



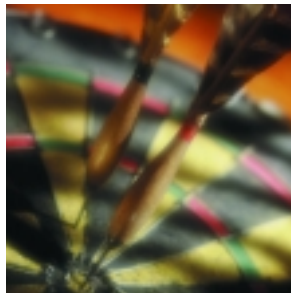
1999 Annual Report



technology into growth



merchandising into opportunity



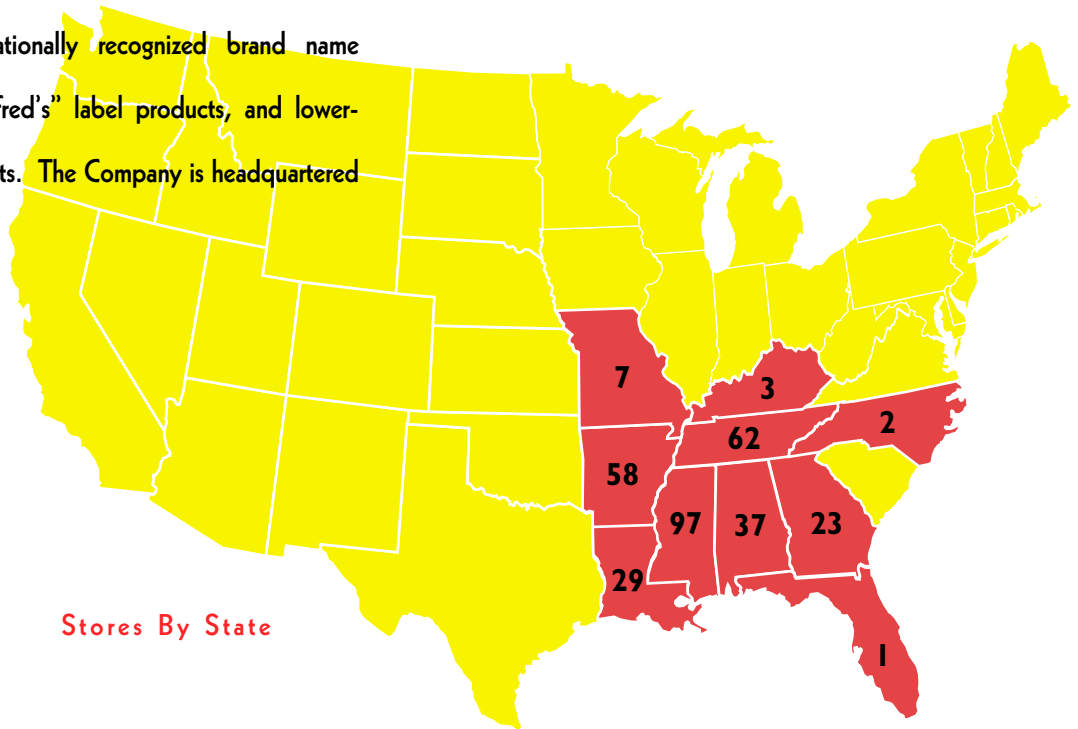
demand into value



About The Company

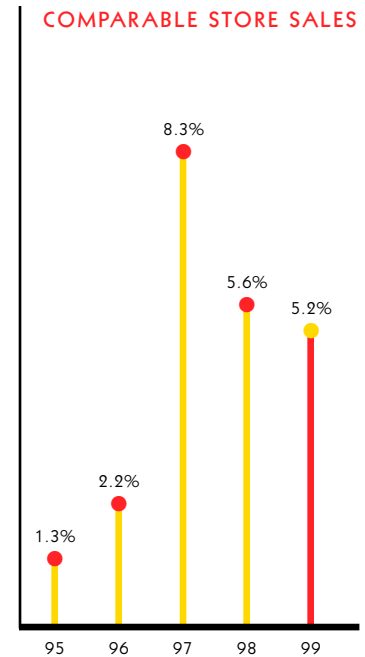
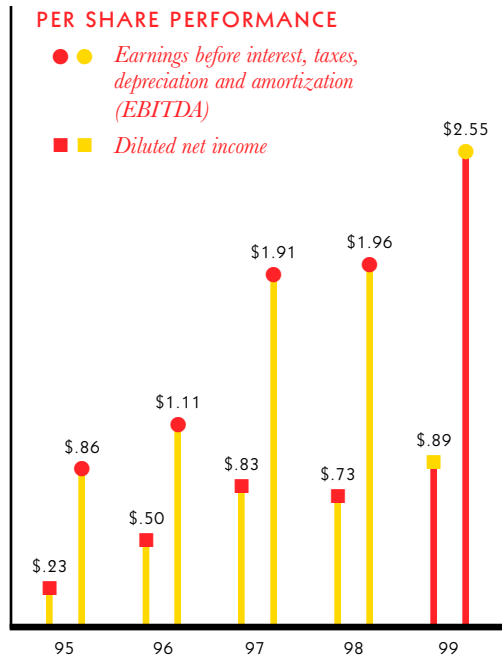
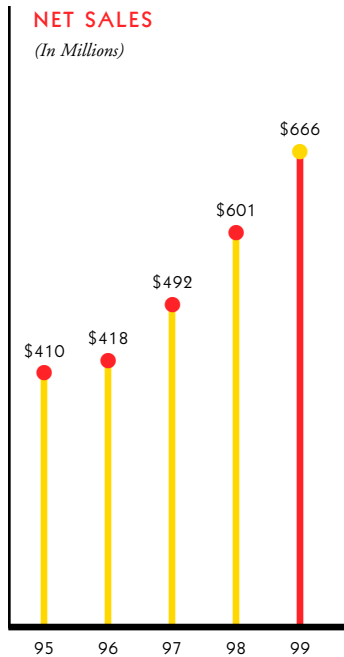
Company Profile

Fred's, Inc., founded in 1947, operates 293 discount general merchandise stores in 10 southeastern states. The Company also markets goods and services to 26 franchised stores. Fred's stores stock more than 12,000 frequently purchased items that address the everyday needs of its customers, including nationally recognized brand name products, proprietary "Fred's" label products, and lower-priced, off-brand products. The Company is headquartered in Memphis, Tennessee.



Financial Highlights

<i>(in thousands, except per share amounts)</i>	Year Ended	
	January 29, 2000	January 30, 1999
Operating Data		
Net sales	\$ 665,777	\$ 600,902
Operating income	18,943	14,711
Net income, as reported	10,702	8,830
Net income per share - diluted	.89	.73
Weighted average shares outstanding - diluted	12,072	12,078
Balance Sheet Data		
Working capital	\$ 79,707	\$ 72,781
Total assets	240,222	220,757
Long-term debt (including capital leases)	11,761	11,821
Shareholders' equity	145,913	136,983
Long-term debt to equity	8.1%	8.6%



Wow! Are these extreme times, or what? They surely have been at Fred's. Nineteen ninety-nine was taxing on several fronts: New system, new president, new distribution center, new millennium, and old Y2K. What a job the Fred's team did guiding us through this maze of challenge and opportunity—engineering record sales and operating profits for the year, culminating with a 52% increase in earnings per share in the fourth quarter.

In 1999, system challenges were paramount because of the need to complete all of our programming for Y2K by calendar year-end. In connection with this work, we recognized that we could seize additional opportunities to upgrade our systems in order to support and advance Fred's future growth prospects and capabilities. One of the most important of these initiatives was the conversion of our mainframe from a closed system to an open one, allowing us to integrate new software programs that are developed throughout the industry. When linked to our business management plan, this change would also enable us to triple the number of stores that we could handle and, at the same time, allow us to engage in e-commerce and utilize the Internet as a means of communication for our entire Company.

I am pleased to report that we were able to successfully complete Y2K preparedness and the transformation to an open system on time and on budget, thanks in large part to the effort and capabilities of our MIS operations. These new capabilities will give Fred's the flexibility and growth potential that will serve the Company well for the foreseeable future.

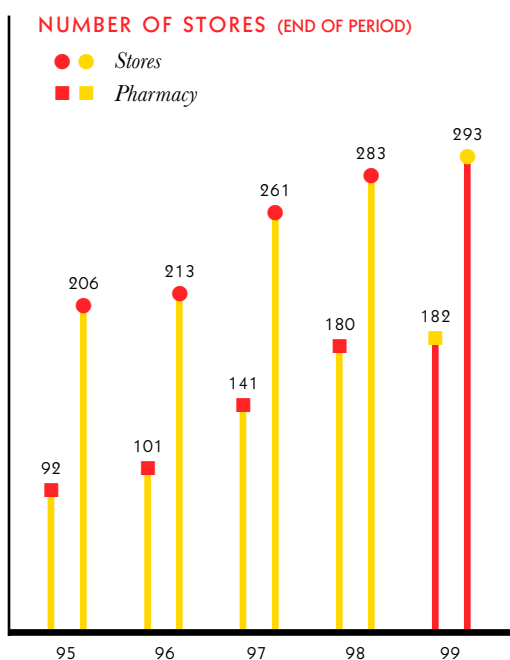
Merchandising

In May 1999, we announced the arrival of John Reier, an experienced merchandising and operations executive, as president of the Company. In the short time that John has been with Fred's, he has had a significant impact on the merchandising and store operations side of the business.

