



#### This 3DAdvisors Report Covers:

- ✓ **Insider Trading:** Insider Trading Behavior
- ✓ **Accounting:** Quality of Earnings Issues
- Governance:** Corporate Governance Issues
- ✓ **Fundamentals:** Analysis of fundamentals
- Deception:** Deception detection analysis

## Insiders Skim More Options Following 2Q09 Results Family Dollar Stores Inc. (NYSE:FDO) Update

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Contact: Bob Gabele (954) 779-3974 or [bgabele@3DAdvisors.com](mailto:bgabele@3DAdvisors.com)

### Business Description

Family Dollar Stores Inc. operates a chain of self-service retail discount stores for low to lower-middle income consumers in the United States. The Company offers consumables, including household chemicals, paper products, candy, snacks and other food, health and beauty aids, hardware and automotive supplies, pet food, and supplies; and home products, which comprise domestics, housewares, giftware, and home decor. It also provides apparel and accessories, including men's and women's clothing, boys' and girls' clothing, infants' clothing, shoes, and fashion accessories; and seasonal and electronics, such as toys, stationery and school supplies, seasonal goods, and personal electronics. As of November 29, 2008, it operated 6,617 stores in 44 states and the District of Columbia.

### Summary of 3DAdvisors Findings for FDO

- ▶ **Insider Trading:** Insiders again act right after earnings, skimming more options
- ▶ **Fundamentals:** Mix continued to shift more toward consumables in 2Q09
- ▶ **Accounting:** Miscellaneous noteworthy items

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### Discussion of 3DAdvisors Findings for FDO

As we predicted at the time of our initial coverage of Family Dollar Stores Inc. on [03/30/09](#), bullish analyst and media sentiment has remained intact regarding FDO and the other "dollar store" companies that satisfy consumer demand for cheap goods when jobs are scarce and family budgets are tight. Despite the ideal environment for FDO, however, the shares have shown little progress since our report and may have run out of momentum. Even after reporting strong 2Q09 results on 04/08/09 that featured a 33% surge in earnings and full-year guidance exceeding analysts' expectations, the shares have not really advanced although they closed yesterday still richly priced at \$32.60 or roughly 77% above the 52-week low.

Clients may recall in our initial report we had noticed how a number of key insiders had moved, just after the Company's 1Q09 earnings release, to exercise options barely in the money, selling the shares immediately. Even though the options

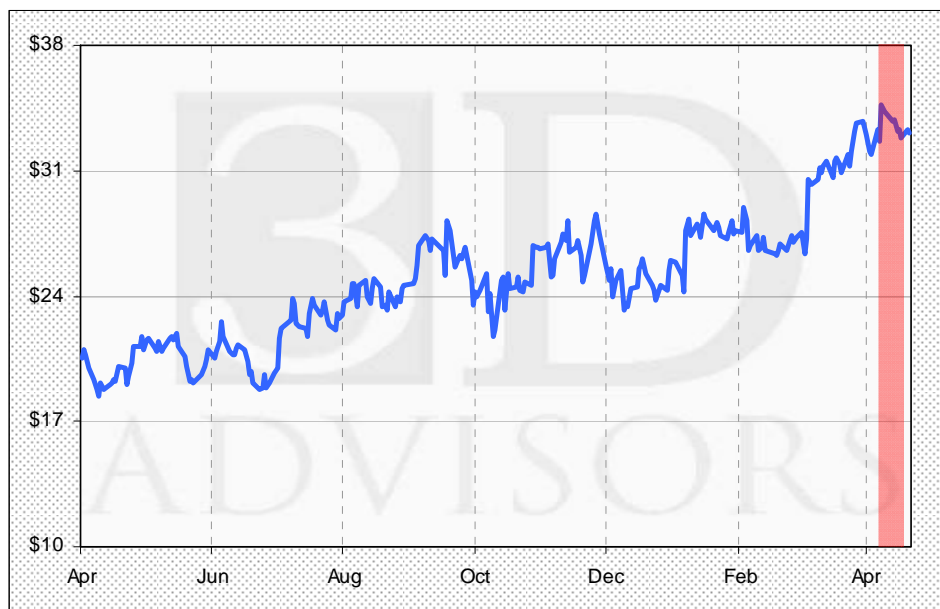
being exercised were scheduled to expire later this year, there were at least 2 additional trading windows still remaining before actual expiration, leading us to wonder if the options “skimming” behavior indicated the insiders were concerned about the options going under water before expiration.

