FREDS INC
Form 10-Q
September 11, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the quarterly period ended August 2, 2008.
OR
o 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 [X] No [].

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

Large accelerated filer o	Accelerated filer þ
Non-accelerated filer o	Smaller reporting company o

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

The registrant had 39,962,902 shares of Class A voting, no par value common stock outstanding as of September 11, 2008.

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Part I FINANCIAL INFORMATION

Item 1. Financial Statements

FRED S, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except for number of shares)

	August 2, 2008 (Unaudited)	February 2, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,555	$ 10,266
Receivables, less allowance for doubtful accounts of $635 and $879, respectively	28,079	30,972
Inventories	335,341	320,268
Other non-trade receivables	18,343	20,536
Prepaid expenses and other current assets	11,045	11,792
Total current assets	402,363	393,834
Property and equipment, at depreciated cost	141,575	145,985
Equipment under capital leases, less accumulated amortization of $4,928 and $4,836, respectively	39	132
Other noncurrent assets, net	10,560	10,621
Total assets	$ 554,537	$ 550,572
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 87,088	$ 70,416
Current portion of indebtedness	609	159
Current portion of capital lease obligations		126
Accrued expenses and other	44,844	39,469
Deferred income taxes	15,695	13,151
Total current liabilities	148,236	123,321
Long-term portion of indebtedness	4,937	35,653
Deferred income taxes	7,687	6,698
Other noncurrent liabilities	13,591	12,841
Total liabilities	174,451	178,513
Commitments and Contingencies		
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		
Common stock, Class A voting, no par value, 60,000,000 shares authorized, 39,962,102 and 39,880,836 shares issued and outstanding, respectively	136,697	135,335

Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding		
Retained earnings	242,370	235,684
Accumulated other comprehensive income	1,019	1,040
Total shareholders equity	380,086	372,059
Total liabilities and shareholders equity	$ 554,537	$ 550,572

See accompanying notes to condensed consolidated financial statements.

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FRED S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(unaudited)
(in thousands, except per share amounts)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Net sales	$ 447,127	$ 424,640	$ 911,419	$ 866,902
Cost of goods sold	323,276	303,157	655,087	618,418
Gross profit	123,851	121,483	256,332	248,484
Depreciation and amortization	6,779	7,408	13,862	14,635
Selling, general and administrative expenses	115,126	108,373	228,786	216,990
Operating income	1,946	5,702	13,684	16,859
Interest income	(104)	(158)	(202)	(291)
Interest expense	181	395	452	432
Income before income taxes	1,869	5,465	13,434	16,718
Provision for income taxes	836	2,407	5,151	6,222
Net income	$ 1,033	$ 3,058	$ 8,283	$ 10,496
Net income per share				
Basic	$ 0.03	$ 0.08	$ 0.21	$ 0.26
Diluted	$ 0.03	$ 0.08	$ 0.21	$ 0.26
Weighted average shares outstanding				
Basic	39,617	39,864	39,710	39,851
Effect of dilutive stock options	223	118	194	123
Diluted	39,840	39,982	39,904	39,974
Dividends per common share	$ 0.02	$ 0.02	$ 0.04	$ 0.04
Comprehensive income:				
Net income	$ 1,033	$ 3,058	$ 8,283	$ 10,496
Other comprehensive income (expense), net of tax postretirement plan adjustment	(11)	(16)	(22)	(32)

Comprehensive income	$	1,022	$	3,042	$	8,261	$	10,464

See accompanying notes to condensed consolidated financial statements.

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

	Twenty-Six Weeks Ended	
	August 2, 2008	August 4, 2007
Cash flows from operating activities:		
Net income	$ 8,283	$ 10,496
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	13,862	14,635
Net (gain) loss on asset disposition	(895)	48
Provision for store closures and asset impairment	419	
Stock-based compensation	1,093	1,117
Provision for uncollectible receivables, net	(244)	48
LIFO reserve increase	1,921	921
Deferred income tax expense (benefit)	3,533	(2,636)
Excess tax benefits (charges) from stock-based compensation	11	7
Provision for post retirement medical	(22)	(32)
(Increase) decrease in operating assets:		
Trade receivables	4,786	1,545
Insurance receivables	324	982
Inventories	(17,275)	(43,546)
Other assets	749	1,620
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	22,047	161
Income taxes payable	(11)	(4,195)
Other noncurrent liabilities	750	3,003
Net cash provided by (used in) operating activities	39,331	(15,826)
Cash flows from investing activities:		
Capital expenditures	(9,379)	(12,770)
Proceeds from asset dispositions	2,286	280
Insurance recoveries for replacement assets	220	650
Asset acquisition, net (primarily intangibles)	(998)	(695)
Net cash used in investing activities	(7,871)	(12,535)
Cash flows from financing activities:		
Payments of indebtedness and capital lease obligations	(207)	(575)
Proceeds from revolving line of credit	198,370	103,086
Payments on revolving line of credit	(229,005)	(73,018)
Excess tax benefits (charges) from stock-based compensation	(11)	(7)
Proceeds from exercise of stock options and employee stock purchase plan	279	305
Cash dividends paid	(1,597)	(1,603)

