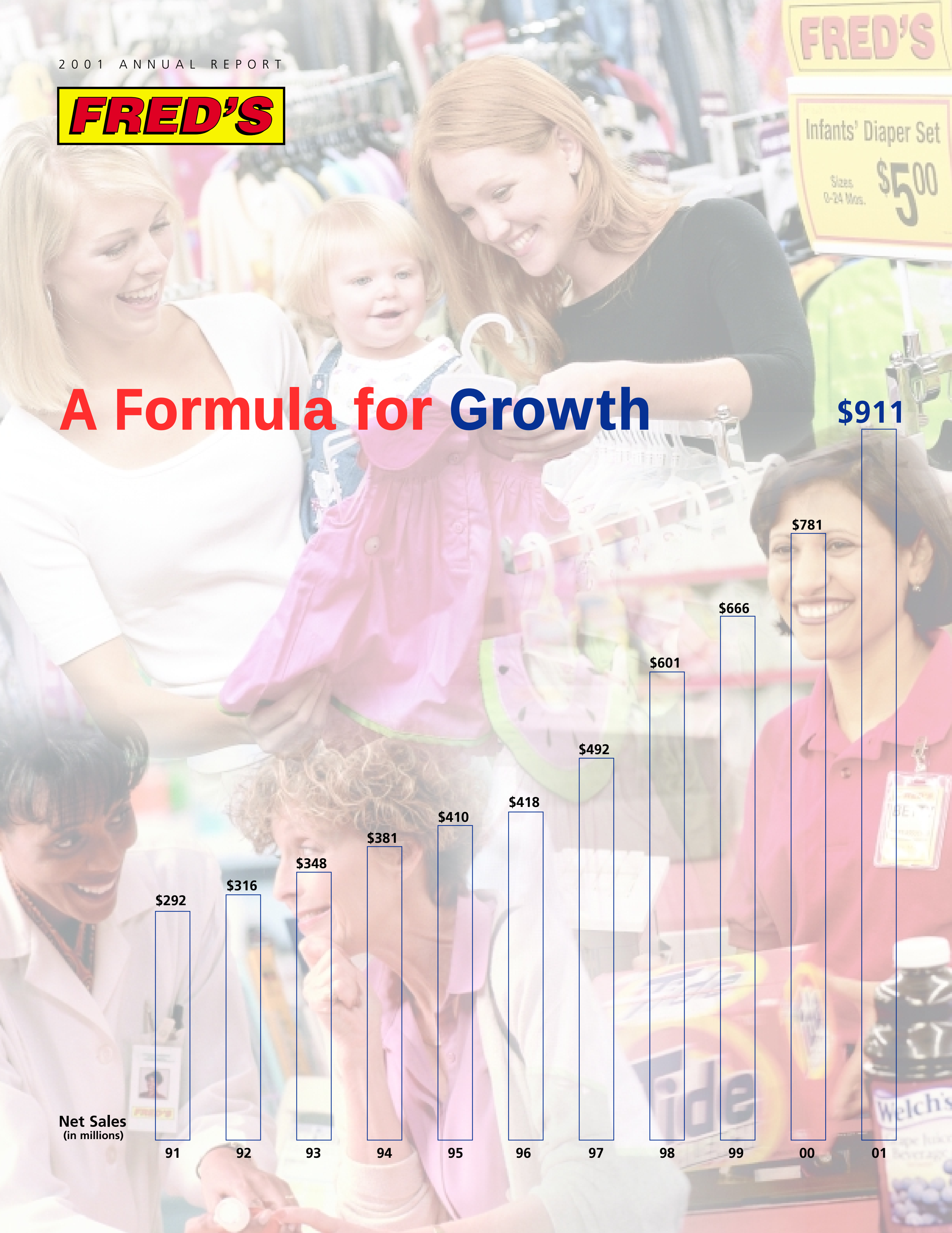
2001 ANNUAL REPORT

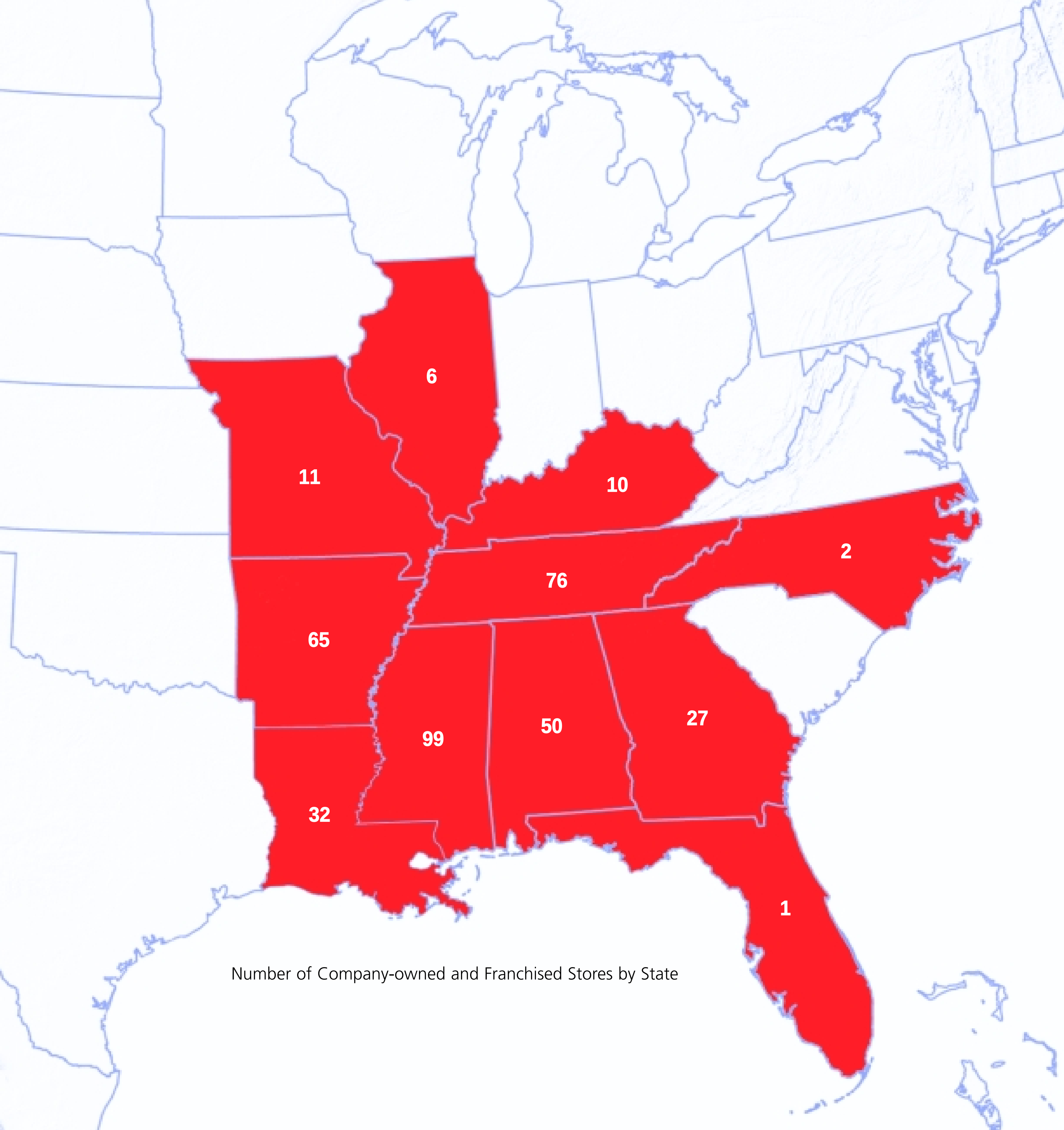
FRED'S

A Formula for Growth



About the Company

Fred's, Inc., founded in 1947, operates 353 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

