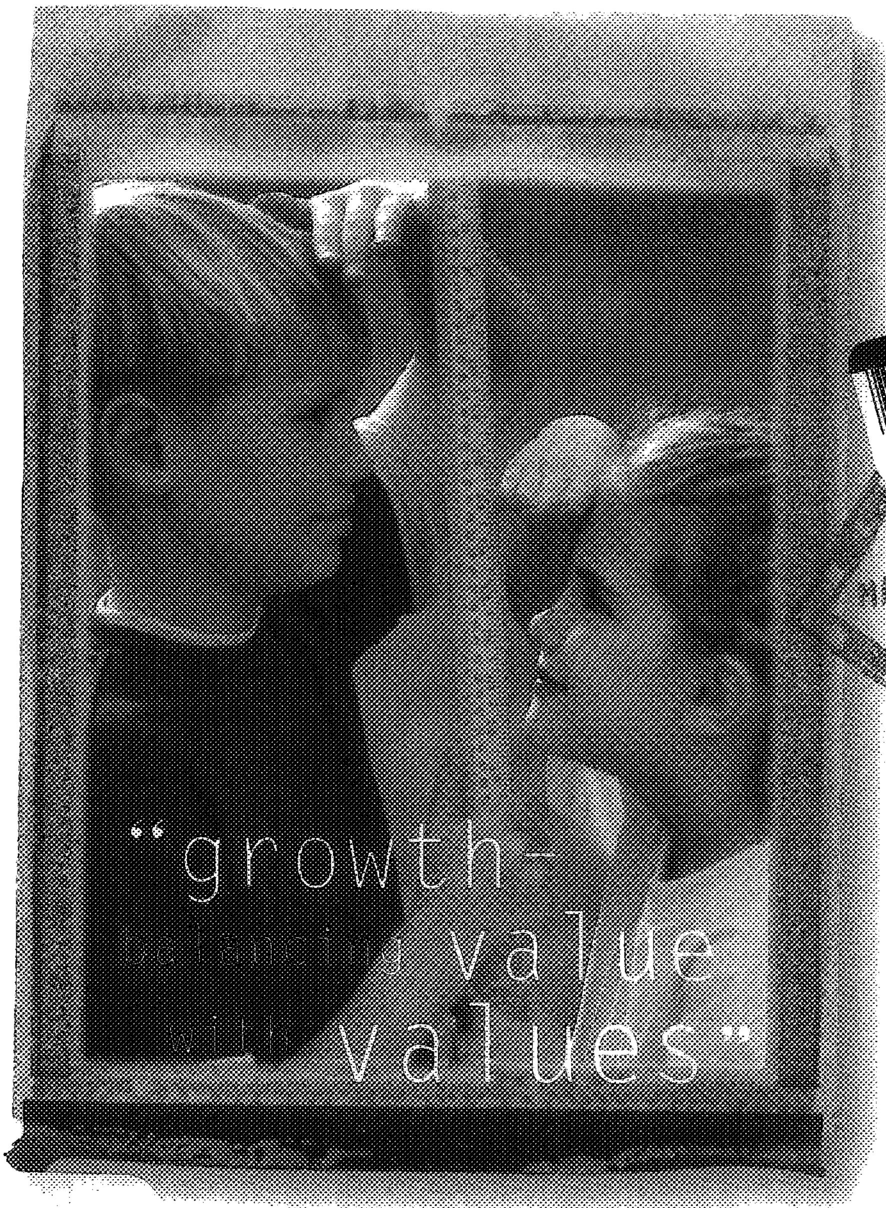
ShopKo® STORES INC.

1996 Annual Report Fiscal Year Ended February 24, 1996



being better, not just different

growing **ProVantage**™ our dynamic, leading-edge healthcare strategy

leading in specific merchandise niches and categories

custom

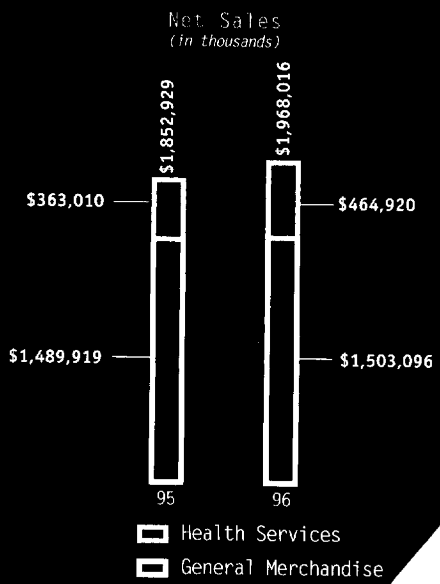
We have demonstrated, by studying and responding, that we are great students of changing lifestyles and customers' needs. We are capable, agile and quick to meet these needs. The management team is dedicated to providing value to its retail customers and meeting the growing healthcare needs of ProVantage™ clients.

SHOPKO STORES MISSION

The mission of ShopKo Stores is to be a "specialty discount retailer" that continuously differentiates our services and merchandise in our retail markets. Our vision is to offer quality merchandise for casual apparel, home, family and health needs – at prices that communicate real value.

PROVANTAGE™ MISSION

The mission of ProVantage is to consistently listen and understand our customers' requirements for innovative managed care products, utilizing people and technology to provide uncompromising quality of service. Our ultimate goal is to help our customers lower their overall healthcare costs through the use of managed care products that positively affect patient outcomes.

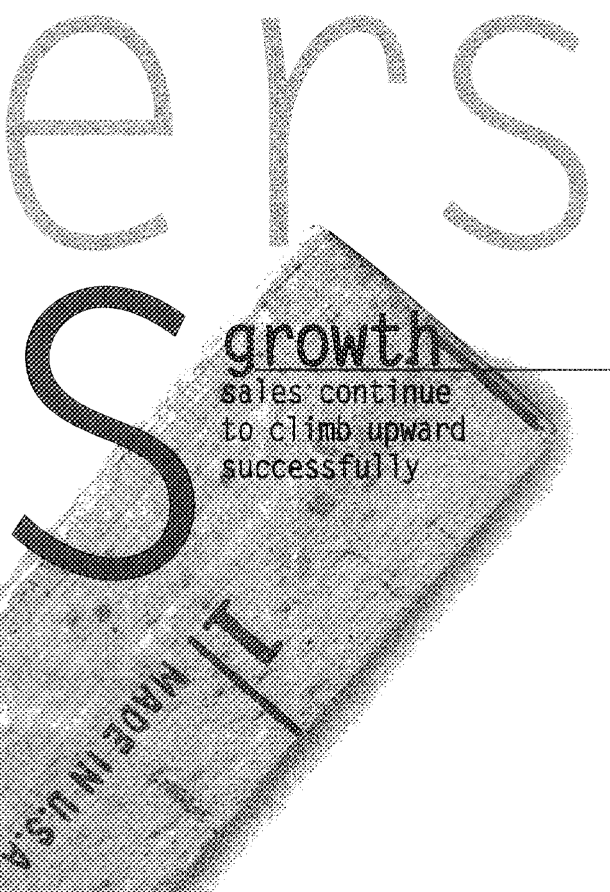


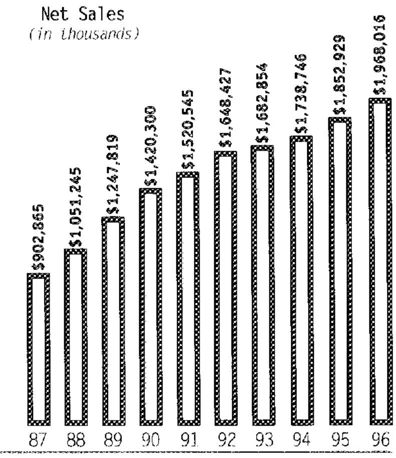
focus

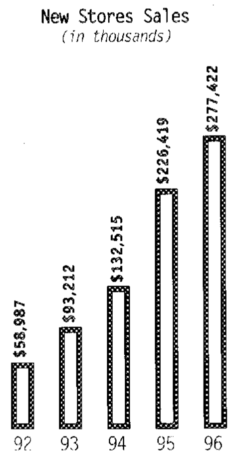
strategic focus on services, presentation, and products that sell

commitment

dedicated associates make the difference

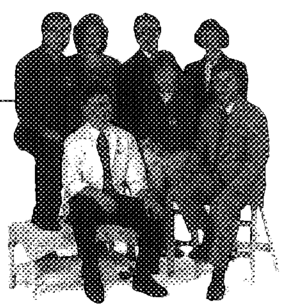






6 destination businesses

bed & bath	casual furniture
housewares	intimate apparel
special sizes in apparel	health services



Financial Highlights

ShopKo Stores, Inc. and Subsidiaries

	Fiscal years ended		
(Dollars in thousands, except per share data)	**Feb. 24, 1996 (52 weeks)**	Feb. 25, 1995 (52 weeks)	Feb. 26, 1994 (52 weeks)
Net Sales	**$1,968,016**	$1,852,929	$1,738,746
Net Earnings	**38,439**	37,790	32,122
Net Earnings Per Common Share	**1.20**	1.18	1.00
Dividends Per Common Share	**0.44**	0.44	0.44
Shareholders' Equity	**$ 421,631**	$ 397,275	$ 373,706
Stores Open at Year End	**129**	124	117

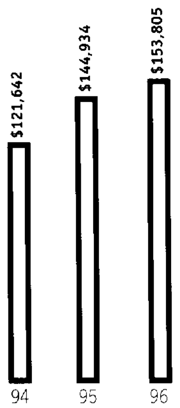
Business Segment Information

	Fiscal years ended		
(In thousands)	**Feb. 24, 1996 (52 weeks)**	Feb. 25, 1995 (52 weeks)	Feb. 26, 1994 (52 weeks)
Net Sales			
General Merchandise	**$1,503,096**	$1,489,919	$1,411,781
Health Services	**464,920**	363,010	326,965
Total Net Sales	**$1,968,016**	$1,852,929	$1,738,746
Operating Earnings Before Interest and Income Taxes			
General Merchandise	**$ 73,124**	$ 67,638	$ 59,151
Health Services	**36,805**	36,547	29,854
Corporate Expenses	**(12,507)**	(12,725)	(14,699)
Income from Operations	**97,422**	91,460	74,306
Interest Expense	**(34,282)**	(29,042)	(21,417)
Provision for Income Taxes	**(24,701)**	(24,628)	(20,767)
Net Earnings	**$ 38,439**	$ 37,790	$ 32,122

Letter from the President

Last year, ShopKo clearly demonstrated its superior staying power. A wildly uncertain economy, rapidly shifting consumer shopping trends, increased consumer debt and dramatic changes in traditional weather patterns, have led some to call last year the "Year of Retail Disasters." However, while most in the retail business suffered major setbacks, ShopKo not only held its ground but experienced healthy gains, outperforming fellow regional retailers and leading nationals in the fourth quarter.

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
(in thousands)



Sales for fiscal year 1996 (year ending Feb. 24, 1996) were a record $1.97 billion, up from $1.85 billion in 1995, a 6.2 percent increase. Again net earnings improved, rising to $38.4 million. Earnings before interest, taxes, depreciation and amortization (EBITDA) set a new record of $153.8 million, a 6.1 percent increase from last year's $144.9 million.

The real story though, lies beyond our financial statements, in the strength of our leadership team and the achievements of all the men and women at ShopKo in the face of these challenges.

5 key factors for SUCCESS

I attribute ShopKo's success this year to five key factors:

- more clearly focused merchandising that drove a dramatic uptrend in apparel sales
- continued gains in our retail health service areas
- improved expense leverage and control
- outstanding inventory management
- continued growth of our ProVantage Prescription Benefit Management (PBM) subsidiary

Our performance in key categories demonstrates customers' steadily growing confidence in the VISION 2000 strategy, and our devotion to understanding and responding to their needs and values. Our strategy of seeking dominance in select merchandise categories, with improved clarity, provided notable sales increases in several key areas. Where other retailers' apparel business was flat, ours expanded. Select home categories also saw solid growth. Perhaps most meaningful of all, however, was the profitability of our sales through gross margin management in a year when consumers' promotional orientation reached an all-time high.