Net cash provided by (used in) financing activities	(32,171)	28,188
Increase (decrease) in cash and cash equivalents	(711)	(173)
Cash and cash equivalents:		
Beginning of year	10,266	2,475
End of year	$ 9,555	$ 2,302
Supplemental disclosures of cash flow information:		
Interest paid	$ 343	$ 442
Income taxes paid	$ 500	$ 14,200
Non-cash investing and financial activities:		
Assets acquired through term loan	$ 450	$ 1,447
Common stock issued for purchase of capital assets	$	$ 432

See accompanying notes to condensed consolidated financial statements.

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FRED S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1: BASIS OF PRESENTATION

Fred s, Inc. and subsidiaries (We , Our , Us or Company) operates as of August 2, 2008, 664 discount general merchandise stores, including 24 franchised Fred s stores, in 15 states in the southeastern United States. 277 of the stores have full service pharmacies.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and are presented in accordance with the requirements of Form 10-Q and therefore do not include all information and notes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with GAAP. The statements do reflect all adjustments (consisting of only normal recurring accruals) which are, in the opinion of management, necessary for a fair presentation of financial position in conformity with GAAP. The statements should be read in conjunction with the Notes to the Consolidated Financial Statements for the fiscal year ended February 2, 2008 incorporated into Our Annual Report on Form 10-K.

The results of operations for the thirteen and twenty-six week periods ended August 2, 2008 are not necessarily indicative of the results to be expected for the full fiscal year.

NOTE 2: RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under SFAS No. 157, fair value measurements are required to be disclosed by level within that hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. However, FASB Staff Position (FSP) No. FAS 157-2, Effective Date of FASB Statement No. 157, (SFAS No. 157-2) issued in February 2008, delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis, to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company adopted SFAS No. 157 effective February 3, 2008, and its adoption did not have a material effect on its results of operations or financial position. The Company has also evaluated FSP No. FAS 157-2 and determined that it will have no impact on its results of operations or financial position.

In February 2007, the Financial Accounting Standards Board issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 , (SFAS No. 159). SFAS No. 159 allows companies the choice to measure many financial instruments and certain other items at fair value. This gives a company the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is in the process of determining the effect, if any, that the adoption of SFAS No. 159 will have on its results of operations or financial position.

In June 2007, the Emerging Issues Task Force (EITF) of the FASB ratified their consensus position 06-11 (EITF 06-11), Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards. EITF 06-11 provides guidance on how a company should recognize the income tax benefit received on dividends that are paid to employees holding equity-classified nonvested shares, equity-classified nonvested share units, or equity-classified outstanding share options charged to retained earnings under FASB Statement 123(R), Share-Based Payment. The Company is required to apply the guidance provided in EITF 06-11 prospectively to income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after September 15, 2007. Early application of EITF 06-11 is permitted for the income tax benefit of dividends on equity-classified employee share-based

payment awards that are declared in periods for which financial statements have not yet been issued. The Company has evaluated EITF 06-11 and determined that it will have no impact on its results of operations or financial position.

In December 2007, the FASB issued FASB Statement No. 141(R), Business Combinations (SFAS 141(R)), which establishes accounting principles and disclosure requirements for all transactions in which a company obtains control over another business. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of determining the effect, if any, that the adoption of SFAS No. 141(R) will have on its results of operations or financial position.

In December 2007, the FASB issued FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS No. 160). SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of determining the effect, if any, that the adoption of SFAS No. 160 will have on its results of operations or financial position.

In March 2008, the FASB issued FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (SFAS No. 161). SFAS No. 161 requires enhanced disclosures about an entity s derivative and hedging activities. SFAS No. 161 is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2008. Earlier adoption is available. The Company has evaluated SFAS No. 161 and determined that it will have no impact on its results of operations or financial position.