Our further investigations into the Company (detailed in our [03/30/09](#) report) revealed potentially costly legal and business model issues involving labor matters, a continuing shift in the product mix towards lower-margin consumable products, an inability to push cost increases on to customers and questions related to the lack of detail provided by the Company regarding its inventory controls. These issues, in combination with the noteworthy trading behavior and the fading momentum of the shares after an impressive run up, provided ample motivation for us to keep a sharp eye out for any further developments. In this update we start with an examination of a new flurry of trades that were filed immediately on the heels of the 2Q09 results in a pattern that mimicked what we observed following the 1Q09 results, but with some twists.

#### Insider Trading: Insiders again act immediately after earnings, skimming more options

Since the Company has trading windows that prevent insiders from selling until after earnings releases, we had been waiting to see if any new trading behavior would emerge in the wake of the Company's 2Q09 earnings release and conference call on April 8<sup>th</sup>. We were not disappointed as six insiders sold 317,312 shares between 04/09/09 and 04/20/09, while the President and COO filed a new 10b5-1 trading plan disclosing his intention to sell 110,000 shares, beginning in May. As was the case in the earlier round following the 1Q09 earnings, some of the current sellers also skimmed options for very slim profit margins in addition to clearing out options not set to expire until 2010. Details on the more interesting aspects of the recent trading behavior are provided below.

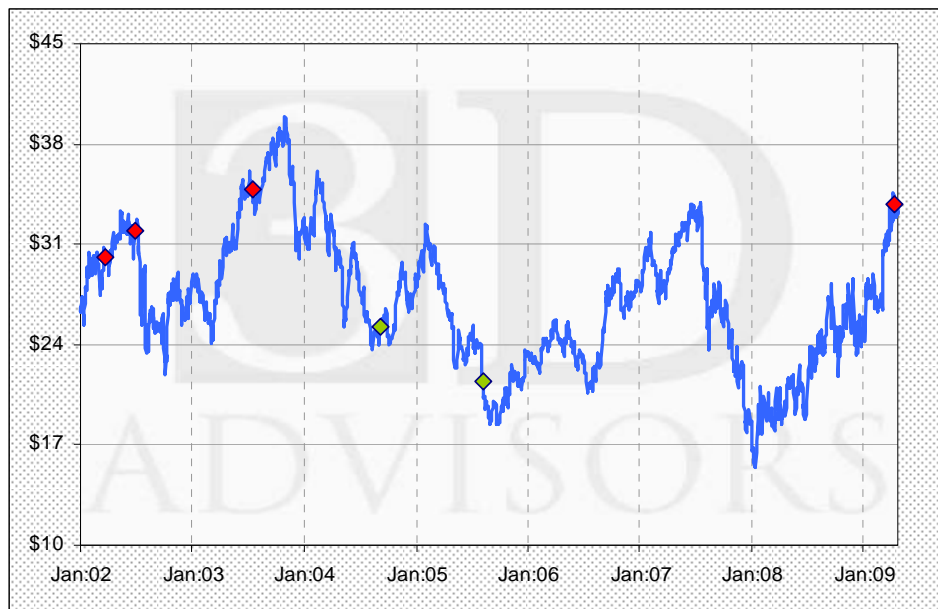
**Figure 1.** FDO Daily Closing Price, 04/01/08 through 04/21/09. Red shaded area is where 6 insiders sold 317,312 shares immediately after the release of 2Q09 earnings. Source: Reuters and FDO SEC Filings.



- **Howard Levine (49)** – Chairman, Chief Executive Officer. It is in fact true the only options CEO Levine monetized after the fiscal second quarter earnings release were those set to expire later in the year. Even so, disregarding his activity on that detail would be a mistake. Levine exercised all 200,000 of his October 2009 options with a \$27 strike price on 04/13/09 and immediately sold the shares for \$6.8 million (\$34 each). This happened to be his first sale in more than five years and his largest based on volume and dollar value since filing as a Section 16 insider back in 1996. The red flags do not end there. For one, Levine has traditionally held his options right up to the last trading window before their expiration dates; a precedent that applied to each of his last seven option exercises dating back to January 2001. In fact, he last exercised options in August 2005, just three weeks before they would have expired. The same cannot be said for his latest trade, which occurred six months before the options' expiration date.