On the merchandising side, we re-implemented an in-depth line review process to identify re-merchandising opportunities. Although we are only approximately 70% through this process, with the remainder to be completed by the end of June, the results to date are significant as reflected in our strong comparable store sales performance over the past few months.

John's leadership and skill in merchandising have invigorated the buyers, store managers, and the entire company—driving us to keep our focus on merchandising and the customer. He began by implementing a complete merchandising review of all merchandise items or SKUs in each department, with a goal toward completing the program by June of this year—in time for the rollout of the all-important back-to-school and holiday seasons. The initial focus of this effort was on under-performing SKUs, SKU productivity, sales per square foot, and SKUs that were higher priced but carried very low margins. He also renewed our concentration on opportunistic buying situations and maintaining a high in-stock store position. The effect of these initiatives became apparent very quickly with strong comparable store sales performances throughout the fourth quarter.

From the store operations side, we have spent in excess of \$1 million improving the appearance of the stores to make them more shopper-friendly for our customers. To this end,





TURNING

technology into growth

As the new millennium approached and Fred's readied for Year 2000 compliance, the Company recognized a wider opportunity to upgrade and improve its information and operating systems. Fred's new open operating system provides a platform for future growth and expanded capabilities, allowing the Company to take advantage of the Internet and other emerging technologies in developing its business plan.

we have added carpet to our soft line area, enhanced lighting, developed new point-of-sales signage, replaced racks and display tables, and reduced our shelf fixture height from 92 inches to 66 inches. The effect of these efforts was best summed up by my secretary, who said, “a really cool look and some really neat stuff.” We also have implemented a simplified paperwork and work efficiency program throughout the stores, which will allow store managers to spend more time on actual customer interaction and service.

Pharmacy

During 1999, we experienced another record year of growth in our pharmacy operations. In the past, we focused on including pharmacies in our new store openings, where feasible, and upgrading our existing stores by adding pharmacy departments. With our pharmacy penetration now at 62% of our stores, our focus is to acquire existing independent pharmacies and consolidate their operations into an existing or a new Fred’s location.

During 1999, pharmacy sales increased to 31% of total sales from 27% in 1998. With the enhancements to our front-end merchandising program, it is anticipated that future pharmacy sales growth, as a percentage of total sales, will grow in line with overall store sales.

In 1999, we entered into a new service agreement with Bergen Brunswig that will reduce our cost of goods and help advance our e-commerce program with the universal co-op Pharmacy Benefits Plan. The transfer was seamlessly completed in January, and we have been delighted with the service level and cooperation of our new business partner.

Automation

After many difficult months of implementation, the automating process of the warehouse and installation of a new warehouse management system became a distinct advantage for us during the important fourth quarter Christmas selling season. This new system allowed us to ship record levels of goods throughout the fourth quarter – more accurately and cost-effectively than ever before. The knowledge and capability developed in the process of implementing the warehouse system will enable our Company to grow for the next two years and give us the foundation from which to expand as we open new stores and increase our warehousing demands throughout the decade.

These new systems are an integral part of our goal to increase our operating margins in 2000.

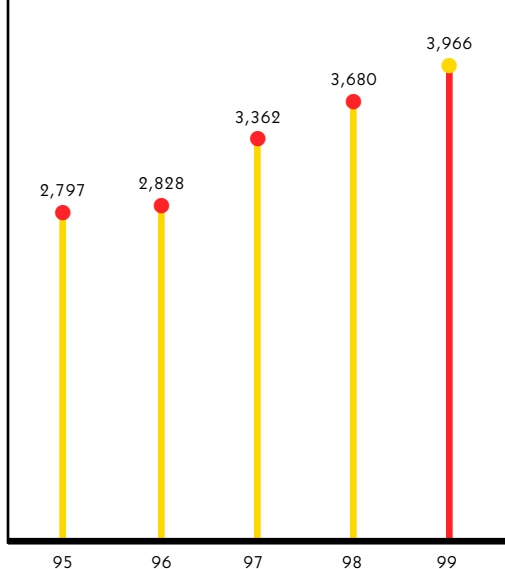
Financial Results

Net sales for 1999 reached a record \$665.8 million compared with \$600.9 million in 1998, reflecting a 11% increase in total sales. On a comparable store basis, net sales rose 5.2% for the year. More importantly, comparable store sales improved significantly throughout the year as we overcame residual effects of our distribution center implementation in the first quarter of 1999. Comparable stores sales improved from 0.8% in the first quarter to 4.6% in the second, to 6.0% in the third quarter, and ending with 8.8% in the fourth quarter of 1999. These consistent gains reflected increased customer acceptance of our new merchandising programs as well as higher confidence in our ability to service and maintain in-stock positions within our stores.

Operating income for 1999 rose 29% to \$18.9 million, or 2.9% of sales, versus \$14.7 million, or 2.5% of sales in 1998.

SELLING SPACE (SQUARE FOOTAGE)

(In Millions)





TURNING

merchandising into opportunity

One of the Company's most visible and successful initiatives in 1999 was to refocus its merchandising philosophy on the customer and how Fred's can make their shopping experience more enjoyable. These efforts involved an in-depth examination of the kinds and amounts of merchandise handled in the stores, where and how it is displayed, as well as other customer-friendly improvements throughout the store.

Although most of our operating margin increase as a percentage of sales was the result of gross margin improvements due to higher initial store purchase margins and reduced markdowns as a percentage of sales, we did begin to see some real selling, general and administrative expense leverage in the fourth quarter of 1999. Higher comparable store sales and reductions in distribution costs as a percentage of sales, because of improved merchandising flow through the distribution center, also contributed to this improvement. As we enter 2000, we expect to continue leveraging selling, general and administrative expense in the areas of store and pharmacy labor costs and distribution costs due to the investments we have made over the last couple of years.

Fred's net income for 1999 increased 21% to \$10.7 million, or \$0.89 per diluted share, compared with net income of \$8.8 million, or \$0.73 per diluted share in 1998. Included in net income was interest expense of approximately \$2.5 million, or .4% of sales in 1999 versus \$1.1 million, or .2% of sales in 1998. Increased interest expense reflects higher average revolver borrowings for modernization of the distribution center, acquisition of a new mainframe computer, improved in-stock positions

over 1998, and duplicate inventories in several re-merchandised inventory categories. In addition, we experienced an accelerated repayment of approximately \$7.5 million in accounts payable in early 2000 as a result of a change made in the Company's pharmacy drug wholesaler in December 1998. We believe that all of these factors will result in higher sales and earnings opportunities as we enter 2000.

Dividends

Quarterly payments in 1999 continued at a rate of \$0.05 per share. For the sixth consecutive year, Fred's paid annual cash dividends of \$0.20 per share.

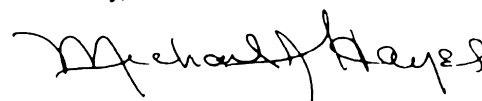
Conclusion

With the 2000 year now a reality, the opportunities and challenges for Fred's are more exciting than ever. By year end, we plan to expand our selling space by 10% - 12% and roll out a new assortment line along with our new store format, all of which have been designed to enhance our customer satisfaction and drive our comparable store sales.

Our new prototype will continue to serve a market that we believe is expanding and will continue to expand as mega store upon mega store is rolled out. The new store prototype is more efficient and friendly, focusing on the \$25.00 shopping trip where the customer is value driven, value sensitive and still concerned with convenience.

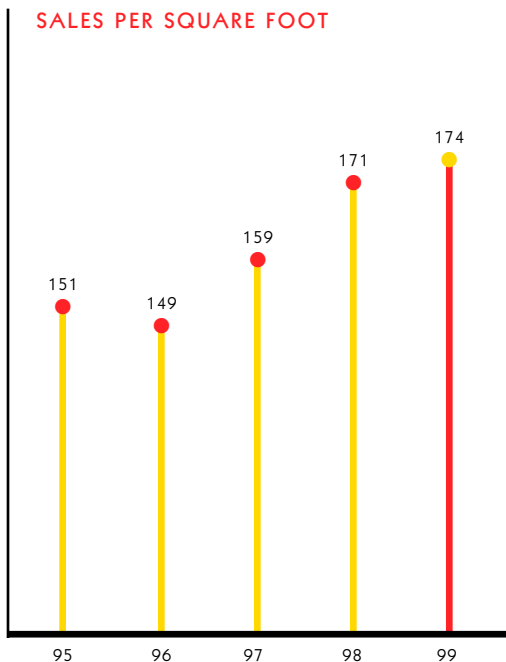
Our expectations are high for 2000. Our management team is experienced and our market niche continues to expand in today's economy. Thank you again for your confidence and interest in Fred's. If you get the chance, do stop by and say "Hi" at one of our Fred's stores. Remember, you will be sure to find low prices and so much more.

