FREDS INC
Form 10-Q
December 13, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended November 3, 2018.

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 Incorporation or Organization)	(I.R.S. Employer 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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or such shorter period that the registrant was required to submit such files). Yes No .

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 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 check mark 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 Exchange Act). Yes No .

The registrant had 37,686,555 shares of Class A voting, no par value common stock outstanding as of December 10, 2018.

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)

	November 3, 2018 (unaudited)	February 3, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,182	$ 6,573
Inventories	236,066	263,831
Receivables, less allowance for doubtful accounts of $1,360 and $1,355; respectively	38,268	37,720
Other non-trade receivables	26,379	31,500
Current assets held for sale	13,849	35,247
Prepaid expenses and other current assets	10,043	10,055
Total current assets	330,787	384,926
Property and equipment, less accumulated depreciation and amortization	105,124	115,466
Intangible assets, net	25,183	34,347
Noncurrent assets held for sale	16,471	62,258
Other noncurrent assets, net	1,510	568
Total assets	$ 479,075	$ 597,565
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 112,883	$ 129,213
Current portion of indebtedness	68	65
Accrued expenses and other	61,942	67,977
Current liabilities held for sale	—	26,572
Total current liabilities	174,893	223,827
Long-term portion of indebtedness	181,174	167,100
Noncurrent liabilities held for sale	—	48
Other noncurrent liabilities	21,036	25,542
Total liabilities	377,103	416,517
Commitments and contingencies (see Note 6-Long-Term Leases, Note 10-Other Commitments and Contingencies and Note 11-Indebtedness)		

Shareholders' equity:		
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	—	—
Preferred stock, Series B junior participating voting, $100 par value, 50,000 shares authorized, no shares issued or outstanding	—	—
Preferred stock, Series C junior participating voting, $60 par value, 50,000 shares authorized, no shares issued or outstanding	—	—
Common stock, Class A voting, no par value, 60,000,000 shares authorized, 37,686,555 and 38,366,517 shares issued and outstanding, respectively	126,568	123,950
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding	—	—
Treasury Stock, at cost; 1,242,000 shares at November 3, 2018 and at February 3, 2018	(4,975)	(4,975)
Retained earnings (deficit)	(20,180)	61,514
Accumulated other comprehensive income	559	559
Total shareholders' equity	101,972	181,048
Total liabilities and shareholders' equity	$ 479,075	$ 597,565

See accompanying notes to condensed consolidated financial statements.

FRED’S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands, except per share amounts)

	Thirteen Weeks Ended		Thirty-Nine Weeks Ended	
	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
Net sales	$306,413	$324,329	$964,654	$1,024,980
Cost of goods sold	229,446	254,298	713,398	753,269
Gross profit	76,967	70,031	251,256	271,711
Depreciation and amortization	7,632	8,588	24,019	26,333
Selling, general and administrative expenses	98,008	109,667	291,759	361,279
Operating loss	(28,673)	(48,224)	(64,522)	(115,901)
Interest expense	2,073	1,647	5,781	4,371
Loss before income taxes	(30,746)	(49,871)	(70,303)	(120,272)
Provision (benefit) for income taxes	71	567	(354)	(1,103)
Net loss from continuing operations	$(30,817)	$(50,438)	$(69,949)	$(119,169)
Net income (loss) from discontinued operations	3,438	(1,377)	(11,745)	1,376
Net Loss	$(27,379)	$(51,815)	$(81,694)	$(117,793)
Net (loss) income per share - basic				
Continuing operations	$(0.83)	$(1.35)	$(1.91)	$(3.18)
Discontinued operations	0.09	(0.04)	(0.32)	0.04
Total loss per common share - basic	$(0.74)	$(1.39)	$(2.23)	$(3.14)
Net (loss) income per share - diluted				
Continuing operations	$(0.83)	$(1.35)	$(1.91)	$(3.18)
Discontinued operations	0.09	(0.04)	(0.32)	0.04
Total loss per common share - diluted	$(0.74)	$(1.39)	$(2.23)	$(3.14)
Weighted average shares outstanding				
Basic	36,962	37,626	36,650	37,481
Effect of dilutive stock options	—	—	—	—
Diluted	36,962	37,626	36,650	37,481

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(unaudited)

(in thousands)

	Thirteen Weeks Ended		Thirty Nine Weeks Ended	
	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
Net loss	$(27,379)	$(51,815)	$(81,694)	$(117,793)
Other comprehensive income (expense), net of tax postretirement plan adjustment	—	—	—	—
Comprehensive loss	$(27,379)	$(51,815)	$(81,694)	$(117,793)

See accompanying notes to condensed consolidated financial statements.

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FRED’S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Thirty Nine Weeks Ended	
	November 3, 2018	October 28, 2017
Cash flows from operating activities of continuing operations:		
Net loss	$(69,949)	$(119,169)
Adjustments to reconcile net loss to net cash flows from operating activities:		
Depreciation and amortization	24,019	26,333
Net gain on asset disposition	(437)	(140)
Provision for store closures and asset impairment	1,772	20,783
Stock-based compensation	2,707	4,640
(Recovery) provision for uncollectible receivables	(817)	37
Change in LIFO reserve	2,693	640
Deferred income tax (expense) benefit	(23)	1,286
Amortization of debt issuance costs	432	182
Changes in operating assets and liabilities, net of effects of business sold:		
(Increase) decrease in operating assets:		
Trade and non-trade receivables	4,459	1,338
Insurance receivables	—	395
Inventories	25,071	(5,278)
Other assets	(923)	6,156
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	(22,366)	20,885
Income taxes receivable	1,062	(28)
Other noncurrent liabilities	(5,147)	8,034
Net cash used in operating activities of continuing operations	(37,447)	(33,906)
Cash flows from investing activities of continuing operations:		
Capital expenditures	(7,523)	(12,418)
Proceeds from asset dispositions	2,203	1,276
Asset acquisitions, net (primarily intangibles)	—	(1,853)
Net cash used in investing activities of continuing operations	(5,320)	(12,995)
Cash flows from financing activities of continuing operations:		
Payments of indebtedness and capital lease obligations	(48)	(45)
Proceeds from revolving line of credit	542,741	715,228
Payments on revolving line of credit	(528,634)	(675,065)

Debt issuance costs	(415)	(489)
Payments from exercise of stock options and employee stock purchase plan	(149)	(112)
Transfer from discontinued operations	28,881	13,513
Cash dividends paid	—	(6,847)
Net cash provided by financing activities of continuing operations	42,376	46,183
Decrease in cash and cash equivalents	(391)	(718)
Cash flows from discontinued operations		
Cash flows from operating activities of discontinued operations, net	(10,025)	13,927
Cash flows from investing activities of discontinued operations, net	38,906	(414)
Cash flows from financing activities of discontinued operations, net	(28,881)	(13,513)
Net decrease in cash and cash equivalents	(391)	(718)
Cash and cash equivalents, beginning of year	6,573	5,830
Cash and cash equivalents of discontinued operations/held for sale operations, beginning of year	—	—
Net decrease in cash and cash equivalents	(391)	(718)
Less: cash and cash equivalents of discontinued/held for sale operations at end of period	—	—
Cash and cash equivalents, end of period	$6,182	$5,112
Supplemental disclosures of cash flow information:		
Interest paid	5,781	4,371
Income taxes refunded	—	(2,002)

See accompanying notes to condensed consolidated financial statements.

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FRED'S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: BASIS OF PRESENTATION

Fred's, Inc. and its subsidiaries ("Fred's", "We", "Our", "Us" or the "Company") operate, as of November 3, 2018, 589 discou general merchandise stores in fifteen states in the Southeastern United States. Included in the count of discount general merchandise stores are 11 franchised locations. There are 346 full service pharmacy departments (179 of which are now classified as Assets held-for-sale) located within our discount general merchandise stores, including one within franchised locations.

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 Article 10 of Regulation S-X 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 accompanying financial 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 accompanying financial statements should be read in conjunction with the Notes to the Consolidated Financial Statements for the fiscal year ended February 3, 2018 included in our Annual Report on Form 10-K, which we filed with the Securities and Exchange Commission (the "SEC") on May 4, 2018.

We meet the SEC's definition of a "Smaller Reporting Company," and therefore qualify for the SEC's reduced disclosure requirements for smaller reporting companies.

During the fourth quarter of 2017, Fred's Board of Directors 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 Accounting Standards Codification ("ASC") Topic 360 (ASC 360), Property, Plant and Equipment, as of February 3, 2018. The specialty pharmacy assets and liabilities are reflected as "Assets held-for-sale" on the consolidated balance sheets in this report in accordance with ASC 360. In addition, the results of operations for the specialty pharmacy business have been presented in this report 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 below reflect the results of operations and financial condition from Fred's continuing operations, unless otherwise noted.

