S, INC.

FORM 10-K

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Cautionary Statement Regarding Forward-looking Information

Comments in this Annual Report on Form 10-K that are not historical facts are forward-looking statements within the meaning of the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. A reader can identify forward-looking statements because they are not limited to historical facts or they use such words as “outlook,” “guidance,” “may,” “should,” “could,” “believe,” “anticipate,” “project,” “plan,” “expect,” “estin “forecast,” “goal,” “intend,” “committed,” “continue,” or “will likely result” and similar expressions that concern the Company strategy, plans, intentions or beliefs about future occurrences or results. Forward-looking statements involve estimates, expectations, projections, goals, forecasts, assumptions, risks and uncertainties. Forward-looking statements include, but are not limited to, statements about future financial and operating results, the Company’s plans, objectives, business outlook, priorities, expectations and intentions, expectations for sales growth, comparable sales, earnings and performance, shareholder value, capital expenditures, cash flows, demand for products, share repurchases, strategic initiatives, including those relating to store closures and acquisitions and dispositions by the Company and the expected impact of such transactions on our strategic and operational plans and financial results, and any statement of an assumption underlying any of the foregoing and other statements that are not historical facts. Although we believe that the expectations, opinions, projections and comments reflected in these forward-looking statements are reasonable, such statements involve risks and uncertainties and we can give no assurance that such statements will prove to be correct. A wide variety of potential risks, uncertainties and other factors could materially affect our ability to achieve the results either expressed or implied by these forward-looking statements including, but not limited to risks and uncertainties associated with: (i) the competitive nature of the industries in which we operate; (ii) our turnaround plan and the implementation of our strategic initiatives, and their impact on our sales, costs and operations; (iii) our store closures and the related sales of inventory and real estate issues; (iv) our divestitures; (v) utilizing our existing and new stores and the extent of our pharmacy department presence in new and existing stores; (vi) conditions affecting the retail sector as a whole; (vii) our reliance on a single supplier of pharmaceutical products; (viii) our pharmaceutical drug pricing; (ix) reimbursement rates and the terms of our agreements with pharmacy benefit management companies; (x) consolidation in the healthcare industry; (xi) our private brands; (xii) the seasonality of our business and the impact of adverse weather conditions; (xiii) operational, supply chain and distribution difficulties; (xiv) merchandise supply and pricing; (xv) consumer demand and product mix; (xvi) delayed openings and operating new stores and distribution facilities; (xvii) our employees; (xviii) risks relating to payment processing; (xix) our computer systems, and the processes supported by our information technology infrastructure; (xx) our ability to protect the personal information of our customers and employees; (xxi) cyber-attacks; (xxii) changes in governmental regulations; (xxiii) the outcome of legal proceedings, including claims of product liability; (xxiv) insurance costs; (xxv) tax assessments and unclaimed property audits; (xxvi) current economic conditions; (xxvii) our indebtedness and our ability to satisfy our debt obligations and obtain forbearance or waivers for any defaults; (xxviii) the terms of our existing and future indebtedness, including the covenants set forth in the documents governing such indebtedness; (xxix) any acquisitions we may pursue and the ability to effectively integrate businesses that we acquire; (xxx) our ability to remediate the material weaknesses in our internal controls over financial reporting and otherwise maintain effective internal controls over financial reporting; (xxxi) our largest stockholder holding a significant percentage of our outstanding equity; (xxxii) our ability to pay dividends and/or repurchase shares of our Class A voting common stock; (xxxiii) our ability to attract and retain talented executives; (xxxiv) any strategic alternatives that we decide to pursue, if any; (xxxv) our ability to continue as a going concern; and (xxxvi) the factors listed under Item 1A: “Risk Factors” below and in any subsequent quarterly filings on Form 10-Q filed with the Securities and Exchange Commission. Forward-looking statements speak only as of the date made. The Company undertakes no obligation to release revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unforeseen events, except as required to be reported under the rules and regulations of the Securities and Exchange Commission.

PART I

ITEM 1: Business

General

Fred's, Inc. and its subsidiaries ("Fred's", “We”, “Our”, “Us” or the “Company”) was founded in 1947 and, as of February 2, 2019, operated 568 discount general merchandise stores in fifteen states in the Southeastern United States. Included in the count of discount general merchandise stores are 11 franchised locations. Fred's stores generally serve low, middle- and fixed-income families located in small- to medium-sized towns. Our customers are value-oriented, budget-conscious, and often live in rural areas without access to large discount retailers, making our offerings a significant value-add. Our mission is to improve the lives of customers by selling products that deliver value and convenience to the communities we serve. As of February 2, 2019, 169 of Fred’s stores included full-service pharmacies. The Company is headquartered in Memphis, Tennessee.

During the second quarter of fiscal year 2018, the Company completed the sale of its specialty pharmacy business for a cash purchase price of $40.0 million (plus an additional $5.5 million for inventory). During the fourth quarter of fiscal 2018, Fred’s completed its sale of certain prescription files and the related data and records, retail pharmaceutical inventory and certain other assets from 179 of the Company’s retail pharmacy stores for a cash purchase price of approximately $176.7 million. The results of operations for both businesses have been presented as discontinued operations in accordance with Accounting Standards Codification (“ASC” Topic 205-20) ASC 205-20- Results of Operations – Discontinued operations for all periods presented. See Note 2: Assets Held for Sale and Discontinued Operations for additional information.

In addition, during the fourth quarter of 2018, Fred’s Board of Directors (the “Board”) approved a plan to actively market its headquarters building located in Memphis, TN. The building has been reflected as Assets Held for Sale on the consolidated balance sheets in accordance with ASC 360 – Assets held for sale.

Excluding the “Assets Held for Sale and Discontinued Operations” subsections amounts and percentages, all periods discussed below reflect the results of operations and financial conditions from Fred’s continuing operations.

Fred's stores stock over 14,000 items which address the everyday needs of its customers, including nationally recognized brand name products, proprietary “Fred's” label products and lower priced off-brand products. Fred's management believes its customers shop Fred's stores as a result of their convenient locations, products at everyday low prices, pharmacy department and healthcare services, regularly advertised departmental promotions and seasonal specials. As of February 2, 2019, Fred's Company-owned, full-service stores had an average selling space of 14,684 square feet.

The Company utilizes a 52 - 53-week accounting period which ends on the Saturday closest to January 31. Fiscal years 2018, 2017 and 2016, as used herein, refer to the years ended February 2, 2019, February 3, 2018 and January 28, 2017, respectively. Fiscal year 2018 had 52 weeks, fiscal year 2017 had 53 weeks and fiscal year 2016 had 52 weeks.

Business Strategy

The Company’s strategy is to offer its customers in small to mid-size markets an assortment of value-priced general merchandise offered in a convenient setting, along with access to safe and affordable health care solutions in locations that contain pharmacies. Of the Company’s 568 stores as of February 2, 2019, 169 offered pharmacy services.

