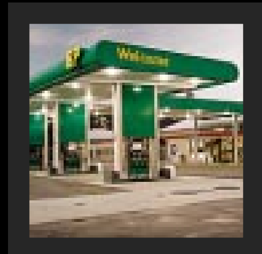
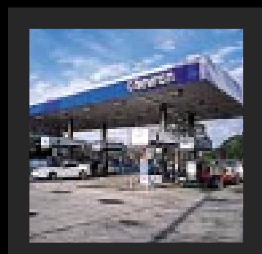
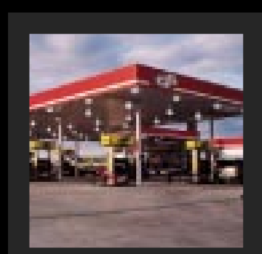
1999 Annual Report

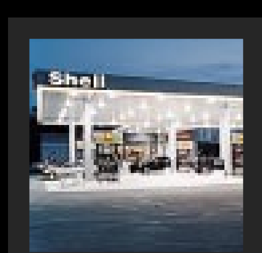
THE PANTRY, INC.

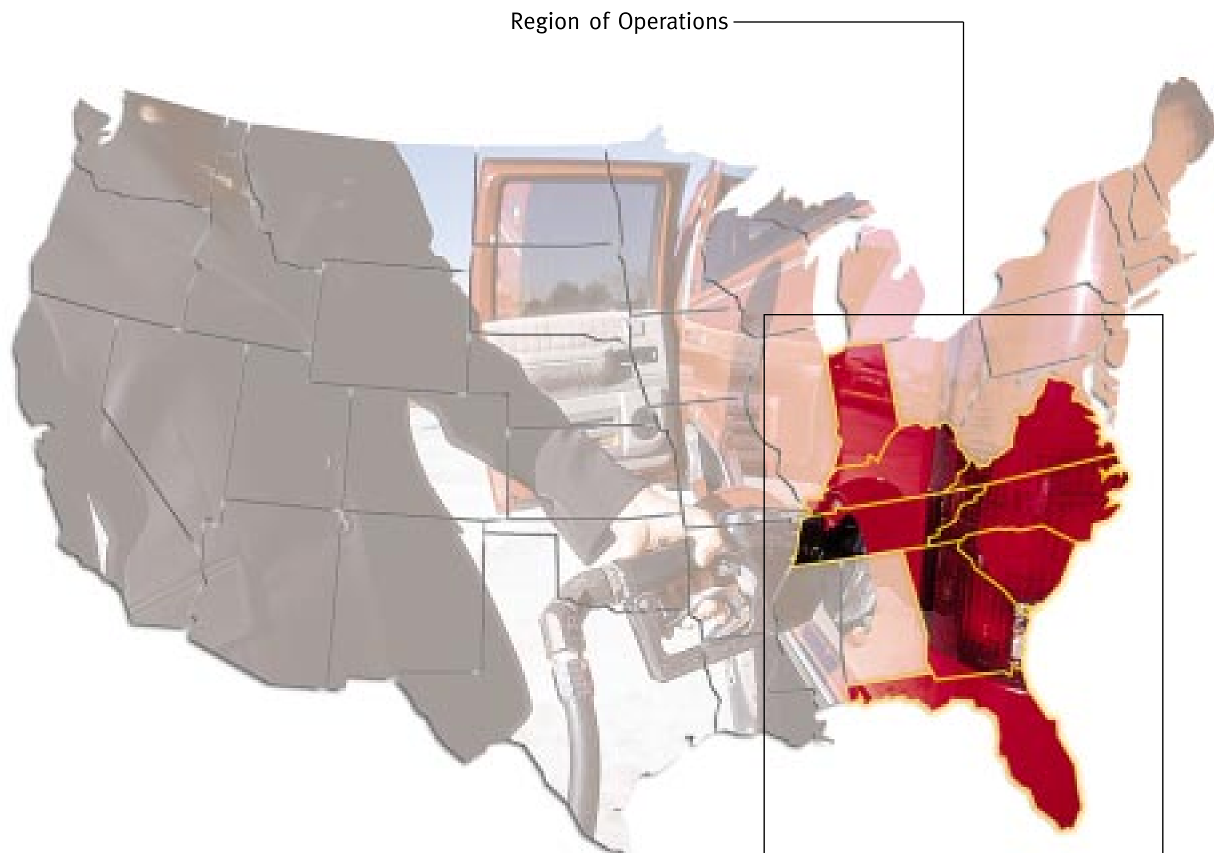
THE RIGHT SELECTION FOR GROWTH











The Pantry, Inc. operates 1,274 stores throughout the Southeastern United States. Through its aggressive growth strategy, the Company is rapidly expanding its presence in its principal markets and moving into growing contiguous markets.

SELECTED
Highlights

(dollars in thousands, except for per share information)	Fiscal Year 1999	Fiscal Year 1998	Fiscal Year 1997
Total revenues	$1,678,870	$984,884	$427,393
Gross profit	370,828	233,351	97,279
Depreciation and amortization	42,798	27,642	9,504
Income from operations	65,178	31,843	10,771
Interest expense	41,280	28,946	13,039
Net income (loss)(1)	14,000	4,673	(975)
Earnings per share(1):			
Basic	$ 0.71	$ (0.18)	$ (1.08)
Diluted	0.65	(0.16)	(1.08)
Comparable store sales growth:			
Merchandise	9.6%	5.3%	8.5%
Gasoline gallons	5.9%	4.8%	7.2%
EBITDA(2)	$ 107,976	$ 60,501	$ 20,275
Store count, end of year	1,215	954	390

(1) Before extraordinary losses of $3,584 in 1999 and $7,998 in 1998.
(2) Before merger integration costs of $1,016 in 1998.

OUR

Company

THE PANTRY, INC. IS THE LEADING CONVENIENCE STORE OPERATOR IN THE SOUTHEASTERN UNITED STATES AND THE SECOND LARGEST INDEPENDENTLY OPERATED CONVENIENCE STORE CHAIN IN THE COUNTRY. THE COMPANY CURRENTLY OPERATES 1,274 STORES IN SUBURBAN AREAS OF RAPIDLY GROWING MARKETS, COASTAL/RESORT AREAS AND SMALLER TOWNS LOCATED IN FLORIDA, NORTH CAROLINA, SOUTH CAROLINA, GEORGIA, KENTUCKY, INDIANA, TENNESSEE AND VIRGINIA.

THE PANTRY'S STORES OFFER A BROAD SELECTION OF MERCHANDISE, GASOLINE AND ANCILLARY SERVICES DESIGNED TO APPEAL TO THE CONVENIENCE NEEDS OF ITS CUSTOMERS.

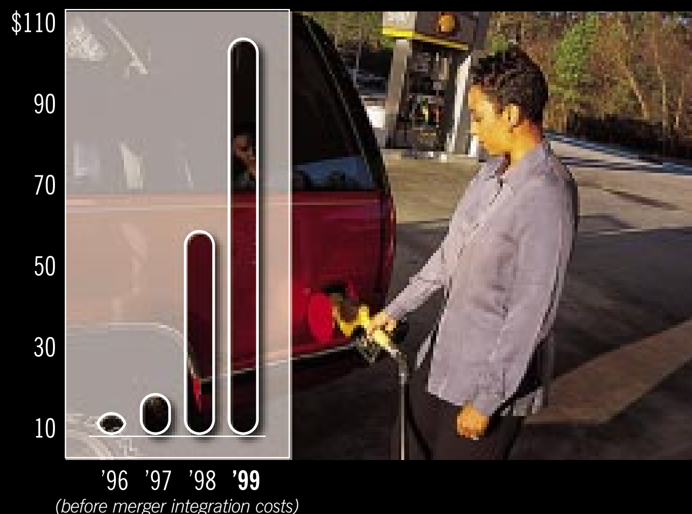
HEADQUARTERED IN SANFORD, NORTH CAROLINA, THE PANTRY, INC. BECAME A PUBLICLY TRADED COMPANY IN JUNE OF 1999. ITS COMMON STOCK TRADES ON THE NASDAQ STOCK MARKET® UNDER THE SYMBOL "PTRY."

Total Revenues
(in millions)

Net Income (Loss)
(in millions)

(before extraordinary losses)

EBITDA
(in millions)



(before merger integration costs)

TABLE OF CONTENTS

1	Our Company
2	Letter to Shareholders
4	Review of Operations
9	Selected Financial Data
11	Management's Discussion and Analysis
22	Consolidated Balance Sheets
24	Consolidated Statements of Operations
25	Consolidated Statements of Shareholders' Equity (Deficit)
26	Consolidated Statements of Cash Flows
27	Notes to Consolidated Financial Statements
44	Independent Auditors' Report
44	Market Data

Shareholders

Peter J. Sodini
President, Chief Executive Officer and Director

THE COMPANY ACHIEVED STRATEGIC GROWTH THROUGH

Nineteen ninety-nine was an exceptional year for The Pantry. We achieved strategic growth by completing a series of major acquisitions and delivered record financial results. In concluding our first fiscal year as a public company, we welcome you, our new shareholders, and proudly report that our performance, across-the-board, exceeded the goals we had established at the time of our Initial Public Offering in June of 1999. Our financial successes and the expansion of our operations reflect our ability to implement "The Right Selection for Growth," which is both a strategy for our business and the theme for this year's annual report.

Strong Financial Performance

Total revenues for 1999 increased by 70.5% to $1.7 billion from $984.9 million in 1998. Earnings before interest, taxes, depreciation and amortization (EBITDA) increased by 78.5% to $108.0 million, representing 6.4% of sales, versus $60.5 million, representing 6.1% of sales in 1998.

Net income for the year, ended September 30, 1999, was $10.4 million compared to a net loss of $3.3 million last year. Earnings per diluted share, before extraordinary items, on a pro forma basis, were $0.72 in 1999 versus $0.27 in 1998.

Our outstanding financial performance was a direct result of our focused growth strategy and initiatives to increase merchandise and gasoline sales. Merchandise sales rose 58.8% to $731.7 million, with merchandise same-store sales up 9.6% for the year. Gasoline sales increased by 81.1% to $923.8 million on a 5.9% gain in gasoline gallon same-store sales. There was a slight decrease in gross profit margins, from 34.0% in 1998 to 33.1% in 1999. The decline was a direct result of significant increases in the price of cigarettes this year.

Executing the Strategy

Our IPO significantly improved our position in 1999 and enabled us to move forward with promised growth. As a result of a strengthened balance sheet, the Company took advantage of industry fragmentation, completing the acquisition of 297 stores, well over original plans to acquire 150 stores.

We believe our selective acquisition strategy is the right one for several reasons. It has allowed us to achieve rapid growth with minimal risk. We have been able to acquire stores with a proven track record of high-volume sales and integrate them into our profitable network of stores. By applying strengthened merchandising and management techniques to newly acquired locations, we have been able to establish a solid base of revenue and cash flow within 60 days of taking charge of new stores. Growth through acquisition has also proven to be a low cost alternative to new store development.

With 1,274 stores now operating throughout the Southeast, we have become the industry leader in our principal markets and the second largest independently owned convenience store chain in the country. Rapid growth through acquisition has allowed us to gain greater market share in Florida, North Carolina, South Carolina and Virginia. It has also enabled us to expand into fast growing contiguous markets such as Georgia.

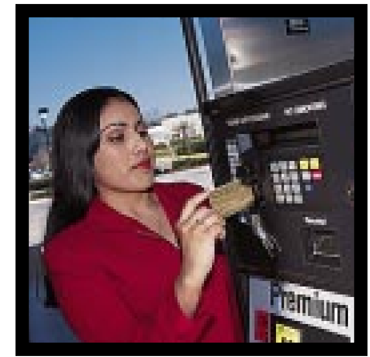
The Pantry also drove growth internally by launching initiatives to increase sales and profitability. A key component of our strategy over the past few years has been to increase product selection in all stores. In 1999, we offered a greater variety of merchandise, including a more extensive line of high-demand branded products and high-margin impulse items. The introduction of these goods positively impacted sales and is expected to enhance gross margins as we go forward. We also increased gasoline sales by offering a wider variety of branded and unbranded fuel. Our strategy of introducing unbranded gasoline to market areas where low cost alternatives were underrepresented has increased sales and secured market share. We believe one of our greatest strengths is our ability to identify consumer demands and preferences across all of our markets.

SUCCESSFUL ACQUISITIONS AND DELIVERED RECORD FINANCIAL RESULTS

Our progress in 1999 was made possible in part by lowering overhead expenses. For the third consecutive year, we eliminated unnecessary expenses, consolidated accounts and renegotiated purchase and service contracts, reducing costs by nearly 200 basis points when measured as a percentage of total revenues. We continued to invest in technology in terms of upgrading fueling locations to Multiple Product Dispensers (MPD) and improving in-store systems and communications network capabilities. We intend to invest over $12 million, to be used over a two year period for these new management information systems, which will come on-line in fiscal 2000 and help us to achieve greater accuracy in our reporting and monitoring of inventory, sales and profits.

Outlook for 2000

We believe the opportunity for growth within the industry remains strong. The convenience store industry is a $164 billion industry with a rate of growth nearly twice that of the consumer price index over the last ten years. This growth reflects a trend among customers to place greater value on convenience, as their lifestyles become increasingly fast-paced.



Our accomplishments over the past several years have uniquely positioned us to capitalize on these positive industry dynamics. Going forward, we will continue to pursue an aggressive growth strategy based on acquisition. We have already acquired over 60 stores during the first quarter of 2000 and feel we are in a strong competitive position to take advantage of attractive opportunities in the future. There are over 26,000 convenience stores operating in our principal markets and nearly 4,400 others in two target, contiguous markets that we have identified. Our acquisition pipeline looks very promising and we have already identified strong potential candidates. We expect to acquire a total of 150 stores during fiscal 2000 as well as build an additional ten stores.

We will also continue to emphasize the right selection of merchandise and gasoline that has become a proven method for increasing customer traffic and raising sales. As we grow, we anticipate even greater savings in our operating expenses by leveraging our ever increasing size, sales volumes and dominant market position to capture favorable purchasing agreements with suppliers.

We would like to acknowledge the contributions and hard work of our dedicated employees and thank our customers and shareholders for their support throughout the year. With the right selection of acquisitions and the right selection of merchandise and gasoline, we are confident that our company will grow and continue to provide value to our customers and shareholders. We anticipate another successful year and look forward to reporting to you on our progress in the future.

Peter J. Sodini
President, Chief Executive Officer and Director

Operations

The Right Selection of Merchandise

We believe today, the key to growth in the competitive convenience store industry is in presenting customers with the right selection of merchandise, which is a balance of a variety of products, staple brands and impulse purchase items. In fiscal 1999, The Pantry implemented a strategic merchandising program aimed at achieving sales growth and higher gross margins by offering customers the broadest range of competitively priced merchandise of any convenience store chain throughout the Southeastern United States. This strategy is based on three core merchandising initiatives: expanding merchandise selection, increasing in-store stock and marketing higher-margin items.

The Pantry focused on expanding its offering of brand name, high-demand goods to increase customer traffic. The Company strengthened its selection of traditional convenience store products, offering a greater variety of recognized names in snack foods, soft drinks, coffee, beer and cigarettes. Additionally, The Pantry significantly expanded its mix of specialty items. The results of these merchandising initiatives have been impressive. In fiscal 1999, the Company achieved record sales. Same-store merchandise sales increased by 9.6% in 1999, on top of a same-store sales increase of 5.3% for fiscal 1998.

Another important aspect of The Pantry's same-store growth strategy was in maintaining fully stocked stores. The Company filled its stores with nearly 25% more merchandise, on average, than its competitors.

ENHANCED MERCHANDISING STRATEGIES AND IMPROVED

Sales growth was also driven through enhanced store appearance and aggressive marketing. The Company increased eye-catching promotional displays, negotiated greater co-marketing deals with top manufacturers of brand name products and improved signage throughout its locations.

