2002 ANNUAL REPORT

About the Company

Fred's, Inc., founded in 1947, operates 414 discount general merchandise stores in 14 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

Fred's new distribution center in Dublin, Georgia. Opened April 2003.

Financial Highlights

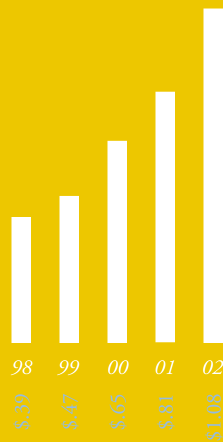
(in thousands, except per share amounts)

	Year Ended February 1, 2003	February 2, 2002
Operating Data		
Net sales	**$1,103,418**	$ 910,831
Operating income	**42,677**	31,751
Net income	**28,216**	19,629
Net income per share - diluted	**1.08**	.81
Weighted average shares outstanding - diluted	**26,167**	24,197
Balance Sheet Data		
Working capital	**$ 138,453**	$ 138,379
Total assets	**345,848**	284,059
Long-term debt (including capital leases)	**2,510**	1,320
Shareholders' equity	**250,770**	218,907
Long-term debt to equity	**1.0%**	0.6%

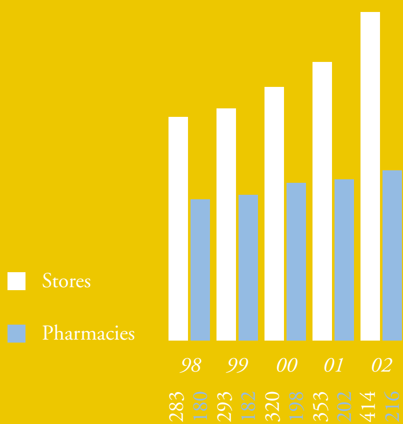
Net Sales
(in millions)

Comparable Store Sales

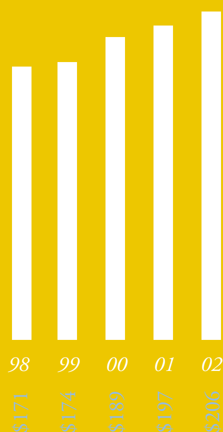
Net Income Per Share-Diluted



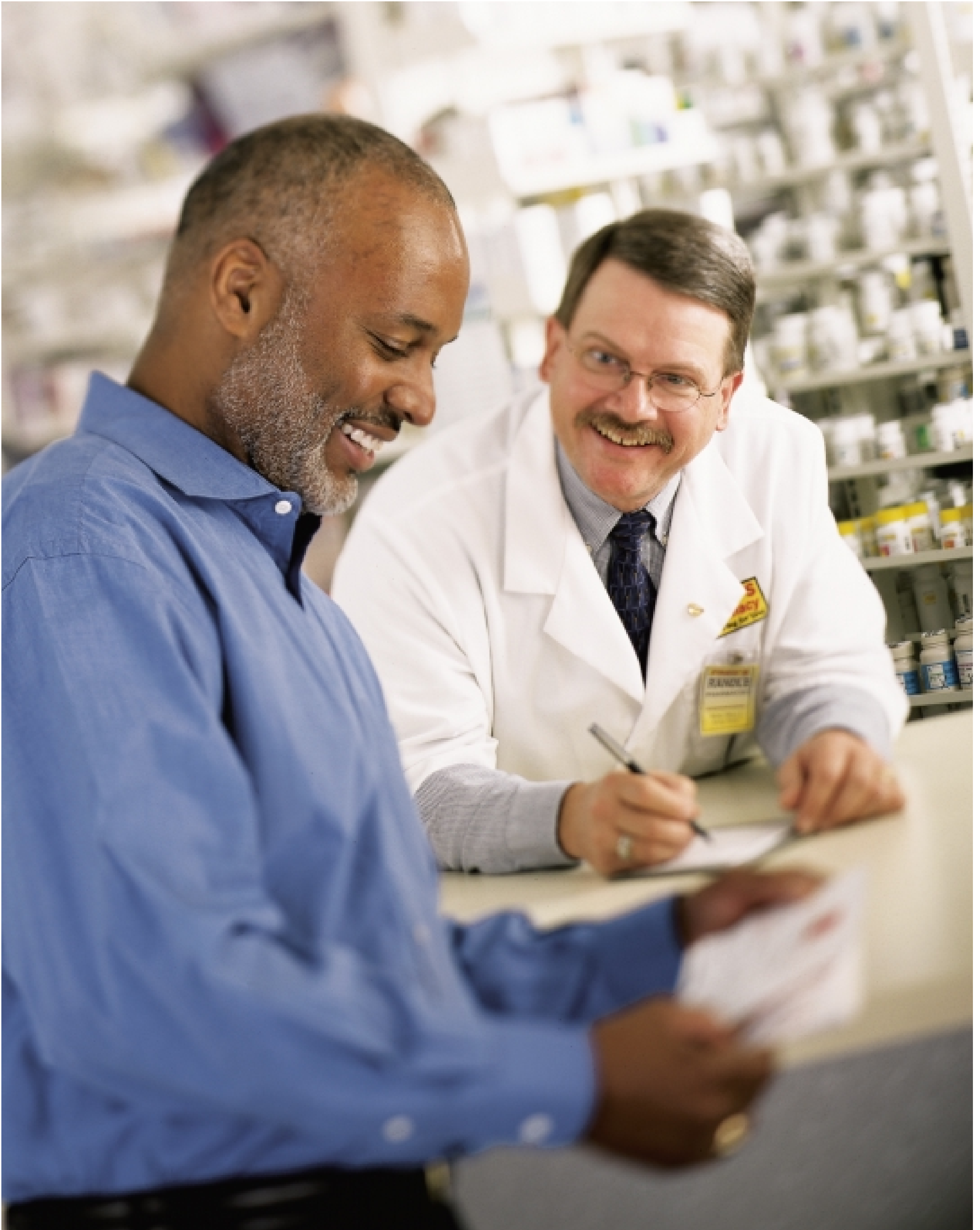
Number of Company-Owned Stores
(end of period)



Sales Per Square Foot



Selling Space (Square Footage)
(in millions)



Letter to Shareholders

"Our market strategy is one that uniquely combines low prices, convenient store settings, friendly service and a wide selection of merchandise, including prescription drugs in more than half our stores."

What a dynamic and interesting year 2002 was for Fred's – the most successful in our company's history and unquestionably the most challenging! Quarter by quarter, Fred's exceeded sales and financial targets that we considered aggressive at the time. These impressive results were even more remarkable when viewed in terms of our strong historical performance over the past five years.

For fiscal 2002, which ended on February 1, 2003, our sales broke through the billion-dollar mark for the first time ever, increasing 21% to $1.103 billion, up from $911 million in fiscal 2001. Comparable store sales for 2002 increased 11.2% over 2001 – our second straight year of double-digit comparable store sales growth. Net income for 2002 increased 44% to $28.2 million from $19.6 million in 2001, while earnings per diluted share rose 33% to $1.08 from $0.81 in 2001.

In terms of sales, market share gains and financial performance, Fred's delivered better-than-anticipated results in 2002. Perhaps more relevant to you, our shareholders, is that even with these solid trends in sales and earnings, our management team still believes that the best is yet to come.

A Strong Niche

This ongoing growth and prosperity, amid one of the most challenging economic environments in some time, has much to do with our market niche and the business model we have created. While many retail segments have been hard hit by the nation's current economic woes, Fred's has gained market share. Our model is built on providing basic merchandise that our customers need every day, promoted by using compelling periodic circulars that highlight the exceptional value pricing and exciting special merchandise purchases that we offer.

