

Chua, Gulati & Kroger Securities

Please see the disclaimer at back of this report for important information.

Initiating Coverage: Family Dollar (Ticker FDO)

Investment Recommendation: SELL

Target Price: \$43.74

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Family Dollar Stock Information

(Nov 18, 2011)

Stock Price: \$56.72

52 Week High: \$60.53

52 Week Low: \$41.31

Market Cap: \$6.66 bn

Shares Outs.: 117.39 mm

Dividend Yield: 1.30%

Investment Thesis: Family Dollar continues to face performance pressure from activist investors who are taking notice of the company's lack luster performance relative to its' largest competitor by market cap, Dollar General, who have been satisfied market expectations after emerging from a private equity buyout last 2007. Last February, 2011, the original founders and directors rejected a fundamentally generous offer from Trian Group. The company continues to be at the heel of buyout threats from the market. FDO's stock has risen up 30% since then on speculation that eventually a buyout will take place. We believe the current price fully reflects the possibility of this buyout but does not take into account the very real scenario of existing management holding on to the company and engaging in moves that provide a short-term lift to the stock at the expense of long-term prudence (e.g. excessive amounts of capex, stock repurchases, poison pill).

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Company Description and Strategy

Family Dollar operates 7,023 general merchandise retail stores with 49.96 mm of total square selling footage exclusively in the United States. The stores are located in urban, strip center and free standing locations throughout the lower 48 states. Family Dollar’s merchandise is mostly priced under ten dollars.

Family Dollar Stock

Family Dollar’s absolute and risk-adjusted performance has lagged against its major competitors over the past one and three year periods. Year on year absolute returns of FDO are at 18%, while competitor’s return performance hover between 30%-40% or 1400-2300 bps points higher than that of FDO. Comparing YoY P/E ratio however reveals that FDO peers does not outperform it y 1%-2% and that the company has in fact outperformed relevant indices and company comparables. Three year return results, tell the same story of FDO stock outperforming major indices but underperforming among its industry peers.

Family Dollar's Relative Stock Performance on a One & Three Year Basis											
		Since 11/18/2010					Since 11/18/08				
Family Dollar & Competitors	P/E Ratio	Total Return	Return vs. FDO	Volatility	Sharpe Ratio	Sharpe Ratio vs. FDO	Total Return	Return vs. FDO	Volatility	Sharpe Ratio	Sharpe Ratio vs. FDO
Family Dollar	18.09	18.11%		29.88%	0.61		115.32%		31.69%	363.87%	
Dollar Tree	20.21	41.16%	23.05%	24.43%	1.68	108%	204.43%	89.11%	17.78%	1149.72%	786%
Dollar General	19.39	32.01%	13.90%	28.57%	1.12	51%	NA	NA	NA	NA	NA
Big Lots	13.48	32.33%	14.22%	33.85%	0.95	35%	148.18%	32.86%	14.19%	1044.19%	680%
Comparables	P/E Ratio	Total Return	Return vs. FDO	Volatility	Sharpe Ratio	Sharpe Ratio vs. FDO	Total Return	Return vs. FDO	Volatility	Sharpe Ratio	Sharpe Ratio vs. FDO
S&P 500	12.78	3.69%	-14.42%	21.11%	0.17	-43%	51.23%	-64.09%	10.91%	469.48%	106%
S&P 500 Consumer Discretionary	15.04	7.06%	-11.05%	22.76%	0.31	-30%	115.85%	0.53%	15.40%	752.21%	388%
S&P 500 Consumer Staples	15.25	10.50%	-7.61%	13.33%	0.79	18%	44.53%	-70.79%	3.50%	1272.00%	908%
Wilshire 5000 ETF - DWAMT	N/A	1.24%	-16.87%	21.36%	0.06	-55%	60.91%	-54.41%	14.95%	407.36%	43%
Wal-Mart	13.04	7.92%	-10.19%	16.06%	0.49	-11%	15.38%	-99.94%	3.57%	430.53%	67%
Target	12.56	-2.79%	-20.90%	23.11%	-0.12	-73%	84.78%	-30.54%	24.31%	348.70%	-15%

Source: Bloomberg - Information through 11/18/2011

Exhibit 1

Family Dollar Valuation

A. Revenue Estimates

Revenue estimates were derived from projections of same store sales growth and new store sales growth.

Same Store Sales

For our model, same store sales growth is derived from the sum of a) year on year change in the number of customers visiting the stores (i.e. customer count) and b) year on year change in the amount of dollars spent, on average, by each customer per visit (i.e. average transaction size). In Exhibit 2, we broke down historical same stores sales growth into these two components for the last eleven years. As the exhibit indicates,

$$\Delta \text{ Average Customer Transaction Size} + \Delta \text{ Annual Customer Count} = \Delta \text{ Annual Same Store Sales}$$

Composition of FDO Same Store Sales Growth			
	Customer Count	Avg. Customer Transaction	Total SSSG
2001	1.5%		2.5%
2002	3.8%		5.7%
2003	1.9%		3.5%
2004	0.7%		1.6%
2005	-0.7%		2.2%
2006	-1.0%		4.0%
2007	0.0%		1.0%
2008	-0.3%		1.2%
2009	2.8%		4.0%
2010	4.3%		4.8%
2011	4.0%		5.5%

Source: Company Filings

Exhibit 2

Change in Average Customer Transaction Size

In order to forecast these two components, we looked at numerous variables and found that inflation is a reasonably good predictor of the change in average customer transaction. As the Consumer Price Index increases and merchandize becomes more expensive, the amount that customers spend per visit increases at a somewhat similar pace. It is important to remember that unlike some other dollar stores (e.g. Dollar Tree) Family Dollar is not philosophically tied to a fixed price strategy of selling all items for \$1 only. Instead, merchandize is priced at a range of less than \$1 to \$10. This allows for the company to take advantage of price optimization measures to ensure prices are adjusted to meet costumer value. The average customer transaction size tends to be around \$10. Moreover, another rationale for such rises in transaction size is the result of dollar stores' expanding customer base. New demand from relatively higher income bracket costumers has pulled average transaction size towards higher levels.