Sincerely,



Michael J. Hayes
Chief Executive Officer

SALES PER SQUARE FOOT





T U R N I N G

d e m a n d i n t o v a l u e

Pharmacies have been a key aspect of Fred's growth strategy for a number of years. About two-thirds of Fred's stores have pharmacy departments, helping build traffic by enhancing the selection of everyday items found at Fred's and making a Fred's shopping trip time-saving and convenient. With a new supplier agreement during 1999, Fred's continues to enhance the value it delivers to its pharmacy customers.

Selected Financial Data

<i>(dollars in thousands, except per share amounts)</i>	1999	1998 ⁽¹⁾	1997	1996	1995 ⁽²⁾
Statement of Income Data:					
Net sales	\$665,777	\$600,902	\$492,236	\$418,297	\$410,086
Operating income	18,943	14,711	15,511	6,779 ⁽³⁾	4,771
Income before income taxes	16,439	13,605	15,660	6,508	4,337
Provision for income taxes	5,737	4,775	5,873	702	1,604
Net income	10,702	8,830	9,787	5,806	2,733
Net income per share:					
Basic	.90	.75	.84	.50	.23
Diluted	.89	.73	.83	.50	.23
Selected Operating Data:					
Operating income as a percentage of sales	2.9%	2.4%	3.2%	1.6% ⁽³⁾	1.2%
Increase in comparable store sales ⁽⁴⁾	5.2%	5.6%	8.3%	2.2%	1.3%
Stores open at end of period	293	283	261	213	206
Balance Sheet Data (at period end):					
Total assets	\$240,222	\$220,757	\$195,407	\$161,148	\$158,023
Short-term debt (including capital leases)	30,736	11,914	214	1,641	1,961
Long-term debt (including capital leases)	11,761	11,821	1,368	138	1,779
Shareholders' equity	145,913	136,983	129,359	119,579	115,570

⁽¹⁾ Results for 1998 include the effect of the 1998 adoption of LIFO for pharmacy inventories (\$3,108).

⁽²⁾ Results for 1995 include 53 weeks.

⁽³⁾ After \$3,289 of restructuring and other charges.

⁽⁴⁾ A store is first included in the comparable store sales calculation after the end of the twelfth month following the store's grand opening month.

Results of Operations

The following table provides a comparison of Fred's financial results for the past three years. In this table, categories of income and expense are expressed as a percentage of net sales.

	1999	1998 ⁽¹⁾	1997
Net Sales	100.0%	100.0%	100.0%
Cost of goods sold	71.8	72.6	72.5
Gross profit	28.2	27.4	27.5
Selling, general and administrative expenses	25.3	24.9	24.3
Operating income	2.9	2.5	3.2
Interest expense, net	.4	.2	—
Income before taxes	2.5	2.3	3.2
Income taxes	.9	.8	1.2
Net income	1.6%	1.5%	2.0%

⁽¹⁾ Results for 1998 include the effect of the 1998 adoption of LIFO for Pharmacy inventories (\$3,108,000).

Fiscal 1999 Compared to Fiscal 1998

Sales

Net sales increased 10.8% (\$65 million) in 1999. Approximately \$37 million of the increase was attributable to the addition of 20 new stores, 5 upgrades, and 2 pharmacies during 1999, together with the sales of 29 stores and 39 pharmacies that were opened or upgraded during 1998 and contributed a full year of sales in 1999. During 1999, the Company also closed 10 store locations. Comparable store sales, consisting of sales from stores that have been open for more than one year, increased 5.2% in 1999.

The Company's front store (non-pharmacy) sales increased approximately 6% over 1998 front store sales. Front store sales growth benefited from the above mentioned store additions, as solid performances in categories such as home furnishings, footwear, ladies accessories, plus size and girls apparel, and trim-a-home were mostly offset by weaker performances in missy and ladies intimate apparel, hardware and several of the companies basic hardlines departments.

Fred's pharmacy sales grew from 27% of total sales in 1998 to 31% of total sales in 1999, and continues to rank as the largest sales category within the Company. The total sales in this department, including the Company's mail order operation, increased 27% over 1998, with third party prescription sales representing approximately 77% of total pharmacy sales, compared with 71% of total pharmacy sales in 1998. The Company's pharmacy sales growth continued to benefit from an ongoing program of purchasing prescription files from independent pharmacies, the addition of pharmacy departments in existing store locations, and inflation caused by drug manufacturer increases.

Sales to Fred's 26 franchised locations decreased approximately \$3 million in 1999 and represented 5% of the Company's total sales compared with approximately 6% of 1998 total sales. It is anticipated that this category of business will continue to decline as a percentage of total Company sales since the Company has not added and does not intend to add any additional franchisees.

Gross Margin

Gross margin as a percentage of sales was 28.2% in 1999 compared to 27.4% in 1998. Gross margin benefited from reduced levels of markdowns as a percentage of sales, higher initial purchase margins resulting from greater volumes of import and opportunistic purchases, a lesser percentage of franchise sales, which carry substantially lower margins than retail sales, and a reduced level of inflation in pharmacy costs.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were 25.3% of net sales in 1999 compared with 24.9% of net sales in 1998. Higher rental costs as a percentage of sales due to a greater percentage of company stores being leased and slightly higher rent costs associated with the Company's build-to-suit prototype store, an increase in repairs and maintenance expense resulting from store improvement programs implemented during 1999, and higher depreciation expense associated with capital investments made over the past 12 to 18 months contributed to most of the higher expense ratio in 1999. These increases were partially offset by the elimination of mailing costs associated with two major advertising circulars during 1999.

Operating Income

Operating income increased approximately \$4.2 million or 28.8% to \$18.9 million in 1999 from \$14.7 million in 1998. Operating income as a percentage of sales, increased to 2.9% in 1999 from 2.5% in 1998, due to the above mentioned reasons.

Interest Expense, Net

Interest expense for 1999 totaled \$2.5 million compared to net interest expense of \$1.1 million in 1998 (interest expense of \$1.2 million less interest income of \$.1 million).

The interest expense for 1999 reflects higher average revolver borrowings for inventory purchases, caused by significantly improved in-stock positions over 1998 and duplicate inventories in several remerchandised inventory categories, and the accelerated repayment of approximately \$7.5 million in accounts payable, originally due in February, as a result of a change made in the company's pharmacy drug wholesaler in December of 1999. The company also experienced full year interest costs on term loan borrowings to finance the distribution center modernization and acquisition of a new mainframe computer.

Income Taxes

The effective income tax rate decreased to 34.9% in 1999 from 35.1% in 1998, due primarily to changes made in the Company's organizational structure during the fourth quarter of 1998, which resulted in a reduction in the Company's liability for taxes.

At January 29, 2000, the Company had certain net operating loss carryforwards which were acquired in reorganizations and certain purchase transactions and are available to reduce income taxes, subject to usage limitations. These carryforwards total approximately \$36.7 million for state income tax purposes, which expire during the period 2001 through 2021. If certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of carryforwards which can be utilized.

Net Income

Net income for 1999 was \$10.7 million (or \$.89 per diluted share) or approximately 21% higher than the \$8.8 million (or \$.73 per diluted share) reported in 1998.

Fiscal 1998 Compared to Fiscal 1997

Sales

Net sales increased 22.1% (\$109 million) in 1998. Approximately \$84 million of the increase was attributable to the addition of 29 store locations and 39 pharmacies during 1998, together with the net sales of 48 stores and 34 pharmacies that were opened during 1997 and contributed a full year of sales in 1998. During 1998, the Company also closed 7 store locations. Comparable store sales, consisting of sales from stores that have been open for more than one year, increased 5.6% in 1998.

The Company's front store (non-pharmacy) sales increased approximately 15% over 1997 front store sales. Front store sales growth benefited from the above mentioned store additions, coupled with solid performances in categories such as home furnishings, domestics, ladies accessories, missy and girls apparel, housewares, hardware and photofinishing.

