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INVESTMENT MANAGEMENT CO.

**Our Motto: *To write investment letters that are readable, without soporific jargon, but with pertinent facts not easily obtained in the ordinary course of research.***

## INVESTMENT LETTER

### FAMILY DOLLAR STORES, INC. (NYSE:FDO)

**Harriett Hurried Falls In and Out of Love with Family Dollar  
And Then Back in Love Again, As She Sees Family Dollar Offering the Complete Package:  
Savings of Time and Money, Even if the Setting is Spartan**

June 15, 2010

In **Dragnet**, a detective show that starred an unfailingly serious, intent, and polite **Jack Webb**, we were told that the names had been changed to protect the innocent. In our story, the names have been changed to protect the thrifty, who often find themselves in awkward positions in a society, in a culture that encourages excessive spending and is often contemptuous of budgets, frugality, and the distinction between need and want. Even after what some call the 'great collapse' of 2007-2008, thrift is often on the defensive, barricaded against the highly imaginative assaults mounted by **MasterCard** and **Visa** and by the high-end merchants, such as **Rolux** and **Tiffany & Co. (NYSE: TIF)** that have spent millions of dollars convincing consumers that they need, rather than want, a watch or a bracelet.

Yet, the thrifty are fighting back. They are standing up for their values and seeking stores such as **Family Dollar Stores, Inc. (NYSE: FDO)**, where they can get great savings in money and in time.

**Harriett Hurried** is not a real person, but she is a real demographic, a symbol of the new class of the sophisticated thrifty. Saving time and money are important considerations, and Family Dollar offers a convenient way to save on both, and that is why Harriett shops at Family Dollar.

We first met **Harriet** and her husband **Tom** in 2001 (when we first became shareholders in **Family Dollar Stores, Inc.**). They and their two children were living in the 500 block of South Xanthus in Tulsa, on a street of modest but well-kept houses within walking distance of **Family Dollar** store # 3413, at 401 South Utica Avenue, Tulsa, OK.

**Harriet Hurried** was a woman who, along with her husband, managed a household with limited means, that is, a household with income, from all sources, whether it be paycheck, investments, social security, or anything else, of less than forty thousand dollars annually.

At the end of 2001, **Family Dollar** Stores, Inc. operated 3,907 retail locations. Today the company operates more than 6,600 stores, serving, as it did in 2001, families like the **Hurrieds**, who are short on time and money, families that, consequently, must use their money and their time efficiently. Unlike the wealthy, people of limited financial means cannot hire out many of the chores, such as housecleaning, that the rich can. But before we go on, there is one misconception that we must clear up, and that is the confusion between the dollar stores and stores such as Family Dollar.

### Who are the dollar stores, anyway?

We must make one thing clear: **Family Dollar** is *not* a dollar store. A dollar store, such as the highly successful **Dollar Tree, Inc. (NASDAQ: DLTR)** chain, offers mostly private label goods that are often of inferior quality or of small size because these items must be priced at one dollar or less. **Family Dollar**, in contrast, offers name brand as well as private label goods at price points that are low, but often above a dollar, and thus can offer similar quality consumable goods that stores such as **Wal-Mart Stores Inc. (NYSE: WMT)** and **Target Corp. (NYSE: TGT)** offer. The average purchase per trip at a **Family Dollar** store is almost nine dollars, whereas at **Dollar Tree** it is less than four dollars.

The strategy at **Family Dollar** is to match or better **Wal-Mart** prices and to better the time it takes to shop at **Wal-Mart**. Below we show how **Family Dollar** does this.

How can it be that **Wal-Mart**, as big as it is, does not under price **Family Dollar**? How can the much smaller **Family Dollar** be competitive, pricewise? After all, **Wal-Mart** has the buying power afforded by a company that had net sales of \$405 billion in 2009,<sup>1</sup> while **Family Dollar** had net sales of only \$7.4 billion.<sup>2</sup>

The answer is twofold. First, **Family Dollar**, with its smaller store size, has greater real estate flexibility. While **Wal-Mart** requires an average of 185,000 square feet<sup>3</sup> for one of its supercenters, **Family Dollar** needs only an average of 8,500 square feet.<sup>4</sup> **Family Dollar** pays low rent for existing store fronts, unlike **Wal-Mart**, which usually must acquire land and build new stand-alone buildings to accommodate its large stores.