Exhibit 3 is a scatter plot showing the relationship between the average customer transaction size and price levels for the last eleven years. Both items are set to \$100 at the start of the time period and then cumulatively grown as per the data.

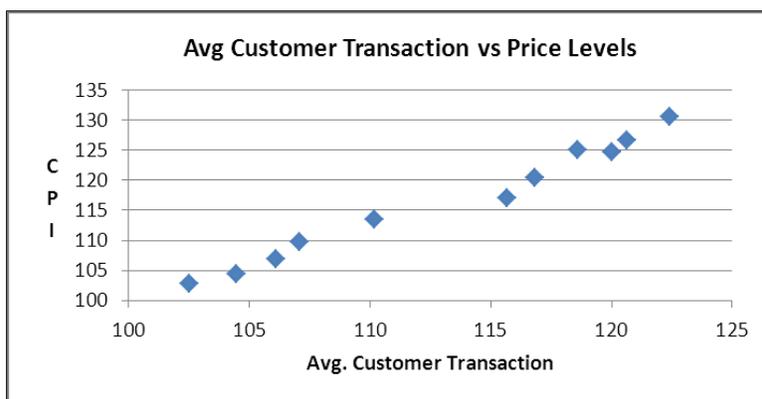


Exhibit 3: Source – Company Filings and Economists Intelligence Unit

In Exhibit 4 we regressed these two data points on each other (price levels and average customer transaction size) to arrive at a regression solution with an adjusted R-squared of .98 and resulting equation of

$$\text{Average Transaction Size}_t = 27.05 + .7387\text{CPI Levels}_t$$

Regression of Inflation on Average Customer Transaction Size						
<i>Regression Statistics</i>						
Multiple R	0.990654613					
R Square	0.981396562					
Adjusted R Square	0.979329513					
Standard Error	1.039981502					
Observations	11					
<i>ANOVA</i>						
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>	
Regression	1	513.505441	513.50544	474.7815348	4.25874E-09	
Residual	9	9.734053729	1.0815615			
Total	10	523.2394948				
	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	27.0502593	3.963315907	6.8251585	7.68469E-05	18.08461585	36.01590275
Avg. Transaction Size	0.738702352	0.033901785	21.789482	4.25874E-09	0.662011185	0.815393518

Exhibit 4

Subsequently, we utilized this regression to forecast the growth in customer transaction size from 2012-2016 based on inflation forecasts for CPI from EIU. The results are shown in Exhibit 5. We expect the average customer transaction size to increase by 2.56% and 1.80% in 2012 and 2013 as inflation picks up before dropping down to around 1.75% in 2016.

Avg. Customer Transaction vs Inflation (both set to \$100 at start of 2001)			
Year	Avg. Customer Transaction	Inflation	Growth in Customer Transaction
2001	102.50	102.80	
2002	104.45	104.44	1.90%
2003	106.12	106.85	1.60%
2004	107.07	109.73	0.90%
2005	110.18	113.46	2.90%
2006	115.69	117.09	5.00%
2007	116.84	120.49	1.00%
2008	118.60	125.07	1.50%
2009	120.02	124.69	1.20%
2010	120.62	126.69	0.50%
2011	122.43	130.62	1.50%
2012	125.56	133.36	2.56%
2013	127.83	136.43	1.80%
2014	129.94	139.29	1.66%
2015	132.21	142.35	1.74%
2016	134.52	145.49	1.75%

Source: Avg Customer Transaction from 2001-2011 from Company Filings
 2012-2016 are our forecasts
 Inflation from 2001-2010 is actual CPI. 2011 is expected. 2012-2016 are forecasts.
 Historic and forecasted inflation from EIU.
 Growth in Customer Transaction is derived from Avg. Customer Transaction

Exhibit 5

Change in Customer Count

We found that the number of people coming into the stores is tied to two variables, a) the change in the unemployment in the previous year and b) the change in crude oil prices in the current year.

An increase in the unemployment rate is usually followed by an increased amount of foot traffic to the dollar stores as new customers eschew the more expensive grocery and apparel stores and look for value. Intuitively however, consumers take a few months to adjust consumption habits in accordance to changes in their employment situation. There is a two year observable time lag before unemployment results materializes into FDO's sales. Statistically significant results indicate that it takes consumers around one year to adjust change shopping stores.

Crude prices also influence the level of traffic in FDO stores as a core strategy is to place these stores in areas where they can serve and attract the maximum amount of customers in a 3-5 mile radius. Hence, crude price increases have a positive effect on consumer traffic to FDO stores on account of its proximity to consumers relative to other big box outlets. If customers have to travel any further than that, then they typically just drive to a Wal-Mart. Therefore, as crude becomes more expensive, customers move away from the driving trips to the big box stores such as Wal-Mart and instead visit the Family Dollar outlets in their neighborhoods.

Regression of Prior Year Change in Unemployment and Change in Crude on Change in Customer Count								
<i>Regression Statistics</i>								
Multiple R	0.739071555							
R Square	0.546226763							
Adjusted R Square	0.432783454							
Standard Error	0.014763667							
Observations	11							
ANOVA								
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>			
Regression	2	0.002099	0.00105	4.8149756	0.04239899			
Residual	8	0.0017437	0.000218					
Total	10	0.0038427						
	<i>Coefficients</i>	<i>tandard Errc</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.008410003	0.0052626	1.598072	0.1486941	-0.003725556	0.0205456	-0.003725556	0.020545561
Δ Unemployment Previous Year	0.066998987	0.0224445	2.985097	0.0174641	0.015241891	0.1187561	0.015241891	0.118756083
Δ Crude	0.003868859	0.0120514	0.321029	0.7564143	-0.023921764	0.0316595	-0.023921764	0.031659483

Exhibit 6

A regression of change in the unemployment rate in the previous year and the change in crude oil prices in the current year on the change in customer count is shown in Exhibit 6. The resulting regression yields below equation

$$\Delta \text{Customer Count}_t = .84 + 6.70\Delta \text{Unemployment}_{t-1} + .39 \Delta \text{Crude oil Prices}_t$$

We utilized this regression to forecast the change in customer count for 2012-2016 based on unemployment and crude prices forecasts from EIU. The results are shown in Exhibit 7. As shown in the exhibit, customer count increased substantially in 2009-2011 due to an increase in unemployment and rise in gas prices. We expect this growth in customer count to moderate in the coming years as the unemployment rates are lowered and the increase in crude oil prices stabilizes.