Ancillary Services—Value-Added

The Pantry offers a selection of ancillary services to attract additional customers and enhance profitability. Lottery, money orders, public phones, car washes and ATMs had a substantial impact on the bottom line in fiscal 1999. High-margin ancillary products and services accounted for $23.4 million in commission revenues, net of expenses, in fiscal 1999 up from $14.1 million in fiscal 1998.

On a selective basis, The Pantry also extended its fresh food offerings to approximately 200 stores, in the form of quick serve restaurants both proprietary and nationally franchised.

In addition to offering customers a broad selection of recognized names in snack foods and beverages, The Pantry's proprietary coffee stores provide customers with coffee, freshly ground and brewed, in its stores throughout the Southeast.

THE USUAL AMENITIES

TECHNOLOGY AT THE PUMPS

To provide customers with the most convenient fueling experience, The Pantry has installed state-of-the-art technology at its pumps throughout the Southeast. Today, 82% of The Pantry's stations are equipped with Multiple Product Dispensers (MPD) and some 59% have pay-at-the-pump credit card readers.

GASOLINE OFFERINGS ARE KEY DRIVERS IN THE COMPANY'S IMPRESSIVE GROWTH

Fueled for Growth

The Pantry has focused considerable attention on strengthening its gasoline strategy. This has been a priority for two reasons: gasoline is an essential high-demand product and it is the single greatest driver of customer traffic to stores. The Company instituted a number of initiatives, which have significantly raised volumes, helped improve merchandise sales and ultimately had a positive impact on the bottom line. The core of the Company's strategy has been providing customers with a greater offering of gasoline, keeping prices competitive and maintaining state-of-the-art facilities and equipment.

The Pantry has concentrated on offering the right selection of branded and unbranded gasoline at its pumps throughout the Southeast. In addition to offering major brands such as BP-Amoco, Shell, Texaco, Citgo and Chevron, the Company selectively introduced a greater number of unbranded locations in appropriate markets depending on customer demand and competition. Unbranded gasoline has proven to be a cost saving alternative to branded gasoline in many markets and has often been introduced as a preemptive measure to keep other unbranded players from gaining market share.

Critical to The Pantry's growth in gasoline sales has been the decentralization of price controls. This allows the Company to closely monitor competitors' prices across markets daily and regional managers have been able to reprice any market or location on a same-day-basis to ensure prices are competitive and volume remains high. The Pantry views selection and competitive pricing as the most important factors in increasing customer traffic, both at the pumps and in stores.

Rapid Fuel Card

In addition to accepting all major commercial and petroleum company credit cards, The Pantry now offers its customers a specially designed universal pay-at-the-pump or in-store gasoline card, accepted at all of its locations. The card allows for a more convenient fueling experience at its pumps and helps increase customer volume by expediting payment.

THE COMPANY'S **AGGRESSIVE** GROWTH

The Pantry card represents a considerable opportunity for the Company to capture a greater number of large volume customers. The advantages of using the card for businesses, such as trucking lines operating in the region, can be significant. The card offers businesses a convenient and efficient means to implement centralized billing for their gasoline expenditures throughout the Southeast. There have already been 20,000 cards issued.

As a result of these initiatives, same-store gallon growth increased by 5.9% in fiscal 1999.

Other factors influencing these advancements have been upgraded facilities and the introduction of the latest technological advancements at the pumps. Today, approximately 82% of The Pantry's locations selling gasoline are equipped with Multiple Product Dispensers (MPD) and some 59% have pay-at-the-pump credit card readers, providing greater convenience to customers. Leveraging its large volume purchases, the Company negotiated strategic branding agreements with key vendors, enabling it to re-image store exteriors and canopies at considerably lower costs than its competitors.

Growth through Selective Acquisition

The Company pursued an aggressive growth strategy in fiscal 1999 focused on increasing its presence in the rapidly growing convenience store industry in the Southeastern region of the United States. Market statistics best illustrate the vast opportunities for growth in this highly fragmented industry. The five largest operators, which include oil companies, account for merely 20% of total stores while the top 50 operators represent only 50%. The Company's strategy for growth focuses on capitalizing on an industry trend toward consolidation. The Pantry achieved significant growth over the past three years by pursuing attractive acquisition opportunities and implementing a new store development program on a selective basis.

The Pantry successfully leveraged its size, capital and management capabilities to acquire 297 stores in fiscal 1999, well ahead of our current target of adding 150 acquired stores per year. With the addition of well-known regional chains, the Company strengthened its presence in existing markets and expanded into contiguous markets. The acquisition of Depot Food Stores and stores operating under the Food Chief name helped the Company reinforce its position as a market leader in South Carolina and establish a foothold in the North Georgia market. Favorable dynamics and regional demographics in these markets are expected to enhance the Company's performance.

Compelling factors support continued Company growth through acquisition:

- Industry growth of 6.4% over the last 10 years, compared with 3.1% for the consumer price index over the same period
- Same-store growth as the primary driver
- Economies of scale through consolidation

Acquisitions provide The Pantry an opportunity for rapid sales and earnings growth through access to established and highly desirable locations as well as real estate, which is no longer available for new store development due to restrictive environmental and zoning regulations. Acquired stores also give the Company a ready source of revenue and cash flows, allowing The Pantry to strengthen its position within the industry without disrupting local markets.

STRATEGY FOCUSES ON BUILDING ITS LEADERSHIP THROUGH ACQUISITION

The Pantry is well positioned to take advantage of substantial growth opportunities in fiscal 2000. In the first quarter of the new fiscal year, over 60 stores have already been acquired. Our pipeline includes many high quality acquisition candidates operating in our principal and contiguous markets. The Pantry anticipates the successful acquisition of some 150 stores in the year ahead as well as building ten additional stores.

1999 Largest Acquisitions:

Date	Chain	Location	Stores
07/22/99	Depot Food	South Carolina, Northern Georgia	53
07/08/99	Food Chief	Eastern South Carolina	29
02/25/99	ETNA	North Carolina, Virginia	60
01/28/99	Handy Way	North-central Florida	121
11/05/98	Express Stop	Southeast North Carolina, Eastern South Carolina	22
10/22/98	Dash-N	East-central North Carolina	10

DRIVING GROWTH

The Pantry's ambitious growth program focuses on acquiring stores and well-known regional chains that are located in highly desirable areas throughout the Southeast.

Operations continued

Driving Results through Efficiency

The Pantry's operating efficiency has been a key element in the Company's impressive growth in fiscal 1999. A substantial increase in the bottom line was achieved through strengthened relationships with vendors, reduced overhead costs and investment in technology.

The Company has gained significant buying power that should continue to grow with the integration of new acquisitions in fiscal 2000 and beyond. Centralized purchasing for same-store and all newly acquired locations has allowed The Pantry to successfully utilize its increasing sales volumes and shelf-space to negotiate favorable purchasing contracts with vendors. The Company's management efficiency and an ability to achieve economies of scale is best illustrated through its tangible results. On average, within the first six months of managing newly acquired stores, The Pantry significantly increased profitability when compared with results for the same period under prior management.

EFFICIENCY AND SUPERIOR TECHNOLOGIES ADD TO THE GROWTH POTENTIAL OF THE PANTRY

The implementation of cost saving programs has resulted in a major reduction in overhead expenses. By renegotiating service agreements, improving employee retention and reducing insurance and workers' compensation costs, the Company has decreased its operating expenses as a percentage of total revenues from 17.7% in fiscal 1998 to 15.7% in fiscal 1999.

The Company has also allocated over $25 million to upgrade its technology at the pumps, in stores and at its corporate offices. Improved pump technology will increase volume by making fueling more convenient, while the latest management information systems will enhance overall operating efficiency. New management information systems are expected to be fully operational by June of 2000. Store and corporate technology investments include point of sale systems and computer hardware and software systems to facilitate communication with individual stores and field managers by establishing on-line links. Improved management systems will simplify inventory tracking and pricing controls as well as the daily monitoring of individual store performance to keep sales and margins on target.

Personnel—The Best in the Industry

The Pantry believes that in order to attract quality personnel it must be able to provide individuals mobility within the Company. Through a selective recruiting and screening process, The Pantry has successfully assembled a highly effective staff of regional and store managers with strong backgrounds in the convenience and drug store, oil company and food retailing industries.

The Company's rapid growth and vast opportunities for career advancement have been the most important factors in its ability to recruit dedicated professionals from all over the country and achieve remarkably high levels of retention.

Selected Financial Data

The following table sets forth historical consolidated financial data and store operating data for the periods indicated. The selected historical annual consolidated financial data is derived from, and is qualified in its entirety by, our annual Consolidated Financial Statements, including those contained elsewhere in this report. The information should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," the Consolidated Financial Statements and related notes thereto included elsewhere in this report. In the table, dollars are in millions except per share, per store and per gallon data.

	September 30, 1999 (53 weeks)	September 24, 1998[f] (52 weeks)	September 25, 1997 (52 weeks)	September 26, 1996 (52 weeks)	September 28, 1995 (52 weeks)
Statement of Operations Data:					
Revenues:					
Merchandise sales	$ 731.7	$ 460.8	$202.4	$188.1	$187.4
Gasoline sales	923.8	510.0	220.2	192.7	187.2
Commissions	23.4	14.1	4.8	4.0	4.5
Total revenues	1,678.9	984.9	427.4	384.8	379.1
Cost of Sales:					
Merchandise	489.3	304.0	132.8	126.0	122.0
Gasoline	818.8	447.6	197.3	167.6	161.2
Gross profit	370.8	233.3	97.3	91.2	95.9
Store operating expense	214.4	140.1	60.2	57.8	56.2
General and administrative expenses	48.5	32.8	16.8	17.8	18.1
Unusual charges	—	1.0[g]	—	4.6[e]	—
Depreciation and amortization	42.8	27.6	9.5	9.1	11.5
Income from operations	65.2	31.8	10.8	1.9	10.1
Interest expense	(41.3)	(28.9)	(13.0)	(12.0)	(13.2)
Income (loss) before other items	24.8	4.7	(1.0)	(8.1)	(3.3)
Extraordinary loss	(3.6)[i]	(8.0)[h]	—	—	—
Net income (loss)	$ 10.4	$ (3.3)	$ (1.0)	$ (8.1)	$ (4.2)
Net income (loss) applicable to common shareholders	$ 6.2	$ (6.3)	$ (6.3)	$ (10.8)	$ (4.2)
Earnings (loss) per share before extraordinary loss:					
Basic	$ 0.71	$ (0.18)	$ (1.08)	$ (1.89)	$ (0.64)
Diluted	$ 0.65	$ (0.16)	$ (1.08)	$ (1.89)	$ (0.64)
Weighted-average shares outstanding:					
Basic	13,768	9,732	5,815	5,688	5,100
Diluted	15,076	11,012	5,815	5,688	5,100
Dividends paid on common stock	—	—	—	—	—
Other Financial Data:					
EBITDA[a]	$ 108.0	$ 60.5	$ 20.3	$ 15.6	$ 21.5
Net cash provided by (used in):					
Operating activities	$ 68.6	$ 48.0	$ 7.3	$ 5.4	$ 11.9
Investing activities	(228.9)	(285.4)	(25.1)	(7.2)	(15.3)
Financing activities	157.1	268.4	15.8	(3.9)	(1.0)
Capital expenditures[b]	47.4	42.1	14.7	7.1	16.7
Ratio of earnings to fixed charges[c]	1.4	1.1	—	—	—

Selected Financial Data continued

	September 30, 1999 (53 weeks)	September 24, 1998[f] (52 weeks)	September 25, 1997 (52 weeks)	September 26, 1996 (52 weeks)	September 28, 1995 (52 weeks)
Store Operating Data:					
Number of stores (end of period)	1,215	954	390	379	403
Average sales per store:					
Merchandise sales (in thousands)	$ 666.4	$ 533.3	$525.8	$481.1	$462.7
Gasoline gallons (in thousands)	834.8	603.9	501.2	450.0	440.3
Comparable store sales growth[d]:					
Merchandise	9.6%	5.3%	8.5%	2.8%	(0.8)%
Gasoline gallons	5.9%	4.8%	7.2%	(4.3)%	0.5%
Operating Data:					
Merchandise gross margin	33.1%	34.0%	34.4%	33.0%	34.9%
Gasoline gallons sold (in millions)	855.7	466.8	179.4	160.7	160.3
Average retail gasoline price per gallon	$ 1.08	$ 1.09	$ 1.23	$ 1.20	$ 1.17
Average gasoline gross profit per gallon	$ 0.123	$ 0.134	$0.128	$0.156	$0.162
Store expense as a percentage of total revenues	12.8%	14.2%	14.1%	15.0%	14.8%
General and administrative expense as a percentage of total revenues	2.9%	3.3%	3.9%	4.6%	4.8%
Operating income as a percentage of total revenues	3.9%	3.2%	2.5%	0.5%	2.7%
Balance Sheet Data (end of period):					
Working capital (deficiency)	$ (27.5)	$ (9.0)	$ (8.2)	$ (6.5)	$ (0.8)
Total assets	793.7	554.8	142.8	120.9	127.7
Total debt and capital lease obligations	455.6	340.7	101.3	101.4	101.8
Shareholders' equity (deficit)	104.2[j]	39.3	(17.9)	(27.5)	(16.3)

(a) "EBITDA" represents income from operations before depreciation and amortization, merger integration costs, restructuring charges, and impairment of long-lived assets. EBITDA is not a measure of performance under generally accepted accounting principles, and should not be considered as a substitute for net income, cash flows from operating activities and other income or cash flow statement data prepared in accordance with generally accepted accounting principles, or as a measure of profitability or liquidity. We have included information concerning EBITDA as one measure of an issuer's historical ability to service debt. EBITDA should not be considered as an alternative to, or more meaningful than, income from operations or cash flow as an indication of our operating performance.

(b) Purchases of assets to be held for sale are excluded from these amounts.

(c) For purposes of determining the ratio of earnings to fixed charges: (i) earnings consist of income (loss) before income tax benefit (expense) and extraordinary item plus fixed charges and (ii) fixed charges consist of interest expense, amortization of deferred financing costs, preferred stock dividends and the portion of rental expense representative of interest (deemed to be one-third of rental expense). Our earnings were inadequate to cover fixed charges by $3.6 million, $14.3 million and $6.3 million for fiscal years 1995, 1996 and 1997, respectively.

(d) The stores included in calculating comparable store sales growth are stores that were under management and in operation for both fiscal years of the comparable period; therefore, acquired stores, new stores and closed stores are not included.

(e) During 1996, we recorded restructuring charges of $1.6 million pursuant to a formal plan to restructure our corporate offices. Also during fiscal 1996, we early-adopted SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. In addition, pursuant to SFAS 121, we evaluated our long-lived assets for impairment on a store-by-store basis. Based on this evaluation, we recorded an impairment loss of $0.4 million for property and equipment and $2.6 million for goodwill.

(f) For a further discussion of the Lil' Champ acquisition and its impact on the comparability of the periods reflected in Selected Financial Data, see "Management's Discussion and Analysis of Financial Condition and Results of Operations."

(g) During 1998, we recorded an integration charge of approximately $1.0 million for costs of combining our existing business with the acquired business of Lil' Champ.

(h) On October 23, 1997 in connection with the Lil' Champ acquisition, we completed the offering of our senior subordinated notes and, in a related transaction, completed a tender offer and consent solicitation with respect to our senior notes. The tender offer resulted in our purchasing $51 million in principal amount of the senior notes at a purchase price of 110% of the aggregate principal amount plus accrued and unpaid interest and other related fees. In connection with this repurchase, we incurred an extraordinary loss of approximately $8.0 million related to cost of the tender offer and consent solicitation and write-off of deferred financing costs.

