

We are exciting selections.

We are great prices.

We are convenient pharmacies.

We are friendly service.

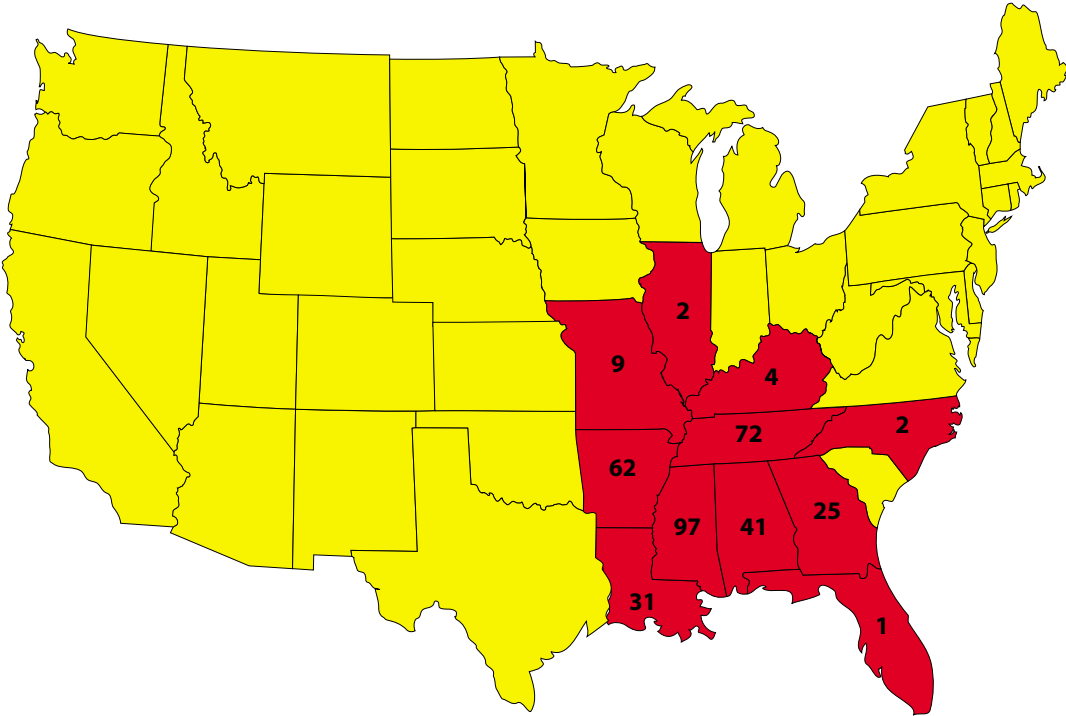
We Are Fred's.



2000 ANNUAL REPORT

about the company

Fred's, Inc., founded in 1947, operates 320 discount general merchandise stores in 11 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.



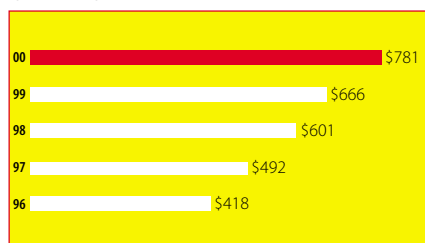
Number of Company-owned and Franchised Stores by State

financial highlights

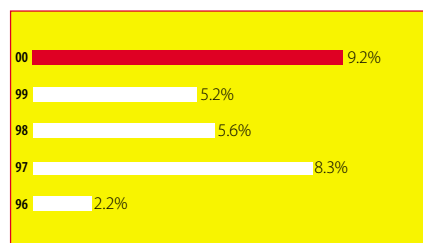
(in thousands, except per share amounts)

	53 Weeks Ended February 3, 2001	52 Weeks Ended January 29, 2000
Operating Data		
Net sales	\$ 781,249	\$ 665,777
Operating income	25,720	18,943
Net income	14,849	10,702
Net income per share - diluted	1.22	.89
Weighted average shares outstanding - diluted	12,197	12,072
Balance Sheet Data		
Working capital	\$ 110,529	\$ 79,707
Total assets	254,795	240,222
Long-term debt (including capital leases)	31,705	11,761
Shareholders' equity	159,687	145,913
Long-term debt to equity	19.9%	8.1%

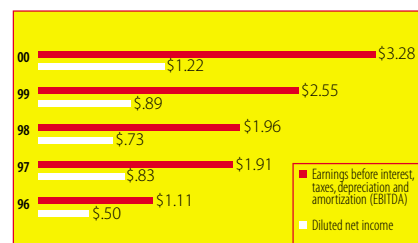
Net Sales
(in millions)



Comparable Store Sales



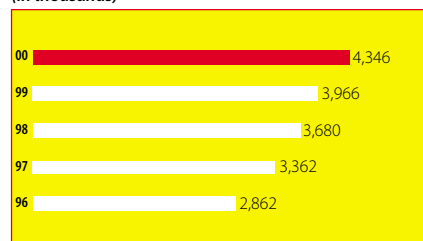
Per Share Performance



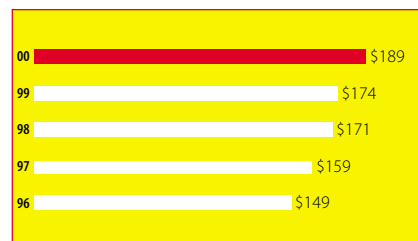
Number of Stores
(end of period)



Selling Space (Square Footage)
(in thousands)



Sales Per Square Foot



to our shareholders:

To attain our goals for the year 2000, we knew that Fred's would have to reach new heights in all of the critical measurement standards. We set a high hurdle for ourselves in 2000, hoping to increase earnings at least 30%, on top of the strong growth we registered in 1999, and expand selling space by at least 10% – all while reducing our debt 10%. I'm pleased to tell you that Fred's accomplished all of that, and more, in 2000. It was a very good year!