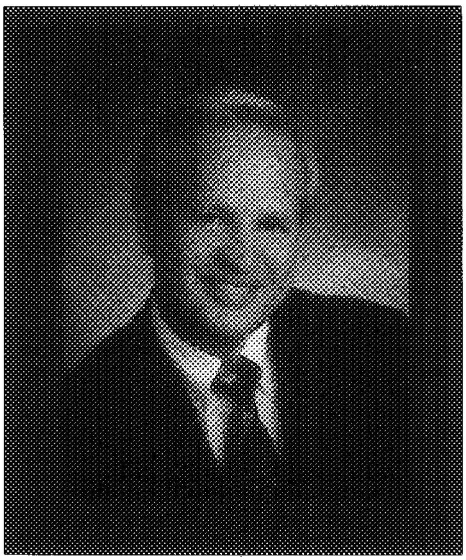
Inventory reductions of 20 percent from a year ago, nearly $80 million, substantially exceeded our plan. At the same time, we increased our responsiveness to customer-driven uptrends and downtrends. We have reduced our cost of selling, general and administrative expenses (SG&A) as a percentage of sales by .8 percent this year, on top of a .6 percent reduction last year.

Once again, retail health services made key contributions to our performance and reported healthy market share gains. These are remarkable accomplishments in light of increasing pressures on margin. Our quarter century of excellence in this core competency continues to give us a strong competitive edge.

While changes in the national healthcare system are still occurring, we at ShopKo have identified our strengths and expertise in the healthcare field. This process has generated considerable reason for excitement as it represents long term growth and profit potential for products and services that are an integral part of our existing core competencies.

It was the analysis of these opportunities that led to our ProVantage Prescription Benefit Management (PBM) strategy. With its first full year of operation in fiscal 1995, ProVantage achieved growth far beyond our expectations. This year with sales reaching nearly $100 million, we exceeded our plan by over $35 million. We expect revenues to exceed $200 million in the coming year, representing a 100 percent increase in sales. The number of lives under contract passed the 1.6 million mark in February, 1996, an annual growth rate in excess of 150 percent.

In the constant pursuit of growth opportunities, we are now capitalizing on our expertise in the optical field and replicating our initial success with the PBM. To that end, we have recently launched a Vision Benefit Management (VBM) service. With the current trend toward providing vision care benefits in the workplace and vision managed care, we will provide outstanding value by reducing the cost of vision products for our clients.



Dale P. Kramer
President and Chief Executive Officer

Our VISION 2000 strategy continues to position us solidly for growth

In a year when many other retailers struggled and some failed, ShopKo improved its financial position. We continued company-wide reengineering efforts to further reduce costs and increase responsiveness to customer needs. We achieved stellar cash flow and maintained one of the strongest balance sheets in the industry.

Few other retailers can claim such far-reaching change as ShopKo has achieved in just a few short years. With the VISION 2000 initiatives, we set out to build an entirely new infrastructure. Today, the VISION 2000 promise is a reality.

We have a visionary merchandising strategy, a rejuvenated store base, distribution and logistics capabilities to support growth, a sound plan for maximizing our existing advantages in healthcare services and ProVantage, a growth strategy that is gaining national recognition in the healthcare arena.

Good people–strong commitment ...bright future

Our associates and suppliers deserve our thanks, for it was their tenacity and commitment that made these achievements possible. Their dedication, however, goes far beyond just corporate responsibility and has been recognized this year by *Discount Store News*, the industry's leading trade publication, with the awarding of the prestigious Discounter in Service to the Community Award.

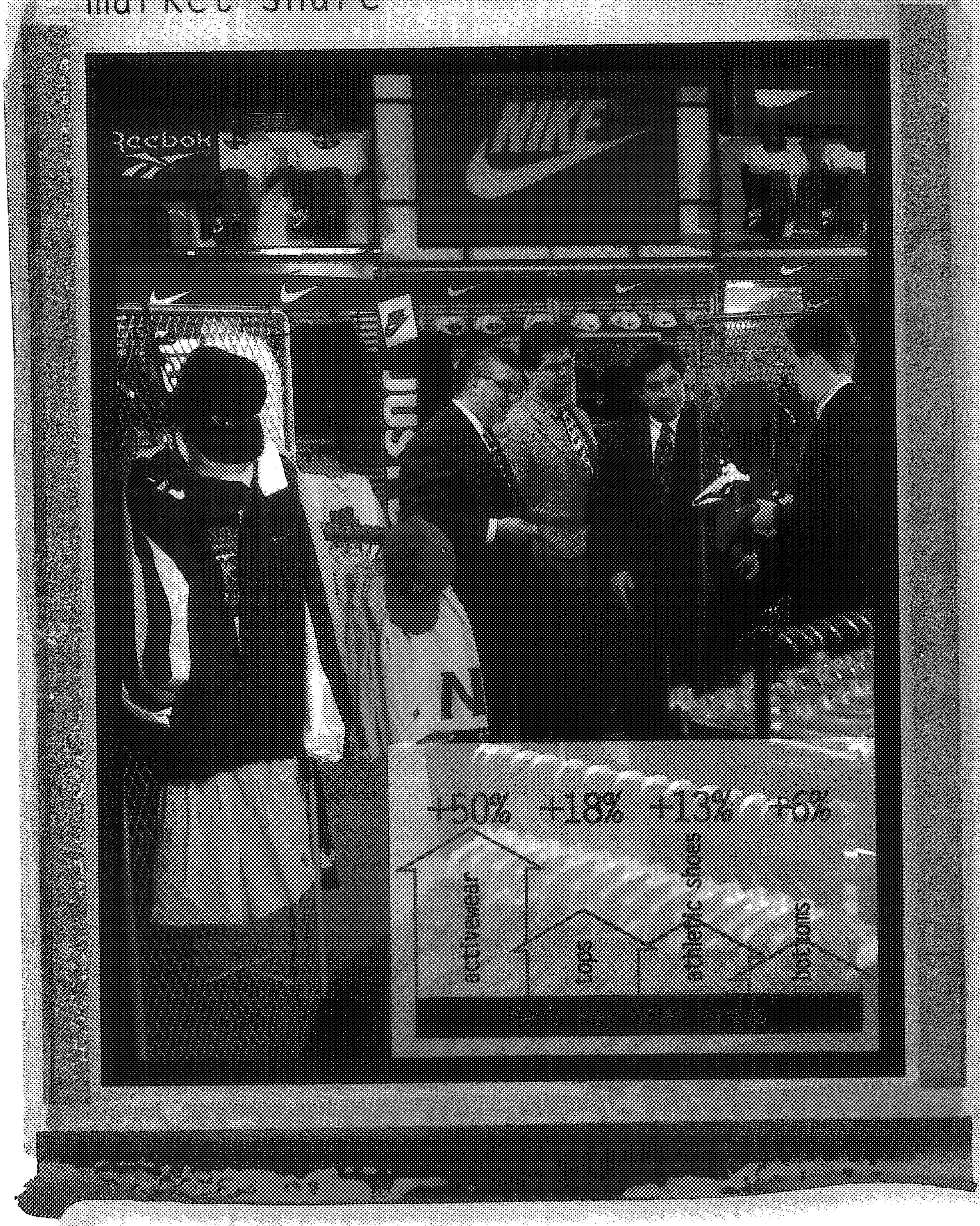
With quality people like these, our future holds tremendous opportunities. Your company is clearly positioned to benefit significantly from clear strategies and sound investments.

Sincerely,

Dale P. Kramer

Dale P. Kramer
President and Chief Executive Officer

"training by top management positioned us to expand our market share"



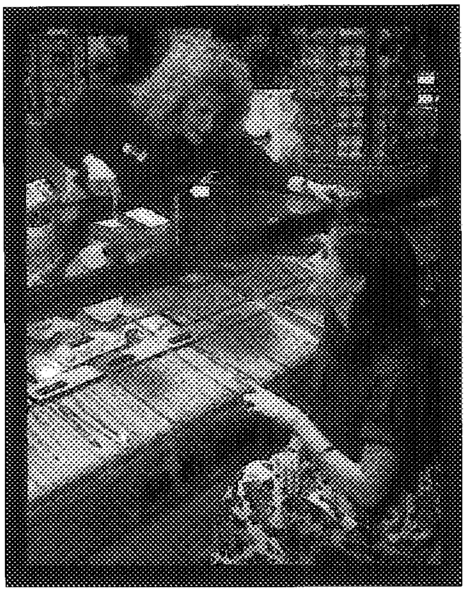
We have accomplished an amazing uptrend in areas focused on customer lifestyle needs. This year, Men's Activewear sales increased 50 percent.

From promise to reality

Several years ago, we set out to differentiate ShopKo from the competition with our VISION 2000 strategy. In the past year, the power of this strategy to propel us to success became crystal clear. While the retail industry as a whole experienced hardship and losses, ShopKo stood above the crowd. If we had merely maintained our ground, that would have been a significant accomplishment but we did much more. We set new records in sales and earnings before taxes, interest, depreciation and amortization (EBITDA), while meeting or exceeding critical business goals. We did this by putting our focus and energy on knowing and serving our customers.

The sources of our strength

ShopKo has proven to be one of very few regional chains that can successfully coexist with top national competitors. During 10 years of extensive market intrusion by national competition, we have maintained our profitability. Part of this success comes from our strong financial position, with record EBITDA of $153.8 million and a decrease in our debt to total capital ratio to 48.5 percent. Other central factors in our continued viability include an amazing uptrend in sales of our men's and women's apparel and accessories, and our retail healthcare business, which once again achieved outstanding performance. This business segment sets us apart in a crowded playing field and brings millions of customers to our stores.

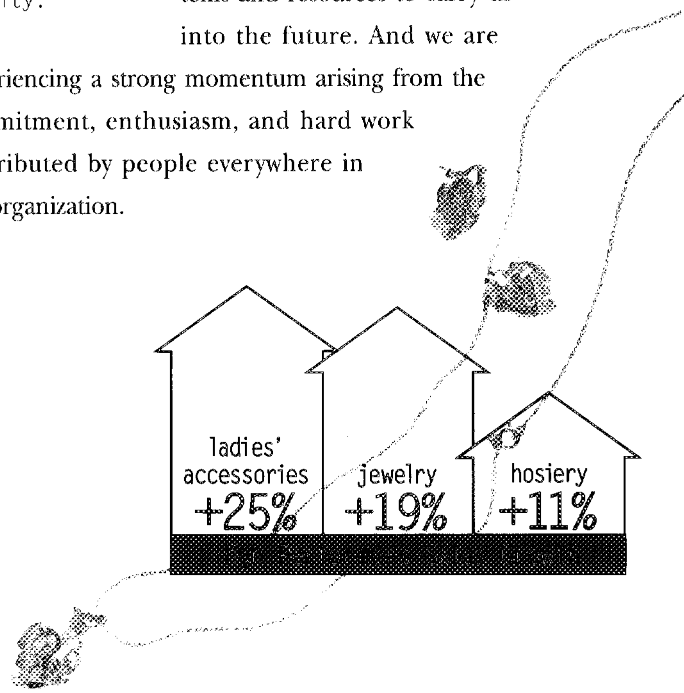


Jewelry and accessories have proven to be excellent performers in both sales and profitability.

The VISION 2000 strategy capitalizes on our strengths. It enables us to define niches that match our core competencies. We're committed to delivering value by becoming students of customers' needs and staying in close touch with their values. They are a growing segment of Americans: typically married with families and two incomes, short on time and focused on value. They are becoming more casual in dress. As they mature, they continue to expect the shopping experience to be productive and pleasant. Focusing on our customers' day-to-day lifestyle needs in the key areas of casual apparel, home, family and health services–we can significantly increase our market share. We meet our customers' needs and expectations in unique ways by taking advantage of our ability to act quickly as a regional retailer in a dynamic business.

