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 Exude Confidence, But Some Skim Options
Family Dollar Stores Inc. (NYSE:FDO)

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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.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Services	**$33.63**	**$4.71B**	**3,963,190**
Industry:	52 Wk Range:	Trailing P/E:	Shrs Out:
Discount, Variety Stores	**$18.43-$33.91**	**19.61**	**139.91M**
F/T Employees:	FYE:	Forward P/E:	Short % of Float:
25,000	**30-Aug**	**16.33**	**9.30%**

Summary of 3DAdvisors Findings for FDO

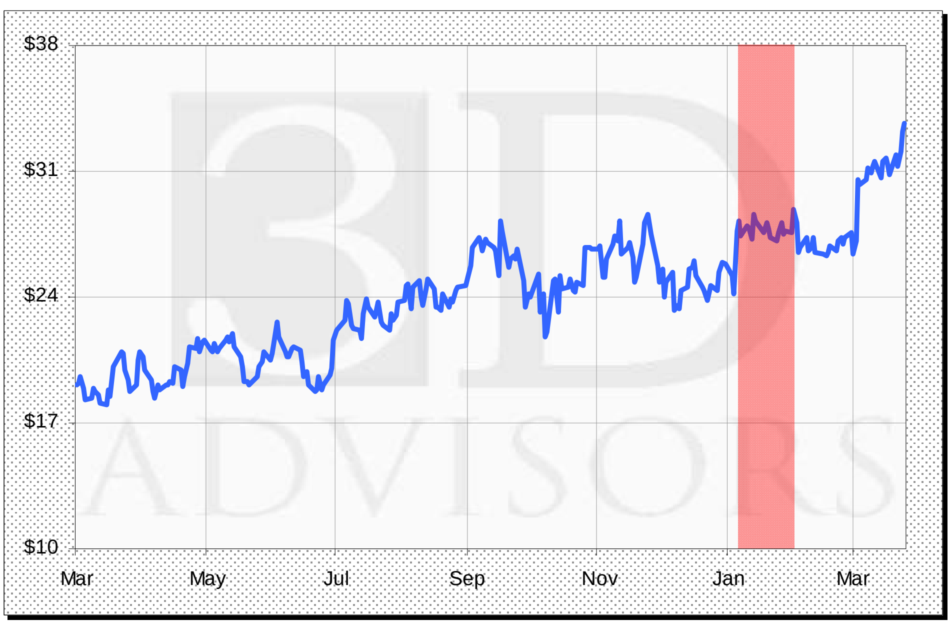
- **Insider Trading:** Recent trades suggest concern about options slipping underwater
- **Fundamentals:** Labor issues loom that could further pressure margins
- **Fundamentals:** Thin margins mean few additional costs can be absorbed
- **Fundamentals:** Product mix shift continues towards lower margin merchandise
- **Fundamentals:** Can revenue growth offset lower margin product mix?
- **Fundamentals:** Questions about the sustainability of 2Q09 earnings hike
- **Accounting:** Miscellaneous noteworthy items

Discussion of 3DAdvisors Findings for FDO

It has always been our take that the trading behavior of "in the trenches" mid-level managers, as opposed to higher visibility C-level executives, often provides us with the best clues regarding true management sentiment as it relates to current share prices. These are frequently the very insiders who know best how the battles on the front lines are going and who may move more quickly to protect their holdings should they perceive the tide beginning to move against them. Their lower visibility and salaries (relative to their bosses') can make them more susceptible to the urge to preserve gains at such times.

Though there is nothing subtle about the bullish thesis developing around the "Dollar Stores" group in a weak economy, we find ourselves inexorably drawn in to the subtle, but significant, contrary nature of the behavior of certain key Family Dollar Stores Inc. (NYSE:FDO) executives in recent months. The trades catching our eye are from insiders involved in inventory and legal matters, areas that potentially pose some of the most serious challenges to the bullish tide taking FDO shares higher.

Figure 1. FDO Daily Closing Price, 03/03/08 through 03/27/09. Red shaded area is where 5 insiders sold 165,818 shares, including the EVP of Supply Chain and General Counsel, both of whom skimmed options for small profit while reducing their holdings as much as 70%. Source: Reuters and FDO SEC Filings.



