DOLLAR GENERAL CORP
Form 10-K
March 29, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended February 2, 2007

Commission file number: 001-11421

DOLLAR GENERAL CORPORATION
(*Exact name of registrant as specified in its charter*)

TENNESSEE	**61-0502302**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

100 MISSION RIDGE
GOODLETTSVILLE, TN 37072
(Address of principal executive offices, zip code)

Registrant s telephone number, including area code: (615) 855-4000
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of the exchange on which registered
	New York Stock Exchange
Common Stock	New York Stock Exchange
Series B Junior Participating Preferred Stock Purchase Rights	

Securities registered pursuant to Section 12(g) of the Act: None

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Large Accelerated Filer [X] Accelerated Filer [ ] Non-accelerated Filer [ ]

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, computed by reference to the closing price on the New York Stock Exchange as of August 4, 2006, was approximately $3.9 billion. The registrant has no non-voting common stock. For purposes of this disclosure only, the registrant has assumed that its directors, executive officers, and beneficial owners of greater than 10% of the registrant s common stock are the affiliates of the registrant.

The registrant had 313,938,190 shares of common stock outstanding on March 20, 2007.

INTRODUCTION

General

This report contains references to years 2007, 2006, 2005, 2004, 2003 and 2002, which represent fiscal years ending or ended February 1, 2008, February 2, 2007, February 3, 2006, January 28, 2005, January 30, 2004 and January 31, 2003, respectively. All of the discussion and analysis in this report should be read with, and is qualified in its entirety by, the Consolidated Financial Statements and the notes thereto.

Forward Looking Statements/Risk Factors

This Form 10-K contains forward-looking statements. These statements may be found throughout this Form 10-K, particularly under the headings Business and Management s Discussion and Analysis of Financial Condition and Results of Operation, among others. Forward-looking statements typically are identified by the use of terms such as may, will, should, expect, believe , anticipate , project , plan , expect , estimate , objective , forec likely result , or will continue and similar expressions, although some forward-looking statements are expressed differently. You should consider statements that contain these words carefully because they may express or imply projections of revenues or expenditures, plans and objectives for future operations, growth or initiatives, expected future economic performance, or the expected outcome or impact of pending or threatened litigation based on currently available information. The factors listed below under the heading Risk Factors , in the other sections of this Form 10-K, including, but not limited to: Item 1 subsections Overall Business Strategy , Seasonality and Competition ; Item 3; and Item 7 subsections Executive Overview and Critical Accounting Policies and Estimates , in our other filings with the Securities and Exchange Commission (SEC), press releases and other communications provide examples of risks, uncertainties and events that could cause our actual results to differ materially from the expectations expressed in our forward-looking statements.

The forward-looking statements made in this Form 10-K relate only to events as of the date on which the statements are made. We undertake no obligation to publicly update or revise any forward-looking statement to reflect events or circumstances arising after the date on which it was made.

PART I

ITEM 1.

BUSINESS

General

We are a leading value discount retailer of quality general merchandise at everyday low prices. Through conveniently located stores, we offer a focused assortment of basic consumable merchandise including health and beauty aids, packaged food and refrigerated products, home cleaning supplies, housewares, stationery, seasonal goods, basic clothing and domestics. Dollar General® stores serve primarily low-, middle- and fixed-income families.

We were founded in 1939 as J.L. Turner and Son, Wholesale. We opened our first dollar store in 1955, when we were first incorporated as a Kentucky corporation under the name J.L. Turner & Son, Inc. We changed our name to Dollar General Corporation in 1968 and reincorporated as a Tennessee corporation in 1998. As of March 2, 2007, we operated 8,260 stores in 35 states, primarily in the southern, southwestern, midwestern and eastern United States.

Proposed Merger

On March 11, 2007, we entered into an Agreement and Plan of Merger (the Merger Agreement) with Buck Holdings LP, a Delaware limited partnership (Parent), and Buck Acquisition Corp., a Tennessee corporation and wholly owned subsidiary of Parent (Merger Sub), pursuant to which Merger Sub will be merged with and into us (the Merger). We will continue as the surviving corporation and as a wholly owned subsidiary of Parent. Merger Sub and Parent are affiliates of Kohlberg Kravis Roberts & Co., L.P.

Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of our common stock, other than any such shares held by any of our wholly owned subsidiaries and any shares owned by us, Parent or Merger Sub, will be cancelled and converted into the right to receive $22.00 in cash, without interest (the Merger Consideration). In addition, immediately prior to the effective time of the Merger, all shares of our restricted stock and restricted stock units will, unless otherwise agreed by the holder and Parent, vest and be converted into the right to receive the Merger Consideration. All options to acquire shares of our common stock will vest immediately prior to the effective time of the Merger and holders of such options will, unless otherwise agreed by the holder and Parent, be entitled to receive an amount in cash equal to the excess, if any, of the Merger Consideration over the exercise price per share of our common stock subject to the option.

Our Board of Directors unanimously approved the Merger Agreement and amended our Shareholder Rights Plan to exempt the Merger from that Plan s operation.

Consummation of the Merger is not subject to a financing condition but is subject to customary closing conditions, including approval of the Merger Agreement by our shareholders, regulatory approval and other customary closing conditions. The Merger Agreement places specified restrictions on certain of our business activities, including but not limited to:

acquisitions or dispositions of assets, capital expenditures, modifications of debt, leasing activities, compensatory changes, dividend increases, investments and share repurchases.

Overall Business Strategy

Our mission is Serving Others. To carry out this mission, we have developed a business strategy of providing our customers with a focused assortment of fairly priced, consumable merchandise in a convenient, small-store format.