Fred's pharmacy sales grew from 23% of total sales in 1997 to 27% of total sales in 1998, and now ranks as the largest sales category within the Company. The total sales in this department, including the Company's mail order operation, increased 54% over 1997, with third party prescription sales representing approximately 71% of total pharmacy sales, compared with 66% of total pharmacy sales in 1997. The Company's pharmacy sales growth continued to benefit from an ongoing program of purchasing prescription files from independent pharmacies, the addition of pharmacy departments in existing store locations, significant inflation caused by drug manufacturer increases and the introduction of more expensive drugs, and favorable industry trends.

Sales to Fred's 29 franchised locations decreased approximately \$2 million in 1998 and represented 6% of the Company's total sales compared with approximately 8% of 1997 total sales. It is anticipated that this category of business will continue to decline as a percentage of total Company sales since the Company has not added nor intends on adding any additional franchisees.

Gross Margin

Gross margin as a percentage of sales was 27.4% in 1998 compared to 27.5% in 1997. During 1998, the Company adopted the LIFO (last in, first out) method of accounting for its pharmacy inventories. This change was made to address the significant inflation incurred in pharmacy costs during 1998 and to provide a better matching of current costs with current revenues. Excluding the LIFO change, gross margin as a percentage of sales increased to 27.9% in 1998 compared with 27.5% in 1997.

Gross margin benefited from reduced levels of markdowns as a percentage of sales, higher initial purchase margins resulting from greater volumes of import and opportunistic purchases and a lesser percentage of franchise sales, which carry substantially lower margins than retail sales. This benefit was partially offset by pharmacy sales growing at a faster pace than front store sales, since, on average, the gross margin on pharmacy sales is lower than gross margins on front store sales. Pharmacy gross margins were also negatively impacted by the continuing shift in pharmacy sales to customers covered by third party insurance programs, which generally carry lower margins than pharmacy cash sales due to the efforts of managed care organizations and other pharmacy benefit managers to reduce prescription drug costs.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were 24.9% of net sales in 1998 compared with 24.3% of net sales in 1997. Higher labor costs and additional rental costs associated with the process of modernizing and automating the Company's distribution center, higher payroll costs associated with a significant increase in average pharmacy labor rates, and a decrease in the percentage of franchise sales, which carry a lower expense percentage than retail sales, contributed to the higher expense ratio in 1998.

Operating Income

Operating income decreased approximately \$.8 million to \$14.7 million in 1998 from \$15.5 million in 1997. Excluding the effect of the Company's adoption of LIFO in 1998, operating income increased by approximately \$2.3 million or 15% in 1998. Operating income as a percentage of sales, excluding the effect of the Company's adoption of LIFO in 1998, decreased from 3.2% in 1997 to 3.0% in 1998, due to the above mentioned reasons.

Interest Expense, Net

Interest expense for 1998 totaled \$1.2 million while interest income totaled \$.1 million, for a net 1998 interest expense of \$1.1 million compared to net interest income of \$.1 million in 1997 (interest income of \$.4 million versus interest expense of \$.3 million).

The interest expense for 1998 reflects higher average revolver borrowing levels to finance inventories and other working capital requirements. Interest expense also includes the partial year impact of a \$12 million seven-year term loan the Company obtained to finance the modernization and automation of its distribution center.

Income Taxes

The effective income tax rate decreased to 35.1% in 1998 from 37.5% in 1997. The Company completed a realignment of its corporate organizational structure during the fourth quarter of 1998, which resulted in a reduction in the Company's liability for taxes.

At January 30, 1999, the Company had certain net operating loss carryforwards which were acquired in reorganizations and certain purchase transactions and are available to reduce income taxes, subject to usage limitations. These carryforwards total approximately \$26.3 million for state income tax purposes, which expire during the period 2000 through 2020. If certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of carryforwards which can be utilized.

Net Income

Net income for 1998 was \$8.8 million (or \$.73 per diluted share) versus \$9.8 million (or \$.83 per diluted share) in 1997. Excluding the \$2.0 million (or \$.17 per diluted share) impact of the Company's adoption of LIFO in 1998, net income increased to \$10.8 million (or \$.90 per diluted share) and 10.2% over 1997 levels.

Liquidity and Capital Resources

Fred's primary sources of working capital are cash flow from operations and borrowings under its current facility. The company had working capital of \$79.7 million, \$72.8 million and \$70.7 million at year end 1999, 1998 and 1997, respectively. Working capital fluctuates in relation to profitability, seasonal inventory levels, net of trade accounts payable, and the level of store openings and closings.

The Company has a five-year \$15 million unsecured revolving credit commitment with a bank that has generally been used to finance inventory levels at specified periods. This \$15 million credit commitment is also supplemented with \$15 million in seasonal overlines, for a total revolving borrowing capacity of \$30 million. The credit commitment expires in June 2003 and bears interest at 1.5% below prime rate or a LIBOR-based rate (weighted average interest rate of 6.25% on 1999 outstanding borrowings).

In April 2000, the above unsecured revolving credit commitment, and related seasonal overlines, were replaced with a new unsecured revolving line of credit commitment of \$40 million that expires in April 2003. All other provisions of the new agreement are essentially the same as the prior agreement. The expanded credit capacity is necessary to accommodate the Company's continued growth and shifting seasonal inventory needs.

At January 29, 2000, approximately \$28.2 million of inventories were financed with outstanding borrowings under the Company's revolver. Higher year-end revolver borrowings resulted from significantly improved in-stock positions compared to 1998, duplicate inventories in several re-merchandised inventory categories, and the accelerated repayment of approximately \$7.5 million in accounts payable, originally due in February, as a result of a change made in the Company's pharmacy drug wholesaler in December 1999.

Delays in the processing of merchandise receipts caused by implementation of the Company's new distribution center automation and computer system in January 1999 resulted in a reduction of days payable at year end 1998. Accordingly, approximately \$10.2 million of inventories were financed with outstanding borrowings under the Company's revolver at year end 1998. No borrowings were outstanding on the revolver as of year end 1997.

In May 1998, the Company entered into a seven-year unsecured term loan of \$12 million to finance the modernization and automation of the Company's distribution center and corporate facilities. The Loan Agreement bears interest of 6.82% per annum and matures on November 1, 2005. At year end 1999, the outstanding principal balance on the term loan was approximately \$10.3 million compared with \$11.7 million at year-end 1998.

In April 1999, the Company entered into a four-year unsecured term loan of \$2.3 million to finance the replacement of the Company's mainframe computer system. The Loan Agreement bears interest at 6.15% per annum and matures on April 15, 2003. At year-end 1999, the outstanding principal balance on the term loan was approximately \$1.8 million.

Cash used in operations was (\$.8) million in 1999 compared to cash provided by operations of \$.6 million in 1998 and \$21.0 million in 1997. As mentioned above, year-end 1999 inventory levels were impacted by improved in-stock positions and duplicate inventories compared to 1998, and accounts payable were impacted by the accelerated repayment of \$7.5 million of payables. Year-end 1998 accounts payable levels were adversely impacted as a result of merchandise processing delays, and were supplemented with short-term borrowings at year-end. The 1997 year-end accounts payable balance also included some vendor dating support associated with the Company's November 1997 acquisition of a 17-store chain.

Capital expenditures in 1999 totaled \$14.8 million compared with \$23.3 million in 1998 and \$9.7 million in 1997. The 1999 capital expenditures included approximately \$2.3 million of expenditures associated with replacement of the Company's mainframe computer system, and approximately \$12.5 million of expenditures associated with new stores and pharmacies, store and pharmacy upgrades, distribution center equipment and annual capital maintenance. The 1998 capital expenditures included \$12.0 million of expenditures associated with the Company's modernization and automation of its distribution center, \$6.7 million of expenditures associated with new stores and pharmacies, and \$4.6 million for store and pharmacy upgrades and annual capital maintenance. This compares with 1997 capital expenditures of \$6.0 million for new stores and pharmacies and \$3.7 million for store and pharmacy upgrades and annual capital maintenance. Cash used for investing activities in 1997 also included \$12.9 million for the acquisition of inventory, fixed assets and pharmacy customer lists of a 17-store chain.

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

Recent Accounting Pronouncements

In June 1999, the FASB issued SFAS no. 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of the effective date of FASB Statement No. 133, which deferred the effective date provisions of SFAS No. 133 for the company to the first quarter of 2001. The Company does not believe this new standard will have an impact on its financial statements since it currently has no derivative instruments.

Year 2000

The Company did not experience any significant problems relating to the change to the year 2000. All key suppliers and service vendors experienced no significant problems. All changes to the system and established contingency plans were effective. It is possible, although management does not consider likely, that other dates in the year 2000 may further affect computer software and systems. There may also be other year 2000 problems that have yet to be discovered by the Company or any third party which the Company conducts business.