Customer Count Forecasts Based on Unemployment and Crude Prices			
Year	Δ Customer Count	Δ Unemployment Previous Year	Δ Crude
2000			-4.76%
2001	1.50%	17.50%	(25.97%)
2002	3.80%	23.40%	57.26%
2003	1.90%	3.45%	3.21%
2004	0.70%	-8.33%	34.94%
2005	-0.70%	-7.27%	40.48%
2006	-1.00%	-9.80%	0.02%
2007	0.00%	0.00%	57.25%
2008	-0.30%	26.09%	(53.54%)
2009	2.80%	60.34%	77.94%
2010	4.30%	3.23%	15.15%
2011	4.00%	-5.21%	(2.06%)
2012	0.94%	1.10%	6.15%
2013	0.67%	-3.26%	13.05%
2014	0.56%	-4.49%	5.21%
2015	0.64%	-3.53%	7.96%
2016	0.29%	-8.54%	6.01%

Source: 2011-2011 Customer Counts from Company Filings
 2012-2016 are our forecasts
 Unemployment from 2000-2011 are actuals. 2012 is expected. 2013-2016 are forecasts.
 Crude from 2001-2010 are actuals. 2011 is expected. 2012-2016 are forecasts.
 All Unemployment and Crude numbers from EIU.

Exhibit 7

As the final step in forecasting same store sales growth, we combined our forecasts for change in customer count with the change in the average customer transaction size. The results are shown in Exhibit 8.

Composition of FDO Same Store Sales Growth			
	Customer Count	Avg. Customer Transaction	Total SSSG
2001	1.50%	2.50%	4.00%
2002	3.80%	1.90%	5.70%
2003	1.90%	1.60%	3.50%
2004	0.70%	0.90%	1.60%
2005	-0.70%	2.90%	2.20%
2006	-1.00%	5.00%	4.00%
2007	0.00%	1.00%	1.00%
2008	-0.30%	1.50%	1.20%
2009	2.80%	1.20%	4.00%
2010	4.30%	0.50%	4.80%
2011	4.00%	1.50%	5.50%
2012	0.94%	2.56%	3.50%
2013	0.67%	1.80%	2.48%
2014	0.56%	1.66%	2.22%
2015	0.64%	1.74%	2.38%
2016	0.29%	1.75%	2.04%

Source: SSG = Customer Count + Avg. Customer Transaction
 2001-2011 are actuals, 2012-2016 are our forecasts

Exhibit 8

New Store Revenues

Net New Store Openings

Net new store openings in a given year are driven by same store sales growth two years ago. Management evaluates the business by looking at same store sales growth each quarter and a strong showing in that regard increases their optimism about the state of the business and propels them to commission the creation of new stores. The typical process to open a new store is about six to twelve months as it includes the time spent looking for locations, negotiating leases, constructing and stocking the store. Another twelve months is needed for new stores to show up in the same store sales metric and therefore, the impact of same stores sales this year is visible in new store openings two years from now. This relationship is shown in the scatter plot in Exhibit 9.

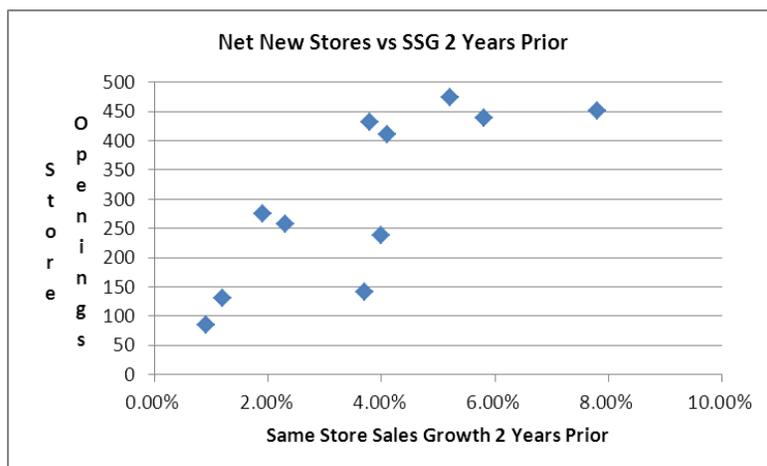


Exhibit 9

After a period of reduced store openings (the number of net new stores opened from 2000-2005 averaged at 429 stores but that number fell to 177 from 2006-2010). Management has vowed to substantially increase the opening of new stores. They are guiding toward the creation of 450-500 new stores in 2012. We have taken the midpoint of the number provided by management and reduced it by 60 (which is the historical average of the number of stores closed in a year) to arrive at a net new store growth number of 415 stores for 2012.

However, for the purposes of forecasting net new stores, we believe that maintaining controlling interests and buyout pressures from the market will induce management to open a greater than optimal number of new stores (See below note on Aggressive Store Openings). So in 2012 and 2013, management will open 415 net new stores each year, though our regression (shown in Exhibit 10) indicates that based on their previously used criteria of same store sales growth two years prior, the number of net new stores should be 363 in 2012 and 401 in 2013. For 2014 and beyond, management will realize that it has been opening too many new stores and assuming the external pressures have eased off, it will revert back to setting the number of net new stores to same store sales growth two years prior. Our new stores forecast based off the above information is shown in Exhibit 11. The number of net new store openings in 2014, 2015 and 2016 will be 292, 236 and 222, respectively and much lower than 2012 and 2013.