Top management is driving proactive change

VISION 2000 has touched every corner of our organization. We remodeled over 60 stores in the past three years, and have implemented the VISION 2000 merchandising and fixturing to fully 100 percent of our stores. Every ShopKo store now features VISION 2000 merchandising and product assortments. With proactive change driven by top management, we streamlined our product mix and vendor supply chain. We continue to upgrade our level of customer service. We are continuously developing and refining the necessary programs, skills, systems and resources to carry us into the future. And we are experiencing a strong momentum arising from the commitment, enthusiasm, and hard work contributed by people everywhere in our organization.



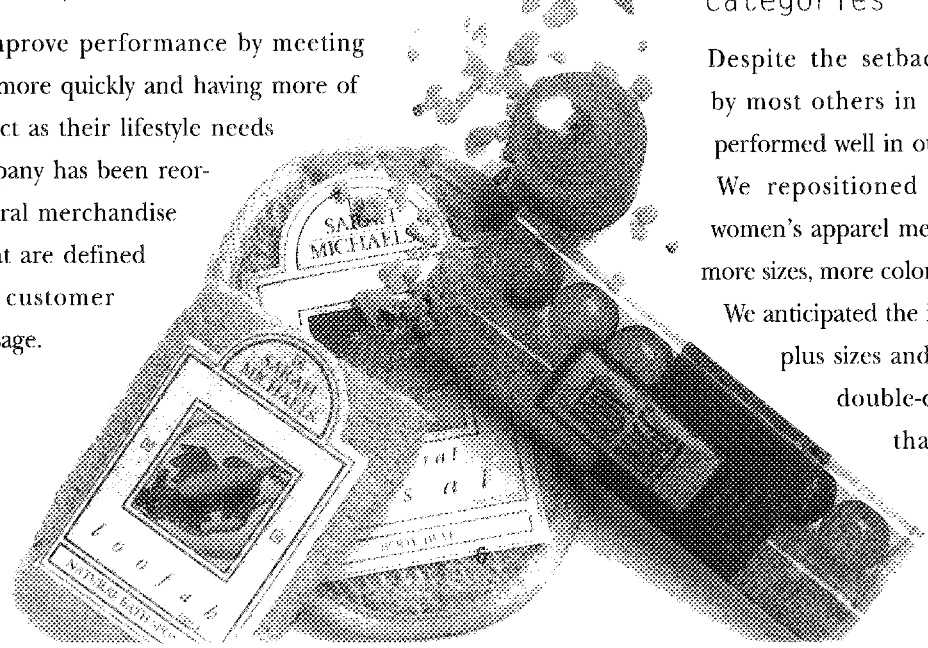
We are committed to maximizing efficiency and controlling our operating expense. We are demanding more productivity from our store space. We are focusing on the results from many changes in systems and internal processes. This focus has allowed us to identify and offer those products that provide growth potential for our organization and truly deliver better quality-to-price relationships to our customers, which is after all, the definition of value. Sometimes this means walking away from sales that do not offer customer value, growth potential or profitability. This approach, plus improved discipline and processes resulted in a 20 percent inventory reduction. It was achieved with minimum impact on gross sales and decreased the need for clearance, allowing us to be prepared for spring sales earlier than last year.

In keeping with our customers' demand for time-efficient, focused shopping, we changed our merchandising approach from an emphasis on single items to categories of merchandise, private label product development, and offering segments of related items that offer value to shoppers while allowing them to get in and out of the store more quickly.

Bed and Bath, one of our key categories, produced an 8 percent increase in sales.

Building a better fit between customers and products

Our goal is to improve performance by meeting customers' needs more quickly and having more of what people expect as their lifestyle needs change. The company has been reorganized into natural merchandise segmentations that are defined and driven by customer lifestyle and end usage.



Each merchandise segmentation is further divided into select and targeted categories in which we plan to differentiate ourselves with powerful assortments and presentations. Each segmentation and every department at ShopKo is engaged in an intensive business planning process to allow us to achieve these goals.

This process has allowed us to identify six key destination businesses that provide opportunities for long-term growth: Bed and Bath, Casual Furniture, Housewares, Intimate Apparel, Special Sizes in Apparel and Health Services.

We are identifying and prioritizing growth potentials based on the changing lifestyle needs of our customer. This evaluation process determines our resource investment in each category. Our emphasis on a narrowed focus is also reflected in a streamlined vendor supply chain and enhanced core vendor partnerships. There is certainly more to do, but we are extremely pleased with the results so far.

Driven by apparel sales, we achieved significant growth in core VISION 2000 categories

Despite the setbacks experienced by most others in our industry, we performed well in our core categories. We repositioned our men's and women's apparel merchandise, adding more sizes, more colors and line extensions. We anticipated the increased demand for plus sizes and were rewarded with double-digit sales growth in that category. We also

By offering great value, broad selection, more sizes and color choices, women's casual knit tops grew 48 percent.

"Our merchandise now reflects customers' casual lifestyle needs"

established exceptional category growth in the area of casual dress, including denim, flannel, core knit tops and shorts. The result was a 10 percent overall increase in men's and women's apparel and women's accessories.

Building tomorrow's success in general merchandise

We laid the groundwork for superior performance and future growth with a series of management initiatives. They will have a direct impact on customer satisfaction and sales. As we continue to reduce costs we will reinvest in lower pricing for commodity items and certain key product categories, and implement new traffic-building strategies. We are also planning a variety of aggressive measures to achieve significant gains in volume and productivity of core basic and seasonal inventories.

Continued success in the healthcare area

ShopKo has a long and successful track record in the healthcare arena. The ProVantage Health Services segment of our business, which includes retail pharmacy and optical operations as well as ProVantage Pharmacy Benefit Management (PBM), experienced dynamic growth while delivering high quality services.

"Staying in touch with values... simply a great place to shop"

Delivering a real quality-to-value relationship. Intimate Apparel produced an 11 percent sales increase.

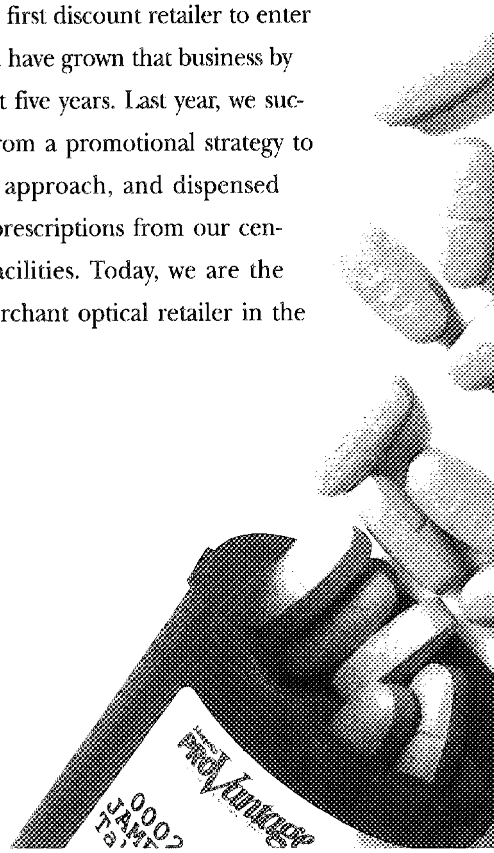
Our comprehensive health services area, with both optical and pharmacy, brought millions of customers to our stores this year.

"Our healthcare services deliver a clear competitive advantage"

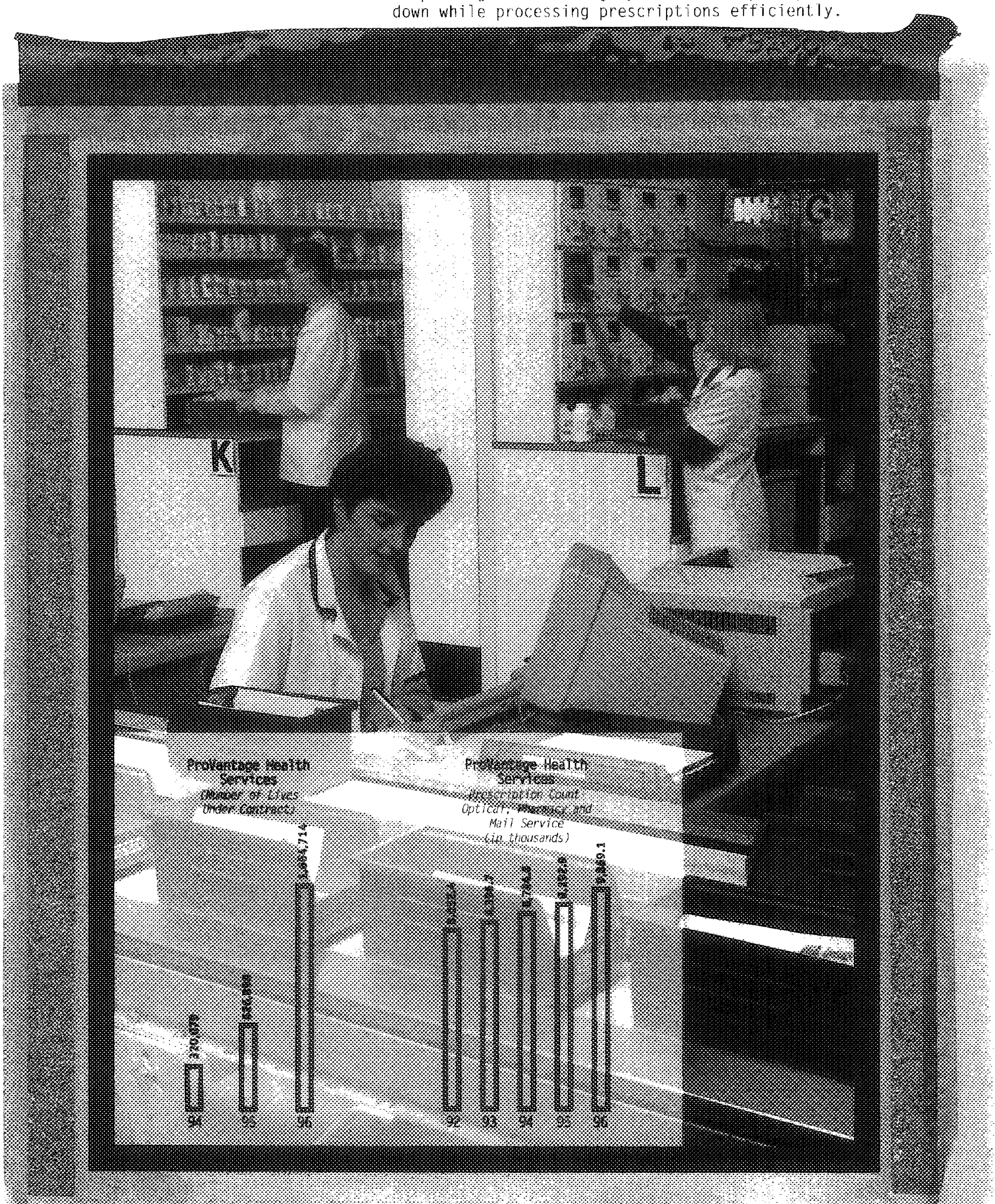
We clearly understand the unique needs of our customers, both retail consumers and corporate America, in the health services arena. By exceeding their expectations for quality, service and value we were able to grow this segment of our business from $363 million to $465 million in fiscal 1996, with minimal capital investment.

Our retail pharmacy operation continued the outstanding trend for growth that we've experienced in recent years. In the last five years alone, we have added $129.4 million in total sales. Since ShopKo pharmacies were introduced in 1971, we have steadily grown in market share to the point where our pharmacies fill 60 percent more prescriptions than the average drugstore.