I think it's important to understand these accomplishments in a historical context. The gain we achieved in 2000 reflected a welcomed acceleration to a level well above the Company's average growth rate for the last five years and was substantially ahead of industry performance. Likewise, our comparable store sales increase for the year was the strongest single-year performance since Fred's became a publicly held company in 1992.

Net sales in 2000 rose 17% to a record \$781.2 million from \$665.8 million in 1999 and reflected both vigorous new store additions and higher comparable sales per store. Fiscal 2000



Fred's earnings growth in 2000 was equally impressive as net income increased 39% to \$14.8 million or \$1.22 per diluted share versus \$10.7 million or \$0.89 per diluted share in 1999. This improvement

also was a 53-week year for Fred's, which contributed slightly to the increase for the year. Adjusting for the extra week in 2000, sales for the year would have increased 15%.

demonstrated increased sales leverage in our selling, general and administrative expenses, particularly pharmacy department and corporate expenses, which more than offset the slight decline in gross margins that occurred as a result of a shift in our sales mix and because of increased promotional activities to drive customer traffic.

Comparable store sales, a widely used barometer for a retailer's health, jumped 9.2% in 2000. A 5.8% increase in customer transactions and a 3.4% increase in average customer purchases helped fuel this remarkable growth.

We also are proud to note that Fred's balance sheet has mirrored the improvements we have registered in sales

We are exciting
selections.

and earnings. In 2000, we improved inventory turnover, increased working capital, and reduced total debt 19% to approximately \$34 million. During the year, we also replaced our existing revolving bank debt, which provided a total lending limit of \$30 million including seasonal overline capacity, with a new revolver that has a total capacity of \$40 million. Moreover, we extended its maturity to April 2003.

With this overview of the Company's performance year, I believe the following details about operational and financial highlights for 2000 will be more enlightening.



Pharmacy Department

In keeping with our store expansion, our pharmacy department has continued to post strong growth. With pharmacies in 198 stores at year's end, up from 182 stores at the end of 1999, this department now accounts for almost one-third of our annual sales. Fred's is now one of the larger pharmacy operations in the Southeast – the largest in some of our markets.

The growth we have achieved in our pharmacy department over the past

decade has come from a combination of acquisitions, store expansion, and, most significantly, from an increasing customer base. The pharmacy department has served as the cornerstone of our strategy to make our stores more relevant to the needs of our customers, producing solid comparable store sales growth and offering an extra dimension to shopping at Fred's that is not found in the other dollar-store competitors.

Interestingly, we believe our pharmacy, distribution and merchandising strategies present a clear distinction over other pharmacy chains that are now seeking to reinvent themselves as value

shopping destinations. Seasoned retailers know there are two essential elements to the retail business – price and distribution. With a building footprint that has a minimal stocking area, these chains are limited in the types and quantity of merchandise they can offer. Make no mistake, we continue to regard these competitors as formidable, but their distribution techniques are not well suited to support the volume that everyday value pricing requires.

We are convenient pharmacies.





We are great
prices.

As part of a 50-year-old company, our pharmacy department has long benefited from some of the factors that currently are reshaping the modern American consumer, including the so-called "Graying of America" phenomenon and the increasing demand for new prescription medicines. We remain confident that there are many attractive opportunities awaiting us in the health care field.

Merchandising

In last year's report we discussed the significant strides Fred's has made in its merchandising programs.

John Reier, our President, believes the old adage about real estate, emphasizing "location, location, location," has implications for our merchandising strategy. For Fred's, however, the three basic rules are "presentation, presentation, presentation." In many ways, presentation is the key to our success. Our initial steps were intended to eliminate under-performing merchandise items and categories, use store size and selection to our advantage, make our stores more user-friendly, and, above all, maintain a keen focus on the customer. We have provided more space for shoppers so

they can navigate our stores comfortably. We have reduced rack height and moved away from round garment racks in favor of stands that show our apparel better and help customers find it more easily. Any long-time customer will tell you that our stores are brighter than ever, easier to shop, and offer a more satisfying shopping experience than ever before. The results of these initiatives were reflected in our overall sales growth for the year, our higher sales per square foot of selling space, and our increasing transactions and average purchase amounts.



The most obvious way our customers ratify these steps, of course, is by voting with their pocket books – and with this vote they continue to reinforce

our belief in the changes we have made, rewarding us with a 9.2% comparable store sales gain in 2000.

Store Growth

One of the key drivers of Fred's performance – past, present and future – is our continued investment in new stores and pharmacies. This key strategy has worked in tandem with our ongoing program of remodeling and refurbishing older stores. During 2000, we accelerated

this program with the opening of 32 stores, which net of the four stores we closed during the year, increased the number of company-owned and operated stores to 320 by year's end (excluding our 26 franchised stores). These new stores helped us increase our total selling space 10% to approximately 4.4 million square feet in 2000. Additionally, we did extensive remodeling of 10 stores in 2000. In both cases, the results were on the high side of our expectations, reaffirming the long-term benefits of our development strategies.



In the coming year, we plan to maintain these solid trends in store growth and increased selling space. In the first half of 2001, our focus will be on new store openings, and we intend to open approximately 30 to 36 stores based on the improved availability of retail locations. In the second half of the year, we plan to monitor the overall economic and retail climate as we consider additional opportunities for new stores, and we will remain opportunistic in committing capital beyond the stores we now have on the drawing boards. Our goal remains to increase our selling space 11% to 13% in 2001. We also plan to continue our

program of remodels, completing 20 to 30 in 2001 and focusing this program on the second half of the year.