Our market strategy is one that uniquely combines low prices, convenient store settings, friendly service and a wide selection of merchandise, including prescription drugs in more than half our stores. It's an offering that differentiates us in the marketplace, apart from the huge mega stores that appeal to destination shoppers who don't mind investing considerable time and effort to navigate the "big box." With an in-store pharmacy, Fred's also is a more complete package than the dollar stores that provide only limited merchandise selections or the chain drugstores that don't offer everyday low pricing and, thus, cannot fully serve the customer who wants to save both time and money.

Our success is more than coincidence, luck, or just being in the right place at the right time. It is a hard-won accomplishment that comes from remaining keenly focused on what you do, why it works, and how to keep winning customers. The perspective of history – knowing where Fred's stood just five years ago and seeing just how far the Company has come during the intervening time – provides useful insight into the key drivers of our performance since 1998 and helps explain why management remains confident and excited about Fred's future.

Now and Then

In fiscal 1998, Fred's had 283 Company-owned stores in 10 states, having just added 22 stores that year, net of store closings. Of the total open at that time, 180 stores had pharmacies. We had just recently completed a significant upgrade of our sole distribution center in Memphis and predicted that, with these improvements, our distribution center would support perhaps up to 425 stores, thus providing significant capacity for future growth.

Our stores in 1998 comprised almost 3.7 million square feet of retail space and generated just over $600 million in sales. Comparable store sales for the year were 5.6% and sales per square

Letter to Shareholders

"A closer review of the changes that have occurred at Fred's over the past five years reveals several fundamental, powerful, Company-specific initiatives that have helped Fred's generate increasing operating momentum and accelerated earnings."

foot rose 8% to $171. Earnings per diluted share for the year totaled $0.39 on a split-adjusted basis.

Dusting off our annual report from 1998, we said we were generally pleased with the Company's accomplishments that year, given the stress of having to complete a major retrofit of our sole distribution center. We were confident that better years were ahead if we could maintain our discipline and continue to refine our merchandise mix. What a contrast we witnessed in the Company's performance over the next five years with those steps taken!

Sales for 2002 were 84% higher than those in 1998, while our profitability expanded at an even faster pace of 220%. Our market region now stretches over four new states, and we have increased our retail base almost 50% to 414 stores, including 216 with pharmacies. Our retail selling space has jumped 57% in five years to almost 5.8 million feet. Comparable store sales have gone from acceptable to exceptional, while sales per square foot have expanded more than 20% to $206 in 2002. And we broke ground on our second distribution center in Dublin, Georgia, which will support our recent and planned expansion to the east and south, augmenting available capacity at our original Memphis center and greatly enhancing the supply logistics of our chain.

Meanwhile, the Company has trimmed long-term debt to a fraction of what it was in 1998, down to about 1.0% of equity from 8.6% in 1998. This was no small feat considering the $35 million in capital expenditures associated with our new distribution center, of which about $24 million was expended in 2002, as well as the substantial investments we continue to make to expand our chain and remodel select stores. Stockholders' equity, on the other hand, has increased 83% since 1998, reaching more than $250 million by the end of 2002. This fact is made more significant knowing that Fred's has returned almost $13 million in cash dividends to shareholders over the past five years.

Supporting Initiatives

A closer review of the changes that have occurred at Fred's over the past five years reveals several fundamental, powerful, Company-specific initiatives that have helped Fred's generate increasing operating momentum and accelerated earnings. One of the most important involves our merchandising strategy. Since 1999, our President, John Reier, has guided our merchants in developing and enhancing a merchandise mix that is more attuned to our customers' needs, and in capitalizing on opportunistic buys that draw customers to our stores and boost gross margin. With store operations focusing on better-planned and better-presented merchandise up and down our aisles, we have seen our traffic and average transaction increase year after year.

Our pharmacy department also continues to leverage upon itself, figuring prominently in Fred's sales growth. Pharmacy sales, which comprised about one-third of total sales in 2002, continue to provide a strong competitive edge for us by expanding Fred's convenience quotient. And, at a time when Americans are taking more prescription medications than ever before, our pharmacies provide increasing rationale for repeat visits and add-on purchases.

Additionally, the new Fred's store prototype has played an integral role in our ability to expand sales and increase market share. Fred's prototypical store has continued to evolve and incorporate improved layouts, fixtures and amenities that welcome our customers and make their visits more convenient and

Letter to Shareholders

"Just as in 1998, when we initiated the bold moves that enhanced our ability to grow and helped ensure that we could sustain that growth, we think the steps taken in 2002 should serve as a catalyst for the next five years."

enjoyable. We have been delighted by the performance of new stores based on this prototype – sales ramp-up faster, they achieve higher sales per square foot, and the use of the new prototype helps us drive down store opening costs.

All of these strategies have enabled us to fulfill our longstanding objective – improving operating margin. With keen merchandising and sourcing strategies, we have witnessed relatively stable gross margins through the years. Couple this with our ability to control costs and leverage operating expenses over a growing sales base, and you can see why Fred's has been able to increase operating margin 63% between 1998 and 2002.

Focus on the Future

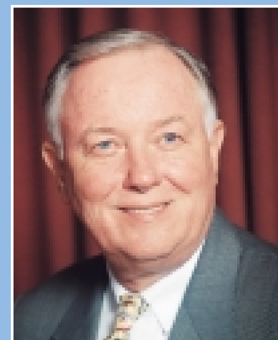
We are gratified by the Company's performance in 2002. It marks the culmination of many initiatives over the past five years to build both quality and value for our customers. Yet we are most excited by what this progress means for Fred's over the next five years.

Our optimism stems partly from the hard work we have dedicated to building an infrastructure that can sustain our ambitious plans for the future. One key piece of this is the new, state-of-the-art distribution center referred to earlier, which is fully operational at this writing. This new 600,000-square-foot center significantly expands our capabilities to support a growing store base, positioning Fred's to serve a growing presence in Alabama, Georgia, Florida, North Carolina, and South Carolina, as well as its expected growth into new markets in the future. We devoted a great deal of time and attention to planning the opening and operation of this new facility and are very pleased with the manner in which these activities are proceeding, with initial receiving and shipping activities ramping up smoothly – on plan and on budget. Consequently, we believe this new capacity will provide the framework for a new era of planned and controlled expansion.

Simultaneous with our expanded distribution capabilities, we have continued to make considerable investments in systems. We have initiated a program to enhance all of our store-level operating systems to provide even faster, more accurate communications between our corporate offices and our retail locations. In lockstep with these efforts, we also continue to enhance our infrastructure, highlighted by additions to logistics, store management and information technology personnel, as we remain focused on our most important assets – our human resources.

In summary, 2002 was an important year, leveraging an extraordinary five-year period of growth for Fred's. Just as in 1998, when we initiated the bold moves that enhanced our ability to grow and helped ensure that we could sustain that growth, we think the steps taken in 2002 should serve as a catalyst for the next five years. This explains management's optimism that the best years are still ahead and that they have the potential to be even more rewarding for Fred's and its shareholders.

