



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 2009,¹ while **Family Dollar** had net sales of only \$7.4 billion.²

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 feet³ for one of its supercenters, **Family Dollar** needs only an average of 8,500 square feet.⁴ **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

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

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

³ Walmartstores.com

⁴ 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

To read the full Investment Letter, please email us at contact@ferimc.com or call (918) 743-5959. You could also fill out your contact information at <http://www.ferimc.com/contact.html>, we will contact you as soon as possible.