(i) On January 28, 1999, we redeemed $49.0 million in principal amount of our senior notes and paid accrued and unpaid interest up to, but not including, the date of purchase and a 4% call premium. We recognized an extraordinary loss of approximately $3.6 million in connection with the repurchase of the senior notes including the payment of the 4% call premium of $2.0 million, fees paid in connection with the amendments and commitments under our bank credit facility, and the write-off of deferred financing costs related to our repayment of our former bank credit facility.

(j) On June 8, 1999, we offered and sold 6,250,000 shares of our common stock in the IPO. The initial offering price was $13.00 per share and we received $75.6 million in net proceeds, before expenses.

Management's Discussion and Analysis

The following discussion and analysis is provided to increase understanding of, and should be read in conjunction with, the Consolidated Financial Statements and accompanying notes. Additional discussion and analysis related to fiscal year 1999 is contained in our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and 8-K/A and our Registration Statement on Form S-1, as amended, effective June 8, 1999.

Introduction

Fiscal year 1999 was an exceptional year for The Pantry and its most successful in terms of revenues, operating profits, and net income. We earned record net income of $10.4 million in 1999 compared to a net loss of $3.3 million in 1998. Results of operations for both 1999 and 1998 included an extraordinary loss of $3.6 million (net of taxes) and $8.0 million associated with the refinancing of our senior notes and credit facilities. Before these extraordinary items, we earned $14 million in 1999 compared to $4.7 million in 1998 or an increase of 200%. These improved operating results were the result of:

- the increased sales and earnings associated with acquired stores,
- our same-store sales and earnings growth,
- the continued operating improvements in terms of merchandising, operating and overhead expenses, and
- the lower extraordinary charges discussed above.

In fiscal year 1999, we hit the following organizational milestones:

- we acquired and successfully integrated 297 stores, making us the second largest independently operated convenience store chain in the country,
- we redeemed and refinanced the remaining portion of our 12% senior notes with borrowings under our new bank facility, and
- we completed our IPO on June 8, 1999, raising $75.6 million in net proceeds, before expenses.

We intend to continue to focus on same-store sales and profit growth through upgraded facilities, improved technology, new service offerings, competitive merchandise and gasoline prices, and cost savings initiatives. We are upgrading our management information systems and continue to remodel our stores. Strategically, we continue to seek acquisition candidates and to implement our operating principles in acquired stores.

Acquisition History

Our acquisition strategy focuses on acquiring convenience stores within or contiguous to our existing market areas. We believe acquiring locations with demonstrated revenue and gasoline volumes involves lower risk and is an economically attractive alternative to traditional site selection and new store development.

The table below provides information concerning the largest acquisitions we have completed during the last three fiscal years:

Acquisition Date	Company Acquired	Trade Name	Store Locations	Number of Stores
July 22, 1999	R&H Maxxon, Inc.	Depot Food	South Carolina, Northern Georgia	53
July 8, 1999	Dilmar Oil Company	Food Chief	Eastern South Carolina	29
February 25, 1999	Taylor Oil Company	ETNA	North Carolina, Virginia	60
January 28, 1999	Miller Enterprises, Inc.	Handy Way	North-central Florida	121
November 5, 1998	Express Stop, Inc.	Express Stop	Southeast North Carolina, Eastern South Carolina	22
October 22, 1998	A. G. Oil Company, Inc.	Dash-N	East-central North Carolina	10
July 15, 1998	Stallings Oil Company, Inc.	Zip Mart	Central North Carolina, Virginia	42
July 2, 1998	Quick Stop Food Mart, Inc.	Quick Stop	Southeast North Carolina, Coastal South Carolina	75
May 2, 1998	United Fuels Corporation, Inc.	Sprint	Gainesville, Florida	10
March 19, 1998	Wooten Oil Company, Inc.	Kwik Mart	Eastern North Carolina	23
October 23, 1997	Lil' Champ Food Stores, Inc.	Lil' Champ	Northeast Florida	440[a]
June 12, 1997	Carolina Ice Company, Inc.	Freshway	Eastern North Carolina	15
April 17, 1997	Gregorie Oil Co., Inc.	Gregorie Oil	South Carolina	15

(a) Net of the disposition of 48 convenience stores located throughout eastern Georgia.

Management's Discussion and Analysis continued

Subsequent to September 30, 1999, we acquired 64 stores located in Georgia (49), North Carolina (7), South Carolina (7) and Florida (1) in four separate transactions. These transactions were primarily funded from borrowings under our bank credit facility and cash on hand.

We seek to improve the productivity and profitability of acquired stores by implementing our merchandising and gasoline initiatives, eliminating duplicative costs, reducing overhead and centralizing functions such as purchasing and information technology. We believe it takes six to twelve months to fully integrate and achieve operational and financial improvements at acquired locations. There can be no assurance, however, that we can achieve revenue increases or cost savings with respect to any acquisition.

Impact of Acquisitions. These acquisitions and the related transactions have had a significant impact on our financial condition and results of operations since each of their respective transaction dates. Due to the method of accounting for acquisitions, the Consolidated Statements of Operations for the fiscal years presented includes results of operations for each of the acquisitions from the date of each acquisition only. For fiscal year 1999 acquisitions, the Consolidated Balance Sheets as of September 24, 1998 and the Consolidated Statements of Operations for fiscal years September 24, 1998 and September 25, 1997 do not include the assets, liabilities, and results of operations relating to these acquisitions. As a result, comparisons to prior fiscal year results and prior balance sheets are impacted materially and obscure the underlying performance of same-store results.

Results of Operations

Our operations for fiscal years 1997 and 1998 each contained 52 weeks and fiscal year 1999 contained 53 weeks. The following table sets forth certain of our results as a percentage of total revenues for the periods indicated:

Fiscal Year Ended	1999	1998	1997
Revenues:			
Merchandise sales	43.6%	46.8%	47.4%
Gasoline sales	55.0	51.8	51.5
Commissions	1.4	1.4	1.1
Total revenues	100.0	100.0	100.0
Gross profit	22.1	23.7	22.7
Store operating expenses	12.8	14.2	14.1
General and administrative expenses	2.9	3.3	3.9
Depreciation and amortization	2.5	3.0	2.2
Income from operations	3.9	3.2	2.5
Interest and other expenses	(2.4)	(2.8)	(2.7)
Income (loss) before income taxes and extraordinary loss	1.5	0.5	(0.2)
Income tax expense	(0.6)	—	—
Income (loss) before extraordinary loss	0.9	0.5	(0.2)
Extraordinary loss	(0.2)	(0.8)	—
Net (loss) income	0.7%	(0.3)%	(0.2)%

Fiscal 1999 Compared to Fiscal 1998

Total Revenue. Total revenue for fiscal 1999 was $1.7 billion compared to $984.9 million for fiscal 1998, an increase of $694.0 million or 70.5%. The increase in total revenue is primarily due to the revenue from stores acquired in fiscal 1999 of $346.4 million, the effect of a full year of revenue from fiscal 1998 acquisitions of $259.9 million, and comparable store revenue growth of 6.9% or approximately $29.3 million. Also, the effect of an extra week in fiscal 1999 contributed $39.4 million or 5.6% of the increase. Comparable store sales increases at our locations are primarily due to increased customer counts and average transaction size resulting from more competitive gasoline pricing, enhanced store appearance and store merchandising, and increased in-store promotional activity.

Merchandise Revenue. Total merchandise revenue for fiscal 1999 was $731.7 million compared to $460.8 million for fiscal 1998, an increase of $270.9 million or 58.8%. The increase in merchandise revenue is primarily due to the revenue from stores acquired in fiscal 1999 of $133.8 million, the effect of a full year of merchandise revenue from fiscal 1998 acquisitions of $92.7 million, and comparable store sales growth of 9.6% or approximately $20.3 million. Based on purchase and sales information, we estimate that cigarette inflation during fiscal year 1999 accounted for 3% to 4% of the 9.6% increase in comparable store sales. Also, the effect of an extra week in fiscal 1999 contributed $16.0 million.

Gasoline Revenue and Gallons. Total gasoline revenue for fiscal 1999 was $923.8 million compared to $510.0 million for fiscal 1998, an increase of $413.8 million or 81.1%. The increase in gasoline revenue is primarily due to the revenue from stores acquired in fiscal 1999 of $208.2 million, the effect of a full year of gasoline revenue from fiscal 1998 acquisitions of $165.2 million, and comparable store gasoline revenue growth of 3.8% or approximately $7.9 million. Also, the effect of an extra week in fiscal 1999 contributed $22.9 million. In fiscal 1999, our average retail price of gasoline was $1.08 which represents a $.01 decrease from fiscal 1998.

In fiscal 1999, total gasoline gallons were 855.7 million gallons compared to 466.8 million gallons in fiscal 1998, an increase of 388.9 million gallons or 83.3%. The increase in gasoline gallons is primarily due to gallon volume of 189.4 million from stores acquired in fiscal 1999, the effect of a full year of gasoline volume from 1998 acquisitions of 163.2 million and comparable store gasoline volume increases of 5.9% or approximately 11.6 million gallons. Also, the effect of an extra week in fiscal 1999 contributed 18.5 million gallons. Fiscal 1999 same-store gallon sales growth was 5.9% and is primarily due to more competitive gasoline pricing, rebranding and promotional activity, enhanced store appearance, and local market and economic conditions.

Commission Revenue. Total commission revenue for fiscal 1999 was $23.4 million compared to $14.1 million for fiscal 1998, an increase of $9.3 million or 65.7%. The increase in commission revenue is primarily due to revenue from stores acquired in fiscal 1999 of $4.4 million, the effect of a full year of commission revenue from 1998 acquisitions of $2.0 million and comparable store commission revenue growth of 18.7% or $1.1 million. The effect of an extra week in fiscal 1999 contributed $0.5 million. The South Carolina legislature has passed a law banning video poker in South Carolina effective July 1, 2000. Commission revenue from video poker in South Carolina represented approximately $6.7 million or 26% of our total commission revenue in fiscal 1999. We anticipate a decline in video gaming commission in fiscal 2000 to approximately $3.5 million. We believe increased commission revenue from acquired locations, additional ancillary services and more favorable vendor contract terms will offset a majority of this decline.

Total Gross Profit. Total gross profit for fiscal 1999 was $370.8 million compared to $233.4 million for fiscal 1998, an increase of $137.4 million or 58.9%. The increase in gross profit is primarily due to the gross profit from stores acquired in fiscal 1999 of $72.1 million, the effect of a full year of operations from stores acquired in 1998 of $50.7 million and the effect of an extra week in fiscal 1999 of $3.0 million.

Merchandise Gross Margin. Merchandise gross margin in fiscal 1999 remained relatively constant compared to fiscal 1998, decreasing 90 basis points despite significant cost inflation in the tobacco category. See "Inflation."

Gasoline Gross Profit Per Gallon. Gasoline gross profit per gallon decreased to $0.123 in fiscal 1999 from $0.134 in fiscal 1998 primarily due to rising crude oil prices and its impact on wholesale fuels costs and lower average margin in acquired locations.

Store Operating Expenses. Store operating expenses for fiscal 1999 were $214.4 million compared to $140.1 million for fiscal 1998, an increase of $74.3 million or 53.0%. The increase in store expenses is primarily due to the operating and lease expenses associated with the stores acquired in fiscal 1999 of $47.9 million, the effect of a full year of expenses for stores acquired in 1998 of $29.9 million, as well as the effect of an extra week of operations in fiscal 1999 of $3.8 million. As a percentage of total revenue, store operating expenses decreased to 12.8% in fiscal 1999 from 14.2% in fiscal 1998.

General and Administrative Expenses. General and administrative expenses for fiscal 1999 were $48.5 million compared to $32.8 million for fiscal

Management's Discussion and Analysis continued

1998, an increase of $15.7 million or 47.9%. The increase in general and administrative expenses is primarily due to the costs associated with managing increased store counts. General and administrative expenses in total decreased as a percentage of total revenues to 2.9% in fiscal 1999 from 3.3% in fiscal 1998.

Income from Operations. Income from operations for fiscal 1999 was $65.2 million compared to $31.8 million for fiscal 1998, an increase of $33.4 million or 104.7%. The increase is primarily due to the items discussed above. As a percentage of total revenue, income from operations increased to 3.9% in fiscal 1999 from 3.2% in fiscal 1998.

EBITDA. EBITDA represents income (loss) before interest expense, income tax benefit, depreciation and amortization, merger integration costs, restructuring charges, impairment of long-lived assets, and extraordinary item. EBITDA for fiscal 1999 was $108.0 million compared to $60.5 million for fiscal 1998, an increase of $47.5 million or 78.5%. The increase is primarily due to the items discussed above.

EBITDA is not a measure of performance under generally accepted accounting principles, and should not be considered as a substitute for net income, cash flows from operating activities and other income or cash flow statement data prepared in accordance with generally accepted accounting principles, or as a measure of profitability or liquidity. We have included information concerning EBITDA as one measure of our cash flow and historical ability to service debt and because we believe investors find this information useful. EBITDA as defined may not be comparable to similarly-titled measures reported by other companies.

Interest Expense (see "Liquidity and Capital Resources; Long-Term Debt"). Interest expense is primarily interest on our senior subordinated notes, borrowings under our bank credit facility and our previously outstanding senior notes. Interest expense in fiscal 1999 was $41.3 million compared to $28.9 million for fiscal 1998, an increase of $12.4 million or 42.6%. Interest expense is primarily related to interest on our senior subordinated notes of $21.9 million, interest on the bank credit facility of approximately $16.6 million and interest on our senior notes of $2.0 million which was partially offset by $1.1 million in interest savings related to the redemption and refinancing of $49.0 million in principal amount of the senior notes.

Income Tax Expense. Our effective income tax rate for fiscal 1999 was 43.4%. Our effective tax rate is negatively impacted by non-deductible goodwill related to acquisitions and other permanent differences.

Extraordinary Loss. We recognized an extraordinary loss, net of taxes, of approximately $3.6 million in fiscal 1999 in connection with the redemption of the remaining outstanding balance of our senior notes and the related consent fees. The extraordinary item includes the payment of the 4% call premium of $2.0 million and the write-off of related deferred financing costs on our senior notes and former credit facility. The extraordinary item also reflects an income tax benefit of approximately $2.3 million.

Net Income. Net income for fiscal 1999 was $10.4 million compared to a net loss of $3.3 million for fiscal 1998, an increase of $13.7 million or 413.3%. The increase is primarily due to results from acquired stores, improved results from operations, and the lower extraordinary charges related to redemption and refinancing activities. Our income before extraordinary loss was $14.0 million for fiscal 1999 compared to $4.7 million during fiscal 1998, an increase of $9.3 million or a 200% increase. Pursuant to Emerging Issues Task Force Topic No. ("EITF") D-42, in connection with our redemption of our preferred stock in our third fiscal quarter, we were required to recognize a one-time deduction to net income applicable to common stockholders (and a related reclassification to accumulated deficit) in the amount of $1.5 million associated with original issue costs incurred in connection with the issuance of preferred stock in December 1996. At that time, the original issue costs were netted against the gross proceeds and thus charged to additional paid-in capital. EITF D-42 requires that the excess of fair value of the consideration transferred to the preferred stockholders over the carrying amount of the preferred stock be subtracted from net income applicable to common stockholders in the calculation of earnings per share.

Fiscal 1998 Compared to Fiscal 1997

Total Revenue. Total revenue for fiscal 1998 was $984.9 million compared to $427.4 million for fiscal 1997, an increase of $557.5 million or

130.4%. The increase in total revenue is primarily due to Lil' Champ revenue of $451.4 million for the eleven month period ended September 24, 1998, the revenue from stores acquired or opened in fiscal 1998 of $92.2 million and comparable store merchandise sales growth of 5.3% (or $9.7 million). Comparable store sales increases at our locations are primarily due to increased customer counts and average transaction size resulting from more competitive gasoline pricing, enhanced store appearance and store merchandising, and increased in-store promotional activity.