Michael J. Hayes
Chief Executive Officer



Selected Financial Data

(dollars in thousands, except per share amounts)

	2002	2001	2000[1]	1999	1998[2]
Statement of Income Data:					
Net sales	**$ 1,103,418**	$ 910,831	$ 781,249	$ 665,777	$ 600,902
Operating income	**42,677**	31,751	25,720	18,943	14,711
Income before income taxes	**42,474**	30,140	22,494	16,439	13,605
Provision for income taxes	**14,258**	10,511	7,645	5,737	4,775
Net income	**28,216**	19,629	14,849	10,702	8,830
Net income per share:[3]					
Basic	**1.11**	.83	.66	.48	.40
Diluted	**1.08**	.81	.65	.47	.39
Cash dividend paid per share[3]	**.12**	.12	.12	.12	.12
Selected Operating Data:					
Operating income as a percentage of sales	**3.9%**	3.5%	3.3%	2.9%	2.4%
Increase in comparable store sales[4]	**11.2%**	10.5%	9.2%[5]	5.2%	5.6%
Stores open at end of period	**414**	353	320	293	283
Balance Sheet Data (at period end):					
Total assets	**$ 345,848**	$ 284,059	$ 254,795	$ 240,222	$ 220,757
Short-term debt (including capital leases)	**905**	1,240	2,678	30,736	11,914
Long-term debt (including capital leases)	**2,510**	1,320	31,705	11,761	11,821
Shareholders' equity	**250,770**	218,907	159,687	145,913	136,983

[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

CRITICAL 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 and the most critical accounting policies are as follows:

INVENTORIES

Warehouse 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. Under the retail inventory method ("RIM"), the valuation of inventories at cost and the resulting gross margin are calculated by applying a calculated cost-to-retail ratio to the retail value of inventories. RIM is an averaging method that has been widely used in the retail industry due to its practicality. Also, it is recognized that the use of the RIM will result in valuing inventories at lower of cost or market if markdowns are currently taken as a reduction of the retail value of inventories. Inherent in the RIM calculation are certain significant management judgments and estimates including, among others, initial markups, markdowns, and shrinkage, which significantly impact the ending inventory valuation at cost as well as resulting gross margin. These significant estimates, coupled with the fact that the RIM is an averaging process, can, under certain circumstances, produce distorted or inaccurate cost figures. Management believes that the Company's RIM provides an inventory valuation which reasonably approximates cost and results in carrying inventory at the lower of cost or market. For pharmacy inventories, which are $27.8 million and $24.7 million at February 1, 2003 and February 2, 2002, respectively, cost was determined using the LIFO (last-in, first-out) method. The current cost of inventories exceeded the LIFO cost by approximately $6.1 million at February 1, 2003 and $4.6 million at February 2, 2002. The LIFO reserve increased by $1.5 million, $.6 million and $.8 million at February 1, 2003, February 2, 2002 and February 3, 2001, respectively.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost, and depreciation is computed using the straight-line method over their estimated useful lives. Leasehold costs and improvements which are included in buildings 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, fixtures, 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.

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. If future claim trends deviate from recent historical patterns, the Company may be required to record additional expense or expense reductions which could be material to the Company's results of operations.

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 sales.

	2002	2001	2000
Net sales	**100.0%**	100.0%	100.0%
Cost of goods sold	**72.4**	72.6	72.5
Gross profit	**27.6**	27.4	27.5
Selling, general and administrative expenses	**23.7**	23.9	24.2
Operating income	**3.9**	3.5	3.3
Interest expense, net	**0.0**	0.2	0.4
Income before taxes	**3.9**	3.3	2.9
Income taxes	**1.3**	1.1	1.0
Net income	**2.6%**	2.2%	1.9%

FISCAL 2002 COMPARED TO FISCAL 2001

Sales

Net sales increased 21.1% ($192.6 million) in 2002. Approximately $95.0 million of the increase was attributable to a net addition of 61 new stores, upgraded stores, and a net addition of 14 pharmacies during 2002, together with the sales of 33 store locations and 7 pharmacies that were opened or upgraded during 2001 and contributed a full year of sales in 2002. During 2002, the Company closed one pharmacy location. Comparable store sales, consisting of sales from stores that have been open for more than one year, increased 11.2% in 2002.

The Company's front store (non-pharmacy) sales increased approximately 24.2% over 2001 front store sales. Front store sales growth benefited from the above mentioned store additions and improvements, and solid sales increases in categories such as ladies and plus size apparel, ladies accessories, footwear, bedding and windows, home furnishings, floor coverings, giftware, small appliances, photo supplies, electronics, tobacco and auto.

Fred's pharmacy sales were 33.2% of total sales in 2002 from 34.4% of total sales in 2001 and continue to rank as the largest sales category within the Company. The total sales in this department, including the Company's mail order operation, increased 17.1% over 2001, with third party prescription sales representing approximately 85% of total pharmacy sales, no change from the prior year. 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 $1.8 million in 2002 and represented 3.2% of the Company's total sales, as compared to 3.7% in 2001. 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 increased to 27.6% in 2002 compared to 27.4% in 2001. The increase in gross margin is a result of product mix in the general merchandise categories and increased margins in the pharmacy department due in part to the shift to more generic medications.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were 23.7% of net sales in 2002 compared with 23.9% of net sales in 2001. Labor expenses as a percent of sales improved in the stores and pharmacies as a result of strong sales coupled with store productivity initiatives. Expenses in the stores and pharmacies improved by .4% as a percent of net sales. Increases offsetting these improvements were in insurance, distribution and transportation expenses. Insurance expense rose in 2002 due to

Management's Discussion and Analysis

premium increases for insurance coverage, as well as increasing reserves associated with business growth. Distribution and transportation expenses increased as a percent of sales due to the distances required to service newer stores which opened in the area of the new distribution center in Dublin, Georgia which is scheduled to open in 2003.

Operating Income

Operating income increased approximately $10.9 million or 34.4% to $42.7 million in 2002 from $31.8 million in 2001. Operating income as a percentage of sales increased to 3.9% in 2002 from 3.5% in 2001, due to the above-mentioned improvements in gross margins and selling, general and administrative expense control.

Interest Expense, Net

Interest expense for 2002 totaled $.2 million (less than .1% of sales) compared to net interest expense of $1.6 million (.2% of sales) in 2001. The significant reduction results from the funds raised from our public offering in September 2001 and March 2002 coupled with cash flows from operations, effective working capital management throughout the year and controlling capital expenditures.

Income Taxes

The effective income tax rate decreased to 33.6% in 2002 from 34.9% in 2001, primarily due to state income tax planning that allowed utilization of $.8 million of state operating losses that were previously reserved.

As a result of certain changes in methods of accounting for income tax purposes, net operating loss carryforwards increased in certain states during 2002. These state net operating loss carryforwards are available to reduce state income taxes in future years. These carryforwards total approximately $63.7 million for state income tax purposes and expire at various times during the period 2003 through 2022. If certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of carryforwards that can be utilized.

Net Income

Net income for 2002 was $28.2 million (or $1.08 per diluted share) or approximately 43.8% higher than the $19.6 million (or $.81 per diluted share) reported in 2001.

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 continue 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.

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.

Management's Discussion and Analysis

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 had 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 totaled approximately $43.9 million for state income tax purposes, and expire at various times during the period 2003 through 2023.

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.

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 March 2002 the Company raised proceeds of $3.5 million from the offering of 98,756 Company shares. In September 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 February 1, 2002). The Company had working capital of $138.5 million, $138.4 million, and $110.5 million at year-end 2002, 2001 and 2000, respectively. Working capital fluctuates in relation to profitability, seasonal inventory levels, net of trade accounts payable, and the level of store openings and closings. Working capital at year-end 2002 and 2001 were approximately the same primarily resulting from inventory purchased for new store openings scheduled for the first quarter of 2003. The Company plans to open 30 new stores during the first quarter of 2003.

Net cash flow provided by operating activities totaled $43.7 million in 2002, $26.4 million in 2001, and $27.1 million in 2000.

In fiscal 2002, cash was primarily used to increase inventories by approximately $31.4 million during the fiscal year. This increase is primarily attributable to our adding a net of 61 new stores, upgrading 30 stores and adding a net of 14 new pharmacies, as well as supporting the improved comparable store sales. Accounts payable and accrued liabilities increased by $20.0 million due primarily to higher inventory purchases. Income taxes payable decreased by approximately $6.8 million and the net deferred income tax asset increased by approximately $12.3 million primarily as a result of certain changes in method of

Management's Discussion and Analysis

accounting for income tax purposes. The majority of the adjustment from the accounting method changes is due to a change in method of accounting for inventory in retail stores from the retail inventory method to the cost method.

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 6 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. Fiscal 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.