In FDO conference calls and regulatory filings, disclosure is lacking, especially regarding inventories where much is said about the Company's sophisticated systems and controls but precious little detail is offered, giving a "Black Box" feel to the presentation. In the 1Q09 (ended 11/29/08), SG&A expense rose 6.3% on a revenue increase of just 4%. During the period, the Company's sales of lower margin consumables rose to 67% of revenues versus 61% in the year ago period. Yet FDO reported a 13% earnings gain for the period. How did they do it? Again, the Black Box seems the answer as management again touts its prowess at inventory management but provides few specific details.

Similar things can be said about the Company's push for more private labeling, which could potentially shift its lower margin consumable-heavy product mix toward higher margin merchandise. In fact, margins are an issue as the Company admits that it has little opportunity to pass price increases on to consumers. At the same time, there appear to be certain challenges on the labor front that could materially compromise earnings performance in the future. To this add the loss of liquidity due to too much of the Company's investment portfolio being locked up in auction rate securities which, in this era of constrained credit markets, has forced FDO to rely heavily on short-term credit to keep the model going.

FDO management seems to be unconcerned about these issues, but offers what strikes us as vague responses to related analyst questions that attempt to get more traction on details. It is these items and others that provide interesting context for the recent trading behavior that took place on the heels of the 1Q09 results, especially that which involve the EVP of Supply Chain and General Counsel. We start with the trading details, followed by a matter that could have significant ramifications for the Company's cost structure that the General Counsel is intimately familiar with.

<u>Insider Trading: Recent trades suggest concern about options slipping underwater</u>

Immediately after the 1Q09 earnings release, five FDO insiders surfaced to sell just fewer than 167,000 shares. The significance of the action lies in the fact that three of the sellers were exercising options and selling the underlying shares at very slim profits. It is always of interest to us to see such actions, which may signal a concern that the options involved may face the risk of slipping underwater in the months ahead. Adding to our interest in this particular instance is the fact that the two sellers behaving in this manner are the head of the Company's supply chain and it's General Counsel:

- **Charles Gibson (47)*** – Executive V.P. of Supply Chain. Gibson has held his current title for six years and began his FDO employment back in 1997. On 02/03/09 he surfaced with his largest sale on record, dumping 70% of his actionable ownership (82,666 shares) at $29. These shares came from two option series exercised on the same day, 60,000 of which had 8 months remaining before expiration and yielded a slight 7% pre-tax profit. He also cleared out all the vested options in his September 2010 series. This sale feels eerily similar to a rather opportune trade two years earlier, when Gibson possessed options with a September 2007 expiration and monetized the options for a narrow 12% profit two trading windows before expiration. This decision proved quite timely as management lowered its expectations for FY 4Q07 earnings and comp sales in early August two full months before the earnings release. Had Gibson held these options for a few more months they would have been worthless (under water) in September. We might never know if his trades were motivated by information he may have possessed relating to the earnings troubles, but his timing certainly makes his latest trades more compelling. All 27,569 options Gibson will add to his actionable position in the next 12 months will vest in September and October 2010. It will be one full year after that period before any additional options become exercisable (see Appendix A).

- **Janet Kelley (55)** – Senior V.P., General Counsel, Secretary. Kelley's recent activity mirrors that of Gibson discussed above. On 01/08/09 she monetized all options in both her October 2009 and September 2010 series, immediately selling all 35,440 shares at $28. She still had plenty of time to exercise the 2009 options but opted to take a negligible 4% profit rather than hold out for a more reasonable spread. Unlike Gibson, however, Kelley sold an additional 1,049 shares out of her common position on the same session, an unmistakable indication her behavior was not motivated solely by expiring options. This sale, which immediately erased more than 50% of her holdings, was only her second disposition since becoming a registered insider back in January 2004. Her only prior trade, which occurred in July 2008 at $23, covered just 1,000 shares so it would seem the issue's move to nearly $30 (at the time) was the incentive she needed to cash out. With just 15,991 options scheduled to vest in the next 18 months, the holdings Kelley just diversified will not be replenished in the near term (see Appendix A).

- **Charles Sowers (50)** – Senior V.P. of Finance. On 01/08/09 the Company's second most visible finance officer surfaced with only his second trade in the last 15 years that did not involve stock options. Sowers dipped into his common stock reserves to sell 39,080 shares, equal to 25% of his actionable position. This disposition, his first in three years, was also record-breaking in terms of volume, topping all 13 of his prior sales since he filed as a Section 16 insider nearly 20 years ago. Furthermore, the $27 exit price was the second lowest associated with any of his dispositions in the last eight years. An abundance of stats indeed, but they distinguish this activity as a stand-out trade from a veteran officer. Sowers will have just 10,343 options vest during the remainder of 2009 (see Appendix A).