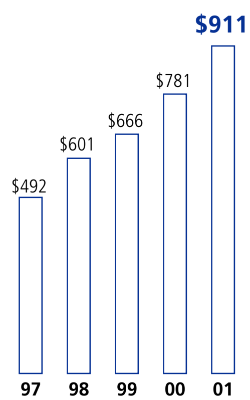
Financial Highlights

(in thousands, except per share amounts)

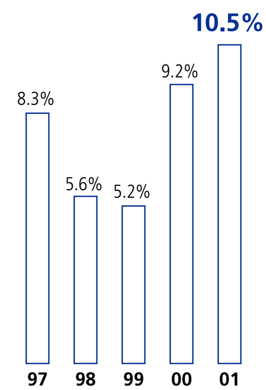
	52 Weeks Ended February 2, 2002	53 Weeks Ended February 3, 2001
Operating Data		
Net sales	$ 910,831	$ 781,249
Operating income	31,751	25,720
Net income	19,629	14,849
Net income per share - diluted *	.81	.65
Weighted average shares outstanding - diluted *	24,197	22,869
Balance Sheet Data		
Working capital	$ 138,379	$ 110,529
Total assets	284,059	254,795
Long-term debt (including capital leases)	1,320	31,705
Shareholders' equity	218,907	159,687
Long-term debt to equity	0.6%	19.9%

* Adjusted for the 5-for-4 stock split effected on June 18, 2001 and the 3-for-2 stock split effected on February 1, 2002.

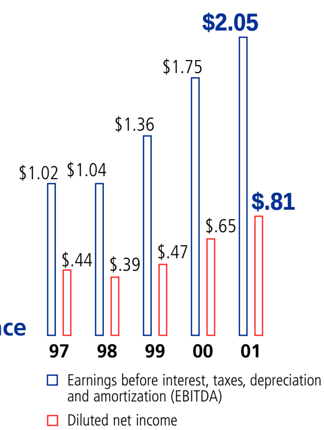
Net Sales
(in millions)



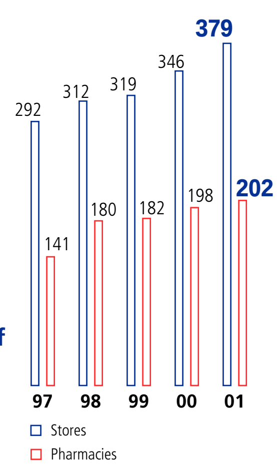
Comparable Store Sales



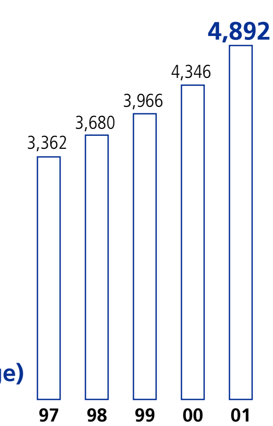
Per Share Performance



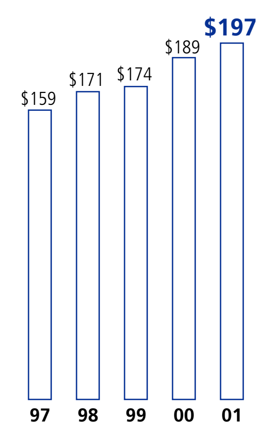
Number of Stores
(end of period)



Selling Space (Square Footage)
(in thousands)



Sales Per Square Foot



Pharmacy = Growth

Our pharmacy department is one of the important differentiating features for Fred's and is a key element of our growth strategy. Today, we have more than 200 pharmacies across our markets, and we expect that this part of our business will continue to expand as we add new stores.

To Our Shareholders

When we were reviewing this year's final numbers for public release, we realized it was almost 10 years to the day that the Company completed its initial public offering. At this juncture, we thought it might be appropriate to make a few comparisons. The first thing to stand out, of course, was sales. To put it into perspective, sales for all of 1991 were just slightly greater than those for the fourth quarter of 2001. Next, as you might suspect, was store count. Fred's was a 45-year-old company in 1992, with fewer than 200 stores. Should all go as planned, we will open 210 stores between 2001 and 2004. Remarkable! The most significant comparison, however, was how well our defined goals and objectives have served the Company and its shareholders – then and still today. How have our shareholders fared? Well, a 100-share purchase during the IPO would equal 234 shares today as a result of the stock splits and would be worth more than six times the original IPO price.

As We Began

When we made the decision to seek public capital to fulfill the promise we envisioned for Fred's, we identified five goals to improve Fred's profitability and lay the groundwork for long-term success. These goals involved growing market share, enhancing incentives for store managers and pharmacists to focus on profits, reducing employee turnover, rightsizing our corporate overhead, and growing our pharmacy business. Now, with the passing of the 10-year milestone, these goals – and the results we have achieved in working toward them – provide a useful and instructive context for measuring and assessing our progress.

By its nature, the word 'goal' expresses a desire or need to improve, and as we ended fiscal 1991 – and looked forward to our public offering that was just months away – we knew that Fred's could be better. In the five years immediately preceding our IPO, sales had virtually stagnated. Profits in those years were volatile (my euphemism for significant operating losses in some years), and the Company languished under a heavy debt load.

As you can see, the goals we set to improve profitability were important. Taken together, they focused on the basics – the customer and the employee. They showed our resolve and recognition of the fact that our customers are king, and everything we do in our stores should be geared toward making their shopping experience easier and friendlier at Fred's. Our goals signified the importance of having the proper incentives for our entire management team – from pharmacists and store managers to buyers and Company officers – that would ensure we all shared a singular focus on profits and cost control. These goals underscored the importance of human resources so our employees would see good reason to stay on board and grow with our Company. Considering Fred's improving record over the past decade, we think it is fair to say that these goals have kept the Company in good stead.

Fast Forward to Today

We know that a company cannot rest on its history, but we'd like to believe that a company's record of performance and its growth over an extended period of time, through up and down cycles, are important criteria for investors. We recognize that markets only judge from a company's history the ability to execute its future plans and, from that, will place a value on that company. It is with this understanding that we look back on 2001 with pride, knowing that the year will be remembered not only for the records set in virtually all areas of our business, but also for the way in which they were set. For Fred's, fiscal 2001 served as a sound exclamation point on a great 10-year performance and the springboard for the future.