Capital expenditures in 2002 totaled $50.8 million compared with $17.4 million in 2001 and $15.8 million in 2000. The 2002 capital expenditures included approximately $23.9 million for the new distribution center being constructed in Dublin, Georgia. This new facility is expected to be opened in April, 2003. Expenditures totaling approximately $24.2 million were associated with upgraded, remodeled, or new stores and pharmacies. Approximately $2.7 million in expenditures related to technology upgrades, distribution center equipment, freight equipment, and capital maintenance. The 2001 capital expenditures included approximately $13.5 million of expenditures associated with upgraded, remodeled, or new stores and pharmacies and approximately $3.9 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. Cash used for investing activities also includes $1.8 million in 2002, $1.0 million in 2001, and $2.8 million in 2000 for the acquisition of customer lists and other pharmacy related items.

In 2003, the Company is planning capital expenditures totaling approximately $34.1 million, including $11.1 million remaining on construction of the new distribution center being constructed in Dublin, Georgia. This new facility is expected to open in April 2003. Expenditures are planned totaling $20.5 million for the upgrades, remodels, or new stores and pharmacies. Planned expenditures of $2.5 million relate to technology upgrades, distribution center equipment and capital maintenance. The Company also plans expenditures of $1.8 million in 2003 for the acquisition of customer lists and other pharmacy related items.

Cash and cash equivalents were $8.2 million at the end of 2002 compared to $15.9 million at year-end 2001. 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.

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 the prime rate or a LIBOR-based rate (weighted average interest rate of 2.9% on 2002 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, as amended on April 30, 2002 extends to March 31, 2004. There were no borrowings outstanding under this agreement at either February 1, 2003 or February 2, 2002.

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 2002, the outstanding principal balance on the term loan was approximately $ .1 million compared with $.7 million at year-end 2001.

On March 6, 2002, the Company filed a Registration Statement on Form S-3 registering 500,000 shares of Class A common stock. The common stock may be used from time to time as consideration in the acquisition of assets, goods, or services for use or sale in the conduct of our business. On March 22, 2002 the Company raised proceeds of $3.5 million from the offering of 98,756 shares.

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.

Management's Discussion and Analysis

OFF-BALANCE SHEET ARRANGEMENTS

The Company has no off-balance sheet financing arrangements.

EFFECTS OF INFLATION AND CHANGING PRICES

The Company believes that inflation and/or deflation had a minimal impact on its overall operations during fiscal years 2002, 2001 and 2000.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

As discussed in Note 6 of the consolidated financial statements, the Company leases certain of its store locations under noncancelable operating leases expiring at various dates through 2029. Many of these leases contain renewal options and require the Company to pay taxes, maintenance, insurance and certain other operating expenses applicable to the leased properties. In addition, the Company leases various equipment under noncancelable operating leases and certain transportation equipment under capital leases. The future minimum rental payments under all operating and capital leases as of February 1, 2003 are $106.3 million and $3.1 million, respectively.

(Dollars in thousands)				Payments due by period			
Contractual Obligations	Total	2003	2004	2005	2006	2007	>2007
Term Loans	$ 141	$ 141	$ –	$ –	$ –	$ –	$ –
Capital Lease Obligations	3,117	728	703	665	543	352	126
Operating Leases	106,269	24,750	21,814	18,879	15,014	10,405	15,407
Financing Obligations	157	36	17	18	19	21	46
Total Contractual Obligations	$109,684	$ 25,655	$ 22,534	$ 19,562	$ 15,576	$ 10,778	$ 15,579

As discussed in Note 10 of the consolidated financial statements, the Company had commitments approximating $10.4 million at February 1, 2003 on issued letters of credit which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating $7.9 million at February 1, 2003 utilized as collateral for their risk management programs.

The Company is financing the construction of its Dublin, Georgia distribution center with taxable industrial development revenue bonds issued by the City of Dublin and County of Laurens Development Authority. The Company purchased 100% of the bonds and intends to hold them to maturity, effectively financing the construction with internal cash flow. The Company has offset the investment in the bonds ($18,485) against the related liability and neither is reflected on the consolidated balance sheet.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (the "FASB") issued SFAS No. 142, Goodwill and Other Intangible Assets. Under the new rules, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed annually for impairment. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. The Company will continue to amortize intangible assets in accordance with existing policy and accordingly the adoption of SFAS No. 142 did not have a material impact on the Company's financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The Company adopted this statement on February 3, 2002. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. It supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of. The adoption of SFAS No. 144 did not have a material impact on the Company's financial position or results of operations.

Management's Discussion and Analysis

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 rescinds both SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, and the amendment to SFAS No. 4, SFAS No. 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements. Generally, under SFAS No. 145, gains and losses from debt extinguishments will no longer be classified as extraordinary items. The Company adopted the provisions of SFAS No. 145 on February 2, 2003 and believes the adoption of SFAS No. 145 will not have a material effect on the Company's financial position or results of operations.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 nullifies EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) ("EITF 94-3"). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, whereas EITF 94-3 had recognized the liability at the commitment date to an exit plan. The Company was required to adopt the provisions of SFAS No. 146 effective for exit or disposal activities initiated after December 31, 2002. The adoption of SFAS No. 146 did not have a material impact on the Company's financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure. SFAS No. 148 is an amendment of SFAS No. 123, Accounting for Stock-Based Compensation, and provides alternative methods of transition to SFAS No. 123's fair value method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure provisions of SFAS No. 123 and APB Opinion No. 28, Interim Financial Reporting, to require disclosure in the summary of significant accounting policies of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. While SFAS No. 148 does not amend SFAS No. 123 to require companies to account for employee stock options using the fair value method, the disclosure provisions of SFAS No. 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair value method of SFAS No. 123 or the intrinsic value method of APB Opinion No. 25, Accounting for Stock Issued to Employees. As allowed by SFAS No. 123, the Company has elected to continue to utilize the accounting method prescribed by APB Opinion No. 25 and has adopted the disclosure requirements of SFAS No. 148 as of February 2, 2003. The adoption of SFAS No. 148 did not have a material impact on the Company's financial position or results of operations.

In November 2002, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 02-16, Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor ("EITF 02-16"). EITF 02-16 addresses the accounting and income statement classification for consideration given by a vendor to a retailer in connection with the sale of the vendor's products or for the promotion of sales of the vendor's products. The EITF concluded that such consideration received from vendors should be reflected as a decrease in prices paid for inventory and recognized in cost of sales as the related inventory is sold, unless specific criteria are met qualifying the consideration for treatment as reimbursement of specific, identifiable incremental costs. As clarified by the EITF in January 2003, this issue is effective for arrangements with vendors initiated on or after January 1, 2003. The provisions of this consensus have been applied prospectively. The adoption of EITF 02-16 is not expected to have a material impact on the Company's financial position or results of operations.

FASB Interpretation No. 46, Accounting for Variable Interest Entities ("FIN 46"), expands upon current guidance relating to when a company should include in its financial statements the assets, liabilities and activities of a variable interest entity. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply for "older" entities in the first fiscal year or interim period beginning after June 15, 2003, which would apply for the Company beginning in the third quarter of 2003. The Company is currently evaluating the impact that the adoption of FIN 46 will have on its financial position and results of operations when adopted in 2003.