Another compelling attribute of his activity is his uncanny timing. During periods FDO appeared oversold, such as in September 2004 and August 2005, Levine went out of pocket to exercise options and acquire the stock outright even though he already owned more than 9 million shares. Other times selling the exercised-for shares into significant strength before the momentum suddenly reversed course. As Figure 2 below illustrates, Levine made the right call with nearly each trade. Though this latest disposition involved a very small percentage of his total holdings (2%) and was partially motivated by the upcoming options expiration, these factors are overshadowed by his stellar trading record. Levine will have 127,000 options become actionable in September and October (see Appendix A).

**Figure 2.** FDO Daily Closing Price, 01/03/02 through 04/22/09. Red diamonds are where CEO Levine exercised options and sold; Green diamonds are where he exercised and *held* the shares. Source: Reuters and FDO SEC Filings.



- **Charles Sowers (50)** – Senior V.P. of Finance. Sowers' activity exemplifies why we do not perceive the recent round of Family Dollar insider sales to be principally motivated by expiring options. His activity began back on 01/08/09 when he took advantage of a 15% gain when the Company increased FY 2Q09 and full-year guidance, cashing in 39,000 shares of common. A few months later, just one day after the issue traded another 6% higher on the 2Q09 earnings release, Sowers resurfaced. This time he cleared out his October 2009 options, the vested portion of his September 2010 options and also some common, all totaling 38,327 shares. The two sales in just a three month span **erased 50% of his ownership**, including the majority of his vested options. It is interesting to us that Sowers, whose trading history goes back to 1991, has routinely exercised options and retained some or all of the shares in most of his past trades, building up a nice common stock cache. On two occasions this year he seems to have displayed a very different sentiment, selling off the very same holdings it took him years to accrue. The 10,300 options he will vest in over the next 12 months will replace a very small portion of the holdings he recently diversified (see Appendix A).
  
- **Dorlisa Flur (43)** – Executive V.P. of Marketing & Strategy. Flur exercised 60,400 options from three series on 04/09/09 that had expiration dates of June 2009, October 2009 and September 2010, and immediately sold 56,413 shares at \$34. The June 2009 series yielded a 9% profit and the entire sale **trimmed her actionable holdings by 74%**. The reason Flur and other executives did not sell all the shares they exercised for is because of the retention component of the Company's stock ownership guidelines. Officers who have not yet reached their targeted stock holdings are required to retain 25% of the net value of any equity award until the targets are met. So, these were not voluntary acquisitions like that carried out in January 2008, when she strategically picked up 2,200 shares at an eight-year low. In fact, the recent sale was her first disposition since becoming a registered insider back in June 2004. Flur will vest in 27,000 options later this year but that will be it until October 2010 (see Appendix A).
  
- **Barry Sullivan (44)** – Executive V.P. of Store Operations. Sullivan is another two-time seller this year, having already cleared out his October 2009 options on 02/03/09 for a scant profit, eight months before their expiration. Proving once again the FDO sales are more likely the result of valuation concerns than the expiring options, Sullivan then resurfaced on 04/09/09, one day after the 2Q earnings release, to monetize all the vested options in two separate series not set to expire until next year (May 2010 and September 2010) which carried strike prices of \$24 and \$26. Although he did retain a few of the shares exercised for in January and April due to the ownership guidelines, **the net result was a 65% drop in his actionable ownership**. Sullivan's last sales before this year occurred in April and July of 2007, just weeks before the Company lowered FY 4Q07 guidance, news that erased 30% of the issue's value in less than one month. The 18,000 shares he sold this year will be replaced later this year by 18,602 vesting options (see Appendix A).
  