Fred’s operations are typically managed at the individual store level, with primary operations at each of these locations consisting of general merchandise, or “Front Store” operations and pharmacy operations.

Front Store – The Company’s front store merchandise strategy emphasizes convenience and value. The Company provides value and low prices to its customers (i.e., a good “price-to-value relationship”) through a coordinated discount strategy that focuses on strong values daily, while controlling the Company’s reliance on promotional activities. As part of this strategy, Fred's maintains low opening price points and competitive prices on key products across all departments and regularly offers seasonal specials and departmental promotions supported by direct mail, newspaper, social media and email advertising. Fred's stores are typically located in convenient shopping and/or residential areas. Approximately 58% of our company-owned stores are freestanding as opposed to being located in strip shopping center sites. Freestanding sites allow for easier access and shorter distances to the store entrance. Fred's full-service stores have a customer-centric assortment and easy checkouts. Fred's combines everyday basic merchandise with certain specialty items to offer its customers a wide selection of over 14,000 general merchandise items. The selection of merchandise is supplemented by seasonal specials, private label products and closeout merchandise throughout the stores.

Pharmacy - Approximately 73% 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 the town or county. Fred's seeks to drive prescriptions, or "scripts," into our stores, improve service to patients and train teams to ensure a consistent and reliable experience at every store for every patient. In 2017, the Company revised its reimbursement strategies, expanded its 340B program (a program under which pharmaceutical manufacturers provide discounted drug prices to statutorily-defined covered entities) and launched store and community-specific marketing campaigns. Additionally, the Company initiated a pharmacist outreach program to win back patients, as well as a health services platform. Through Fred's many relationships with hospitals and payors, we leverage our pharmacists, who are already the most accessible go-to healthcare professionals for a wide variety of preventive care, screening and disease management services.

Progress on Turnaround and Strategic Initiatives

Fred's continued executing its turnaround strategy during the 2018 fiscal year, and the team remains focused on creating value through execution of the following strategic initiatives:

- Monetizing non-core assets;
- Reducing selling, general and administrative expenses;
- Driving traffic;
- Improving assortment and optimizing inventory levels;
- Generating free cash flow;
- Closing underperforming stores; and
- Reducing debt levels.

Front Store

During fiscal year 2018, we continued to make improvements to the front store that we believe will result in better operating performance going forward, including:

- Continued reductions in our workforce and other operating expenses, which should result in lower selling, general and administrative expenses on a go forward basis;
- New talent being hired in all areas;
- Growth in new categories such as closeouts, beer and wine, lottery and expansion of private brand offerings throughout many departments;
- Implementation of our "Fred's Rewards Club" loyalty program, which now has over one million members; and
- Continued reductions in unproductive inventory and optimization of merchandise selection throughout the front store.

Retail Pharmacy

During fiscal year 2018, we closed two significant transactions involving our pharmacy portfolio. During the second quarter of fiscal year 2018, we completed the sale of our specialty pharmacy business to a subsidiary of CVS for a cash purchase price of $40.0 million, plus an additional $5.5 million for inventory. During the fourth quarter of fiscal 2018, we completed our sale of certain prescription files and the related data and records, retail pharmaceutical inventory and certain other assets from 179 of the Company's retail pharmacy stores to Walgreen Co. for a cash purchase price of approximately $176.7 million. We are also continuing to pursue the sale of our remaining pharmacy assets as part of our previously announced plan to unlock shareholder value by monetizing non-core assets.

Within our remaining retail pharmacy portfolio, we continue to focus on execution of the following key initiatives:

- Continued reduction in operating expenses for the retail pharmacy business;
- Continuing aggressive inventory management by reducing inventory levels and analyzing the profitability of every script filled while delivering excellent care to patients;
- Expanding our 340B program to help customers and healthcare partners gain access to more affordable drugs; and
- Deepening relationships with payors to gain access to new networks, resulting in the potential to drive increased traffic and more prescriptions.

Recent Developments

Store Closures

On April 11, 2019, the Company announced that the Board had approved a plan to close 159 underperforming stores (the "Closures"). The decision to close these stores was the result of a comprehensive evaluation of the Company's store portfolio, which examined historical and recent store performance and the timing of lease expirations, among other factors. The Company intends to close these stores by the end of May 2019. The timing of the Closures is subject to change until finalized, and the actual timing may vary materially based on various factors. The Company is further evaluating certain additional store closures, although no applicable approvals to do so have been obtained at this time.

The Company is currently unable in good faith to make a determination of an estimate of the amount or range of amounts expected to be incurred in connection with the Closures, both with respect to each major type of cost associated therewith and with respect to the total cost, or an estimate of the amount or range of amounts that will result in future cash expenditures. Nor is the Company currently able in good faith to make a determination of an estimate of the amount or range of amounts of impairment charge to be incurred in connection with the Closures, or an estimate of the amount or range of amounts of the impairment charge that will result in future cash expenditures. The Company will file an amendment to the Current Report on Form 8-K filed on April 11, 2019 relating to, among other things, the Closures, after it determines such estimates or ranges of estimates.

Strategic Alternatives

On April 11, 2019, the Company also announced that it had retained PJ Solomon to assist the Board in undertaking a comprehensive review of the full range of strategic alternatives available to the Company, which may include an evaluation of the Company's current operating plan, as well as potential alternatives to maximize value, including, among other things, a sale, merger, a consolidation or business combination, further store closures, asset divestitures, financing transactions or restructurings.

The Company has not set a timetable for completion of the evaluation process. As previously disclosed, no decision has been made to pursue any specific strategic transaction or any other strategic alternative, and there can be no assurance that the Board's exploration of strategic alternatives will result in the completion of any transaction or other alternative. The Company does not intend to discuss or disclose developments with respect to this process unless and until the Board has approved a specific transaction, or otherwise deems further disclosure is appropriate or if disclosure is required by applicable law.

Recent Developments Relating to the Revolving Credit Agreement

On April 15, 2019, Bank of America, N.A. imposed an additional reserve of $20.0 million under our Revolving Credit Agreement in connection with the Closures and related matters, which reduced our excess availability at such time to $37.9 million, and the administrative agent declared an “Account Control Event” under our Revolving Credit Agreement in connection with the Closures and exercised control over our collection accounts.

As described elsewhere in this Annual Report on Form 10-K, the audit report prepared by our auditors with respect to the financial statements in this Annual Report on Form 10-K includes an explanatory paragraph indicating that there is substantial doubt about Fred’s ability to continue as a going concern. The receipt of this explanatory paragraph with respect to Fred’s financial statements for the year ended February 2, 2019 will result in a breach of a covenant under the Revolving Credit Agreement that requires annual financial statements accompanied by an unqualified audit report to be delivered to the lenders within 120 days of fiscal year end and a breach of this covenant will constitute an event of default under the Revolving Credit Agreement (the “Going Concern Event of Default”). In addition, Fred’s lenders under the Revolving Credit Agreement have indicated to Fred’s their belief that certain other events of default have occurred under the Revolving Credit Agreement in connection with the Closures, the inventory sales at certain stores and the timing of delivery, and content, of a borrowing base certificate due under the Revolving Credit Agreement (such purported events of default, together with the Going Concern Event of Default, are referred to herein as the “Revolver EODs”).