Consolidated Statements of Income

(in thousands, except per share amounts)

	For the Years Ended		
	February 1, 2003	February 2, 2002	February 3, 2001
Net sales	**$ 1,103,418**	$ 910,831	$ 781,249
Cost of goods sold	**798,441**	661,110	566,115
Gross profit	**304,977**	249,721	215,134
Selling, general and administrative expenses	**262,300**	217,970	189,414
Operating income	**42,677**	31,751	25,720
Interest expense, net	**203**	1,611	3,226
Income before taxes	**42,474**	30,140	22,494
Income taxes	**14,258**	10,511	7,645
Net income	**$ 28,216**	$ 19,629	$ 14,849
Net income per share			
Basic	**$ 1.11**	$ .83	$ .66
Diluted	**$ 1.08**	$ .81	$ .65
Weighted average shares outstanding			
Basic	**25,503**	23,553	22,382
Diluted	**26,167**	24,197	22,869

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

(in thousands, except for number of shares)

	February 1, 2003	February 2, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,209	$ 15,906
Receivables, less allowance for doubtful accounts of $975 ($657 at February 2, 2002)	18,400	15,705
Inventories	193,506	163,560
Deferred income taxes	–	1,790
Other current assets	7,775	2,499
Total current assets	227,890	199,460
Property and equipment, at depreciated cost	110,794	78,225
Equipment under capital leases, less accumulated amortization of $2,542 ($1,849 at February 2, 2002)	2,425	1,533
Other noncurrent assets, net	4,739	4,841
Total assets	$ 345,848	$ 284,059
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 58,489	$ 43,747
Current portion of indebtedness	177	562
Current portion of capital lease obligations	728	678
Accrued liabilities	19,484	14,228
Deferred tax liability	10,559	–
Income taxes payable	–	1,866
Total current liabilities	89,437	61,081
Long-term portion of indebtedness	121	141
Deferred tax liability	676	696
Capital lease obligations	2,389	1,179
Other noncurrent liabilities	2,455	2,055
Total liabilities	95,078	65,152
Commitments and contingencies (Notes 6 and 10)		
Shareholders' equity:		
Preferred stock, nonvoting, no par value, 10,000,000 shares authorized, none outstanding	–	–
Preferred stock, Series A junior participating nonvoting, no par value, 224,594 shares authorized, none outstanding	–	–
Common stock, Class A voting, no par value, 60,000,000 shares authorized, 25,673,259 shares issued and outstanding (25,361,112 shares issued and outstanding at February 2, 2002)	117,209	110,508
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding	–	–
Retained earnings	133,589	108,462
Deferred compensation on restricted stock incentive plan	(28)	(63)
Total shareholders' equity	250,770	218,907
Total liabilities and shareholders' equity	$ 345,848	$ 284,059

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity

(in thousands, except share and per share amounts)

	Common Stock		Retained	Deferred	
	Shares	Amount	Earnings	Compensation	Total
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
Cash dividends paid ($.12 per share)			**(3,089)**		**(3,089)**
Issuance of restricted stock	**750**	**19**		**(19)**	**–**
Other issuances	**100,722**	**3,592**			**3,592**
Exercises of stock options	**210,675**	**1,684**			**1,684**
Amortization of deferred compensation on restricted stock incentive plan				**54**	**54**
Tax benefit on exercise of stock options		**1,406**			**1,406**
Net income			**28,216**		**28,216**
Balance, February 1, 2003	**25,673,259**	**$ 117,209**	**$ 133,589**	**$ (28)**	**$ 250,770**

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(in thousands)

	For the Years Ended		
	February 1, 2003	February 2, 2002	February 3, 2001
Cash flows from operating activities:			
Net income	**$ 28,216**	$ 19,629	$ 14,849
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	**21,032**	17,846	14,277
Provision for uncollectible receivables	**318**	142	64
LIFO Reserve	**1,535**	642	753
Deferred income taxes	**12,329**	1,026	1,747
Amortization of deferred compensation on restricted stock incentive plan	**54**	137	145
Issuance (net of cancellation) of restricted stock	**–**	(52)	(203)
Tax benefit upon exercise of stock options	**1,406**	756	313
(Increase) decrease in assets:			
Receivables	**(3,014)**	(416)	(4,583)
Inventories	**(31,424)**	(14,291)	(8,743)
Other assets	**(365)**	(194)	(444)
Increase (decrease) in liabilities:			
Accounts payable and accrued liabilities	**19,998**	3,532	5,110
Income taxes payable	**(6,778)**	(2,411)	3,628
Other noncurrent liabilities	**400**	52	174
Net cash provided by operating activities	**43,707**	26,398	27,087
Cash flows from investing activities:			
Capital expenditures	**(50,835)**	(17,372)	(15,801)
Proceeds from dispositions of property and equipment	**–**	–	493
Asset acquisition, net of cash acquired (primarily intangibles)	**(1,844)**	(986)	(2,807)
Net cash used in investing activities	**(52,679)**	(18,358)	(18,115)
Cash flows from financing activities:			
Reduction of indebtedness and capital lease obligations	**(855)**	(9,892)	(2,495)
Proceeds from revolving line of credit, net of payments	**–**	(22,623)	(5,617)
Proceeds from public offering, net of expenses	**3,535**	38,156	–
Proceeds from exercise of options	**1,684**	2,165	1,079
Payment of cash for dividends and fractional shares	**(3,089)**	(2,509)	(2,406)
Net cash provided by (used in) financing activities	**1,275**	5,297	(9,439)
Increase (decrease) in cash and cash equivalents	**(7,697)**	13,337	(467)
Cash and cash equivalents:			
Beginning of year	**15,906**	2,569	3,036
End of year	**$ 8,209**	$ 15,906	$ 2,569
Supplemental disclosures of cash flow information:			
Interest paid	**$ 180**	$ 1,775	$ 3,332
Income taxes paid	**$ 7,300**	$ 11,000	$ 2,000
Non cash investing and financing activities:			
Assets acquired through capital lease obligations	**$ 1,585**	$ 691	$ –
Common stock issued for acquisition	**$ 57**	$ 937	$ –

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

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 414 retail discount stores located in fourteen states in the Southeastern United States. Two hundred and sixteen of the Company's stores have full service pharmacies. 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 2002, 2001 and 2000, as used herein, refer to the years ended February 1, 2003, February 2, 2002, and February 3, 2001, respectively. Results for 2000 include 53 weeks.

Use of estimates. The preparation of financial statements in accordance with accounting principles generally accepted in the United States 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 and such differences could be material to the financial statements.

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.

Allowance for doubtful accounts. The Company is reimbursed for drugs sold by its pharmacies by many different payors including the insurance companies, Medicare and various state Medicaid programs. The Company estimates the allowance on a payor-specific basis, given its interpretation of the contract terms or applicable regulations. However, the reimbursement rates are often subject to interpretations that could result in payments that differ from the Company's estimates. Additionally, updated regulations and contract negotiations occur frequently, necessitating the Company's continual review and assessment of the estimation process.

Inventories. Warehouse 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. Under the retail inventory method ("RIM"), the valuation of inventories at cost and the resulting gross margin are calculated by applying a calculated cost-to-retail ratio to the retail value of inventories. RIM is an averaging method that has been widely used in the retail industry due to its practicality. Also, it is recognized that the use of the RIM will result in valuing inventories at lower of cost or market if markdowns are currently taken as a reduction of the retail value of inventories. Inherent in the RIM calculation are certain significant management judgments and estimates including, among others, initial markups, markdowns, and shrinkage, which significantly impact the ending inventory valuation at cost as well as resulting gross margin. These significant estimates, coupled with the fact that the RIM is an averaging process, can, under certain circumstances, produce distorted or inaccurate cost figures. Management believes that the Company's RIM provides an inventory valuation which reasonably approximates cost and results in carrying inventory at the lower of cost or market. For pharmacy inventories, which are $27,819 and $24,700 at February 1, 2003 and February 2, 2002, respectively, cost was determined using the LIFO (last-in, first-out) method. The current cost of inventories exceeded the LIFO cost by $6,138 at February 1, 2003 and $4,603 at February 2, 2002. The LIFO reserve increased by $1,535, $642, and $753 during 2002, 2001, and 2000, respectively.

Property and equipment. Property and equipment are stated at cost, and depreciation is computed using the straight-line method over their estimated useful lives. Leasehold costs and improvements which are included in buildings 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, fixtures 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.