Conclusion

Going forward, Fred's future is brighter than ever. Today's retail shopper will continue to make shopping decisions that are increasingly based on convenience and price - two factors that form the foundation of Fred's merchandising strategy. Our goals and expectations for 2001 are to build on our successes and set new highs in both sales and profit. The stage has been set for continued

success at Fred's, and we are ready.

Michael J. Hayes
Chief Executive Officer

We are friendly. service.



selected financial data

(in thousands, except per share amounts)

	2000 ¹	1999	1998 ²	1997	1996
Statement of Income Data:					
Net sales	\$ 781,249	\$ 665,777	\$ 600,902	\$ 492,236	\$ 418,297
Operating income	25,720	18,943	14,711	15,511	6,779 ³
Income before income taxes	22,494	16,439	13,605	15,660	6,508
Provision for income taxes	7,645	5,737	4,775	5,873	702
Net income	14,849	10,702	8,830	9,787	5,806
Net income per share:					
Basic	1.24	.90	.75	.84	.50
Diluted	1.22	.89	.73	.83	.50
Selected Operating Data:					
Operating income as a percentage of sales	3.3%	2.9%	2.4%	3.2%	1.6% ³
Increase in comparable store sales ⁴	9.2% ⁵	5.2%	5.6%	8.3%	2.2%
Company-owned stores open at end of period	320	293	283	261	213
Balance Sheet Data (at period end):					
Total assets	\$ 254,795	\$ 240,222	\$ 220,757	\$ 195,407	\$ 161,148
Short-term debt (including capital leases)	2,678	30,736	11,914	214	1,641
Long-term debt (including capital leases)	31,705	11,761	11,821	1,368	138
Shareholders' equity	159,687	145,913	136,983	129,359	119,579

¹ Results for 2000 include 53 weeks.

² Results for 1998 include the effect of the 1998 adoption of LIFO for pharmacy inventories.

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.

⁵ The increase in comparable store sales for 2000 is computed on the same 53-week period for 1999.

management's discussion and analysis

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.

	2000	1999	1998 ⁽¹⁾
Net sales	100.0%	100.0%	100.0%
Cost of goods sold	72.5	71.8	72.6
Gross profit	27.5	28.2	27.4
Selling, general and administrative expenses	24.2	25.3	24.9
Operating income	3.3	2.9	2.5
Interest expense, net	.4	.4	.2
Income before taxes	2.9	2.5	2.3
Income taxes	1.0	.9	.8
Net income	1.9%	1.6%	1.5%

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

Fiscal 2000 Compared to Fiscal 1999

Sales

Net sales increased 17.3% (\$115 million) in 2000. Approximately \$57 million of the increase was attributable to the addition of 31 new or upgraded stores, and 16 pharmacies during 2000, together with the sales of 20 store locations and 2 pharmacies that were opened or upgraded during 1999 and contributed a full year of sales in 2000. During 2000, the Company also closed 4 store locations. Comparable store sales based on a 53-week comparison, consisting of sales from stores that have been open for more than one year, increased 9.2% in 2000.

The Company's front store (non-pharmacy) sales increased approximately 15% over 1999 front store sales. Front store sales growth benefited from the above mentioned store additions, and solid performances in categories such as home furnishings, floor coverings, bath, small appliances, giftware, ladies intimate, ladies accessories, men's and boy's apparel, ethnic products, beverages, food and snacks, and tobacco. Lawn and garden sales decreased due to reduced emphasis of large lawn and garden equipment that carried lower margins and required additional labor outside the stores.

Fred's pharmacy sales grew to 33% of total sales in 2000 from 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 25% over 1999, with third party prescription sales representing approximately 83% of total pharmacy sales, compared with 77% of total pharmacy sales in 1999. 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 increased approximately \$1 million in 2000 and represented 4% of the Company's total sales, as compared to 5% in 1999. It is anticipated that this category of business will 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 27.5% in 2000 compared to 28.2% in 1999. The decrease in gross margin is primarily attributed to the changes in sales mix and promotional activities to increase customer traffic.

management's discussion and analysis

Selling, General and Administrative Expenses

Selling, general and administrative expenses were 24.2% of net sales in 2000 compared with 25.3% of net sales in 1999. Labor expenses improved in the stores and pharmacies as a result of the strong sales coupled with store productivity initiatives. Advertising expense improved as a percentage of sales by reducing the cost of advertising circulars while maintaining the same number of circulars issued during the year. Other expenses such as store supplies and distribution center equipment rental also improved as a result of cost control efforts.

Operating Income

Operating income increased approximately \$6.8 million or 35.8% to \$25.7 million in 2000 from \$18.9 million in 1999. Operating income as a percentage of sales increased to 3.3% in 2000 from 2.9% in 1999, due to the above-mentioned reasons.

Interest Expense, Net

Interest expense for 2000 totaled \$3.2 million compared to net interest expense of \$2.5 million in 1999.

The interest expense for 2000 reflects higher average revolver borrowings for inventory purchases, caused by significantly improved in-stock positions over 1999 and inventory for the new stores opened throughout the year. Higher interest rates during 2000 were also a factor in the higher expense.

Income Taxes

The effective income tax rate decreased to 34.0% in 2000 from 34.9% in 1999, due to changes made in the Company's organizational structure during the fourth quarter of 1998 and the implementation of a federal program to generate employment related tax credits, which resulted in a reduction in the Company's liability for taxes.

At February 3, 2001, 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 \$43.8 million for state income tax purposes, which expire during the period 2002 through 2022. 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 2000 was \$14.8 million (or \$1.22 per diluted share) or approximately 39% higher than the \$10.7 million (or \$.89 per diluted share) reported in 1999.

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 and upgrade of 25 store locations and 2 pharmacies during 1999, together with the sales of 29 stores and 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 Company's 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,

management's discussion and analysis

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.

management's discussion and analysis

Net Income

Net income for 1999 was \$10.7 million (or \$.89 per diluted share) or approximately 22% higher than the \$8.8 million (or \$.73 per diluted share) reported in 1998.