An event of default, which is not cured or waived, would permit, among other remedies, acceleration of Fred’s indebtedness under the Revolving Credit Agreement and the addition, at the option of the Required Lenders (as defined in the Revolving Credit Agreement), of 200 basis points to the applicable interest rate with respect to all loans under the Revolving Credit Agreement (the “Default Rate”). As of the date of this Annual Report on Form 10-K, the lenders under the Revolving Credit Agreement have not taken any action to accelerate our indebtedness, impose the Default Rate or exercise other remedies with respect to the Revolver EODs, but there can be no assurance that such lenders will not do so in the future. Fred’s is currently seeking an agreement with its lenders pursuant to which such lenders would forbear for a period of time from seeking remedies on account of, or waive, the Revolver EODs, but there is no assurance that Fred’s will receive such forbearance or waivers. If our indebtedness is accelerated, whether due to the Revolver EODs or otherwise, we cannot be certain that we will have sufficient funds available to pay the accelerated indebtedness or that we will have the ability to refinance the accelerated indebtedness on terms favorable to us or at all.

Each of the foregoing recent developments involve various risks and uncertainties. See “Cautionary Statement Regarding Forward-Looking Information” and Item 1A: “Risk Factors” included elsewhere in this Form 10-K.

Going Concern

As discussed elsewhere in this Form 10-K, the audit report prepared by our auditors with respect to the financial statements in this Form 10-K includes an explanatory paragraph expressing uncertainty as to our ability to continue as a “going concern.” For additional information, see Item 7: “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources” and Item 1A: “Risk Factors” included elsewhere in this Form 10-K, as well as Note 1 to the Consolidated Financial Statements included in Part II of this Form 10-K.

Assets Held for Sale and Discontinued Operations

During the fourth quarter of the fiscal year 2017, the Board approved a plan to actively market its specialty pharmacy business. The specialty pharmacy business met the criteria for “Assets held for Sale” in accordance with ASC Topic 360 (ASC 360), Property, Plant and Equipment as of February 3, 2018. The specialty pharmacy assets and liabilities were reflected as “Assets Held for Sale” for the period ended February 3, 2018, within the consolidated balance sheets in accordance with ASC 360. The results of operations for the specialty pharmacy business are presented as discontinued operations in accordance with ASC 205-20, Presentation of Financial Statements – Discontinued Operations for all periods presented. The specialty pharmacy business operations have been segregated from continuing operations. All disclosures throughout Part I of this Form 10-K exclude the specialty pharmacy business.

On May 4, 2018, Fred's entered into an Asset Purchase Agreement (the "Specialty Asset Purchase Agreement") with Advance Care Scripts, Inc. (the "Specialty Buyer"), pursuant to which the Specialty Buyer agreed to purchase certain specialty pharmacy assets of certain subsidiaries of Fred's, National Pharmaceutical Network, Inc. and Reeves-Sain Drug Store, Inc. (collectively referred to as "Entrust"), consisting of three pharmacy locations, pharmaceutical inventory, and related intellectual property. The Specialty Buyer paid Fred's approximately $40.0 million for the purchased assets (plus up to an additional $5.5 million for inventory). On June 1, 2018, the sale of the specialty pharmacy assets was completed. See Note 2: Assets Held for Sale and Discontinued Operations for additional information.

Discontinued operations also include the results of certain operations for the retail pharmacy business. On September 7, 2018 the Company entered into an Asset Purchase Agreement with Walgreen Co., an Illinois corporation. On October 23, 2018, the Company entered into an amendment to the Asset Purchase Agreement (the "Amendment"). Under such Asset Purchase Agreement, as amended by the Amendment (the "Amended WBA Asset Purchase Agreement"), the Company agreed to sell certain prescription files and related data and records, retail pharmaceutical inventory, and certain other assets from 179 of the Company's retail pharmacy stores (such assets from such 179 retail pharmacy stores collectively referred to as “Retail Pharmacy”) for a cash purchase price of approximately $157 million plus an amount equal to the value of the inventory included in the Retail Pharmacy assets up to an approximately $35 million cap, in each case subject to certain adjustments. The results of operations for the year ended February 2, 2019, have been presented as discontinued operations in accordance with ASC 205-20, Results of Operations – Discontinued Operations for all periods presented. Amounts and percentages for all periods discussed reflect the results of operations and financial condition from Fred’s continuing operations, unless otherwise noted.

As of January 17, 2019, the Company had closed the transactions contemplated by the Amended WBA Asset Purchase Agreement, and the Company had received cash proceeds of approximately $156.0 million, plus approximately $20.6 million for the inventory included in the sale, in each case after adjustment as described in the Amended WBA Asset Purchase Agreement. The Company used the proceeds received in the transaction to pay down the Company’s existing indebtedness and for general corporate purposes.

During the fourth quarter of fiscal year 2018, the Board approved a plan to actively market its headquarters building located in Memphis, TN. As a result, the Company has reclassified the headquarters building to Assets Held for Sale in accordance with ASC 360 – Assets held for sale. The building has been reclassified to Assets Held for Sale on the consolidated balance sheet and the depreciation associated with the asset has concluded. See Note 2: Assets Held for Sale and Discontinued Operations for additional information.

Certain prior year amounts have been reclassified to conform to the 2018 presentation. Such reclassifications had no effect on previously reported net loss. Excluding the “Assets Held for Sale and Discontinued Operations” subsection, amounts and percentages for all periods discussed below reflect the results of operations and financial condition from Fred’s continuing operations.

Fred's “Xpress” Designation: The term “Xpress” refers to our locations that are smaller in square footage and offer pharmacy services along with a scaled-down, convenience-centered general merchandise area. The Xpress designation is simply a way of describing our locations that are atypical to our other full-service stores. These locations range in size from 1,000 to 5,000 square feet and enable the Company to enter a new market with a more cost-effective initial investment. These locations primarily sell pharmaceuticals, other health and beauty related items, and limited general merchandise offerings, consisting of mainly consumables. Xpress locations usually originate from a pharmacy acquisition and are in a location that is not suitable for the typical layout of a Fred's store. Therefore, the new store location is given the Xpress designation, and is targeted for conversion to a typical Fred's store once a suitable location can be obtained. In some cases, Xpress locations are located in areas that may not be able to support a full-service store. In all other ways, including resource allocation, management, training, marketing and corporate support, it is treated just as any other location in the Company’s network of stores. Given their smaller physical size, however, Xpress locations are not stocked with the full breadth of merchandise in all departments that are carried by the Company’s other stores.