Merchandise Revenue. Merchandise revenue for fiscal 1998 was $460.8 million compared to $202.4 million for fiscal 1997, an increase of $258.4 million or 127.7%. The increase in merchandise revenue is primarily due to Lil' Champ merchandise revenue of $212.2 million for the eleven month period ended September 24, 1998, the revenue from stores acquired or opened in fiscal 1998 of $30.5 million and comparable store merchandise sales growth of $9.7 million. Fiscal 1998 comparable store merchandise revenue increased 5.3% over fiscal 1997.

Gasoline Revenue and Gallons. Gasoline revenue for fiscal 1998 was $510.0 million compared to $220.2 million for fiscal 1997, an increase of $289.8 million or 131.6%. The increase in gasoline revenue is primarily due to Lil' Champ gasoline revenue of $231.7 million for the eleven month period ended September 24, 1998 and the revenue from stores acquired or opened in fiscal 1998 of $61.1 million. Overall, gasoline revenue growth was partially offset by lower average gasoline retail prices in fiscal 1998 versus fiscal 1997. In fiscal 1998, the Company's average retail price of gasoline was $0.14, or 11.4%, lower than in fiscal 1997. The decrease in average retail is primarily due to lower wholesale gasoline pricing.

In fiscal 1998, total gasoline gallons were 466.8 million gallons compared to 179.4 million gallons in fiscal 1997, an increase of 287.4 million gallons or 160.2%. The increase in gasoline gallons is primarily due to Lil' Champ gallon volume of 204.9 million and comparable store gasoline volume increases of 7.9 million. Fiscal 1998 comparable store gallon sales growth was 4.8% and is primarily due to more competitive gasoline pricing, rebranding and promotional activity, enhanced store appearance, and local market and economic conditions.

Commission Revenue. Total commission revenue for fiscal 1998 was $14.1 million compared to $4.8 million for fiscal 1997, an increase of $9.3 million or 193.8%. The increase in commission revenue is primarily due to Lil' Champ revenue of $7.5 million for the eleven month period ended September 24, 1998 and revenue from stores acquired or opened in fiscal 1998 of $0.5 million. Lil' Champ's commission revenue is principally lottery revenue in locations throughout Florida and Georgia.

Total Gross Profit. Total gross profit for fiscal 1998 was $233.4 million compared to $97.3 million for fiscal 1997, an increase of $136.1 million or 139.9%. The increase in gross profit is primarily due to Lil' Champ gross profit of $108.5 million for the eleven month period ended September 24, 1998, the gross profit from stores acquired or opened in fiscal year 1998 of $15.7 million and comparable store gross profit increases of $5.8 million.

Merchandise Gross Margin. Merchandise gross margins in fiscal 1998 remained relatively constant compared to fiscal 1997, decreasing only 40 basis points despite cost inflation in the tobacco category.

Gasoline Gross Profit Per Gallon. The gasoline gross profit per gallon increased to $0.134 in fiscal 1998 from $0.128 in fiscal 1997 as the result of more favorable retail price and wholesale cost conditions in Lil' Champ's markets and improved gasoline market conditions in our other primary markets. This increase occurred in spite of decreases in retail gasoline prices to $1.09 in fiscal 1998 from $1.23 in fiscal 1997.

Store Operating and General and Administrative Expenses. Store operating expenses for fiscal 1998 were $140.1 million compared to $60.2 million for fiscal 1997, an increase of $79.9 million or 132.7%. The increase in store expenses is primarily due to Lil' Champ expenses of $63.6 million for the eleven month period ended September 24, 1998 and the operating and lease expenses associated with the stores acquired or opened in fiscal 1998 of $9.6 million. As a percentage of total revenue, store operating expenses increased to 14.2% in fiscal 1998 from 14.1% in fiscal 1997.

General and administrative expenses for fiscal 1998 were $32.8 million compared to $16.8 million for fiscal 1997, an increase of $16.0 million or 95.2%. The increase in general and administrative expenses is primarily due to Lil' Champ

Management's Discussion and Analysis continued

expenses of $16.0 million for the eleven month period ended September 24, 1998. Operating, general and administrative expenses in total decreased as a percentage of total revenues. As a percentage of total revenue, general and administrative expenses decreased to 3.3% in fiscal 1998 from 3.9% in fiscal 1997.

Merger Integration Costs. In connection with the Lil' Champ acquisition, we incurred merger integration costs of approximately $1.0 million related to the combination of its existing business with the acquired business of Lil' Champ. These costs include $0.3 million related to the relocation of personnel, $0.6 million related to the provision for duplicated contracted services that provide no future economic benefit and $0.1 million for other consolidation and related expenses.

Income from Operations. Income from operations for fiscal 1998 was $31.8 million compared to $10.8 million for fiscal 1997, an increase of $21.0 million or 194.4%. The increase is primarily due to Lil' Champ income from operations of $16.7 million. As a percentage of total revenue, income from operations increased to 3.2% in fiscal 1998 from 2.5% in fiscal 1997.

EBITDA. EBITDA for fiscal 1998 was $60.5 million compared to $20.3 million for fiscal 1997, an increase of $40.2 million or 198.0%. The increase is primarily due to Lil' Champ EBITDA of $31.4 million for the eleven month period ended September 24, 1998 and the items discussed above. Excluding Lil' Champ, EBITDA increased 43.3% in fiscal 1998 compared to fiscal 1997.

Interest Expense (see "Liquidity and Capital Resources; Long-Term Debt"). Interest expense in fiscal 1998 was $28.9 million compared to $13.0 million for fiscal 1997, an increase of $15.9 million or 122.3%. This increase is primarily due to interest on the senior notes of $6.5 million, the senior subordinated notes of $18.9 million and borrowing under the former bank credit facility of approximately $2.0 million, which was partially offset by $0.8 million in interest savings related to the redemption and refinancing of $51.0 million in principal amount of the senior notes.

Income Tax Benefit (Expense). We did not record an income tax benefit for fiscal 1998 or fiscal 1997. Income tax benefit (expense) is recorded net of a valuation allowance to provide for operating loss carryforwards and available tax credits based on estimated future earnings and for temporary differences based on expected timing of reversals. In fiscal 1998, the valuation allowance increased $551,000, which resulted primarily from the allowance for 1998 federal net operating loss benefits, offset by a $1.2 million allowance adjustment related to a corresponding reduction of $1.2 million of deferred tax assets which resulted from a preliminary settlement of a North Carolina tax assessment.

Extraordinary Loss. We recognized an extraordinary loss of approximately $8.0 million in fiscal 1998 in connection with the redemption of a portion of the senior notes and related consent fees. The extraordinary item relates to the purchase of $51.0 million in principal amount of the senior notes and includes tender costs of $5.1 million, consent solicitation costs of $0.9 million, and the write-off of a respective portion of the deferred financing cost of $2.0 million.

Net Loss. Net loss for fiscal 1998 was $3.3 million compared to $1.0 million for fiscal 1997, an increase of $2.3 million or 230.0%. The increase is primarily due to the extraordinary loss of $8.0 million in connection with the redemption of the senior notes and related consent fees. Our income before extraordinary loss was $4.7 million for fiscal 1998 compared to a loss of $1.0 million during fiscal 1997, an increase of $5.7 million. The income before extraordinary loss for fiscal 1998 represents an increase of $12.8 million over fiscal year 1996.

Liquidity and Capital Resources

Cash Flows from Operations. Due to the nature of our business, substantially all sales are for cash. Cash provided by operations is our primary source of liquidity. Acquisitions, interest expense and capital expenditures represent the primary uses of funds. We rely primarily upon cash provided by operating activities, supplemented as necessary from time to time by borrowings under the bank credit facility, sale-leaseback transactions, asset dispositions and equity investments, to finance our operations, pay interest, and fund capital expenditures and acquisitions. Cash provided by operating activities for fiscal 1997 totaled $7.3 million, for fiscal 1998 totaled $48.0 million and for fiscal 1999 totaled $68.6 million. We had $31.2 million of cash and cash equivalents on hand at September 30, 1999.

Bank Credit Facility. On January 28, 1999, we entered into the 1999 bank credit facility. The bank credit facility consists of a $45.0 million

revolving credit facility, a $50.0 million acquisition facility and a $240.0 million term loan facility. The revolving credit facility is available to fund working capital and for the issuance of standby letters of credit. The acquisition facility is available to fund future acquisitions of related businesses. As of September 30, 1999, there were no borrowings outstanding under the working capital line of credit and $12.0 million outstanding under the acquisition facility. As of September 30, 1999, approximately $16.1 million of letters of credit were issued under the standby letter of credit facility.

Subsequent to September 30, 1999, we entered into an amendment to our bank credit facility and borrowed an additional $75.0 million under our term loan facility. This term loan generally carries the same terms and conditions as our existing term loan facility. Proceeds from the term loan were used to prepay amounts outstanding under our acquisition facility and to fund acquisitions closed after September 30, 1999. On January 31, 2000 we attained an additional $25.0 million term loan with proceeds to be used to finance future acquisitions. With these transactions, we currently have $75.0 million in additional capacity to fund future acquisitions.

The 1999 bank credit facility contains covenants restricting our ability and the ability of any of our subsidiaries to, among other things, (i) incur additional indebtedness, (ii) declare dividends or redeem or repurchase capital stock, (iii) prepay, redeem or purchase debt, (iv) incur liens, (v) make loans and investments, (vi) make capital expenditures, (vii) engage in mergers, acquisitions or asset sales, and (viii) engage in transactions with affiliates. The 1999 bank credit facility also contains financial ratios and tests which must be met with respect to minimum coverage and leverage ratios, pro forma cash flow and maximum capital expenditures.

Restrictive covenants in our debt agreements may restrict our ability to implement our acquisition strategy.

1999 Acquisitions. In fiscal 1999, we acquired a total of 297 convenience stores in eight transactions for approximately $194.4 million, net of cash acquired. These acquisitions were funded with borrowings under the bank credit facility, proceeds from the IPO and cash on hand.

Subsequent to fiscal year end 1999, we acquired the operating assets of 64 stores located in North Carolina, South Carolina, Georgia and Florida. We funded these transactions with proceeds from the acquisition facility and cash on hand.

Capital Expenditures. Capital expenditures (excluding all acquisitions) for fiscal 1999 were $47.6 million. Capital expenditures are primarily expenditures for existing store improvements, store equipment, new store development, information systems and expenditures to comply with regulatory statutes, including those related to environmental matters. We finance substantially all capital expenditures and new store development through cash flow from operations, a sale-leaseback program or similar lease activity, vendor reimbursements and asset dispositions.

Our sale-leaseback program includes the packaging of our owned convenience store real estate, both land and buildings, for sale to investors in return for their agreement to leaseback the property to us under long-term leases. Generally, the leases are operating leases at market rates with terms of twenty years with four five-year renewal options. The lease payment is based on market rates ranging from 10.5% to 11.5% applied to the cost of each respective property. We retain ownership of all personal property and gasoline marketing equipment. The bank credit facility limits or caps the proceeds of sale-leasebacks that we can use to fund our operations or capital expenditures. Under this sale-leaseback program, we received $10.7 million in fiscal 1999 and $4.8 million during fiscal 1998.

In fiscal 1999, we received approximately $17.5 million in sale-leaseback proceeds, vendor reimbursements for capital improvements and proceeds from asset dispositions; therefore, net capital expenditures, excluding all acquisitions, for fiscal 1999 were $30.1 million. We anticipate that net capital expenditures for fiscal 2000 will be approximately $45.0 million.

Long-Term Debt. At September 30, 1999, our long-term debt consisted primarily of $200.0 million of the senior subordinated notes, $227.5 million in term loans and $12.0 million outstanding under the acquisition facility. See "Bank Credit Facility."

We have outstanding $200.0 million of 10¼% senior subordinated notes due 2007. Interest on the senior subordinated notes is due on October 15 and April 15 of each year. The senior subordinated notes are unconditionally guaranteed, on an unsecured basis, as to the payment of

principal, premium, if any, and interest, jointly and severally, by our subsidiaries, except for PH Holding and its subsidiaries. The senior subordinated notes contain covenants that, among other things, restrict our ability and any restricted subsidiary's ability to (i) pay dividends or make distributions, except in amounts not in excess of a percentage of our net income of proceeds of debt or equity issuances and in amounts not in excess of $5.0 million, (ii) issue stock of subsidiaries, (iii) make investments of non-affiliated entities, except employee loans of up to $3.0 million, (iv) repurchase stock, except stock owned by employees in amounts not in excess of $2.0 million with the proceeds from debt or equity issuances, (v) incur liens not securing debt permitted under the senior subordinated notes, (vi) enter into transactions with affiliates, (vii) enter into sale-leaseback transactions, or (viii) engage in mergers or consolidations.

We can incur debt under the senior subordinated notes if its ratio of pro forma EBITDA to fixed charges, after giving effect to such incurrence, is at least 2 to 1. Even if we do not meet this ratio we can incur: (i) bank credit facility debt of up to $50.0 million of acquisition debt and other debt in an amount equal to the greater of $45.0 million or an amount equal to 4.0% times our annualized revenues, (ii) capital leases or acquisition debt in amounts not to exceed in the aggregate 10% of its tangible assets at time of incurrence, (iii) intercompany debt, (iv) pre-existing debt, (v) up to $15.0 million in any type of debt, or (vi) debt for refinancing of the above described debt.

The senior subordinated notes also place conditions on the terms of asset sales or transfers and require us either to reinvest the proceeds of an asset sale or transfer, or, if we do not reinvest those proceeds, to pay down our bank credit facility or other senior debt or to offer to redeem our senior subordinated notes with any asset sale proceeds not so used. Up to 35% of the senior subordinated notes may be redeemed prior to October 15, 2000 at a redemption price of 110.25% plus accrued interest with the net proceeds of one or more public equity offerings. All of the senior subordinated notes may be redeemed after October 15, 2002 at a redemption price which begins at 105.125% and decreases to 100.0% after October 2005.

Cash Flows from Financing Activities. We used proceeds from our 1999 bank credit facility, our IPO, our cash on hand and the net proceeds of approximately $1.2 million from the sale of common stock to employees under our stock subscription plan to finance:

- fiscal 1999 acquisitions,
- the redemption of $49.0 million of senior notes,
- the redemption of $17.5 million of preferred stock,
- the payment of $6.5 million in preferred dividends, and
- the related fees and expenses.

Cash Requirements. We believe that cash on hand, together with cash flow anticipated to be generated from operations, short-term borrowing for seasonal working capital, permitted borrowings under our credit facilities and permitted borrowings by our unrestricted subsidiary will be sufficient to enable us to satisfy anticipated cash requirements for operating, investing and financing activities, including debt service, for the next twelve months.

Shareholders' Equity. As of September 30, 1999, our shareholders' equity totaled $104.2 million. The increase in shareholders' equity of $64.9 million is attributed to the proceeds from our IPO and our current year net income of $7.7 million.

Additional paid-in capital is impacted by the accounting treatment applied to a 1987 leveraged buyout of the outstanding common stock of our predecessor which resulted in a debit to equity of $17.1 million. This debit had the effect, among others, of offsetting $7.0 million of equity capital invested in us by our shareholders.

Environmental Considerations. We make certain expenditures to comply with various federal, state and local environmental laws and regulations governing underground storage tanks. Environmental reserves of $15.4 million as of September 30, 1999, represent estimates for future expenditures for remediation, tank removal and litigation associated with the 233 known contaminated sites as a result of releases (e.g., overfills, spills and underground storage tank releases) and are based on current regulations, historical results and certain other factors. Although we can make no assurances, we anticipate that we will be reimbursed for a portion of these expenditures from state trust funds and private insurance. As of September 30, 1999, amounts which are probable of reimbursement (based on our experience) from those sources total $13.1 million and are recorded as long-term environmental receivables. These receivables are expected to

be collected within a period of twelve to eighteen months after the reimbursement claim has been submitted. In Florida, remediation of such contamination will be performed by the state and we expect substantially all of the costs will be paid by the state trust fund. We will perform remediation in other states through independent contractor firms engaged by us. For certain sites the trust fund does not cover a deductible or has a co-pay which may be less than the cost of such remediation.