A Note on Aggressive Store Openings

Over the last twelve months, considerable pressure has been placed on management from activist shareholders. To note, Nelson Peltz (of Trian Fund Management) amassed a 7.70% stake in the company and proposed a buyout of FDO at \$55-\$60 per share (the company rejected this offer and adopted a poison pill and subsequently, Peltz settled for a board seat) and Bill Ackman (of Pershing Square) who amassed a 9.45% position have both raised market sentiments about the potential for buyout offers directed at FDO. FDO's has been led by Leon Levine or his son Howard Levine ever since it was founded in 1959. The current CEO, Howard Levine, owns 8.12% of the company. Therefore, we believe management is very averse to losing control even if a handsome premium is offered for the company (as it was by Peltz - his offer was at a premium of 10-20% to the all-time high of the stock and a 26-37% premium to the stock price the day before the offer was made public). As a result of management's desire to retain control, they are making some decisions that are necessarily not in the long-term interests of shareholders. One of these decisions is the opening of an excessive amount of stores to give the impression that the business is extremely healthy and deserving of a substantially increased amount of capital expenditure. Management is selling the view that FDO is very well-run and that it is in the best position to continue to own and run it on a long-term basis. It has also often stated that the best use of the company's resources is to continue to plow it back in the business (i.e.

increased cap-ex on new store openings and remodels). This is a subtle dig at the idea of diverting some of those resources to do a leveraged buyout - something its biggest competitor, Dollar General (DG) was put through by KKR and Goldman Sachs in 2007. We will demonstrate later that management's actions are not always consistent with its publicly stated position.

The resulting equation from the regression analysis done for net new store openings produced below equation

$$\text{New Store Openings}_t = 100 + 5466.30 \text{Same Store Sales Growth}_{t-2}$$

Regression of Same Store Sales Growth 2 Years Prior on Net New Store Openings								
<i>Regression Statistics</i>								
Multiple R	0.782671							
R Square	0.612573							
Adjusted R Square	0.569526							
Standard Error	95.04357							
Observations	11							
<i>ANOVA</i>								
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>gnificance F</i>			
Regression	1	128545.4	128545.4	14.2302	0.004401			
Residual	9	81299.52	9033.28					
Total	10	209844.9						
	<i>Coefficients</i>	<i>andard Err</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	100.838	60.79321	1.658705	0.13155	-36.6858	238.3618	-36.6857956	238.3618
SSG 2 Years Prior	5466.295	1449.064	3.772294	0.004401	2188.284	8744.305	2188.28447	8744.305

Exhibit 10

Net New Stores Forecast		
Year	SSSG	Net New Stores
1997		186
1998		250
1999	7.80%	307
2000	5.20%	365
2001	4.10%	452
2002	5.80%	475
2003	3.80%	411
2004	1.90%	439
2005	2.30%	432
2006	3.70%	275
2007	0.90%	257
2008	1.20%	141
2009	4.00%	84
2010	4.80%	130
2011	5.50%	238
2012	3.50%	415
2013	2.48%	415
2014	2.22%	292
2015	2.38%	236
2016	2.04%	222

Source: 1997-2011 numbers are actuals from company filings
 2012-2016 numbers are our forecasts
 363 and 401 net new stores would be opened in 2012 and 2013 in absence of external pressure

Exhibit 11

New Store Revenue Estimates

We calculated the average revenue per new store in the first year of its operation by breaking down total revenue into same store revenue and new store revenue for the past thirteen years and dividing the latter by the number of net new stores opened each year. Based on this, we estimate that a new store generates about \$960,000 of revenue in its

first year of operation. This calculation is shown in Exhibit 12. We assume that each of the new stores is opened for half of the first year.

Year	SSSG	Revenue	Same Store Revenues	New Stores Revenues	Net New Stores	Revenue Per New Store	Existing Stores	Revenue Per Existing Store
2011	5.5%	8547.84	8299.65	248.18	238	1.04	6785	1.22
2010	4.8%	7866.97	7755.84	111.14	130	0.85	6655	1.17
2009	4.0%	7400.61	7262.97	137.63	84	1.64	6571	1.11
2008	1.2%	6983.63	6916.32	67.31	141	0.48	6430	1.08
2007	1.0%	6834.31	6458.72	375.59	257	1.46	6173	1.05
2006	5.0%	6394.77	6116.05	278.72	275	1.01	5898	1.04
2005	2.2%	5824.81	5398.09	426.72	432	0.99	5466	0.99
2004	1.6%	5281.89	4826.17	455.71	439	1.04	5027	0.96
2003	3.5%	4750.17	4308.34	441.83	411	1.08	4616	0.93
2002	5.7%	4162.65	3874.29	288.36	475	0.61	4141	0.94
2001	4.0%	3665.36	3257.94	407.42	452	0.90	3689	0.88
2000	5.2%	3132.64	2894.24	238.40	365	0.65	3324	0.87
1999	7.8%	2751.18	2546.16	205.02	307	0.67	3017	0.84
1998		2361.93						
Average						\$ 0.96	\$ 1.01	

Source: Company Filings and Interpolations from Company Filings

Exhibit 12

One item worth noting is that the number of net new stores opened in any given year is negatively correlated to the same store sales growth two years into the future. This seems to indicate that management could be doing a better job of picking new store locations and rolling them out more quickly and/or maintaining the momentum generated in the first year. We believe that sustaining momentum is the bigger challenge. Exhibit 12 also indicates that sales per existing store are \$1.01 million/year. That is only 5% greater than sales per new store in the first year. But two years down the line (i.e. two years since the new stores start getting counted in same store sales metrics), this performance gap widens. The data indicates that if you look at the performance of a new store two years from its creation, its sales would be appreciably worse than a store that has been open for a while and therefore, this depresses same store sales. So, the new stores start off strong and then lose momentum. Exhibit 13 is a scatter plot that shows this finding.