Second, **Family Dollar** has far fewer stock keeping units, meaning it can concentrate its buying power, focusing on getting the few items it carries as cheaply as possible.

During a call with our firm on April 21, 2010, **Kiley Rawlins**, head of Investor Relations for **Family Dollar Stores, Inc.**, said, “We still can’t carry the flavor varieties and breadth of assortment as, say, **Wal-Mart** can, but that’s why our prices can be lower. We can order a large volume of one or two SKUs—our prices are better *because* we offer fewer flavors.”

The difference between wants and necessities is an elusive, tantalizing question. Marketers spend much money to convince us to spend more money and to consider wants as needs. Certainly **Family Dollar** is not in the same marketing or psychological category as **Starbucks Corp. (NASDAQ: SBUX)**, **Estee Lauder Companies, Inc. (NYSE: EL)**, or **Apple Inc. (NASDAQ: AAPL)**. For these companies it is imperative to convince the consumer that he or she needs everything they sell. For these companies, the concept of selling wants versus needs is academic. The consumer must be educated to believe that everything these companies sell is a necessity. For **Family Dollar**, there is a distinction between wants and needs, and yet the company is moving, slowly but deliberately to train the consumer to buy the high-priced items, the discretionary items that produce higher gross margins than do the basics or necessities.

For instance, on a visit that **Katie**, **Meredith**, and **Fred** made to **Family Dollar** store #5336 on April 9, 2010, **Fred** could not resist the previously-viewed DVDs. He spent twenty-four dollars (DVDs are six dollars

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<sup>1</sup> Income statement of Wal-Mart Stores Inc.’s 10-K filing for the fiscal year ended January 31, 2009

<sup>2</sup> Income statement of Family Dollar Stores Inc.’s 10-K filing for the fiscal year ended August 29, 2009

<sup>3</sup> Walmartstores.com

<sup>4</sup> Total square footage divided by total number of stores. Numbers taken from Exhibit 99 of Family Dollar Stores Inc.’s 8-K filing dated April 7, 2010

apiece, and include recent box office hits) succumbing to impulse, obviously not being able to separate his wants from his needs. Defining the basics is a deceptively challenging exercise, he learned.

**Family Dollar** stores carry the items considered basics by low- to middle-income American families. Coffee makers can be found here, but discretionary items such as popcorn makers, gelato makers, and espresso machines are not on the shelves. A shopper can find **Hershey bars**, but not **Dove chocolates**. At **Family Dollar** you can get **Folger's**, but you cannot get **Starbucks**. You can get **Gain Original Fresh** laundry detergent at six cents a load, but you cannot get **Martha Stewart Clean Laundry Detergent** at twenty-eight cents per load (rated in the **July 2010 Consumer Reports** ratings of laundry detergents, as fourth and twenty-third, respectively). The **Family Dollar** experience may not be an exciting one, but it is a satisfying one, especially for the thrifty.

### Family Dollar Stores, Inc. Business Summary

**Family Dollar Stores, Inc.**, as of March 31, 2010, operated more than 6,600 stores, each typically between 7500 and 9500 square feet, in a contiguous forty-four state area. The stores offer the basics, necessities such as hand soap, laundry detergent, toothpaste, shaving cream and many other items that most households with an income of less than forty thousand dollars per year consider to be basic or necessary to operate. They also have a limited selection of electronics, clothing, and home décor items.

It is reasonable to ask, “What are the basics?” For an answer to this question, see the chart prepared by Katie Michaels-Johnson on pages six and seven of this letter. Every demographic sees the basics in a different way. In India, where the per capita gross income is less than one thousand dollars a year, the basics comprise a far more modest list than for the typical **Family Dollar** shopper. In India, a bowl to contain rice is a basic, a necessity. Believe it or not, running water could be considered a luxury, not a basic, as many people in India must carry water to its ultimate destination. For a **Family Dollar** shopper, a necessity may mean soap, laundry detergent, dishwasher detergent, paper towels, and all-purpose cleaners. These are necessities, not wants, in their minds.