- **Barry Sullivan (44)** – Executive V.P. of Store Operations. Sullivan is the third officer to 'skim' stock options in the first quarter. Seven months before the options were to expire Sullivan cleared out his October 2009 series on 02/03/09, accepting a slim 7% profit on the immediate sale of 7,123 shares. This was the lowest volume of any of his last three sales since filing his Form 3 in May 2005, and the smallest in terms of share count of any of his peers, but this does not diminish the significance of his behavior. Sullivan still had two later open windows to act on these options if he expected further upside that would increase his profits above the substandard 7%. Plus, he has a notable record for selling ahead of negative earnings news. Sullivan last dumped 14,000 shares on 07/16/07 at $35, just weeks before the Company lowered FY 4Q07 guidance. The shares would lose 30% in just one month following his sale date. And finally, while the sale volume was light, the shares still accounted for 25% of his actionable ownership. Sullivan will have 18,000 options become exercisable in the next 12 months (see Appendix).

* Indicates that the individual is a Named Executive in the Company's most recent Proxy.

One may ask why there were no insiders selling into the rally precipitated by the March 5th guidance hike. The answer is simply that insiders have likely been blocked from trading in advance of the 2Q09 earnings. There has not been a sale by an FDO insider in the month of March in the past seven years. This, and the pattern of past insider sales, strongly suggest that the Company uses a typical window which closes 15 days before the end of a quarter (2Q09 closed on March 2) and reopens 1 to 7 days after the earnings release. FDO reports 2Q09 results before the open on April 8th.

Fundamentals: Labor issues loom that could further pressure margins

Followers of FDO are well aware of an enduring class-action suit, initiated in 2001, that not only has refused to go away but now seems poised to go all the way to the U.S. Supreme Court. It started with two individuals who had held the position of Store Manager for subsidiaries of FDO that filed a complaint against the Company, alleging violation of the Fair Labor Standards Act. The suit charges that former Store Managers and other similarly situated employees were classified as "exempt" employees and therefore not entitled to overtime compensation. The court allowed the case to proceed as a collective action and 2,550 other plaintiffs joined the lawsuit. In a jury trial in 2005 it was found that the employees should not have been classified as exempt and should have been entitled to overtime compensation. The court found that FDO did not act in good faith and it was ruled that $35.6 million in damages should be awarded.

FDO appealed the ruling and on December 16, 2008 the Court of Appeals upheld the ruling. According to the 1Q09 SEC Form 10-Q, FDO plans to petition the United States Supreme Court to grant certiorari for review of this ruling. Although FDO had accrued liabilities of approximately $51.1 million with respect to this litigation, including $45 million recognized as a litigation charge in the 2Q06, the implications of this matter are significantly more far reaching: The 1Q09 SEC Form 10-Q goes on to state [bolding is ours]:

> **"While the Company is currently unable to quantify the impact of such a determination, if the Company determines that a reclassification of some or all of its Store Managers as non-exempt employees under the FLSA is required, such action could have a material adverse effect on the Company's financial position, liquidity or results of operation."**

The impact of a potential re-classification of exempt store managers to non-exempt would be no small matter. With over 6,500 stores, the ranks of store managers are well stocked with individuals who, we have found, through checking various blogs containing employee posts, are basically required to work six-day weeks and a minimum of 52-hours per week. It seems that many, if not a majority, of these managers put in far more hours than even the official requirement.[1] According to a number of these posts, the typical store manager is not allotted enough payroll hour resources in order to accomplish tasks required by Corporate in order to make the grade. Consequently, it is the manager who ends up putting much unpaid overtime in cleaning and straightening stores, unloading trucks, stocking merchandise, keeping track of inventory shrinkage, etc. Considering the razor thin margins achieved by this sort of store, any move to cause all the non-compensated overtime hours to be converted into payroll increases would have an effect on margins that should not be discounted as insignificant.

A second wild card, potentially affecting separate strata of the FDO staff, looms on the horizon. It could materialize in the form of the pending Employee Free Choice

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[1] The following URL is from an online employee complaint web site called "The Rip-Off Report" and is an example of a store manager complaining about work hours and general treatment by "upper management". We do not frequently place much weight on such sources, but given the related class-action suit, we found this and other stories interesting: http://www.ripoffreport.com/reports/0/339/RipOff0339180.htm

Act. Pushed by the Obama Administration, the act would activate the much-debated "Card Check" practice which would enable employees to form, join, or assist labor organizations and provide for mandatory injunctions for unfair labor practices during organizing efforts. We are certain that our clients are well aware of the implications of this pro-union act so we will not belabor the issue. Suffice it to say that the act missed passage in last year's 110th Congress but, under the current Democratic administration, has a much higher chance of passage in this year's session.