Our Customers. We serve the basic consumable needs of customers primarily in the low- and middle-income brackets and those on fixed incomes. According to AC Nielsen s 2006 Homescan® data, in 2006 approximately 41% of our customers had gross income of less than $30,000 per year and approximately 24% had gross income of less than $20,000 per year. Our merchandising and operating strategies are primarily designed to meet the need for basic consumable products of consumers in these lower income groups.

Our Stores. The traditional Dollar General store has, on average, approximately 6,900 square feet of selling space and generally serves customers who live within five miles of the store. Of our 8,260 stores operating as of March 2, 2007, approximately 4,750 serve communities with populations of 20,000 or less. We believe that our target customers prefer the convenience of a small, neighborhood store. We believe that our convenient discount store format will continue to attract customers and provide us with a competitive advantage.

In 2003, we began testing a Dollar General Market® store concept. Dollar General Markets are larger than the average Dollar General store and carry, among other items, an expanded assortment of grocery products and perishable items. At March 2, 2007, our 8,260 total stores included 56 Dollar General Market stores with an average of approximately 17,250 square feet of selling space.

Our Merchandise. We are committed to offering a focused assortment of quality, consumable merchandise in a number of core categories, such as health and beauty aids, packaged food and refrigerated products, home cleaning supplies, housewares, stationery, seasonal goods, basic clothing and domestics. This focused merchandise assortment allows customers to shop at Dollar General stores for their everyday household needs. In 2006, the average customer purchase was $9.31.

Our Prices. We distribute quality, consumable merchandise at everyday low prices. Our strategy of a low-cost operating structure and a focused assortment of merchandise allows us to offer quality merchandise at competitive prices. As part of this strategy, we emphasize even-dollar prices on many of our items. In the typical Dollar General store, the majority of the products are priced at $10 or less, with approximately 30% of the products priced at $1 or less.

Our Cost Controls. We emphasize aggressive management of our overhead cost structure. Additionally, we seek to locate stores in neighborhoods where rental and operating costs are relatively low. We attempt to control operating costs by implementing new technology where feasible. Examples of this strategy in recent years include the implementation of EZstore , our initiative designed to improve inventory flow from distribution centers (DCs) to consumers; other improvements to our supply chain and warehousing systems; an automatic

inventory replenishment system at the store level; the implementation of a new merchandise planning system designed to assist our merchants with their purchasing and store allocation decisions; enhancements and improvements to the inventory replenishment and merchandise planning systems; and the reengineering of our open-to-buy inventory procurement process.

Recent Strategic Initiatives

In the fourth quarter of 2006, we launched certain strategic initiatives related to our merchandising and real estate strategies based upon a comprehensive analysis of the performance of each of our stores and the impact of our inventory model on our ability to effectively serve our customers.

With regard to merchandising, we reviewed our historic inventory management strategies, changes in recent years to those practices and the potential impact on future profitability of an acceleration of our transition away from some of those practices. Under our traditional inventory disposition strategy, we carried forward any remaining prior season inventory (packaway) and attempted to adjust future inventory purchases to account for the carryover product. Beginning in the fourth quarter of 2003, principally at the conclusion of the holiday selling season, we began taking end-of-season markdowns materially in excess of markdowns that had been taken historically to attempt to accelerate the disposition of certain holiday-related items, as well as certain other seasonal, home and basic clothing items that had not sold as expected. Although these increased end-of-season markdowns resulted in less packaway inventory, there continued to be a packaway component of our merchandising practices and a significant amount of merchandise from prior seasons remained in many stores. Based on our review, we decided to discontinue our traditional inventory packaway management model in an attempt to better meet our customers needs and to ensure an appealing, fresh merchandise selection. We are currently in the process of executing that initiative, as further discussed below under Merchandising Initiatives .

We made significant improvements to the policies, procedures and controls relating to our real estate practices during 2006. We have fully integrated the functions of site selection, lease renewals, relocations, remodels and store closings and have defined and implemented additional criteria for decision-making in those areas. We continue to analyze our real estate performance and to look for ways to further refine and improve our practices. As a first step in our initiative to revitalize our store base, we plan to close approximately 400 underperforming stores by the end of fiscal 2007, including 151 stores that have already been closed as of March 2, 2007. The closings are in addition to stores that might be closed in the normal course of business. We will continue to evaluate our store base for additional closing candidates as part of our revitalization efforts. We also are focusing on upgrading our existing store base with plans to decelerate our new store growth rate to enable us to remodel or relocate a number of stores to improve productivity and enhance the shopping experience for the customers in those stores. We expect that these actions will result in better disciplined inventory management and a more productive store base.

Growth Strategy

We have experienced a rapid rate of expansion in recent years, increasing our number of stores from 5,540 as of February 1, 2002, to 8,260 as of March 2, 2007. In addition to growth from new store openings, we recorded same-store sales increases of 3.3% and 2.0% in 2006 and 2005, respectively. Same-store sales calculations for 2005 and prior include only those stores that were open both at the end of that period and at the beginning of the preceding fiscal year, based on the comparable calendar weeks in the prior year. As further described below in Part II, Item 7, 2006 was a 52-week accounting period while 2005 was a 53-week accounting period. Accordingly, the same store sales percentages discussed above exclude sales from the 53rd week in 2005 as there was no comparable week in 2006 or 2004. We will continue to seek to grow our business and believe that this future growth will come from a combination of new store openings, remodeled and relocated stores, infrastructure investments and merchandising initiatives, each as discussed more fully below.

New Store Growth. We believe that our convenient, small-store format is adaptable to small towns and neighborhoods throughout the country. The majority of our stores are located in these small towns (which we define as communities with populations of 20,000 or less). In 2006, approximately half of our new stores were opened in small towns while the remainder were opened either in rural or in more densely populated areas. We expect a similar mix of new store openings between small towns and other areas in 2007. New store openings in 2007 will include our existing market area as well as certain other geographic areas where management believes we have the potential to expand our store base. As part of the strategic initiatives discussed above, we plan to decrease the number of new store openings and increase the number of remodeled or relocated stores in 2007. Opening or remodeling/relocating stores in our existing market area allows us to take advantage of brand awareness and to maximize our operating efficiencies.