Xpress sales, as a percentage of total sales, for 2018, 2017 and 2016 were 5.1%, 5.4%, and 6.0%, respectively, and gross profit, as a percentage of total gross profit, for the same time periods was 3.1%, 4.8% and 4.6%, respectively.

The following tables set forth certain information with respect to stores and pharmacies for each of the last three fiscal years:

	2018	2017	2016

Full-service stores open at the beginning of the year	536	573	581
Full-service stores opened/acquired	4	4	2
Full-service stores closed	(6)	(41)	(10)
Full-service stores open at the end of the year	534	536	573
Xpress stores open at the beginning of the year	48	55	60
Xpress stores opened/acquired	—	—	1
Xpress stores closed	(23)	(5)	(5)
Xpress stores converted to full-service stores	(2)	(2)	(1)
Xpress stores open at the end of the year	23	48	55
Total Company-owned stores	557	584	628
Franchise stores at end of period	11	12	16
Total Fred's retail stores	568	596	644
Number of stores with pharmacies at the end of the year (1)	169	348	362
Total selling square feet of full-service stores (in thousands)	7,841	7,876	8,451
Average selling square feet per full-service store	14,684	14,694	14,749

(1) Pharmacies are included in the count of full-service, Xpress and franchise stores.

Merchandising and Marketing

The discount retail and retail pharmacy industries in which the Company is engaged are highly competitive. The principal competitive factors include location of stores, price and quality of merchandise, in-stock consistency, merchandise assortment and presentation, and customer service. The Company competes for sales and store locations in varying degrees with national, regional and local retailing establishments, including drug stores, independent pharmacies, department stores, discount stores, variety stores, dollar stores, discount clothing stores, grocery stores, outlet stores, convenience stores, warehouse stores and other stores. Many of the largest retail companies in the nation have stores in areas in which the Company operates. Management believes that its knowledge of regional and local consumer preferences, developed over its 70-year history, enables the Company to compete effectively within its region.

Management believes that Fred's has a distinctive niche in that it offers a wider variety of merchandise with a more attractive price-to-value relationship than either a drug store or smaller variety/dollar store, is more shopper-convenient than a larger discount store and includes closeout merchandise throughout the store.

Purchasing

The Company's primary front store buying activities are directed by the merchandising department. The merchandising department is made up of a staff of merchants and assistant merchants, some of whom purchase for multiple, similar general merchandise departments. The merchants are participants in an incentive compensation program, which is based upon both individual and total company performance metrics, all of which are designed to drive shareholder value. The Company purchases its merchandise from a wide variety of domestic and import suppliers. Many of the import suppliers generally require long lead times and orders are placed four to six months in advance of delivery. These products are either imported directly by us or acquired from distributors based in the United States and their purchase prices are denominated in United States dollars. The Supply Chain division manages all replenishment and forecasting functions using JDA software combined with the Company's proprietary software which generates open-to-buy reports. Each merchandising category develops vendor line reviews and assortment plans and tests new products and programs to continually improve overall inventory productivity and in-stock positions.

In 2018, approximately 6.5% of the Company's total purchases were from McLane Company Inc. ("McLane"), as compared to 7.5% of all purchases in 2017 and 1.8% in 2016. The 2018 decrease in McLane's purchases as a percent of total purchases is due to the shift in the total sales mix. In 2017, the Company moved from regional vendors to McLane as the Company's sole provider of tobacco, chilled and frozen grocery items, and certain candy and snack items. The Company believes that adequate alternative sources of products are available for these categories of merchandise should the need arise.

The Company's prescription drugs are replenished through the pharmacy inventory management system and shipped directly from the Company's primary pharmaceutical wholesaler, Cardinal Health, Inc. ("Cardinal Health"), to our pharmacies five days a week. Cardinal Health provides substantially all of the Company's prescription drugs. During 2018, 2017 and 2016, approximately 50.0%, 43.5%, and 43.2%, respectively, of the Company's total purchases were made from Cardinal Health. Although there are alternative wholesalers that supply pharmaceutical products, the Company operates under a purchase and supply contract with Cardinal Health as its primary wholesaler, which continues through December 2021. Accordingly, the unplanned loss of this particular supplier could have a short-term gross margin impact on the Company's business until an alternative wholesaler arrangement could be implemented.

Excluding the purchases made from our pharmaceutical supplier, Cardinal Health, and those made from McLane mentioned previously, no other supplier accounted for more than 5% of the Company's total purchases for 2018, 2017 and 2016.

Sales Mix

The Company’s sales, which occur through Company-owned stores and to franchised Fred's stores, constitute a single reportable operating segment. The Company is organized around individual stores. The Company stores have similar economic characteristics, offer pharmaceuticals or general merchandise consistent with all other locations, and have discrete financial information. Each store therefore represents an operating segment that is aggregated into one reportable segment – the retail sale of general merchandise and pharmaceuticals.

The Company’s sales mix by major category for the preceding three years were as follows:

	For the Years Ended					
	February 2, 2019		February 3, 2018		January 28, 2017	
Pharmacy	32.0	%	29.7	%	29.6	%
Consumables	38.9	%	37.8	%	35.4	%
Household Goods and Softlines	28.1	%	31.4	%	33.3	%
Franchise	1.0	%	1.1	%	1.7	%
Total Sales Mix	100.0	%	100.0	%	100.0	%

The sales mix varies from store to store depending upon local consumer preferences and whether the stores include pharmacy departments or the Company's full product line offerings.

Fred's Brand products include health, beauty and personal care products, household cleaning supplies, disposable diapers, pet foods, paper products and a variety of general merchandise, food and beverage products. Private label products afford the Company higher than average gross margins while providing the customer with lower priced products that are of a quality comparable to that of competing branded products. An independent laboratory-testing program is used for substantially all of the Company's private label products. As part of our own brand initiative, we expanded our private label program in 2015 to include additional over-the-counter healthcare products and consumables and continued this expansion in 2016, 2017 and 2018.

The Company sells merchandise to its 11 franchised Fred's stores. These sales totaled approximately $13.0 million in 2018, $15.1 million in 2017 and $25.6 million in 2016. Franchise and other fees earned totaled approximately $0.6 million in 2018, $0.7 million in 2017 and $1.2 million in 2016. These fees represent a reimbursement for use of the Fred's name and administrative costs incurred on behalf of the franchised stores. Two franchise locations were purchased by the Company from a franchisee in 2017 and two locations were closed. During 2018, one additional store was closed. There was no activity for franchised stores during the fiscal 2016 year. The Company does not intend to expand its franchise network.

Advertising and Promotions

Net advertising and promotion costs represented approximately 1.1% of net sales in 2018, 1.5% of net sales in 2017 and 1.3% of net sales in 2016. The Company uses direct mail, newspaper, email and social media advertising to deliver the Fred's value message, and "Fred's Rewards Club" loyalty program now has over one million members. The Company utilizes circulars coordinated by our internal advertising staff to promote its merchandise, special promotional events and a discount retail image.