In 1978, we became the first discount retailer to enter the optical business and have grown that business by $20.4 million in the last five years. Last year, we successfully moved away from a promotional strategy to an everyday low price approach, and dispensed over 574,000 eyewear prescriptions from our central lab and in-store facilities. Today, we are the fourth largest mass merchant optical retailer in the United States.



Our mail service pharmacy features highly automated dispensing and tracking systems to help keep costs down while processing prescriptions efficiently.



"initiatives that move us forward to growth and profitability"

ProVantage: "The ability to listen, the commitment to deliver"

In fiscal 1994, we began to develop a natural extension of our core competencies in healthcare by launching the ProVantage Prescription Benefit Management (PBM) subsidiary. Our fiscal 1995 acquisition of Bravell, a prescription claims processor, firmly established ProVantage as a true competitor among national PBMs. To say that ProVantage has performed spectacularly since that time would be an understatement. In fiscal 1995 it did $13 million in business, covering 627,000 lives. This year we projected $64 million, but our actual results were nearly $100 million, covering 1.7 million lives. In fiscal 1997, we plan to continue this dramatic growth and double our sales, while improving the quality of our systems and processes and increasing our profits.

Currently over 155 million people in the United States require some vision correction, a $14 billion market.

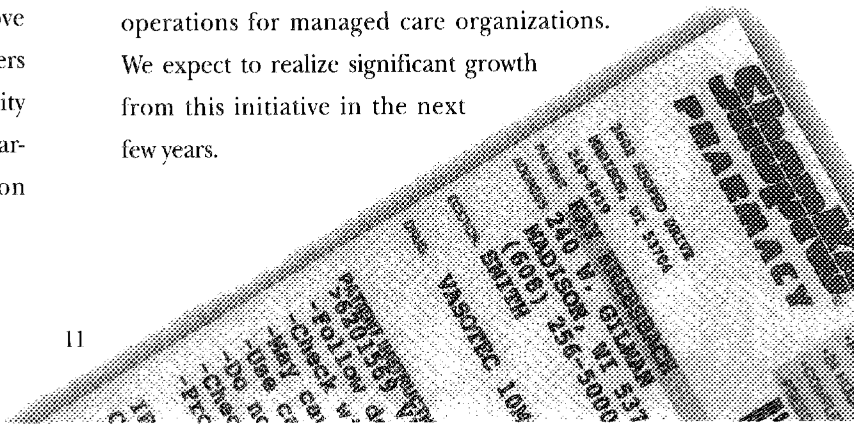
ProVantage draws its strength from significant social and demographic forces. Escalating healthcare costs have caused corporations and other organizations to place a high priority on managed healthcare options while an aging population is creating a growing need for prescription drugs and vision care. By controlling these costs, ProVantage is positioned firmly at the center of one of the most promising growth areas in American business today.

A strong presence, a powerful product

With over 40,000 network pharmacies across all 50 states, and a presence in virtually every town in the U.S. above 5,000 in population, our ProVantage PBM subsidiary offers plan providers and sponsors a means of providing quality prescription benefits at lower cost. Our mail order pharmacy offers greater cost-effectiveness to customers on maintenance medications by providing 90-day supplies along with medically sound generic and therapeutic substitutions for more costly drugs. Our advanced system allows us to monitor participant eligibility, provide a range of clinical services, and educate all parties in cost control strategies. These capabilities help our clients meet their employee benefit and fiscal goals.

Requiring minimal inventory and capital investment, ProVantage PBM is a promising part of our future. To make the most of this promise, we implemented a national sales and marketing program and developed an infrastructure to support our exciting growth.

Another major initiative recently launched is the ProVantage Vision Benefit Management (VBM) service. The optical market currently represents about $14 billion per year in the United States with more than 155 million individuals requiring some form of vision correction. Already strong, the demand for vision care benefits will increase as the population ages, and so will the demand for vision benefit management. With our existing retail optical and PBM expertise, ProVantage is well positioned to enter the national vision managed care marketplace. We are developing an integrated, nationwide provider network that includes retail optical chains and private ophthalmologists and optometrists. Through this network we will offer a variety of flexible products, including standard vision plans, insured and self-insured options, direct services to insurance companies and providers, and turnkey operations for managed care organizations. We expect to realize significant growth from this initiative in the next few years.



"ProVantage is at the forefront of our growth strategy"

Our central lab and in-store facilities dispensed 574,000 eyewear prescriptions last year.

"We use ProVantage because of the company's excellent service and its **commitment** toward using technology to lower the overall cost of healthcare."

Penny Paque, Vice President of Operations, American Medical Security*

ShopKo is clearly committed to utilizing technology to increase efficiencies and improve our ability to satisfy our customers. This is most evident in our efforts to embrace enterprise-wide Decision Support Services (DSS). DSS is a technology-driven process used to provide actionable information to decision-makers through massive warehousing of existing data.

We are combining state-of-the-art technology with friendly service to assure a pleasant shopping experience.

ShopKo merchandising and planning requirements and ProVantage operations are highly data-intensive. Both are using DSS as a tool to collect and collaborate useful information. At ShopKo, it helps us create a better understanding of how our customers group purchases. ProVantage has leveraged the power of DSS to enhance its clinical programs, help reduce its customers' overall healthcare costs and provide clients with a better view of medical outcomes. Currently over 1 million medical records are paired to pharmaceutical records in this system.

DSS technology is especially effective when used on the IBM SP2 massive parallel processing computer systems, of which ShopKo is one of the leading commercial users in the United States.

Besides helping our retail and healthcare business, our DSS capabilities also have potential to be sold as a stand-alone service, with significant potential as a future source of revenue and growth.

ShopKo – the end of a good year is the springboard for dynamic growth

ShopKo completed the year in a position of strength. In our retail operations, we demonstrated our staying power when most of our competitors lost ground. We are financially sound and strategically solid. Our health services operations continue to grow dramatically, with ProVantage presenting significant potential for even greater success in the immediate future.

We remain dedicated to building the company with solid, sustained growth. We are confident in continuing our growth and performance. Increased sales will come from clearly focused merchandising programs and our commitment to the healthcare sector with our PBM, VBM and retail health services. In addition, we are currently prepared to initiate a new free-standing Super Optical Center concept during the second half of fiscal 1997.

We could not have come this far without the commitment, loyalty, and enthusiasm of our people. They have contributed their hard work, resourcefulness, intelligence, and dedication to our shared goals of success. In transforming all of ShopKo to the VISION 2000 strategy, we had the rare and wonderful experience of seeing 18,000 people marching to a single drumbeat. We have retained a large family of people who really know our business and have a stable, talented management team. For all these reasons, we consider the company very fortunate and well positioned for the future.

*AMS provides employee benefit and healthcare solutions in 32 states and Washington, D.C.

Management Discussion and Analysis

Results of Operations

The following table sets forth items from the Company's Consolidated Statements of Earnings as a percentage of net sales:

	Fiscal years ended		
	Feb. 24, 1996 (52 Weeks)	Feb. 25, 1995 (52 Weeks)	Feb. 26, 1994 (52 Weeks)
Revenues:			
Net sales	**100.0%**	100.0%	100.0%
Licensed department rentals and other income	**.7**	.7	.7
	100.7	100.7	100.7
Costs and expenses:			
Cost of sales	**74.5**	73.7	73.9
Selling, general and administrative expenses	**18.4**	19.2	19.8
Depreciation and amortization expenses	**2.9**	2.9	2.8
	95.8	95.8	96.5
Income from operations	**4.9**	4.9	4.2
Interest expense	**1.7**	1.6	1.2
Earnings before income taxes	**3.2**	3.3	3.0
Provision for income taxes	**1.2**	1.3	1.2
Net earnings	**2.0%**	2.0%	1.8%

Fiscal 1996 Compared to Fiscal 1995

Net sales for fiscal 1996 (52 weeks) increased $115.1 million or 6.2% over fiscal 1995 (52 weeks). Consolidated comparable sales decreased 0.2% for fiscal 1996 compared to an increase of 0.7% in fiscal 1995. Changes in consolidated comparable sales for a fiscal year were based upon those facilities (both store and non-store) which were open for the entire preceding fiscal year. In fiscal 1996, comparable sales included pharmacy mail service, since it was open for the entire preceding fiscal year. On a comparable store basis, sales decreased 0.5% for fiscal 1996.

The Company conducts business in two business segments: general merchandise and health services. General merchandise is conducted through retail stores. Health services include professional healthcare services provided in the retail stores and prescription benefit management services which are generally provided through other facilities. Beginning in fiscal 1997, health services will include vision benefit management services and decision support services (DSS).

General merchandise sales increased $13.2 million or 0.9% over fiscal 1995. Management attributes this sales increase to the opening of five new stores. Comparable store general merchandise sales decreased 2.1%. Management believes general merchandise sales were negatively impacted by a difficult retail environment, planned contraction of several departments and increased competitive entries.

Health services sales increased $101.9 million or 28.1% over fiscal 1995. Management attributes this increase to growth in prescription benefit management sales of $74.0 million, increases in comparable sales and the opening of five new stores. Comparable sales increased 7.4% due to increased business in the Company's retail pharmacy and optical centers. Health services comparable sales were based upon sales generated from healthcare services provided in retail stores which were open for the entire preceding fiscal year and from the pharmacy mail service sales.

Consolidated gross margins as percentages of sales were 25.5% and 26.3% for fiscal 1996 and 1995, respectively. The gross margin for fiscal 1996 includes a LIFO charge of $2.2 million. The gross margin for fiscal 1995 includes a LIFO credit of $2.0 million and a $5.5 million charge to reduce certain inventories to market value. Gross margin, before LIFO expense, was 25.6% in fiscal 1996 as compared to 26.2% in fiscal 1995. The decrease is primarily due to the impact of lower gross margin prescription benefit management sales.

Consolidated selling, general and administrative expenses decreased 0.8% of net sales to 18.4% compared with 19.2% in fiscal 1995. Improvement of 0.6% of net sales is due to increased sales related to the prescription benefit management business and improvement of 0.2% of net sales is due to expense control initiatives in retail operations.

The Company's operating earnings (earnings before interest and income taxes) increased 6.5% to $97.4 million in fiscal 1996 from $91.5 million in fiscal 1995. General merchandise operating earnings (earnings before corporate expenses, interest and income taxes) increased 8.1% to $73.1 million in fiscal 1996 compared to $67.6 million in fiscal 1995. This increase is primarily due to increased gross margin rates and expense control initiatives. Health services operating earnings increased in fiscal 1996 to $36.8 million compared to $36.5 million in fiscal 1995. This increase is primarily due to expense control initiatives and growth in prescription benefit management services but is reduced by lower gross margin rates in the retail pharmacies as a result of a larger percentage of sales coming from third party managed care business. Management anticipates continued gross margin pressure due to the increased managed care business.

Interest expense in fiscal 1996 increased from the prior year by 0.1% of net sales to 1.7% of net sales. The increase reflects last year's issuance of long-term debentures.

Fiscal 1995 Compared to Fiscal 1994

Net sales for fiscal 1995 (52 weeks) increased $114.2 million or 6.6% over fiscal 1994 (52 weeks). The Company opened seven new stores and remodeled 32 stores in fiscal 1995. Consolidated comparable sales increased 0.7% for fiscal 1995 compared to 1.2% in fiscal 1994. Consolidated comparable sales increases for a fiscal year were based upon those stores which were open for the entire preceding fiscal year.

General merchandise sales increased $78.1 million or 5.5% over fiscal 1994. Management attributes this sales increase to the opening of seven new stores. Comparable store general merchandise sales decreased 0.2%. Management believes general merchandise sales were negatively impacted by increased competition, reduced clearance sales this year compared to last year, the planned contraction of several departments and the disruption caused by the remodeling of 32 stores during fiscal 1995.