### Harriett's Story

In our last letter on **Family Dollar**, we left Harriett as she moved down the aisles at **Family Dollar** store #3413 on South Utica, shopping for the basics

In 2001, **Tom Hurried**, Harriett's husband, was working as an assistant manager at **QuikTrip**, making thirty-two thousand dollars per year. Harriett did not work outside of the home, but had her hands full taking care of two young children. Harriett and Tom appreciated **Family Dollar** store #3413, which was within five minutes' walking distance of their house.

In 2003, the **Hurried** family experienced much change. **QuikTrip** promoted Tom to the position of manager at sixty-five thousand dollars per year, and Harriet entered the work force as a secretary. She was making twenty-five thousand dollars per year, a modest salary but with excellent benefits. With both **Hurried** parents working, the family needed to purchase a second car. A year later, they moved to a slightly larger and newer home at 6537 E. 26<sup>th</sup> Place.

The **Hurried** family stopped shopping at **Family Dollar**. Their children, ages five and seven when we last saw them, are now fourteen and sixteen, with the expensive tastes and appetites of teenagers, and are no longer content to wear **Family Dollar** or even **Wal-Mart** fashions or eat private label **Family Dollar** cookies. The **Hurrieds** began making more frequent trips to the mall and began purchasing their cleaning supplies, toiletries, and medicines—all the household staples Mrs. **Hurried** used to acquire at **Family Dollar**—at **Target**,

especially after they moved to the new house, which is only 1.8 miles from **Target store #0019 at 1701 South Yale Avenue**.

Because **Harriett** now worked outside the home, she no longer had time to make her carefully updated price charts comparing the prices between Family Dollar and Wal-Mart (she never shopped at **Target** in 2001).

**Mrs. Hurried** knows her household staples are more expensive at **Target** than at **Family Dollar**, but items purchased at **Target** seem to be of higher quality—or at least, her children and her new friends think so. Perhaps **Harriett** is laboring under a misconception. The two chains carry many of the same national brands, but admittedly in the drab atmosphere of **Family Dollar**, it is difficult for a shopper to realize that these consumables, such as laundry detergent and dish soap, are the same goods. However, as we will see later, **Family Dollar** is working to overcome this impression. **Family Dollar** wants to court the upper middle class shopper who is now, after the crisis of 2007-2008, embracing the concept of thrift.

**Harriett** lost her job in July 2009 when the firm where she worked as a secretary filed for bankruptcy. She had been looking for other positions, but, almost a year later, she was starting to give up hope. While **QuikTrip** has never had widespread layoffs, **Tom** worries about how the 2007-2008 recession will affect his job security. Sixteen-year-old **Helen Hurried** is already looking at colleges, and her parents wish their savings accounts were larger. The **Hurried** family had become accustomed to two incomes, but its spending habits were now in need of a makeover.

Today, we pick up with **Harriett** again as she faces the realities of a tightened budget.

**Harriett**, having finally ushered her husband and children out the door to work and school, heaves a sigh as she sits down with her morning coffee and her to-do list.

“To Do,” writes **Harriett** in her neat cursive. “1. Clean kitchen. 2. Laundry. 3. Clean kids’ bathroom.” She taps her finger on the table. She knows she used the last of the **Pine Sol** last week, and she cannot remember if she has enough **Tide**, **Windex**, or paper towels to complete today’s tasks. “4,” she writes. “Go to **Target**. Buy: **Pine Sol**.”

**Harriett** stands and heads to the laundry room, taking her list. She has enough **Tide** to do one, maybe two, loads of laundry. “**Tide**,” she writes on her list.

She then heads for the kids’ bathroom and the cabinet where she keeps the bathroom cleaning supplies. “**Windex**,” she writes on her list, taking stock of the mostly-empty bottles in the cabinet. “**Clorox** wipes. Hand soap. **Liquid Plumr gel**. **Tilex Mold & Mildew Cleaner**. Toilet paper.”

The last stop is the kitchen closet, where the family keeps the surplus paper towels. One roll sits lonely at the back of the shelf. “Paper towels,” **Harriett** adds to her list, and reaches for the last roll. As she does, her arm catches a piece of paper taped to the inside of the closet door and it flutters to the floor.