Cautionary Statement Regarding Forward-looking Information

Statements, other than those based on historical facts, are forward-looking statements which are based upon a number of assumptions concerning future conditions that may ultimately prove to be inaccurate. Actual events and results may materially differ from anticipated results described in such statements. The Company's ability to achieve such results is subject to certain risks and uncertainties, including, but not limited to, economic and weather conditions which affect buying patterns of the Company's customers, changes in consumer spending and the Company's ability to anticipate buying patterns and implement appropriate inventory strategies, continued availability of capital and financing, competitive factors, and other factors affecting business beyond the Company's control. Consequently, all of the forward-looking statements are qualified by these cautionary statements and there can be no assurance that the results or developments anticipated by the Company will be realized or that they will have the expected effects on the Company or its business or operations.

Consolidated Statements of Income

<i>(in thousands, except share and per share amounts)</i>	For the Years Ended		
	January 29, 2000	January 30, 1999	January 31, 1998
Net sales	\$ 665,777	\$ 600,902	\$ 492,236
Cost of goods sold	478,138	436,523	357,135
Gross profit	187,639	164,379	135,101
Selling, general and administrative expenses	168,696	149,668	119,590
Operating income	18,943	14,711	15,511
Interest expense (income), net	2,504	1,106	(149)
Income before taxes	16,439	13,605	15,660
Income taxes	5,737	4,775	5,873
Net income	\$ 10,702	\$ 8,830	\$ 9,787
Net income per share			
Basic	\$.90	\$.75	\$.84
Diluted	\$.89	\$.73	\$.83
Weighted average shares outstanding			
Basic	11,827	11,798	11,670
Diluted	12,072	12,078	11,863

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

<i>(in thousands, except for number of shares)</i>	January 29, 2000	January 30, 1999
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,036	\$ 2,406
Receivables, less allowance for doubtful accounts of \$452 (\$644 at January 30, 1999)	10,911	8,931
Inventories	141,612	126,577
Deferred income taxes	3,002	3,783
Other current assets	1,865	1,367
Total current assets	160,426	143,064
Property and equipment, at depreciated cost	73,459	68,923
Equipment under capital leases, less accumulated amortization of \$856 (\$501 at January 30, 1999)	1,835	1,578
Deferred income taxes	866	2,598
Other noncurrent assets, net	3,636	4,594
Total assets	\$ 240,222	\$ 220,757
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 39,653	\$ 46,767
Current portion of indebtedness	30,306	11,606
Current portion of capital lease obligations	430	308
Accrued liabilities	9,680	10,776
Income taxes payable	650	826
Total current liabilities	80,719	70,283
Long-term portion of indebtedness	10,027	10,264
Capital lease obligations	1,734	1,557
Other noncurrent liabilities	1,829	1,670
Total liabilities	94,309	83,774
Commitments and contingencies (Notes 7 and 11)		
Shareholders' equity:		
Common stock, Class A voting, no par value, 11,988,276 shares issued and outstanding (11,946,772 shares at January 30, 1999)	67,326	66,951
Retained earnings	78,902	70,596
Deferred compensation on restricted stock incentive plan	(315)	(564)
Total shareholders' equity	145,913	136,983
	\$ 240,222	\$ 220,757

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity

<i>(in thousands, except share data)</i>	Common Stock		Retained Earnings	Deferred Compensation	Total
	Shares	Amount			
Balance, February 1, 1997	9,328,822	\$ 63,369	\$ 56,364	\$ (154)	\$ 119,579
Cash dividends paid (\$.17 per share)			(1,999)		(1,999)
Repurchase of shares	(80)				
Issuance of restricted stock	56,491	507		(507)	
Exercises of stock options	97,557	1,211			1,211
Other issuances	18,046	300			300
Amortization of deferred compensation on restricted stock incentive plan				173	173
Tax benefit on exercise of stock options		313			313
Five-for-four stock split	2,365,953		(5)		(5)
Net income			9,787		9,787
Balance, January 31, 1998	11,866,789	65,700	64,147	(488)	129,359
Cash dividends paid (\$.20 per share)			(2,381)		(2,381)
Repurchase of shares	(30)				-
Issuance of restricted stock	46,182	752		(362)	390
Cancellation of restricted stock	(5,500)	(38)		38	-
Exercises of stock options	39,331	329			329
Amortization of deferred compensation on restricted stock incentive plan				248	248
Tax benefit on exercise of stock options		208			208
Net income			8,830		8,830
Balance, January 30, 1999	11,946,772	\$ 66,951	\$ 70,596	\$ (564)	\$ 136,983
Cash dividends paid (\$.20 per share)			(2,396)		(2,396)
Issuance of restricted stock	9,900	124		(124)	
Cancellation of restricted stock	(5,700)	(118)		118	
Other issuances	1,714	30			30
Exercises of stock options	35,590	296			296
Amortization of deferred compensation on restricted stock incentive plan				255	255
Tax benefit on exercise of stock options		43			43
Net income			10,702		10,702
Balance, January 29, 2000	11,988,276	\$ 67,326	\$ 78,902	\$ (315)	\$ 145,913

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

<i>(in thousands)</i>	For the Years Ended		
	January 29, 2000	January 30, 1999	January 31, 1998
Cash flows from operating activities:			
Net income	\$ 10,702	\$ 8,830	\$ 9,787
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	11,830	8,939	7,112
Provision for uncollectible receivables	80	124	589
LIFO reserve	100	3,108	—
Deferred income taxes	2,513	2,344	(652)
Amortization of deferred compensation on restricted stock incentive plan	255	248	173
Issuance of restricted stock	—	390	—
Gain on sale of fixed assets	(41)	—	(114)
(Increase) decrease in assets:			
Receivables	(2,060)	(1,969)	(3,182)
Inventories	(15,135)	(14,664)	(16,852)
Other assets	(847)	(2,354)	(1,099)
Increase (decrease) in liabilities:			
Accounts payable and accrued liabilities	(8,210)	(3,712)	25,137
Income taxes payable	(176)	(890)	68
Other noncurrent liabilities	159	175	1
Net cash (used in) provided by operating activities	<u>(830)</u>	<u>569</u>	<u>20,968</u>
Cash flows from investing activities:			
Capital expenditures	(14,848)	(23,266)	(9,696)
Proceeds from dispositions of property and equipment	215	—	279
Acquisition, net of cash acquired	—	—	(12,850)
Net cash used in investing activities	<u>(14,633)</u>	<u>(23,266)</u>	<u>(22,267)</u>
Cash flows from financing activities:			
Reduction of indebtedness and capital lease obligations	(2,139)	(556)	(1,487)
Proceeds from revolving line of credit, net of payments	18,040	10,200	—
Proceeds from term loan	2,249	12,000	—
Proceeds from exercise of options	296	329	1,211
Tax benefit upon exercise of stock options	43	208	313
Payment of cash for dividends and fractional shares	(2,396)	(2,381)	(2,004)
Net cash provided by (used in) financing activities	<u>16,093</u>	<u>19,800</u>	<u>(1,967)</u>
Increase (decrease) in cash and cash equivalents	630	(2,897)	(3,266)
Cash and cash equivalents:			
Beginning of year	2,406	5,303	8,569
End of year	<u>\$ 3,036</u>	<u>\$ 2,406</u>	<u>\$ 5,303</u>
Supplemental disclosures of cash flow information:			
Interest paid	\$ 2,399	\$ 1,239	\$ 346
Income taxes paid	\$ 3,810	\$ 2,828	\$ 6,154
Non cash investing and financing activities:			
Assets acquired through capital lease obligations	\$ 612	\$ 509	\$ 1,290
Common stock issued for acquisition	\$ 30	\$ —	\$ 300

See accompanying notes to consolidated financial statements.

Note 1 - Description of Business and Summary of Significant Accounting Policies

Description of business. The primary business of Fred's, Inc. (the "Company") is the sale of general merchandise through its 293 retail discount stores located in the southeastern United States. In addition, the Company sells general merchandise to its 26 franchisees.

Consolidated financial statements. The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions are eliminated.

Fiscal year. The Company utilizes a 52 - 53 week accounting period which ends on the Saturday closest to January 31. Fiscal years 1999, 1998 and 1997, as used herein, refer to the years ended January 29, 2000, January 30, 1999, and January 31, 1998, respectively.

Use of estimates. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

Inventories. Wholesale inventories are stated at the lower of cost or market using the FIFO (first-in, first-out) method. Retail inventories are stated at the lower of cost or market as determined by the retail inventory method. For pharmacy inventories, which comprise approximately 18% and 16% of the retail inventories at January 29, 2000 and January 30, 1999, respectively, cost was determined using the LIFO (last-in, first-out) method. For the remainder of the retail inventories, the FIFO (first-in, first-out) method was applied. The current cost of inventories exceeded the LIFO cost by approximately \$3,208,000 at January 29, 2000 and \$3,108,000 at January 30, 1999.