The Company executes, through its store managers, impactful in-store advertising displays and signage in order to increase impulse purchases. The Company also offers clearance events of seasonal merchandise and conducts sales and promotions of particular items.

Store Operations

Fred's stores are open seven days a week and store hours at most locations are from 8:00 a.m. to 9:00 p.m. Pharmacy departments typically close at 6:00 p.m. Monday through Saturday and are closed on Sunday. Each Fred's store is managed by a full-time store manager and those stores with a pharmacy employ a pharmacist-in-charge, who manages the pharmacy department within the store. The Company's Market Leaders, Regional Vice Presidents and Chief Stores Officer supervise the management and operation of Fred's stores.

The Company has an incentive compensation plan for store managers, pharmacists, and market leaders based on targeted profit goals. Among the factors included in determining profit goals are gross profits and controllable expenses at the store level. These factors of operating performance are reviewed regularly by executive management. Management believes that this incentive compensation plan, together with the Company's store management training program, are instrumental in maximizing store performance. The Company's training program covers all aspects of the Company's operation from product knowledge to handling customers with courtesy.

Inventory Control

The Company's centralized management information system maintains a daily stock-keeping unit ("SKU") level inventory and current and historical sales information for each store and the distribution centers. This system is supported by our in-store point-of-sale ("POS") system, which captures SKU and other data at the time of sale. In 2015, the Company partnered with JDA Software Group, Inc. for a multi-year implementation of a new replenishment, allocation and space management planning system. The Company also utilizes OrderInsite, a pharmacy inventory management system designed to optimize our inventory and improve our in-stock position on pharmaceuticals. Additionally, the Company uses NEX/DEX technology for in-store receiving and inventory control for all items delivered directly to our stores. The Company conducts annual physical inventory counts at all Fred's stores and uses radio frequency devices ("RF guns") to conduct cycle counts to ensure replenishment accuracy.

Distribution

The Company has an 850,000 square foot distribution center in Memphis, Tennessee, which is currently listed within Assets held for sale on the Consolidated Balance Sheet, that services 286 stores and a 600,000 square foot distribution center in Dublin, Georgia that services 271 stores. See Item 2, Properties for additional information. Approximately 73% of the general merchandise received by Fred's stores in 2018 was shipped through these distribution centers, with the remainder (primarily pharmaceuticals, certain snack food items, greeting cards, beverages, frozen foods and tobacco products) shipped directly to the stores by suppliers. For distribution, the Company uses owned and leased trailers and tractors, as well as common carriers. The Company's warehouse management system is automated and provides conveyor control and pick, pack and ship processes by using portable radio-frequency terminals. This system is integrated with the Company's centralized management information system to provide up-to-date perpetual records as well as facilitating merchandise allocation and distribution decisions. The Company uses weekly cycle counts throughout the year to ensure accuracy within the warehouse management system. The Company also utilizes a store replenishment system called JDA that replenishes on a by-store by-item basis to improve merchandise in-stock status.

Payment Cycles and Seasonality

Our business is subject to both monthly and seasonal sales shifts. The Company's sales volume is heavier around the first day of each calendar month due to the fact many of the customers who shop at Fred's stores rely on government aid, social security, and other means that are typically paid around this time. These governmental payment cycles, coupled with the concurrent distribution of our direct and shared mail advertising, are major factors in concentrating sales earlier in the calendar month. Sales are also impacted by the holiday selling season and the timing and severity of the cough, cold and flu season. We typically experience highest sales in the first and fourth quarters as a result.

The following table reflects the payment cycles and seasonality of net sales by quarter:

For the year ended:	1st Quarter		2nd Quarter		3rd Quarter		4th Quarter	
February 2, 2019								
Net Sales	26.5	%	25.3	%	24.1	%	24.1	%
February 3, 2018								
Net Sales	25.9	%	24.3	%	23.2	%	26.6	%
January 28, 2017								
Net Sales	26.3	%	25.1	%	23.7	%	24.9	%

Our quarterly results can also be affected by the timing of certain holidays and by store openings and closings. Higher volumes of inventory are purchased in the third quarter in preparation for higher traffic and sales volume in the fourth quarter.

Intellectual Property - Trademarks

The Company owns trademarks that are registered with the United States Patent and Trademark Office and are protected under applicable intellectual property trade laws. We attempt to obtain registration of our trademarks whenever practicable and to pursue vigorously any infringement of those marks. Our trademark registrations have various expiration dates; however, assuming that the trademark registrations are properly renewed, they have a perpetual duration.

Employees

As of February 2, 2019, the Company had 2,642 full-time and 3,930 part-time employees, the majority of which are store employees. The number of employees varies during the year, reaching a peak during the Christmas selling season, which typically begins after the Thanksgiving holiday. The Memphis, Tennessee distribution center employees are represented by a union, Workers United, pursuant to a three-year collective bargaining agreement which went into effect on July 1, 2017. The Company is required to make minimal contributions to the distribution center employees 401(k) plan each year, in accordance with the plan. None of the contributions are associated with a defined benefit plan. The Company is in good standing with the collective bargaining agreement and believes it continues to have good relations with all its employees.

Competition

The discount retail and retail pharmacy industries are highly competitive. We compete with respect to price, store location, in-stock consistency, merchandise quality, assortment and presentation, and customer service with many national, regional and local retailing establishments, including drug stores, independent pharmacies, department stores, discount stores, variety stores, dollar stores, discount clothing stores, grocery stores, outlet stores, convenience stores, warehouse stores and other stores. Our competitors range from smaller, growing companies to considerably larger retail businesses that have greater financial, distribution, marketing and other resources than we do. Furthermore, the retail sector continues to experience a trend towards an increase in sales initiated online and using mobile applications, and some online-only businesses have lower operating costs. Online and multi-channel retailers continue to focus on delivery services, with customers increasingly seeking faster, guaranteed delivery times and low-price or free shipping. We compete with many of these e-commerce and mail order businesses, a space in which we do not have a presence. There is no assurance that we will be able to compete successfully with them in the future. See Cautionary Statement Regarding Forward-Looking Information and Item 1A, Risk Factors for additional information.

Government Regulation

As a publicly-traded company, we are subject to numerous federal securities laws and regulations, including the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and related rules and regulations promulgated by the Securities and Exchange Commission ("SEC"), as well as the Sarbanes-Oxley Act of 2002 and the Dodd–Frank Wall Street Reform and Consumer Protection Act. These laws and regulations impose significant requirements in the areas of accounting and financial reporting, corporate governance and insider trading, among others.

Each of our locations must comply with regulations adopted by federal and state agencies regarding licensing, health, sanitation, safety, fire and other regulations. In addition, we must comply with the Fair Labor Standards Act, as amended, and various state laws governing various matters such as minimum wage, overtime and other working conditions. We must also comply with provisions of the Americans with Disabilities Act of 1990, as amended, which requires generally that employers provide reasonable accommodation for employees with disabilities and that our stores be accessible to customers with disabilities. The Company’s pharmacy department, in particular, is subject to extensive federal and state laws and regulations.