“What’s this?” she asks, picking it up. It takes her a moment to recognize the neat Excel chart she had made nine years ago, comparing the prices of name brand and private label household staples at **Family Dollar** and **Wal-Mart**. **Harriett** had not thought to update the chart since moving to her new home. Her new neighbors and the friends she had made at her office all shopped at **Target** or sometimes at **Wal-Mart**; most avoided discount stores like **Family Dollar**, which they thought drab and low-class.

Looking at her chart, **Harriett** remembers the good deals she used to find at **Family Dollar** and that goods there cost about the same as at **Wal-Mart**. She had enjoyed the quiet, contemplative walks to the nearby store and the ease and efficiency a trip to the smaller **Family Dollar** had afforded compared to the crowded, acres-large **Wal-Mart Supercenter**.

“Hmm,” thinks Harriett, studying her chart. She knows the family needs to spend less. Perhaps she ought to find out if Family Dollar still offers the savings in time and money she enjoyed nine years ago.

She goes into the living room and logs on to the family computer. A quick search reveals that Family Dollar store #6216 is located only half a mile miles from her house—even closer than Target, and much closer than the Wal-Mart Supercenter 3.2 miles away. She could easily walk there.

Before she logs off the computer, Harriett does a Google search for “Family Dollar” and “Target,” wondering if she would really save that much by returning to Family Dollar. She finds a letter on the website of the Fredric E. Russell Investment Management Co. that includes a chart very similar to the one she made in 2001. The chart shows the prices of name and store brand goods at Family Dollar, Wal-Mart, and Target as of May 2010. (You can find this chart on pages six and seven of this letter.)

Harriett is shocked to see that, when purchasing all store brand goods, she would save \$14.78 by shopping at Family Dollar rather than Target. If she buys all national brand goods instead, she would save \$16.70 at Family Dollar. If, at Family Dollar, she bought all store brand goods rather than national brands, she would save a whopping \$31.40.

“Thirty-one dollars!” exclaims Harriett. That was an oil change for their second car or a date-night meal for her and Tom. Even the sixteen dollars she would save buying her favorite national brands at Family Dollar rather than at Target was a week’s worth of lunches at the three-dollar burger shop where Tom ate every day. And buying some store brand items at Family Dollar might allow her to still buy the kids’ favorite national brand snacks.

In this economy, Harriett decides, she needs to save money more than she needs to save face. She will walk to Family Dollar rather than drive to Target or Wal-Mart, saving additional money on gas. And, since she noticed on the company’s website that Family Dollar stores now accept credit and debit cards, she will not need to go to the bank first to withdraw cash.

Her day is looking better already.

As the economy improves, however, many wonder if consumers will return to the more upscale stores, such as Target, where they have long shopped, abandoning the less-prestigious Family Dollar (“upscale” may have as much or more to do with a store’s ambience as it does with its products).

The North Carolina-based chain has taken steps to retain its new middle-income customer without alienating its low-income core.

Technology plays a significant role in this effort. In March, the company completed a rollout of new point-of-sale (POS) technology that allows its stores to more quickly process debit and credit card transactions, meaning that all locations can now accept these payment forms, which are preferred by middle-income shoppers. The new system will save more than a minute on each customer transaction.