In 2001, net income rose 32% to $19.6 million from $14.8 million in 2000, reflecting our continued success in leveraging our selling, general and administrative expenses over a larger sales base, as well as reduced interest expense. On a diluted-per-share basis, and adjusted for a five-for-four stock split in June 2001 and a three-for-two stock split in February 2002, earnings increased 25% to $0.81 from $0.65 in 2000.

Net sales for the year increased 17% to a record $911 million versus $781 million in 2000, but like a year ago, year-to-year results are not readily comparable because of a difference in the number of weeks included in the periods. Fiscal 2001 was a 52-week period versus 53 weeks in fiscal 2000. Adjusting for the extra week last year, net sales for 2001 increased 19% compared with $768 million for the pro forma 52-week period last year. Comparable store sales for 2001 increased 10.5% over the pro forma fiscal 2000 period.

Underlying our improved sales performance for the year were ongoing gains in key sales metrics. Our transaction volume increased 5.7% while the average ticket rose 4.8%. Sales per square foot increased 4% to $197.

During 2001, we also continued to strengthen our balance sheet. Following the events of September 11, we were the first company in the retail sector to complete a public stock offering. This secondary offering of 1,585,000 Company shares at $25.50 per share raised approximately $38 million in net proceeds for the Company, which were used to repay most of Fred's long-term debt. Consequently, we ended 2001 virtually debt-free compared with last year when long-term debt totaled about $32 million, or approximately 17% of our total capitalization. Elsewhere on the balance sheet, we continued to see sound inventory management, with turnover increasing to 4.1 times versus 3.9 times last year.

Performance Drivers

As we look ahead to the next few years, we can point to many of our current strategies that will continue to drive sales and profits higher. The central change, which has had such a profound effect on our comparable store sales growth recently, is merchandising. This is really a two-pronged strategy. First, maintaining a theme from the past few years, we will strive to make our stores more shopper-friendly through more effective displays, better organization of merchandise, and a brighter environment. We also continue to fine-tune our prototype store format, which is a centerpiece of our shopper-friendly focus. Second, we have kept a sharp eye on merchandise categories that appeal to our growing customer base. In 2001, we had great success with home furnishings – especially clocks and lamps – as well as other housewares and apparel. In sum, you might say merchandising is the heart and soul of our retailing strategy at Fred's.

Our strategy also relies on continuing to build our pharmacy department as one of the important differentiating features for Fred's. Our pharmacy department accounted for over 34% of sales in 2001 – up from 33% in 2000 and, together with our concentration on the items customers need everyday, it's the core of our plan to make Fred's a quick and convenient stop for our customers. Our pharmacy departments place us in a favorable position relative to many other dollar-store competitors, and our ability to offer pharmacy products and services, together with an extensive line of apparel and other merchandise in volume, gives us an advantage with many customers. During 2001, we expanded our pharmacy department in step with our store growth, increasing its breadth to 202 pharmacies by the end of 2001, giving us one of the more sizable pharmacy operations in our market region.

The expansion of our store base remains the fundamental part of our

Merchandising = Growth

The results of our merchandising initiatives were reflected in our sales growth for the year, our higher sales per square foot of selling space, and our increasing transactions and average purchase amounts.

We have spent considerable time and effort in building our management team, getting the right people in the right positions, and giving them the proper incentives to deliver improved results on both the top line and the bottom line.

Focus = Growth

long-range growth plans. During 2001, we increased our chain to 353 company stores, up from 320 in 2000, which pushed our total retail selling space 13% higher to approximately 4.9 million square feet. Most of the new stores for 2001 contained pharmacies – which is always our preference when site, lease and market considerations permit – and they were increasingly developed with a view toward our successful prototype format. Next year, we will accelerate our store growth by opening approximately 60 new Fred's stores, increasing our retail sales space by 15% to 18%. We expect this expansion will be aided by the general economic slowdown that has occurred over the past year, which has placed pressure on many retail concepts and forced others into reorganization.

To help support this growth and augment the capacity provided by our Memphis distribution center, we recently announced our plans to construct a new multi-million-dollar, 600,000-square-foot distribution center in Dublin, Georgia. The new distribution center will provide us with the capacity to increase our chain to 750 stores over the next few years and, because of its location, is positioned to serve Fred's growing presence in Alabama, Georgia, northern Florida, North Carolina, and South Carolina, as well as its expected growth into other markets in the future. The new center should open during the first quarter of 2003.

The Future

As exciting as the past 10 years have been, and as gratifying as our growth and financial progress have been, we think the best years for Fred's are still ahead. Our plans to accelerate growth will lead to the opening of up to 60 new stores in 2002, then 70 in 2003, followed by 80 more in 2004. That represents an increase in our chain of more than 50% over the next three years. Couple that with our planned annual average growth in comparable store sales of between 6% and 8%, and underpin those aspirations with expanded, highly automated distribution capabilities, and you can quickly seize the scale of our abiding dreams for Fred's. It's easy to see that the next stop for this train will be the billion-dollar mark for sales in 2002, but we think our final destination is well beyond that.

Higher sales, of course, would be a hollow victory for us if we were not able to manage that growth and convert it into greater profitability for our shareholders. Consequently, we have spent considerable time and effort in building our management team, getting the right people in the right positions, and giving them the proper incentives to bring those results from the top line to the bottom line. With this increased focus on quality management – and managing for quality – we think it's important to target ongoing gains in our operating margins over the next three years as we strive to raise them steadily through increased expense leverage.

Put these drivers together – solid top line growth and improving operating profitability – and you can understand why we think the best is yet to come. We hope you enjoy the ride.

In closing, let me say that the excitement felt throughout our organization in 2001 was tempered somewhat for me by the loss in December of David Gardner, our managing director and my friend and partner for 30 years. David succumbed to muscular dystrophy after a hard-fought battle. He was an extraordinary person who brought sun into every room he entered. We will sorely miss his astute observation of what was and his unswayable faith in what might be. We know how much he would have loved to be here when we break through the billion-dollar mark. The Company and I will miss him dearly.

Michael J. Hayes

Michael J. Hayes
Chief Executive Officer

Selected Financial Data

(dollars in thousands, except per share amounts)

	2001	2000[1]	1999	1998[2]	1997
Statement of Income Data:					
Net sales	$ 910,831	$ 781,249	$ 665,777	$ 600,902	$ 492,236
Operating income	31,751	25,720	18,943	14,711	15,511
Income before income taxes	30,140	22,494	16,439	13,605	15,660
Provision for income taxes	10,511	7,645	5,737	4,775	5,873
Net income	19,629	14,849	10,702	8,830	9,787
Net income per share:[3]					
Basic	.83	.66	.48	.40	.45
Diluted	.81	.65	.47	.39	.44
Selected Operating Data:					
Operating income as a percentage of sales	3.5%	3.3%	2.9%	2.4%	3.2%
Increase in comparable store sales [4]	10.5%	9.2%[5]	5.2%	5.6%	8.3%
Stores open at end of period	353	320	293	283	261
Balance Sheet Data (at period end):					
Total assets	$ 284,059	$ 254,795	$ 240,222	$ 220,757	$ 195,407
Short-term debt (including capital leases)	1,240	2,678	30,736	11,914	214
Long-term debt (including capital leases)	1,320	31,705	11,761	11,821	1,368
Shareholders' equity	218,907	159,687	145,913	136,983	129,359

1 Results for 2000 include 53 weeks.

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

3 Adjusted for the 5-for-4 stock split effected on June 18, 2001 and the 3-for-2 stock split effected on February 1, 2002.