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

Impairment of long-lived assets. The Company's policy is to review the carrying value of all long-lived assets annually and whenever events or changes indicate that the carrying amount of an asset may not be recoverable. The Company adjusts the net book value of the underlying assets if the sum of expected future cash flows is less than the book value. Assets to be disposed of are adjusted to the fair value less the cost to sell if less than the book value. Based upon the Company's review as of February 1, 2003 and February 2, 2002, no material adjustments to the carrying value of such assets were necessary.

Vendor rebates. The Company records vendor rebates for new store allowances, when realized, as a reduction of cost associated with new stores and/ or remodeled stores. The Company records volume purchase rebates and allowances, when realized, as a reduction to inventory purchases, at cost, which has the effect of reducing cost of goods sold, as prescribed by Emerging Issues Task Force ("EITF") Issue No. 02-16, Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor ("EITF 02-16").

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 2002, 2001, and 2000 was $14,124, $12,079 and $10,166 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 and administrative expenses. Total franchise income for 2002, 2001, and 2000 was $2,016, $1,764, and $1,806 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 years ended February 1, 2003 and February 2, 2002, the Company issued 1,966 and 55,980 shares for pharmacy acquisitions, respectively. Intangibles, net of accumulated amortization, totaled $4,661 at February 1, 2003, and $4,778 at February 2, 2002. Accumulated amortization for 2002 and 2001 totaled $7,218 and $5,272, respectively. Amortization expense for 2002, 2001, and 2000 was $1,945, $1,795, and $1,421, respectively. Estimated amortization expense for each of the next 5 years is as follows: 2003 - $1,546; 2004 - $1,325; 2005 - $970; 2006 - $485; and 2007 - $165.

Financial instruments. At February 1, 2003, 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 future claims cost and incurred but not reported claims. If future claim trends deviate from recent historical patterns, the Company may be required to record additional expense or expense reductions which could be material to the Company's results of operations.

Deferred rent. The Company records rental expense on a straight-line basis over the base, non-cancelable lease term. Any differences between the calculated expense and the amounts actually paid are reflected as a liability in accrued liabilities in the accompanying consolidated balance sheet and totaled approximately $714 and $494 at February 1, 2003 and February 2, 2002, respectively.

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

Stock-based compensation. The Company grants stock options having a fixed number of shares and an exercise price equal to the fair value of the stock on the date of grant to certain executive officers, directors and key employees. The Company accounts for stock option grants in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB No. 25"), and related interpretations because the Company believes the alternative fair value accounting provided for under SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation – Transition and Disclosure, requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB No. 25, compensation expense is generally not recognized for plans in which the exercise price of the stock options equals the market price of the underlying stock on the date of grant and the number of shares subject to exercise is fixed. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant date for awards under these plans consistent with the methodology prescribed under SFAS No. 123, net income and earnings per share would have been reduced to the pro forma amounts indicated in the following table.

	2002	2001	2000
Net income – as reported	**$ 28,216**	$ 19,629	$ 14,849
Less pro forma effect of stock option grants	**456**	567	589
Net income – pro forma	**$ 27,760**	$ 19,062	$ 14,260
Earnings per share – as reported			
Basic	**$ 1.11**	$ 0.83	$ 0.66
Diluted	**$ 1.08**	$ 0.81	$ 0.65
Earnings per share – pro forma			
Basic	**$ 1.09**	$ 0.81	$ 0.63
Diluted	**$ 1.06**	$ 0.79	$ 0.62

The Company also periodically awards restricted stock having a fixed number of shares at a purchase price that is set by the Compensation Committee of the Company's Board of Directors, which purchase price may be set at zero, to certain executive officers, directors and key employees. The Company also accounts for restricted stock grants in accordance with APB No. 25 and related interpretations. Under APB No. 25, the Company calculates compensation expense as the difference between the market price of the underlying stock on the date of grant and the purchase price, if any, and recognizes such amount on a straight-line basis over the period in which the restricted stock award is earned by the recipient. The Company recognized compensation expense relating to its restricted stock awards of approximately $54, $137, and $145 in 2002, 2001, and 2000, respectively. (See Note 8 for further disclosure relating to stock incentive plans).

Income taxes. The Company reports income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Under SFAS No. 109, the asset and liability method is used for computing future income tax consequences of events, which have been recognized in the Company's consolidated financial statements or income tax returns. Deferred income tax expense or benefit is the net change during the year in the Company's deferred income tax assets and liabilities.

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 2002 presentation.

Recent Accounting Pronouncements. In June 2001, the Financial Accounting Standards Board (the "FASB") issued SFAS No. 142, Goodwill and Other Intangible Assets. Under the new rules, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed annually for impairment. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. The Company will continue to amortize intangible assets in accordance

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

with existing policy and accordingly the adoption of SFAS No. 142 did not have a material impact on the Company's financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The Company adopted this statement on February 3, 2002. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. It supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of. The adoption of SFAS No. 144 did not have a material impact on the Company's financial position or results of operations.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 rescinds both SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, and the amendment to SFAS No. 4, SFAS No. 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements. Generally, under SFAS No. 145, gains and losses from debt extinguishments will no longer be classified as extraordinary items. The Company adopted the provisions of SFAS No. 145 on February 2, 2003 and believes the adoption of SFAS No. 145 will not have a material effect on the Company's financial position or results of operations.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 nullifies EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) ("EITF 94-3"). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, whereas EITF 94-3 had recognized the liability at the commitment date to an exit plan. The Company was required to adopt the provisions of SFAS No. 146 effective for exit or disposal activities initiated after December 31, 2002. The adoption of SFAS No. 146 did not have a material impact on the Company's financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation – Transition and Disclosure. SFAS No. 148 is an amendment of SFAS No. 123, Accounting for Stock-Based Compensation, and provides alternative methods of transition to SFAS No. 123's fair value method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure provisions of SFAS No. 123 and APB Opinion No. 28, Interim Financial Reporting,to require disclosure in the summary of significant accounting policies of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. While SFAS No. 148 does not amend SFAS No. 123 to require companies to account for employee stock options using the fair value method, the disclosure provisions of SFAS No. 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair value method of SFAS No. 123 or the intrinsic value method of APB Opinion No. 25, Accounting for Stock Issued to Employees. As allowed by SFAS No. 123, the Company has elected to continue to utilize the accounting method prescribed by APB Opinion No. 25 and has adopted the disclosure requirements of SFAS No. 148 as of February 1, 2003. The adoption of SFAS No. 148 did not have a material impact on the Company's financial position or results of operations.

In November 2002, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 02-16, Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor ("EITF 02-16"). EITF 02-16 addresses the accounting and income statement classification for consideration given by a vendor to a retailer in connection with the sale of the vendor's products or for the promotion of sales of the vendor's products. The EITF concluded that such consideration received from vendors should be reflected as a decrease in prices paid for inventory and recognized in cost of sales as the related inventory is sold, unless specific criteria are met qualifying the consideration for treatment as reimbursement of specific, identifiable incremental costs. As clarified by the EITF in January 2003, this issue is effective for arrangements with vendors initiated on or after January 1, 2003. The provisions of this consensus have been applied prospectively. The adoption of EITF 02-16 is not expected to have a material impact on the Company's financial position or results of operations.

FASB Interpretation No. 46, Accounting for Variable Interest Entities ("FIN 46"), expands upon current guidance relating to when a company should include in its financial statements the assets, liabilities and activities of a variable interest entity. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply for "older" entities in the first fiscal year or interim period beginning after June 15, 2003, which would apply for the Company beginning in the third quarter of 2003. The Company believes the adoption of FIN 46 in 2003 will not have a material effect on the Company's financial position or results of operations.