Health services sales increased $36.1 million or 11.0% over fiscal 1994. Management attributes this increase to increases in comparable sales, expansion into claims processing activities, growth of the pharmacy mail service and the opening of seven new stores. Health services comparable store sales increased 4.5%, which is due to increased business in the Company's retail pharmacy and optical centers. Health services comparable sales increases for a fiscal year were based upon sales generated from healthcare services provided in those retail stores which were open for the entire preceding fiscal year. Sales from prescription benefit management services, pharmacy mail service and claims processing activities were not included in fiscal 1995 or fiscal 1994.

Consolidated gross margins as percentages of sales were 26.3% and 26.1% for fiscal 1995 and 1994, respectively. The gross margin for fiscal 1995 includes a LIFO credit of $2.0 million and a $5.5 million charge to reduce certain inventories to market value. The gross margin for fiscal 1994 includes a LIFO charge of $3.7 million. Gross margin, before LIFO expense, was 26.2% in fiscal 1995 as compared to 26.3% in fiscal 1994.

Consolidated selling, general and administrative expenses decreased 0.6% of net sales to 19.2% compared with 19.8% in fiscal 1994. The percentage decrease is primarily due to expense control initiatives, which were partially offset by increased costs associated with the operation of seven new stores and 32 store remodels during fiscal 1995.

Depreciation and amortization expenses as percentages of sales were 2.9% and 2.8% for fiscal 1995 and 1994, respectively. The increase is primarily due to the opening of new stores and the remodeling of existing stores to the VISION 2000 format.

The Company's operating earnings (earnings before interest and income taxes) increased 23.1% to $91.5 million in fiscal 1995 from $74.3 million in fiscal 1994. General merchandise operating earnings (earnings before corporate expenses, interest and income taxes) increased 14.3% to $67.6 million in fiscal 1995 compared to $59.2 million in fiscal 1994. This increase is primarily due to expense control initiatives. Health services operating earnings increased 22.4% in fiscal 1995 to $36.5 million compared to $29.9 million in fiscal 1994. This increase is primarily due to increased sales and increased gross margin percentage.

Interest expense in fiscal 1995 increased from the prior year by 0.4% of net sales to 1.6% of net sales. The increase is primarily due to long-term borrowing which principally funded new stores, the Company's remodeling program and additional related working capital.

Liquidity and Capital Resources

The Company relies on cash generated from its operations, with the remaining needs being met from short-term and long-term borrowings. Cash provided from operating activities was $155.6 million, $40.9 million and $33.8 million in fiscal years 1996, 1995 and 1994, respectively. The increase in cash in fiscal 1996 reflects a reduction in inventory investment of $78.2 million.

Management Discussion and Analysis

On November 9, 1994, the Company issued $100 million 9.0% senior unsecured notes due November 15, 2004. The net proceeds of $98.9 million, after underwriting and issuance costs, were used to reduce the Company's short-term borrowings and to provide for working capital needs and other general corporate purposes.

Funds generated from operations, and if necessary, the existing $175 million revolving credit agreement are expected to fund the projected working capital needs and total capital expenditures through fiscal 1997.

Capital Expenditures

The Company's principal use of cash was for capital expenditures. The Company spent $53.0 million on capital expenditures in fiscal 1996, compared to $94.6 million in fiscal 1995 and $133.8 million in fiscal 1994. The following table sets forth the components of the Company's capital expenditures (in millions):

	Fiscal Year		
	1996	1995	1994
New stores	**$14.9**	$31.3	$ 82.4
Remodeling and refixturing	**24.7**	45.2	29.4
Distribution centers	**0.7**	2.8	0.7
Management information and point-of-sale equipment and systems	**11.7**	14.8	20.1
Other	**1.0**	0.5	1.2
Total	**$53.0**	$94.6	$133.8

The Company opened four new stores in the first quarter and one new store in the third quarter of fiscal 1996. The Company plans to open one additional store in fiscal 1997. With respect to store remodels, the Company completed 13 remodels under the VISION 2000 format during fiscal 1996. The rate of remodeling activity in fiscal 1996 was substantially reduced compared to fiscal 1995 and is expected to approximate the future annual level of major remodels based on a seven to ten year cycle. It is anticipated that seven stores will be remodeled and one leased store will be relocated in the first half of fiscal 1997. Store expansion and remodeling plans are subject to change and normal delays.

The Company's total capital expenditures for fiscal 1997 for new store construction, remodels, management information systems and other expenditures are anticipated to approximate $60 million, of which $40 million would relate to existing retail business and $20 million to health related businesses. Such plans may be reviewed and revised from time to time in light of changing conditions.

The Company may consider the acquisition of existing retail stores or businesses, or health services businesses, or the construction or acquisition of stores which vary from the Company's existing stores. If the Company were to undertake a large acquisition, additional capital may be required.

In addition to the above capital expenditures, the Company may be required to make additional payments of up to $12.3 million over the next several years as a result of its fiscal 1995 acquisition of Bravell, Inc. These payments are contingent upon the future results of Bravell's operations.

Inflation

Inflation has not had a significant effect on the results of operations of the Company or its internal and external sources of liquidity.

Nine Year Financial Summary

ShopKo Stores, Inc. and Subsidiaries

	Fiscal years ended								
	Feb. 24, 1996 (52 Weeks)	Feb. 25, 1995 (52 Weeks)	Feb. 26, 1994(1) (52 Weeks)	Feb. 27, 1993 (52 Weeks)	Feb. 29, 1992 (53 Weeks)	Feb. 23, 1991 (52 Weeks)	Feb. 24, 1990(2) (52 Weeks)	Feb. 25, 1989 (52 Weeks)	Feb. 27, 1988 (52 Weeks)
Summary of Operations (Millions)									
Net sales	**$ 1,968**	$ 1,853	$ 1,739	$ 1,683	$ 1,648	$ 1,521	$ 1,420	$ 1,248	$ 1,051
Licensed department rentals and other income	**14**	12	12	11	11	12	11	10	9
Gross margin	**501**	488	453	457	452	417	396	360	298
Selling, general and administrative expenses	**361**	356	344	326	325	296	282	262	221
Depreciation and amortization expenses	**56**	53	47	43	40	39	35	31	25
Interest expense	**34**	29	21	18	17	21	20	16	13
Earnings before income taxes	**63**	62	53	81	81	73	70	61	48
Net earnings	**38**	38	32	50	50	45	43	37	27
Per Share Data (Dollars)									
Net earnings per common share	**$ 1.20**	$ 1.18	$ 1.00	$ 1.56	$ 1.55(3)	$ 1.41(3)	$ 1.33(3)	$ 1.15(3)	$ 0.85(3)
Cash dividends declared per common share (4)	**0.44**	0.44	0.44	0.44	0.11				
Financial Data (Millions)									
Working capital	**$ 215**	$ 187	$ 119	$ 82	$ 79	$ 70	$ 59	$ 57	$ 37
Property and equipment–net	**617**	618	578	493	445	432	412	369	313
Total assets	**1,118**	1,110	953	792	706	692	648	576	485
Total debt (5)	**416**	429	337	225	193	215	237	231	193
Total shareholders' equity	**422**	397	374	355	320	273	228	186	149
Capital expenditures	**53**	95	134	91	53	59	80	91	88
Financial Ratios									
Current ratio	**1.8**	1.7	1.5	1.4	1.4	1.4	1.3	1.4	1.3
Return on beginning assets	**3.5%**	4.0%	4.1%	7.1%	7.2%	7.0%	7.4%	7.6%	6.9%
Return on beginning shareholders' equity	**9.7%**	10.1%	9.0%	15.7%	18.1%	19.7%	22.9%	24.8%	22.3%
Total debt as % of total capitalization (6)	**48.5%**	50.9%	46.2%	37.9%	36.7%	42.8%	50.0%	53.9%	54.9%
Other Year End Data									
Stores open at year end	**129**	124	117	111	109	104	98	87	75
Average store size–square feet	**89,945**	90,260	90,440	89,500	87,400	87,200	87,000	85,900	84,700

(1) The effect of adopting Statement of Financial Accounting Standards ("SFAS") No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," resulted in a decrease in net earnings of $0.6 million ($0.02 per share). Adoption of SFAS No. 109, "Accounting for Income Taxes," had no effect on reported net earnings or financial position.

(2) Includes the effect of a change in the method of accounting for LIFO inventories which increased net earnings by $3.0 million.

(3) The number of common shares used in the computation is the total number of shares of the Company's Common Stock oustanding upon completion of the initial public offering.

(4) First quarterly dividend was declared in the fourth quarter of fiscal 1992.

(5) Total debt includes short-term debt, current portion of long-term obligations, long-term obligations and payable to related party.

(6) Total capitalization includes shareholders' equity, total debt and non-current deferred income taxes.

Consolidated Statements of Earnings

ShopKo Stores, Inc. and Subsidiaries

	Fiscal years ended		
(In thousands, except per share data)	**February 24, 1996 (52 Weeks)**	February 25, 1995 (52 Weeks)	February 26, 1994 (52 Weeks)
Revenues:			
Net sales	**$ 1,968,016**	$1,852,929	$1,738,746
Licensed department rentals and other income	**13,924**	12,433	11,509
	1,981,940	1,865,362	1,750,255
Costs and expenses:			
Cost of sales	**1,466,733**	1,364,913	1,285,232
Selling, general and administrative expenses	**361,402**	355,515	343,381
Depreciation and amortization expenses	**56,383**	53,474	47,336
	1,884,518	1,773,902	1,675,949
Income from operations	**97,422**	91,460	74,306
Interest expense	**34,282**	29,042	21,417
Earnings before income taxes	**63,140**	62,418	52,889
Provision for income taxes	**24,701**	24,628	20,767
Net earnings	**$ 38,439**	$ 37,790	$ 32,122
Net earnings per common share	**$ 1.20**	$ 1.18	$ 1.00
Weighted average number of common shares outstanding	**32,005**	32,014	32,001

See notes to consolidated financial statements.

Consolidated Balance Sheets

ShopKo Stores, Inc. and Subsidiaries

(In thousands)	**February 24, 1996**	February 25, 1995
Assets		
Current assets:		
Cash and cash equivalents	**$ 89,469**	$ 12,598
Receivables, less allowance for losses of $3,212 and $3,590, respectively	**55,514**	42,067
Merchandise inventories	**322,433**	400,623
Other current assets	**8,775**	13,456
Total current assets	**476,191**	468,744
Other assets and deferred charges	**24,621**	22,943
Property and equipment – net	**617,148**	618,064
Total assets	**$ 1,117,960**	$ 1,109,751

Liabilities and Shareholders' Equity		
Current liabilities:		
Short-term debt	**$ —**	$ 15,000
Accounts payable – trade	**144,638**	149,293
Accrued compensation and related taxes	**25,290**	24,612
Accrued other liabilities	**72,943**	61,858
Accrued income and other taxes	**16,797**	29,955
Current portion of long-term obligations	**1,127**	755
Total current liabilities	**260,795**	281,473
Long-term obligations	**415,138**	413,580
Deferred income taxes	**20,396**	17,423
Shareholders' equity:		
Preferred stock; none outstanding		
Common stock; shares outstanding, 32,005 in 1996 and 1995	**320**	320
Additional paid-in capital	**242,843**	242,843
Retained earnings	**178,468**	154,112
Total shareholders' equity	**421,631**	397,275
Total liabilities and shareholders' equity	**$ 1,117,960**	$ 1,109,751