- **R. James Kelly (61)** – President, Chief Operating Officer. Kelly is the last Section 16 executive to take action on his soon-to-expire October 2009 options series. On 04/19/09 the Company issued an SEC Form 8-K disclosing Kelly adopted a 10b5-1 sales plan to monetize only these particular options, 110,000 in all, between 05/11/09 and the options' expiration date. It also says that the sales will be triggered only if certain price thresholds are reached, but does not provide the prices. We will

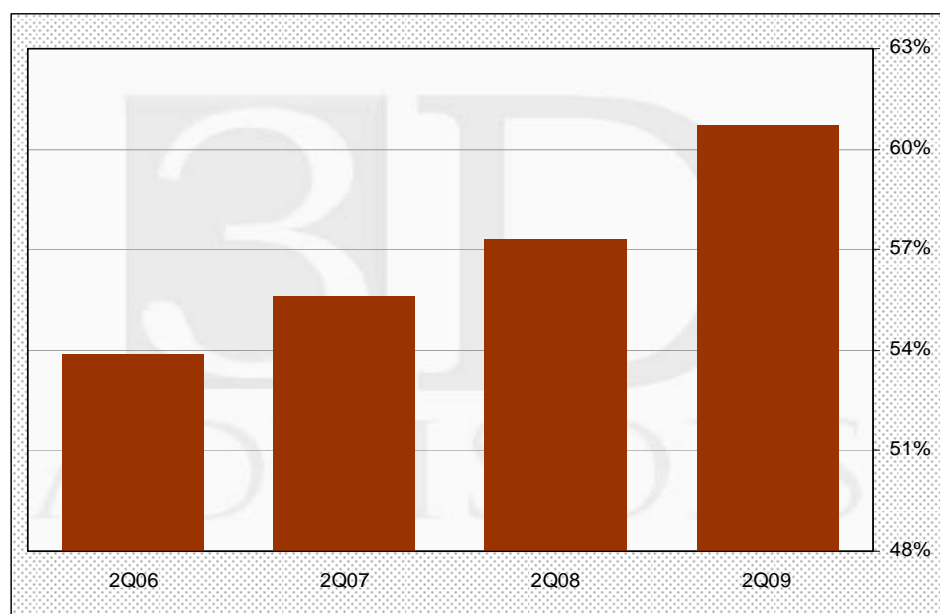
be paying close attention to see if these shares are disposed of in one fell swoop counter to the spirit of the Rule or if the sales are spread out over a longer period to satisfy the good faith aspect of the plan. These options currently make up nearly 20% of his actionable holdings, but he does stand to gain access to another 127,000 options when they become actionable in September and October of this year (see Appendix A). Sales under the plan will be his first in more than five years.

#### Fundamentals: Mixed continued to shift more toward consumables in 2Q09

The FDO product mix continued to trend toward a higher percentage of lower-margin “consumable” goods in 2Q09. This shift, as we noted in our report on [03/30/09](#), is significant in that margins are already notably thin, and FDO stands out among its peers as the share of total sales represented by consumables has increased rapidly. Much of the share growth is attributable to efforts to increase FDO stores’ ability to collect Food Stamp revenues. In order to do so, a store must have refrigeration facilities and be able to sell items such as milk. Dorlisa Flur, who has just sold 74% of her holdings (see above), has spearheaded much of the initiative to install refrigeration units in FDO stores, earning her the nickname “the Cooler Queen.”<sup>1</sup>

There appear to be as many negatives as positives when it comes to evaluating the strategy in shifting towards more consumable merchandise. It is a safe assumption that our clients are aware of both sides of the argument. We would submit, however, that in this environment, with FDO contributing more floor space to such merchandise, its inability to pass on any cost increases continues to increase. At the same time, the strategy compromises the Company’s ability to eventually expand margins in an improving economy by introducing more discretionary items in its merchandise mix.

**Figure 3.** FDO Percentage of Total Revenue from “Consumable” Goods in Second Quarter, 2006 to 2009. Source: FDO SEC Filings.



<sup>1</sup> Kapner, Suzanne, “The Mighty Dollar”, Fortune Magazine, April 15, 2009.

At first glance, the 2Q09 results (the Christmas quarter for FDO) seemed to show a drop in the percentage of total sales contributed by consumables, as the percentage dropped from 66% in 1Q09 to 61% in 2Q09. But that is an illusion caused by seasonality. In each 2Q since 2003, as FDO sells more Christmas items (non-consumables), the percentage mix for the quarterly period drops below that year's annual average. Figure 3 above shows that in each successive year-over-year 2Q, the consumable mix has increased significantly, with the sharpest move higher being the jump between 2Q08 and 2Q09.