Licensure and Regulation of Retail Pharmacies

There are extensive federal and state regulations applicable to the practice of pharmacy at the retail level. We are subject to numerous federal and state laws and regulations concerning the protection of confidential patient medical records and information, including the federal Health Insurance Portability and Accountability Act (“HIPAA”). Most states have laws and regulations governing the operation and licensing of pharmacies and regulate standards of professional practice by pharmacy providers. These regulations are issued by an administrative body in each state, typically a pharmacy board, which is empowered to impose sanctions for non-compliance. Additionally, the Drug Enforcement Agency (“DEA”) requires that controlled substances be monitored and controlled at all times.

Our business is also subject to federal, state and local laws, regulations, and administrative practices concerning the provision of and payment for health care services, including, without limitation: federal, state and local licensure and registration requirements concerning the operation of pharmacies and the practice of pharmacy; Medicare, Medicaid and other publicly financed health benefit plan regulations prohibiting kickbacks, beneficiary inducement and the submission of false claims.

As a provider of Medicare prescription drug plan benefits, we are subject to various federal regulations promulgated by the Centers for Medicare and Medicaid Services under the Medicare Prescription Drug, Improvement and Modernization Act of 2003. In the future we may also be subject to changes to various state and federal insurance laws and regulations in connection with the Company’s pharmacy operations.

Healthcare Initiatives

Legislative and regulatory initiatives pertaining to such healthcare related issues as reimbursement policies, payment practices, therapeutic substitution programs, and other healthcare cost containment issues are frequently introduced at both the state and federal levels. In March 2010, the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act (collectively, the “PPACA”), was enacted, but we did not experience a material impact to our business. This PPACA legislation made it possible for states to expand their Medicaid rolls, but many chose not to exercise their expansion ability under the new legislation. The majority of any incremental pharmacy business generated under the healthcare exchanges created by PPACA has been assimilated into our traditional commercial payor networks.

Some of the provisions of the PPACA have yet to be implemented, and there have been judicial and Congressional challenges to certain aspects of the PPACA. In addition, the current administration and Congress will likely continue to seek legislative and regulatory changes, including repeal and replacement of certain provisions of the PPACA. In January 2017, President Trump signed an Executive Order directing federal agencies with authorities and responsibilities under the PPACA to waive, defer, grant exemptions from, or delay the implementation of any provision of the PPACA that would impose a fiscal or regulatory burden on states, individuals, healthcare providers, health insurers, or manufacturers of pharmaceuticals or medical devices. In March 2017, following the passage of the budget resolution for fiscal year 2017, the U.S. House of Representatives introduced legislation known as the American Health Care Act, which, if enacted, would have amended or repealed significant portions of the PPACA. However, consensus over the scope and content of the American Health Care Act could not be reached by its proponents in the U.S. House of Representatives. Thus, the proposed legislation has been withdrawn and the prospects for legislative action on this bill are uncertain. Congress could consider other legislation to repeal or replace certain elements of the PPACA. At this time, we continue to evaluate the effect that the PPACA, and the impact of its possible repeal and replacement has and may have on our business.

In December of 2018, a U.S. District Court judge in Texas ruled that the PPCA was unconstitutional because the Tax Cuts and Jobs Act eliminated the tax penalty under the individual mandate. The case is likely to be appealed to the U.S. Supreme Court. The judge sided with 20 states that argued that eliminating a penalty for not having health insurance invalidated the PPACA. Once the tax penalty was eliminated, the judge concluded the law was no longer constitutional.

In January of 2019, the U.S. House of Representatives was authorized to intervene and defend the PPACA in court. By a vote of 235 to 192, the House adopted Title III of the Rules of the 116th Congress, which authorized the House Speaker to intervene in the federal court case in Texas that challenges the PPACA's fundamental constitutionality, and in any appellate proceedings arising from the case. In the case, a district court held that, considering the elimination of the shared responsibility payment (the individual mandate), effective January 2019, the PPACA as a whole could not stand.

Substantial Compliance

The Company's management believes the Company is in substantial compliance with all existing statutes and regulations material to the operation of the Company's businesses and is unaware of any material non-compliance action against the Company.

Environmental Matters

We are not aware of any federal, state or local environmental laws or regulations that will materially affect our earnings or competitive position or result in material capital expenditures. However, we cannot predict the effect on our operations of possible future environmental legislation or regulations. During fiscal year 2018, we did not incur any material capital expenditures for environmental control facilities, and no such material expenditures are anticipated.

Termination of Rite Aid Asset Purchase Agreement

On December 19, 2016, Fred's and its wholly-owned subsidiary, AFAE, LLC ("Buyer"), entered into an Asset Purchase Agreement (the "Rite Aid Asset Purchase Agreement") with Rite Aid Corporation ("Rite Aid") and Walgreens Boots Alliance, Inc. ("Walgreens"), pursuant to which Buyer agreed to purchase 865 stores, certain intellectual property and other tangible assets (collectively, the "Rite Aid Assets") and to assume certain liabilities for a cash purchase price of $950 million (the "Rite Aid Transaction"). Pursuant to Section 8.01(g) of the Rite Aid Asset Purchase Agreement, each of Buyer, Walgreens or Rite Aid was permitted to terminate the Rite Aid Asset Purchase Agreement upon the termination of that certain Agreement and Plan of Merger, dated as of October 27, 2015, among Walgreens, Rite Aid and the other parties thereto (as amended, the "Merger Agreement").

On June 29, 2017, the Merger Agreement was terminated and, accordingly, the Rite Aid Asset Purchase Agreement was also terminated, effective immediately. In connection with the termination of the Rite Aid Asset Purchase Agreement, the Company received a termination fee payment of $25 million on June 30, 2017 from Walgreens.

Available Information

Our website address is http://www.fredsinc.com. We make available through this website, without charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports, including related exhibits and supplemental schedules, as soon as reasonably practicable after these materials are electronically filed with or furnished to the SEC. Also included free of charge on our website is the Company's Code of Business Conduct and Ethics, and the Board s committee charters. The SEC maintains a website at http://www.sec.gov that contains reports, proxy and information statements and other information regarding issuers, such as Fred's, that file electronically with the SEC.

ITEM 1A. Risk Factors

Investors are encouraged to carefully consider the risks described below and other information contained in this document when considering an investment decision with respect to Fred's securities. Additional risks and uncertainties not presently known to management, or that management currently deems immaterial, may also impair the Company’s business operations. Any of the events discussed in the risk factors below may occur. If one or more of these events do occur, our business, results of operations or financial condition could be materially adversely affected. In that instance, the trading price of Fred's securities could decline and investors might lose all or part of their investment.