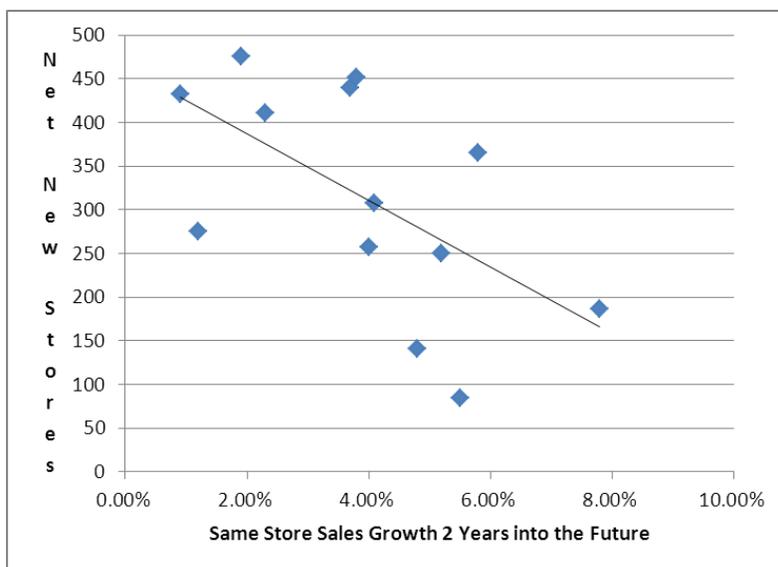


Exhibit 13

B. Gross Margin

Since 2009 Family Dollar’s gross margins have broken out of the 32% to 34% range that had been pervasive from FY1995 through FY2008 to stand at 35.5% for FY2011(see Exhibit 14) . The following list comprises the major factors which impact gross margins and their impact on 2011’s margins:

- 1) Sales Mix: Consumables continued to represent an ever greater percentage of sales at 66.5%. These items typically have lower margins than Family Dollar’s other merchandise categories which have been losing share to consumables (see Exhibit 15).
- 2) Private Label Mix: Private label sales which have been reported sporadically by management have grown strongly since 2003 (see Exhibit 16). Private label items provide higher margins to Family Dollar compared to both non-label and brand name items.
- 3) Fuel Prices: Crude prices rose on average over the past year by 20.5% pressuring shipping costs.
- 4) Foreign Currency and Ocean Freight Prices: According to their 10-K, 31% of Family Dollar’s inventory purchases in FY11 were for products manufactured overseas. The U.S. dollar has depreciated by 4.3% against the Chinese Yuan which pressured Family Dollar’s gross margin. According to the UNCTAD Review of Maritime Transport Index, is expected to fall slightly in 2011 relative to 2010.

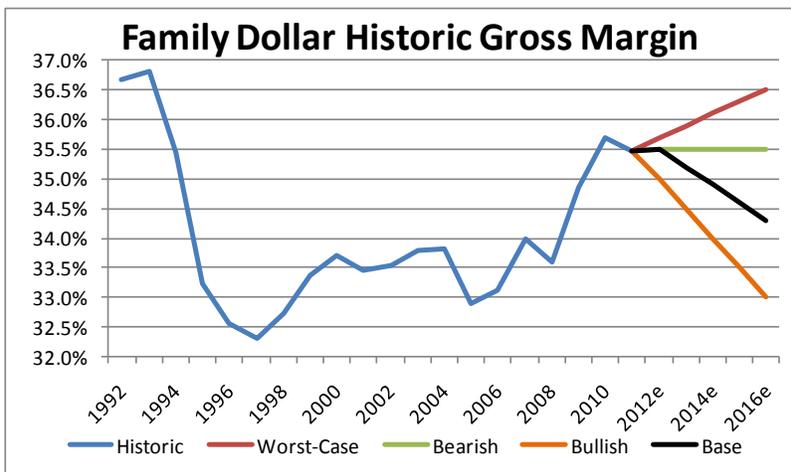


Exhibit 14: Source Company Filings and Chua, Gulati & Kroger Securities’ estimates