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

ShopKo Stores, Inc. and Subsidiaries

(In thousands)	February 24, 1996 (52 Weeks)	February 25, 1995 (52 Weeks)	February 26, 1994 (52 Weeks)
	Fiscal years ended		
Cash flows from operating activities:			
Net earnings	**$ 38,439**	$ 37,790	$ 32,122
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	**56,383**	53,474	47,336
Provision for losses on receivables	**23**	287	63
(Gain) loss on the sale of property and equipment	**(2,739)**	421	(1,410)
Deferred income taxes	**5,206**	(3,764)	5,995
Change in assets and liabilities:			
Receivables	**(13,470)**	(5,611)	(9,317)
Merchandise inventories	**78,190**	(71,769)	(65,521)
Other current assets	**2,448**	(1,504)	(397)
Other assets	**(2,879)**	(2,059)	(1,025)
Accounts payable	**(4,655)**	2,142	21,369
Accrued liabilities	**(1,395)**	31,486	4,590
Net cash provided by operating activities	**155,551**	40,893	33,805
Cash flows from investing activities:			
Payments for property and equipment	**(53,012)**	(94,600)	(133,842)
Proceeds from the sale of property and equipment	**4,171**	6,982	4,644
Business acquisitions, net of cash acquired		(15,885)	
Net cash (used in) investing activities	**(48,841)**	(103,503)	(129,198)
Cash flows from financing activities:			
Net proceeds from long-term obligations		98,939	98,714
Change in short-term debt	**(15,000)**	(11,200)	11,175
Change in common stock		(135)	185
Dividends paid	**(14,083)**	(14,087)	(14,080)
Reduction in capital lease obligations	**(756)**	(879)	(823)
Net cash (used in) provided by financing activities	**(29,839)**	72,638	95,171
Net increase (decrease) in cash and cash equivalents	**76,871**	10,028	(222)
Cash and cash equivalents at beginning of year	**12,598**	2,570	2,792
Cash and cash equivalents at end of year	**$ 86,469**	$ 12,598	$ 2,570
Supplemental cash flow information:			
Noncash investing and financial activities –			
Capital lease obligations incurred	**$ 2,573**	$ 4,992	$ 1,769
Cash paid during the period for:			
Interest	**$ 34,803**	$ 27,734	$ 23,248
Income taxes	**$ 33,062**	$ 12,910	$ 15,467

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

ShopKo Stores, Inc. and Subsidiaries

(In thousands, except per share data)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings
Balances at February 27, 1993	32,000	$320	$242,793	$112,367
Net earnings				32,122
Issuance of common stock	16		185	
Cash dividends declared on common stock – $0.44 per share				(14,081)
Balances at February 26, 1994	32,016	320	242,978	130,408
Net earnings				37,790
Cancellation of common stock	(16)		(185)	
Issuance of common stock	5		50	
Cash dividends declared on common stock – $0.44 per share				(14,086)
Balances at February 25, 1995	32,005	320	242,843	154,112
Net earnings				38,439
Cash dividends declared on common stock – $0.44 per share				(14,083)
Balances at February 24, 1996	32,005	$320	$242,843	$178,468

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

ShopKo Stores, Inc. and Subsidiaries

A. Summary of Significant Accounting Policies

Organization and Basis of Presentation:

The consolidated financial statements include the accounts of ShopKo Stores, Inc. and all its subsidiaries ("ShopKo" or the "Company"). All significant intercompany accounts and transactions have been eliminated. The Company, which is a Minnesota corporation, was incorporated in 1961. On October 16, 1991, the Company sold 17,250,000 common shares or 54% of equity ownership in an initial public offering. Prior to completion of the offering, the Company was a wholly owned subsidiary of Supermarket Operators of America, Inc., ("SOA") which, in turn, is wholly owned by SUPERVALU INC. ("SUPERVALU"). As of February 24, 1996, 46% of the Company's common stock was owned by SUPERVALU.

ShopKo is engaged in the business of providing general merchandise and health services through its retail stores; prescription benefit management services; pharmacy mail service and claims processing activities. Retail stores are operated in the Upper Midwest, Mountain and Pacific Northwest states. All other business is conducted throughout the United States.

Cash and Cash Equivalents:

The Company records all highly liquid investments with a maturity of three months or less as cash equivalents. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities," these investments are classified as trading securities and are reported at fair value.

Receivables:

Receivables consist of amounts collectible from merchandise vendors for promotional and advertising allowances, from third party pharmacy insurance carriers and self-funded medical plan sponsors, from pharmaceutical manufacturers for formulary fees and from store customers for optical, main store layaway and pharmacy purchases. Substantially all amounts are expected to be collected within one year.

Merchandise Inventories:

Merchandise inventories are stated at the lower of cost or market. Cost, which includes certain distribution and transportation costs, is determined through use of the last-in, first-out (LIFO) method for substantially all inventories. If the first-in, first-out (FIFO) method had been used to determine cost of inventories, the Company's inventories would have been higher by approximately $39.2 million at February 26, 1996, $37.0 million at February 25, 1995 and $39.0 million at February 26, 1994.

Property and Equipment:

Property and equipment are carried at cost. The cost of buildings and equipment is depreciated over the estimated useful lives of the assets. Buildings and certain equipment (principally computer and retail store equipment) are depreciated using the straight-line method. Remaining properties are depreciated on an accelerated basis. Useful lives generally assigned are: buildings–25 to 50 years; retail store equipment–8 to 10 years; warehouse, transportation and other equipment–3 to 10 years. Costs of leasehold improvements are amortized over the period of the lease or the estimated useful life of the asset, whichever is shorter, using the straight-line method. Property under capital leases is amortized over the related lease term using the straight-line method. Interest on property under construction of $0.2, $1.3 and $2.1 million was capitalized in fiscal years 1996, 1995 and 1994, respectively.

The components of property and equipment are:

(In thousands)	**Feb. 24, 1996**	Feb. 25, 1995
Property and equipment at cost:		
Land	**$107,915**	$107,532
Buildings	**479,124**	441,665
Equipment	**286,763**	278,391
Leasehold improvements	**49,306**	50,581
Property under construction	**10,585**	23,081
Property under capital leases	**21,968**	19,591
	955,661	920,841
Less accumulated depreciation and amortization:		
Property and equipment	**331,541**	294,798
Property under capital leases	**6,972**	7,979
Net property and equipment	**$617,148**	$618,064

Impairment of Long Lived Assets:

The Company evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long lived assets may warrant revision or that the remaining balance of an asset may not be recoverable. The measurement of possible impairment is based on the ability to recover the balance of assets from expected future operating cash flows on an undiscounted basis. In the opinion of management, no such impairment existed as of February 24, 1996 or February 25, 1995.

Pre-opening Costs:

Pre-opening costs of retail stores are charged against earnings in the year of the store openings.

Net Earnings Per Common Share:

Net earnings per common share are computed by dividing net earnings by the weighted average number of common shares outstanding. Outstanding stock options do not have a significant dilutive effect on earnings per share.

Notes to Consolidated Financial Statements

Use of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reporting period. Actual results could differ from those estimates.

Reclassifications:

Certain reclassifications have been made to fiscal 1994 consolidated financial statements to conform to those used in fiscal 1996 and fiscal 1995.

B. Acquisition

On January 3, 1995, the Company completed the acquisition of Bravell, Inc. ("Bravell"). The transaction was accounted for as a purchase, whereby the Company acquired 97% of the outstanding common stock of Bravell for approximately $17.3 million. The Company may be required to make additional payments of up to $12.3 million, contingent upon future results of Bravell's operations. Bravell is a pharmacy benefit management firm that provides custom prescription benefit plan design, program administration and claims and benefit processing services to insurance companies, third party administrators and self-funded medical plan sponsors.

The allocation of the purchase price of Bravell was based on fair values at the date of acquisition. The excess of the purchase price over the fair value of the net assets acquired ("goodwill") of approximately $16.7 million is being amortized on a straight-line basis over 22 years. The results of Bravell's operations since the date of acquisition have been included in the consolidated statements of earnings.

Bravell records as sales the amounts billed to insurance companies, third party administrators and self-funded medical plan sponsors and the amounts billed to pharmaceutical manufacturers for formulary fees. Cost of sales includes the amounts paid to network pharmacies and the amounts paid to plan sponsors for shared formulary fees.

C. Short-Term Debt

As of February 24, 1996, the Company had a $175.0 million revolving credit agreement with a consortium of banks. The credit agreement is unsecured and will expire October 4, 1996, subject to an extension for an additional year. The Company pays an annual facility and commitment fee of 1/4 of one percent. As of February 24, 1996, the Company had zero outstanding under this agreement compared to $15.0 million as of February 25, 1995. The weighted average interest rate on borrowings under the credit agreement for fiscal 1996 was 6.2%.

The Company also issues letters of credit during the ordinary course of business as required by foreign vendors. As of February 24, 1996 and February 25, 1995, the Company had issued letters of credit for $19.8 million and $13.6 million, respectively.

D. Long-Term Obligations and Leases

(In thousands)	**Feb. 24, 1996**	Feb. 25, 1995
Senior Unsecured Notes, 9.0% due November 15, 2004, less unamortized discount of $257 and $287 respectively	**$ 99,743**	$ 99,713
Senior Unsecured Notes, 8.5% due March 15, 2002, less unamortized discount of $221 and $258 respectively	**99,779**	99,742
Senior Unsecured Notes, 9.25% due March 15, 2022, less unamortized discount of $499 and $518 respectively	**99,501**	99,482
Senior Unsecured Notes, 6.5% due August 15, 2003, less unamortized discount of $209 and $236 respectively	**99,791**	99,764
Industrial Revenue Bond, 6.4%, due May 1, 2008	**1,000**	1,000
Capital lease obligations	**16,451**	14,634
	416,265	414,335
Less current portion	**1,127**	755
Long-term obligations	**$415,138**	$413,580

On November 9, 1994, the Company issued $100 million 9.0% senior unsecured notes due November 15, 2004. The notes provide for semi-annual interest payments payable on May 15 and November 15 of each year. There is no sinking fund applicable to the notes and the notes are not redeemable prior to maturity. The net proceeds of $98.9 million, after underwriting and issuance costs, were used to reduce the Company's short-term borrowings and to provide for working capital needs and other general corporate purposes.

The notes contain certain covenants which, among other things, restrict the ability of the Company to consolidate, merge or convey, transfer or lease its properties and assets substantially as an entirety, to create liens or to enter into sale and leaseback transactions.

The underwriting and issuance costs of all the long-term obligations are being amortized over the terms of the notes using the straight-line method. At February 24, 1996 and February 25, 1995, $2.9 million and $3.2 million remained to be amortized over future periods. Amortized expense for these costs was $0.3, $0.2 and $0.2 million in fiscal years 1996, 1995 and 1994, respectively.

The Company leases certain stores and computer equipment under capital leases. Many of these leases include renewal options, and occasionally, include options to purchase.

Amortization of property under capital leases was $1.1, $0.9 and $0.8 million in fiscal years 1996, 1995 and 1994, respectively. Minimum future obligations under capital leases in effect at February 24, 1996 are as follows (in thousands):

Year	Lease Obligations
1997	$ 2,883
1998	3,551
1999	3,406
2000	2,128
2001	1,931
Later	20,386
Total minimum future obligations	34,285
Less interest	17,834
Present value of minimum future obligations	$16,451

The present values of minimum future obligations shown above are calculated based on interest rates ranging from 7.4% to 13.4%, with a weighted average of 12.1%, determined to be applicable at the inception of the leases.

Interest expense on the outstanding obligations under capital leases was $1.7, $1.2 and $1.0 million in fiscal years 1996, 1995 and 1994, respectively.

Contingent rent expense, based primarily on sales performance, for capital and operating leases was $0.5 million in each of the fiscal years 1996, 1995 and 1994, respectively.

In addition to its capital leases, the Company is obligated under operating leases, primarily for land and buildings. Minimum future obligations under operating leases in effect at February 24, 1996 are as follows (in thousands):

Year	Lease Obligations
1997	$ 3,610
1998	3,529
1999	3,366
2000	3,266
2001	3,230
Later	50,326
Total minimum obligations	$67,327

Total minimum rental expense, net of sublease income, related to all operating leases with terms greater than one year was $3.5, $2.9 and $2.7 million in fiscal years 1996, 1995 and 1994, respectively.