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 $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.

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 346 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. During the third quarter of 2018, the assets therefore met the criteria for "Assets held-for-sale" in accordance with ASC 360. Such assets have been reflected as "held-for-sale" on the consolidated balance sheets in accordance with ASC 360. In addition, the results of operations 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 below reflect the results of operations and financial condition from Fred's continuing operations, unless otherwise noted.

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.

The results of operations for the thirteen-week and thirty-nine week periods ended November 3, 2018 are not necessarily indicative of the results to be expected for the full fiscal year.

All references in this Quarterly Report on Form 10-Q to 2017 and 2018 refer to the Company's fiscal years ended February 3, 2018 and ending February 2, 2019, respectively.

Recent Accounting Pronouncements

In February 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects* *from Accumulated Other Comprehensive Income.* This ASU provides companies with the option to reclassify tax effects resulting from the Tax Cuts and Jobs Act ("TCJA") within Accumulated Other Comprehensive Income into Retained Earnings. This ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The Company is currently evaluating the effect this ASU will have on its financial position, results of operations and cash flows.

In October 2016, the FASB issued ASU 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory*. ASU 2016-16 requires that an entity recognize the income tax consequences of an intra-entity transfer of assets other than inventory when the transfer occurs. The guidance must be applied using the modified retrospective basis. This update is effective for the Company at the beginning of fiscal 2018. The Company has adopted the provisions of ASU 2016-16 and it has had no impact on its financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The amendments in the ASU are designed to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this ASU are effective for the annual reporting periods beginning after December 15, 2018, including the interim periods within that reporting period. Early adoption is permitted. The Company has identified all leases impacted by this pronouncement. The Company has selected a lease accounting and administration software to maintain all leases in compliance with this pronouncement and is currently working on the software implementation and testing, as well as accounting process development to ensure compliance with this standard upon adoption in 2019. The Company does not plan to early adopt and expects material changes to the financial position created at the inception of compliance with this standard. The Company will continue to evaluate the impact the guidance will have on the Company’s financial position, results of operations and cash flows.

In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606), an update to ASU 2014-09. This ASU amends ASU 2014-09 to defer the effective date by one year for annual reporting periods beginning after December 15, 2017. Subsequently, the FASB has also issued accounting standards updates which clarify the guidance. This ASU removes inconsistencies, complexities and allows transparency and comparability of revenue transactions across entities, industries, jurisdictions and capital markets by providing a single comprehensive principles-based model with additional disclosures regarding uncertainties. The principles-based revenue recognition model has a five-step analysis of transactions to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Early adoption is permitted for annual reporting periods beginning after December 15, 2016. In transition, the ASU may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company has evaluated all contracts and has implemented this standard and there was no material impact to the Company’s statement of position, results of operations, or statement of cash flow.

Revenue Recognition

Sales

The vast majority of Fred’s contracts with customers are made at the point of sale (POS) in the retail stores, and the performance obligation is the transfer of merchandise which is satisfied at POS when customer pays for merchandise and title transfers to them.

340B Revenues

We evaluated principal versus agent considerations with regards to the 340B Direct program under ASC 606. Because Fred’s is primarily responsible for fulfilling the promise to provide the 340B Direct prescription drugs and assumes control of and risk for inventory prior to transfer of goods to the customer, including pricing apart from when determined by federal mandate, Fred’s recognizes revenue on a gross basis as principal for the 340B Direct program.

Gift Card and Breakage

When customers purchase gift cards, the sale is not recognized until the card is redeemed. The gift cards are not always fully redeemed and as such, the Company recognizes breakage. Based on the results from our historical breakage model, the Company defines the likelihood of redemption as remote after three years of no activity.

Layaway Plans

Store layaways are agreements with our customers to provide or deliver goods for a specified price at a future date. Layaway programs run annually for a duration of less than one year and are most popular during the Christmas seasons. Under the Company’s layaway plan, the customer is obligated to pay only the amount equivalent to the value of the good plus sales tax. The Company does not assess a layaway fee or interest but requires an upfront deposit. The customer does not take delivery of the merchandise until the full value is collected.

Our performance obligation is the transfer of merchandise which is satisfied at the point of customer pick-up, not at transaction initiation. Any payments received prior to customer pick-up are considered advance payments and deferred and recognized when the performance obligation is satisfied. Layaway sales are deferred when the customer transaction is initiated and are recognized as revenue when the layaway merchandise is transferred.

Disaggregated Revenues

In the following table, consolidated sales are disaggregated by major merchandising category.

(in thousands)	Thirteen Weeks Ended November 3, 2018	Thirty-Nine Weeks Ended November 3, 2018
Pharmacy	$ 203,570	$ 692,766
Consumables	119,086	380,993
Household Goods and Softlines	80,277	270,401
Franchise	3,711	9,367
Total	$ 406,644	$ 1,353,527

Termination of Rite Aid Asset Purchase Agreement

On December 19, 2016, Fred’s and its wholly-owned subsidiary, AFAE, LLC (“AFAE”), 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 AFAE agreed to purchase 865 stores, certain intellectual property and other tangible assets and to assume certain liabilities for a cash purchase price of $950 million. Pursuant to Section 8.01(g) of the Rite Aid Asset Purchase Agreement, each of AFAE, 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. 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, which was recorded in selling, general and administrative expenses to offset the expenses incurred.

See Note 11: Indebtedness for additional information relating to the termination of the Rite Aid Asset Purchase Agreement.

NOTE 2: ASSETS HELD-FOR-SALE AND DISCONTINUED OPERATIONS

During the fourth quarter of 2017, Fred’s Board of Directors approved a plan to actively market its specialty pharmacy business (“Entrust”). Accordingly, Entrust met the criteria for “Assets Held-for-Sale” in accordance with ASC 360 as of February 3, 2018. Entrust’s assets and liabilities were reflected as “held-for-sale” on the consolidated balance sheets in accordance with ASC 360 at February 3, 2018. In addition, the results of operations for the Entrust business have been presented as discontinued operations in accordance with ASC 205-20 for all periods presented. On May 4, 2018, Fred’s entered into the Specialty Asset Purchase Agreement with the Specialty Buyer, pursuant to which, the Specialty Buyer agreed to purchase Entrust, consisting of three pharmacy locations, pharmaceutical inventory, and related intellectual property. The Specialty Buyer paid Fred’s $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 Entrust assets was completed.

The results of the Entrust business were previously allocated to the Pharmacy segment within the sales mix. There were no earnings related to the Entrust business in the third quarter of 2018, but Entrust recorded a loss from discontinued operations, net of tax, of $1.9 million for the third quarter of 2017, and a loss from discontinued operations, net of tax, of $11.5 million and $1.1 million for the first nine months of 2018 and 2017, respectively.

Certain corporate overhead and other costs previously allocated to the specialty pharmacy business for segment reporting purposes did not qualify for classification within discontinued operations and have been reallocated to continuing operations.

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 the 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 346 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 Company decided to sell the assets to raise cash to pay down existing debt. As of November 3, 2018, the Company had not yet completed any dispositions of assets. The Company intends to transfer ownership of the Retail Pharmacy assets to Walgreen Co. in a series of ongoing closings, with the initial closing occurring on November 13, 2018 and the final closing expected to occur in the first quarter of calendar year 2019. During the third quarter the assets therefore met the criteria for “Assets Held-for-Sale” in accordance with ASC 360. Such assets have been reflected as “held-for-sale” on the consolidated balance sheets in accordance with ASC 360. In addition, the results of operations have been presented as discontinued operations in accordance with ASC 205-20 for all periods presented. Assets and liabilities which meet the held for sale criteria are carried at the lesser of fair value less selling costs or carrying value. The Company determined the fair value less costs to sell exceeded the carrying value of the held for sale, therefore no adjustment to the disposal group's net book value was recognized.

The results of the Retail Pharmacy business were previously allocated to the Pharmacy segment within the sales mix. Retail Pharmacy recorded a profit from discontinued operations, net of tax, of $3.4 million and $0.5 million for the third quarter of 2018 and 2017, respectively. Retail Pharmacy recorded a loss from discontinued operations, net of tax, of $0.2 million and a profit from discontinued operations, net of tax, of $2.5 million, for the first nine months of 2018 and 2017, respectively.

The total recorded profit from discontinued operations for Entrust and Retail Pharmacy, net of tax, was $3.4 million for the third quarter of 2018 and the total recorded loss from discontinued operations for Entrust and Retail Pharmacy, net of tax, was $1.4 million for the third quarter 2017. The total recorded loss from discontinued operations for Entrust and Retail Pharmacy, net of tax, was $11.7 million for the first nine months of 2018 and the total recorded profit from discontinued operations for Entrust and Retail Pharmacy, net of tax, was $1.4 million for the first nine months of 2017.