Competitive and Strategic Risks

Our financial performance has raised substantial doubt about our ability to remain a going concern.

The financial statements included in this report have been prepared assuming the Company will continue as a going concern. The Company has experienced significant net losses and negative cash flows from operating activities in recent years, and we cannot assure you that such losses and negative cash flows will not continue for the foreseeable future. For the fiscal years ended February 2, 2019 and February 3, 2018, we incurred net losses of $137.2 million and $144.5 million, respectively, and our net cash flows used in operating activities were $91.5 million and $44.7 million, respectively. Furthermore, the Company has limited availability under its Revolving Credit Agreement, which along with cash from operations has traditionally been the Company’s primary source of working capital. As of April 30, 2019, the Company had outstanding borrowings of $78.3 million under our Revolving Credit Agreement and excess availability of $37.1 million. Under our Revolving Credit Agreement, we have a financial covenant to maintain at all times excess availability of at least the greater of $21,000,000 and 10% of the commitments, and if excess availability falls below such threshold, it would constitute an event of default under the Revolving Credit Agreement. The Company’s failure to comply with the financial covenants and other obligations under the Revolving Credit Agreement would result in an event of default, which if not cured or waived, may permit acceleration of our indebtedness and other remedies. Furthermore, as described above under Item 1: Business – Recent Developments – Recent Developments Affecting the Revolving Credit Agreement, the failure to deliver audited financial statements without a going concern qualification within 120 days of fiscal year end will result in the Going Concern Event of Default, and there are certain other events of default that may be outstanding under our Revolving Credit Agreement.

An event of default, which is not cured or waived, would permit, among other remedies, acceleration of Fred’s indebtedness under the Revolving Credit Agreement and the addition, at the option of the Required Lenders (as defined in the Revolving Credit Agreement), of 200 basis points to the applicable interest rate with respect to all loans under the Revolving Credit Agreement (the “Default Rate”). As of the date of this Annual Report on Form 10-K, the lenders under the Revolving Credit Agreement have not taken any action to accelerate our indebtedness, impose the Default Rate or exercise other remedies with respect to the Revolver EODs, but there can be no assurance that such lenders will not do so in the future. Fred’s is currently seeking an agreement with its lenders pursuant to which such lenders would forbear for a period of time from seeking remedies on account of, or waive, the Revolver EODs, but there is no assurance that Fred’s will receive such forbearance or waivers. If our indebtedness is accelerated, whether due to the Revolver EODs or otherwise, we cannot be certain that we will have sufficient funds available to pay the accelerated indebtedness or that we will have the ability to refinance the accelerated indebtedness on terms favorable to us or at all.

If our indebtedness is accelerated, the Company cannot be certain that we will have sufficient funds available to pay the accelerated indebtedness or that we will have the ability to refinance the accelerated indebtedness on terms favorable to us or at all, which could have a material adverse effect on the Company’s business, results of operations and financial condition and could impact our ability to continue as a going concern. In addition, our Revolving Credit Agreement has a maturity date of April 9, 2020, and we can provide no assurance that we will be able to renew or refinance such facility on terms acceptable to us or at all. The foregoing conditions raise substantial doubt about the Company's ability to continue as a going concern.

The Company has evaluated its plans to alleviate this doubt, including evaluating strategic alternatives, assessing alternative financing arrangements, and undertaking certain operational measures, such as store closures, renegotiated lease terms and reductions in general and administrative expenses and capital expenditures. The Company can provide no assurance, however, regarding the outcome of its evaluation of strategic alternatives, that alternative financing will be on terms acceptable to us or at all, or that the operational measures being undertaken by the Company will be successful in improving the Company's financial performance, in which case the Company may be unable to continue as a going concern. The financial statements included in this report do not include any adjustments to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. See Item 7: "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

We are exploring strategic alternatives and there can be no assurance that we will be successful in identifying or completing any strategic alternative or that any such strategic alternative will yield additional value for shareholders.

We have commenced a review of strategic alternatives to maximize shareholder value, which could result in, among other things, a sale, a merger, a consolidation or business combination, further store closures or other asset divestitures, financing transactions, or restructurings. There can be no assurance that the exploration of strategic alternatives will result in the identification or consummation of any transaction. In addition, we may incur substantial expenses associated with identifying and evaluating potential strategic alternatives. The process of exploring strategic alternatives may be time consuming and disruptive to our business operations and if we are unable to effectively manage the process, our business, financial condition and results of operations could be adversely affected. We also cannot assure that any potential transaction or other strategic alternative, if identified, evaluated and consummated, will provide greater value to our shareholders than that reflected in the current stock price. Any potential transaction would be dependent upon a number of factors that may be beyond our control, including, among other factors, market conditions, industry trends, the interest of third parties in our business and the availability of financing on reasonable terms.

We operate in a competitive industry.

The discount retail and retail pharmacy industries in which we operate are highly competitive. We compete with respect to price, store location, in-stock consistency, merchandise quality, assortment and presentation and customer service with many national, regional and local retailing establishments, including drug stores, independent pharmacies, department stores, discount stores, variety stores, dollar stores, discount clothing stores, grocery stores, outlet stores, convenience stores, warehouse stores and other stores. Our competitors range from smaller, growing companies to considerably larger retail businesses that have greater financial, distribution, marketing and other resources than we do. Furthermore, the retail sector continues to experience a trend towards an increase in sales initiated online and using mobile applications, and some online-only businesses have lower operating costs. Online and multi-channel retailers continue to focus on delivery services, with customers increasingly seeking faster, guaranteed delivery times and low-price or free shipping. We compete with many of these e-commerce and mail order businesses, a space in which we do not have a presence. This competitive environment subjects us to various risks, including the ability to continue to provide competitively priced products to our customers that will allow us to achieve and maintain profitability. Some of our competitors utilize aggressive promotional activities, advertising programs and pricing discounts and our results of operations could be adversely affected if we do not respond effectively to these efforts. If we fail to successfully compete, our profitability and results of operations could be adversely affected.

Our turnaround plans depend significantly on strategies and initiatives designed to improve long-term growth, profitability and shareholder value. Failure to achieve or sustain these plans could affect the Company’s performance adversely.

Throughout 2018, we sought to execute our turnaround strategy through the following strategic initiatives: monetizing non-core assets; reducing selling, general and administrative expenses; bringing new talent into the organization; driving traffic; improving assortment and optimizing inventory levels; generating free cash flow; and reducing debt levels. The successful design and implementation of these initiatives present significant challenges, many of which are beyond our control. We were not successful in executing all of our strategic initiatives in 2018, and we may not be successful in doing so in 2019. In addition, these initiatives may not advance our business strategy as expected. Events and circumstances, such as financial or strategic difficulties, delays and unexpected costs may occur that could result in our not realizing all or any of the anticipated benefits or our not realizing the anticipated benefits on our expected timetable. If we are unable to realize the anticipated financial benefits of these initiatives, our ability to fund other initiatives may be adversely affected. Any failure to implement these initiatives in accordance with our expectations could adversely affect our financial condition, results of operations and cash flows.