**Price Comparisons of Common Household Goods**  
*Family Dollar, WalMart, and Target Stores*

May 1, 2010

National Brand Name of Product	Family Dollar		WalMart		Target	
	Name Brand Size	Store Brand Price	Name Brand Size	Store Brand Price	Name Brand Size	Store Brand Price
Bic Comfort 3 Shavers	10 count	\$2.65	12 count	\$2.57	12 count	\$2.27
Bounty paper towels	12 rolls	\$9.00	8 rolls	\$8.87	12 count	\$6.84
Cascade Dishwashing Detergent	75 oz	\$4.50	75 oz	\$4.28	8 rolls	\$6.84
Charmin Ultra Strong Toilet Paper	24 rolls	\$14.00	24 rolls	\$11.50	12 count	\$2.94
Clorox Disinfecting Wipes	35 count	\$2.75	35 count	\$2.54	8 rolls	\$12.49
Liquid Dial Gold Antimicrobial Soap	11.25 oz	\$1.00	9.4 oz	\$1.47	12 count	\$2.94
Gillette Clear Gel Deodorant	3 oz	\$3.50	4 oz	\$3.88	8 rolls	\$10.29
Greeting cards	\$0.50 to \$1.00		\$0.50 to \$4.99		12 count	\$2.29
Heinz Tomato Ketchup	20 oz	\$1.85	20 oz	\$1.93	8 rolls	\$10.29
Liquid-Plumr Gel Clog Remover	80 oz	\$7.00	80 oz	\$6.56	12 count	\$2.94
Lysol Disinfectant Spray	12.5 oz	\$4.25	19 oz	\$4.50	8 rolls	\$10.29
Pantene Pro-V Daily Moisture Renewal Shampoo	12.6 oz	\$4.00	22.8 oz	\$5.88	8 rolls	\$10.29
Original Pine-Sol Brand Cleaner	48 oz	\$3.00	48 oz	\$2.97	12 count	\$2.94

Quaker State Advanced Durability Motor Oil	1 quart	\$3.25	1 quart	\$2.35	1 quart	\$3.27	1 quart	\$2.27	1 quart	\$4.89	1 quart	\$2.39
Resolve High Traffic Foam carpet cleaner	22 oz.	\$2.75	22 oz.	\$2.25	22 oz.	\$3.92	22 oz.	\$2.92	22 oz.	\$3.94	22 oz.	\$2.92
Tide with a Touch of Downy Liquid Laundry Detergent	36 loads	\$11.00	44 loads	\$3.00	48 loads	\$10.94	64 loads	\$8.78	48 loads	\$13.99	64 loads	\$8.79
Tilix Mold & Mildew Remover	21 oz.	\$3.00	33 oz.	\$1.00	32 oz.	\$3.73	40 oz.	\$1.97	32 oz.	\$3.74	32 oz.	\$1.97
Extra Strength Tylenol Rapid Release Gels	24 count	\$3.75	65 count	\$2.00	24 count	\$3.48	24 count	\$1.82	125 count	\$7.99	100 count	\$4.39
Windex Original Glass Cleaner	32 oz.	\$3.00	32 oz.	\$1.00	32 oz.	\$2.46	32 oz.	\$1.12	32 oz.	\$2.69	32 oz.	\$1.12
<b>Total Cost of a Trip:</b>		<b>\$84.25</b>		<b>\$52.85</b>		<b>\$84.75</b>		<b>\$57.56</b>		<b>\$100.95</b>		<b>\$67.63</b>

Sizes and prices in red are the cheapest item in that category per unit. Items highlighted in green are the cheapest items in that category by dollar amount. For example, if a shopper wants to get the lowest price per ounce on Liquid Dial Gold Antimicrobial Soap or its equivalent, he would buy the national brand bottle at Family Dollar. If he wishes to spend the least money in absolute dollars, he would buy the smaller store brand bottle at Wal-Mart.

	<u>If you shopped at:</u>	<u>brand items</u>	<u>Only national items</u>	<u>Only store brand items</u>
	Family Dollar instead of Wal-Mart	\$0.50	\$4.71	
	Family Dollar instead of Target	\$16.70	\$14.78	
	Wal-Mart instead of Target	\$16.20	\$10.07	

No matter which store you shop, purchasing store brand products instead of national brand products will save you about thirty dollars if you purchase one of each item on our list (excluding gift cards).

Family Dollar	\$31.40
Wal-Mart	\$27.19
Target	\$33.32

“Credit cards are not a tender that is used by our core low-income customers, but it is the tender of choice of our middle-income customers. Credit cards are not more profitable in themselves because of the fees associated with their use, but they allow more impulse shopping. Debit and credit card transactions, on average, double what a cash ticket brings in,” said [Kiley Rawlins](#), the [head of Investor Relations](#) for [Family Dollar Stores, Inc.](#) during a call with [Fred](#), [Meredith](#), and [Katie](#) on April 21, 2010. (Rawlins’s comments suggest that when possible it would be smart not to take a credit or a debit card on any shopping expedition, or at least to carry a shopping list with needs separated from wants.)