NOTE 3: INVENTORIES

Merchandise inventories are valued at the lower of cost or market using the retail first-in, first-out (FIFO) method for goods in our stores and the cost first-in, first-out (FIFO) method for goods in our distribution centers. The retail inventory method is a reverse mark-up, averaging method which has been widely used in the retail industry for many years. This method calculates a cost-to-retail ratio that is applied to the retail value of inventory to determine the cost value of inventory and the resulting cost of goods sold and gross margin. The assumption that the retail inventory method provides for valuation at lower of cost or market and the inherent uncertainties therein are discussed in the following paragraphs.

In order to assure valuation at the lower of cost or market, the retail value of our inventory is adjusted on a consistent basis to reflect current market conditions. These adjustments include increases to the retail value of inventory for initial markups to set the selling price of goods or additional markups to adjust pricing for inflation and decreases to the retail value of inventory for markdowns associated with promotional, seasonal or other declines in the market value. Because these adjustments are made on a consistent basis and are based on current prevailing market conditions, they approximate the carrying value of the inventory at net realizable value (market value). Therefore, the cost value of our inventory is stated at the lower of cost or market as is prescribed by GAAP.

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

The Company calculates inventory losses (shrink) based on actual inventory losses occurring as a result of physical inventory counts during each fiscal period and estimated inventory losses occurring between yearly physical inventory counts. The estimate for shrink occurring in the interim period between physical counts is calculated on a store-specific basis and is based on history, as well as performance on the most recent physical count. It is calculated by multiplying each store s shrink rate, which is based on the previously mentioned factors, by the interim period s sales for each store. Additionally, the overall estimate for shrink is adjusted at the corporate level to a three-year historical average to ensure

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that the overall shrink estimate is the most accurate approximation of shrink based on the Company s overall history of shrink. The three-year historical estimate is calculated by dividing the book to physical inventory adjustments for the trailing 36 months by the related sales for the same period.

In order to reduce the uncertainty inherent in the shrink calculation, the Company first performs the calculation at the lowest practical level (by store) using the most current performance indicators. This ensures a more reliable number, as opposed to using a higher level aggregation or percentage method. The second portion of the calculation ensures that the extreme negative or positive performance of any particular store or group of stores does not skew the overall estimation of shrink. This portion of the calculation removes additional uncertainty by eliminating short-term peaks and valleys that could otherwise cause the underlying carrying cost of inventory to fluctuate unnecessarily. The Company has not experienced any significant change in shrink as a percentage of sales from year to year during the subject reporting periods.

Management believes that the Company s Retail Inventory Method provides an inventory valuation which reasonably approximates cost and results in carrying inventory at the lower of cost or market. For pharmacy inventories, which were approximately $33.9 million and $30.5 million at August 2, 2008 and February 2, 2008, respectively, cost was determined using the retail last-in, first-out (LIFO) method in which inventory cost is maintained using the Retail Inventory Method, then adjusted by application of the Producer Price Index published by the U.S. Department of Labor for the cumulative annual periods. The current cost of inventories exceeded the LIFO cost by approximately $17.4 million at August 2, 2008 and $15.4 million at February 2, 2008.

The Company includes an estimate of inbound freight and certain general and administrative expenses in merchandise inventory as prescribed by GAAP. These costs include activities surrounding the procurement and storage of merchandise inventory such as buying, warehousing, accounting, merchandise planning, information technology and human resources, as well as inbound freight. The total amount of expenses and inbound freight included in merchandise inventory at August 2, 2008 is $21.7 million, with the corresponding amount of $21.9 million at February 2, 2008.

NOTE 4: STOCK-BASED COMPENSATION

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

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

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

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Stock option expense	$ 278	$ 255	$ 649	$ 739
Restricted stock expense	195	134	356	274
ESPP expense	44	52	88	104
Total stock-based compensation	$ 517	$ 441	$ 1,093	$ 1,117
Income tax benefit on stock-based compensation	111	54	226	168