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 \$110.5 million, \$79.7 million and \$72.8 million at year end 2000, 1999 and 1998, respectively. Working capital fluctuates in relation to profitability, seasonal inventory levels, net of trade accounts payable, and the level of store openings and closings.

On April 3, 2000, the Company and a bank entered into a new Revolving Loan and Credit Agreement to replace the existing \$15 million unsecured revolving credit commitment that has generally been used to finance inventory levels at specified periods. The expanded credit capacity is necessary to accommodate the Company's continued growth and shifting seasonal inventory needs. This \$40 million credit commitment was supplemented with a \$5 million seasonal overline, for a total revolving borrowing capacity of \$45 million. The credit commitment expires on April 3, 2003 and bears interest at 1.5% below prime rate or a LIBOR-based rate (weighted average interest rate of 7.4% on 2000 outstanding borrowings). All other provisions of the new agreement are essentially the same as the prior agreement.

At February 3, 2001, approximately \$22.6 million of inventories were financed with outstanding borrowings under the Company's revolver. The reduction in borrowings from the prior year results from the Company's focus on inventory management and the accelerated payment made in the prior year as explained below.

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.

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 2000, the outstanding principal balance on the term loan was approximately \$8.8 million compared with \$10.3 million at year-end 1999.

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 2000, the outstanding principal balance on the term loan was approximately \$1.3 million compared with \$1.8 million at year-end 1999.

Cash provided by operations was \$27.1 million in 2000 compared to cash used in operations of (\$.8) million in 1999 and cash provided by operations of \$.7 million in 1998. Year-end 2000 inventory levels were better managed to improve turnover and reduce duplicate inventories in several product categories. Also, income taxes payable increased as a result of tax strategies put in place in prior years that had a favorable effect in 2000. 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.

management's discussion and analysis

Capital expenditures in 2000 totaled \$15.8 million compared with \$14.0 million in 1999 and \$21.3 million in 1998. The 2000 capital expenditures included approximately \$12.2 million of expenditures associated with upgraded or new stores and pharmacies. Approximately \$3.6 million in expenditures related to technology upgrades, distribution center equipment, freight equipment, and capital maintenance. The 1999 capital expenditures included approximately \$2.3 million of expenditures associated with replacement of the Company's mainframe computer system, and approximately \$11.7 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, \$4.7 million of expenditures associated with new stores and pharmacies, and \$4.6 million for store and pharmacy upgrades and annual capital maintenance. Cash used for investing activities also includes \$2.8 million in 2000, \$0.8 million in 1999, and \$2.0 million in 1998 for the acquisition of customer lists and other pharmacy related items.

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.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 "Revenue Recognition in Financial Statements" (SAB 101). SAB 101 identifies various revenue recognition issues, several of which are common within the retail industry including treatment of revenue recognition on layaway sales. In the fourth quarter of 2000, the Company revised its revenue recognition for layaway sales to defer revenue recognition until all terms of the sale have been satisfied and the customer takes delivery of the merchandise. Under the prior method of accounting, net sales were recognized at the time the customer put the merchandise into layaway. The effects of this change on prior quarters in 2000 and the proforma effect on 1999 are reflected in Note 12. The effects of this change on the fourth quarter of 2000 was an increase in net sales, gross profit, net income per share (basic and diluted) of \$1,932,000, \$482,000, \$318,000 and \$.02, respectively. Annual financial results were not affected.

Cautionary Statement Regarding Forward-looking Information

Statements, other than those based on historical facts that the Company expects or anticipates may occur in the future 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, changes in reimbursement practices for pharmaceuticals, governmental regulation, 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

(in thousands, except per share amounts)

	For the Years Ended		
	February 3, 2001	January 29, 2000	January 30, 1999
Net sales	\$ 781,249	\$ 665,777	\$ 600,902
Cost of goods sold	566,115	478,138	436,523
Gross profit	215,134	187,639	164,379
Selling, general and administrative expenses	189,414	168,696	149,668
Operating income	25,720	18,943	14,711
Interest expense, net	3,226	2,504	1,106
Income before taxes	22,494	16,439	13,605
Income taxes	7,645	5,737	4,775
Net income	\$ 14,849	\$ 10,702	\$ 8,830
Net income per share			
Basic	\$ 1.24	\$ 0.90	\$ 0.75
Diluted	\$ 1.22	\$ 0.89	\$ 0.73
Weighted average shares outstanding			
Basic	11,937	11,827	11,798
Diluted	12,197	12,072	12,078

See accompanying notes to consolidated financial statements.

consolidated balance sheets

(in thousands, except number of shares)

	February 3, 2001	January 29, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,569	\$ 3,036
Receivables, less allowance for doubtful accounts of \$516 (\$452 at January 29, 2000)	15,430	10,911
Inventories	149,602	141,612
Deferred income taxes	2,022	3,002
Other current assets	2,306	1,865
Total current assets	171,929	160,426
Property and equipment, at depreciated cost	76,360	73,459
Equipment under capital leases, less accumulated amortization of \$1,305 (\$856 at January 29, 2000)	1,387	1,835
Deferred income taxes	98	866
Other noncurrent assets, net	5,021	3,636
Total assets	\$ 254,795	\$ 240,222
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 40,432	\$ 39,653
Current portion of indebtedness	2,175	30,306
Current portion of capital lease obligations	503	430
Accrued liabilities	14,012	9,680
Income taxes payable	4,278	650
Total current liabilities	61,400	80,719
Long-term portion of indebtedness	30,475	10,027
Capital lease obligations	1,230	1,734
Other noncurrent liabilities	2,003	1,829
Total liabilities	95,108	94,309
Commitments and contingencies (Notes 6 and 10)		
Shareholders' equity:		
Common stock, Class A voting, no par value, 12,068,518 shares issued and outstanding (11,988,276 shares at January 29, 2000)	68,557	67,326
Retained earnings	91,342	78,902
Deferred compensation on restricted stock incentive plan	(212)	(315)
Total shareholders' equity	159,687	145,913
	\$ 254,795	\$ 240,222