In 2006, 2005 and 2004, we opened 537, 734 and 722 new stores, and remodeled or relocated 64, 82 and 80 stores, respectively. In 2007, we plan to open approximately 300 new Dollar General stores and plan to remodel or relocate an additional 300 stores.

Infrastructure Investments. Our distribution network is an integral component of our efforts to reduce transportation expenses and effectively support our growth. In recent years, we have made significant investments in our distribution network. As of March 2, 2007, we operated nine DCs, one of which opened during 2006. In recent years, we have expanded our DCs in South Boston, Virginia, and Ardmore, Oklahoma, by completing the conversion of these DCs from single to dual sortation systems, which enables them to serve more stores.

We also have invested in technological improvements and upgrades in recent years. In 2006, new systems for assortment planning, merchandise allocations and drop ship receiving were installed. We implemented improvements to our transportation, sales audit, loss prevention and planogram systems. In addition, we completed store system enhancements for promotions and coupons. In 2005, we installed new systems for store operating statements, store labor scheduling, supplier communications and transportation and claims management. In addition, we enhanced our store systems to allow us to sell Dollar General gift cards. In 2004, we added a merchandising data warehouse, completed the rollout of credit/debit and electronic benefit

transfer capabilities and installed an automatic inventory replenishment system in all stores. In addition, we completed a new stock ledger and sales flash system. Also, for the first time, we equipped store district managers with personal computers to enable them to access daily merchandising information.

Merchandising Initiatives. Our merchandising initiatives are designed to promote same-store sales increases. We continually evaluate the performance of our merchandise mix and make adjustments when appropriate. In recent years, we have increased our emphasis on the highly consumable category by adding items in the food, paper, pet products, household chemicals, and health and beauty aids categories. Also in recent years, we began offering perishable products, which include a selection of dairy products, luncheon meats, frozen foods and ice cream. Other recent initiatives include prepaid phone cards and branded apparel.

In the fourth quarter of 2006, we commenced execution of an initiative to discontinue our traditional inventory packaway management model in an attempt to better meet our customers needs and to ensure an appealing, fresh merchandise selection. With few exceptions, we plan to eliminate, through end-of-season and other markdowns, existing seasonal, home products and basic clothing packaway merchandise by the end of fiscal 2007. In addition, beginning in fiscal 2007, we plan to sell virtually all current-year non-replenishable merchandise by taking end-of-season markdowns, allowing for increased levels of newer, current-season merchandise. We believe this strategy change will enhance the appearance of our stores and will positively impact customer satisfaction as well as the store employees ability to manage stores, ultimately resulting in higher sales, increased gross profit, lower employee turnover, and decreased inventory shrink and damages. We also expect that this improved inventory management will result in more appropriate per store inventory levels.

We expect to increase our sales mix of merchandise categories with higher gross profit rates, such as home products, basic clothing and seasonal merchandise, as we become increasingly able to improve our merchandise assortments and stock our stores with more current inventory. Achievement of our goals is contingent upon this expected sales mix improvement as well as effective inventory management and reductions in inventory shrink and damages.

In 2006, we initiated a new store layout that we believed would drive sales and improve our merchandising mix. The new layout was launched in a test mode in early 2006, was further developed during the year, and became our standard new store format by the end of 2006. Through the process of opening new stores and re-formatting a limited number of existing stores there were approximately 359 stores operating in this new format as of March 2, 2007. The results have been encouraging, as we have seen additional sales, including increased sales of higher margin goods. Additionally, improved merchandise adjacencies and wider, more open aisles have enhanced the overall guest shopping experience.

Merchandise

Dollar General stores offer a focused assortment of quality merchandise in a number of core categories. We operate as one reportable segment and separate our merchandise into the following four categories for reporting purposes: highly consumable, seasonal, home products,

and basic clothing. Detailed information on our net sales by product class can be found in Note 13 to the consolidated financial statements contained in Item 8 of this report.

We maintain approximately 4,900 core stock-keeping units (SKUs) per store.

For the preceding three years, the percentage of total sales of each of the four categories we track is as follows:

	2006	2005	2004
Highly consumable	**65.7** %	65.3 %	63.0 %
Seasonal	**16.4** %	15.7 %	16.5 %
Home products	**10.0** %	10.6 %	11.5 %
Basic clothing	**7.9** %	8.4 %	9.0 %

Of the four categories, the home products and seasonal categories typically account for the highest gross profit rates and the highly consumable category typically accounts for the lowest gross profit rate.

We purchase our merchandise from a wide variety of suppliers. Approximately 11% of our purchases in 2006 were from The Procter & Gamble Company. Our next largest supplier accounted for approximately 5% of our purchases in 2006. We directly imported approximately 14% of our retail receipts in 2006.

Through 2005, we generally did not use advertising circulars widely throughout our network of stores. Instead we advertised to support new traditional store openings primarily with targeted circulars and in-store signage. In 2006, we used several advertising circulars in an attempt to increase sales and customer traffic. Additionally, during 2006 we advertised on both television and radio. Advertising expenses remained less than 1% of sales. In 2005, we initiated a marketing program as the sponsor of a National Association for Stock Car Auto Racing (NASCAR) Busch Series car, which continued in 2006. During 2005 and 2006, we participated in the Busch Series racing season, which ran from February to November and served as the title sponsor of the Dollar General 300 NASCAR Busch Series race at Lowe s Motor Speedway in Concord, North Carolina.