At first blush, it is easy to pass on this issue as a risk facing FDO given the Company's fragmented retail presence of over 6,500 stores and 25,000 full-time employees, which means that on average each store has only a few employees. While union organizers may very well pass on the employees in the retail stores, they could find the Company's nine distribution centers, each employing about 450 workers, very fertile ground indeed. With distribution employees amounting to about 20% of the FDO workforce, one can easily see Company management keeping a wary eye on this situation.

<u>Fundamentals: Thin margins mean few additional costs can be absorbed</u>

We note the potential significance of the above labor issues because of the margin contraction risk they would bring about should either situation evolve in a manner unfavorable to the Company. Family Dollar's thin margin structure already lags most of its peers. The situation could easily get worse: By the Company's own admission, the competitive nature of its business and the profile of its low-income customers make it very difficult, if not impossible in some cases, to pass cost increases on to its customers. Confirming this, consider the following risk disclosure in the recently filed 2008 SEC Form 10-K:

> ***Economic conditions, including inflation and energy prices, could affect our profitability.***
>
> Increases in our cost of goods and services, including changes resulting from inflationary pressures, may reduce our sales or profitability. Our ability to pass on incremental pricing changes may be limited due to operational or competitive factors. Increases in prices and other operating costs, including changes in energy prices, wage rates, lease and utility costs may increase our costs of goods or operating expenses and reduce our profitability.

In a quiet exclamation point to the above risk, FDO slipped the following new disclosure into a separate section of its risk disclosures in the 2008 SEC Form 10-K [bolding in the body of the text is ours]:

> ***Changes in currency exchange rates, trade restrictions, tariffs, quotas and freight rates could increase our cost of doing business.***
>
> Changes in federal or state wage requirements (**including changes in the process for our employees to join a union**) or in entitlement programs such as health insurance, paid leave programs, or other changes in workplace regulation or federal tax rates could adversely impact our ability to achieve our financial targets.

Once one realizes that the majority of the risk disclosures in the new SEC Form 10-K are virtual cut and paste from the previous year's version, the significance of subtle changes, such as the above, becomes better appreciated.

The thin margin environment that FDO and its peers operate in is well known by analysts. FDO operating margins have ranged primarily around the low end of the 5% to 6% range. In one brief quarter (3Q08) a short-lived 6% was attained which management attributed to "operational and process improvements", "lower professional fees", "lower workers' compensation", "strong cost controls", and the "implementation of centralized procurement and facility management programs." Such efforts, however, were not enough to prevent these margins from slipping back to the 5% range for the full year.

In 1Q09, management again touted strength in gross margins, which inched up to 5.3% (up 10 bps from year end; 20 bps year-over-year), attributing the gain to fewer markdowns. Possibly remembering past fleeting success in this area, one analyst was looking for better detail. Not much was offered:

> **Analyst:** I was wondering if we could dig into the gross margin performance a little bit. You have identified the categories that drove the improvement and offset the mix. I was wondering if you could as you have in the past, quantify the individual components, in particular IMU's and how much the mix shift hurt?
>
> **Kenneth T. Smith, CFO; SVP:** I don't think historically we've quantified – and don't typically break out the components – a number related to each component on the gross margin components. I would suggest, from a - again, from a size sense of magnitude, that the [inaudible] of the markdowns is a significant one, and the year-over-year comparison markdown rate this year versus last year would be the – have a significant impact on the improved margin.

FDO management frequently comments that they have been working hard to contain expenses. However, looking at the table below of SG&A costs (which have been stubbornly rising for FDO) one sees that competitors (especially Wal-Mart Stores Inc.) have performed much better in their efforts to keep SG&A down:

SG&A Cost as a % of Sales	2005	2006	2007	1Q08	2Q08	3Q08	2008	1Q09
FDO	27.0	27.5	28.3	29.2	28.3	28.4	28.4	29.8
DG	22.2	23.1	24.2	24.2	23.6	24.4	23.4	--
DLTR	26.2	26.2	26.4	27.3	27.6	27.8	26.4	--
FRED	23.9	24.0	25.0	24.5	25.7	25.9	24.1	--
NDN	33.3	35.6	36.2	36.1	39.6	33.4	--	--
WMT	17.8	18.0	18.6	18.6	18.9	19.7	18.8	--