See accompanying notes to consolidated financial statements.

consolidated statements of changes in stockholders' equity

(in thousands, except share data)

	Common Stock		Retained Earnings	Deferred Compensation	Total
	Shares	Amount			
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
Cash dividends paid (\$.20 per share)			(2,409)		(2,406)
Issuance of restricted stock	3,800	57		(57)	
Cancellation of restricted stock	(29,072)	(218)		15	(203)
Exercises of stock options	105,514	1,079			1,079
Amortization of deferred compensation on restricted stock incentive plan				145	145
Tax benefit on exercise of stock options		313			313
Net income			14,849		14,849
Balance, February 3, 2001	12,068,518	\$ 68,557	\$ 91,342	\$ (212)	\$ 159,690

See accompanying notes to consolidated financial statements.

consolidated statements of cash flows

(in thousands)

	For the Years Ended		
	February 3, 2001	January 29, 2000	January 30, 1999
Cash flows from operating activities:			
Net income	\$ 14,849	\$ 10,702	\$ 8,830
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	14,277	11,830	8,939
Provision for uncollectible receivables	64	80	124
LIFO Reserve	753	100	3,108
Deferred income taxes	1,747	2,513	2,344
Amortization of deferred compensation on restricted stock incentive plan	145	255	248
Issuance (net of cancellation) of restricted stock	(203)	-	390
Tax benefit upon exercise of stock options	313	43	208
Gain on sale of fixed assets	-	(41)	-
(Increase) decrease in assets:			
Receivables	(4,583)	(2,060)	(1,969)
Inventories	(8,743)	(15,135)	(14,664)
Other assets	(444)	(847)	(2,354)
Increase (decrease) in liabilities:			
Accounts payable and accrued liabilities	5,110	(8,210)	(3,712)
Income taxes payable	3,628	(176)	(890)
Other noncurrent liabilities	174	159	175
Net cash (used in) provided by operating activities	27,087	(787)	777
Cash flows from investing activities:			
Capital expenditures	(15,801)	(14,043)	(21,273)
Proceeds from dispositions of property and equipment	493	215	-
Asset acquisition, net of cash acquired (primarily intangibles)	(2,807)	(805)	(1,993)
Net cash used in investing activities	(18,115)	(14,633)	(23,266)
Cash flows from financing activities:			
Reduction of indebtedness and capital lease obligations	(2,495)	(2,139)	(556)
Proceeds from revolving line of credit, net of payments	(5,617)	18,040	10,200
Proceeds from term loan	-	2,249	12,000
Proceeds from exercise of options	1,079	296	329
Payment of cash for dividends and fractional shares	(2,406)	(2,396)	(2,381)
Net cash provided by (used in) financing activities	(9,439)	16,050	19,592
Increase (decrease) in cash and cash equivalents	(467)	630	(2,897)
Cash and cash equivalents:			
Beginning of year	3,036	2,406	5,303
End of year	\$ 2,569	\$ 3,036	\$ 2,406
Supplemental disclosures of cash flow information:			
Interest paid	\$ 3,332	\$ 2,399	\$ 1,239
Income taxes paid	\$ 2,000	\$ 3,810	\$ 2,828
Non cash investing and financing activities:			
Assets acquired through capital lease obligations	\$ -	\$ 612	\$ 509
Common stock issued for acquisition	\$ -	\$ 30	\$ -

See accompanying notes to consolidated financial statements.

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. and subsidiaries (the "Company") is the sale of general merchandise through its 320 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 2000, 1999 and 1998, as used herein, refer to the years ended February 3, 2001, January 29, 2000, and January 30, 1999, 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 19% and 18% of the retail inventories at February 3, 2001 and January 29, 2000, respectively, cost was determined using the LIFO (last-in, first-out) method. The current cost of inventories exceeded the LIFO cost by approximately \$3,961,000 at February 3, 2001 and \$3,208,000 at January 29, 2000.

Property and equipment. Buildings, furniture, fixtures and equipment are stated at cost and depreciation is computed using the straight-line method over their estimated useful lives. 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. Gains or losses on the sale of assets are recorded at disposal.

Long lived assets. The Company's policy is to review the recoverability of all long-lived assets annually and whenever events or changes indicate that the carrying amount of an asset may not be recoverable. Based upon the Company's review as of February 3, 2001 and January 29, 2000, no material adjustments to the carrying value of such assets were necessary.

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 2000, 1999, and 1998 was \$10,166,000, \$8,926,000, and \$9,621,000 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. Net sales includes sales of merchandise from Company owned stores, net of returns and exclusive of sales taxes. Sales to franchised stores are recorded when the merchandise is shipped from the Company's warehouse. Revenues resulting from layaway sales are recorded upon delivery of the merchandise to the customer. In addition, the Company charges the

notes to consolidated financial statements

franchised stores a fee based on a percentage of their purchases from the Company. These fees represent a reimbursement for use of the Fred's name and other administrative costs incurred on behalf of the franchised stores. Total franchise income for 2000, 1999 and 1998 was \$1,809,000, \$1,761,000 and \$1,957,000 respectively.