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

Significant Accounting Policies

The preparation of Fred's financial statements requires management to make estimates and judgments in the reporting of assets, liabilities, revenues, expenses and related disclosures of contingent assets and liabilities. Our estimates are based on historical experience and on other assumptions that we believe applicable under the circumstances, the results of which form the basis for making judgments about the values of assets and liabilities that are not readily apparent from other sources. While we believe that the historical experience and other factors considered provide a meaningful basis for the accounting policies applied in the consolidated financial statements, the Company cannot guarantee that the estimates and assumptions will be accurate under different conditions and/or assumptions. A summary of our critical accounting policies and related estimates and judgments, can be found in Note 1 to the consolidated financial statements.

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 sales.

	2001	2000	1999
Net sales	100.0%	100.0%	100.0%
Cost of goods sold	72.6	72.5	71.8
Gross profit	27.4	27.5	28.2
Selling, general and administrative expenses	23.9	24.2	25.3
Operating income	3.5	3.3	2.9
Interest expense, net	0.2	0.4	0.4
Income before taxes	3.3	2.9	2.5
Income taxes	1.1	1.0	0.9
Net income	2.2%	1.9%	1.6%

Fiscal 2001 Compared to Fiscal 2000

Sales

Net sales increased 16.6% ($129.6 million) in 2001. Approximately $54.0 million of the increase was attributable to the addition of 33 new or upgraded stores, and 7 pharmacies during 2001, together with the sales of 31 store locations and 16 pharmacies that were opened or upgraded during 2000 and contributed a full year of sales in 2001. During 2001, the Company closed 3 pharmacy locations. Comparable store sales, consisting of sales from stores that have been open for more than one year, increased 10.5% in 2001.

The Company's front store (non-pharmacy) sales increased approximately 15.5% over 2000 front store sales. Front store sales growth benefited from the above mentioned store additions and improvements, and solid sales increases in categories such as home furnishings, floor coverings, bath, giftware, small appliances, photo finishing, girl's apparel, missy ready-to-wear, infants and toddler apparel, beverages, food and snacks.

Fred's pharmacy sales grew to 34.4% of total sales in 2001 from 33% of total sales in 2000 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 21.2% over 2000, with third party prescription sales representing approximately 85% of total pharmacy sales, compared with 83% of total pharmacy sales in 2000. 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.

Management's Discussion and Analysis

Sales to Fred's 26 franchised locations decreased approximately $.8 million in 2001 and represented 3.7% of the Company's total sales, as compared to 4.0% in 2000. 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 27.4% in 2001 compared to 27.5% in 2000. The decrease in gross margin is a result of margin reduction in the pharmacy department partially offset by margin improvements in general merchandise departments.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were 23.9% of net sales in 2001 compared with 24.2% of net sales in 2000. Labor expenses improved in the stores and pharmacies as a result of the strong sales coupled with store productivity initiatives. Distribution center labor expense also improved as a percentage of volume processed. Corporate communications expense improved as a result of installing new technology that reduced expenses.

Operating Income

Operating income increased approximately $6.0 million or 23.5% to $31.8 million in 2001 from $25.7 million in 2000. Operating income as a percentage of sales increased to 3.5% in 2001 from 3.3% in 2000, due to the above-mentioned reasons.

Interest Expense, Net

Interest expense for 2001 totaled $1.6 million or .2% of sales compared to net interest expense of $3.2 million or .4% of sales in 2000. The significant reduction results from the funds raised from our public offering of 1,585,000 company shares in September 2001(unadjusted for 3-for-2 stock split completed February 1, 2002), lower interest rates, and improved inventory turnover and expense control.

Income Taxes

The effective income tax rate increased to 34.9% in 2001 from 34.0% in 2000, due to increased income levels which eliminated the benefit of graduated tax rates.

At February 2, 2002, 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 $43.9 million for state income tax purposes, and expire at various times during the period 2003 through 2023. 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 2001 was $19.6 million (or $ .81 per diluted share) or approximately 32.2% higher than the $14.8 million (or $.65 per diluted share) reported in 2000.

Management's Discussion and Analysis

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.

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.

Management's Discussion and Analysis

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 $.65 per diluted share) or approximately 39% higher than the $10.7 million (or $.47 per diluted share) reported in 1999.

Liquidity and Capital Resources

Fred's primary sources of working capital have traditionally been cash flow from operations and borrowings under its credit facility. In October 2001 the Company raised proceeds of $38.2 million from a secondary offering of 1,585,000 Company shares (unadjusted for 3-for-2 stock split completed on February 1, 2002). The Company had working capital of $138.4 million, $110.5 million, and $79.7 million at year-end 2001, 2000 and 1999, respectively. Working capital fluctuates in relation to profitability, seasonal inventory levels, net of trade accounts payable, and the level of store openings and closings.

Cash and cash equivalents were $15.9 million at year-end 2001, $2.6 million at year-end 2000, and $3.0 million at year-end 1999. Short-term investment objectives are to maximize yields while minimizing company risk and maintaining liquidity. Accordingly, limitations are placed on amounts and types of investments.

Net cash flow provided by operating activities totaled $26.4 million in 2001 compared to $27.1 million in 2000 and cash used in operations of $.8 million in 1999.

In fiscal 2001, cash was primarily used to increase inventories by approximately $14.3 million during the fiscal year. This increase is primarily attributable to our adding 33 new stores, upgrading six stores and adding a net of 4 new pharmacies, as well as supporting the improved comparable store sales. Accounts payable and accrued liabilities increased by $3.5 million due primarily to higher inventory purchases. Income taxes payable decreased by approximately $2.4 million as a result of required income tax payments.

Year-end 2000 cash was primarily used to increase inventories by approximately $ 8.7 million during the fiscal year. Also, accounts receivable increased $4.6 million due to increased pharmacy sales involving third party carriers. Accounts payable and accrued liabilities increased by $5.1 million due primarily to higher inventory purchases. 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 store and pharmacy growth. Accounts payable were impacted by the accelerated repayment of $7.5 million.

Management's Discussion and Analysis

Capital expenditures in 2001 totaled $17.4 million compared with $15.8 million in 2000 and $14.0 million in 1999. The 2001 capital expenditures included approximately $13.5 million of expenditures associated with upgraded, remodeled, or new stores and pharmacies. Approximately $3.8 million in expenditures related to technology upgrades, distribution center equipment, freight equipment, and capital maintenance. The 2000 capital expenditures included approximately $12.2 million of expenditures associated with upgraded, remodeled, 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 $11.7 million of expenditures associated with upgraded, remodeled, or new stores and pharmacies. Approximately $2.3 million in expenditures related to technology upgrades, distribution center equipment, freight equipment, and capital maintenance. Cash used for investing activities also includes $1.0 million in 2001, $2.8 million in 2000, and $.8 million in 1999 for the acquisition of customer lists and other pharmacy related items.