During the fourth quarter of fiscal 1998, the Company adopted the LIFO method of accounting for its pharmacy inventories. The change was made to address the significant inflation experienced in pharmacy inventory costs during 1998 and provide for a better matching of costs and revenues. Net income for the year ended January 30, 1999 was reduced by \$2,017,000 as a result of this adoption.

Depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of buildings, furniture, fixtures and equipment. Leasehold costs and improvements are amortized over the lesser of their estimated useful lives or the remaining lease terms. Average useful lives are as follows: buildings and improvements - 8 to 30 years; furniture and fixtures - 5 to 10 years; and equipment - 3 to 10 years. Amortization on equipment under capital leases is computed on a straight-line basis over the terms of the leases.

Selling, general and administrative expenses. The Company includes buying, warehousing, transportation and occupancy costs in selling, general and administrative expenses.

Advertising. The Company charges advertising, including production costs, to expense on the first day of the advertising period. Advertising expense for 1999, 1998, and 1997 was \$8,926,000, \$9,621,000, and \$7,383,000, respectively.

Preopening costs. The Company charges to expense the preopening costs of new stores as incurred. These costs are primarily labor to stock the store, preopening advertising, store supplies and other expendable items.

Revenue recognition. The Company markets goods and services through Company owned stores and 26 franchised stores. Sales are recorded at Company owned stores when sold to the public. Sales to franchised stores are recorded when purchased from the Company's warehouse. In addition, the Company charges the franchised stores a fee based on a percentage of their purchases from the Company. These fees represent a reimbursement for the use of Fred's name and other administrative cost incurred on behalf of the franchised stores. Total franchise income for 1999, 1998, and 1997 was \$1,761,000, \$1,957,000, and \$1,967,000, respectively.

Other intangibles assets. Other identifiable intangible assets which are included in other noncurrent assets primarily represents amounts associated with acquired pharmacies and are being amortized over five years. These intangibles, net of accumulated amortization, totaled \$3,559,000 at January 29, 2000, \$4,521,000 at January 30, 1999, and \$3,742,000 at January 31, 1998. Amortization expense for 1999, 1998 and 1997 was \$1,307,000, \$1,214,000, and \$739,000, respectively.

Cash and cash equivalents. Cash on hand and in banks, together with other highly liquid investments having original maturities of three months or less, are classified as cash equivalents. Included in accounts payable are outstanding checks in excess of funds on deposit which totaled \$14,089,000 at January 29, 2000 and \$15,818,000 at January 30, 1999.

Financial instruments. At January 29, 2000, the Company did not have any outstanding derivative instruments. The recorded value of the Company's financial instruments, which include cash and cash equivalents, receivables, accounts payable and indebtedness, approximates fair value. The following methods and assumptions were used to estimate fair value of each class of financial instrument: (1) the carrying amounts of current assets and liabilities approximate fair value because of the short maturity of those instruments and (2) the fair value of the Company's indebtedness is estimated based on the current borrowing rates available to the Company for bank loans with similar terms and average maturities.

Business segments. The Company has one reportable operating segment, its sales of merchandise through its Company owned stores and to franchised Fred's locations, which are organized around the products sold and markets served.

Comprehensive income. The Company discloses all comprehensive income items in accordance with Statement of Financial Accounting Standards No. 130. Reporting Comprehensive Income. Comprehensive income does not differ from the consolidated net income presented in the consolidated statements of income.

Reclassifications. Certain prior year amounts have been reclassified to conform to the 1998 presentation.

Recent Accounting Pronouncements. In June 1999, the FASB issued SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of the effective date of FASB Statement No. 133, which deferred the effective date provisions of SFAS No. 133 for the company to the first quarter of 2001. The Company does not believe this new standard will have an impact on its financial statements since it currently has no derivative instruments.

Note 2 - Acquisition

Effective October 10, 1997, the Company executed an Asset Purchase Agreement for the purchase of inventory and other selected assets of CVS Revco D.S., Inc. for \$12.85 million in cash. Tangible assets acquired consisted of inventory of \$9.7 million and fixed assets of \$2.0 million. The remaining purchase price was allocated to identifiable intangible assets acquired.

Note 3 - Property and Equipment

Property and equipment, at cost, consist of the following:

<i>(in thousands)</i>	1999	1998
Buildings and improvements	\$ 65,660	\$ 63,975
Furniture, fixtures and equipment	81,424	71,612
	<u>147,084</u>	<u>135,587</u>
Less accumulated depreciation and amortization	(78,018)	(70,966)
	69,066	64,621
Land	4,393	4,302
	<u>\$ 73,459</u>	<u>\$ 68,923</u>

Depreciation expense totaled \$10,168,000, \$7,442,000, and \$6,115,000 for 1999, 1998 and 1997, respectively.

Note 4 - Accrued Liabilities

The components of accrued liabilities are as follows:

<i>(in thousands)</i>	1999	1998
Payroll and benefits	\$ 2,992	\$ 2,761
Sales and use taxes	1,726	1,909
Insurance	2,904	3,328
Other	2,058	2,778
	<u>\$ 9,680</u>	<u>\$ 10,776</u>

Note 5 - Indebtedness

On May 15, 1992, the Company and a bank entered into a Revolving Loan and Credit Agreement (the "Agreement"). The Agreement, as amended, provides the Company with an unsecured revolving line of credit commitment of up to \$15 million, and is also supplemented with \$15 million of seasonal overline capabilities and bears interest at 1.5% below prime rate or a LIBOR-based rate. Under the most restrictive covenants of the Agreement, the Company is required to maintain specified shareholders' equity and net income levels. There were \$28,240,000 and \$10,200,000 borrowings outstanding under the Agreement at January 29, 2000 and January 30, 1999, respectively. The Company is required to pay a commitment fee to the bank at a rate per annum equal to .18% on the unutilized portion of the revolving line commitment over the term of the Agreement.

On April 3, 2000, a new Revolving Loan and Credit Agreement (the "Agreement") was entered into to replace the May 15, 1992 Revolving Loan and Credit Agreement, as amended. The new Agreement increases the revolving line of credit commitment to \$40 million and the term of the Agreement extends to April 3, 2003. All other provisions of the Agreement are essentially the same as the May 15, 1992 Agreement, as amended.

On April 23, 1999, the Company and a bank entered into a loan Agreement (the "Loan Agreement"). The Loan Agreement provided the Company with a four-year unsecured term loan of \$2.3 million to finance the replacement of the Company's mainframe computer system. The Loan Agreement bears interest of 6.15% per annum and matures on April 15, 2003. Borrowings outstanding under this agreement at January 29, 2000 were \$1,828,000 and the principal maturity on this loan is as follows: \$562,500 in fiscal 2000; \$562,500 in fiscal 2001; \$562,500 in fiscal 2002; \$140,500 in fiscal 2003.

On May 5, 1998, the Company and a bank entered into a Loan Agreement (the "Loan Agreement"). The Loan Agreement provided the Company with an unsecured term loan of \$12 million to finance the modernization and automation of the Company's distribution center and corporate facilities. The Loan Agreement bears interest of 6.82% per annum and matures on November 1, 2005. Under the most restrictive covenants of the Loan Agreement, the Company is required to maintain specified shareholders' equity and net income levels. Borrowings outstanding under this Loan Agreement totaled \$10,265,000 at January 29, 2000 and \$11,670,000 at January 30, 1999. The principal maturity under this Agreement for debt outstanding at January 29, 2000 is as follows: \$1,503,358 in fiscal 2000; \$1,612,742 in fiscal 2001; \$1,727,860 in fiscal 2002; \$1,851,199 in fiscal 2003; \$1,983,338 in fiscal 2004; and \$1,586,503 thereafter.

Interest expense for 1999, 1998 and 1997 totaled \$2,504,000, \$1,206,000 and \$343,000, respectively.