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The fair value of each option granted during the thirteen week and twenty-six week periods ended August 2, 2008 and August 4, 2007 (there were no grants for the thirteen weeks ended August 4, 2007), respectively, are estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Stock Options				
Expected volatility	40.2%	N/A	40.3%	41.0%
Risk-free interest rate	3.3%	N/A	3.4%	4.4%
Expected option life (in years)	5.84	N/A	5.84	5.84
Expected dividend yield	0.49%	N/A	0.45%	0.40%
Weighted average fair value at grant date	$ 4.82	N/A	$ 4.60	$ 6.49
Employee Stock Purchase Plan				
Expected volatility	37.8%	42.3%	39.4%	37.5%
Risk-free interest rate	3.1%	4.7%	3.1%	4.7%
Expected option life (in years)	0.5	0.5	0.38	0.38
Expected dividend yield	0.34%	0.30%	0.26%	0.23%
Weighted average fair value at grant date	$ 2.44	$ 3.36	$ 2.31	$ 3.01

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

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

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

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

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

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

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Employee Stock Purchase Plan

The 2004 Employee Stock Purchase Plan (the 2004 Plan), which was approved by Fred s stockholders, permits eligible employees to purchase shares of our common stock through payroll deductions at the lower of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value at the time of exercise. There were 37,095 shares issued during the twenty-six weeks ended August 2, 2008. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of August 2, 2008, there were 1,186,852 shares available.

Stock Options

The following table summarizes stock option activity during the twenty-six weeks ended August 2, 2008:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (Thousands)
Outstanding at February 2, 2008	1,216,451	$ 15.40	4.6	$ 0
Granted	29,500	$ 11.03		
Forfeited / Cancelled	(68,890)	$ 16.31		
Exercised				
Outstanding at August 2, 2008	1,177,061	$ 15.23	4.3	$ 682
Exercisable at August 2, 2008	421,929	$ 16.58	2.3	$ 55

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between Fred s closing stock price of $13.12 on the last trading day of the period ended August 2, 2008 and the exercise price of the option multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on that date. As of August 2, 2008, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately $1.16 million, which is expected to be recognized over a weighted average period of approximately 3.4 years. The total fair value of options vested during the twenty-six weeks ended August 2, 2008 was $.38 million.

Restricted Stock

The following table summarizes restricted stock activity during the twenty-six weeks ended August 2, 2008:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested Restricted Stock at February 2, 2008	285,635	$ 13.83
Granted	71,565	$ 9.89
Forfeited / Cancelled	(23,897)	$ 13.31
Vested	(4,790)	$ 16.34
Non-vested Restricted Stock at August 2, 2008	328,513	$ 12.97

The aggregate pre-tax intrinsic value of restricted stock outstanding as of August 2, 2008 is $4.3 million with a weighted average remaining contractual life of 6.3 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding stock is approximately $3.0 million, which is expected to be recognized over a weighted average period of approximately 5.8 years. The total fair value of restricted stock awards that vested during the twenty-six weeks ended August 2, 2008 was $.08 million.

NOTE 5: ASSETS HELD FOR SALE

In the first quarter of fiscal 2008, the Company purchased the home of a recently hired executive for $874.6 thousand pursuant to its contractual obligation. The asset was sold during the second quarter for $805.0 thousand less selling and administrative expenses of $69.4 thousand. The Company incurred a loss on the sale of the asset of $139.0 thousand.

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

The following illustrates the breakdown of the major categories within Property and Equipment:

	August 2, 2008 (Unaudited)	February 2, 2008
Furniture, fixtures and equipment	$ 226,821	$ 224,734
Building and building improvements	88,432	88,459
Leasehold improvements	48,041	50,859
Automobiles and vehicles	5,204	5,500
Airplane	4,697	4,697
	373,195	374,249
Less: Accumulated Depreciation and Amortization	(239,888)	(235,281)
	133,307	138,968
Construction in Progress	2,085	1,034
Land	6,183	5,983
Total Property and Equipment, at depreciated cost	$ 141,575	$ 145,985

NOTE 7: EXIT AND DISPOSAL ACTIVITIES

During the course of 2008, the Company is planning approximately 75 store closings and 22 pharmacy closings (of which 67 stores and 22 pharmacies have been closed as of August 2, 2008 and seven stores are planned to close in the third quarter).

Inventory Impairment

During the year ended February 2, 2008, we recorded a below-cost inventory adjustment of approximately $10.0 million to reduce the value of inventory to lower of cost or market in stores that were planned for closure as part of the Company s strategic plan to improve profitability and operating margin. The adjustment was recorded in cost of goods sold in the consolidated statement of income for the year ended February 2, 2008.

Through the second quarter of fiscal year 2008, we recorded an additional below-cost inventory adjustment of $.3 million to reduce the value of inventory to lower of cost or market associated with stores that are planned to close in the third quarter and utilized $9.6 million related to the 67 stores during the twenty-six weeks ended August 2, 2008.