Summarized Discontinued Operations Financial Information

The following table provides a reconciliation of the carrying amounts of major classes of assets and liabilities which are included in assets and liabilities held-for-sale in the accompanying consolidated balance sheet for each of the periods presented:

	Entrust Discontinued Operations		Retail Pharmacy Discontinued Operations		Total Discontinued Operations	
(in thousands)	November 3, 2018 (unaudited)	February 3, 2018	November 3, 2018 (unaudited)	February 3, 2018	November 3, 2018 (unaudited)	February 3, 2018
Current assets:						
Receivables, less allowance for doubtful accounts	$—	$15,983	$—	$—	$—	$15,983
Inventories	—	3,756	13,849	15,344	13,849	19,100
Other non-trade receivables	—	152	—	—	—	152
Prepaid expenses and other current assets	—	12	—	—	—	12
Total current assets held-for-sale	$—	$19,903	$13,849	$15,344	$13,849	$35,247
Property and equipment, less accumulated depreciation and amortization	—	1,036	—	—	—	1,036
Goodwill	—	30,609	—	—	—	30,609
Intangible assets, net	—	9,533	16,471	20,541	16,471	30,074
Other noncurrent assets, net	—	539	—	—	—	539
Total noncurrent assets held-for-sale	$—	$41,717	$16,471	$20,541	$16,471	$62,258
Current liabilities:						
Accounts payable	—	22,045	—	—	—	22,045
Accrued expenses and other	—	4,527	—	—	—	4,527
Total current liabilities held-for-sale	$—	$26,572	$—	$—	$—	$26,572
Deferred income taxes	—	—	—	—	—	—
Other noncurrent liabilities	—	48	—	—	—	48
Total noncurrent liabilities held-for-sale	$—	$48	$—	$—	$—	$48

The following tables summarize the results of discontinued operations for the thirteen and thirty nine weeks ended November 3, 2018, and October 28, 2017, respectively:

Discontinued Operations - Entrust

(in thousands)	For the Thirteen Weeks Ended (unaudited) November 3, 2018	October 28, 2017	For the Thirty Nine Weeks Ended (unaudited) November 3, 2018	October 28, 2017
Net Sales	$—	$68,168	$90,112	$205,626
Cost of goods sold	—	66,238	88,454	196,097
Gross profit	—	1,930	1,658	9,529
Depreciation and amortization	—	631	796	2,010
Selling, general and administrative expenses	—	2,763	12,398	8,424
Loss from discontinued operations	—	(1,464)	(11,536)	(905)
Income tax expense	—	394	—	244
Loss from discontinued operations, net of tax	$—	$(1,858)	$(11,536)	$(1,149)

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Discontinued Operations - Retail Pharmacy

(in thousands)	For the Thirteen Weeks Ended (unaudited) November 3, 2018	October 28, 2017	For the Thirty Nine Weeks Ended (unaudited) November 3, 2018	October 28, 2017
Net Sales	$100,403	$101,088	$298,933	$303,136
Cost of goods sold	80,948	78,432	241,695	230,847
Gross profit	19,455	22,656	57,238	72,289
Depreciation and amortization	616	1,751	4,071	5,549
Selling, general and administrative expenses	15,401	20,971	53,376	61,962
Income (loss) from discontinued operations	3,438	(66)	(209)	4,778
Income tax (benefit) expense	—	(546)	—	2,253
Income (loss) from discontinued operations, net of tax	$3,438	$480	$(209)	$2,525

Total Discontinued Operations

(in thousands)	For the Thirteen Weeks Ended (unaudited) November 3, 2018	October 28, 2017	For the Thirty Nine Weeks Ended (unaudited) November 3, 2018	October 28, 2017
Net Sales	$100,403	$169,256	$389,045	$508,762
Cost of goods sold	80,948	144,670	330,149	426,944
Gross profit	19,455	24,586	58,896	81,818
Depreciation and amortization	616	2,382	4,867	7,559
Selling, general and administrative expenses	15,401	23,734	65,774	70,386
Income (loss) from discontinued operations	3,438	(1,530)	(11,745)	3,873
Income tax (benefit) expense	—	(152)	—	2,497
Income (loss) from discontinued operations, net of tax	$3,438	$(1,378)	$(11,745)	$1,376

NOTE 3: INVENTORIES

Merchandise inventories are valued at the lower of cost or market using the retail first-in, first-out (FIFO) inventory method for goods in our stores and the cost FIFO inventory 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 process, conducted 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 on a particular product class. 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 third 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 $14.6 million and $18.0 million at November 3, 2018 and February 3, 2018, respectively, cost was determined using the retail last-in, first-out (LIFO) inventory 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 cumulative annual periods. The current cost of inventories exceeded LIFO cost by approximately $27.6 million at November 3, 2018 and $28.8 million at February 3, 2018.

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 November 3, 2018 is $17.6 million, with the corresponding amount of $17.2 million at February 3, 2018.

During 2016, the Company recorded impairment charges for inventory clearance of product that management identified as low-productive and does not fit our go-forward model. The Company recorded a below-cost inventory adjustment in accordance with FASB Accounting Standards Codification (“ASC”) 330, “*Inventory*,” of approximately $13.0 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. At the beginning of 2018, there was $1.8 million (including $0.1 million, for the accelerated recognition of freight capitalization expense) of impairment charges remaining for inventory clearance of product related to 2016 strategic initiatives. During the first nine months of 2018, the Company utilized $1.8 million of existing impairment charges related to the 2016 initiatives (including $0.1 million for the accelerated recognition of freight capitalization expense). No amounts remain related to the 2016 initiatives.

During the third quarter of 2017, the Company recorded impairment charges for inventory clearance of product that management identified as low-productive and does not fit our go-forward model. The Company recorded a below-cost inventory adjustment in accordance with FASB Accounting Standards Codification (“ASC”) 330, “*Inventory*,” of approximately $15.6 million (including $1.3 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. At the beginning of 2018, there was $4.3 million (including $1.0 million, for the accelerated recognition of freight capitalization expense) of impairment charges remaining for inventory clearance of product related to the 2017 initiatives. During the first nine months of 2018, the Company utilized $3.7 million of existing impairment charges related to the 2017 initiatives (including $1.0 million, for the accelerated recognition of freight capitalization expense) leaving approximately $0.6 million remaining.

The following table illustrates the inventory impairment charges related to the inventory clearance initiatives discussed in the previous paragraph (in millions):

	Balance at February 3, 2018	Additions	Utilization	Ending Balance November 3, 2018
Inventory markdown on low-productive inventory (2016 initiatives)	$ 1.7	—	(1.7)	$ —
Inventory provision for freight capitalization expense (2016 initiatives)	0.1	—	(0.1)	—
Inventory markdown on low-productive inventory (2017 initiatives)	3.3	—	(2.7)	0.6
Inventory provision for freight capitalization expense (2017 initiatives)	1.0	—	(1.0)	0.0
Total	$ 6.1	$ —	$ (5.5)	$ 0.6

NOTE 4: STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation plans in accordance with 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. The following information includes separate disclosures for discontinued operations. These disclosures relate solely to our Entrust discontinued operation. There are no stock-based compensation disclosures related to the Retail Pharmacy discontinued operations. 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:

	Thirteen Weeks Ended		Thirty-Nine Weeks Ended	
(in thousands)	November 3, 2018	October 28, 2017	November 3, 2018	October 28, 2017
Continuing Operations				

Stock option expense	$215	$307	$709	$1,152
Restricted stock expense	226	1,059	1,976	3,026
ESPP expense	—	244	—	428
Total stock-based compensation	$441	$1,610	$2,685	$4,606
Income tax benefit on stock-based compensation	$11	$414	$34	$1,192

(in thousands)	Thirteen Weeks Ended November 3, 2018	October 28, 2017	Thirty-Nine Weeks Ended November 3, 2018	October 28, 2017
Discontinued Operations				
Stock option expense	$13	$ 50	$48	$ 174
Restricted stock expense	9	15	34	63
Total stock-based compensation	$22	$ 65	$82	$ 237
Income tax benefit on stock-based compensation	$—	$ —	$4	$ 14

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The fair value of each option granted during the thirteen and thirty-nine week periods ended November 3, 2018 and October 28, 2017 is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

Continuing Operations	Thirteen Weeks Ended November 3, 2018	Thirteen Weeks Ended October 28, 2017	Thirty Nine Weeks Ended November 3, 2018	Thirty Nine Weeks Ended October 28, 2017
Stock Options				
Expected volatility	0.0 %	46.1 %	0.0 %	41.7 %
Risk-free interest rate	0.0 %	1.9 %	0.0 %	2.1 %
Expected option life (in years)	0	5.84	0	5.84
Expected dividend yield	0.00 %	1.98 %	0.00 %	1.87 %
Weighted average fair value at grant date	$—	$ 2.44	$—	$ 4.11