Seasonality

Our business is modestly seasonal in nature. We expect to continue to experience seasonal fluctuations, with a larger percentage of our net sales, operating profit and net income being realized in the fourth quarter. In addition, our quarterly results can be affected by the timing of new store openings and store closings, the amount of sales contributed by new and existing stores, as well as the timing of certain holidays. We purchase substantial amounts of inventory in the third quarter and incur higher shipping costs and higher payroll costs in anticipation of the increased sales activity during the fourth quarter. In addition, we carry merchandise during our fourth quarter that we do not carry during the rest of the year, such as gift sets, holiday decorations, certain baking items, and a broader assortment of toys and candy.

The following table reflects the seasonality of net sales, operating profit, and net income (loss) by quarter. All of the quarters reflected below are comprised of 13 weeks with the exception of the fourth quarter of the year ended February 3, 2006, which was comprised of 14 weeks.

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Year Ended February 2, 2007				
Net sales	23.5 %	24.5 %	24.1 %	27.9 %
Operating profit (a)	32.7 %	32.5 %	1.3 %	33.5 %
Net income (loss) (a)	34.5 %	33.0 %	(3.8) %	36.3 %
Year Ended February 3, 2006				
Net sales	23.0 %	24.1 %	24.0 %	28.9 %
Operating profit	19.0 %	21.5 %	18.1 %	41.3 %
Net income	18.5 %	21.6 %	18.4 %	41.5 %
Year Ended January 28, 2005				
Net sales	22.8 %	24.0 %	24.5 %	28.7 %
Operating profit	20.6 %	19.4 %	20.5 %	39.6 %
Net income	19.7 %	20.7 %	20.7 %	38.9 %

(a)

Results for the 3rd and 4th quarters of 2006 reflect the impact of Recent Strategic Initiatives as discussed above and in further detail below under Management s Discussion and Analysis of Financial Condition and Results of Operations .

The Dollar General Store

The typical Dollar General store is operated by a manager, an assistant manager and two or more sales clerks. Approximately 49% of our stores are located in strip shopping centers, 49% are in freestanding buildings and 2% are in downtown buildings. We generally have not encountered difficulty locating suitable store sites in the past, and management does not currently anticipate experiencing material difficulty in finding suitable locations.

Our recent store growth is summarized in the following table:

Year	Stores at Beginning of Year	Stores Opened	Stores Closed	Net Store Increase	Stores at End of Year
2004	6,700	722	102	620	7,320
2005	7,320	734	125 (a)	609	7,929

2006	7,929	537	237 (b)	300	8,229

(a) Includes 41 stores closed as a result of hurricane damage.

(b) Includes 128 stores closed as a result of certain recent strategic initiatives

Employees

As of March 2, 2007, we employed approximately 69,500 full-time and part-time employees, including divisional and regional managers, district managers, store managers, and DC and administrative personnel, compared with approximately 64,500 employees on March 3, 2006. Management believes our relationship with our employees is generally good, and we are not a party to any collective bargaining agreements.

Competition

We operate in the discount retail merchandise business, which is highly competitive with respect to price, store location, merchandise quality, assortment and presentation, in-stock consistency, and customer service. We compete with discount stores and with many other retailers, including mass merchandise, grocery, drug, convenience, variety and other specialty stores. These other retail companies operate stores in many of the areas where we operate and many of them engage in extensive advertising and marketing efforts. Our direct competitors in the dollar store retail category include Family Dollar, Dollar Tree, Fred s, 99 Cents Only and various local, independent operators. Competitors from other retail categories include Wal-Mart and Walgreens, among others. Certain of our competitors have greater financial, distribution, marketing and other resources than we do.

The dollar store category differentiates itself from other forms of retailing by offering consistently low prices in a convenient, small-store format. We believe that our prices are competitive due in part to our low cost operating structure and the relatively limited assortment of products offered. Historically, we have minimized labor by offering fewer price points and a reliance on simple merchandise presentation. We attempt to locate primarily in second-tier locations, either in small towns or in the neighborhoods of more densely populated areas where occupancy expenses are relatively low. We maintain a strong purchasing power position due to our leadership position in the dollar store retail category, which centers on a focused assortment of merchandise.

Trademarks

Through our subsidiary, Dollar General Merchandising, Inc., we own marks that are registered with the United States Patent and Trademark Office including the trademarks Dollar General®, Dollar General Market®, Clover Valley®, American Value®, DG Guarantee® and the Dollar General price point designs, along with certain other trademarks. We attempt to obtain registration of our trademarks whenever practicable and to pursue vigorously any infringement of those marks. Our trademarks have various expirations dates; however, assuming that the trademarks are properly renewed, they have a perpetual duration.

Available Information

Our website address is www.dollargeneral.com. We make available through this address, without charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after they are electronically filed or furnished to the SEC.

ITEM 1A.

RISK FACTORS

Investing in our securities involves a degree of risk. Persons buying our securities should carefully consider the risks described below and the other information contained in this report and other filings that we make from time to time with the SEC, including our consolidated financial statements and accompanying notes. If any of the following risks actually occurs, our business, financial condition, results of operation or cash flows could be materially adversely affected. In any such case, the trading price of our securities could decline and you could lose all or part of your investment. The risks described below are not the only ones facing us and are not intended to be a complete discussion of all potential risks or uncertainties. Additional risks not presently known to us or that we currently deem immaterial may also impair our business operations.