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Lease Termination

Also during the year ended February 2, 2008 we closed 22 under performing stores and recorded lease contract termination costs of $1.6 million in rent expense in conjunction with those closings, of which $1.1M was utilized during the year, leaving $.6 million in the reserve at the beginning of fiscal year 2008.

Through the second quarter of fiscal year 2008, we closed 67 under performing stores and recorded lease contract termination costs of $8.7 million, of which $7.9 million was charged to rent expense and $.8 reduced the reserve for deferred rent. We also utilized $1.2 million during the period, leaving $8.1 million in the reserve at August 2, 2008.

During the current year, the Company expects to incur $8.8 million in lease contract termination costs, of which $7.9 million was incurred through the second quarter and charged to rent expense.

The following table illustrates the activity in the reserves (liability) related to activities discussed in the previous paragraphs (in millions):

	Balance at February 2, 2008	Additions FY08 (Unaudited)	Utilized FY08 (Unaudited)	Balance at August 2, 2008
Inventory markdowns for planned store closings	$ 10.0	$ 0.3	$ 9.6	$ 0.7
Lease contract termination liability	0.6	8.7	1.2	8.1
	$ 10.6	$ 9.0	$ 10.8	$ 8.8

Fixed Asset Impairment

During the second quarter, the Company recorded a charge of $.1 million in selling, general and administration expense for the impairment of fixed assets and leasehold improvements associated with store closures planned in the third quarter.

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 under GAAP are recorded as an element of shareholders equity but are excluded from net income. The Company s accumulated other comprehensive income includes the unrecognized prior service costs, transition obligations and actuarial gains/losses associated with our postretirement benefit plan.

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

	Twenty- Six Weeks Ended		Year Ended
(in thousands)	August 2, 2008	August 4, 2007	February 2, 2008
Accumulated other comprehensive income	$ 1,040	$ 1,083	$ 1,083
Amortization of postretirement benefit	(21)	(32)	(43)
Ending balance	$ 1,019	$ 1,051	$ 1,040

NOTE 9: RELATED PARTY TRANSACTIONS

The Company leases eleven of its store locations from Atlantic Retail Partners, LLC, which is partially owned by Michael J. Hayes, a director and officer of the Company. The terms and conditions regarding the leases on these locations are consistent in all material respects with other store leases of the Company. Rent payments on these locations were $321.5 thousand and $635.5 thousand for the quarter and year-to-date ended August 2, 2008, respectively. During quarter and year-to-date ended August 4, 2007, the Company leased only one of its store locations from Atlantic Retail Partners, LLC and incurred rent on that location of $0 and $31.7 thousand, respectively.

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Item 2:

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

GENERAL

Executive Overview

During the second quarter of 2008, the Company continued its previously announced strategic plan to improve profitability and operating margin. The plan, which included closing of 75 underperforming stores and 22 underperforming pharmacies, coupled with slowing growth in 2008 will have a positive impact on the Company s cash flow and operating margin in 2008 and beyond. In the second quarter of 2008, we closed 50 stores and 1 pharmacy while opening 7 new stores and 2 new pharmacies. During 2008, we have closed 67 stores and 22 pharmacies. For the year-to-date period, the Company has opened 15 stores and three pharmacies. The remaining eight going out of business sales and the resulting store closures will be substantially completed in the third quarter of 2008. The majority of our new store openings in the quarter were in Georgia and South Carolina. We did not enter into any new states during the quarter.

Another key area of concentration in the quarter was our initiatives to improve service level and in-stock positions. Our We Got It program focuses on our highest demand consumable type items (700 800 items). These are items that we have promised, through our We Got It campaign, to always have on our shelves and available for our customers. We continued in the second quarter of 2008 to implement supply chain and distribution procedures to ensure that our We Got It pledge is fulfilled.

In the second quarter of 2008, we introduced to our customers a new pricing strategy and marketing campaign entitled Price Alert . This campaign focuses the customer s attention on particular items in our stores that are value priced and attractive to any budget, especially during current economic conditions. This marketing campaign is chain-wide and is delivered to the customer via print and media advertising in addition to specifically designed in-store signage. We will continue to use the Price Alert campaign throughout the remainder of this year and beyond to deliver value priced products to our customers.