Discontinued Operations	Thirteen Weeks Ended November 3, 2018	Thirteen Weeks Ended October 28, 2017	Thirty Nine Weeks Ended November 3, 2018	Thirty Nine Weeks Ended October 28, 2017
Stock Options				
Expected volatility	0.0 %	0.0 %	0.0 %	43.1 %
Risk-free interest rate	0.0 %	0.0 %	0.0 %	2.2 %
Expected option life (in years)	0	0	0	5.84
Expected dividend yield	0.00 %	0.00 %	0.00 %	1.85 %
Weighted average fair value at grant date	$—	$ —	$—	$ 4.89

	Thirteen Weeks Ended November 3, 2018	Thirteen Weeks Ended October 28, 2017	Thirty Nine Weeks Ended November 3, 2018	Thirty Nine Weeks Ended October 28, 2017
Employee Stock Purchase Plan				
Expected volatility	0.0 %	86.1 %	0.0 %	82.2 %
Risk-free interest rate	0.0 %	1.0 %	0.0 %	1.0 %
Expected option life (in years)	0.00	0.75	0.00	0.50
Expected dividend yield	0.00 %	1.24 %	0.00 %	0.81 %
Weighted average fair value at grant date	$—	$ 7.95	$—	$ 6.86

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 may 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 to ten 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.

Employee Stock Purchase Plan

The 2004 Employee Stock Purchase Plan (“ESPP”) (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. During the fourth quarter of 2017, management and the Board of Directors suspended purchases through the ESPP effective December 31, 2017. The ESPP suspension resulted in zero shares issued during the thirty-nine weeks ended November 3, 2018. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of November 3, 2018, there were 595,681 shares available.

Stock Options

The following table summarizes stock option activity during the thirty-nine weeks ended November 3, 2018:

Continuing Operations	Options	Weighted-Average Exercise Price	Weighted-Average Contractual Life (years)	Aggregate Intrinsic Value (000s)
Outstanding at February 3, 2018	1,171,825	$ 13.12	5.1	$ —
Granted	—	—		
Cancelled	(537,254)	12.29		
Exercised	—	—		
Outstanding at November 3, 2018	634,571	$ 13.83	4.4	$ —
Exercisable at November 3, 2018	442,605	$ 14.60	4.2	—

Discontinued Operations	Options	Weighted-Average Exercise Price	Weighted-Average Contractual Life (years)	Aggregate Intrinsic Value (000s)
Outstanding at February 3, 2018	167,375	$ 14.23	5.4	$ —
Granted	—	—		
Cancelled	(158,984)	14.17		
Exercised	—	—		
Outstanding at November 3, 2018	8,391	$ 15.44	4.5	$ —
Exercisable at November 3, 2018	3,356	$ 15.44	4.5	$ —

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 November 3, 2018 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 November 3, 2018, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options for continuing operations was approximately $1.0 million, which is expected to be recognized over a weighted average period of approximately 3.0 years. As of November 3, 2018, there was no unrecognized stock-based compensation expense, net of estimated forfeitures related to non-vested stock options for discontinued operations. The total fair value of options vested during the thirty-nine weeks ended November 3, 2018 for continuing operations was $146.3 thousand. The total fair value of options vested during the thirty-nine weeks ended November 3, 2018 for discontinued operations was $10.3 thousand.

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Restricted Stock

The following table summarizes restricted stock activity during the thirty-nine weeks ended November 3, 2018:

Continuing Operations	Number of Shares	Weighted-Average Grant Date Fair Value
Non-vested Restricted Stock at February 3, 2018	653,895	$ 10.14
Granted	649,233	2.23
Forfeited / Cancelled	(109,512)	10.68
Vested	(413,630)	7.73
Non-vested Restricted Stock at November 3, 2018	779,986	$ 4.77

Discontinued Operations	Number of Shares	Weighted-Average Grant Date Fair Value
Non-vested Restricted Stock at February 3, 2018	11,194	$ 15.35
Granted	—	—
Forfeited / Cancelled	(8,862)	14.95
Vested	(2,332)	15.44
Non-vested Restricted Stock at November 3, 2018	—	$ —

For continuing operations, the aggregate pre-tax intrinsic value of restricted stock outstanding as of November 3, 2018 is $2.3 million with a weighted average remaining contractual life of 8.6 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding stock is approximately $2.2 million, which is expected to be recognized over a weighted average period of approximately 2.9 years. The total fair value of restricted stock awards that vested during the thirty-nine weeks ended November 3, 2018 was $3.2 million.

For discontinued operations, there was no aggregate pre-tax intrinsic value of restricted stock outstanding as of November 3, 2018, no weighted average remaining contractual life, and no unrecognized compensation expense related to the outstanding stock The total fair value of restricted stock awards related to discontinued operations that vested during the thirty-nine weeks ended November 3, 2018 was $0.04 million.

NOTE 5: 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, which are based on an entity's own assumptions as there is little, if any, observable activity in identical assets or liabilities.

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 sheets at a reasonable estimate of their fair value as of November 3, 2018 and February 3, 2018. The fair value of the revolving lines 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, notes payable and mortgage loans as of the following dates:

(in thousands)	November 3, 2018 Carrying Value	November 3, 2018 Fair Value	February 3, 2018 Carrying Value	February 3, 2018 Fair Value
Revolving line of credit	$167,539	$167,539	$153,431	$153,431
Mortgage loans on land & buildings	1,531	1,615	1,579	1,684
Notes Payable	13,000	12,185	13,000	12,421

NOTE 6: PROPERTY AND EQUIPMENT

Property and equipment are carried at cost. Depreciation is recorded using the straight-line method over the estimated useful lives of 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):

(in thousands)

Property and equipment, at cost:	November 3, 2018	February 3, 2018
Buildings and building improvements	$116,808	$119,039
Leasehold improvements	89,071	86,402
Automobiles and vehicles	3,772	4,525
Furniture, fixtures and equipment	288,346	286,962
	497,997	496,928
Less: Accumulated depreciation and amortization	(403,790)	(390,633)
	94,207	106,295
Construction in progress	2,447	590
Land	8,470	8,581
Total Property and equipment, at depreciated cost	$105,124	$115,466

NOTE 7: 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 a discounted cash flow model, which are considered Level 3 inputs.

In 2015, the Company recorded impairment charges for fixed assets and leasehold improvements related to 2014 and 2015 planned store closures. In 2016, the Company utilized all of the impairment charges related to the 2015 store closures and $0.2 million related to the 2014 store closures, leaving $0.5 million of impairment charges. None of the remaining $0.5 million impairment charges were utilized as of November 3, 2018.

During fiscal 2016, the Company recorded impairment charges of $3.6 million for fixed asset impairments related to the corporate headquarters. None of the impairment charges relating to the corporate headquarters were utilized as of November 3, 2018.

In the third quarter of 2017, in association with the planned closure of additional underperforming stores and pharmacies, the Company recorded charges in the amount of $0.8 million in selling, general and administrative expense for the impairment of fixed assets associated with the closing stores and pharmacies and $1.4 million for the accelerated recognition of amortization of intangible assets associated with the closing pharmacies. None of these charges were utilized as of November 3, 2018.

In the fourth quarter of 2017, the Company recorded a charge of $1.1 million in selling, general and administrative expense for the impairment of fixed assets associated with several underperforming locations. None of the impairment charges relating to these assets were utilized as of November 3, 2018.

Inventory

As discussed in Note 3 - 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.

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.

In the first quarter of 2017, the Company recorded a lease liability relating to the 39 underperforming store closures in fiscal 2017 of $8.2 million. Additional $0.2 million reserve was recorded in the fourth quarter of 2017 and $2.1 million of reserve was utilized during the year, leaving $6.3 million reserve balance as of February 3, 2018. In the first three quarters of 2018, the Company utilized $1.7 million, leaving $4.6 million reserve balance as of November 3, 2018.

The following table illustrates the exit and inventory related to store closures, inventory strategic initiatives along with the lease liability related to the planned store closures discussed in the previous paragraphs (in millions):

	Balance at February 3, 2018	Additions	Utilization	Ending Balance November 3,

				2018
Impairment charge for the disposal of fixed assets for 2014 planned closures	$ 0.5	$ —	$ —	$ 0.5
Impairment charge for the disposal of fixed assets for corporate office	3.6	—	—	3.6
Impairment charge for the disposal of fixed assets for 2017 planned closures	0.8	—	—	0.8
Impairment charge for the disposal of intangible assets for 2017 planned closures	1.4	—	—	1.4
Impairment charge for the write down of fixed assets for underperforming stores	1.1	—	—	1.1
Subtotal	$ 7.4	$ —	$ —	$ 7.4
Lease contract termination liability, 2017 closures	6.3		(1.7)	4.6
Total	$ 13.7	$ —	$ (1.7)	$ 12.0

NOTE 8: 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 are recorded as an element of shareholders’ equity but are excluded from net income pursuant to GAAP. The Company’s accumulated other comprehensive income includes the unrecognized prior service costs, transition obligations and actuarial gains/losses associated with our post-retirement benefit plan.