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

NOTE 2
PROPERTY AND EQUIPMENT

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

	2002	2001
Buildings and improvements	$ 75,779	$ 68,922
Furniture, fixtures and equipment	125,723	102,075
	201,502	170,997
Less accumulated depreciation and amortization	(117,312)	(99,121)
	84,190	71,876
Construction in progress	22,308	2,109
Land	4,296	4,240
Total property and equipment, at depreciated cost	$ 110,794	$ 78,225

Depreciation expense totaled $18,394, $15,507 and $12,407 for 2002, 2001 and 2000, respectively.

NOTE 3
ACCRUED LIABILITIES

The components of accrued liabilities are as follows:

	2002	2001
Payroll and benefits	$ 6,900	$ 6,727
Sales and use taxes	3,320	2,694
Insurance	5,036	1,753
Other	4,228	3,054
Total accrued liabilities	$ 19,484	$ 14,228

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 the prime rate or a LIBOR-based rate. Under the most restrictive covenants of the Agreement, the Company is required to maintain specified shareholders' equity (which was $187,731 at February 1, 2003) 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 March 31, 2004. There were no borrowings outstanding under the Agreement at February 1, 2003 or February 2, 2002.

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 $141 and $703 borrowings outstanding under the loan Agreement at February 1, 2003 and February 2, 2002, respectively.

The Company has other miscellaneous financing obligations totaling $157, which relate primarily to business acquisitions. The Company's indebtedness under miscellaneous financing matures as follows: 2003 - $36; 2004 - $17; 2005 - $18; 2006 - $19; 2007 - $21; and $46 thereafter.

The Company is financing the construction of its Dublin, Georgia distribution center with taxable industrial development revenue bonds issued by the City of Dublin and County of Laurens Development Authority. The Company purchased 100% of the issued bonds and intends to hold them to maturity, effectively financing the construction with internal cash flow. The Company has offset the investment in the bonds ($18,485) against the related liability and neither is reflected on the consolidated balance sheet.

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

NOTE 5
INCOME TAXES

The provision for income taxes consists of the following:

	2002	2001	2000
Current			
Federal	**$ 1,929**	$ 9,485	$ 5,642
Deferred			
Federal	**12,824**	907	1,679
State	**(495)**	119	324
	12,329	1,026	2,003
	$ 14,258	$ 10,511	$ 7,645

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below:

	2002	2001
Current deferred tax assets:		
Accrual for inventory shrinkage	**$ 235**	$ 1,060
Allowance for doubtful accounts	**333**	357
Insurance accruals	**1,467**	933
Net operating loss carryforwards	**2,474**	1,532
Postretirement benefits other than pensions	**960**	799
Restructuring costs	**59**	73
Amortization of intangibles	**2,209**	1,768
Other	**–**	76
Total deferred tax assets	**7,737**	6,598
Less: valuation allowance	**(700)**	(1,532)
Deferred tax assets, net of valuation allowance	**7,037**	5,066
Deferred tax liabilities:		
Property, plant, and equipment	**(5,939)**	(3,598)
Inventory valuation	**(12,305)**	(347)
Other	**(28)**	(27)
Total deferred tax liability	**(18,272)**	(3,972)
Net deferred tax asset (liability)	**$ (11,235)**	$ 1,094

A net current deferred tax liability in the amount of $10.6 million primarily resulted from a change in method of accounting for inventory in retail stores from the retail inventory method to the cost method for income tax purposes.

The net operating loss carryforwards are available to reduce state income taxes in future years. These carryforwards total approximately $63.7 million for state income tax purposes and expire at various times during the period 2003 through 2022.

During 2002, the valuation allowance decreased $832, and during 2001, the valuation allowance decreased $24. Based upon expected future income, management believes that it is more likely than not that the results of operations will generate sufficient taxable income to realize the deferred tax asset after giving consideration to the valuation allowance.

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

	2002	2001	2000
Income tax provision at statutory rate	**35.0%**	35.0%	35.0%
State income taxes, net of federal benefit	**1.4**	0.1	0.9
Permanent differences	**(1.0)**	–	–
Change in valuation allowance	**(2.0)**	(0.1)	–
Other	**0.2**	(0.1)	(1.9)
	33.6%	34.9%	34.0%

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

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 2029. Many of these leases contain renewal options and require the Company to pay taxes, maintenance, insurance and certain other operating expenses applicable to the leased properties. In addition, the Company leases various equipment under noncancelable operating leases and certain transportation equipment under capital leases. Total rent expense under operating leases was $26,844, $22,207 and $17,465 for 2002, 2001 and 2000, respectively. Total contingent rentals included in operating leases above was $786, $409 and $370 for 2002, 2001 and 2000, respectively. Amortization expense on assets under capital lease for 2002, 2001 and 2000 was $693, $544 and $449, respectively.

Future minimum rental payments under all operating and capital leases as of February 1, 2003 are as follows:

	Operating Leases	Capital Leases
2003	$ 24,750	$ 1,020
2004	21,814	917
2005	18,879	808
2006	15,014	626
2007	10,405	385
Thereafter	15,407	129
Total minimum lease payments	$ 106,269	3,885
Imputed interest		(768)
Present value of net minimum lease payments, including $728 classified as current portion of capital lease obligations		$ 3,117

NOTE 7
SHAREHOLDERS' EQUITY

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.

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.

On March 6, 2002, the Company filed a Registration Statement on Form S-3 registering 500,000 shares of Class A common stock. The common stock may be used from time to time as consideration in the acquisition of assets, goods, or services for use or sale in the conduct of our business. On March 22, 2002 the Company raised proceeds of $3.5 million from the offering of 98,756 shares.

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

NOTE 8
EMPLOYEE BENEFIT PLANS

Incentive stock option plan. The Company has a long-term incentive plan under which an aggregate of 2,430,651 shares may be granted. These options expire five years from the date of grant. Options outstanding at February 1, 2003 expire in 2003 through 2007.

Under the plan, stock option grants are made to key employees including executive officers, as well as other employees, as prescribed by the Compensation Committee (the "Committee") of the Board of Directors. The number of options granted is directly linked to the employee's job classification. Options, which include non-qualified stock options and incentive stock options, are rights to purchase a specified number of shares of Fred's Common Stock at a price fixed by the Committee. The exercise price for stock options issued under the plan that qualify as incentive stock options within the meaning of Section 422(b) of the Code shall not be less than 100% of the fair value as of the date of grant. The option exercise price may be satisfied in cash or by exchanging shares of Fred's Common Stock owned by the optionee, or a combination of cash and shares. Options have a maximum term of ten years from the date of grant. Options granted under the plan generally become exercisable one-third on the first anniversary, one-third on the second anniversary, and one-third on the third anniversary. The plan also provides for annual stock grants to non-employee directors according to a non-discretionary formula. The number of shares granted is dependent upon current director compensation levels at the fair value of the stock on the grant date.

A summary of activity in the plan follows:

	2002		2001		2000	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	**924,035**	**$ 8.65**	1,242,415	$ 8.16	1,056,475	$ 7.01
Granted	**174,982**	**20.94**	288,219	9.39	647,824	8.03
Forfeited/canceled	**(83,143)**	**7.93**	(292,253)	9.22	(264,046)	5.88
Exercised	**(210,675)**	**7.99**	(314,346)	6.82	(197,838)	4.63
Outstanding at end of year	**805,199**	**11.57**	924,035	8.65	1,242,415	8.16
Exercisable at end of year	**439,059**	**10.24**	356,068	8.32	288,871	5.67

The weighted average remaining contractual life of all outstanding options was 2.3 years at February 1, 2003.