Certain operating leases require payments to be made on an escalating basis. The accompanying consolidated statements of earnings reflect rent expense on a straight-line basis over the term of the leases. An obligation of $1.4 million and $1.1 million, representing pro rata future payments, is reflected in the accompanying consolidated balance sheets at February 24, 1996 and February 25, 1995, respectively.

E. Income Taxes

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Components of the Company's net deferred tax liability are as follows (in thousands):

	1996	1995
Deferred tax liabilities:		
Property and equipment	**$ 22,556**	$19,752
LIFO inventory valuation	**6,415**	5,210
Other	**2,181**	3,462
Total deferred tax liabilities	**31,152**	28,424
Deferred tax assets:		
Reserves and allowances	**(11,239)**	(13,070)
Capital leases	**(733)**	(1,380)
Total deferred tax assets	**(11,972)**	(14,450)
Net deferred tax liability	**$ 19,180**	$13,974

The amounts reflected in the provision for income taxes are based on applicable federal statutory rates, adjusted for permanent differences between financial and taxable income. The provision for federal and state income taxes includes the following (in thousands):

	1996	1995	1994
Current			
Federal	**$16,163**	$24,379	$12,562
State	**3,332**	4,488	2,560
General business and other tax credits	**—**	(475)	(350)
Deferred	**5,206**	(3,764)	5,995
Total provision	**$24,701**	$24,628	$20,767

The effective tax rate varies from the statutory federal income tax rate for the following reasons:

	1996	1995	1994
Statutory income tax rate	**35.0%**	35.0%	35.0%
State income taxes, net of federal tax benefits	**4.0**	4.1	4.1
Other	**0.1**	0.3	0.2
Effective income tax rate	**39.1%**	39.4%	39.3%

Provision is made for deferred income taxes and future income tax benefits applicable to temporary differences between financial and tax reporting. The sources of these differences and the effects of each were as follows (in thousands):

	1996	1995	1994
Depreciation	**$2,804**	$ (247)	$1,398
Inventory valuation reserves	**1,339**	(2,261)	—
LIFO inventory valuation	**1,205**	(1,370)	5,370
Bad debt and return reserves	**241**	(806)	22
Other	**(383)**	920	(795)
Total deferred tax expense (benefit)	**$5,206**	$(3,764)	$5,995

Other temporary differences between financial and tax reporting include amortization and interest relating to capital leases and certain provisions for expenses which are not deducted for tax purposes until paid.

F. Preferred and Common Stock

The Company has 20,000,000 shares of $0.01 preferred stock authorized but unissued.

There are 75,000,000 shares of $0.01 par value common stock authorized with 32,005,000 shares issued and outstanding at both February 24, 1996 and February 25, 1995, respectively.

The Company's Stock Option Plans allow the granting of stock options to various officers, directors and other employees of the Company at prices not less than 100 percent of fair market value, determined by the closing price on the date of grant. The Company has reserved 2,400,000 shares for issuance under the 1991 Stock Option Plan. The 1995 Stock Option Plan, which is subject to shareholder approval, allows for the issuance of 1,200,000 shares. The majority of these options vest at the rate of 40% on the second anniversary of the grant date and 20% annually thereafter for officers and employees and at the rate of 60% on the second anniversary of the date of grant and 20% annually thereafter for non-employee directors. Changes in the options are as follows (shares in thousands):

	Shares	Price Range
Outstanding, February 27, 1993	1,505	$15.00 - $16.25
Granted	627	10.13 - 15.00
Canceled and forfeited	(208)	10.88 - 16.25
Outstanding, February 26, 1994	1,924	10.13 - 16.25
Granted	250	10.00 - 11.00
Canceled and forfeited	(238)	10.00 - 16.25
Outstanding at February 25, 1995	1,936	10.00 - 16.25
Granted	576	10.50 - 10.75
Canceled and forfeited	(139)	10.00 - 16.25
Outstanding at February 24, 1996	2,373	10.00 - 16.25
Exercisable at February 24, 1996	1,062	10.13 - 16.25

In October 1995, SFAS No. 123 "Accounting for Stock-Based Compensation" was issued. SFAS No. 123 establishes a fair value based method of accounting for stock-based compensation; however, it allows entities to continue accounting for employee stock-based compensation under the intrinsic value method proscribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123 requires certain disclosures, including pro forma net income and earnings per share as if the fair value based accounting method had been used for employee stock-based compensation cost. The Company has decided to adopt SFAS No. 123 through disclosure with respect to employee stock-based compensation; such disclosure requirements are effective with the Company's 1997 fiscal year.

In fiscal 1994, the Company adopted a Restricted Stock Plan which provides awards of up to 200,000 shares of common stock to key employees of the Company. Plan participants are entitled to cash dividends and to vote their respective shares. Restrictions limit the sale or transfer of the shares during a restricted period. There are 5,000 shares of restricted stock outstanding for both February 24, 1996 and February 25, 1995, respectively.

G. Employee Benefits

Substantially all employees of the Company are covered by a defined contribution profit sharing plan. The plan provides for two types of company contributions; an amount determined annually by the Board of Directors and an employer matching contribution equal to one-half of the first 6 percent of compensation contributed by participating employees. Contributions were $7.7, $6.7 and $5.6 million for fiscal years 1996, 1995 and 1994, respectively.

The Company also has change of control severance agreements with certain key officers. Under these agreements, the officers are entitled to a lump-sum cash payment equal to a multiple of one, two or three times their annual salary plus a multiple of one, two or three times their average annual bonus for the three fiscal years immediately preceding the date of termination, if, within two years after a "change of control" (as defined in such agreements) the Company terminates the individual's employment without cause.

In fiscal 1994, the Company adopted SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." SFAS No. 106 requires the Company to accrue the estimated cost of retiree benefits, other than pensions, during employees' credited service period. The cost of these benefits, which are principally healthcare, was previously expensed as claims were incurred. The Company elected to immediately recognize the accumulated postretirement benefit obligation, resulting in a charge to earnings of $0.6 million or $0.02 per share.

The net periodic costs for postretirement benefits include the following (in thousands):

	1996	1995	1994
Service cost for benefits accumulated during the year	**$ 98**	$ 78	$ 77
Interest cost on accumulated benefit obligation	**96**	60	60
Net periodic postretirement benefit cost	**$194**	$138	$137

The Company's postretirement healthcare plans currently are not funded. The accumulated postretirement benefit obligations are as follows (in thousands):

	Feb. 24, 1996	Feb. 25, 1995
Retirees	**$ 371**	$ 347
Active plan participants	**1,022**	728
Total accumulated postretirement obligations	**$1,393**	$1,075

The assumed discount rate used in determining the accumulated postretirement benefit obligation was 7.3% and 7.0% for fiscal years 1996 and 1995, respectively.

The assumed healthcare cost trend rate used in measuring the accumulated postretirement benefit obligation was 8.9% for fiscal 1996 decreasing each successive year until it reaches 5.5% in fiscal 2015 after which it remains constant. A 1% increase in the healthcare trend rate would have an immaterial effect on the accumulated postretirement benefit obligation at the end of fiscal 1996 and fiscal 1995 and on the net periodic cost for the fiscal years.

H. Related Party Transactions

In accordance with service agreements entered into in connection with the initial public offering, general, administrative and other services were allocated to the Company from SUPERVALU. The Company also provided services and allocated general, administrative and other expenses to two wholly-owned subsidiaries of SUPERVALU. In such cases, allocations were made using procedures deemed appropriate to the nature of the services involved. Management believes the allocations were made on a reasonable basis. Although these allocations do not necessarily equal the costs which would have been or may be incurred by the Company on a stand-alone basis, management believes that any variance in costs would not be material. The service agreements between ShopKo and SUPERVALU expired in early fiscal 1994.

Selling, general and administrative expenses include the following allocations (in thousands):

	1994
From SUPERVALU to ShopKo	$ 96
From ShopKo to wholly owned subsidiaries of SUPERVALU	$323

Purchases of inventory from SUPERVALU were $1.0, $2.7 and $9.7 million for the fiscal years 1996, 1995 and 1994, respectively.

Also, as a result of the initial public offering, the Company and SUPERVALU entered into certain other agreements of which the following are still in effect:

A food products supply agreement under which the Company has agreed to purchase from SUPERVALU, through October 16, 1998, all of the Company's requirements for certain products sold in any food store owned or operated by the Company and located within the geographic areas serviced by SUPERVALU.

A registration rights agreement under which SOA (and certain affiliates of SUPERVALU) has the right to require the Company to file up to three registration statements under the Securities Act.

Notes to Consolidated Financial Statements

I. Fair Values of Financial Instruments

The following disclosure is made in accordance with the requirements of SFAS No. 107, "Disclosures about Fair Value of Financial Instruments." The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments.

Short-term debt and long-term obligations: The carrying amounts of the Company's borrowings under its short-term revolving credit agreement approximate their fair value. The fair values of the Company's long-term obligations are estimated using discounted cash flow analysis based on interest rates that are currently available to the Company for issuance of debt with similar terms and remaining maturities.

The carrying amounts and fair values of the Company's financial instruments at February 24, 1996 are as follows (amounts in thousands):

	Carrying Amount	Fair Value
Long-term obligations:		
Senior Unsecured Notes, due November 15, 2004	$ 99,743	$105,356
Senior Unsecured Notes, due March 15, 2002	99,779	107,309
Senior Unsecured Notes, due March 15, 2022	99,501	105,922
Senior Unsecured Notes, due August 15, 2003	99,791	91,147
Industrial Revenue Bond, due May 1, 2008	1,000	1,000
Capital lease obligations	16,451	18,477

J. Unaudited Quarterly Financial Information

Unaudited quarterly financial information is as follows:

	Fiscal Year (52 Weeks) Ended February 24, 1996				
(In thousands, except per share data)	**First (16 wks)**	**Second (12 wks)**	**Third (12 wks)**	**Fourth (12 wks)**	**Year (52 wks)**
Net sales	**$560,472**	**$418,165**	**$491,019**	**$498,360**	**$1,968,016**
Gross margins	**143,359**	**103,745**	**122,670**	**131,509**	**501,283**
Net earnings	**5,368**	**1,869**	**10,132**	**21,070**	**38,439**
Net earnings per common share	**0.17**	**0.06**	**0.32**	**0.66**	**1.20**
Weighted average shares	**32,005**	**32,005**	**32,005**	**32,005**	**32,005**
Dividends declared per common share	**0.11**	**0.11**	**0.11**	**0.11**	**0.44**
Price range per common share*	**11¾-8¾**	**14-10¼**	**13¼-10¼**	**11¾-10⅞**	**14-8¾**

	Fiscal Year (52 Weeks) Ended February 25, 1995				
	First (16 wks)	Second (12 wks)	Third (12 wks)	Fourth (12 wks)	Year (52 wks)
Net sales	$514,926	$381,297	$470,919	$485,787	$1,852,929
Gross margins	135,411	99,910	120,718	131,977	488,016
Net earnings	4,980	2,750	11,303	18,757	37,790
Net earnings per common share	0.16	0.09	0.35	0.59	1.18
Weighted average shares	32,016	32,016	32,016	32,014	32,014
Dividends declared per common share	0.11	0.11	0.11	0.11	0.44
Price range per common share*	12-10¼	10⅜-9¾	10⅝-9¾	9¾-8⅝	12-8⅝

*Price range per common share reflects the highest and lowest stock market prices on the New York Stock Exchange during the quarter.

Notes to Consolidated Financial Statements

K. Business Segment Information

The Company conducts business in two business segments: general merchandise and health services. General merchandise is conducted through retail stores. Health services include professional healthcare services provided in the retail stores and prescription benefit management services which are generally provided through other facilities.