Other intangible assets. Other identifiable intangible assets which are included in other noncurrent assets primarily represent amounts associated with acquired pharmacies and are being amortized on a straight line basis over five years. These intangibles, net of accumulated amortization, totaled \$4,945,000 at February 3, 2001, and \$3,559,000 at January 29, 2000. Accumulated amortization for 2000 and 1999 totaled \$3,964,000 and \$2,543,000, respectively. Amortization expense for 2000, 1999 and 1998 was \$1,421,000, \$1,307,000 and \$1,214,000 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 \$5,823,000 at February 3, 2001 and \$14,089,000 at January 29, 2000.

Financial instruments. At February 3, 2001, 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's only reportable operating segment is its sale 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. 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 2000 presentation.

Recent accounting pronouncements. In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 "Revenue Recognition in Financial Statements" (SAB 101). SAB 101 identifies various revenue recognition issues, several of which are common within the retail industry including treatment of revenue recognition on layaway sales. In the fourth quarter of 2000, the Company revised its revenue recognition for layaway sales to defer revenue recognition until all terms of the sale have been satisfied and the customer takes delivery of the merchandise. Under the prior method of accounting, net sales were recognized at the time the customer put the merchandise into layaway. The effects of this change on prior quarters in 2000 and the proforma effects on 1999 are reflected in Note 12. The effects of this change on the fourth quarter of 2000 was an increase in net sales, gross profit, net income and net income per share (basic and diluted) of \$1,932,000, \$482,000, \$318,000 and \$.02, respectively. Annual financial results were not affected.

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.

notes to consolidated financial statements

NOTE 2 - PROPERTY AND EQUIPMENT

Property and equipment, at cost, consist of the following (in thousands):

	2000	1999
Buildings and improvements	\$ 67,068	\$ 65,660
Furniture, fixtures and equipment	89,152	81,424
	156,220	147,084
Less accumulated depreciation and amortization	(84,100)	(78,018)
	72,120	69,066
Land	4,240	4,393
	<u>\$ 76,360</u>	<u>\$ 73,459</u>

Depreciation expense totaled \$12,407,000, \$10,168,000 and \$7,442,000 for 2000, 1999 and 1998, respectively.

NOTE 3 - ACCRUED LIABILITIES

The components of accrued liabilities are as follows (in thousands):

	2000	1999
Payroll and benefits	\$ 5,136	\$ 2,992
Sales and use taxes	2,000	1,726
Insurance	2,497	2,904
Other	4,379	2,058
	<u>\$ 14,012</u>	<u>\$ 9,680</u>

NOTE 4 - INDEBTEDNESS

On April 3, 2000, the Company and a bank entered into a new Revolving Loan and Credit Agreement (the "Agreement") to replace the May 15, 1992 Revolving Loan and Credit Agreement, as amended. The Agreement provides the Company with an unsecured revolving line of credit commitment of up to \$40 million 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. 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. The term of the Agreement extends to April 3, 2003. There were \$22,623,000 and \$28,240,000 of borrowings outstanding under the Agreement at February 3, 2001 and January 29, 2000, respectively.

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. Under the most restrictive covenants of the Loan Agreement, the Company is required to maintain specified debt service levels. There were \$1,265,500 and \$1,828,000 borrowings outstanding under the Agreement at February 3, 2001 and January 29, 2000, respectively. The principal maturity under this Agreement for debt outstanding at February 3, 2001 is as follows: \$562,500 in fiscal 2001; \$562,500 in fiscal 2002 and \$140,500 in fiscal 2003.

notes to consolidated financial statements

On May 5, 1998, the Company and a bank entered into a Loan Agreement (the "Term Loan Agreement"). The Term 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 Term Loan Agreement bears interest of 6.82% per annum and matures on November 1, 2005. Under the most restrictive covenants of the Term Loan Agreement, the Company is required to maintain specified shareholders' equity and net income levels. Borrowings outstanding under this Term Loan Agreement totaled \$8,762,000 at February 3, 2001 and \$10,265,000 at January 29, 2000. The principal maturity under this Agreement for debt outstanding at February 3, 2001 is as follows: \$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 in fiscal 2005.

Interest expense for 2000, 1999 and 1998 totaled \$3,226,000, \$2,504,000 and \$1,206,000, respectively.

NOTE 5 - 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 (in thousands):

	2000	1999	1998
Current			
Federal	\$ 5,597	\$ 3,224	\$ 2,639
State	-	-	(208)
	<u>5,597</u>	<u>3,224</u>	<u>2,431</u>
Deferred			
Federal	1,423	2,116	1,974
State	324	397	370
	<u>1,747</u>	<u>2,513</u>	<u>2,344</u>
	<u>\$ 7,344</u>	<u>\$ 5,737</u>	<u>\$ 4,775</u>

notes to consolidated financial statements

Deferred tax assets (liabilities) are comprised of the following (in thousands):

	2000	1999
Current deferred tax assets:		
Inventory valuation methods	\$ 465	\$ 758
Accrual for inventory shrinkage	768	672
Allowance for doubtful accounts	310	285
Insurance accruals	1,200	990
Other	654	749
Gross current deferred tax assets	2,467	3,454
Deferred tax asset valuation allowance	(289)	(182)
	2,178	3,272
Current deferred tax liabilities	(156)	(270)
Net current deferred tax asset	<u>\$ 2,022</u>	<u>\$ 3,002</u>
Noncurrent deferred tax assets:		
Net operating loss carryforwards	\$ 1,685	\$ 1,421
Postretirement benefits other than pensions	760	694
Restructuring costs	82	82
Other	1,769	1,583
Gross noncurrent deferred tax assets	4,296	3,780
Deferred tax asset valuation allowance	(1,267)	(1,239)
	3,029	2,541
Noncurrent deferred tax liabilities:		
Depreciation	(2,904)	(1,648)
Other	(27)	(27)
Gross noncurrent deferred tax liabilities	(2,931)	(1,675)
Net noncurrent deferred tax asset	<u>\$ 98</u>	<u>\$ 866</u>

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 2000 and 1999, the valuation allowance increased \$264,000 and \$393,000, respectively, as the result of the company generating additional net operating loss carryforwards in certain states.