Our Battleship Store Program, which was developed late in 2007 and became fully operational in the first quarter, is intended to sharpen focus on our upper tier of profit producing stores. This program is designed to reward our customers with additional benefits such as expanded selections of products, one time or one-of-a-kind type items, or special events such as treasure hunts or outdoor activities. Customer and employee appreciation are key tenets of the Battleship Store Program. As this program is in its infancy, we continued in the second quarter to refine our understanding of our customers needs in our Battleship Stores markets. Along with refining our understanding of our customers needs, we continued to hone our delivery and execution of this strategy so that our Battleship Stores will help drive increased operating profit in line with the Company s overall profit improvement strategies.

We continued in the second quarter of 2008 to focus on building our private label line of products which should build and solidify customer loyalty while simultaneously increasing gross margin. We are currently developing additional private label brand names that we believe the customer will find appealing and will become synonymous with Fred s promise to deliver quality products at low prices. As a result of our focus in this area, in the first half of 2008, we have increased our market penetration in our private label products.

Over the course of 2008, we intend to continue with capital improvements in infrastructure, including new and existing store expansions and remodels, distribution center upgrades and further development of our information technology capabilities. Technology upgrades will be made in the areas of direct store delivery systems, stores POS systems, and pharmacy systems.

As previously reported, the Company expects total earnings per diluted share for 2008 to be in the range of $0.54 to $0.58 including costs in 2008 related to the announced store closings. Excluding the estimated store closing expenses of $10.8 million, earnings per diluted share for 2008 are expected to be in the range of $0.72 to $0.76. These earnings projections include the following significant events affecting the balance of the year:

The second year incremental raising of the federal minimum wage which occurred in the second quarter and will negatively impact our labor expense by approximately $5.2 million for the fiscal year.

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The continued product mix shift to more basic and consumable type items, coupled with inflationary pressures, will continue to negatively affect gross margin.

The positive impact of our initiatives to drive traffic into our stores.

Key factors that will be critical to the Company s future success include managing the strategy for opening new stores and pharmacies, including the ability to open and operate efficiently, maintaining high standards of customer service, maximizing efficiencies in the supply chain, controlling working capital needs through improved inventory turnover, controlling the effects of inflation, especially in regard to occupancy costs, controlling product mix, increasing operating margin through improved gross margin and leveraging operating costs, and generating adequate cash flow to fund the Company s future needs. Additionally, managing the store closing process effectively and efficiently will be a key factor in delivering projected benefits in 2008 and beyond.

Other factors that will affect Company performance in 2008 include the continuing management of the impacts of the changing regulatory environment in which our pharmacy department operates, especially the anticipated implementation of the federally approved change in pricing of generic pharmaceuticals to Average Manufacturer s Price (AMP), which could negatively affect gross margin. Additionally, inflated oil and gas prices continue to have a negative impact on our business in terms of reducing our customer s disposable income, as well as increasing the cost of our petroleum based products and increasing our transportation costs. We also believe that the current housing crisis is having an impact on the disposable income of our customers and will continue to do so throughout 2008.

It also appears that 2008 will be affected by an active hurricane season, with Hurricane Gustav making land fall in southern Louisiana over the Labor Day weekend. Initially, it appears that Hurricane Gustav did not create the kind of devastation caused by Hurricane Katrina three years ago, but did create business interruption and minor structural damage. With additional time in the current hurricane season, a risk remains that hurricanes may be a key factor affecting our business in the third quarter of 2008.

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company s discussion and analysis of its financial condition and results of operations are based upon the Company s condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The critical accounting matters that are particularly important to the portrayal of the Company s financial condition and results of operations and require some of management s most difficult, subjective and complex judgments are described in detail in the Company s Annual Report on Form 10-K for the fiscal year ended February 2, 2008. The preparation of condensed financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to inventories, income taxes, insurance reserves, contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

RESULTS OF OPERATIONS

Thirteen Weeks Ended August 2, 2008 and August 4, 2007

Net sales increased to $447.1 million in 2008 from $424.6 million in 2007, an increase of $22.5 million or 5.3%. The increase was attributable to comparable store sales increases of 4.9% ($20.8 million) and sales by stores not yet included as comparable stores ($1.7 million). Sales to franchisees increased $.6 million in 2008 compared to the same quarter last year. The sales mix for the period was 30.7% Pharmaceuticals, 25.5% Household Goods, 15.3% Food and Tobacco, 9.3% Paper and Cleaning Supplies, 9.1% Apparel and Linens, 7.9% Health and Beauty Aids, and 2.2% Franchise. This compares with

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32.6% Pharmaceuticals, 23.8% Household Goods, 14.1% Food and Tobacco, 9.2% Paper and Cleaning Supplies, 10.0% Apparel and Linens, 8.2% Health and Beauty Aids, and 2.1% Franchise for the same period last year.