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

(in thousands)	Thirteen Weeks Ended November 3, 2018	October 28, 2017	Year Ended February 03, 2018
Accumulated other comprehensive income	$559	$ 466	$ 466
Amortization of post-retirement benefit	—	—	93
Ending balance	$559	$ 466	$ 559

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NOTE 9: RELATED PARTY TRANSACTIONS

On April 10, 2015, the Company completed the acquisition of Reeves-Sain Drug Store, Inc., a provider of retail and specialty pharmaceutical services. As part of the total consideration for the purchase, Fred's provided notes payable totaling $13.0 million to the sellers of Reeves-Sain Drug Store, Inc., who became employees of Fred's as part of the acquisition. As of May 5, 2018, the sellers were former employees. The notes payable are due in three equal installments to be paid on January 31st of 2021, 2022 and 2023 and are subordinate to the Company's revolving line of credit. This amount is reflected in "Long Term Portion of Indebtedness" on the Balance Sheet.

NOTE 10: LEGAL CONTINGENCIES

On October 15, 2015, a lawsuit entitled Southern Independent Bank v. Fred's, Inc. was filed in the U.S. District Court, Middle District of Alabama. The complaint includes allegations made by the plaintiff on behalf of itself and financial institutions similarly situated ("alleged class of financial institutions") that the Company was negligent in failing to use reasonable care in obtaining, retaining, securing and deleting the personal and financial information of customers who use debit cards issued by the plaintiff and alleged class of financial institutions to make purchases at Fred's stores. The complaint also includes allegations that the Company made negligent misrepresentations that the Company possessed and maintained adequate data security measures and systems that were sufficient to protect the personal and financial information of shoppers using debit cards issued by the plaintiff and alleged class of financial institutions. The complaint seeks monetary damages and equitable relief to be proved at trial as well as attorneys' fees and costs. The Company has denied the allegations and has filed a motion to dismiss all claims. This motion has since been denied, and the Company filed a motion to reconsider by certifying the question to the Alabama Supreme Court for clarity. However, the Company's motion was denied, and the Company has now completed discovery and is moving to trial. A motion for class certification is currently pending before the U.S. District Court, Middle District of Alabama. Future costs or liabilities related to the incident may have a material adverse effect on the Company. The Company has not made an accrual for future losses related to these claims at this time as the future losses are not considered probable. The Company has a cyber liability policy with a $10 million limit and $100,000 deductible.

On July 27, 2016, a lawsuit entitled The State of Mississippi v. Fred's Inc., et al was filed in the Chancery Court of Desoto County, Mississippi, Third Judicial District. The complaint alleges that the Company fraudulently reported their usual and customary prices to Mississippi's Division of Medicaid in order to receive higher reimbursements for prescription drugs. The complaint seeks declaratory and monetary relief for the profits alleged to have been unfairly earned as well as attorney costs. The Company denies these allegations and believes it acted appropriately in its dealings with the Mississippi Division of Medicaid. The Company successfully filed a Motion to Transfer to Circuit Court. The State filed a Petition for Interlocutory Appeal with the Mississippi Supreme Court, but the Mississippi Supreme Court ruled in our favor and the case is now proceeding in Circuit Court. Future costs and liabilities related to this case may have a material adverse effect on the Company; however, the Company has not made an accrual for future losses related to these claims as it is not possible at this time to evaluate the likelihood of an unfavorable outcome or to estimate the amount or range of any potential loss. The Company has multiple insurance policies which the Company believes will limit its potential exposure.

On September 29, 2016, the Company reported to the Office of Civil Rights ("OCR") that an unencrypted laptop containing clinical and demographic data for 9,624 individuals had been stolen from an employee's vehicle while the vehicle was parked at the employee's residence. On January 13, 2017, the OCR opened an investigation into the incident. The Company has fully complied with the investigation and timely responded to all requests for information from the OCR. The Company received several supplemental requests for information from the OCR during the third and fourth fiscal quarters of 2018, to which the Company has timely responded. Future costs and liabilities related to this case may have a material adverse effect on the Company; however, the Company has not made an accrual for future losses related to these claims as future losses are not considered probable and an estimate is unavailable.

On March 30, 2017, a lawsuit entitled Tiffany Taylor, individually and on behalf of others similarly situated, v. Fred's Inc. and Fred's Stores of Tennessee, Inc. was filed in the United Stated District Court for the Northern District of Alabama Southern Division. The complaint alleges that the Company wrongfully and willfully violated the Fair and Accurate Credit Transactions Act ("FACTA"). On April 11, 2017, a lawsuit entitled Melanie Wallace,

Sascha Feliciano, and Heather Tyler, on behalf of themselves and all others similarly situated, v. Fred's Stores of Tennessee, Inc. was filed in the Superior Court of Fulton County in the state of Georgia. The complaint alleges that the Company wrongfully and willfully violated FACTA. On April 13, 2017, a lawsuit entitled Lillie Williams and Cussetta Journey, on behalf of themselves and all others similarly situated, v. Fred's Stores of Tennessee, Inc. was filed in the Superior Court of Fulton County in the state of Georgia. The complaint also alleges that the Company wrongfully and willfully violated FACTA. The complaints are filed as Class Actions, with the class being open for five (5) years before the date the complaint was filed. The complaint seeks statutory damages, attorney's fees, punitive damages, an injunctive order, and other such relief that the court may deem just and equitable. The Company filed a Motion to Dismiss the Taylor complaint, and this Motion has been granted by the Court. Plaintiff's counsel has appealed the Taylor complaint, which appeal is pending before the 11th Circuit Court of Appeals. The Company filed, and the Court granted Motions to Remove and Motions to Transfer the Williams and Wallace matters to the U.S. District Court for the Northern District of Alabama. Since the Williams and Wallace matters were removed and transferred to the U.S. District Court for the Northern District of Alabama, the Company has filed a Motion to Consolidate the Williams and Wallace matters. When the court granted the Company's motion to dismiss in the Taylor case, the court simultaneously denied the Motion to Consolidate, in light of the dismissal in Taylor. In the Wallace and Williams actions, the District Court entered an order staying both cases until the U.S Court of Appeals for the 11th Circuit decides on the appeal. Oral argument for the appeal has been set with the Court of Appeals for the 11th Circuit at the end of January 2019. Future costs and liabilities related to this case may have a material adverse effect on the Company; however, the Company has not made an accrual for future losses related to these claims as future losses are not considered probable and an estimate is unavailable.

On March 3, 2018, a lawsuit entitled Abel Eddington and Judy Hudson, individually and on behalf of all others similarly situated, v. Fred's Inc., and Fred's Stores of Tennessee, Inc. was filed in the United States District Court Eastern District of Texas, Marshall Division. The complaint alleges that the Company committed various Federal and state wage and hours violations. The complaint is filed as Class Action and seeks back wages, attorneys' fees, and all other damages allowable by law. The Company denies these allegations and believes it acted appropriately in its wage and hour calculations and payments. The Company and the named plaintiffs have reached an agreement in principle to settle the case for $250,000, including plaintiffs' attorneys' fees, and the Court has accepted the parties' notice of settlement and cancelled all pending deadlines. The parties are currently negotiating the formal settlement agreement and preparing the related court filings.