Making matters on the SG&A front more interesting, FDO seems to be battling increasing costs in this area in spite of its claims that it is has the issue under control. In

1Q09, SG&A reached 29.8% of sales. According to the Company, insurance expense and occupancy costs are what pushed SG&A higher as compared to the year ago period. Management says the comps are skewed and attempts to imply that they have the matter under control. From the prepared remarks at the beginning of the 1Q09 conference call:

> During the first quarter of fiscal 2008, we leveraged insurance expense by approximately 60 basis points. Reflecting our ongoing efforts to lower store-level inventories, increase store manager retention, and improve our operational processes, we have experienced improving Workers' Compensation and general liability trends for the past several quarters. This quarter, the absolute number of Workers' Compensation and general liability claims continued to decline. However, we also experienced a limited number of large claims. In addition, we face some strong headwinds as we cycle last year's improvements. As a result, insurance expense increased approximately 60 basis points as compared with last year.

So on the one hand, SG&A looks higher in 1Q09 from a year ago because of tough comps. And while claiming things are improving, however, other temporary items are offsetting the improvement. In the end, it sounds to us like more SG&A increases are in the cards for 2009, despite any improvements. The reality is that SG&A is now pushing toward 30% of sales, up from 28.3% in 2007. What would this number look like without the implied improvements?

Another Black Box for FDO relates to inventory disclosure. There is considerable estimation involved in inventory valuation, which of course is not unusual, but there is very little disclosure. Interestingly, there is zero disclosure on the inventory line item in the FDO SEC Form 10-Ks or the 10Qs with regards to shrinkage, write-downs, or inventory turns. As such, it is difficult to get a grasp on how efficient FDO is with its inventory, despite oft repeated claims of improvement. DLTR does disclose inventory turns while the other competitors do not. DLTR has seen its inventory turns increase from 2.9 in 2005 to 3.7 in 2008. The FDO conference calls do not provide any enlightenment either except for the reiteration from management that shrinkage is down, inventory levels per store are down, and inventory purchasing has been more selective with discretionary inventory purchases more strategic. No real specifics are ever provided.

In the deep discount retail industry one can presume that inventory management is one of the key variables. Although inventory turns are not readily disclosed by the Company (instead, left to calculation by interested parties, which we have done below), it is interesting to take a look at inventory as a percentage of total assets. Not surprisingly, some players appear to maintain a much lower percentage of inventories to total assets than others. FDO had been experiencing a drop in inventory levels until the 1Q09. One might presume the ratio rose in anticipation of the holiday season; however, we will have to wait until the 2Q09 figures are released to determine the veracity of that statement.

Inventory as a % of Total Assets	2005	2006	2007	1Q08	2Q08	3Q08	2008	1Q09
FDO	45.3	41.1	40.6	43.1	39.3	39.5	38.8	40.5
DG*	49.5	47.1	14.9	15.2	16.7	18.1	15.9	--
DLTR	32.1	32.1	35.9	36.9	38.5	43.5	33.2	--
FRED	61.0	59.1	58.2	59.8	60.5	62.6	55.4	--
NDN	22.3	23.8	21.3	22.7	24.9	26.1	--	--
WMT	23.3	22.2	21.5	21.2	21.2	24.1	21.1	--

*Merger in 2007 and a restatement significantly increased assets.

Inventory Turns	2006	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09
FDO	4.018	4.29	1.055	1.215	1.11	1.163	4.42	1.073
DG	--	--	1.313	1.319	1.175	--	5.471	--
DLTR	4.42	4.46	1.074	1.066	.946	1.18	4.636	--
FRED	4.152	4.076	1.007	.965	.83	1.029	4.142	--
NDN	4.593	4.92	1.267	1.239	1.22	--	--	--
WMT*	8.02	8.32	2.03	2.189	1.953	2.205	8.22	--

*Figures for WMT include Sam's Club.

With FDO carrying one of the highest percentages of inventory to assets and lowest turnovers amongst its peers, one could do with more detail from the Company as to how its claimed improvements in efficiency, inventory purchasing and control procedures work towards aiding the bottom line.

Fundamentals: Product mix shift continues towards lower margin merchandise

FDO is on a continued march toward lower margin consumables dominating its product mix. As of 1Q09, 66% of the Company's revenues were comprised of this category of goods, this up from 61% at the end of 2008 and 57.9% at the end of fiscal 2005. Although not all competitors report the same segments or fiscal year-end, the table below makes it clear that the shift to lower margin receivables may be an industry trend but is more pronounced for FDO than it is for the most of its competitors.