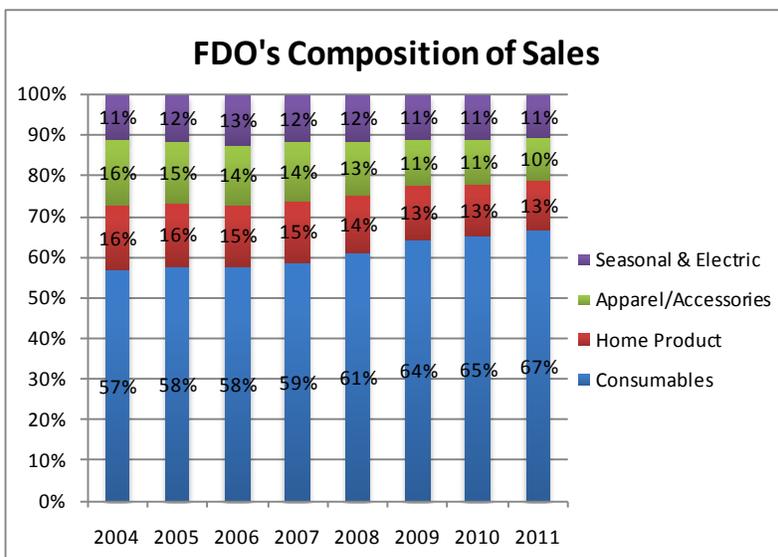


Exhibit 15: Source Company Filings

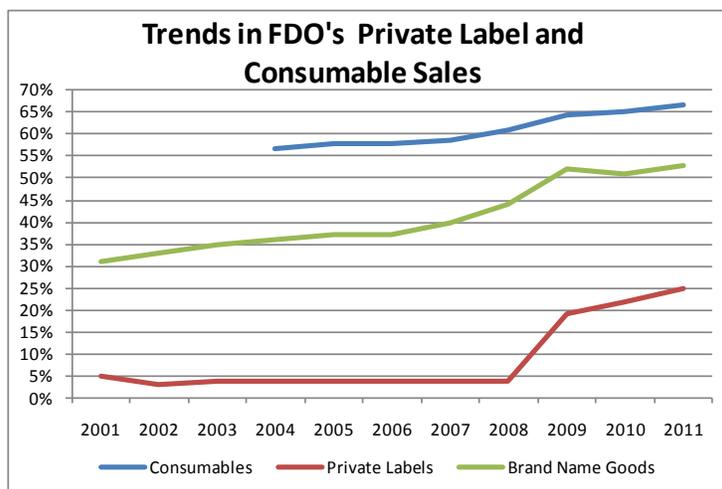


Exhibit 16: Source Company Filings

We have regressed a number of combination of the variables above where possible as well as employment, population and poverty figures. However, due to the limited history and changing dynamics of Family Dollar's strategy we have employed a scenario analysis to forecast gross margins. Our base case on gross margins follows, after which we display a sensitivity with alternate scenarios. We see sales mix continuing to skew more toward consumables based on a continued weak economic and employment environment. Growth in proportional consumables should more than offset the impact of growing private label sales. We also want to mention that the potentially aggressive net store opening of 238 stores by FDO will allow lead to increases the purchasing power of the chain over suppliers, and hence accord it volume discount advantages.

In terms of crude oil prices, the median Bloomberg consensus is for crude prices to remain flat next year and then grow by 5.1%, 2.6% and 3.9% on average from 2013 to 2015. As long forward looking shipping index forecasts are not available, we use crude as a proxy for shipping rates.

For currency considerations, the forward market is currently pricing a 0.4% depreciation in the Yuan in 2013 followed by an appreciation between of the currency against the dollar in 2014 through 2016 of between 1% and 2% each year. With Family Dollar's current plans for an aggressive store opening schedule, greater volume discounts should result in a minor boost gross margins over the next four years. Our base case analysis results in gross margins remaining flat in 2012 before declining by 30bps each year 2013 through 2016. A bearish case is for margins to flatline at the current level and a worst case is presented with margins growing by 20bps each of the next five years. Finally, a bullish case results in margins declining by 50 bps over the next five years.

We have created a sensitivity analysis of gross margins in 2016 and going forward and its impact on our valuation model (see Exhibit 17).

Worst Case	36.50%	\$70.08
Bearish	35.50%	\$58.11
Base	34.30%	\$43.74
Bullish	33.00%	\$28.18

Exhibit 17

C. Selling, General & Administrative Expense

Over the last 5 years, Family Dollar's SG&A expense has been extremely stable relative to sales with an average of 28.34%, a standard deviation of 0.23% and a range of 0.65%. Going forward, we expect advertising expenses to continue to increase as a larger number of new store constructions call for a higher marketing budget to inform local communities about this alternative shopping option. However, we believe this will be balanced out by the current fixed SG&A expenses being spread over a larger sales base. Therefore, we model SG&A expense as the average of the prior three years' SG&A expense divided by sales.

D. Depreciation & Amortization

Depreciation and Amortization are projected by taking our estimate of Family Dollar's current year capital expenditure and multiplying it by the average of the prior five years ratio of depreciation and amortization to capital expenditure.

E. Effective Tax Rate

An effective tax rate of 37.25% is employed in the model as this rate is in the middle of management's effective tax rate guidance for 2012 (i.e. 37% - 37.5%).

F. Working Capital

We found that Family Dollar's working capital requirements as a percentage of sales are tied to the changes in the number of its stores. As management opens a greater number of stores, more working capital is tied up in inventory. This is because stores have to be fully stocked before they are opened and it takes the local store managers a while to adjust their inventory purchases to the buying habits of the new customer base. Therefore, we model change in working capital as change in working capital of the previous adjusted for the relative level of new net store openings. Mechanically, change in working capital this year = change in working capital the previous year * (number of net new stores opened this year / number of net new stores opened the previous year). As a result of this, we believe working capital will continue to be a net use of cash throughout 2012-2016 but more so in 2012 and 2013 when the level of new store openings will be especially high.

G. Capital Expenditures

Our capital expenditure forecasts for 2012-2016 are highlighted in Exhibit 18. To arrive at these numbers, we looked at total cap-ex, number of stores remodeled and number of net new store openings over the past seven years. We backed out the cost of remodeling stores (assuming a cost of remodeling of \$115k per store¹) from cap-ex to get cap-ex net of remodeling. We divided this number by the number of net new stores opened each year to get cap-ex per net new store opening. Now, we have both cap-ex per remodeled store and cap-ex per net new store opening.

Next, we plugged in our forecasts for net new store openings which we have described earlier in the report. In terms of remodeling, management has said they intend to substantially accelerate their remodeling program and remodel 1000 stores in 2012. We believe this pace is unsustainable, and management will cut back once the pressure from external investors to improve the business subsides. So, we project remodels to decline starting in 2013 and to return to historical levels by 2016.

We multiplied our projections for number of stores to be remodeled by the cost of remodeling a store to get total projected remodeling costs. Then we multiplied our projections for net new store openings by the average cap-ex per net new store for 2005-2011 to get total projected cap-ex for new store openings. We used an average for a seven year period because this number is the blended average of opening new stores and opening new distribution centers. Since management is aggressively building new stores, we wanted our cap-ex projections to factor in the cost of opening new distribution centers too. Finally, the sum of projected remodeling costs and projected net new store cap-ex is our total projected cap-ex.