We have reserved $.5 million to cover third-party claims for environmental conditions at adjacent real properties that are not covered by state trust funds or by private insurance. This reserve is based on management's best estimate of losses that may be incurred over the next several years based on, among other things, the average remediation cost for contaminated sites and our historical claims experience. Although we are not aware of releases or contamination at other locations where we currently operate or have operated stores, any such releases or contamination could require substantial remediation costs, some or all of which may not be eligible for reimbursement from state trust funds.

Several of the locations identified as contaminated are being cleaned up by third parties who have indemnified us as to responsibility for cleanup matters. Additionally, we are awaiting closure notices on several other locations which will release us from responsibility related to known contamination at those sites. These sites continue to be included in our environmental reserve until a final closure notice is received.

Year 2000 Initiative

The following discussion about the implementation of our Year 2000 program, the costs expected to be associated with the program and the results we expect to achieve constitute forward-looking information. As noted below, there are many uncertainties involved with the Year 2000 issue, including the extent to which we will be able to adequately provide for contingencies that may arise, as well as the broader scope of the Year 2000 issue as it may affect third parties and our trading partners. Accordingly, the costs and results of our Year 2000 program and the extent of any impact on our results of operations could vary materially from that stated herein.

The Year 2000 issue is the result of computer programs being written using two digits rather than four to define the applicable year in respective date fields. We use a combination of hardware devices run by computer programs at our support centers and retail locations to process transactions and other data which are essential to our business operations. The Year 2000 issue and its impact on data integrity could result in system interruptions, miscalculations or failures causing disruptions of operations.

We completed 90% of our assessment phase of Year 2000 vulnerability early in fiscal year 1998, after a formal third-party assessment was completed in November 1997. Assessment activities found that 30% of our systems would require remediation and 20% of our systems were planned for replacement or would be best served if replaced. Based on this third-party assessment, internal assessment, and project results as of December 16, 1999, we believe all system modifications, hardware and software replacements or upgrades and related testing have been completed.

We have tested, modified or replaced, or plan to modify or replace our existing systems and related hardware which did not properly interpret dates beyond December 31, 1999 to ensure Year 2000 compliance. We have assessed software and technology infrastructures, embedded systems such as microchips in point-of-sale systems, fuel consoles and office equipment, and building facilities such as telephone-related systems, HVAC and security. Our testing methodology plan included, but was not limited to, rolling dates forward to critical dates in the future and simulating transactions, inclusion of several critical date scenarios, and utilizing software programs which test for compliance on certain equipment. Our applications requiring remediation or replacement have been tested and implemented.

We initiated communications with our significant vendors, suppliers and financial institutions to determine the extent to which we are vulnerable to those third parties' failure to be Year 2000 compliant. The replies indicate that they will be Year 2000 compliant before the end of the calendar year. Specifically, our grocery wholesaler, McLane, has stated in their "Year 2000 Readiness Disclosure" that they are "committed to identifying and correcting all business critical Year 2000 problems by June 1, 1999." Based on these communications and presently available information, we do not anticipate any material effects related

Management's Discussion and Analysis continued

to vendor, supplier or financial institution compliance. Additionally, due to the nature of our business, Year 2000 compliance with respect to our customers is not relevant. Noncompliance by vendors, suppliers, credit card processing companies and financial institutions utilized by us could result in a material adverse effect on our financial condition and results of operations. We believe that the worst-case scenario in the event of a Year 2000 related failure would be delays in the receipt of payment from credit card processing companies and a return to manual accounting processing at our individual stores.

In addition, we have reviewed the assets acquired since our original assessment for Year 2000 compliance. This includes the acquisition of other companies, as well as procurement and service arrangements. We believe that our recently acquired assets are Year 2000 compliant. The assessments have been conducted through the due diligence process, vendor compliance communications and requests for disclosure statements as part of contract negotiations. In general, the systems and suppliers of acquired companies are the same as those used in our existing operations.

State of Readiness as of December 16, 1999

Phase	Estimated Percent Complete	Estimated Completion Date[a]
Awareness	99%	January 2000
Assessment	99%	January 2000
Remediation	Completed	September 1999
Replacement	Completed	September 1999
Testing	99%	January 2000
Contingency planning	Completed	November 1999

(a) Indicates month when work was substantially completed. We will continue to reevaluate awareness, assess acquired assets and update contingency plans as needed.

The direct and indirect costs of Year 2000 compliance have not been material to our operations or operating results. Our expenditures, which have been funded through operating cash flow, consist primarily of internal costs and expenses associated with third-party contractors. To date, our spending with contractors and consultants has been approximately $350,000.

Our Year 2000 Contingency Plan has been developed and distributed. We believe this plan provides for emergency and alternative contact numbers, and alternative procedures related to accounting for store level transactions, credit card processing, corporate accounting and payroll processing. The plan also calls for expanded help desk and external support coverage for the January 1st weekend. Our marketing staff has worked with our primary merchandise supplier, McLane, to have a standing order ready should there be any particular McLane related system problems.

While we believe our planning efforts are adequate to address our Year 2000 concerns, there can be no assurances that the systems of other companies on which our systems and operations rely will be converted on a timely basis. We cannot provide assurance that any such failure will not have a material impact on our operations.

Recently Issued Accounting Standards Not Yet Adopted

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. In June 1999, the effective date of SFAS No. 133 was extended for one year and consequently the statement is now effective for the first fiscal quarter of fiscal 2001. Earlier application of all of the provisions of SFAS No. 133 is encouraged. As of September 30, 1999, we have not determined the effect of SFAS No. 133 on our consolidated financial statements, however, we do not believe adoption of this accounting standard will have a material impact on our financial condition.

Inflation

During fiscal 1999, cigarette prices increased 33.4%. The largest increase occurred on November 23, 1998, when major cigarette manufacturers increased prices by $0.45 per pack. In September 1999, manufacturers raised cigarette prices an additional $0.10 per pack. In general, we have passed price increases to our customers. However, during fiscal 1999 as in years past, major cigarette manufacturers offered rebates to retailers, and we passed along these rebates to our customers. Based on purchase and sales information, we estimate that cigarette inflation during fiscal year 1999 accounted for 3% to 4% of the 9.6% increase in comparable store merchandise sales.

During 1999, wholesale gasoline fuel prices increased significantly from a low of $12 per barrel in February 1999 to a high of $26 per barrel in September 1999. Generally we pass along wholesale gasoline cost changes to our customers through retail price changes. Gasoline price inflation has had an impact on total revenue and gross margin percentage, however, this inflation has not materially impacted gross margin dollars.

General CPI increased 2.6% during fiscal 1999 and food at home, which is most indicative of our merchandise inventory, increased 2.0%. While we have generally been able to pass along these price increases to our customers, we make no assurances that continued inflation will not have a material adverse effect on our sales and gross profit dollars.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Quantitative Disclosures

We are exposed to certain market risks inherent in our financial instruments. These instruments arise from transactions entered into in the normal course of business and, in some cases, relate to our acquisitions of related businesses. We are subject to interest rate risk on our existing long-term debt and any future financing requirements. Our fixed rate debt consists primarily of outstanding balances on our senior subordinated notes and our variable rate debt relates to borrowings under our bank credit facility.

On March 2, 1999, we entered into an interest rate swap arrangement with respect to $45.0 million of borrowings under our outstanding Tranche A and Tranche B term loan facilities. The interest rate swap arrangement fixes the interest rate on these borrowings at 8.62% for the Tranche A facility and 9.12% for the Tranche B facility for approximately two years.

On November 30, 1999, we entered into an interest rate swap with respect to $50 million of borrowings under our outstanding Tranche A and Tranche B term loan facilities. The interest rate swap arrangement fixes an interest rate on these borrowings at 9.28% for the Tranche A facility and 9.78% for the Tranche B facility for approximately two years.

The following table presents the future principal cash flows and weighted-average interest rates expected on our existing long-term debt instruments. Fair values have been determined based on quoted market prices as of December 16, 1999.

EXPECTED MATURITY DATE

(dollars in thousands)

As of September 30, 1999

	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Thereafter	Total	Fair Value
Long-term debt	$10,687	$19,939	$24,942	$28,196	$39,510	$317,633	$440,907	$434,907
Weighted-average interest rate	9.42%	9.46%	9.52%	9.60%	9.69%	10.08%	9.67%	

As of September 24, 1998

	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	Thereafter	Total
Long-term debt	$ 45	$ 45	$49,040	$ 45	$78,045	$200,049	$327,269
Weighted-average interest rate	10.59%	10.29%	10.25%	10.25%	10.25%	10.25%	

Quantitative Disclosures

Our primary exposure relates to:

- interest rate risk on long-term and short-term borrowings,
- our ability to refinance our senior subordinated notes at maturity at market rates,
- the impact of interest rate movements on our ability to meet interest expense requirements and exceed financial covenants, and
- the impact of interest rate movements on our ability to obtain adequate financings to fund future acquisitions.

We manage interest rate risk on our outstanding long-term and short-term debt through our use of fixed and variable rate debt. While we cannot predict or manage our ability to refinance existing debt or the impact interest rate movements will have on our existing debt, management continues to evaluate our financial position on an ongoing basis.

Consolidated Balance Sheets

(dollars in thousands)	September 30, 1999	September 24, 1998
ASSETS		
Current assets:		
Cash and cash equivalents	$ 31,157	$ 34,404
Receivables (net of allowance for doubtful accounts of $280 at September 24, 1998, $766 at September 30, 1999)	24,234	9,907
Inventories (Note 3)	76,237	47,809
Income taxes receivable (Note 6)	—	488
Prepaid expenses	3,497	2,216
Property held for sale	135	3,761
Deferred income taxes (Note 6)	4,849	3,988
Total current assets	140,109	102,573
Property and equipment, net (Notes 4, 5, and 7)	421,685	300,978
Other assets:		
Goodwill (net of accumulated amortization of $11,940 at September 24, 1998, $18,324 at September 30, 1999) (Note 2)	197,705	120,025
Deferred lease costs (net of accumulated amortization of $9,001 at September 24, 1998, $9,046 at September 30, 1999)	224	269
Deferred financing costs (net of accumulated amortization of $4,871 at September 24, 1998, $3,499 at September 30, 1999) (Note 5)	12,680	14,545
Environmental receivables (Note 8)	13,136	13,187
Other	8,179	3,243
Total other assets	231,924	151,269
Total assets	$793,718	$554,820

Consolidated Balance Sheets continued

(dollars in thousands)	September 30, 1999	September 24, 1998
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt (Note 5)	$ 10,687	$ 45
Current maturities of capital lease obligations (Note 7)	1,205	1,240
Accounts payable:		
Trade	85,011	49,559
Money orders	4,113	5,181
Accrued interest (Note 5)	9,928	11,712
Accrued compensation and related taxes	8,042	6,719
Income taxes payable (Note 6)	5,004	—
Other accrued taxes	13,834	7,007
Accrued insurance	8,820	5,745
Other accrued liabilities	20,976	24,348
Total current liabilities	167,620	111,556
Long-term debt (Note 5)	430,220	327,269
Other noncurrent liabilities:		
Environmental costs (Note 8)	15,402	17,137
Deferred income taxes (Note 6)	26,245	20,366
Deferred revenue (Note 8)	28,729	16,660
Capital lease obligations (Note 7)	13,472	12,129
Employment obligations	486	934
Accrued dividends on preferred stock (Note 11)	—	4,391
Other	7,347	5,074
Total other noncurrent liabilities	91,681	76,691
Commitments and contingencies (Notes 5, 7, 8 and 13)		
Shareholders' equity:		
Preferred stock, $.01 par value, 150,000 shares authorized; 17,500 issued and outstanding at September 24, 1998 and none issued and outstanding at September 24, 1999 (aggregate liquidation value: September 24, 1998—$17,500) (Note 11)	—	—
Common stock, $.01 par value, 50,000,000 shares authorized; 11,704,857 issued and outstanding at September 24, 1998, 18,111,474 issued and outstanding at September 30, 1999 (Note 10)	182	117
Additional paid-in capital (Note 11)	128,256	68,939
Shareholder loans	(937)	(215)
Accumulated deficit	(23,304)	(29,537)
Total shareholders' equity	104,197	39,304
Total liabilities and shareholders' equity	$793,718	$554,820

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Operations

(dollars in thousands, except per share amounts)	September 30, 1999 *(53 weeks)*	September 24, 1998 *(52 weeks)*	September 25, 1997 *(52 weeks)*
Revenues:			
Merchandise sales	$ 731,681	$460,798	$202,440
Gasoline sales	923,786	509,958	220,166
Commissions	23,403	14,128	4,787
Total revenues	1,678,870	984,884	427,393
Cost of sales:			
Merchandise	489,258	303,968	132,846
Gasoline	818,784	447,565	197,268
Total cost of sales	1,308,042	751,533	330,114
Gross profit	370,828	233,351	97,279
Operating expenses:			
Store expenses	214,384	140,089	60,208
General and administrative expenses	48,468	32,761	16,796
Merger integration costs (Note 2)	—	1,016	—
Depreciation and amortization	42,798	27,642	9,504
Total operating expenses	305,650	201,508	86,508
Income from operations	65,178	31,843	10,771
Other income (expense):			
Interest expense	(41,280)	(28,946)	(13,039)
Miscellaneous	852	1,776	1,293
Total other expense	(40,428)	(27,170)	(11,746)
Income (loss) before income taxes and extraordinary loss	24,750	4,673	(975)
Income tax expense (Note 6)	(10,750)	—	—
Income (loss) before extraordinary loss	14,000	4,673	(975)
Extraordinary loss (Note 5)	(3,584)	(7,998)	—
Net income (loss)	$ 10,416	$ (3,325)	$ (975)
Net income (loss) applicable to common shareholders (Note 14)	$ 6,233	$ (6,267)	$ (6,279)
Earnings per share (Note 14):			
Basic:			
Income (loss) before extraordinary item	$ 0.71	$ 0.18	$ (1.08)
Extraordinary loss	$ (0.26)	$ (0.82)	—
Net income (loss)	$ 0.45	$ (0.64)	$ (1.08)
Diluted:			
Income (loss) before extraordinary item	$ 0.65	$ 0.16	$ (1.08)
Extraordinary loss	$ (0.24)	$ (0.73)	—
Net income (loss)	$ 0.41	$ (0.57)	$ (1.08)

The accompanying notes are an integral part of these consolidated financial statements.

Shareholders' Equity (Deficit)

	Preferred Stock		Common Stock							
(dollars in thousands)	Shares	Par Value	Shares	Par Value	Additional Paid-In Capital	Other[1]	Total Additional Paid-In Capital	Shareholder Loans	Accumulated Deficit	Total
Balance, September 26, 1996	25,999	$—	5,815,479	$ 58	$ 6,495	$(17,109)	$(10,614)	$ —	$(16,991)	$(27,547)
Net loss	—	—	—	—	—	—	—	—	(975)	(975)
Net proceeds from stock and warrants issued	17,500	—	—	—	15,953	—	15,953	—	—	15,953
Dividends on preferred stock	—	—	—	—	—	—	—	—	(5,304)	(5,304)
Balance, September 25, 1997	43,499	—	5,815,479	58	22,448	(17,109)	5,339	—	(23,270)	(17,873)
Net loss	—	—	—	—	—	—	—	—	(3,325)	(3,325)
Issuances of common stock	—	—	5,889,378	59	57,092	—	57,092	(215)	—	56,936
Contribution of Series A preferred stock and related dividends to additional paid-in capital	(25,999)	—	—	—	6,508	—	6,508	—	—	6,508
Dividends on preferred stock	—	—	—	—	—	—	—	—	(2,942)	(2,942)
Balance, September 24, 1998	17,500	—	11,704,857	117	86,048	(17,109)	68,939	(215)	(29,537)	39,304
Net loss	—	—	—	—	—	—	—	—	10,416	10,416
Issuances of common stock	—	—	156,617	2	1,788	—	1,788	(722)	—	1,068
Public sale of common stock at $13.00 per share, net of expenses	—	—	6,250,000	63	72,916	—	72,916	—	—	72,979
Redemption of Series B preferred stock	(17,500)	—	—	—	(15,387)	—	(15,387)	—	(2,113)	(17,500)
Dividends on preferred stock	—	—	—	—	—	—	—	—	(2,070)	(2,070)
Balance, September 30, 1999	—	$—	18,111,474	$182	$145,365	$(17,109)	$128,256	$(937)	$(23,304)	$104,197

(1) Represents excess of amount paid in 1987 leveraged buyout over net book value for "carry over" shareholders. See Note 1.