As the product mix continues its shift more towards lower margin consumables, management acknowledges the margin pressure as it discloses to analysts its plan of attack. Yet few details are provided other than what was offered in the 1Q09 conference call, that "benefits from lower markdowns, lower transportation expense, and better inventory shrinkage may offset much of this pressure".

% of Total Sales	Consum-ables	Seasonal & Electronics	Home Products	Basic Clothing	Pharmacy & Health	Other
FDO						
1Q09	65.9	10.2	13.3	10.6	--	--
2008	61.0	11.5	14.4	13.1	--	--
2007	58.8	11.7	15.1	14.4	--	--
2006	57.9	12.5	15.2	14.4	--	--
DG						
2008	69.3	14.6	8.2	7.9	--	--
2007	66.5	15.9	9.2	8.4	--	--
2006	65.7	16.4	10.0	7.9	--	--
DLTR[1]						
2008	--	--	--	--	--	--
2007	46.0	5.9	48.1	--	--	--
2006	45.3	5.8	48.9	--	--	--
FRED[2]						
2007	22.2	0.0	33.6	9.9	32.2	2.1
2006	21.0	0.0	33.3	11.7	31.9	2.1
NDN[3]						
2007	52.0	21.0	18.0	--	9.0	--
2006	51.0	20.0	20.0	--	9.0	--
2005	48.0	21.0	22.0	--	9.0	--
WMT[4]						
2008	--	--	--	--	--	--
2007	47.0	26.0	6.0	12.0	9.0	--
2006	45.0	27.0	6.0	13.0	9.0	--

[1] DLTR discloses one category for both home and clothing entitled “variety categories.” 2008 figures are not available yet although the transcript generally says 40% consumables 60% general merchandise.
[2] Consumables for FRED contain food & tobacco products and health & beauty aids. FRED also does not break out a “seasonal” category. FRED also does not provide segment information on a quarterly basis.
[3] Consumables for NDN is food and grocery; Seasonal includes stationery/party and other.
[4] Consumables for WMT includes grocery and health and beauty aids. Quarterly segment information is not disclosed.

Fundamentals: Can revenue growth offset lower margin product mix?

In spite of the hype that the crisis environment makes growth at the deep discount retailers seem a no-brainer, further inspection does not make FDO look as if it is in the midst of a sustainable revenue expansion. Indeed, a look at the table below shows that the Company had been experiencing slower sequential growth since 2006.

Furthermore, revenues on a year-over-year basis seem to be supported by new store openings more than anything else. In fiscal 2006 FDO reported a net opening of 275 stores, with 257 opening in fiscal 2007, 141 in fiscal 2008, and 46 in the 1Q09. However, same store sales on a quarterly basis for 2008 are not so encouraging. In the

1Q08 same store sales fell year-over-year by 1%, remaining flat in the 2Q08, falling again in the 3Q08 by 0.3% and posting a 1.2% increase for the full-year 2008 thanks in part to "the government stimulus program and additional advertising." In the 1Q09, same store sales rose by 2.1% year-over-year.

Sequential Industry Revenue Growth (%)	2005	2006	2007	1Q08	2Q08	3Q08	2008	1Q09
FDO[3]	10.3	9.79	6.9	3.13	-7.12	3.74	2.2	-0.68
DG[1]	12.0	6.8	3.2	-6.1	8.6	-0.4	10.1	--
DLTR[1]	8.6	16.9	6.9	-19.0	3.98	1.91	6.9	--
FRED[1]	10.2	11.2	0.77	-6.0	-3.7	-6.5	-5.1	--
NDN[2]	12.7	5.3	7.9	4.9	4.2	10.5	--	--
WMT[1]	11.3	10.5	8.65	-11.3	7.72	-4.2	8.6	--

[1] Fiscal year end is January 31.
[2] Fiscal year end is March 31.
[3] Fiscal year end is August 31.

Although management has been pushing hard to attract new customers through new store openings, store renovations and increased advertising, it appears that the strategy is not paying off. In fact, returning to the new store opening issue, we can see that as new store openings have slowed over the past few years, so has revenue growth (see chart above). One analyst asks about store closings on the 4Q08 call. The response seems to indicate business as normal, however, while the revenue trend seems to indicate otherwise.

> **Analyst:** We haven't heard recently anything about the urban initiative. I am wondering if that is part of your go forward plan. Looking at your fiscal 2009 growth and net openings, its seems like there's more store closings than usual. I am wondering if there's anything you can comment on that as well.
>
> **Jim Kelly, President and COO:** Starting with the later part, our closing schedule has roughly been in the 70 to 80 range over the last several years and we would expect to continue basically business as usual from that perspective.