In April, 2000, the Company and a bank entered into a new Revolving Loan and Credit Agreement. 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 (weighted average interest rate of 5.2% on 2001 outstanding borrowings). The credit capacity is used to accommodate the Company's continued growth and seasonal inventory needs. Under the most restrictive covenants of the Agreement, we are required to maintain specific shareholders' equity and net income levels. We are 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 credit commitment extends to April 3, 2003. There were no borrowings outstanding under this agreement at February 2, 2002 and $22.6 million outstanding borrowings at February 3, 2001. The reduction in borrowings from the prior year results from cash flow from current operations, continued focus on asset management, and from the proceeds of the secondary public offering completed during the fiscal year.

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 2001, the outstanding principal balance on the term loan was approximately $ .7 million compared with $1.3 million at year-end 2000.

In May, 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 bore interest of 6.82% per annum and would have matured on November 1, 2005. The Company used the proceeds of the public offering to pay off the Agreement and the borrowings outstanding under the Agreement at February 3, 2001 totaled $8.8 million.

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.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet financing arrangements.

Contractual Obligations and Commercial Commitments

As discussed in Note 6 of consolidated financial statements, 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. The future minimum rental payments under all operating and capital leases as of February 2, 2002 are $87.7 million and $2.4 million, respectively.

Management's Discussion and Analysis

As discussed in Note 10 of the consolidated financial statements, the Company had commitments approximating $9.1 million at February 2, 2002 on issued letters of credit which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating $6.8 million at February 2, 2002 utilized as collateral for their risk management programs.

Recent Accounting Pronouncements

In June 2001, the FASB issued SFAS No. 141, Business Combinations. SFAS No. 141 supercedes Accounting Principles Board Opinion ("APB") No. 16, Business Combinations, and SFAS No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 and for all business combinations accounted for by the purchase method for which the date of acquisition is after June 30, 2001. The Company does not expect the adoption of SFAS No. 141 to have a material impact on its financial statements.

In June 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 supercedes APB No. 17, Intangible Assets, and its provisions are effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires that: 1) goodwill and indefinite lived intangible assets will no longer be amortized; 2) goodwill will be tested for impairment at least annually at the reporting unit level (reporting unit levels to be determined upon adoption); 3) intangible assets deemed to have an indefinite life will be tested for impairment at least annually; and 4) the amortization period of intangible assets with finite lives will no longer be limited to forty years. As of February 2, 2002, the Company has intangible assets, net of accumulated amortization, of $4.8 million and has recognized amortization expense of approximately $1.8 million during the year February 2, 2002. The Company will continue to amortize intangible assets in accordance with its existing policy and accordingly does not anticipate a material impact on adoption of SFAS No. 142.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, effective for years beginning after December 15, 2001. This Statement supercedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets to Be Disposed of, but retains the fundamental provision of SFAS 121 for recognition and measurement of the impairment of long-lived assets to be held and used and measurement of long-lived assets to be held for sale. The statement requires that whenever events or changes in circumstances indicate that a long-lived asset's carrying value may not be recoverable, the asset should be tested for recoverability. The statement also requires that a long-lived asset classified as held for sale should be carried at the lower of its carrying value or fair value, less cost to sell. The Company is evaluating the potential impact the provisions of SFAS 144 could have on it's financial statements but does not believe there will be a material effect on the financial statements upon adoption.

Management's Discussion and Analysis

Cautionary Statement Regarding Forward-looking Information

Statements, other than those based on historical facts that the Company expect or anticipate 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. Our ability to achieve such results is subject to certain risks and uncertainties, including:

- Economic and weather conditions which affect buying patterns of our customers;
- Changes in consumer spending and our ability to anticipate buying patterns and implement appropriate inventory strategies;
- Continued availability of capital and financing;
- Competitive factors;
- Changes in reimbursement practices for pharmaceuticals;
- Governmental regulation; and
- Other factors affecting business beyond our control.

Consequently, all of the forward-looking statements are qualified by this cautionary statement and there can be no assurance that the results or developments anticipated by us will be realized or that they will have the expected effects on our business or operations. Actual results, performance or achievements can differ materially from results suggested by this forward-looking statement because of a variety of factors. We undertake no obligation to update any forward-looking statement to reflect events or circumstances arising after the date on which it was made.

Consolidated Statements of Income

(in thousands, except share and per share amounts)

	For the Years Ended		
	February 2, 2002	February 3, 2001	January 29, 2000
Net sales	$ 910,831	$ 781,249	$ 665,777
Cost of goods sold	661,110	566,115	478,138
Gross profit	249,721	215,134	187,639
Selling, general and administrative expenses	217,970	189,414	168,696
Operating income	31,751	25,720	18,943
Interest expense, net	1,611	3,226	2,504
Income before taxes	30,140	22,494	16,439
Income taxes	10,511	7,645	5,737
Net income	$ 19,629	$ 14,849	$ 10,702
Net income per share			
Basic	$ .83	$ .66	$ .48
Diluted	$ .81	$ .65	$ .47
Weighted average shares outstanding			
Basic	23,553	22,382	22,176
Diluted	24,197	22,869	22,635

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

(in thousands, except for number of shares)

	February 2, 2002	February 3, 2001
Assets		
Current assets:		
Cash and cash equivalents	$ 15,906	$ 2,569
Receivables, less allowance for doubtful accounts of $657 ($516 at February 3, 2001)	15,705	15,430
Inventories	163,560	149,602
Deferred income taxes	1,790	2,022
Other current assets	2,499	2,306
Total current assets	199,460	171,929
Property and equipment, at depreciated cost	78,225	76,360
Equipment under capital leases, less accumulated amortization of $1,849 ($1,305 at February 3, 2001)	1,533	1,387
Deferred income taxes	–	98
Other noncurrent assets, net	4,841	5,021
Total assets	$ 284,059	$ 254,795
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 43,747	$ 40,432
Current portion of indebtedness	562	2,175
Current portion of capital lease obligations	678	503
Accrued liabilities	14,228	14,012
Income taxes payable	1,866	4,278
Total current liabilities	61,081	61,400
Long-term portion of indebtedness	141	30,475
Deferred tax liability	696	–
Capital lease obligations	1,179	1,230
Other noncurrent liabilities	2,055	2,003
Total liabilities	65,152	95,108
Commitments and contingencies (Notes 6 and 10)		
Shareholders' equity:		
Common stock, Class A voting, no par value, 25,361,112 shares issued and outstanding (22,628,471 shares at February 3, 2001)	110,508	68,557
Retained earnings	108,462	91,342
Deferred compensation on restricted stock incentive plan	(63)	(212)
Total shareholders' equity	218,907	159,687
Total liabilities and shareholders' equity	$ 284,059	$ 254,795