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

Year Ended (dollars in thousands)	September 30, 1999 (53 weeks)	September 24, 1998 (52 weeks)	September 25, 1997 (52 weeks)
Cash Flows from Operating Activities:			
Net income (loss)	$ 10,416	$ (3,325)	$ (975)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Extraordinary loss	3,406	2,006	—
Depreciation and amortization	42,798	27,642	9,504
Provision for deferred income taxes	530	138	371
(Gain) loss on sale of property and equipment	4,484	531	(1,054)
Provision for environmental expenses	(1,735)	6,181	1,574
Provision for closed stores	—	50	(11)
Changes in operating assets and liabilities, net of effects of acquisitions:			
Receivables	9,454	(8,512)	(527)
Inventories	(11,155)	(4,518)	(2,273)
Prepaid expenses	(7)	390	(429)
Other noncurrent assets	(1,540)	5,111	(4,295)
Accounts payable	19,103	13,896	603
Other current liabilities and accrued expenses	(17,425)	2,241	3,393
Employment obligations	(448)	(407)	(698)
Other noncurrent liabilities	10,686	6,608	2,155
Net cash provided by operating activities	68,567	48,032	7,338
Cash Flows from Investing Activities:			
Additions to property held for sale	(178)	(5,203)	(1,828)
Additions to property and equipment	(47,416)	(42,067)	(14,749)
Proceeds from sale-leaseback transactions	10,724	4,807	1,345
Proceeds from sale of property and equipment	2,366	7,648	2,315
Acquisitions of related businesses, net of cash acquired	(194,414)	(250,592)	(12,162)
Net cash used in investing activities	(228,918)	(285,407)	(25,079)
Cash Flows from Financing Activities:			
Principal repayments under capital leases	(1,495)	(1,424)	(303)
Principal repayments of long-term debt	(184,888)	(51,543)	(26)
Proceeds from issuance of long-term debt	297,000	278,508	200
Redemption of Series B preferred stock	(17,500)	—	—
Net proceeds from initial public offering	72,979	—	—
Net proceeds from other stock issuances	1,068	56,935	15,953
Accrued dividends paid on preferred stock	(6,461)	—	—
Other financing costs	(3,599)	(14,044)	(74)
Net cash provided by financing activities	157,104	268,432	15,750
Net increase (decrease)	(3,247)	31,057	(1,991)
Cash and Cash Equivalents at Beginning of Year	34,404	3,347	5,338
Cash and Cash Equivalents at End of Year	$ 31,157	$ 34,404	$ 3,347

The accompanying notes are an integral part of these consolidated financial statements.

Notes to Consolidated Financial Statements

1 HISTORY OF COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The Pantry

The consolidated financial statements include the accounts of The Pantry, Inc. (the "Company" or "The Pantry") and its wholly-owned subsidiaries, Sandhills, Inc., Lil' Champ Food Stores, Inc. and its wholly-owned subsidiary, Miller Enterprises Inc., Global Communications, Inc., PH Holding Corporation and PH Holding's wholly-owned subsidiaries, TC Capital Management, Inc. and Pantry Properties, Inc. All intercompany transactions and balances have been eliminated in consolidation. The Pantry owns and operates approximately 1,215 convenience stores in Florida (533), North Carolina (336), South Carolina (232), Kentucky (45), Indiana (20), Tennessee (19), Virginia (18) and Georgia (12).

During fiscal 1996, Freeman Spogli & Co. ("Freeman Spogli") and Chase Manhattan Capital Corporation ("Chase") acquired a controlling interest in the Company through a series of transactions which included the purchase of common stock from certain shareholders and the purchase of newly issued common and preferred stock. During fiscal years 1997 and 1998, the Company issued additional shares of common and preferred stock to existing shareholders and certain directors and executives of the Company. As of September 30, 1999, Freeman Spogli owns 9,349,524 shares of common stock and warrants to purchase 2,346,000 shares of common stock which represents beneficial ownership of approximately 57.2% of our outstanding shares, including shares underlying warrants. Subsequent to September 30, 1999, Freeman Spogli purchased an additional 420,000 shares, giving them beneficial ownership of approximately 59.2% of the outstanding common stock (including shares underlying warrants) (unaudited). Chase and its affiliates own 2,298,438 shares of common stock, or 12.7% of the outstanding shares.

On June 8, 1999, we offered and sold 6,250,000 shares of our common stock in our initial public offering (the "IPO"). The initial offering price was $13.00 per share and the Company received $75.6 million in net proceeds, before expenses. The net proceeds were used (i) to repay $19.0 million in indebtedness under the 1999 bank credit facility, (ii) to redeem $17.5 million in outstanding preferred stock, and (iii) to pay accrued dividends on the preferred stock of $6.5 million. Of the remaining $32.6 million, $30.2 million was used to fund acquisitions closed during the fourth quarter and $2.4 million was reserved to pay fees and expenses associated with the IPO.

Accounting Period

The Pantry operates on a 52 or 53 week fiscal year ending on the last Thursday in September. For 1997 and 1998, The Pantry's fiscal years contained 52 weeks and for 1999, The Pantry's fiscal year contained 53 weeks.

Acquisition Accounting

Generally, our acquisitions are accounted for under the purchase method of accounting whereby purchase price is allocated to assets acquired and liabilities assumed based on fair value. Excess of purchase price over fair value of net assets acquired is recorded as goodwill. Accordingly, the Consolidated Statements of Operations for the fiscal years presented includes the results of operations for each of the acquisitions from the date of acquisition only.

On August 13, 1987, Montrose Pantry Acquisition Corporation acquired all of our common stock in a leveraged buyout. Certain individuals and entities which held an ownership interest retained approximately 45% ownership after the leveraged buyout and a new basis of accounting was established which resulted in a partial step-up in basis. In accordance with EITF 88-16 and to the extent that certain individuals and entities maintained their equity interests, the excess amount paid over net book value was recorded as a debit in shareholders' deficit ($17,109,000).

Cash and Cash Equivalents

For purposes of the consolidated financial statements, cash and cash equivalents includes cash on hand, demand deposits and short-term investments with original maturities of three months or less.

Inventories

Inventories are valued at the lower of cost or market. Cost is determined using the last-in, first-out method, except for gasoline inventories for which cost is determined using the first-in, first-out method.

Notes to Consolidated Financial Statements

continued

Property Held for Sale

Property is classified as current assets when management's intent is to sell these assets in the ensuing fiscal year and is recorded at the lower of cost or fair value less cost to sell.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization is provided primarily by the straight-line method over the estimated useful lives of the assets for financial statement purposes and by accelerated methods for income tax purposes.

Estimated useful lives for financial statement purposes are as follows:

Buildings	20 to 33½ years
Gasoline equipment	7 to 10 years
Other equipment, furniture and fixtures	3 to 10 years
Automobiles	3 to 5 years

Upon sale or retirement of depreciable assets, the related cost and accumulated depreciation are removed from the accounts and any gain or loss is recognized. Leased buildings capitalized in accordance with SFAS No. 13, Accounting for Leases, are recorded at the lesser of fair value or the discounted present value of future lease payments at the inception of the leases. Amounts capitalized are amortized over the estimated useful lives of the assets or terms of the leases (generally 5 to 20 years) using the straight-line method.

Goodwill

Goodwill, which represents the excess of purchase price over fair value of net assets acquired, is amortized on a straight-line basis over periods of 20 to 40 years. The Pantry considers legal, contractual, regulatory, obsolescence and competitive factors in determining the useful life and amortization period of this intangible asset. Additions to goodwill and increases in goodwill amortization expense primarily relate to our acquisition of the stock or assets of convenience store operators. The useful life of the associated goodwill is either indefinite for real property purchased or tied directly to leases with terms, including renewal options of 30 to 40 years. The Pantry assesses the recoverability of this intangible asset by determining whether amortization of the goodwill balance over its remaining life can be recovered through estimated undiscounted future operating results. Estimated future results are based on a trend of historical results for the trailing three fiscal years and management's estimate of future results which indicate that the goodwill balances will be recovered over the various periods remaining to be benefited.

Long-Lived Assets

Long-lived assets are reviewed for impairment on a store-by-store basis whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When an evaluation is required, the projected future undiscounted cash flows due to each store are compared to the carrying value of the long-lived assets, including an allocation of goodwill if appropriate, of that store to determine if a write-down to fair value is required.

Deferred Lease Cost

Deferred lease cost represents the value assigned to favorable leases acquired. Such amounts are being amortized over the remaining term of the respective leases.

Deferred Financing Cost

Deferred financing cost represents expenses related to issuing The Pantry's long-term debt, obtaining its lines of credit and obtaining lease financing. See Note 5—Long-Term Debt and Note 7—Leases. Such amounts are being amortized over the remaining term of the respective financing.

Vendor Allowances, Rebates and Other Vendor Payments

The Pantry receives payments for vendor allowances, volume rebates and other supply arrangements in connection with various programs. The Pantry records these payments as a reduction to cost of sales or expenses to which the particular vendor payment relates. For unearned payments, The Pantry records deferred income and amortizes the balance, as earned, over the term of the respective agreement. The amounts recorded against cost of sales were $9.0 million, $21.6 million and $54.7 million for fiscal years 1997, 1998 and 1999, respectively.

Environmental Costs

The Pantry accounts for the cost incurred to comply with federal and state environmental regulations as follows:

- The environmental reserve reflected in the financial statements is based on internal and external estimates of the costs to remediate sites relating to the operation of underground storage tanks. Factors considered in the estimates of the reserve are:
  - the expected cost to remediate each contaminated site
  - the estimated length of time to remediate each site
- Future remediation costs for amounts of deductibles under or amounts not covered by state trust fund programs and third-party insurance arrangements and for which the timing of payments can be reasonably estimated are discounted using a 10% rate. All other environmental costs are provided for on an undiscounted basis.
- Amounts which are probable of reimbursement under state trust fund programs or third-party insurers, based on The Pantry's experience, are recognized as receivables and are expected to be collected within a period of twelve to eighteen months after the reimbursement claim has been submitted. These receivables exclude all deductibles and an estimate for uncollectible reimbursements. The Pantry's reimbursement experience exceeds a 95% collection rate. The adequacy of the liability and uncollectible receivable reserve is evaluated quarterly and adjustments are made based on updated experience at existing sites, newly identified sites and changes in governmental policy.
- Annual fees for tank registration and environmental compliance testing are expensed as incurred.
- Expenditures for upgrading tank systems including corrosion protection, installation of leak detectors and overfill/spill devices are capitalized and depreciated over the remaining useful life of the asset or the respective lease term, whichever is less.
- The tank removal costs associated with locations which The Pantry plans to sell or dispose of in the near future are estimated annually and a liability is established through a charge to expense. The costs to remove tanks at active locations are expensed as incurred.

Income Taxes

All operations of The Pantry and its subsidiaries are included in a consolidated federal income tax return. Pursuant to SFAS No. 109, Accounting for Income Taxes, The Pantry recognizes deferred tax liabilities and assets for the expected future tax consequences of temporary differences between financial statement carrying amounts and the related tax bases.

Excise and Use Taxes

The Pantry collects and remits various federal and state excise taxes on petroleum products. Sales and cost of sales included approximately $61,192,000, $154,954,000 and $303,466,000 for 1997, 1998 and 1999, respectively.

Advertising costs

Advertising costs are expensed as incurred. Advertising expense was approximately $581,000, $1,019,000 and $1,694,000 for fiscal 1997, 1998 and 1999, respectively.

Stock-Based Compensation

The Pantry's stock option plan is accounted for in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. The Pantry follows the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation.

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 liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Segment Reporting

In 1999, The Pantry adopted SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, which establishes annual and interim reporting standards for an enterprise's business segments and related disclosures about its products, services, geographic areas and major customers. The Pantry operates in one reportable segment.

Notes to Consolidated Financial Statements

continued

Reclassifications

Certain amounts in the fiscal 1997 and 1998 consolidated financial statements have been reclassified to conform to the current year presentation.

Newly Adopted Accounting Standards and Recently Issued Accounting Standards Not Yet Adopted

In June 1997, the Financial Accounting Standards Board issued SFAS No. 130, Reporting Comprehensive Income. SFAS No. 130 establishes standards for reporting and display of comprehensive income and its components (revenues, expenses, gains and losses) in a full set of general-purpose financial statements. SFAS No. 130 requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. This Statement requires that an enterprise:

- classify items of other comprehensive income by their nature in a financial statement
- display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position

SFAS No. 130 is effective for fiscal 1999. The adoption of SFAS No. 130 did not have a material impact on The Pantry's net income or stockholders' equity as The Pantry had no differences between net income and comprehensive income.

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (i) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (ii) a hedge of the exposure to variable cash flows of a forecasted transaction, or (iii) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

Under SFAS No. 133, an entity that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk. In June 1999, the effective date of SFAS No. 133 was extended one year; consequently, the statement will now be effective for the first quarter of fiscal 2001. Earlier application of all of the provisions of SFAS No. 133 is encouraged. As of September 30, 1999, The Pantry has not determined the effect of SFAS No. 133 on its consolidated financial statements.

2 BUSINESS ACQUISITIONS:

During fiscal 1999, The Pantry acquired 297 convenience stores located in North Carolina, South Carolina, Florida, Georgia and Virginia in eight separate transactions. The transactions were accounted for by the purchase method of accounting. The 1999 acquisitions were funded from borrowings under the bank credit facility, the IPO and cash on hand.

During fiscal 1998, The Pantry acquired 643 convenience stores located in North Carolina, South Carolina, Florida and Virginia in eight separate transactions. The transactions were accounted for by the purchase method of accounting. The 1998 acquisitions were funded from borrowings under the 1998 bank credit facility, an equity investment and cash on hand.

The purchase prices have been allocated to the assets purchased and the liabilities assumed based upon the fair values on the dates of the acquisitions, as follows (amounts in thousands):

	1999	1998
Assets Acquired:		
Receivables, net	$ 23,220	$ 3,717
Inventories	17,347	28,871
Deferred income taxes	733	2,992
Prepaid expenses and other current assets	1,192	1,402
Property and equipment	120,856	204,064
Other noncurrent assets	4,308	3,696
Total assets acquired	167,656	244,742
Liabilities Assumed:		
Short-term capital lease obligation	—	1,027
Accounts payable—trade	15,308	11,098
Other liabilities and accrued expenses	20,615	36,093
Income taxes payable	6,863	—
Long-term capital lease obligations	—	11,716
Environmental remediation liabilities	—	3,150
Noncurrent deferred income taxes	5,221	20,530
Other noncurrent liabilities	4,402	9,066
Total liabilities assumed	52,409	92,680
Net tangible assets acquired	115,247	152,062
Excess of purchase price over fair value of net assets acquired	79,167	98,530
Total consideration paid, including direct costs, net of cash acquired	$194,414	$250,592

The purchase price allocations for certain of the 1999 acquisitions are preliminary estimates, based on available information, internal estimates and certain assumptions management believes are reasonable. Accordingly, the purchase price allocations are subject to finalization pending the completion of internal and external appraisals of assets acquired. The excess of the purchase prices over fair values of the net assets acquired for all acquisitions has been recorded as goodwill, which is being amortized on a straight-line basis over 30 years.