### Investment Thesis

There are far more poor households and middle-class households in the United States than there are affluent households. For the majority of the poor and the middle class, households that struggle to buy the basics, [Family Dollar](#) offers convenience at [Wal-Mart](#) prices. As the charts above show, [Family Dollar](#) is an efficient way to shop for the basics. The [Family Dollar](#) simplicity of strategy, along with a reasonably priced common stock price, and management’s intent to raise the dividend yearly, ought to provide an above average return for us.

### Selected financial ratios of Family Dollar Stores, Inc. (1)

	2009	2008	2007	3-year Average
Current ratio	1.51	1.26	1.36	1.38
Capital expenditures as a percentage of revenue	2.10%	2.40%	1.93%	2.14%
Percentage growth in revenue	5.97%	2.18%	6.87%	5.01%
Percentage growth in net income	24.97%	-4.03%	24.47%	15.14%
Return on equity	21.68%	19.25%	20.05%	20.33%
Long-term debt as a percentage of assets	8.79%	9.39%	9.53%	9.24%
Percentage growth in cash flow from operating activities	2.74%	24.04%	-7.81%	6.32%
Gross profit margin	34.84%	33.59%	33.98%	34.13%
Times interest earned	35X	25X	22X	28X

*This table was done by [Pu Wang](#) of the firm*

*(1) Numbers are from the [Family Dollar Stores Inc.](#) Form 10-K filed with the Securities and Exchange Commission on October 27, 2009, for the fiscal year ended August 29, 2009.*

In April, the chain began a new advertising campaign promoting its extensive selection of brand-name basics that can be obtained more cheaply at [Family Dollar](#) than at a traditional grocery or drug store. The advertisements feature images of brand-name products such as [Oreo Cakesters](#) or [Tide Laundry Detergent](#) with the text “**EXACTLY the same as the grocery [or drug] store. We just price them lower!**” The company has also increased its selection of brand name products, adding [Jif](#) peanut butter, [Rice-A-Roni](#), [Nabisco Premium Saltine Crackers](#), and [Betty Crocker](#) foods to its product offerings this year.

“Our middle-income customers are very brand loyal,” said [Rawlins](#). “They’re looking for ways to continue to buy the brands like [Tide](#) and [Oreo](#), but they’re using sales, coupons, and other ways to save money while

doing so. We can carry these brand name products to broaden our appeal to these customers, while still keeping the less expensive house brands that our core customers prefer,” said Rawlins.

Finally, the company seeks to improve its shopping standards and execution, looking to make Family Dollar stores a more attractive as well as a more convenient place to shop.

“We have strong employee retention numbers, which allows us to build on their experience,” said Rawlins. “It helps us evaluate and execute our standards more consistently. For instance, we’re doing a better job of rotating food products and getting expired products off the shelf. It’s part of improving the in-store shopping experience. Seeing expired food on the shelf undermines our credibility and quality perception to middle-income customers, and we’re working to make sure that doesn’t happen.”

Although two-thirds of Family Dollar’s business continues to come from a core of low-income customers, those numbers have held steady over the past two years. The chain sees more growth coming from the remaining one-third of their more affluent customer base.

“Middle-income customers who used to come in maybe once or twice a year are now visiting more often,” said Rawlins.

As of the close of business on **June 14, 2010**, clients and employees of our firm owned **36,825 shares** of **Family Dollar Stores, Inc.**, with a **market value of \$1,435,438.50**.

We may liquidate, decrease, or increase our position in **Family Dollar Stores, Inc.** at any time, without notice before or after we do so.

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*Note to readers: This letter is the combined work of Katie Michaels-Johnson and Fredric E. Russell.*

Fredric E. Russell, lists his academic and professional background as follows: B.A., Swarthmore College, Swarthmore, PA; M.B.A, and M.A., Washington University, St. Louis, MO. He also holds the CPA certificate and has taught accounting and finance at three universities. He believes his love for writing and his usually correct grammar come from spending four years learning the English language at Deerfield Academy in Deerfield, MA, and from reading everything well-written he can find.

Katie Michaels-Johnson joined the firm in February. She graduated in 2008 with a Bachelor of Arts degree in English and German from the University of Tulsa, where she studied as a National Merit Scholar. She also spent a semester studying literature and philosophy at Albert-Ludwigs Universität in Freiburg, Germany.