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity

(in thousands, except share data)

	Common Stock		Retained	Deferred	
	Shares	Amount	Earnings	Compensation	Total
Balance, January 30, 1999	11,946,772	$ 66,951	$ 70,596	$ (564)	$ 136,983
Stock split - (Note 7)	2,986,693				
Stock split - (Note 7)	7,466,732				
Cash dividends paid ($.11 per share)			(2,396)		(2,396)
Issuance of restricted stock	18,562	124		(124)	
Cancellation of restricted stock	(10,687)	(118)		118	
Other issuances	3,213	30			30
Exercises of stock options	66,732	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	22,478,017	$ 67,326	$ 78,902	$ (315)	$ 145,913
Cash dividends paid ($.11 per share)			(2,409)		(2,409)
Issuance of restricted stock	7,125	57		(57)	-
Cancellation of restricted stock	(54,510)	(218)		15	(203)
Exercises of stock options	197,839	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	22,628,471	$ 68,557	$ 91,342	$ (212)	$ 159,687
Proceeds from public offering	2,377,500	38,156			38,156
Cash dividends paid ($.12 per share)			(2,509)		(2,509)
Cancellation of restricted stock	(15,185)	(63)		12	(51)
Other issuances	55,980	937			937
Exercises of stock options	314,346	2,165			2,165
Amortization of deferred compensation on restricted stock incentive plan				137	137
Tax benefit on exercise of stock options		756			756
Net income			19,629		19,629
Balance, February 2, 2002	25,361,112	$110,508	$ 108,462	$ (63)	$ 218,907

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(in thousands)

	For the Years Ended		
	February 2, 2002	February 3, 2001	January 29, 2000
Cash flows from operating activities:			
Net income	$ 19,629	$ 14,849	$ 10,702
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	17,846	14,277	11,830
Provision for uncollectible receivables	142	64	80
LIFO Reserve	642	753	100
Deferred income taxes	1,026	1,747	2,513
Amortization of deferred compensation on restricted stock incentive plan	137	145	255
Issuance (net of cancellation) of restricted stock	(52)	(203)	–
Tax benefit upon exercise of stock options	756	313	43
Gain on sale of fixed assets	–	–	(41)
(Increase) decrease in assets:			
Receivables	(416)	(4,583)	(2,060)
Inventories	(14,291)	(8,743)	(15,135)
Other assets	(194)	(444)	(847)
Increase (decrease) in liabilities:			
Accounts payable and accrued liabilities	3,532	5,110	(8,210)
Income taxes payable	(2,411)	3,628	(176)
Other noncurrent liabilities	52	174	159
Net cash provided by (used in) operating activities	26,398	27,087	(787)
Cash flows from investing activities:			
Capital expenditures	(17,372)	(15,801)	(14,043)
Proceeds from dispositions of property and equipment	–	493	215
Asset acquisition, net of cash acquired (primarily intangibles)	(986)	(2,807)	(805)
Net cash used in investing activities	(18,358)	(18,115)	(14,633)
Cash flows from financing activities:			
Reduction of indebtedness and capital lease obligations	(9,892)	(2,495)	(2,139)
Proceeds from revolving line of credit, net of payments	(22,623)	(5,617)	18,040
Proceeds from term loan	–	–	2,249
Proceeds from public offering, net of expenses	38,156		
Proceeds from exercise of options	2,165	1,079	296
Payment of cash for dividends and fractional shares	(2,509)	(2,406)	(2,396)
Net cash provided by (used in) financing activities	5,297	(9,439)	16,050
Increase (decrease) in cash and cash equivalents	13,337	(467)	630
Cash and cash equivalents:			
Beginning of year	2,569	3,036	2,406
End of year	$ 15,906	$ 2,569	$ 3,036
Supplemental disclosures of cash flow information:			
Interest paid	$ 1,775	$ 3,332	$ 2,399
Income taxes paid	$ 11,000	$ 2,000	$ 3,810
Non cash investing and financing activities:			
Assets acquired through capital lease obligations	$ 691	$ –	$ 612
Common stock issued for acquisition	$ 937	$ –	$ 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 353 retail discount stores located in eleven states 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 2001, 2000 and 1999, as used herein, refer to the years ended February 2, 2002, February 3, 2001, and January 29, 2000, 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 20% and 19% of the retail inventories at February 2, 2002 and February 3, 2001, respectively, cost was determined using the LIFO (last-in, first-out) method. The current cost of inventories exceeded the LIFO cost by approximately $4,603,000 at February 2, 2002 and $3,961,000 at February 3, 2001.

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 2, 2002 and February 3, 2001, no material adjustments to the carrying value of such assets were necessary.

Selling, general and administrative expenses. The Company includes buying, warehousing, distribution, depreciation 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 2001, 2000, and 1999 was $12,079,000, $10,166,000, and $8,926,000 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 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 and are therefore netted against selling, general

Notes to Consolidated Financial Statements

and administrative expenses. Total franchise income for 2001, 2000, and 1999 was $1,764,000, $1,806,000, and $1,761,000 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. During the year ended February 2, 2002, the Company issued 55,980 (split-adjusted) shares for pharmacy acquisitions. These intangibles, net of accumulated amortization, totaled $4,778,000 at February 2, 2002, and $4,945,000 at February 3, 2001. Accumulated amortization for 2001 and 2000 totaled $5,272,000 and $3,490,000, respectively. Amortization expense for 2001, 2000, and 1999 was $1,795,000, $1,421,000, and $1,307,000, respectively.

Cash and cash equivalents. Cash on hand and in banks, together with other highly liquid investments which are subject to market fluctuations and 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 for which there was no excess amounts at February 2, 2002 and $5,823,000 at February 3, 2001.

Financial instruments. At February 2, 2002, 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.

Insurance reserves. The Company is largely self-insured for workers compensation, general liability and medical insurance. The Company's liability for self-insurance is determined based on known claims and estimates for incurred but not reported claims.

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.

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 2001 presentation.

Recent Accounting Pronouncements. In June 2001, the FASB issued SFAS No. 141, Business Combinations. SFAS No. 141 supercedes Accounting Principles Board Opinion ("APB") No. 16, Business Combinations, and SFAS No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 and for all business combinations accounted for by the purchase method for which the date of acquisition is after June 30, 2001. The Company does not expect the adoption of SFAS No. 141 to have a material impact on its financial statements.

In June 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 supercedes APB No. 17, Intangible Assets, and its provisions are effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires that: 1) goodwill and indefinite lived intangible assets will no longer be amortized; 2) goodwill will be tested for impairment at least annually at the reporting unit level (reporting unit levels to be determined upon adoption); 3) intangible assets deemed to have an indefinite life will be tested for impairment at least annually; and 4) the amortization period of intangible assets with finite lives will no longer be limited to forty years. As of February 2, 2002, the Company has intangible assets, net of accumulated amortization, of $4.8 million and has recognized amortization expense of approximately $1.8 million during the year February 2, 2002. The Company will continue to amortize intangible assets in accordance with its existing policy and accordingly does not anticipate a material impact on adoption of SFAS No. 142.