On March 16, 2018, a lawsuit entitled Roxie Whitley , individually and as next friend of Baby Z.B.D., and Chris and Diane Denson, individually and as next friends of Baby L.D.L., on behalf of themselves and all others similarly situated, v. Purdue Pharma L.P.; Purdue Pharma, Inc.; The Purdue Frederick Company, Inc.; McKesson Corporation; Cardinal Health, Inc.; AmeriSourceBergen Corporation; Teva Pharmaceutical Industries, Ltd.; Teva Pharmaceuticals USA, Inc.; Cephalon, Inc.; Johnson & Johnson; Janssen Pharmaceuticals, Inc.; Ortho-McNeil-Janssen Pharmaceuticals, Inc. n/k/a Janssen Pharmaceuticals, Inc.; Janssen Pharmaceuticals, Inc. n/k/a Janssen Pharmaceuticals, Inc.; Endo Health Solutions Inc.; Endo Pharmaceuticals, Inc; Allergan PLC; Watson

Pharmaceuticals, Inc. n/k/a Actavis, Inc.; Watson Laboratories, Inc.; Actavis LLC; Actavis Pharma, Inc. f/k/a Watson Pharma, Inc.; and Fred's Stores of Tennessee, Inc. was filed in the Circuit Court of Fayette County, Tennessee for the 25th Judicial District at Somerville. The complaint fails to allege any wrong-doing by the Company. The Complaint is filed as a class action seeking various remedies allowed under Federal and state laws. The Company denies any purported wrong-doing. On May 9, 2018, the Company filed a Motion to Dismiss for Lack of Standing, a Motion to Dismiss Plaintiff's Product Liability Causes of Action, a Motion to Dismiss for Statute of Limitations, and a Motion to Dismiss for Failure to State a Claim on which Relief may be Sought (collectively, the "May 9, 2018 Motions"). The Court has not ruled on the May 9, 2018 Motions. On May 9, 2018 this matter was transferred to the United States District Court for the Northern District of Ohio as part of the National Prescription Opiate Litigation Multidistrict Litigation. Future costs and liabilities related to this case may have a material adverse effect on the Company; however, the Company has not made an accrual for future losses related to these claims as future losses are not considered probable, and an estimate is unavailable. The Company has multiple insurance policies which the Company believes will limit its potential exposure.

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 outcomes of these proceedings and claims against the Company 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 Company's 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 Company's financial statements as a whole.

NOTE 11: INDEBTEDNESS

On April 9, 2015, the Company entered into a Revolving Loan and Credit Agreement (the “Agreement”) with Regions Bank and Bank of America to replace the Company’s previous revolving credit facility. The proceeds were used to refinance amounts outstanding under the prior credit and to support acquisitions and the Company’s working capital needs. The Agreement initially provided for a $150.0 million secured revolving line of credit, including a sublimit for letters of credit and swingline loans. The Agreement, which expires on April 9, 2020, was amended effective January 30, 2017 to increase the loan commitment from $150.0 million to $225.0 million. On July 31, 2017, the Company amended the Agreement and related security agreement to: (i) increase the revolving loan commitment from $225 million to $270 million, (ii) increase the pharmacy scripts advance rate, (iii) revise the excess availability requirements for certain acquisitions, and (iv) add Bank of America as a co-collateral agent. Draws are limited to the lesser of the commitment amount or the borrowing base, which is periodically determined by reference to the value of certain receivables, inventory and scripts, less applicable reserves. The Company may choose to borrow at a spread to either LIBOR or a Base Rate. For LIBOR loans the spread ranges from 1.75% to 2.25% and for Base Rate loans the spread ranges from 0.75% to 1.25%. The spread depends on the level of excess availability. Commitment fees on the unused portion of the credit line are 37.5 basis points. The Agreement included an up-front credit facility fee which is being amortized over the Agreement term. There were $167.5 million of borrowings outstanding and $33.3 million, net of borrowings and letters of credit, remaining available under the Agreement at November 3, 2018.

On October 15, 2018, the Company entered into the Third Amendment to the Amended and Restated Addendum to Credit Agreement (the “Third Amendment”). The Third Amendment amends the Company’s existing Amended and Restated Addendum to Credit Agreement, dated as of January 27, 2017, as amended as of July 31, 2017 and August 23, 2018. The Third Amendment does not otherwise amend the Credit Agreement dated as of April 9, 2015, as amended as of October 23, 2015, December 28, 2016, January 27, 2017, July 31, 2017, August 22, 2017, April 5, 2018 and August 23, 2018 (the “Credit Agreement”), or the Security Agreement, dated as of April 9, 2015, as amended as of July 31, 2017 and August 23, 2018 (the “Security Agreement”). Among other things, the Third Amendment increases the frequency of certain financial reporting obligations of the Company and its subsidiaries to the lenders that apply only during the period from October 15, 2018 until the earlier of November 30, 2018 and the date on which the Company fails to comply with such reporting obligations, reduces the excess availability requirements during such period, and increases the percentage of the projected value of customer prescription files under the borrowing base, potentially allowing for increased borrowing capability during such period.

On August 23, 2018, the Company entered into the Seventh Amendment to Credit Agreement, Second Amendment to Amended and Restated Addendum to Credit Agreement and Second Amendment to Security Agreement (the “Amendment”). Among other changes, the Amendment decreases, at the Company’s request, the revolving loan commitment from $270.0 million to $210.0 million, permits certain sale-leaseback transactions, allows transfers of properties to non-Loan Party (as defined in the Credit Agreement) subsidiaries for financing and allows for the assumption of debt and financing for such transactions, permits the sale of real estate, other than distribution centers for fair market value and adds repurchases and redemption to the definition of restricted payments, which are limited under the restricted payments covenant.

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On December 19, 2016, the Company entered into a commitment letter with respect to a senior secured asset based loan facility (the "ABL Commitment Letter"), and a commitment letter with respect to a term loan facility (the "Term Loan Commitment Letter"); and on January 18, 2017, the Company entered into an amended and restated ABL Commitment Letter (the "Amended and Restated ABL Commitment Letter"). The Amended and Restated ABL Commitment Letter and the Term Loan Commitment Letter were entered into with lenders who agreed to provide $1.65 billion of debt financing to be used by the Company to fund its proposed acquisition of 865 stores, certain intellectual property and certain other tangible assets of Rite Aid Corporation.

On June 9, 2017, the Company amended and restated the Amended and Restated ABL Commitment (the "Second Amended and Restated ABL Commitment Letter"), and the Term Loan Commitment Letter (the "Amended and Restated Term Loan Commitment Letter") for the purpose of increasing the aggregate committed debt financing available thereunder to $2.2 billion.

Upon termination of the Rite Aid Asset Purchase Agreement, as discussed in Note 1 above, the Company terminated the Second Amended and Restated ABL Commitment Letter and the Amended and Restated Term Loan Commitment Letter. In connection with such termination, the Company incurred applicable termination fees contemplated by the Second Amended and Restated ABL Commitment Letter and Amended and Restated Term Loan Commitment Letter, which were paid in the third quarter of 2017.

In connection with the aforementioned commitment letters, the Company incurred approximately $30 million of debt issuance costs. These costs are reflected in SG&A in the Statement of Operations. The $25 million termination fee paid by Walgreens, on June 30, 2017, discussed in Note 1: Basis of Presentation, partially offset these costs.

During the second and third quarter of fiscal 2007, the Company acquired the land and buildings, occupied by seven Fred's stores which we had previously leased. In consideration for the seven properties, the Company assumed debt that has fixed interest rates from 6.31% to 7.40%. Mortgages remain on two locations with a combined balance of $1.5 million outstanding at November 3, 2018. The weighted average interest rate on mortgages outstanding at November 3, 2018 was 7.40%. The debt is collateralized by the land and buildings.

NOTE 12: INCOME TAXES

The Company accounts for its income taxes in accordance with FASB ASC 740 "*Income Taxes*." Pursuant to FASB ASC 740, the Company must consider all positive and negative evidence regarding the realization of deferred tax assets including past operating results and future sources of taxable income. A cumulative loss in recent years is a significant piece of negative evidence when evaluating the need for a valuation allowance. Under the provisions of

FASB ASC 740, the Company determined that a full valuation allowance is needed given the cumulative loss in recent years.

NOTE 13: SUBSEQUENT EVENT

As described in Note 2, the Company entered into the Amended WBA Asset Purchase Agreement with Walgreen Co., an Illinois corporation, to sell certain prescription files and related data and records, retail pharmaceutical inventory, and certain other assets from 179 of the Company’s 346 retail pharmacy stores (such assets collectively referred to as “Retail Pharmacy”). The Company intends to transfer ownership of the Retail Pharmacy assets to Buyer in a series of ongoing closings, with the goal of completing the asset transfers in the first month of calendar year 2019. As of December 12, 2018, the Company had transferred to Walgreen Co. assets from 138 stores and had received cash proceeds of approximately $152.5 million for such assets, subject to $11.2 million in adjustments for the final inventory valuation as described in the Amended WBA Asset Purchase Agreement. The remaining transfers of such assets remain subject to certain customary closing conditions as specified in the Amended WBA Asset Purchase Agreement.