In addition, the complexity of these initiatives has and will continue to require a substantial amount of management and operational resources. Our management team must successfully implement administrative and operational changes necessary to achieve the anticipated benefits of these initiatives. These and related demands on our resources may divert the organization's attention from existing core businesses, integrating financial or other systems, have adverse effects on existing business relationships with suppliers and customers and impact employee morale. As a result, our financial condition, results of operations, or cash flows may be adversely affected.

Further, the success of our merchandising initiatives, particularly those with respect to non-consumable merchandise such as pharmaceutical products, as well as store-specific allocations such as those made to Xpress stores, depends in part upon our ability to predict consistently and successfully the products that our customers will demand and to identify and timely respond to evolving trends in demographics and consumer preferences, expectations and needs. If we are unable to select products that are attractive to customers in amounts that customers are likely to buy, to timely obtain such products at costs that allow us to sell them at an acceptable profit, or to effectively market such products, then our sales, market share and profitability could be adversely affected. Further, if our merchandising efforts in the areas of general pharmaceutical products and higher margin consumables are unsuccessful, it could be further adversely affected by our inability to offset the lower margins associated with the Company’s other lines of business.

Divestiture of our specialty pharmacy businesses, all or part of our retail pharmacy business, or any other business line, including those that we have acquired or will acquire, may materially adversely affect our financial condition, results of operations or cash flows, or may result in impairment charges that may adversely affect our results of operations.

Divestitures involve risks, including difficulties in the separation of operations, services, products and personnel, the diversion of management's attention from other business concerns, the disruption of our business, the loss of customers and customer-loyalty, the potential loss of key employees and the retention of uncertain contingent liabilities related to the divested business, any of which could result in a material adverse effect to our financial condition, results of operations or cash flows. Divestitures of previously acquired businesses may result in significant asset impairment charges, including those related to goodwill and other intangible assets, which could have a material adverse effect on our financial condition and results of operations. Future impairment may result from, among other things, deterioration in the performance of the acquired business or product line, adverse market conditions and changes in the competitive landscape, adverse changes in applicable laws or regulations, including changes that restrict the activities of the acquired business or product line, changes in accounting rules and regulations and a variety of other circumstances. The amount of any impairment is recorded as a charge to the statement of operations. We may never realize the full value of our goodwill and intangible assets, and any determination requiring the write-off of a significant portion of these assets may have an adverse effect on our financial condition and results of operations. We cannot assure you that we will be successful in managing these or any other significant risks that we encounter in divesting a business or product line.

We may not realize the anticipated benefits of the sale of assets to Advance Care Scripts/CVS and Walgreen Co., which could adversely impact our results of operations.

We have sold certain prescription files and records, pharmaceutical inventory, and certain other assets used in our specialty and retail pharmacy businesses with the expectation that the transactions will result in various benefits, including, among other things, cost savings and operating efficiencies. We can provide no assurance that:

- the anticipated benefits of the transactions, including cost savings, will be fully realized in the time frame anticipated or at all;
- unanticipated costs, charges and expenses will not result from the transactions;
- litigation relating to the transactions will not be filed; and
- the transaction will not cause disruption to the parties' business and operations and relationships with employees and suppliers, payers, customers and other third parties.

If one or more of these risks are realized, it could have a material adverse impact on our operating results.

We could also encounter unforeseen transaction costs or other circumstances, such as unforeseen liabilities or other issues resulting from the transactions. Many of these potential circumstances are outside of our control and any of them could result in increased costs, decreased revenue and the diversion of management time and attention, which could adversely impact our agility to respond to market opportunities and our ability to timely identify and implement other strategic actions. If we are unable to achieve our objectives within the anticipated time frame, or at all, the expected benefits may not be realized fully or at all, or may take longer to realize than expected, which could have a material adverse impact on our business operations, financial condition and results of operations. In addition, we have incurred significant transaction costs related to the transactions. These costs, including legal, accounting, financial and tax advisory and other fees and costs, may be higher than expected and some of these costs may be material.

Our ability to achieve the results of store closures under our strategic plan initiatives could adversely affect our business.

As part of our continuing operations, we perform research and analysis to identify underperforming stores and to determine if store closure is necessary. For example, in April 2019, the Company announced a plan to close 159 underperforming stores. The decision to close these stores was the result of a comprehensive evaluation of the Company's store portfolio, which examined historical and recent store performance and the timing of lease expirations, among other factors. These store closings, and any other store closures that the Company may pursue, may cause us to expend significant capital and other resources, write-off assets, accelerate rent expenses, incur impairment charges, adversely affect our credit, terms and relationships with vendors and suppliers, adversely affect our distribution and cost structure, and may subject to us to litigation. On April 11, 2019, we announced on a Current Report on Form 8-K that material charges for impairment and other costs would be required in connection with the plan to close 159 performance stores and that we will file an amendment to such Current Report on Form 8-K after we determine an estimate or range of estimates for such impairment charges and other costs. Our reputation and brand may be damaged in connection with the store closings. Customers that shopped in our stores may not purchase the same number (or any) of our products after our stores are closed. While we are attempting to negotiate favorable lease terms with our landlords, we may be unsuccessful in doing so and may incur significant lease termination charges. Any of these results could have a material and adverse effect on our business, financial condition, or results of operations. There can be no assurance that the store closings, or any future store closings, will improve our business, financial condition, or results of operations. The estimated costs and charges associated with these and any future store closures may vary materially and adversely based upon various factors, including the timing of execution, the outcome of negotiations with landlords and other third parties, or unexpected costs, any of which could result in our not realizing the anticipated benefits from the strategic plan.

Underperforming stores can result in charges and expenses.

If individual stores underperform to the point that their future estimated cash flows will not cover our un-depreciated fixed asset investment, we take an impairment charge. We also close certain underperforming stores, generally based on the lack of store profitability. Such closures subject us to costs, including lease termination payments and the write-down of leasehold improvements, equipment, furniture, fixtures and inventory. For early terminations, we may incur charges for asset write-downs and remain liable for future lease obligations, which could adversely affect our profitability and results of operations.

We depend on successfully increasing the utilization of our existing stores and, in the longer-term, opening new stores, for a portion of our growth.

Our growth is dependent on both increases in sales in existing stores and, in the longer-term, the ability to open new stores. Unavailability of store locations that we deem desirable, delays in the opening of new stores, difficulties in staffing and operating new store locations and the lack of customer acceptance of stores in expanded market areas all may negatively impact our new store growth, the costs associated with new stores and/or the profitability of new stores. In addition, there can be no assurance that we will be able to re-negotiate leases at similar or satisfactory terms at the end of the lease, and we could be forced to move or exit locations if another favorable arrangement cannot be made. There is also no assurance that we will be