Consumables increased by 15% from the year-ago quarter, accounting for virtually all of the sales improvement, while over 70% of the quarterly sales increase came from an increase in comps, as opposed to new store openings, again driven by the shift toward consumables. As we have noted in the past, however, emphasis on the food component of consumables is a key element of their strategy and carries with it a certain degree of risk.

#### Accounting: Miscellaneous noteworthy items

- ➔ **Auction Rate Securities:** During 2Q09, FDO was able to liquidate just \$5 .6 million of its Student Loan-Backed Auction Rate Securities. Net of related OCI losses (totaling \$8.7 million), the Company's Auction Rate Security portfolio now stands at just under \$208 million.
- ➔ **Labor-Related Class Action:** The Company still intends to appeal to the U.S. Supreme Court to review a ruling against it that could cause FDO to have to re-classify its store managers as "non-exempt" employees making them eligible for overtime pay. Thus far, the Company is facing a judgment for \$35.6 million and has accrued liabilities related to this matter of \$51 million. Should the Company not prevail, however, the real impact would be the increased costs, going forward, of compensating managers of its 6,600 stores for overtime pay. We are unable to quantify the potential impact on the Company's margins and profitability, but it is believed that the number of overtime hours worked by store managers is significant, leading to a potentially significant impact on the Company.

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## Appendix A

Common Stock and Option Holdings for Selected Family Dollar Stores Inc. (FDO) Insiders

Name	Actionable Position as of 04/24/09:			Derivative Equity Expected to Vest in Next 12 Months			
	Common	Options <sup>1</sup>	Total <sup>2</sup>	Grant Date	Strike Price	Vesting Dates	# Vesting
<b>Dorlisa Flur</b> EVP of Strategy and Marketing	14,039	5,811	<b>19,850</b>	09/28/05	\$19.75	09/28/09	10,500
				10/03/06	\$29.41	10/03/09	6,402
				10/09/07	\$27.31	10/09/09	10,667
							<b>27,569</b>
<b>Charles Gibson Jr.</b> EVP of Supply Chain	25,291	8,536	<b>33,827</b>	09/28/05	\$19.75	09/28/09	10,500
				10/03/06	\$29.41	10/03/09	6,402
				10/09/07	\$27.31	10/09/09	10,667
							<b>27,569</b>
<b>Janet Kelley</b> SVP, General Counsel	3,442	29,698	<b>33,140</b>	09/28/05	\$19.75	09/28/09	6,600
				10/03/06	\$29.41	10/03/09	3,524
				10/09/07	\$27.31	10/09/09	5,867
							<b>15,991</b>
<b>R. James Kelly</b> President, COO	256,452	220,500	<b>476,952</b>	09/28/05	\$19.75	09/28/09	28,500
				10/03/06	\$29.41	10/03/09	33,000
				10/09/07	\$27.31	10/09/09	66,147
							<b>127,647</b>
<b>Howard Levine</b> Chairman, CEO	9,734,748	165,000	<b>9,899,748</b>	09/28/05	\$19.75	09/28/09	45,000
				10/03/06	\$29.41	10/03/09	45,000
				10/09/07	\$27.31	10/09/09	66,147
							<b>156,147</b>
<b>Kenneth Smith</b> SVP, CFO	21,780	6,280	<b>28,060</b>	09/28/05	\$19.75	09/28/09	1,500
				10/03/06	\$29.41	10/03/09	947
				10/09/07	\$27.31	10/09/09	5,334
				04/17/07	\$31.76	04/17/09	1,138
							<b>8,919</b>
<b>Charles Sowers</b> SVP of Finance	72,600	3,527	<b>76,127</b>	09/28/05	\$19.75	09/28/09	3,900
				10/03/06	\$29.41	10/03/09	2,443
				10/09/07	\$27.31	10/09/09	4,000
							<b>10,343</b>
<b>Barry Sullivan</b> EVP of Store Operations	5,521	4,424	<b>9,945</b>	05/26/05	\$26.00	05/26/09	7,500
				10/03/06	\$29.41	10/03/09	3,319
				06/19/07	\$24.06	06/19/09	1,650
				10/09/07	\$27.31	10/09/09	6,134
							<b>18,602</b>

<sup>1</sup> Total number of vested, in-the-money options.

<sup>2</sup> Total actionable position includes common stock plus vested in-the-money options.