Item 2:

Management's Discussion and Analysis of Financial

Condition and Results of Operations

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Other than statements based on historical facts, many of the matters discussed in this Quarterly Report on Form 10-Q relate to events which we expect or anticipate may occur in the future. Such statements are defined as "forward-looking statements" under the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), 15 U.S.C.A. Sections 77z-2 and 78u-5 (Supp. 1996). The Reform Act created a safe harbor to protect companies from securities law liability in connection with forward-looking statements. Fred's Inc. ("Fred's", "We", "Our", "Us" or the "Company") intends to qualify b its 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", " "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: (i) the competitive nature of the industries in which we operate; (ii) the implementation of our strategic plan, and its impact on our sales, costs and operations; (iii) utilizing our existing and new stores and the extent of our pharmacy department presence in new and existing stores; (iv) our reliance on a single supplier of pharmaceutical products; (v) our pharmaceutical drug pricing; (vi) reimbursement rates and the terms of our agreements with pharmacy benefit management companies; (vii) our private brands; (viii) the seasonality of our business and the impact of adverse weather conditions; (ix) operational difficulties; (x) merchandise supply and pricing; (xi) consumer demand and product mix; (xii) delayed openings and operating new stores and distribution facilities; (xiii) our employees; (xiv) risks relating to payment processing; (xv) our computer system, and the processes supported by our information technology infrastructure; (xvi) our ability to protect the person information of our customers and employees; (xvii) cyber-attacks; (xviii) changes in governmental regulations; (xix) the outcome of legal proceedings, including claims of product liability; (xx) insurance costs; (xxi) tax assessments and unclaimed property audits; (xxii) current economic conditions; (xxiii) changes in third-party reimbursements; (xxiv) the terms of our existing and future indebtedness; (xxv) any acquisitions and the ability to effectively integrate any businesses that we acquire; (xxvi) our ability to pay dividends; and (xxvii) statements regarding the Amended WBA Asset Purchase Agreement, the transactions contemplated thereby, the possible timing and effects thereof, and the ability of the parties to complete the transactions consider the various closing conditions to which such transactions are subject.

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.

GENERAL

Executive Overview

As of November 3, 2018, Fred’s and its subsidiaries operate 589 general merchandise and pharmacy stores, including 11 franchised locations. Fred’s unique format offers customers a full range of value-priced everyday items, along with terrific deals on closeout merchandise throughout the store. Fred’s offerings include nationally recognized brands, proprietary Fred’s label products, and a full range of value-priced selections.

During the fourth quarter of 2017, Fred’s Board of Directors approved a plan to actively market its specialty pharmacy business for sale. As a result of this decision, Fred’s reclassified its specialty pharmacy business from continuing operations to discontinued operations in accordance with ASC 205-20, *Presentation of Financial Statements – Discontinued Operations*. The specialty pharmacy business has been reported as discontinued operations in our Consolidated Statements of Income, and the related assets and liabilities have been presented as held-for-sale in the Consolidated Balance Sheets. These changes have been applied to all periods presented. Unless otherwise noted, amounts, percentages and discussion for all periods included below reflect the results of operations and financial condition from Fred’s continuing operations. Refer to Note 2 to Fred’s consolidated financial statements for additional information on discontinued operations.

On September 7, 2018, Fred's Stores of Tennessee, Inc., a Delaware corporation ("Seller") and wholly owned subsidiary of Fred's, Inc. (the "Company"), entered into an Asset Purchase Agreement (the "WBA Asset Purchase Agreement") with Walgreen Co., an Illinois corporation, ("Buyer"). On October 23, 2018, Seller and Buyer entered into an amendment to the WBA Asset Purchase Agreement (the "Amendment"). Under the WBA Asset Purchase Agreement, as amended by the Amendment (the "Amended WBA Asset Purchase Agreement"), Buyer agreed to purchase from Seller certain prescription files and related data and records, retail pharmaceutical inventory, and certain other assets from 179 of the Company's retail pharmacy stores (collectively, the "Assets") for a cash purchase price of approximately $157 million plus an amount equal to the value of the inventory included in the Assets up to an approximately $35 million cap, in each case subject to certain adjustments (the "Transaction"). The Transaction is scheduled to close in a series of ongoing closings, with the initial closing occurring on November 13, 2018 and the final closing expected to occur in the first quarter of calendar year 2019, all as set forth in the Amended WBA Asset Purchase Agreement. As of December 12, 2018, the Seller had transferred to Buyer Assets from 138 stores and had received cash proceeds of approximately $152.5 million for such Assets, subject to $11.2 million in adjustments for the final inventory valuation as described in the Amended WBA Asset Purchase Agreement.

Progress on Turnaround and Strategic Initiatives

Fred's continued executing its turnaround strategy during the third quarter 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;
- Bringing new talent into the organization;
- Driving traffic;
- Improving assortment and optimizing inventory levels;
- Generating free cash flow; and
- Reducing debt levels.

Front Store

We continue to make improvements to the front store that we believe will result in better operating performance going forward. These include:

- 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, particularly within our merchandising group;
- 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 close to one million members; and
- Continued reductions in unproductive inventory and optimization of merchandise selection throughout the front store.

Retail Pharmacy

Within the retail pharmacy, we are focused 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;
- Deepening relationships with payors to gain access to new networks, resulting in the potential to drive increased traffic and more prescriptions; and
- Continuing to evaluate the potential to monetize pharmacy related assets.

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 consolidated financial statements, which have been prepared in accordance with GAAP. The critical accounting matters that are particularly important to the portrayal of the Company's financial condition and results of operations, and require some of management's most difficult, subjective and complex judgments, are described in detail in the Company's Annual Report on Form 10-K for the fiscal year ended February 3, 2018. The preparation of condensed consolidated 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.

RESULTS OF OPERATIONS

Thirteen Weeks Ended November 3, 2018 and October 28, 2017

Sales

Net sales for the third quarter of 2018 decreased to $306.4 million from $324.3 million in 2017, a year-over-year decrease of $17.9 million or 5.5%. On a comparable store basis, sales decreased 5.3% compared to a 1.0% decrease in the same period last year.

General merchandise (non-pharmacy) sales for the third quarter of 2018 decreased 9.5% to $199.4 million from $218.3 million in 2017. This was driven by a decrease in Household Goods and Softline products.

Pharmacy department sales were 33.7% of total sales in the third quarter of 2018 compared to 31.6% of total sales in the comparable period of the prior year. The total sales for the third quarter of 2018 in this department increased 4.5% from the third quarter of 2017. This increase was primarily driven by a change in sales mix between pharmacy and front store sales.

The Company had 11 franchised locations at November 3, 2018 and 13 franchised locations as of October 28, 2017. Sales to our franchised locations during the quarter were $3.7 million (1.2% of sales) compared to $3.7 million (1.1% of sales) in the comparable period of 2017. The Company does not intend to expand its franchise network.

The following table provides a comparison of the sales mix for the thirteen weeks ended November 3, 2018 and October 28, 2017.

	Thirteen Weeks Ended			
	November 3, 2018		October 28, 2017	
Pharmacy	33.7	%	31.6	%
Consumables	38.9	%	39.6	%

Household Goods and Softlines	26.2	%	27.7	%
Franchise	1.2	%	1.1	%
Total Sales Mix	100.0	%	100.0	%

For the third quarter of 2018, comparable store customer traffic decreased 6.9% from the prior period, while the average customer ticket was $19.12 for the quarter.

Gross Profit

Gross profit for the third quarter increased to $77.0 million in 2018 from $70.0 million in 2017, an increase of $7.0 million or 9.9%. The gross profit increase was driven primarily by a one time event in 2017 that included a markdown for inventory reserve that did not occur in 2018. Gross margin for the quarter, measured as a percentage of net sales, increased to 25.1% in 2018 from 21.6% in the same quarter last year.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the third quarter, including depreciation and amortization, decreased to $105.6 million in 2018 (34.5% of sales) from $118.3 million in 2017 (36.5% of sales). This decrease was primarily attributable to cost containment measures and workforce reduction.

Operating Loss

Operating loss for the third quarter of 2018 was $28.7 million, or 9.4% of sales, compared to an operating loss of $48.2 million in 2017, or 14.9% of sales. This decrease reflects the impact of cost containment measures and higher gross profit in the quarter.

Interest Expense, Net

Net interest expense for the third quarter of 2018 totaled $2.1 million, or 0.7% of sales, compared to $1.6 million, or 0.5% of sales, in the same period of the prior year.

Income Taxes

The effective income tax rate for the third quarter of 2018 was 0.2% compared to 0.8% in the third quarter of 2017.

Net Loss

Net loss from continuing operations for the third quarter of 2018 was $30.8 million ($0.83 per share) compared to a net loss of $50.4 million ($1.35 per share) for the third quarter of 2017, an improvement of $19.6 million. The decrease in net loss was primarily attributable to cost containment measures and workforce reduction and one time events in 2017.

Thirty-Nine weeks Ended November 3, 2018 and October 28, 2017

Sales

Net sales for the first nine months of 2018 decreased to $964.7 million from $1,025.0 million during the same period in 2017, a year-over-year decrease of $60.3 million or 5.9%. On a comparable store basis, sales decreased 4.9% compared to a 2.3% decrease in the same period last year.

General merchandise (non-pharmacy) sales for the first nine months of 2018 decreased 8.3% to $651.4 million from $705.4 million in 2017. This was driven by sales decreases in general merchandise departments such as home furnishings, domestics, electronics and health and beauty products, partially offset by sales increases in beverages and tobacco.