Interestingly, management has also for some time been focusing on other revenue enhancing initiatives. In 2005 FDO initiated a food strategy and began introducing more quick prep and ready to eat foods. By the end of fiscal 2008, 86% of FDO stores were equipped with refrigerated coolers. FDO has also maintained a private label business since 2005, but it seems that investment has remained flat and perhaps even decreased recently. At the end of fiscal 2005, it was disclosed that private label goods accounted for 4% of total sales. Sales remained at these levels throughout fiscal 2006 and 2007 and in fiscal 2008 the disclosure, the little that there is, becomes even more general.

The 2008 SEC Form 10-K now places private label merchandise together with "other brands" and "unlabeled merchandise." In 2007 nationally branded items accounted for 37% of revenues with 4% coming from private label and the remaining from other or unlabeled goods. In fiscal 2008, nationally branded items jumped to 44% of revenues with the balance generated from private label, other brands and unlabeled. One would guess that private label sales have fallen to meaningless levels. However, on the 4Q08 conference call management does state, “And, we do intend to increase our private label offering in fiscal ’09.” Nevertheless, no disclosure is given for the 1Q09. Taken all together, it seems that perhaps the strategies for sustaining revenue growth outside of opening new stories are running dry.

Fundamentals: Questions about the sustainability of 2Q09 earnings hike

So in spite of the continued shift to lower margin product mix, Company CFO **Kevin Smith** still said he saw no problems on the horizon, this according to his prepared text for the 1Q09 conference call:

> “We expect that strong sales of consumable merchandise and weakness in more discretionary categories will pressure gross margin but we anticipate that benefits from lower markdowns, lower transportation expense and better inventory shrinkage may offset much of this pressure.”

Indeed, FDO shares blasted higher on March 5th when the Company pre-announced net sales and comparable store sales for the 2Q09, and hiked guidance rather significantly. Again, citing “double digit sales growth of consumable merchandise” and comparable store sales increasing 6.4%, the Company disclosed that net sales for the second quarter (complete results to be announced on April 8th) increased 8.7%. The numbers allowed FDO to hike guidance significantly: 2Q earnings are now expected to be $0.59 to $0.61 (up from $0.48 to $0.52). We wonder, however, whether the guidance hike is a one-quarter phenomenon. Nothing was said in the release about the Company hiking full-year 2009 guidance.

To this, we note the method by which inventories are valued. FDO inventories are valued using the retail method, based on retail prices less mark-on percentages, which approximates the lower of first-in, first-out (FIFO) cost or market. DLTR utilizes the weighted-average basis and WMT and DG the LIFO method (although WMT uses FIFO for its international operations). To provide a general reminder, when prices are rising as they did through much of 2008, then FIFO would provide a better indication of the value of the inventory on the balance sheet. However, FIFO also would serve to increase net income in future quarters because the related cost of goods sold would have been measured using older inventory on the books at lower cost. Whether this affected FDO during 2Q09, its Christmas quarter, is difficult to speculate. Except for, that is, any pack-away (unsold) items in inventory from Christmas the year prior. Items such as cards, wrapping paper, ornaments, Christmas decorations and such would clearly have been bought at lower prices the year prior.

Accounting: Miscellaneous noteworthy items

- **Auction Rate Securities.** A significant portion of the Company’s potential liquidity has been frozen by the fact that the entire amount of the Company’s investment assets, totaling $217 million, are tied up in Auction Rate Securities (ARS). Given the fact that ARS holdings outnumber Cash and Equivalents on the books by 141% this is no small matter. Virtually all of the ARS holdings are tax-exempts which are collateralized by federally guaranteed student loans. The Company discloses that substantially all of these are subject to failed auctions and, as a result, it does not expect to be able to liquidate these, except through issuer re-financings, settlements with broker dealers, or upon maturity. FDO was able to liquidate a total of $10.4 million of these during the 4Q08 and the 1Q09 but the remaining $217 million currently exist on the books as “Level 3” non-current assets.