The following table summarizes information about stock options outstanding at February 1, 2003:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at February 1, 2003	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number Exercisable at February 1, 2003	Weighted Average Exercise Price
$ 3.84 to $ 8.47	551,103	1.9	$ 7.62	326,320	$ 7.35
$ 10.61 to $18.53	184,721	2.8	$ 16.85	89,273	$ 15.62
$ 20.91 to $37.05	69,375	4.5	$ 28.89	23,466	$ 30.03
	805,199			439,059	

Pro forma information regarding net income and earnings per share, as disclosed in Note 1, has been determined as if the Company had accounted for its employee stock-based compensation plans under the fair value method of SFAS No. 123. The fair value of options granted during 2002, 2001, and 2000 was $10.03, $6.90 and $2.08, respectively. The fair value of each

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

stock option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	2002	2001	2000
Average expected life (years)	**3.0**	3.0	3.0
Average expected volatility	**46.1%**	41.9%	39.0%
Risk-free interest rates	**2.1%**	2.6%	5.6%
Dividend yield	**0.5%**	1.6%	1.3%

The Black-Scholes option model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide reliable single measure of the fair value of its employee stock options.

Restricted Stock. During 2002, 2001, and 2000, the Company issued (forfeited/cancelled) a net of 750, (15,185), and (47,385) 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 and the plan owns 242,023 shares of Company stock.

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 2002, 2001, and 2000 were $176, $117 and $100, respectively.

Postretirement benefits. The Company provides certain health care benefits to its full-time employees who 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:

	February 1, 2003	February 2, 2002
Benefit obligation at beginning of year	**$ 1,786**	$ 1,617
Service cost	**213**	140
Interest cost	**152**	123
Participant contributions	**–**	1
Actuarial (gain) loss	**378**	(74)
Benefits paid	**(28)**	(21)
Benefit obligation at end of year	**$ 2,501**	$ 1,786

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

	February 1, 2003	February 2, 2002
Funded status	**$ (2,501)**	$ (1,786)
Unrecognized net actuarial gain	**(2)**	(380)
Unrecognized prior service cost	**(4)**	(5)
Other	**52**	116
Accrued benefit costs	**$ (2,455)**	$ (2,055)

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

The medical care cost trend used in determining this obligation is 11.0% effective December 1, 2001, decreasing annually before leveling at 5.0% in 2011. 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 $343. The discount rate used in calculating the obligation was 7.0% in 2002 and 7.25% in 2001.

The annual net postretirement cost is as follows:

	For the Years Ended		
	February 1, 2003	February 2, 2002	February 3, 2001
Service cost	**$ 213**	$ 140	$ 132
Interest cost	**152**	123	116
Amortization of net gain from prior periods	**–**	(17)	(17)
Amortization of unrecognized prior service cost	**1**	1	1
Net periodic postretirement benefit cost	**$ 366**	$ 247	$ 232

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.

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

	For the Years Ended								
	February 1, 2003			February 2, 2002			February 3, 2001		
	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount
Basic EPS	**$ 28,216**	**25,503**	**$ 1.11**	$ 19,629	23,553	$ .83	$ 14,849	22,382	$ .66
Effect of dilutive securities		**664**			644			487	
Diluted EPS	**$ 28,216**	**26,167**	**$ 1.08**	$ 19,629	24,197	$ .81	$ 14,849	22,869	$ .65

Options to purchase shares of common stock that were outstanding at the end of the respective fiscal year were not included in the computation of diluted earnings per share when the options' exercise prices were greater than the average market price of the common shares. There were 56,625 such options outstanding at February 1, 2003 and there were no such options outstanding at February 2, 2002.

NOTE 10
COMMITMENTS AND CONTINGENCIES

Commitments. The Company had commitments approximating $10,434 at February 1, 2003 and $9,133 at February 2, 2002 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating $7,871 at February 1, 2003 and $6,838 at February 2, 2002 utilized as collateral for its risk management programs.

Litigation. The Company is a party to several pending legal proceedings and claims arising 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

Notes to Consolidated Financial Statements

(in thousands, except share and per share amounts)

flows, or the financial condition of the Company. However, litigation involves an element of uncertainty. Future developments could cause these actions or claims to have a material adverse effect on the results of operations, cash flows, or the financial condition of the Company.

NOTE 11
SALES MIX

The Company manages its business on the basis of one reportable segment. See Note 1 for a brief description of the Company's business. As of February 1, 2003, all of the Company's operations were located within the United States. The following data is presented in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information.

The Company's sales mix by major category during the last 3 years is as follows:

	2002	2001	2000
Pharmaceuticals	**33.2%**	34.4%	32.7%
Household Goods	**23.0%**	22.4%	20.4%
Apparel and Linens	**13.6%**	12.3%	13.8%
Food and Tobacco Products	**9.6%**	9.5%	9.4%
Health and Beauty Aids	**9.0%**	9.4%	11.0%
Paper and Cleaning Supplies	**8.4%**	8.3%	8.3%
Sales to Franchised Fred's Stores	**3.2%**	3.7%	4.4%
Totals	**100.0%**	100.0%	100.0%

NOTE 12
QUARTERLY FINANCIAL DATA (UNAUDITED)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended February 1, 2003				
Net sales	**$ 258,427**	**$ 256,470**	**$ 263,197**	**$ 325,324**
Gross profit	**69,425**	**69,638**	**75,994**	**89,920**
Net income	**6,275**	**3,667**	**7,408**	**10,866**
Net income per share				
Basic	**0.25**	**0.14**	**0.29**	**0.42**
Diluted	**0.24**	**0.14**	**0.28**	**0.42**
Cash dividends paid per share	**0.03**	**0.03**	**0.03**	**0.03**
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				
Basic	0.18	0.09	0.22	0.34
Diluted	0.18	0.09	0.22	0.32
Cash dividends paid per share	0.03	0.03	0.03	0.03

Report of Independent Auditors

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

We have audited the accompanying consolidated balance sheet of Fred's, Inc. and subsidiaries as of February 1, 2003, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended. 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 audit. The consolidated financial statements of Fred's, Inc. and subsidiaries for the years ended February 2, 2002 and February 3, 2001, were audited by other auditors whose report dated March 15, 2002, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Fred's, Inc. and subsidiaries at February 1, 2003, and the consolidated results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

Memphis, Tennessee
March 7, 2003

Directors and Officers

Board of Directors

Michael J. Hayes
Chairman and 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
President Emeritus
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 –
Store Operations

Charles S. Vail
Corporate Secretary, Vice President –
Legal Services and General Counsel

Corporate Information

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(800) 937-5449

Independent Auditors
Ernst & Young LLP
Memphis, Tennessee

General Counsel
Baker, Donelson, Bearman & Caldwell
Memphis, Tennessee

Annual Report on Form 10-K
Shareholders of record may obtain a copy of the Company's Annual Report on Form 10-K for the year ended February 1, 2003, as filed with the Securities and Exchange Commission, without charge upon written request to Jerry A. Shore, Executive Vice President and Chief Financial Officer.

Annual Meeting of Shareholders
The 2003 annual meeting of shareholders will be held at 7:00 p.m. Eastern Daylight Time on Wednesday, June 18, 2003, at the Holiday Inn Express, 2192 South Highway 41, Dublin, Georgia. Shareholders of record as of May 2, 2003, 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 2, 2003, the Company had an estimated 16,000 shareholders, including beneficial owners holding shares in nominee or street name.

The table below sets forth the high and low stock prices, together with cash dividends paid per share, for each fiscal quarter in the past two fiscal years. All amounts have been adjusted for a five-for-four stock split distributed in June 2001 and a three-for-two stock split distributed in February 2002.

	High	Low	Dividends Per Share
2001			
First	$ 13.89	$ 10.87	$ 0.03
Second	$ 17.20	$ 12.91	$ 0.03
Third	$ 22.70	$ 15.99	$ 0.03
Fourth	$ 28.73	$ 20.77	$ 0.03
2002			
First	$ 40.10	$ 27.39	$ 0.03
Second	$ 39.05	$ 26.25	$ 0.03
Third	$ 35.00	$ 26.10	$ 0.03
Fourth	$ 30.22	$ 23.23	$ 0.03

SIC 5331

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