Some of the statements in our reports are not statements of historical fact; instead, they are what are known as forward-looking statements that may or may not come to fruition. Certain of the discussions in this report and in the documents incorporated by reference into this report may express or imply projections of revenues or expenditures; plans and objectives for future operations, growth or initiatives (such as the proposed merger; expectations regarding certain planned real estate and merchandising strategic and operational changes and their related timing, charges and cost estimates and anticipated results and benefits; the expected number of new store openings, relocations and remodels; our gross profit rate; the expected sale of inventory and our plans with respect to product assortment, inventory levels and the impact of seasonality; and other potential initiatives and plans referred to in Results of Operations Executive Overview); expected future economic performance; the expected outcome or impact of pending or threatened litigation; our anticipated effective tax rate; or the anticipated levels of borrowings under our amended credit facility and the expected use of those funds. These and similar statements regarding events or results which we expect will or may occur in the future are forward-looking statements concerning matters that involve risks and uncertainties that may cause actual results to differ materially from those projected. Forward-looking statements generally may be identified through the use of words such as believe, anticipate, project, plan, expect, estimate, objective, forecast, goal, intend, will likely result, or will continue and similar expressions.

Although when we make forward-looking statements we believe they are based on reasonable assumptions within the bounds of our knowledge of our business, a number of factors could cause our actual results to differ materially from those that are projected. Factors and risks that may cause actual results to differ from this forward-looking information include, but are not limited to, those described below, as well as other factors discussed throughout this document, including, without limitation, the factors described under Critical Accounting Policies and Estimates or, from time to time, in our SEC filings, press releases and other communications. We cannot assure you that the results or developments expected or anticipated by us will be realized or, even if substantially realized, that those results or developments will result in the expected consequences for us or affect us or our operations in the way that we expect.

We caution readers to evaluate all forward-looking information in the context of these risks and uncertainties and not to place undue reliance on forward-looking statements made in this document which speak only as of the document s date. We have no obligation, and do

not intend, to publicly update or revise any of these forward-looking statements to reflect events or circumstances occurring after the date of this document or to reflect the occurrence of unanticipated events. We advise you, however, to consult any further disclosures we may make on related subjects in the documents we file with or furnish to the SEC or in our other public disclosures. Investors should also be aware that while we do, from time to time, communicate with securities analysts and others, it is against our policy to selectively disclose to them any material nonpublic information or other confidential commercial information. Shareholders should not assume that we agree with any statement or report issued by any analyst regardless of the content of the statement or report. To the extent that reports issued by securities analysts contain any financial projections, forecasts or opinions, those reports are not our responsibility.

General economic factors may adversely affect our financial performance. General economic conditions in one or more of the markets we serve may adversely affect our financial performance. A general slowdown in the economy, higher interest rates, higher fuel and other energy costs, inflation, higher levels of unemployment, higher consumer debt levels, higher tax rates and other changes in tax laws, and other economic factors could adversely affect consumer demand for the products we sell, change our sales mix of products to one with a lower average gross profit and result in slower inventory turnover and greater markdowns on inventory. Higher interest rates, higher commodities rates, higher fuel and other energy costs, transportation costs, inflation, higher costs of labor, insurance and healthcare, foreign exchange rate fluctuations, higher tax rates and other changes in tax laws, changes in other laws and regulations and other economic factors increase our cost of sales and operating, selling, general and administrative expenses, and otherwise adversely affect the operations and operating results of our stores.

Our plans depend significantly on initiatives designed to improve the efficiencies, costs and effectiveness of our operations, and failure to achieve or sustain these plans could affect our performance adversely. We have had, and expect to continue to have, initiatives (such as those relating to marketing, advertising, merchandising, promotions and real estate) in various stages of testing, evaluation, and implementation, upon which we expect to rely to improve our results of operations and financial condition. These initiatives are inherently risky and uncertain, even when tested successfully, in their application to our business in general. It is possible that successful testing can result partially from resources and attention that cannot be duplicated in broader implementation. Testing and general implementation also can be affected by other risk factors described herein that reduce the results expected. Successful systemwide implementation relies on consistency of training, stability of workforce, ease of execution, and the absence of offsetting factors that can influence results adversely. Failure to achieve successful implementation of our initiatives or the cost of these initiatives exceeding management s estimates could adversely affect our results of operations and financial condition. Please reference the discussion of the initiatives in the Executive Overview portion of Management s Discussion and Analysis below.

Because our business is moderately seasonal, with the highest portion of sales occurring during the fourth quarter, adverse events during the fourth quarter could materially affect our financial statements as a whole. We generally recognize a significant portion of our net sales and net income during the Christmas selling season, which occurs in the fourth quarter of our fiscal year. In anticipation of this holiday, we purchase substantial amounts of seasonal

---

inventory and hire many temporary employees. A seasonal merchandise inventory imbalance could result if for any reason our net sales during the Christmas selling season were to fall below either seasonal norms or expectations. If for any reason our fourth quarter results were substantially below expectations, our profitability and operating results could be adversely affected by unanticipated markdowns, especially in seasonal merchandise. Lower than anticipated sales in the Christmas selling season would also negatively affect our ability to absorb the increased seasonal labor costs.

We face intense competition that could limit our growth opportunities and reduce our profitability. The retail business is highly competitive. We operate in the discount retail merchandise business, which is highly competitive with respect to price, store location, merchandise quality, assortment and presentation, in-stock consistency, and customer service. This competitive environment subjects us to the risk of reduced profitability because of the lower prices, and thus the lower margins, required to maintain our competitive position. Also, companies operating in the discount retail merchandise sector (due to customer demographics and other factors) have limited ability to increase prices in response to increased costs (including vendor price increases). This limitation may adversely affect our margins and profitability. We compete for customers, employees, store sites, products and services and in other important aspects of our business with many other local, regional and national retailers. We compete with retailers operating discount, mass merchandise, drug, convenience, variety and specialty stores, supermarkets and supercenter-type stores. Certain of our competitors have greater financial, distribution, marketing and other resources than we do. These other competitors compete in a variety of ways, including aggressive promotional activities, merchandise selection and availability, services offered to customers, location, store hours, in-store amenities and price. If we fail to respond effectively to competitive pressures and changes in the retail markets, it could adversely affect our financial performance. See Business in Item 1 above for additional discussion of our competitive situation.