The liquidity problem posed by large exposure to ARS (amounting to 8% of the Company’s total assets) has caused the Company to rely heavily on short term financing options for liquidity. FDO has two separate credit facilities totaling $600 million. During FY 2007, it was only necessary to tap them for a total of $26 million. The ARS freeze-up, however, caused FDO to work its credit facilities to the tune of $763 million during F/Y 2008. Although no such borrowings took place in the 1Q09, there were outstanding standby letters of credit in the amount of $196.6 million. This is an increase from the $185.9 million that was outstanding at the end of fiscal 2008. In addition, the 2008 SEC Form 10-K provides additional disclosure that FDO also had $211.1 million in merchandise letters of credit that are due August 2009 and $47.7 million in surety bonds. Again, the dependency upon short-term credit to meet cash flow needs is apparent.

- **Impact of food inflation on revenue growth.** An interesting question was posed in the FDO 1Q09 conference call regarding the impact of food inflation on the Company’s results. It related to comments by both Kroger and Wal-Mart as both companies spoke of food inflation benefiting their growth numbers at about 5% to 6% during 2008:

  Analyst: Just to follow back on your earlier question on price inflation, Kroger, Wal-Mart, they've all spoke of food inflation benefiting, you know -- or being roughly 5-ish, 6%. Would you say that's a fair estimate for what you guys saw through your pipeline in '08? And Kroger's talked about that number falling to, call it, 1 to 3% for next year. Is that what you guys are thinking as well in your outlook?

  R. James Kelly, President: If you look at branded merchandise, food costs increase in that range is -- has been what we've experienced; but again, I would note, in terms of our customers, they very, very quickly go from the better/best categories to the good category, and that basically mitigates the impact on the comp number.

  Though Kelly’s answer did not necessarily reject the notion that a chunk of 2008 revenue growth may have been from food price inflation, his implication that FDO customers would be quick to shift to a lesser goods categories is interesting, given the fact that, in 2008 (as stated above) nationally branded Items represented 44% of revenues for the period. It would seem then that there was a good chunk of 2008 revenues that were generated by inflationary pressures; pressures that will not likely be in the picture during 2009. Ditto for the sustainability of any FIFO related tailwinds.

- **Food stamp strategy.** FDO places much emphasis on its Store of the Future initiative which not only encompasses the processing of Food Stamps but also credit cards. Food stamps will essentially be obsolete this June and be replaced with debit-type cards. For a store to be able to sell Food Stamps it must be in a position to sell milk. In response to this, FDO is in the process of installing refrigerator units in its stores, 86% of which will be so-equipped by the end of 2009. Though it seems that FDO is somewhat ahead of competition in its Food Stamp initiative, it remains to be seen how long such of an “advantage” will exist as a result. Additionally, with the average customer ticket for 2008 at just $9.70, it seems doubtful that FDO customers will be using credit cards to any significant extent.

- **Store leases.** Our checking indicates a large portion of FDO store leases are based on percentage of rent calculations which set the lease at percentages of a store’s gross sales. Such percentages that we have seen are between 2% and 3%. This practice is not uncommon and frequently is seen, by real estate professionals, to favor renters who, when moving into a new market, wish to limit their downside should the store not perform up to expectations. By the same token, however, to a certain extent, upside is compromised as well which may curtail some of the crisis-related windfall benefits such related lessees are currently experiencing.

- **China FX exposure.** Currently, goods manufactured in China represent 51% of FDO purchases, which are in dollar denominations. Clearly any weakness in the Greenback pressures margins.

Appendix A

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

Name	Actionable Position as of 03/29/09: Common	Options [1]	Total [2]	Derivative Equity Expected to Vest in Next 12 Months: Grant Date	Strike Price	Vesting Dates	# Vesting
Charles Gibson Jr.	25,291	8,536	**33,827**	09/28/05	$19.75	09/28/09	10,500
EVP of Supply Chain				10/03/06	$29.41	10/03/09	6,402
				10/09/07	$27.31	10/09/09	10,667
							27,569
Janet Kelley	3,442	29,698	**33,140**	09/28/05	$19.75	09/28/09	6,600
SVP, General Counsel				10/03/06	$29.41	10/03/09	3,524
				10/09/07	$27.31	10/09/09	5,867
							15,991
Charles Sowers	76,827	37,357	**114,184**	09/28/05	$19.75	09/28/09	3,900
SVP of Finance				10/03/06	$29.41	10/03/09	2,443
				10/09/07	$27.31	10/09/09	4,000
							10,343
Barry Sullivan	5,053	15,774	**20,827**	05/26/05	$26.00	05/26/09	7,500
EVP of Store Operations				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
							18,602

[1] Total number of vested, in-the-money options.

[2] Total actionable position includes common stock plus vested in-the-money options.

Note: Red text indicates series is currently out-of-the-money