At February 3, 2001, the Company has certain net operating loss carryforwards which were acquired in reorganizations and purchase transactions which are available to reduce income taxes, subject to usage limitations. These carryforwards total approximately \$43,784,000 for state income tax purposes, and expire at various times during the period 2002 through 2022. 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.

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

	2000	1999	1998
Income tax provision at statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	0.9	1.6	0.8
Change in valuation allowance	-	-	0.7
Surtax Exemptions	(1.0)	(1.0)	(1.0)
Other	(0.9)	(0.7)	(0.4)
	<u>34.0%</u>	<u>34.9%</u>	<u>35.1%</u>

notes to consolidated financial statements

NOTE 6 - LONG-TERM LEASES

The Company leases certain of its store locations under noncancelable operating leases expiring at various dates through 2031. 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 \$17,465,000, \$15,329,000 and \$13,618,000 for 2000, 1999 and 1998, respectively. Amortization expense on assets under capital lease for 2000, 1999 and 1998 was \$449,000, \$355,000 and \$283,000, respectively.

Future minimum rental payments under all operating and capital leases as of February 3, 2001 are as follows:

	Operating Leases	Capital Leases
	(in thousands)	
2001	\$ 16,055	\$ 741
2002	14,189	741
2003	11,505	364
2004	8,491	255
2005	6,121	142
Thereafter	11,426	0
Total minimum lease payments	<u>\$ 67,787</u>	<u>\$ 2,243</u>
Imputed interest		<u>(510)</u>
Present value of net minimum lease payments, including \$503 classified as current portion of capital lease obligations		<u>\$ 1,733</u>

NOTE 7 - 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.

NOTE 8 - 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 February 3, 2001 expire in 2001 through 2005.

notes to consolidated financial statements

A summary of activity in the plan follows:

	2000		1999		1998	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	563,454	\$ 13.13	490,139	\$ 13.40	411,298	\$ 8.55
Granted	345,507	15.04	136,750	11.82	150,695	25.61
Canceled	(140,825)	11.02	(26,101)	14.79	(32,523)	12.46
Expired	-		(1,744)	11.33	-	-
Exercised	(105,514)	8.67	(35,590)	8.38	(39,331)	8.42
Outstanding at end of year	<u>662,622</u>	15.29	<u>563,454</u>	13.13	<u>490,139</u>	13.4
Exercisable at end of year	<u>154,065</u>	10.62	<u>169,313</u>	9.1	<u>152,483</u>	9.85

The weighted average remaining contractual life of all outstanding options was 3.2 years at February 3, 2001.

The following table summarizes information about stock options outstanding at February 3, 2001:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at February 3, 2001	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number Exercisable at February 3, 2001	Weighted Average Exercise Price
\$ 5.90 to \$ 7.20	70,634	1	\$ 7.04	69,084	\$ 7.03
\$ 11.50 to \$16.19	483,113	3.8	\$ 14.19	80,881	\$12.94
\$ 20.00 to \$25.88	108,875	2.1	\$ 25.52	4,100	\$25.50
	<u>662,622</u>			<u>154,065</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 2000, 1999, and 1998 consistent with the method prescribed by SFAS No. 123, Accounting for Stock-Based Compensation, the Company's operating results for 2000, 1999, and 1998 would have been reduced to the pro forma amounts indicated below:

	2001	2000	1999
	(in thousands, except per share data)		
Net income			
As reported	\$ 14,849	\$ 10,702	\$ 8,830
Pro forma	14,260	10,363	8,322
Basic earnings per share			
As reported	1.24	0.9	0.75
Pro forma	1.19	0.88	0.71
Diluted earnings per share			
As reported	1.22	0.89	0.73
Pro forma	1.17	0.86	0.69

notes to consolidated financial statements

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 2000, 1999 and 1998, respectively:

	2000	1999	1998
Average expected life (years)	3	3	3
Average expected volatility	39.00%	43.30%	41.50%
Risk-free interest rates	5.60%	4.80%	5.50%
Dividend yield	1.30%	1.50%	1.30%

The weighted average grant-date fair value of options granted during 2000, 1999, and 1998 was \$3.90, \$4.17, and \$7.85 respectively.

Restricted stock. During 2000, 1999, and 1998, the Company issued (cancelled) a net of (25,272), 4,200, and 40,682 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 February 3, 2001, January 29, 2000 and January 30, 1999 were \$100,000, \$96,000 and \$83,000, 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:

	For the Years Ended		
	February 3, 2001	January 29, 2000	January 30, 1999
	(in thousands)		
Benefit obligation at beginning of year	\$ 1,377	\$ 1,252	\$ 1,132
Service cost	132	127	103
Interest cost	116	91	85
Participant contributions	-	-	4
Amendments	-	-	-
Actuarial (gain) loss	68	(17)	(67)
Benefits paid	(76)	(76)	(5)
Benefit obligation at end of year	\$ 1,617	\$ 1,377	\$ 1,252

notes to consolidated financial statements

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

	February 3, 2001	January 29, 2000	January 30, 1999
	(in thousands)		
Funded status	\$ (1,617)	\$ (1,377)	\$ (1,252)
Unrecognized net actuarial gain	(322)	(406)	(405)
Unrecognized prior service cost	(5)	(6)	(6)
Accrued benefit costs	<u>\$ (1,944)</u>	<u>\$ (1,789)</u>	<u>\$ (1,663)</u>

The medical care cost trend used in determining this obligation is 10.0% effective February 1, 1997, decreasing annually before leveling at 6.0% 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 \$238,000. The discount rate used in calculating the obligation was 7.5% in 2000, 7.75% in 1999 and 6.75% in 1998.