Note 6 - Income Taxes

Deferred income taxes are provided for the tax effects of temporary differences between the financial reporting basis and income tax basis of the Company's assets and liabilities. The provision for income taxes consists of the following:

<i>(in thousands)</i>	1999	1998	1997
Current			
Federal	\$ 3,224	\$ 2,639	\$ 6,225
State	-	(208)	300
	<u>3,224</u>	<u>2,431</u>	<u>6,525</u>
Deferred			
Federal	2,116	1,974	(840)
State	397	370	188
	<u>2,513</u>	<u>2,344</u>	<u>(652)</u>
	<u>\$ 5,737</u>	<u>\$ 4,775</u>	<u>\$ 5,873</u>

Deferred tax assets (liabilities) comprise the following:

<i>(in thousands)</i>	1999	1998
Current deferred tax assets:		
Inventory valuation methods	\$ 758	\$ 861
Accrual for inventory shrinkage	672	1,028
Allowance for doubtful accounts	285	358
Insurance accruals	990	1,160
Other	749	1,084
Gross current deferred tax assets	3,454	4,491
Deferred tax asset valuation allowance	(182)	(328)
	3,272	4,163
Current deferred tax liabilities	(270)	(380)
Net current deferred tax asset	\$ 3,002	\$ 3,783
Noncurrent deferred tax assets:		
Net operating loss carryforwards	\$ 1,421	\$ 1,028
Postretirement benefits other than pensions	694	634
Restructuring costs	82	229
Other	1,583	1,759
Gross noncurrent deferred tax assets	3,780	3,650
Deferred tax asset valuation allowance	(1,239)	(700)
	2,541	2,950
Noncurrent deferred tax liabilities:		
Depreciation	(1,648)	(319)
Other	(27)	(33)
Gross noncurrent deferred tax liabilities	(1,675)	(352)
Net noncurrent deferred tax asset	\$ 866	\$ 2,598

The ultimate realization of these assets is dependent upon the generation of future taxable income sufficient to offset the related deductions and loss carryforwards within the applicable carryforward periods as described below. The valuation allowance is based upon management's conclusion that certain tax carryforward items will expire unused. During 1999 and 1998, the valuation allowance increased \$393,000 and \$98,000, respectively, as the result of the company generating additional net operating loss carry forwards in certain states. The release of valuation allowance of \$206,000 for the year ended January 31, 1998 resulted from the Company's ability to assure utilization of certain state net operating loss carry forwards and tax credits that were originally anticipated to expire unused.

At January 29, 2000, the Company has certain net operating loss carry forwards which were acquired in reorganizations and purchase transactions which are available to reduce income taxes, subject to usage limitations. These carry forwards total approximately \$36,687,000 for state income tax purposes, and expire at various times during the period 2001 through 2021. If certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of carry forwards which can be utilized.

A reconciliation of the statutory Federal income tax rate to the effective tax rate is as follows:

	1999	1998	1997
Income tax provision at statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	1.6	0.8	3.4
Change in valuation allowance	-	0.7	(1.3)
Surtax exemptions	(1.0)	(1.0)	(1.0)
Other	(0.7)	(0.4)	1.4
	34.9%	35.1%	37.5%

Note 7 - Long-term Leases

The Company leases certain of its store locations under noncancelable operating leases expiring at various dates through 2029. Many of these leases contain renewal options and require the Company to pay taxes, maintenance, insurance and certain other operating expenses applicable to the leased properties. In addition, the Company leases various equipment under noncancelable operating leases and certain transportation equipment under capital leases. Total rent expense under operating leases was \$15,329,000, \$13,618,000, and \$10,239,000 for 1999, 1998 and 1997, respectively. Amortization expense on assets under capital lease for 1999, 1998 and 1997 was \$355,000, \$283,000, and \$258,000, respectively.

Future minimum rental payments under all operating and capital leases as of January 29, 2000 are as follows:

Operating <i>(in thousands)</i>	Capital Leases	Leases
2000	14,738	741
2001	12,842	741
2002	11,032	741
2003	8,618	364
2004	6,021	255
Thereafter	13,465	142
Total minimum lease payments	<u>\$ 66,716</u>	2,984
Imputed interest		<u>(820)</u>
Present value of net minimum lease payments, including \$430 classified as current portion of capital lease obligations		<u>\$ 2,164</u>

Note 8 - Shareholders' Equity

The Company has 30 million shares of Class A voting common stock authorized. The Company's authorized capital also consists of 11.5 million shares of Class B nonvoting common stock, of which no shares have been issued. In addition, the Company has authorized 10 million shares of preferred stock, of which no shares have been issued.

Effective October 12, 1998 the Company adopted a Shareholders Rights Plan which granted a dividend of one preferred share purchase right ("the Right") for each common share outstanding at that date. Each Right represents the right to purchase one-hundredth of a preferred share of stock at a preset price to be exercised when any one individual, firm, corporation or other entity acquires 15% or more of the Company's common stock. The Rights will become dilutive at the time of exercise and will expire, if unexercised, on October 12, 2008.

On November 20, 1997, the board of directors approved a five-for-four stock split to be effective on December 19, 1997 for shareholders of record on December 5, 1997. The split resulted in the issuance of 2,365,953 shares of common stock. All per share data included herein have been restated to reflect the stock split.

Note 9 - Employee Benefit Plans

Incentive stock option plan. The Company has a long-term incentive plan under which an aggregate of 1,168,750 shares may be granted. These options expire five years from the date of grant. Options outstanding at January 29, 2000 expire in 2000 through 2004.

A summary of activity in the plan follows:

	1999		1998		1997	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	490,139	\$ 13.40	411,298	\$ 8.55	297,113	\$ 10.60
Granted	136,750	11.82	150,695	25.61	364,355	8.61
Canceled	(26,101)	14.79	(32,523)	12.46	(16,353)	9.81
Expired	(1,744)	11.33	—	—	(120,778)	14.45
Exercised	(35,590)	8.38	(39,331)	8.42	(113,039)	10.65
Outstanding at end of year	563,454	13.13	490,139	13.40	411,298	8.55
Exercisable at end of year	169,313	\$ 9.10	152,483	\$ 9.85	90,115	\$ 10.70

The weighted average remaining contractual life of all outstanding options was 2.9 years at January 29, 2000.

The following table summarizes information about stock options outstanding at January 29, 2000:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at January 29, 2000	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number Exercisable at January 29, 2000	Weighted Average Exercise Price
\$ 5.90 to \$ 8.00	247,951	2.0	\$ 7.15	131,160	\$ 7.09
\$ 11.00 to \$ 17.90	189,228	3.8	\$ 12.69	34,053	\$ 14.85
\$ 22.75 to \$ 25.88	126,275	3.2	\$ 25.54	4,100	\$ 25.50
	<u>563,454</u>			<u>169,313</u>	

The Company applies Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations in accounting for its plans. Accordingly, no compensation expense has been recognized for its stock-based compensation. Had compensation cost for the Company's stock option plan been determined based on the fair value at the grant date for awards in 1999, 1998 and 1997 consistent with the method prescribed by SFAS No. 123, Accounting for Stock-Based Compensation, the Company's operating results for 1999, 1998 and 1997 would have been reduced to the pro forma amounts indicated below:

(in thousands, except per share data)	1999	1998	1997
Net income			
As reported	\$ 10,702	\$ 8,830	\$ 9,787
Pro forma	10,363	8,322	9,492
Basic earnings per share			
As reported	0.90	0.75	0.84
Pro forma	0.88	0.71	0.81
Diluted earnings per share			
As reported	0.89	0.73	0.83
Pro forma	0.86	0.69	0.80

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions using grants in 1999, 1998 and 1997, respectively:

	1999	1998	1997
Average expected life (years)	3.0	3.0	3.0
Average expected volatility	43.3%	41.5%	37.6%
Risk-free interest rates	4.8%	5.5%	6.0%
Dividend yield	1.5%	1.3%	2.4%

The weighted average grant-date fair value of options granted during 1999, 1998 and 1997 was \$4.17, \$7.85, and \$2.40 respectively.

Restricted Stock. During 1999, 1998 and 1997, the Company issued a net of 4,200, 40,682, and 56,491 restricted shares, respectively. Compensation expense related to the shares issued is recognized over the period for which restrictions apply.

Employee stock ownership plan. The Company has a non-contributory employee stock ownership plan for the benefit of qualifying employees who have completed one year of service and attained the age of 18. Benefits are fully vested upon completion of seven years of service. The Company has not made any contributions to the plan since 1996.

Salary reduction profit sharing plan. The Company has a defined contribution profit sharing plan for the benefit of qualifying employees who have completed one year of service and attained the age of 21. Participants may elect to make contributions to the plan up to a maximum of 15% of their compensation. Company contributions are made at the discretion of the Company's Board of Directors. Participants are 100% vested in their contributions and earnings thereon. Contributions by the Company and earnings thereon are fully vested upon completion of seven years of service. The Company's contributions for the years ended January 29, 2000, January 30, 1999, and January 31, 1998 were \$96,000, \$83,000, and \$65,000, respectively.