Although the retail industry as a whole is highly fragmented, certain segments of the retail industry have recently undergone and continue to undergo some consolidation, which can significantly alter the competitive dynamics of the retail marketplace. This consolidation may result in competitors with greatly improved financial resources, improved access to merchandise, greater market penetration and other improvements in their competitive positions. These business combinations could result in the provision of a wider variety of products and services at competitive prices by these consolidated companies, which could adversely affect our financial performance. Competition for customers has intensified in recent years as larger competitors have moved into, or increased their presence in, our geographic markets. We remain vulnerable to the marketing power and high level of consumer recognition of these larger competitors and to the risk that these competitors or others could venture into the dollar store industry in a significant way. Generally, we expect an increase in competition.

Natural disasters, unusually adverse weather conditions, pandemic outbreaks, boycotts and geo-political events could adversely affect our financial performance. The occurrence of one or more natural disasters, such as hurricanes and earthquakes, unusually adverse weather conditions, pandemic outbreaks, boycotts and geo-political events, such as civil unrest in countries in which our suppliers are located and acts of terrorism, or similar disruptions could adversely affect our operations and financial performance. These events could result in physical

damage to one or more of our properties, increases in fuel (or other energy) prices, the temporary or permanent closure of one or more of our stores or DCs, delays in opening new stores, the temporary lack of an adequate work force in a market, the temporary or long-term disruption in the supply of products from some local and overseas suppliers, the temporary disruption in the transport of goods from overseas, delay in the delivery of goods to our DCs or stores, the temporary reduction in the availability of products in our stores and disruption to our information systems. These events also can have indirect consequences such as increases in the costs of insurance following a destructive hurricane season. These factors could otherwise disrupt and adversely affect our operations and financial performance.

Risks associated with the domestic and foreign suppliers from whom our products are sourced could adversely affect our financial performance. The products we sell are sourced from a wide variety of domestic and international suppliers. Political and economic instability in the countries in which foreign suppliers are located, the financial instability of suppliers, suppliers failure to meet our supplier standards, labor problems experienced by our suppliers, the availability of raw materials to suppliers, merchandise quality issues, currency exchange rates, transport availability and cost, inflation, and other factors relating to the suppliers and the countries in which they are located are beyond our control. In addition, the United States foreign trade policies, tariffs and other impositions on imported goods, trade sanctions imposed on certain countries, the limitation on the importation of certain types of goods or of goods containing certain materials from other countries and other factors relating to foreign trade are beyond our control. Disruptions due to labor stoppages, strikes or slowdowns, or other disruptions, involving our vendors or the transportation and handling industries also may negatively affect our ability to receive merchandise and thus may negatively affect sales. These and other factors affecting our suppliers and our access to products could adversely affect our financial performance. In addition, our ability to obtain indemnification from foreign suppliers may be hindered by the manufacturers lack of understanding of U.S. product liability or other laws, which may make it more likely that we may be required to respond to claims or complaints from customers as if we were the manufacturer of the products. As we increase our imports of merchandise from foreign vendors, the risks associated with foreign imports will increase.

We are dependent on attracting and retaining qualified employees while also controlling labor costs. Our future performance depends on our ability to attract, retain and motivate qualified employees. Many of these employees are in entry-level or part-time positions with historically high rates of turnover. Availability of personnel varies widely from location to location. Our ability to meet our labor needs generally, including our ability to find qualified personnel to fill positions that become vacant at our existing stores and DCs, while controlling our labor costs, is subject to numerous external factors, including the availability of a sufficient number of qualified persons in the work force of the markets in which we are located, unemployment levels within those markets, prevailing wage rates and changes in minimum wage laws, changing demographics, health and other insurance costs and changes in employment legislation. Increased turnover also can have significant indirect costs, including more recruiting and training needs, store disruptions due to management changeover and potential delays in new store openings or adverse customer reactions to inadequate customer service levels due to personnel shortages. Competition for qualified employees exerts upward pressure on wages paid to attract such personnel.

Also, our stores are decentralized and are managed through a network of geographically dispersed management personnel. Our inability to effectively and efficiently operate our stores, including the ability to control losses resulting from inventory and cash shrinkage, may negatively affect our sales and/or operating margins.

Our planned future growth will be impeded, which would adversely affect sales, if we cannot open new stores on schedule or if we close a number of stores materially in excess of anticipated levels. Our growth is dependent on both increases in sales in existing stores and the ability to open new stores. Our ability to timely open new stores and to expand into additional market areas depends in part on the following factors: the availability of attractive store locations; the absence of occupancy delays; the ability to negotiate favorable lease terms; the ability to hire and train new personnel, especially store managers; the ability to identify customer demand in different geographic areas; general economic conditions; and the availability of sufficient funds for expansion. In addition, many of these factors affect our ability to successfully relocate stores. Many of these factors are beyond our control. Delays or failures in opening new stores, or achieving lower than expected sales in new stores, or drawing a greater than expected proportion of sales in new stores from existing stores, could materially adversely affect our growth. In addition, we may not anticipate all of the challenges imposed by the expansion of our operations and, as a result, may not meet our targets for opening new stores or expanding profitably.

Some of our new stores may be located in areas where we have little or no meaningful experience. Those markets may have different competitive conditions, market conditions, consumer tastes and discretionary spending patterns than our existing markets, which may cause our new stores to be less successful than stores in our existing markets.

Some of our new stores will be located in areas where we have existing units. Although we have experience in these markets, increasing the number of locations in these markets may cause us to over-saturate markets and temporarily or permanently divert customers and sales from our existing stores, thereby adversely affecting our overall profitability.