Information about the Company's operations in the different businesses is as follows (in thousands):

	1996	1995	1994
Net sales			
General merchandise	**$1,503,096**	$1,489,919	$1,411,781
Health services	**464,920**	363,010	326,965
Total net sales	**$1,968,016**	$1,852,929	$1,738,746
Earnings before income taxes			
General merchandise	**$ 73,124**	$ 67,638	$ 59,151
Health services	**36,805**	36,547	29,854
Corporate	**(12,507)**	(12,725)	(14,699)
Interest expense	**(34,282)**	(29,042)	(21,417)
Earnings before income taxes	**$ 63,140**	$ 62,418	$ 52,889
Assets			
General merchandise	**$ 884,275**	$ 950,719	$ 846,052
Health services	**101,130**	91,208	58,586
Corporate	**132,555**	67,824	48,411
Total assets	**$1,117,960**	$1,109,751	$ 953,049
Depreciation and amortization expenses			
General merchandise	**$ 51,466**	$ 49,542	$ 44,375
Health services	**4,525**	3,439	2,629
Corporate	**392**	493	332
Total depreciation and amortization expenses	**$ 56,383**	$ 53,474	$ 47,336
Capital expenditures			
General merchandise	**$ 49,268**	$ 89,346	$ 120,988
Health services	**2,783**	4,740	11,398
Corporate	**961**	514	1,456
Total capital expenditures	**$ 53,012**	$ 94,600	$ 133,842

Independent Auditors' Report

To the Board of Directors and Shareholders
ShopKo Stores, Inc.:

We have audited the consolidated balance sheets of ShopKo Stores, Inc. and Subsidiaries as of February 24, 1996 and February 25, 1995 and the related consolidated statements of earnings, shareholders' equity and cash flows for each of the three years (52 weeks) in the period ended February 24, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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 audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of ShopKo Stores, Inc. and Subsidiaries as of February 24, 1996 and February 25, 1995, and the results of their operations and their cash flows for each of the three years (52 weeks) in the period ended February 24, 1996 in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE LLP
Milwaukee, Wisconsin
April 2, 1996

Shareholders' Information

ShopKo Stores, Inc. common shares are listed on the New York Stock Exchange under the symbol "SKO" and in the newspapers as "ShopKo." As of April 26, 1996, ShopKo's common shares were held by 1,436 record owners.

Transfer Agent and Registrar

For help with questions regarding lost, stolen or destroyed stock certificates, non-receipt of dividend checks, consolidation of accounts, transferring of shares and name and address changes call Norwest Banks at 1-800-468-9716.

1996 Annual Meeting

The annual meeting of shareholders will be held June 19, 1996 at 10 a.m. at the Ramada Inn, 2750 Ramada Way, Green Bay, Wisconsin.

Investor Relations/Form 10-K

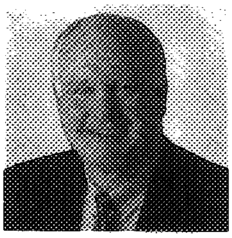
A copy of the company's 1996 Form 10-K annual report to the Securities and Exchange Commission will be furnished without charge to any shareholder upon written request.

Quarterly reports are furnished to shareholders of record by the company's stock transfer agent. Any shareholder whose stock is not registered in the shareholder's name will be furnished quarterly reports without charge upon written request.

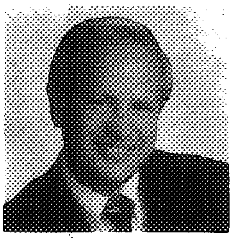
All written requests should be directed to:

Investor Relations Department
ShopKo Stores, Inc.
P.O. Box 19060
Green Bay, WI 54307-9060

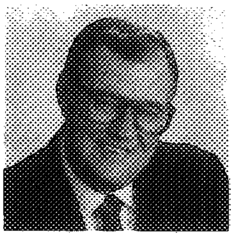
Board of Directors



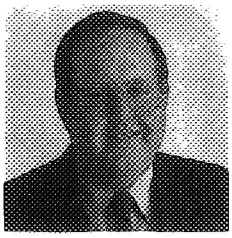
Michael W. Wright
Chairman of the Board
Chairman, President and Chief Executive Officer of SUPERVALU



Dale P. Kramer
President and Chief Executive Officer of ShopKo



William J. Tyrrell
Vice Chairman of the Board, Former President of ShopKo



Jeffrey C. Girard
Executive Vice President and Chief Financial Officer of SUPERVALU

Jack W. Eugster
Chairman, President and Chief Executive Officer of The Musicland Group, Inc.

Officers

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President and Chief Executive Officer

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Senior Vice President of Health Services

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Vice President, Advertising

Oscar R. Cavazos
Vice President, Divisional Merchandise Manager

Roger J. Chustz
Senior Vice President, General Merchandise Manager, Apparel

Lawrence J. Clark
Vice President, Finance

Joseph A. Coffini
Vice President, Managed Care Services

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Vice President, Distribution, Transportation

Rose A. Downs
Vice President, Operations Administration

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Senior Vice President of Stores

Steven T. Harig
Senior Vice President of Planning, Replenishment and Analysis, Distribution

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Regional Vice President

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Senior Vice President, General Merchandise Manager, Hardlines

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Vice President, Divisional Merchandise Manager

Michael J. Hopkins
Senior Vice President, General Merchandise Manager, Home

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Vice President, Loss Prevention

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Senior Vice President of Human Resources

L. Terry McDonald
Senior Vice President of Marketing

Steven C. Peters
Vice President, Divisional Merchandise Manager

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Vice President, Merchandise Operations

Dennis R. Ruebel
Vice President, Merchandising/Mfg. Health Services

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Regional Vice President

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Vice President, Legal Affairs and Secretary

Robert S. Segal
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Jeffery R. Simons
Vice President and Controller

James W. Smekal
Vice President, Divisional Merchandise Manager

Jean R. Srour
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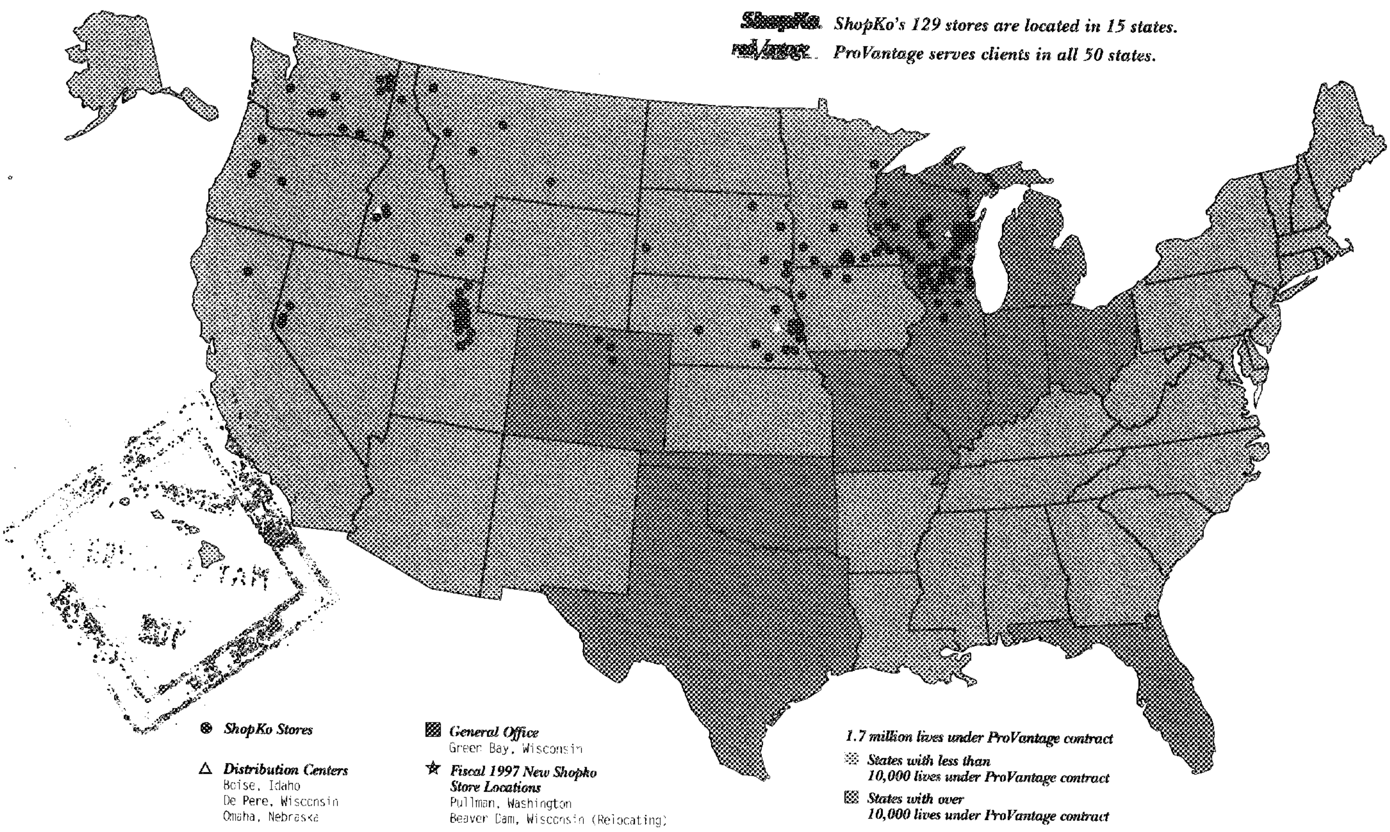
Katherine W. Steirly
Vice President, Divisional Merchandise Manager

James F. Tucker
Senior Vice President, Information Services and Chief Information Officer

Larry J. Vick
Vice President, Divisional Merchandise Manager

Michael F. Wilson
Vice President, Store Planning



129 Store Locations

California (1)
Redding

Colorado (3)
Fort Collins
Longmont
Loveland

Idaho (8)
Boise (2)
Chubbuck
Coeur d'Alene
Idaho Falls
Lewiston
Nampa
Twin Falls

Illinois (3)
Belvidere
Dixon
Freeport

Iowa (3)
Mason City
Sioux City
Spencer

Michigan (4)
Escanaba
Houghton
Kingsford
Marquette

Minnesota (13)
Albert Lea
Austin
Duluth
Fairmont
Hutchinson
Mankato
Marshall
Rochester (2)
St. Cloud (2)
Winona
Worthington

Montana (5)
Billings
Great Falls
Helena
Kalispell
Missoula

Nebraska (11)
Bellevue
Grand Island
Hastings
Lincoln (2)
Norfolk
North Platte
Omaha (4)

Nevada (3)
Reno (2)
Sparks

Oregon (4)
Bend
Eugene (2)
Salem

South Dakota (6)
Aberdeen
Mitchell
Rapid City
Sioux Falls (2)
Watertown

Utah (15)
Brigham City
Layton
Logan
Murray
Ogden
Orem
Provo
Riverdale
Salt Lake City (2)
Sandy City
Spanish Fork
West Bountiful
West Jordan
West Valley City

Washington (9)
Kennewick
Lacey
Spokane (3)
Union Gap
Walla Walla
Wenatchee
Yakima

Wisconsin (41)
Appleton
Ashwaubenon
Beaver Dam
Beloit
Chippewa Falls
Delavan
De Pere
Eau Claire
Fond du Lac
Fort Atkinson
Grafton
Green Bay (2)
Janesville
Kenosha
Kimberly
La Crosse (2)
Madison (3)
Manitowoc
Marinette
Marshfield
Menasha
Monona
Monroe
Neenah
Onalaska
Oshkosh
Racine
Rice Lake
River Falls
Rothschild
Sheboygan
Stevens Point (2)
Watertown
Wausau
West Bend
Wisconsin Rapids

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