¹ From 'All in the Family', dated May 25, 2011. This is presentation on FDO prepared by Pershing Square.

Family Dollar Capital Expenditures												
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Beginning # of Stores	5466	5898	6173	6430	6571	6655	6785	7,023	7,438	7,853	8,145	8,381
Ending # of Stores	5898	6173	6430	6571	6655	6785	7023	7,438	7,853	8,145	8,381	8,603
# of Net New Openings	432	275	257	141	84	130	238	415	415	292	236	222
# of Stores Remodeled	154	36	32	97	51	117	238	1000	500	250	200	175
% of Stores Remodeled	2.8%	0.6%	0.5%	1.5%	0.8%	1.8%	3.5%	14.2%	6.7%	3.2%	2.5%	2.1%
Remodeling Cost	(\$17.71)	(\$4.14)	(\$3.68)	(\$11.16)	(\$5.87)	(\$13.46)	(\$27.37)	(\$115.00)	(\$57.50)	(\$28.75)	(\$23.00)	(\$20.13)
Capex	(\$229.07)	(\$192.17)	(\$131.59)	(\$167.93)	(\$155.40)	(\$212.44)	(\$345.27)	(\$555.44)	(\$497.94)	(\$338.63)	(\$273.75)	(\$255.68)
Capex Net of Remodeling	(\$211.36)	(\$188.03)	(\$127.91)	(\$156.78)	(\$149.54)	(\$198.98)	(\$317.90)	(\$440.44)	(\$440.44)	(\$309.88)	(\$250.75)	(\$235.56)
Capex Per Net New Store	(\$0.49)	(\$0.68)	(\$0.50)	(\$1.11)	(\$1.78)	(\$1.53)	(\$1.34)	(\$1.06)	(\$1.06)	(\$1.06)	(\$1.06)	(\$1.06)
# of Distribution Centers	1	1					1	1				1

Source: Company Filings and Our Interpolations and Projections

Exhibit 18

H. Terminal Growth Rate

We think a long-term terminal growth rate of 1.5% is sustainable. As stated in our industry report, we believe the terminal growth rate for the entire dollar store industry is going to be 1.5%. Since we have no particular reason to believe that Family Dollar is going to be able to outperform the industry on a long-term sustainable basis, we are pegging its terminal growth rate to be 1.5% too. We provide a sensitivity analysis varying the terminal growth rate from 0.75% to 2.5% in Exhibit 19.

		Valuation Sensitivity Analysis					
		Equity Value					
		Equity Beta					
		0.15	0.32	0.41	0.55	0.75	
T e r m i n a l	G	0.75%	\$48.45	\$35.79	\$31.29	\$26.39	\$21.41
	r	1.00%	\$52.66	\$38.12	\$33.12	\$27.73	\$22.37
	o	1%	\$57.61	\$40.75	\$35.14	\$29.20	\$23.40
	w	1.50%	\$63.54	\$43.74	\$37.40	\$30.82	\$24.51
	i	1.75%	\$70.74	\$47.16	\$39.93	\$32.61	\$25.73
	h	2.00%	\$79.70	\$51.10	\$42.81	\$34.59	\$27.06
	a	2.25%	\$91.15	\$55.72	\$46.08	\$36.80	\$28.52
l	2.50%	\$106.31	\$61.18	\$49.85	\$39.29	\$30.13	

Exhibit 19

I. Stock Repurchase Program

Family Dollar's stock repurchase program gives us a big reason to doubt management judgment's forecasts. Exhibit 20 is a history of their stock repurchases as a percentage of free cash flow. 2011 saw an outsized level of stock buybacks. In fact, management substantially increased the debt level of the company by \$298.57 million in 2011 (bumping total debt from \$233.8 million to \$532.37 million) to help fund its much higher than normal stock buyback program and capital expenditure outlays. We have already expressed our doubts about the long-term value of the increased cape-x and we have similar doubts about the judgment behind these large buybacks. Management is often quoted as saying that it believes that the business is so solid that the best use of cash is to plow it back in the business. That might explain the high levels of cap-ex, but is counter to the philosophy of taking out debt to buyback additional stock. We believe that management is actually buying back stock because it desperately wants to retain ownership of the company and keep pressure from activist investors such as Nelson Peltz and Bill Ackman at bay. However, in doing so, management is buying large amounts of stock at inflated prices (the stock was up 23.19% in 2011) and it is essentially taking away value from long-term shareholders and giving it to short-term stockholders. Management authorized another \$250 million in stock buybacks at the start of 2012 and therefore, we are projecting a high-level of stock repurchases in 2012 too which will again likely be funded by debt. *Management is also getting compensated by performance share rights that are based off two metrics - return on equity and income growth. Both these metrics are substantially and (some might say) artificially improved with a high level of buybacks. Dollar General and Dollar Tree do not mention in their 10-ks that they compensate management on these metrics. So we*

have reason to suspect that there might be a misalignment of management incentives with the long-term interests of shareholders in the case of Family Dollar.

FDO Buybacks as a percentage of FCF			
	Buybacks	FCF	Buybacks/FCF
2003	65.84	82.04	80.3%
2004	176.65	157.73	112.0%
2005	92.00	70.29	130.9%
2006	367.32	258.82	141.9%
2007	257.52	284.18	90.6%
2008	97.67	347.81	28.1%
2009	71.07	373.80	19.0%
2010	332.19	379.10	87.6%
2011	670.47	182.80	366.8%
2012 (e)	337.30	-74.21	(454.5%)

Source: 2003-2011 numbers are actuals from filings
2012 FCF and buybacks are our projection

Exhibit 20

J. Debt Profile

Exhibit 21 has our projection of the debt situation at FDO over the next 5 years. The first 3 tranches of debt listed are currently outstanding (the \$298.57 tranche was added in 2011). The last tranche of debt listed is what we project the company will have to take on in 2013 to meet its capex and stock repurchase commitments. Since the level of debt at the company is increasing substantially in the space of only a couple of years, we believe FDO's debt rating will be downgraded from the current 'BBB' to 'BB' and therefore, we are using the higher interest rate associated with that lowered debt rating (5.49% - the current Bloomberg Seven Year US Retail Generic Yield) in our model to discount cash flows.