Gross margin for the second quarter of 2008 was 27.7% of sales as compared to 28.6% of sales in the second quarter of 2007. The reduction in gross margin during the second quarter resulted from pricing pressures, an unfavorable shift in the product mix toward lower margin basic and consumable products, and higher inbound freight costs. These negative factors were partially offset by the positive margin effect of a mix shift in the pharmacy department from branded to generic drugs.

Selling, general and administrative expenses, including depreciation and amortization, increased to $121.9 million in 2008 from $115.8 million in 2007. This quarter over quarter increase is primarily attributable to lease write-offs related to store closures ($6.7 million) as well as additional insurance expense due to unfavorable claims experience ($0.5 million), offset by reduced depreciation ($0.6 million) resulting from less capital spending and assets written-off in store closures and increased labor and operating expense efficiencies ($0.5 million).

As a percent of sales, selling, general and administrative expenses were 27.3%, unchanged from the same period last year. Excluding net costs associated with the store restructuring program, of which $6.7 million was incurred for expected lease related liabilities, expenses were 26.4% of sales versus 27.2% in the same period last year.

For the second quarter of 2008, the Company incurred net interest expense of $0.1 million compared to $.2 million in the second quarter of 2007.

For the second quarter of 2008, the effective income tax rate was 44.7%, as compared to 44.0% in the second quarter of last year. The increase in the effective tax rate was due to the expiration of federal and state job related income tax credits, as well as timing of reserves necessary under FASB Interpretation 48, Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement 109 .

Twenty-six Weeks Ended August 2, 2008 and August 4, 2007

Net sales increased to $911.4 million in 2008 from $866.9 million in 2007, an increase of $44.5 million or 5.1%. The increase was attributable to comparable store sales increases of 3.5% ($30.5 million) and sales by stores not yet included as comparable stores ($14.0 million). Sales to franchisees increased $1.7 million in 2008. The sales increase was driven, in part, by the 2008 Economic Stimulus checks that were issued during the first half of 2008. The sales mix for the period was 31.3% Pharmaceuticals, 24.9% Household Goods, 15.4% Food and Tobacco, 8.9% Apparel and Linens, 9.2% Paper and Cleaning Supplies, 8.1% Health and Beauty Aids, and 2.2% Franchise. This compares with 32.9% Pharmaceuticals, 23.4% Household Goods, 14.2% Food and Tobacco, 10.2% Apparel and Linens, 9.0% Paper and Cleaning Supplies, 8.2% Health and Beauty Aids, and 2.1% Franchise for the same period last year.

For the twenty-six weeks ended August 2, 2008, we opened 15 new stores and 3 new pharmacies and we closed 67 stores and 22 pharmacies.

Gross profit decreased to 28.1% of sales in 2008 compared with 28.7% of sales in the prior-year period. Gross profit margin for the first six months was unfavorably affected by the same factors as listed for the second quarter.

Selling, general and administrative expenses, including depreciation and amortization, increased to $242.6 million in 2008 from $231.6 million in 2007. As a percentage of sales, expenses were positively leveraged at 26.6% of sales compared to 26.8% of sales last year. The leveraging in selling, general and administrative expenses resulted primarily from increased labor efficiency (.18%) partially offset by liquidation fees from store closings (.06%). Excluding the effect of net costs associated with the store restructuring program, expenses were 26.1% of sales versus 26.7% in the first six months last year.

For the twenty-six weeks ended August 2, 2008, the effective income tax rate was 38.3% compared to 37.2% last year. We anticipate the tax rate for the remaining two quarters of 2008 to be in the 35% to 37% range.

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LIQUIDITY AND CAPITAL RESOURCES

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

Cash provided by operating activities totaled $39.3 million during the twenty-six week period ended August 2, 2008 as contrasted with a $15.8 million use of cash in the same period prior year. While cash was used for our normal seasonal build up of inventories, we generated cash through our closing of 67 stores in the current year-to-date period. We also extended vendor payment periods to improve cash flows.