We are dependent upon the smooth functioning of our distribution network, the capacity of our DCs, and the timely receipt of inventory. We rely upon the ability to replenish depleted inventory through deliveries to our DCs from vendors and from the DCs to our stores by various means of transportation, including shipments by sea and truck. Labor shortages in the transportation industry could negatively affect transportation costs. In addition, long-term disruptions to the national and international transportation infrastructure that lead to delays or interruptions of service would adversely affect our business.

The efficient operation of our business is heavily dependent upon our information systems. We depend on a variety of information technology systems for the efficient functioning of our business. We rely on certain software vendors to maintain and periodically upgrade many of these systems so that they can continue to support our business. The software programs supporting many of our systems were licensed to us by independent software developers. The inability of these developers or us to continue to maintain and upgrade these information systems and software programs would disrupt or reduce the efficiency of our operations if we were unable to convert to alternate systems in an efficient and timely manner. In addition, costs and

potential problems and interruptions associated with the implementation of new or upgraded systems and technology or with maintenance or adequate support of existing systems could also disrupt or reduce the efficiency of our operations. We also rely heavily on our information technology staff. If we cannot meet our staffing needs in this area, we may not be able to fulfill our technology initiatives while continuing to provide maintenance on existing systems.

We are subject to governmental regulations, procedures and requirements. A significant change in, or noncompliance with, these regulations could have a material adverse effect on profitability. Our business is subject to numerous federal, state and local regulations. Changes in these regulations, particularly those governing the sale of products, may require extensive system and operating changes that may be difficult to implement and could increase our cost of doing business. Untimely compliance or noncompliance with applicable regulations or untimely or incomplete execution of a required product recall can result in the imposition of penalties, including loss of licenses or significant fines or monetary penalties.

Our current insurance program may expose us to unexpected costs and negatively affect our profitably. Historically, our insurance coverage has reflected deductibles, self-insured retentions, limits of liability and similar provisions that we believe are prudent based on the dispersion of our operations. However, there are types of losses we may incur but against which we cannot be insured or which we believe are not economically reasonable to insure, such as losses due to acts of war, employee and certain other crime and some natural disasters. If we incur these losses, our business could suffer. Certain material events may result in sizable losses for the insurance industry and adversely impact the availability of adequate insurance coverage or result in excessive premium increases. To offset negative insurance market trends, we may elect to self-insure, accept higher deductibles or reduce the amount of coverage in response to these market changes. In addition, we self-insure a significant portion of expected losses under our workers compensation, automobile liability, general liability and group health insurance programs. Unanticipated changes in any applicable actuarial assumptions and management estimates underlying our recorded liabilities for these losses, including expected increases in medical and indemnity costs, could result in materially different amounts of expense than expected under these programs, which could have a material adverse effect on our financial condition and results of operations. Although we continue to maintain property insurance for catastrophic events, we are effectively self-insured for losses up to the amount of our deductibles. If we experience a greater number of these losses than we anticipate, our profitability could be adversely affected.

Litigation may adversely affect our business, financial condition and results of operations. Our business is subject to the risk of litigation by employees, consumers, suppliers, shareholders, government agencies, or others through private actions, class actions, administrative proceedings, regulatory actions or other litigation. The outcome of litigation, particularly class action lawsuits and regulatory actions, is difficult to assess or quantify. Plaintiffs in these types of lawsuits may seek recovery of very large or indeterminate amounts, and the magnitude of the potential loss relating to these lawsuits may remain unknown for substantial periods of time. In addition, certain of these lawsuits, if decided adversely to us or settled by us, may result in liability material to our financial statements as a whole or may negatively affect our operating results if changes to our business operation are required. The cost to defend future litigation may be significant. There also may be adverse publicity associated

with litigation that could negatively affect customer perception of our business, regardless of whether the allegations are valid or whether we are ultimately found liable. As a result, litigation may adversely affect our business, financial condition and results of operations. Please see Note 8 to the consolidated financial statements for further details regarding certain of these pending matters.

In addition, from time to time third parties may claim that our trademarks or product offerings infringe upon their proprietary rights. Any such claim, whether or not it has merit, could be time-consuming and distracting for executive management, result in costly litigation, cause changes to our private label offerings or delays in introducing new private label offerings, or require us to enter into royalty or licensing agreements. As a result, any such claim could have a material adverse effect on our business, results of operations and financial condition.

Our credit facility and other debt instruments place financial and other restrictions on us. Our debt obligations and financings have certain financial covenants and limits on our ability to incur additional indebtedness, to sell assets and to make certain payments. The lender s ongoing obligation to extend credit under these financings will depend upon our compliance with these and other covenants. In addition, we may need to incur additional indebtedness which may have important consequences, including placing us at a competitive disadvantage compared to our competitors that may have proportionately less debt, limiting our flexibility in planning for changes in our business and the industry and making us more vulnerable to economic downturns and adverse developments in our business.

Our profitability could decline if we substantially exceed our anticipated borrowings under our amended credit facility. The amount of borrowings under our amended credit facility may fluctuate materially, particularly given the seasonality of our business, depending on various factors, including the time of year, our need to acquire merchandise inventory, changes to our merchandising plans and initiatives, changes to our capital expenditure plans and the occurrence of other events or transactions that may require funding through the amended credit facility. If these borrowings under our amended credit facility exceed our anticipated levels, our interest expense would increase beyond our expectations and a decrease in our profitability could result.

Our annual and quarterly operating results may fluctuate significantly and could fall below the expectations of securities analysts and investors due to a number of factors, some of which are beyond our control, resulting in a decline in the price of our securities. Our annual and quarterly operating results may fluctuate significantly because of several factors, including those described above. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for any other quarter or for any year, and revenues and net income for any particular future period may decrease. In the future, operating results may fall below the expectations of securities analysts and investors. In that event, the price of our securities could decrease.