Debt Profile	2012	2013	2014	2015	2016
Debt Outstanding	532.37	766.17	749.97	733.77	548.57
5.24% Notes due September 27, 2015	64.8	48.6	32.4	16.2	0
5.41% Notes due September 27, 2015	169	169	169	169	0
5.00% Notes due February 1, 2021	298.57	298.57	298.57	298.57	298.57
Additional Debt We Project		250	250	250	250
Debt Repaid	16.2	-233.8	16.2	16.2	185.2
Interest Payments	27.47	39.12	38.27	37.42	27.43

Exhibit 21

Valuation Model										
Numbers in Million \$	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenue	6834.31	6983.63	7400.61	7866.97	8547.84	9044.96	9467.3	9816.5	10162.7	10476.3
Revenue Growth		2.18%	5.97%	6.30%	8.65%	5.82%	4.67%	3.69%	3.53%	3.09%
Same Store Sales Growth	0.90%	1.20%	4.00%	4.80%	5.50%	3.50%	2.48%	2.22%	2.38%	2.04%
# of Stores	6,430	6,571	6,655	6,785	7,023	7,438	7,853	8,145	8,381	8,603
COGS	(4512.24)	(4637.83)	(4822.40)	(5058.97)	(5515.54)	(5834.00)	(6134.79)	(6390.54)	(6646.42)	(6882.91)
% of sales	66.02%	66.41%	65.16%	64.31%	64.53%	64.50%	64.80%	65.10%	65.40%	65.70%
Gross Profit	2322.06	2345.80	2578.21	2808.00	3032.30	3210.96	3332.48	3425.96	3516.30	3593.36
% of sales	34.0%	33.6%	34.8%	35.7%	35.5%	35.5%	35.2%	34.9%	34.6%	34.3%
SG&A	(1789.37)	(1830.90)	(1961.13)	(2060.37)	(2211.77)	(2368.72)	(2469.49)	(2557.13)	(2653.22)	(2732.25)
% of sales	26.2%	26.2%	26.5%	26.2%	25.9%	26.2%	26.1%	26.0%	26.1%	26.1%
Depreciation & Amortization	(144.06)	(149.60)	(159.81)	(172.04)	(182.46)	(443.18)	(383.76)	(257.11)	(201.98)	(186.70)
% of capex	109.5%	89.1%	102.8%	81.0%	52.8%	79.8%	77.1%	75.9%	73.8%	73.0%
Operating Income (EBIT)	388.63	365.31	457.27	575.60	638.07	399.07	479.23	611.72	661.10	674.41
Taxes on EBIT	(139.04)	(128.69)	(159.66)	(205.72)	(228.71)	(148.65)	(178.51)	(227.86)	(246.26)	(251.22)
NOPLAT	249.59	236.62	297.61	369.88	409.36	250.41	300.72	383.85	414.84	423.19
Depreciation & Amortization	144.06	149.60	159.81	172.04	182.46	443.18	383.76	257.11	201.98	186.70
Change in Working Capital	(20.78)	107.02	51.52	48.77	(121.79)	(212.36)	(212.36)	(149.41)	(120.90)	(113.58)
% of sales	(0.3%)	1.5%	0.7%	0.6%	(1.4%)	(2.5%)	(2.5%)	(1.7%)	(1.4%)	(1.3%)
Capex	(131.59)	(167.93)	(155.40)	(212.44)	(345.27)	(555.44)	(497.94)	(338.63)	(273.75)	(255.68)
% of sales	1.9%	2.4%	2.1%	2.7%	4.0%	6.1%	5.3%	3.4%	2.7%	2.4%
Free Cash Flow	241.27	325.30	353.54	378.25	124.76	(74.21)	(25.83)	152.92	222.17	240.63
Terminal Value										6605.91
PV FCF						(70.55)	(23.34)	131.36	181.41	186.78
PV of Terminal Value						4957.59				
NPV FCF	5363.24									
Debt Balance	250.00	250.00	250.00	250.00	548.57					
Interest on Debt						27.47	39.12	38.27	37.42	27.43
PV of Tax Shield						26.04	35.15	32.60	30.22	21.00
Terminal Value of Tax Shield						424.94				
NPV Tax Shield	569.94									
Shares Outstanding	117.39	Price Per Share								
Enterprise Value	5933.19									
Outstanding Debt	(798.57)									
Equity Value	5134.62	\$43.74								
Current Market Cap	6658.36	\$56.72								
Implied Model Valuation to Market Value	(22.9%)									
Market Cap	4262.73	3481.25	4230.84	5675.62	5533.19					

Exhibit 22

Key Inputs	
Tax Rate	37.25% Based on Mgt Projections
Rm-rf	9% Enhanced Risk Premium Due to Current Risk Averse Environment
rf	2.23% 10 year Treasury Bond Yield
rD	5.49% "BB" Bloomberg Seven Year US Retail Generic Yield
Bd	0.36 Implied Debt Beta
Be	0.32 Company Equity Beta Based on Past 10 Years
Re	5.11% Cost of Equity
D/E	31.11% Including Operating Leases as Debt
Ba	0.33 Asset Beta (Unlevered Beta)
Ra	5.20% Unlevered Cost of Equity
Terminal Growth Rate	1.50% Sensitivity Analysis from 0.75% to 2.5%
Average Sales Per Store	\$0.96 (in Millions) Average New Store Revenue in First Year
% of Sales in Store for First Year	50% Assuming All Stores Open in Middle of Year
Average Cost of Remodeling/Store	(\$0.115) (in Millions) From Pershing Square Presentation

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