Cash used in investing activities totaled $7.9 million, and consisted primarily of capital expenditures associated with the store and pharmacy expansion program ($4.4 million), expenditures related to existing stores ($3.0 million) and technology and other corporate expenditures ($1.9 million). During the second quarter of 2008, we opened 7 stores and 2 pharmacies and closed 50 stores and 1 pharmacy. We expect to open 18 stores and 15 pharmacies for the year, and expect to close 75 stores and 22 pharmacies. In 2008, the Company is planning capital expenditures totaling approximately $18.3 million. Expenditures are planned totaling approximately $11.3 million for upgrades, remodels, or new stores and pharmacies; $3.7 million for technology upgrades $1.3 million for distribution center equipment and capital replacements. In addition, the Company also plans expenditures of $2.0 million for the acquisition of customer lists and other pharmacy related items. Depreciation expense for 2008 will be approximately $26.5 million.

Cash used by financing activities totaled $32.2 million and included $30.1 million in net repayments under the Company s revolving credit facility and $1.6 million for the payment of cash dividends. There were $5.5 million in borrowings outstanding at August 2, 2008 and $35.9 million in borrowings outstanding at February 2, 2008.

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

FORWARD-LOOKING STATEMENTS

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

The words believe , anticipate , project , plan , expect , estimate , objective , forecast , goal , intend , w continue and similar expressions generally identify forward-looking statements. All forward-looking statements are inherently uncertain, and concern matters that involve risks and other factors that may cause the actual performance of the Company to differ materially from the performance expressed or implied by these statements. Therefore, forward-looking statements should be evaluated in the context of these uncertainties and risks, including but not limited to:

Economic and weather conditions which affect buying patterns of our customers and supply chain efficiency.

Changes in consumer spending and our ability to anticipate buying patterns and implement appropriate inventory strategies.

Continued availability of capital and financing.

Competitive factors.

Changes in reimbursement practices for pharmaceuticals.

Governmental regulation.

Increases in fuel and utility rates.

Potential adverse results in the Fair Labor Standards Act (FSLA) litigation described under Legal Proceedings on page 17.

Other factors affecting business beyond our control, including (but not limited to) those discussed under Part 1, ITEM 1A Risk Factors of the Company s Annual Report on Form 10-K for the fiscal year ended February 2, 2008.

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.

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Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We have no holdings of derivative financial or commodity instruments as of August 2, 2008. We are exposed to financial market risks, including changes in interest rates. All borrowings under our Revolving Credit Agreement bear interest at 1.5% below prime rate or a LIBOR-based rate. An increase in interest rates of 100 basis points would not significantly affect our income. All of our business is transacted in U.S. dollars and, accordingly, foreign exchange rate fluctuations have not had a significant impact on us, and they are not expected to in the foreseeable future.

Item 4.

CONTROLS AND PROCEDURES

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

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

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In June 2006, a lawsuit entitled Sarah Ziegler, et al. v. Fred s Discount Store was filed in the United States District Court for the Northern District of Alabama in which the plaintiff alleges that she and other current and former Fred s Discount assistant store managers were improperly classified as exempt executive employees under the Fair Labor Standards Act (FLSA) and seeks to recover overtime pay, liquidated damages, and attorneys fees and court cost. In July 2006, the plaintiffs filed an emergency motion to facilitate notice pursuant to the FLSA that would give current and former assistant managers information about their rights to opt-in to the lawsuit. After initially denying the motion, in October 2006, the judge granted plaintiffs motion to facilitate notice pursuant to the FLSA. Notice was sent to some 2,055 current and former assistant store managers and approximately 450 persons opted into the case. The cut off date for individuals to advise of their interest in becoming part of this lawsuit was February 2, 2007.

The Company believes that its assistant store managers are and have been properly classified as exempt employees under the FLSA and that the actions described above are not appropriate for collective action treatment. The Company is and will continue to vigorously defend these actions in this matter. Discovery is ongoing and data continues to be reviewed. Following the close of the discovery period in this case, the Company will have an opportunity to seek decertification of the class, and the Company expects to file such a decertification and other motions.

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 including those mentioned in Part I Item 3. Legal Proceedings in the Annual Report on Form 10-K for the fiscal year ended February 2, 2008. There have been no material developments in those proceedings and claims. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the Company is of the opinion that it is unlikely that these proceedings and claims will have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. There can be no assurance that pending lawsuits will not consume the time and energy of our management or that future developments will not cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole. We intend to vigorously defend or prosecute each pending lawsuit.

Item 1A. Risk Factors

The risk factors listed in Part I Item 1A. Risk Factors in the Annual Report on Form 10-K for the fiscal year ended February 2, 2008, 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 6. Exhibits

Exhibits:

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

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: 9/11/2008

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

Date: 9/11/2008

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