The following unaudited pro forma information presents a summary of consolidated results of operations of The Pantry and acquired businesses as if the 1999 transactions occurred at the beginning of the fiscal year for each of the periods presented (amounts in thousands):

	1999	1998
Total revenues	$1,950,161	$1,818,546
Income before extraordinary loss	$ 12,845	$ 3,634
Net income (loss)	$ 9,261	$ (4,365)
Net income (loss) applicable to common shareholders	$ 5,078	$ (7,307)
Earnings per share applicable to common shareholders:		
Basic:		
Income before extraordinary loss	$ 0.63	$ 0.07
Extraordinary loss	(0.26)	(0.82)
Net income (loss)	$ 0.37	$ (0.75)
Diluted:		
Income before extraordinary loss	$ 0.58	$ 0.06
Extraordinary loss	(0.24)	(0.73)
Net income (loss)	$ 0.34	$ (0.67)

In connection with the Lil' Champ acquisition, The Pantry recorded an integration charge of approximately $1.0 million in fiscal 1998 for costs of combining its existing businesses with the acquired businesses of Lil' Champ. The charge included:

- $300,000 for relocation costs
- $600,000 for elimination of duplicated contractual services for which there is no future economic benefit
- $100,000 for other consolidation and related expenses

The Pantry's integration plan included:

- the relocation of approximately 11 employees
- the elimination of duplicate contractual services
- conforming Lil' Champ's corporate and field operations to The Pantry's policies and procedures
- the disposal of unprofitable and unstrategic locations and operations

In accordance with generally accepted accounting principles, these integration costs were not included as part of the purchase price allocation for the Lil' Champ acquisition.

In connection with the October 23, 1997 acquisition of Lil' Champ and as contemplated at the consummation date, The Pantry sold all 48

Notes to Consolidated Financial Statements

continued

Lil' Champ store operations and idle property in the state of Georgia. The sale was completed on September 1, 1998. As required by SFAS No. 121, these assets were measured at fair value less costs to sell during the allocation period following the consummation date of the acquisition. The Pantry received cash proceeds of $2.5 million from the disposition, which approximated the carrying value of the assets. Accordingly, no gain or loss was recorded on the disposition. Revenues and net loss before taxes related to the 48 stores disposed of and included in our historical financial statements totaled approximately $30,313,000 and $(954,000), respectively, for the year ended September 24, 1998.

3 INVENTORIES:

At September 24, 1998 and September 30, 1999, inventories consisted of the following (in thousands):

	1999	1998
Inventories at FIFO cost:		
Merchandise	$ 63,941	$ 41,967
Gasoline	22,431	11,510
	86,372	53,477
Less adjustment to LIFO cost:		
Merchandise	(10,135)	(5,668)
Inventories at LIFO cost	$ 76,237	$ 47,809

The positive effect on cost of sales of LIFO inventory liquidations was $4,000, $482,000 and $53,000 for fiscal years 1997, 1998 and 1999, respectively.

4 PROPERTY AND EQUIPMENT:

At September 24, 1998 and September 30, 1999, property and equipment consisted of the following (in thousands):

	1999	1998
Land	$ 86,708	$ 62,183
Buildings	125,875	85,278
Gasoline equipment	115,530	95,729
Other equipment, furniture and fixtures	140,600	96,874
Leasehold improvements	51,218	28,286
Automobiles	787	516
Construction in progress	10,072	9,443
	530,790	378,309
Less—accumulated depreciation and amortization	(109,105)	(77,331)
	$ 421,685	$300,978

5 LONG-TERM DEBT:

At September 24, 1998 and September 30, 1999, long-term debt consisted of the following (in thousands):

	1999	1998
Senior subordinated notes payable; due October 15, 2007; interest payable semi-annually at 0.25%	$200,000	$200,000
Term loan facility—Tranche A; interest payable monthly at LIBOR (5.39% at September 30, 1999) plus 3.0%; principal due in quarterly installments through January 31, 2004	70,656	—
Term loan facility—Tranche B; interest payable monthly at LIBOR (5.39% at September 30, 1999) plus 3.5%; principal due in quarterly installments through January 31, 2006	156,794	—
Acquisition facility; interest payable monthly at LIBOR (5.39% at September 30, 1999) plus 3.0%; principal due in quarterly installments beginning April 30, 2001 through January 31, 2004	12,000	—
Senior notes payable; due November 15, 2000; interest payable semi-annually at 12%	—	48,995
1998 bank credit facility; interest payable monthly at LIBOR (5.85% at September 24, 1998) plus 2.5%; principal due in quarterly installments through October 31, 2002	—	78,000
Note payable; zero (0.0%) interest; principal due in annual installments through February 26, 2003	1,185	—
Other notes payable; various interest rates and maturity dates	272	319
	440,907	327,314
Less—current maturities	(10,687)	(45)
	$430,220	$327,269

On January 28, 1999, The Pantry redeemed $49.0 million in principal amount of senior notes and paid accrued and unpaid interest up to, but not including, the date of purchase and a 4% call premium. The repurchase of 100% of the senior

notes outstanding, the payment of accrued interest and the call premium were financed with proceeds from The Pantry's term loan facilities and a draw under the revolving credit facility.

The Pantry recognized an extraordinary loss of approximately $5.9 million ($3.6 million net of tax benefit) in connection with the repurchase of the senior notes including the payment of the 4% call premium of $2.0 million, fees paid in connection with the amendments and commitments under the bank credit facility and the write-off of deferred financing costs related to our repayment of our former credit facility.

On October 23, 1997, in connection with the Lil' Champ acquisition, The Pantry completed the offering of the senior subordinated notes and, in a related transaction, completed the tender offer and consent solicitation with respect to the senior notes. The tender offer resulted in The Pantry's purchase of $51 million in principal amount of the senior notes at a purchase price of 110% of the aggregate principal amount plus accrued and unpaid interest and other related fees. In connection with this repurchase, The Pantry incurred an extraordinary loss of approximately $8.0 million related to costs of the tender offer and consent solicitation and write-off of deferred financing costs.

The senior subordinated notes are unconditionally guaranteed, on an unsecured senior subordinated basis, as to the payment of principal, premium, if any, and interest, jointly and severally, by all guarantors. See Note 15—Supplemental Guarantors Information. The senior subordinated notes contain covenants that, among other things, restrict the ability of The Pantry and any restricted subsidiary to (i) incur additional debt, (ii) pay dividends or make distributions, (iii) issue stock of subsidiaries, (iv) make certain investments or repurchase stock, (v) create liens, (vi) enter into transactions with affiliates or sale-leaseback transactions, and (vii) merge or consolidate The Pantry or any of its subsidiaries or sell or transfer assets. The senior subordinated notes also contain financial ratios and tests which must be met with respect to minimum coverage and leverage ratios, pro forma cash flow and capital expenditures.

During fiscal 1998, the 1998 bank credit facility was amended to increase the amount available to The Pantry for acquisitions from $30.0 million to $85.0 million. In addition, amendments were made to certain of The Pantry's financial ratios and tests including the minimum coverage and leverage ratios, pro forma cash flow and maximum capital expenditures.

On January 28, 1999, The Pantry entered into the 1999 bank credit facility, replacing the 1998 bank credit facility consisting of (i) a $45.0 million revolving credit facility available for working capital financing, general corporate purposes and issuing commercial and standby letters of credit, (ii) a $50.0 million acquisition facility available to finance acquisitions of related businesses, and (iii) term loan facilities with outstanding borrowings of $240.0 million.

On October 27, 1999, The Pantry entered into an amendment to its bank credit facility which increased the borrowing capacity to include an additional $75.0 million term loan. The term loan bears interest, at The Pantry's option, based on margins over a base rate or an adjusted Eurodollar rate. Proceeds from the term loan were used to prepay amounts outstanding under the acquisition facility and to fund acquisitions after September 30, 1999.

The 1999 bank credit facility contains covenants restricting the ability of The Pantry and any of its subsidiaries to, among other things, (i) incur additional indebtedness, (ii) declare dividends or redeem or repurchase capital stock, (iii) prepay, redeem or purchase debt, (iv) incur liens, (v) make loans and investments, (vi) make capital expenditures, (vii) engage in mergers, acquisitions or asset sales, and (viii) engage in transactions with affiliates. The 1999 bank credit facility also contains financial ratios and tests which must be met with respect to minimum coverage and leverage ratios, pro forma cash flow and maximum capital expenditures.

The Pantry used the proceeds of the term loan facilities and a $5.0 million initial draw under its revolving credit facility, along with cash on hand, to:

- finance the Miller acquisition
- repay $94.0 million outstanding under the prior bank credit facility, and replace outstanding letters of credit
- redeem its outstanding senior notes in the aggregate principal amount of $49.0 million
- pay related transaction costs

Notes to Consolidated Financial Statements

continued

As of September 30, 1999, there was $12,000,000 outstanding under the acquisition facility. The Pantry had outstanding letters of credit of $15,979,000 at September 30, 1999, issued under the revolving credit facility.

As of September 30, 1999, The Pantry was in compliance with all covenants and restrictions relating to all its outstanding borrowings.

As of September 30, 1999, substantially all of The Pantry's and its subsidiaries' net assets are restricted as to payment of dividends and other distributions.

The Pantry's long-term debt maturities for the five years following September 30, 1999 are: $10.7 million in 2000; $19.9 million in 2001; $25.0 million in 2002; $28.2 million in 2003; $39.5 million in 2004; and $317.6 million thereafter.

Subsequent to September 30, 1999, we entered into an amendment to our bank credit facility and borrowed an additional $75.0 million under our term loan facility. This term loan generally carries the same terms and conditions as our existing term loan facility. Proceeds from the term loan were used to prepay amounts outstanding under our acquisition facility and to fund acquisitions closed after September 30, 1999. We have commitments for an additional $25.0 million term loan that is expected to fund on January 31, 2000 with proceeds to be used to finance future acquisitions. With these transactions, we have approximately $79.0 million in additional borrowing capacity to fund future acquisitions.

6 INCOME TAXES:

The components of income tax expense (benefit) are summarized below (in thousands):

	1999	1998	1997
Current:			
Federal	$ 7,093	$ —	$ 163
State	800	138	(534)
	7,893	138	(371)
Deferred:			
Federal	2,488	—	371
State	369	(138)	—
	2,857	(138)	371
	$10,750	$ —	$ —

As of September 24, 1998 and September 30, 1999, deferred tax liabilities (assets) are comprised of the following (in thousands):

	1999	1998
Depreciation	$ 39,695	$ 33,969
Deferred lease cost	17	17
Inventory	2,761	3,417
Amortization	1,315	—
Other	581	1,673
Gross deferred tax liabilities	44,369	39,076
Capital lease obligations	(1,499)	(1,207)
Allowance for doubtful accounts	(301)	(108)
Environmental expenses	(345)	(2,114)
Accrued insurance reserves	(4,692)	(4,482)
Exit and employee termination costs	(1,328)	(1,293)
Other	(3,653)	(3,254)
Gross deferred tax assets	(11,818)	(12,458)
Net operating loss carryforwards	(3,223)	(7,097)
General business credits	(1,833)	(1,832)
AMT credits	(7,282)	(2,494)
Deferred tax assets valuation allowance	1,183	1,183
	$ 21,396	$ 16,378

As of September 24, 1998 and September 30, 1999, net current deferred income tax assets totaled $3,988,000 and $4,849,000, respectively, and net noncurrent deferred income tax assets (liabilities) totaled $(20,366,000) and $(26,245,000), respectively.

Reconciliations of income taxes at the federal statutory rate (34%) to actual taxes provided are as follows (in thousands):

	1999	1998	1997
Tax expense (benefit) at federal statutory rate	$ 8,415	$(1,131)	$(332)
Tax expense (benefit) at state rate, net of federal income tax expense (benefit)	1,188	(149)	(325)
Permanent differences:			
Amortization of goodwill	1,081	677	235
Other	66	52	248
Tax benefit from creation of general business credits	—	—	(151)
Valuation allowance	—	551	325
Net income tax expense	$10,750	$ —	$ —

As of September 30, 1999, The Pantry had net operating loss carryforwards, general business credits and AMT credits which can be used to offset future federal income taxes. The benefit of these carryforwards is recognized, net of a valuation allowance for a portion of the net operating losses and credits which The Pantry believes may expire unused, as deferred tax assets. Loss carryforwards as of September 30, 1999 have the following expiration dates (in thousands):

	Federal	State
2009	$ —	$ 3,158
2010	—	2,974
2011	—	10,919
2012	2,332	5,101
2013	—	13,755
2014	—	6,854
2017	9,374	—
Total loss carryforwards	$11,706	$42,761

The valuation allowance increased $325,000 in 1997, primarily to provide for operating loss carryforwards and available tax credits that more likely than not will not be realized, based on estimates of future earnings and expected timing of reversals of temporary differences. The valuation allowance increased $551,000 in 1998, which was primarily due to federal net operating losses, net of a decrease for state tax net economic loss carryovers (as discussed below).

The State of North Carolina and the State of Tennessee have assessed Sandhills, Inc., a subsidiary of The Pantry, with additional taxes plus penalties and accrued interest totaling approximately $5 million, for the periods February 1, 1992 to September 26, 1996. For the tax years ending January 26, 1993 through September 30, 1999, The Pantry has reached a preliminary settlement with the State of North Carolina, which is pending final approval by the state. Under the proposed settlement, The Pantry will reduce state net economic loss carryforwards and pay a de minimis amount of additional tax. The expected settlement is reflected in the financial statements as a reduction to state net economic losses and a reduction of deferred tax assets (and related valuation allowance). The Pantry is contesting the Tennessee assessment and believes that, in the event of a mutual settlement, the assessment amount and related penalties (approximately $250,000) would be substantially reduced. Based on this, The Pantry believes the outcome of the audits will not have a material adverse effect on The Pantry's financial condition or financial statements.

7 LEASES:

The Pantry leases store buildings, office facilities and store equipment under both capital and operating leases. The asset balances related to capital leases at September 24, 1998 and September 30, 1999 are as follows (in thousands):

	1999	1998
Buildings	$13,542	$ 12,344
Less—accumulated amortization	(1,564)	(2,142)
	$11,978	$ 10,202

Amortization expense related to capitalized leased assets was $185,000, $1,249,000, and $1,299,000 for fiscal 1997, 1998, and 1999 respectively.

Future minimum lease payments as of September 30, 1999, for capital leases and operating leases that have initial or remaining terms in excess of one year are as follows (in thousands):

Fiscal Year	Capital Leases	Operating Leases
2000	$ 2,738	$ 35,441
2001	2,591	34,112
2002	2,546	31,519
2003	2,462	29,996
2004	2,309	27,473
Thereafter	13,506	57,272
Net minimum lease payments	$26,152	$215,813
Amount representing interest (8% to 20%)	11,475	
Present value of net minimum lease payments	14,677	
Less—current maturities	1,205	
	$13,472	

Rental expense for operating leases was approximately $9,618,000, $23,758,000 and $40,551,000 for fiscal years 1997, 1998 and 1999, respectively. Some of The Pantry's leases require contingent rental payments; such amounts are not material for the fiscal years presented.

During 1997, 1998 and 1999, The Pantry entered into sale-leaseback transactions with unrelated parties with net proceeds of $1,345,000, $4,807,000 and $10,724,000, respectively. The assets sold in these transactions consisted of newly constructed or acquired convenience stores. The Pantry retained ownership of all personal property and gasoline marketing equipment at these locations.