Failure to complete the proposed merger could adversely affect us. On March 11, 2007, we entered into a merger agreement with affiliates of Kohlberg Kravis Roberts & Co. L.P. (KKR). There is no assurance that the merger agreement and the merger will be approved by our shareholders or that the other conditions to the completion of the merger will be satisfied. The current market price of our common stock may reflect a market assumption that the merger

will be completed, and a failure to complete the merger could result in a decline in the market price of our common stock. Consummation of the merger is subject to the following risks:

- the occurrence of any event, change or other circumstances that could give rise to a termination of the merger agreement;

- the outcome of any legal proceedings that have been or may be instituted against us, members of our Board of Directors and others relating to the merger agreement, including the terms of any settlement of such legal proceedings that may be subject to court approval;

- the inability to complete the merger due to the failure to obtain shareholder approval or the failure to satisfy other conditions to consummation of the merger;

- the failure by KKR or its affiliates to obtain the necessary debt financing arrangements set forth in the commitment letter received in connection with the merger; and

- the failure of the merger to close for any other reason.

In addition, in connection with the merger we will be subject to several risks, including the following:

- there may be substantial disruption to our business and a distraction of our management and employees from day-to-day operations, because matters related to the merger may require substantial commitments of their time and resources;

- uncertainty about the effect of the merger may adversely affect our credit rating and our relationships with our employees, suppliers and other persons with whom we have business relationships;

- certain costs relating to the merger, such as legal, accounting and financial advisory fees, are payable by us whether or not the merger is completed; and

- under certain circumstances, if the merger is not completed we may be required to pay the buyer a termination fee of up to $225 million.

Provisions in our charter, Tennessee law and our shareholder rights plan may discourage potential acquirors of our company, which could adversely affect the value of our securities. Our charter contains provisions that may have the effect of making it more difficult for a third party to acquire or attempt to acquire control of our company. In addition, we are subject to certain provisions of Tennessee law that limit, in some cases, our ability to engage in certain business combinations with significant shareholders. Also, our shareholder rights plan may inhibit accumulations of substantial amounts of our common stock without the approval of our Board of Directors.

These provisions, either alone, or in combination with each other, give our current directors and executive officers a substantial ability to influence the outcome of a proposed

---

acquisition of our company. These provisions would apply even if an acquisition or other significant corporate transaction was considered beneficial by some of our shareholders. If a change-in-control or change in management is delayed or prevented by these provisions, the market price of our securities could decline.

ITEM 1B.

UNRESOLVED STAFF COMMENTS

None.

ITEM 2.

PROPERTIES

As of March 2, 2007, we operated 8,260 retail stores located in 35 states as follows:

State	Number of Stores	State	Number of Stores
Alabama	443	Nebraska	90
Arizona	60	New Jersey	24
Arkansas	222	New Mexico	41
Colorado	8	New York	231
Delaware	25	North Carolina	456
Florida	429	Ohio	452
Georgia	471	Oklahoma	281
Illinois	310	Pennsylvania	410
Indiana	290	South Carolina	306
Iowa	178	South Dakota	5
Kansas	148	Tennessee	409
Kentucky	291	Texas	958
Louisiana	327	Utah	4
Maryland	63	Vermont	1
Michigan	250	Virginia	252
Minnesota	13	West Virginia	151
Mississippi	254	Wisconsin	99
Missouri	308		

Most of our stores are located in leased premises. Individual store leases vary as to their terms, rental provisions and expiration dates. The majority of our leases are relatively low-cost, short-term leases (usually with initial or primary terms of three to five years) often with multiple renewal options. We also have stores subject to build-to-suit arrangements with landlords, which typically carry a primary lease term of between 7 and 10 years with multiple renewal options. In recent years, an increasing percentage of our new stores have been subject to build-to-suit arrangements. In 2007, we expect approximately 70% of our new stores to be build-to-suit arrangements.

18

As of March 2, 2007, we operated nine DCs, as described in the following table:

Location	Year Opened	Approximate Square Footage	Approximate Number of Stores Served
Scottsville, KY	1959	720,000	871
Ardmore, OK	1994	1,310,000	1,144
South Boston, VA	1997	1,250,000	794
Indianola, MS	1998	820,000	854
Fulton, MO	1999	1,150,000	1,264
Alachua, FL	2000	980,000	698
Zanesville, OH	2001	1,170,000	1,281
Jonesville, SC	2005	1,120,000	783
Marion, IN	2006	1,110,000	571

We lease the DCs located in Oklahoma, Mississippi and Missouri and own the other six DCs. Approximately 7.25 acres of the land on which our Kentucky DC is located is subject to a ground lease. We lease additional temporary warehouse space as necessary to support our distribution needs.

Our executive offices are located in approximately 302,000 square feet of leased space in Goodlettsville, Tennessee.

ITEM 3.

LEGAL PROCEEDINGS

The information contained in Note 8 to the consolidated financial statements under the heading Legal Proceedings contained in Part II, Item 8 of this report is incorporated herein by this reference.

ITEM 4.

SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of shareholders during the fourth quarter of 2006.

PART II

ITEM 5.

MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the New York Stock Exchange under the symbol DG. The following table sets forth the range of the high and low sales prices of our common stock during each quarter in 2006 and 2005, as reported in the consolidated transaction reporting system, together with dividends.

2006	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High	**$ 18.32**	**$ 17.26**	**$ 14.80**	**$ 17.88**
Low	**$ 17.01**	**$ 13.02**	**$ 12.10**	**$ 13.54**
Dividends	**$ .050**	**$ .050**	**$ .050**	**$ .050**

2005	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High	$ 22.80	$ 22.50	$ 20.39	