Notes to Consolidated Financial Statements

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, effective for years beginning after December 15, 2001. This Statement supercedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets to Be Disposed of, but retains the fundamental provision of SFAS 121 for recognition and measurement of the impairment of long-lived assets to be held and used and measurement of long-lived assets to be held for sale. The statement requires that whenever events or changes in circumstances indicate that a long-lived asset's carrying value may not be recoverable, the asset should be tested for recoverability. The statement also requires that a long-lived asset classified as held for sale should be carried at the lower of its carrying value or fair value, less cost to sell. The Company is evaluating the potential impact the provisions of SFAS 144 could have on it's financial statements but does not believe there will be a material effect on the financial statements upon adoption.

NOTE 2 - PROPERTY AND EQUIPMENT

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

	2001	2000
Buildings and improvements	$ 69,217	$ 67,068
Furniture, fixtures and equipment	103,889	89,152
	173,106	156,220
Less accumulated depreciation and amortization	(99,121)	(84,100)
	73,985	72,120
Land	4,240	4,240
Total property and equipment, at depreciated cost	$ 78,225	$ 76,360

Depreciation expense totaled $15,507,000, $12,407,000, and $10,168,000 for 2001, 2000 and 1999, respectively.

NOTE 3 - ACCRUED LIABILITIES

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

	2001	2000
Payroll and benefits	$ 6,727	$ 5,136
Sales and use taxes	2,694	2,000
Insurance	1,753	2,497
Other	3,054	4,379
Total accrued liabilities	$ 14,228	$ 14,012

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 a 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 no borrowings outstanding under the Agreement at February 2, 2002 and the borrowings outstanding under the Agreement at February 3, 2001 totaled $22,623,000.

Notes to Consolidated Financial Statements

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 $703,000 and $1,265,500 borrowings outstanding under the Agreement at February 2, 2002 and February 3, 2001, respectively. The principal maturity under this Agreement for debt outstanding at February 2, 2002 is as follows: $562,500 in fiscal 2002 and $140,500 in fiscal 2003.

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 bore interest of 6.82% per annum and would have matured on November 1, 2005. The Company used the proceeds of the public offering to pay off the Agreement and the borrowings outstanding under the Agreement at February 3, 2001 totaled $8,762,000.

Interest expense for 2001, 2000, and 1999 totaled $1,611,000, $3,226,000, and $2,504,000, 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):

	2001	2000	1999
Current			
Federal	$ 9,485	$ 5,642	$ 3,224
State	–	–	–
	9,485	5,642	3,224
Deferred			
Federal	907	1,679	2,116
State	119	324	397
	1,026	2,003	2,513
	$ 10,511	$ 7,645	$ 5,737

Notes to Consolidated Financial Statements

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

	2001	2000
Current deferred tax assets:		
Inventory valuation methods	$ 530	$ 627
Accrual for inventory shrinkage	1,060	768
Allowance for doubtful accounts	357	310
Insurance accruals	933	1,200
Other	76	26
Gross current deferred tax assets	2,956	2,931
Deferred tax asset valuation allowance	(289)	(289)
	2,667	2,642
Current deferred tax liabilities	(877)	(620)
Net current deferred tax asset	$ 1,790	$ 2,022
Noncurrent deferred tax assets:		
Net operating loss carryforwards	$ 1,532	$ 1,685
Postretirement benefits other than pensions	799	760
Restructuring costs	73	82
Other	1,768	1,769
Gross noncurrent deferred tax assets	4,172	4,296
Deferred tax asset valuation allowance	(1,243)	(1,267)
	2,929	3,029
Noncurrent deferred tax liabilities:		
Depreciation	(3,598)	(2,904)
Other	(27)	(27)
Gross noncurrent deferred tax liabilities	(3,625)	(2,931)
Net noncurrent deferred tax (liability) asset	$ (696)	$ 98

The ultimate realization of the current deferred tax liability 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 2001 the valuation allowance decreased ($24,000) and during 2000 the valuation allowance increased $135,000. The Company was able to use net operating loss carryforwards in certain states during 2001 as compared to the Company generating additional net operating loss carryforwards in certain states during 2000.

At February 2, 2002, 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 $43,939,000 for state income tax purposes, and expire at various times during the period 2003 through 2023. 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.

Notes to Consolidated Financial Statements

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

	2001	2000	1999
Income tax provision at statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	0.1	0.9	1.6
Surtax Exemptions	–	(1.0)	(1.0)
Other	(0.2)	(0.9)	(0.7)
	34.9%	34.0%	34.9%

NOTE 6 - LONG-TERM LEASES

The Company leases certain of its store locations under noncancelable operating leases that require monthly rental payments primarily at fixed rates (although a number of the leases provide for additional rent based upon sales) 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 $22,207,000, $17,465,000, and $15,329,000 for 2001, 2000, and 1999, respectively. Amortization expense on assets under capital lease for 2001, 2000, and 1999 was $544,000, $449,000, and $355,000, respectively.

Future minimum rental payments under all operating and capital leases as of February 2, 2002 are as follows:

	Operating Leases	Capital Leases
2002	$ 20,611	$ 914
2003	18,112	536
2004	15,072	428
2005	12,280	315
2006	8,869	173
Thereafter	12,789	28
Total minimum lease payments	$ 87,733	$ 2,394
Imputed interest		(537)
Present value of net minimum lease payments, including $678 classified as current portion of capital lease obligations		$ 1,857

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 (a "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.

Notes to Consolidated Financial Statements

On May 24, 2001, the Company announced a five-for-four stock split of its common stock, Class A voting, no par value. The new shares, one additional share for each four shares held by stockholders, were distributed on June 18, 2001 to stockholders of record on June 4, 2001. All share and per share amounts included in the accompanying financial statements have been adjusted to reflect this stock split.

In October 2001, the company completed a secondary stock offering of 1,585,000 company shares (unadjusted for 3-for-2 stock split completed on February 1, 2002) raising net proceeds to the Company of $38.2 million dollars.

On January 15, 2002, the Company announced a three-for-two stock split of its common stock, Class A voting, no par value. The new shares, one additional share for each two shares held by stockholders, were distributed on February 1, 2002 to stockholders of record on January 25, 2002. All share and per share amounts included in the accompanying financial statements have been adjusted to reflect this stock split.

NOTE 8 - EMPLOYEE BENEFIT PLANS

Incentive stock option plan. The Company has a long-term incentive plan under which an aggregate of 2,191,409 shares may be granted. These options expire five years from the date of grant. Options outstanding at February 2, 2002 expire in 2002 through 2006.