The annual net postretirement cost is as follows:

	For the Years Ended		
	February 3, 2001	January 29, 2000	January 30, 1999
	(in thousands)		
Service cost	\$ 132	\$ 127	\$ 103
Interest cost	116	91	85
Amortization of net gain from prior periods	(17)	(17)	(21)
Amortization of unrecognized prior service cost	1	1	1
Net periodic postretirement benefit cost	<u>\$ 232</u>	<u>\$ 202</u>	<u>\$ 168</u>

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

NOTE 9 - 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.

notes to consolidated financial statements

A reconciliation of basic earnings per share to diluted earnings per share follows (in thousands, except per share data):

	Years Ended								
	February 3, 2001			January 29, 2000			January 31, 1999		
	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount
Basic EPS	\$ 14,849	11,937	\$ 1.24	\$ 10,702	11,827	\$ 0.90	\$ 8,830	11,798	\$ 0.75
Effect of Dilutive Securities									
Restricted stock		78			108			79	
Stock options		182			137			201	
Diluted EPS	\$ 14,849	12,197	\$ 1.22	\$ 10,702	12,072	\$ 0.89	\$ 8,830	12,078	\$ 0.73

NOTE 10 - COMMITMENTS AND CONTINGENCIES

Commitments. At February 3, 2001, the Company had commitments approximating \$5,082,000 on issued letters of credit which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating \$2,552,000 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 11 - 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 at February 3, 2001 represents remaining future base payments required on one location that has been closed.

The 2000 activity in this reserve is as follows:

	January 30, 1999	January 29, 2000	Payments	February 3, 2001
			(in thousands)	
Lease obligations	\$ 400	\$ 215	\$ (129)	\$ 86

notes to consolidated financial statements

NOTE 12 – QUARTERLY FINANCIAL DATA (UNAUDITED)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands, except per share data)			
Year Ended February 3, 2001 - restated ^{(1) (2)}				
Net sales	\$ 176,132	\$ 180,353	\$ 180,141	\$ 244,623
Gross profit	48,990	49,060	51,850	65,234
Net income	3,345	1,654	3,829	6,021
Net income per share				
Basic	0.28	0.14	0.32	0.5
Diluted	0.28	0.14	0.31	0.49
Cash dividends paid per share	0.05	0.05	0.05	0.05
Year Ended January 29, 2000 - pro forma ⁽³⁾				
Net sales	\$ 154,226	\$ 155,792	\$ 156,741	\$ 199,018
Gross profit	44,135	43,775	46,780	52,949
Net income	2,766	920	2,677	4,339
Net income per share				
Basic	0.23	0.08	0.22	0.37
Diluted	0.23	0.08	0.22	0.36
Cash dividends paid per share	0.05	0.05	0.05	0.05
Year Ended January 29, 2000 - as reported				
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

⁽¹⁾ Based upon a 53 week year.

⁽²⁾ As discussed in "Recent Accounting Pronouncements" in Note 1, the above information has been restated to reflect the impact of the Company implementing the interpretations in SAB 101 related to layaway sales during the fourth quarter of 2000. In the quarters in the year ended February 3, 2001, the effects of this restated on previously reported net sales, gross profit, net income and net income per share (basic & diluted) was a decrease of \$528,000, \$132,000, \$87,000 and \$.01, respectively, for the 1st quarter; a decrease of \$453,000, \$111,000, \$73,000 and \$.00, respectively, for the 2nd quarter; and a decrease of \$951,000, \$239,000, \$158,000 and \$.01, respectively, for the 3rd quarter.

⁽³⁾ For informational purposes only, 1999 quarterly results have been restated on proforma basis as if the effects of SAB 101 on layaway sales had been applied to the 1999 quarterly reports.

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 February 3, 2001 and January 29, 2000, and the results of their operations and their cash flows for each of the three years in the period ended February 3, 2001, in conformity with accounting principles generally accepted in the United States of America. 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 auditing standards generally accepted in the United States of America, 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 our opinion expressed above.

The image shows a handwritten signature in cursive script that reads "PricewaterhouseCoopers LLP". The signature is written in black ink and is positioned above the date.

April 4, 2001

directors and officers

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 of 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)

John D. Reier
President
Fred's Inc.

Thomas J. Tashjian
Private Investor

Executive Officers

Michael J. Hayes
Chief Executive Officer

David A. Gardner
Managing Director

John D. Reier
President

John A. Casey
Executive Vice President – Pharmacy Operations

Jerry A. Shore
Executive Vice President and Chief Financial Officer

Charles A. Brunjes
Senior Vice President of Store Operations

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

Securities Counsel

Baker, Donelson, Bearman & Caldwell
Memphis, Tennessee

Annual Report on Form 10-K

A copy of the Company's Annual Report on Form 10-K for the year ended February 3, 2001, 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 2001 annual meeting of shareholders will be held at 10:00 a.m. local time on Wednesday, June 6, 2001, at the Memphis Marriott Hotel, 2625 Thousand Oaks Boulevard, Memphis, Tennessee. Shareholders of record as of April 20, 2001, 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 20, 2001, the Company had an estimated 5,400 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
1999			
First	\$ 15.00	\$ 9.75	\$ 0.05
Second	\$ 17.63	\$ 10.31	\$ 0.05
Third	\$ 18.00	\$ 10.69	\$ 0.05
Fourth	\$ 17.63	\$ 11.50	\$ 0.05
2000			
First	\$ 16.00	\$ 14.13	\$ 0.05
Second	\$ 21.06	\$ 15.00	\$ 0.05
Third	\$ 25.00	\$ 18.75	\$ 0.05
Fourth	\$ 23.69	\$ 17.13	\$ 0.05

SIC 5331



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Memphis, Tennessee 38118