Postretirement benefits. The Company provides certain health care benefits to its full-time employees that retire between the ages of 58 and 65 with certain specified levels of credited service. Health care coverage options for retirees under the plan are the same as those available to active employees. The Company's change in benefit obligation based upon an actuarial valuation is as follows:

(in thousands)	For the Year Ended		
	January 29, 2000	January 30, 1999	January 31, 1998
Benefit obligation at beginning of year	\$ 1,252	\$ 1,132	\$ 1,235
Service cost	127	103	97
Interest cost	91	85	83
Participant contributions	-	4	2
Amendments	-	-	(7)
Actuarial (gain) loss	(17)	(67)	(258)
Benefits paid	(76)	(5)	(20)
Benefit obligation at end of year	\$ 1,377	\$ 1,252	\$ 1,132

Notes to Consolidated Financial Statements

A reconciliation of the Plan's funded status to accrued benefit cost follows:

<i>(in thousands)</i>	January 29, 2000	January 30, 1999	January 31, 1998
Funded status	\$ (1,377)	\$ (1,252)	\$ (1,132)
Unrecognized net actuarial loss (gain)	(406)	(405)	(356)
Unrecognized prior service cost	(6)	(6)	(7)
Accrued benefit costs	<u>\$ (1,789)</u>	<u>\$ (1,663)</u>	<u>\$ (1,495)</u>

The medical care cost trend used in determining this obligation is 10.0% effective February 1, 1997, decreasing annually before leveling at 6.5% in 2003. This trend rate has a significant effect on the amounts reported. To illustrate, increasing the health care cost trend by 1% would increase the accumulated postretirement benefit obligation by \$202,000. The discount rate used in calculating the obligation was 7.75% in 1999, 6.75% in 1998 and 7.5% in 1997.

The annual net postretirement cost is as follows:

<i>(in thousands)</i>	For the Year Ended		
	January 29, 2000	January 30, 1999	January 31, 1998
Service cost	\$ 127	\$ 103	\$ 97
Interest cost	91	85	83
Amortization of net loss (gain) from prior periods	(17)	(21)	(19)
Amortization of unrecognized prior service cost	1	1	-
Net periodic postretirement benefit cost	<u>\$ 202</u>	<u>\$ 168</u>	<u>\$ 161</u>

The Company's policy is to fund claims as incurred.

Note 10 - Net Income Per Share

Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Restricted stock is considered contingently issuable and is excluded from the computation of basic earnings per share.

A reconciliation of basic earnings per share to diluted earnings per share follows:

<i>(in thousands, except per share data)</i>	Year Ended								
	January 29, 2000			January 30, 1999			January 31, 1998		
	Income	Shares	Per-Share Amount	Income	Shares	Per-Share Amount	Income	Shares	Per-Share Amount
Basic EPS	\$10,702	11,827	\$ 0.90	\$ 8,830	11,798	\$ 0.75	\$ 9,787	11,670	\$ 0.84
Effect of Dilutive Securities									
Restricted stock		108			79			42	
Stock options		137			201			151	
Diluted EPS	<u>\$10,702</u>	<u>12,072</u>	<u>\$ 0.89</u>	<u>\$ 8,830</u>	<u>12,078</u>	<u>\$ 0.73</u>	<u>\$ 9,787</u>	<u>11,863</u>	<u>\$ 0.83</u>

Note 11 - Commitments and Contingencies

Commitments. At January 29, 2000, the Company had commitments approximating \$5,695,000 on issued letters of credit which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating \$2,240,000 utilized as collateral for their risk management programs.

Litigation. The Company is a party to several pending legal proceedings and claims in the normal course of business. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the Company is of the opinion that it is unlikely that these proceedings and claims will have a material adverse effect on the results of operations, cash flows, or the financial condition of the Company.

Note 12 - Other Expenses

During the fourth quarter of 1996, the Company recorded a \$2,860,000 accrual for the closure of certain underperforming stores and the repositioning of certain merchandise categories. This charge included an accrual for closed facility lease obligations of \$1,156,000. The remaining lease obligation reserves at January 29, 2000 represents remaining future base payments required on one locations that has been closed.

The 1999 activity in this reserve is as follows:

<i>(in thousands)</i>	January 31, 1998	January 30, 1999	Payments	January 29, 2000
Lease obligations	\$ 666	\$ 400	\$ (185)	\$ 215

Note 13 - Quarterly Financial Data (Unaudited)

<i>(in thousands, except per share data)</i>	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<u>Year Ended January 29, 2000</u>				
Net sales	\$ 154,934	\$ 156,498	\$ 158,049	\$ 196,296
Gross profit	44,319	43,952	47,117	52,251
Net income	2,886	1,037	2,896	3,883
Net income per share				
Basic	0.24	0.09	0.24	0.33
Diluted	0.24	0.09	0.24	0.32
Cash dividends paid per share	0.05	0.05	0.05	0.05
<u>Year Ended January 30, 1999⁽¹⁾</u>				
Net sales	\$ 144,156	\$ 141,635	\$ 142,339	\$ 172,772
Gross profit	37,869	38,614	41,449	46,447
Net income	2,286	1,430	2,568	2,546
Net income per share				
Basic	0.19	0.12	0.22	0.22
Diluted	0.19	0.12	0.21	0.21
Cash dividends paid per share	0.05	0.05	0.05	0.05

⁽¹⁾ The quarterly data for the year ended January 30, 1999 includes the impact of the accounting change described in Note 1.

Report of Independent Accountants

To the Board of Directors and Shareholders of Fred's, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Fred's, Inc. and its subsidiaries at January 29, 2000 and January 30, 1999, and the results of their operations and their cash flows for each of the three years in the period ended January 29, 2000, in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with accounting principles generally accepted in the United States, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for pharmacy inventories during the year ended January 30, 1999.



March 13, 2000
except for Note 5,
as to which the date is April 3, 2000

Board of Directors

Michael J. Hayes

Chief Executive Officer
Fred's, Inc.

David A. Gardner

Managing Director
Fred's, Inc.

President

Gardner Capital Corporation
(a real estate and venture capital investment firm)

John R. Eisenman

Real Estate Investments
REMAX Island Realty, Inc.

Former President

Sally's, Inc.

(a restaurant chain)

Former commercial real estate developer

Roger T. Knox

Chief Executive Officer and President
Memphis Zoological Society

Former Chairman of the Board and Chief Executive Officer

Goldsmith's Department Stores

(retailing)

Executive Officers

Michael J. Hayes

Chief Executive Officer

David A. Gardner

Managing Director

John D. Reier

President

Edwin C. Boothe

Executive Vice President and Chief Operating Officer

John A. Casey

Executive Vice President – Pharmacy Operations

Jerry A. Shore

Executive Vice President and Chief Financial Officer

Charles S. Vail

*Corporate Secretary, Vice President – Legal Services
and General Counsel*

Corporate Information

Corporate Offices

Fred's, Inc.
4300 New Getwell Road
Memphis, Tennessee 38118
(901) 365-8880

Transfer Agent

Union Planters National Bank
Memphis, Tennessee

Independent Accountants

PricewaterhouseCoopers LLP
Memphis, Tennessee

General Counsel

Waring Cox, PLC
Memphis, Tennessee

Annual Report on Form 10-K

A copy of the Company's Annual Report on Form 10-K for the year ended January 29, 2000, as filed with the Securities and Exchange Commission, may be obtained by shareholders of record without charge upon written request to Jerry A. Shore, Executive Vice President and Chief Financial Officer.

Annual Meeting of Shareholders

The 2000 annual meeting of shareholders will be held at 10:00 a.m. local time on Wednesday, June 21, 2000, at the Memphis Marriott Hotel, 2625 Thousand Oaks Boulevard, Memphis, Tennessee. Shareholders of record as of April 24, 2000, are invited to attend this meeting.

Stock Market Information

The Company's common stock trades on the Nasdaq Stock Market under the symbol FRED (CUSIP No. 356108-10-0). At April 24, 2000, the Company had an estimated 5,000 shareholders, including beneficial owners holding shares in nominee or "street" name.

The table below sets forth the high and low stock prices, together with cash dividends paid per share, for each fiscal quarter in the past two fiscal years:

	High	Low	Dividends Per Share
1998			
First	\$26 $\frac{7}{8}$	\$19	\$.05
Second	\$26 $\frac{1}{2}$	\$20 $\frac{3}{4}$	\$.05
Third	\$22 $\frac{3}{8}$	\$10 $\frac{1}{2}$	\$.05
Fourth	\$18	\$12 $\frac{9}{16}$	\$.05
1999			
First	\$15	\$9 $\frac{3}{4}$	\$.05
Second	\$17 $\frac{5}{8}$	\$10 $\frac{5}{16}$	\$.05
Third	\$18	\$10 $\frac{11}{16}$	\$.05
Fourth	\$17 $\frac{5}{8}$	\$11 $\frac{1}{2}$	\$.05

SIC 5331



4300 New Getwell Road
Memphis, Tennessee 38118