A summary of activity in the plan follows:

	2001		2000		1999	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	1,242,415	$ 8.16	1,056,475	$ 7.01	919,009	$ 7.15
Granted	288,219	9.39	647,824	8.03	256,405	6.31
Forfeited/ canceled	(292,253)	9.22	(264,046)	5.88	(48,939)	7.89
Expired	–		–		(3,270)	6.05
Exercised	(314,346)	6.82	(197,838)	4.63	(66,730)	4.47
Outstanding at end of year	924,035	8.65	1,242,415	8.16	1,056,475	7.01
Exercisable at end of year	356,068	8.32	288,871	5.67	317,461	4.86

The weighted average remaining contractual life of all outstanding options was 2.8 years at February 2, 2002.

The following table summarizes information about stock options outstanding at February 2, 2002:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at February 2, 2002	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number Exercisable at February 2, 2002	Weighted Average Exercise Price
$ 3.15 to $ 3.84	37,068	0.8	$ 3.76	33,429	$ 3.75
$ 6.14 to $ 8.64	743,474	2.4	$ 7.57	243,858	$ 6.90
$ 10.67 to $18.53	143,493	2.2	$ 13.62	78,781	$13.61
	924,035			356,068	

Notes to Consolidated Financial Statements

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 2001, 2000, and 1999 consistent with the method prescribed by SFAS No. 123, Accounting for Stock-Based Compensation, the Company's operating results for 2001, 2000, and 1999 would have been reduced to the pro forma amounts indicated below:

(in thousands, except per share data)	2001	2000	1999
Net income			
As reported	$ 19,629	$ 14,849	$ 10,702
Pro forma	19,245	14,260	10,363
Basic earnings per share			
As reported	0.83	0.66	0.48
Pro forma	0.82	0.63	0.47
Diluted earnings per share			
As reported	0.81	0.65	0.47
Pro forma	0.80	0.62	0.46

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 2001, 2000 and 1999, respectively:

	2001	2000	1999
Average expected life (years)	3.0	3.0	3.0
Average expected volatility	41.9%	39.0%	43.3%
Risk-free interest rates	2.6%	5.6%	4.8%
Dividend yield	1.6%	1.3%	1.5%

The weighted average grant-date fair value of options granted during 2001, 2000,and 1999 was $6.90, $2.08, and $2.22, respectively.

Restricted Stock. During 2001, 2000, and 1999, the Company issued (forfeited/ cancelled) a net of (15,185),(47,385), and 7,875 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 2, 2002, February 3, 2001, and January 29, 2000 were $117,000, $100,000, and $96,000, respectively.

Notes to Consolidated Financial Statements

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 Year Ended		
(in thousands)	February 2, 2002	February 3, 2001	January 29, 2000
Benefit obligation at beginning of year	$ 1,617	$ 1,377	$ 1,252
Service cost	140	132	127
Interest cost	123	116	91
Participant contributions	1	–	–
Amendments	–	–	–
Actuarial (gain) loss	(74)	68	(17)
Benefits paid	(21)	(76)	(76)
Benefit obligation at end of year	$ 1,786	$ 1,617	$ 1,377

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

(in thousands)	February 2, 2002	February 3, 2001	January 29, 2000
Funded status	$ (1,786)	$ (1,617)	$ (1,377)
Unrecognized net actuarial gain	(380)	(322)	(406)
Unrecognized prior service cost	(5)	(5)	(6)
Accrued benefit costs	$ (2,171)	$ (1,944)	$ (1,789)

The medical care cost trend used in determining this obligation is 11.0% effective December 1, 2000, decreasing annually before leveling at 5.5% in 2012. 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 $259,000. The discount rate used in calculating the obligation was 7.25% in 2001, 7.5% in 2000 and 7.75% in 1999.

The annual net postretirement cost is as follows:

	For the Year Ended		
(in thousands)	February 2, 2002	February 3, 2001	January 29, 2000
Service cost	$ 140	$ 132	$ 127
Interest cost	123	116	91
Amortization of net gain from prior periods	(17)	(17)	(17)
Amortization of unrecognized prior service cost	1	1	1
Net periodic postretirement benefit cost	$ 247	$ 232	$ 202

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

Notes to Consolidated Financial Statements

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.

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

	Year Ended								
	February 2, 2002			February 3, 2001			January 29, 2000		
	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount
Basic EPS	$ 19,629	23,553	$ .83	$ 14,849	22,382	$ .66	$ 10,702	22,176	$ .48
Effect of Dilutive Securities									
Restricted stock		69			146			203	
Stock options		575			341			256	
Diluted EPS	$ 19,629	24,197	$ .81	$ 14,849	22,869	$ .65	$ 10,702	22,635	$ .47

NOTE 10 - COMMITMENTS AND CONTINGENCIES

Commitments. The Company had commitments approximating $9,133,000 at February 2, 2002 and $5,082,000 at February 3, 2001 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating $6,838,000 at February 2, 2002 and $2,552,000 at February 3, 2001 utilized as collateral for its 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.

Notes to Consolidated Financial Statements

Note 11 – QUARTERLY FINANCIAL DATA (UNAUDITED)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands, except per share data)			
Year Ended February 2, 2002				
Net sales	$ 207,359	$ 210,278	$ 219,242	$ 273,952
Gross profit	57,758	56,781	62,038	73,144
Net income	4,159	2,114	5,128	8,228
Net income per share (1)				
Basic	0.18	0.09	0.22	0.34
Diluted	0.18	0.09	0.22	0.32
Cash dividends paid per share	0.027	0.027	0.027	0.027
Year Ended February 3, 2001				
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 (1)				
Basic	0.15	0.07	0.17	0.27
Diluted	0.15	0.07	0.17	0.26
Cash dividends paid per share	0.027	0.027	0.027	0.027

(1) Per share data adjusted for stock split (Note 7).

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 2, 2002 and February 3, 2001, and the results of their operations and their cash flows for each of the three years in the period ended February 2, 2002, 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.

PricewaterhouseCoopers LLP
Memphis, Tennessee
March 15, 2002

Directors and Officers

Board of Directors

Michael J. Hayes
Chief Executive Officer
Fred's, Inc.

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

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

American Stock Transfer & Trust Company
59 Maiden Lane
New York, New York 10038
(800) 937-5449

Independent Accountants

PricewaterhouseCoopers LLP
Memphis, Tennessee

General 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 2, 2002, 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 2002 annual meeting of shareholders will be held at 10:00 a.m. local time on Wednesday, June 26, 2002, at the Memphis Marriott Hotel, 2625 Thousand Oaks Boulevard, Memphis, Tennessee. Shareholders of record as of May 3, 2002, 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 May 3, 2002, the Company had an estimated 16,500 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. All amounts have been adjusted for a 5-for-4 stock split distributed in June 2001 and a 3-for-2 stock split distributed in February 2002.

	High	Low	Dividends Per Share
2000			
First	$ 8.53	$ 7.54	$0.027
Second	$11.23	$ 8.00	$0.027
Third	$13.33	$10.00	$0.027
Fourth	$12.63	$ 9.14	$0.027
2001			
First	$13.89	$10.87	$0.027
Second	$17.20	$12.91	$0.027
Third	$22.70	$15.99	$0.027
Fourth	$28.73	$20.77	$0.027

SIC 5331

FRED'S

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Memphis, Tennessee 38118