The Company's pharmacy department sales for the first nine months were 31.5% of total sales in 2018 compared to 30.1% of total sales in the prior year. The total sales in this department increased 1.4% in the first nine months of 2018 over 2017.

The Company had 11 franchised locations at November 3, 2018 and 13 franchised locations at October 28, 2017. Sales to our franchised locations for the first nine months of 2018 were $9.4 million (1.0% of sales) compared to $11.0 million (1.1% of sales) in the prior year. The Company does not intend to expand its franchise network.

The following table provides a comparison of the sales mix for the thirty-nine weeks ended November 3, 2018 and October 28, 2017.

	Thirty-Nine Weeks Ended	
	November 3, 2018	October 28, 2017
Pharmacy	31.5 %	30.1 %
Consumables	39.5 %	38.3 %
Household Goods and Softlines	28.0 %	30.5 %
Franchise	1.0 %	1.1 %
Total Sales Mix	100.0 %	100.0 %

For the first nine months of 2018, comparable store customer traffic decreased 4.4% over the prior period, while the average customer ticket was $16.90 for the thirty-nine week period.

Gross Profit

Gross profit for the first nine months decreased to $251.3 million in 2018 from $271.7 million in 2017, a decrease of $20.5 million or 7.5%. Factors contributing to the decline in adjusted gross profit percentage were primarily related to continued pressures we are seeing in our retail pharmacy business, specifically related to prescription rebates in 2017 that did not recur in 2018, reimbursement pressure from payors and an increase in DIR fees to PBMs. In the front store, we are continuing to see a margin impact from a shift in sales mix from general merchandise to food and consumables. Gross margin for the first nine months, measured as a percentage of net sales, decreased to 26.0% for the first nine months of 2018 from 26.5% in the same period last year.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the first nine months, including depreciation and amortization, decreased to $315.8 million in 2018 (32.7% of sales) from $387.6 million in 2017 (37.8% of sales). The decrease in expenses is primarily driven by headcount reductions and cost containment. The impact of professional fees incurred in 2017 related to the attempted Rite Aid acquisition and in closing 39 underperforming stores were not repeated in 2018.

Operating Loss

Operating loss for the first nine months was $64.5 million in 2018 (6.7% of sales) compared to an operating loss of $115.9 million in 2017 (11.3% of sales). The decrease in operating loss in the period was primarily driven by cost containment and work force reduction and a one time inventory markdown reserve charge.

Interest Expense, Net

Net interest expense for the first nine months of 2018 totaled $5.8 million, or 0.6% of sales, compared to $4.4 million, or 0.4% of sales, in the same period of the prior year.

Income Taxes

The effective income tax rate for the first nine months of 2018 was 0.5% compared to 1.2% in the same period of 2017.

Net Loss

Net loss from continuing operations for the first nine months was $69.9 million ($1.91 loss per share) in 2018 compared to a net loss of $119.2 million ($3.18 loss per share) in 2017. The improvement in net loss was mainly driven by the operating loss, as detailed above. The net loss from discontinued operations was $11.7 million for the first nine months of 2018 compared to net income from discontinued operations of $1.4 million in the first nine months of 2017, the impact of which offset the improvement in net loss from continuing operations.

LIQUIDITY AND CAPITAL RESOURCES

Due to the seasonality of our business, inventories are generally lower at our fiscal year-end than at each quarter-end of the following year.

Net cash used in operating activities totaled $37.4 million during the thirty-nine week period ended November 3, 2018 and $33.9 million in the same period of the prior year.

Net cash used in investing activities totaled $5.3 million during the thirty-nine week period ended November 3, 2018 and $13.0 million in the same period of the prior year. Purchases of capital assets in the first three quarters of 2018 was $7.5 million compared to $12.4 million in 2017.

Net cash provided by financing activities totaled $42.4 million during the thirty-nine week period ended November 3, 2018 as compared to $46.2 million in the same period of the prior year. The cash flows provided by financing activities includes net borrowings of $14.1 million and $40.2 million on our revolving line of credit in 2018 and 2017, respectively. As of December 12, 2018, the balance under our revolving line of credit stood at $51.9 million, as compared to $153.4 million as of the beginning of this fiscal year.

As further discussed under "Item 2. Unregistered Sales of Equity Securities and Use of Proceeds," the Company has a share repurchase program allowing for the repurchase of up to 3.8 million shares of the Company's outstanding Class A voting common stock. The amount and timing of any purchases will depend on a number of factors, including trading price, trading volume and general market conditions. No assurance can be given that any particular amount of common stock will be repurchased.

The Company believes that sufficient capital resources are available in both the short-term and long-term through currently available cash, amounts available under the revolving line of credit and cash generated from future operations to sustain the Company's operations and to fund our strategic plans.

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company has no holdings of derivative financial or commodity instruments as of November 3, 2018. The Company is exposed to financial market risks, including changes in interest rates, primarily related to the effect of interest rate changes on borrowings outstanding under our revolving line of credit. Borrowings under the Agreement bear interest at rates ranging from 1.75% to 2.25% plus LIBOR or 0.75% to 1.25% plus the Base Rate depending on excess availability. Our potential additional interest expense over one year that would result from a hypothetical and unfavorable change of 100 basis points in short term interest rates would be in the range of $0.03 to $0.05 of pretax earnings per share assuming borrowing levels of $125.0 million to $175.0 million throughout 2018. All of the Company's business is transacted in U.S. dollars and, accordingly, foreign exchange rate fluctuations have never had a significant impact on the Company, 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 November 3, 2018 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

For a description of our material pending legal proceedings, see Note 10 - Legal Contingencies - of the Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q, which is incorporated herein by reference.

Item 1A. Risk Factors.

The risk factors listed in Part I, “Item 1A. Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended February 3, 2018, 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.

On December 6, 2017, the Company announced the amendment of the share repurchase program described above. The amended program will allow for the repurchase of up to 3.8 million shares of the Company’s outstanding Class A voting common stock (the “common stock”). Under the amended program, the common stock may be purchased through a combination of a Rule 10b5-1 automatic trading plan and discretionary purchases on the open market, block trades or in privately negotiated transactions. The amount and timing of any purchases will depend on a number of factors, including trading price, trading volume and general market conditions. No assurance can be given that any particular amount of common stock will be repurchased. This repurchase program is valid for up to two years and may be modified, extended or terminated by the Board at any time. As of the date of this filing, there were 2.6 million shares available for repurchase. No shares were repurchased in the thirty-nine weeks ended November 3, 2018.

Item 3. Defaults Upon Senior Securities.

Not applicable.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibit Number	Exhibit Description	Incorporation by Reference Form	SEC File No.	Exhibit	Filing Date
2.1	Asset Purchase Agreement, dated September 7, 2018, by and between Walgreen Co. and Fred's Stores of Tennessee, Inc.	8-K	001-14565	2.1	September 10, 2018
2.2	Amendment to Asset Purchase Agreement, dated October 23, 2018, by and between Walgreen Co. and Fred's Stores of Tennessee, Inc.	8-K	001-14565	2.1	November 14, 2018
10.1	Seventh Amendment to Credit Agreement, Second Amendment to Amended and Restated Addendum to Credit Agreement and Second Amendment to Security Agreement, dated as of August 23, 2018, by and among Fred's, Inc. and certain of its subsidiaries, Regions Bank, in its capacity as administrative agent, co-collateral agent and lender, and Bank of America, N.A., in its capacity as co-collateral agent and lender.	8-K	001-14565	10.1	August 29, 2018
10.2	Third Amendment to Amended and Restated Addendum to Credit Agreement, dated as of October 15, 2018, by and among Fred's, Inc. and certain of its subsidiaries, Regions Bank, in its capacity as administrative agent, co-collateral agent and lender, and Bank of America, N.A., in its capacity as co-collateral agent and lender.	8-K	001-14565	10.1	October 19, 2018
10.3	Amendment to Cooperation Agreement, dated as of August 11, 2017, by and among Fred's, Inc., Alden Global Capital LLC, Strategic Investment Opportunities LLC and Heath B. Freeman.	8-K	001-14565	10.1	October 10, 2018
31.1†	Certification of Interim Chief Executive Officer pursuant to Exchange Rule 13a-14(a) of the Securities Exchange Act.	—	—	—	—
31.2†	Certification of Chief Financial Officer pursuant to Exchange Rule 13a-14(a) of the Securities Exchange Act.	—	—	—	—
32††	Certification of Interim 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.

†† Furnished herewith.

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SIGNATURES

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

	FRED'S, INC.
Date: December 13, 2018	/s/ Joseph M. Anto Interim Chief Executive Officer, Executive Vice President and Chief Financial Officer

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