Notes to Consolidated Financial Statements

continued

The net proceeds from these transactions approximated the carrying value of the assets at the time of sale; accordingly, any gains or losses recognized on these transactions were insignificant for all periods presented. Generally, the leases are operating leases at market rates with terms of twenty years with four five-year renewal options.

8 COMMITMENTS AND CONTINGENCIES:

As of September 30, 1999, The Pantry was contingently liable for outstanding letters of credit in the amount of $16,113,000 related primarily to several areas in which The Pantry is self-insured. The letters of credit are not to be drawn against unless The Pantry defaults on the timely payment of related liabilities.

The Pantry is involved in certain legal actions arising in the normal course of business. In the opinion of management, based on a review of such legal proceedings, the ultimate outcome of these actions will not have a material effect on the consolidated financial statements.

Unamortized Liabilities Associated with Vendor Payments

In accordance with the terms of each service or supply agreement and in accordance with generally accepted accounting principles, service and supply allowances are amortized over the life of each agreement in accordance with the specific terms. The unamortized liabilities associated with these payments as of September 24, 1998 and September 30, 1999 were $22,702,000 and $35,195,000, respectively.

McLane Company, Inc. ("McLane"). The Pantry purchases over 50% of its general merchandise from a single wholesaler, McLane. The Pantry's arrangement with McLane is governed by a five-year distribution service agreement under which McLane supplies general merchandise, including tobacco products, grocery items, health and beauty aids and other products. The Pantry receives annual service allowances based on the number of stores operating on each contract anniversary date. If The Pantry were to default under the contract or terminate the distribution service agreement prior to March 28, 2003, The Pantry must reimburse McLane the unearned, unamortized portion of the service allowance payments received to date. In accordance with the terms of the distribution service agreement and in accordance with generally accepted accounting principles, the original service allowances received and all future service allowances are amortized to cost of goods sold on a straight-line method over the life of the agreement.

Major Oil Companies. The Pantry has entered into product purchase agreements with numerous oil companies to buy specified quantities of gasoline at market prices. The length of these contracts range from five to thirteen years and in some cases include minimum annual purchase requirements. In connection with these agreements, The Pantry may receive upfront vendor allowances, volume incentive payments and other vendor assistance payments. If The Pantry were to default under the terms of any contract or terminate the supply agreement prior to the end of the initial term, The Pantry must reimburse the respective oil company for the unearned, unamortized portion of the payments received to date. In accordance with generally accepted accounting principles, these payments are amortized using the specific amortization periods in accordance with the terms of each agreement, either using the straight-line method or based on gasoline volume purchased. The Pantry has exceeded the minimum required annual purchases each year and expects to exceed the minimum required annual purchase levels in future years.

Environmental Liabilities and Contingencies

The Pantry is subject to various federal, state and local environmental laws and regulations governing underground petroleum storage tanks that require The Pantry to make certain expenditures for compliance. In particular, at the federal level, the Resource Conservation and Recovery Act, as amended, requires the EPA to establish a comprehensive regulatory program for the detection, prevention and cleanup of leaking underground storage tanks. Regulations enacted by the EPA in 1988 established requirements for:

- installing underground storage tank systems
- upgrading underground storage tank systems
- taking corrective action in response to releases
- closing underground storage tank systems
- keeping appropriate records
- maintaining evidence of financial responsibility for taking corrective action and compensating third parties for bodily injury and property damage resulting from releases

In addition to the technical standards, The Pantry is required by federal and state regulations to maintain evidence of financial responsibility for taking corrective action and compensating third parties in the event of a release from its underground storage tank systems. In order to comply with this requirement, The Pantry maintains surety bonds in the aggregate amount of approximately $900,000 in favor of state environmental agencies in the states of North Carolina, Virginia, South Carolina and Georgia, and a letter of credit in the aggregate amount of approximately $1.1 million issued by a commercial bank in favor of state environmental agencies in the states of Florida, Tennessee, Indiana and Kentucky and relies on reimbursements from applicable state trust funds. In Florida, The Pantry meets such financial responsibility requirements by state trust fund coverage through December 31, 1998 and met such requirements thereafter through a combination of private commercial liability insurance and a letter of credit.

All states in which The Pantry operates or has operated underground storage tank systems have established trust funds for the sharing, recovering and reimbursing of certain cleanup costs and liabilities incurred as a result of releases from underground storage tank systems. These trust funds, which essentially provide insurance coverage for the cleanup of environmental damages caused by the operation of underground storage tank systems, are funded by an underground storage tank registration fee and a tax on the wholesale purchase of motor fuels within each state. The Pantry has paid underground storage tank registration fees and gasoline taxes to each state where it operates to participate in these programs and has filed claims and received reimbursement in North Carolina, South Carolina, Kentucky, Indiana, Florida, Georgia and Tennessee. The coverage afforded by each state fund varies but generally provides from $150,000 to $1.0 million per site or occurrence for the cleanup of environmental contamination, and most provide coverage for third-party liabilities.

In addition to immaterial amounts to be spent by The Pantry, a substantial amount will be expended for remediation on behalf of The Pantry by state trust funds established in The Pantry's operating areas or other responsible third parties (including insurers). To the extent such third parties do not pay for remediation as anticipated by The Pantry, The Pantry will be obligated to make such payments, which could materially adversely affect The Pantry's financial condition and results of operations. Reimbursement from state trust funds will be dependent upon the maintenance and continued solvency of the various funds.

Environmental reserves of $17,137,000 and $15,402,000 as of September 24, 1998 and September 30, 1999, respectively, represent estimates for future expenditures for remediation, tank removal and litigation associated with 205 and 233 known contaminated sites, respectively, as a result of releases (e.g., overfills, spills and underground storage tank releases) and are based on current regulations, historical results and certain other factors. As of September 30, 1999, the current average remediation cost per site is approximately $70,000. Remediation costs for known sites are expected to be incurred over the next one to ten years. Environmental reserves have been established on an undiscounted basis with remediation costs based on internal and external estimates for each site. Future remediation costs for amounts of deductibles under, or amounts not covered by, state trust fund programs and third-party insurance arrangements and for which the timing of payments can be reasonably estimated are discounted using a 10% rate. The undiscounted amount of future estimated payments for which The Pantry does not expect to be reimbursed for each of the five years and thereafter at September 30, 1999 are as follows:

Fiscal Year	Expected Payments
2000	$ 186
2001	179
2002	141
2003	46
2004	20
Thereafter	2,408
Total undiscounted amounts not covered by a third party	2,980
Other current cost amounts	16,531
Amount representing interest (10%)	(4,109)
Environmental reserve	$15,402

The Pantry anticipates that it will be reimbursed for a portion of these expenditures from state trust funds and private insurance. As of September 30, 1999, anticipated reimbursements of $13,136,000 are recorded as long-term environmental receivables. In Florida, remediation of such contamination reported before January 1, 1999 will be

Notes to Consolidated Financial Statements

continued

performed by the state and substantially all of the costs will be paid by the state trust fund. The Pantry will perform remediation in other states through independent contractor firms engaged by The Pantry. For certain sites the trust fund does not cover a deductible or has a co-pay which may be less than the cost of such remediation. Although The Pantry is not aware of releases or contamination at other locations where it currently operates or has operated stores, any such releases or contamination could require substantial remediation expenditures, some or all of which may not be eligible for reimbursement from state trust funds.

The Pantry has reserved $500,000 to cover third-party claims for environmental conditions at adjacent real properties that are not covered by state trust funds or by private insurance. This reserve is based on management's best estimate of losses that may be incurred over the next several years based on, among other things, the average remediation cost for contaminated sites and our historical claims experience.

Several of the locations identified as contaminated are being cleaned up by third parties who have indemnified The Pantry as to responsibility for cleanup matters. Additionally, The Pantry is awaiting closure notices on several other locations which will release The Pantry from responsibility related to known contamination at those sites. These sites continue to be included in our environmental reserve until a final closure notice is received.

9 BENEFIT PLANS:

The Pantry sponsors a 401(k) Employee Retirement Savings Plan for eligible employees. Employees must be at least nineteen years of age and have one year of service with at least 1,000 hours worked to be eligible to participate in the plan. Employees may contribute up to 15% of their annual compensation, and contributions are matched by The Pantry on the basis of 50% of the first 5% contributed. Matching contribution expense was $305,000, $396,000 and $573,000 for fiscal years 1997, 1998 and 1999, respectively.

10 COMMON STOCK:

On June 4, 1999, the Company effected a 51 for 1 stock split of its common stock. In connection with the stock split, the number of authorized shares of common stock was increased to 50,000,000 (300,000 shares previously). The accompanying financial statements give effect to the stock split, retroactively applied to all periods presented. There was no change in par values of the common stock as a result of the stock split.

On June 8, 1999, the Company completed an initial public offering of 6,250,000 shares of its common stock at a public offering price of $13.00 per share (the "IPO"). The net proceeds from the IPO of $75.6 million, before expenses, were used (i) to repay $19.0 million in indebtedness under the 1999 bank credit facility, (ii) to redeem $17.5 million in outstanding preferred stock, and (iii) to pay accrued dividends on the preferred stock of $6.5 million. Of the remaining $32.6 million, $30.2 million was used to fund acquisitions closed during the fourth quarter and $2.4 million was reserved to pay fees and expenses associated with the IPO.

Upon completion of the IPO, Freeman Spogli owned approximately 9,349,524 shares and owned warrants for the purchase of an additional 2,346,000 shares, giving Freeman Spogli beneficial ownership of approximately 57.2% of the outstanding common stock (including shares underlying warrants). Subsequent to September 30, 1999, Freeman Spogli purchased an additional 420,000 shares, giving them beneficial ownership of approximately 59.2% of the outstanding common stock (including shares underlying warrants) (unaudited).

In 1998 and in connection with the Lil' Champ acquisition and related transactions, The Pantry issued 3,672,000 shares of common stock, par value $0.01, to certain existing shareholders and a member of management for $32.4 million. Prior to the purchase of common stock, Freeman Spogli and Chase contributed all outstanding shares of Series A preferred stock and related accrued and unpaid dividends to the capital of The Pantry. As a result, the par value of preferred stock and accrued dividends were reduced by $260 and $6,508,000, respectively, and additional paid-in capital was increased by $6,508,260.

On July 2, 1998, in connection with two acquisitions completed in July 1998, The Pantry issued 2,217,378 shares of common stock, par value $0.01 per share, to certain existing shareholders for an aggregate purchase price of $25.0 million.

11 PREFERRED STOCK:

As of September 24, 1998, preferred stock consisted of 150,000 authorized shares. As discussed in Note 10—Common Stock, holders of The Pantry's 25,999 shares of Series A preferred stock contributed all outstanding shares of Series A preferred stock and related accrued and unpaid dividends to the capital of The Pantry in connection with the Lil' Champ acquisition. Issued and outstanding shares of preferred stock at September 24, 1998 included 17,500 shares designated as Series B, all of which were held by the Freeman Spogli entities. On June 8, 1999, in conjunction with the IPO, The Pantry redeemed the outstanding preferred stock for $17.5 million and paid accrued dividends on the preferred stock of $6.5 million. As of September 30, 1999, the Company has no preferred stock issued or outstanding.

In 1999 and upon the redemption of its Series B preferred stock, The Pantry recorded a one-time dividend of $613,000 which represents the difference between the gross proceeds ($16,887,000) from the initial sale of Series B preferred stock and the consideration paid upon redemption ($17,500,000). In accordance with Emerging Issues Task Force Topic No. ("EITF") D-42, The Pantry was also required to recognize a one-time deduction to net income applicable to common stockholders (and a related reclassification to accumulated deficit) in the amount of $1,500,000 associated with original issue costs incurred in connection with the issuance of the Series B preferred stock in December 1996. At that time, the original issue costs were netted against the gross proceeds and, thus, charged to additional paid-in capital. EITF D-42 requires that the excess of fair value of the consideration transferred to the preferred shareholders over the carrying amount of the preferred stock be subtracted from net income applicable to common shareholders in the calculation of earnings per share.

12 STOCK OPTIONS AND OTHER EQUITY INSTRUMENTS:

On January 1, 1998, The Pantry adopted an incentive and non-qualified stock option plan. Pursuant to the provisions of the plan, options may be granted to officers, key employees and consultants of The Pantry or any of its subsidiaries and certain members of the board of directors to purchase up to 1,275,000 shares of The Pantry's common stock. The plan is administered by the board of directors or a committee of the board of directors. Options are granted at prices determined by the board of directors and may be exercisable in one or more installments. Additionally, the terms and conditions of awards under the plan may differ from one grant to another. Under the plan, incentive stock options may only be granted to employees with an exercise price at least equal to the fair market value of the related common stock on the date the option is granted. Fair values are based on the most recent common stock sales. During 1998, options to acquire 576,861 shares of common stock were granted under the plan with exercise prices ranging from $8.82–$11.27 per share (weighted-average exercise price of $9.39 per share).

On June 3, 1999, the Pantry adopted a new 1999 stock option plan providing for the grant of incentive stock options and non-qualified stock options to officers, directors, employees and consultants, with provisions similar to the 1998 stock option plan. During 1999, options to acquire 240,000 shares of common stock were granted under the 1999 plan with exercise prices of $13.00 per share. These options vest over three years and have contractual lives of seven years.

The following table summarizes information about stock options outstanding at September 30, 1999:

Exercise Prices	Number Outstanding at Date Issued	Weighted-Average September 30, 1999	Remaining Contractual Life	Weighted-Average Exercise Price
$ 8.82	1/1/98	443,751	8 years	$ 8.82
$11.27	8/25/98	133,110	8 years	$11.27
$13.00	6/8/99, 9/30/99	240,000	7 years	$13.00
Total		816,861		

Notes to Consolidated Financial Statements

continued

All options granted in 1998 and 1999 vest over a three-year period, with one-third of each grant vesting on the anniversary of the initial grant. There were no exercises, forfeitures or terminations of options in 1998 or 1999. All stock options are granted at estimated fair market value of the common stock at the grant date.

Had compensation cost for the plan been determined consistent with SFAS No. 123, The Pantry's pro forma net income (loss) for 1998 and 1999 would have been approximately $(3,446,000) and $10,136,000, respectively. Pro forma basic earnings (loss) per share for 1998 and 1999 would have been $(0.66) and $0.43, respectively.

Pro forma diluted earnings (loss) per share for 1998 and 1999 would have been $(0.59) and $0.39, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	1999	1998
Weighted-average grant date fair value	$2.07	$1.12
Weighted-average expected lives (years)	2.00	2.33
Weighted-average grant date fair value—exercise price equals market price	$2.24	$1.12
Weighted-average grant date fair value—exercise price greater than market price	$1.18	—
Risk-free interest rate	5.5%	5.5%
Expected volatility	0.00%–21.0%	0.00%
Dividend yield	0.00%	0.00%

On August 31, 1998, The Pantry adopted a stock subscription plan. The subscription plan allows The Pantry to offer to certain employees the right to purchase shares of common stock at a purchase price equal to the fair market value on the date of purchase. A purchaser may not sell, transfer or pledge their shares:

- prior to the first anniversary of the date on which the purchaser acquires the shares
- after the first anniversary, except in compliance with the provisions of the subscription agreement and a pledge agreement if part of the consideration for such shares includes a secured promissory note

In the event that the purchaser's employment with The Pantry and all of its subsidiaries terminates for any reason, The Pantry shall have the option to repurchase from the purchaser all or any portion of the shares acquired by the purchaser under the subscription agreement for a period of six months after the effective date of such termination. The repurchase option shall terminate upon the later to occur of:

- the first anniversary of the date the shares were originally acquired
- an initial public offering of common stock by The Pantry registered under the Securities Act (other than an offering registered on Form S-4 or Form S-8) resulting in gross proceeds to The Pantry in excess of $25 million

After the first anniversary of the date the shares were originally acquired by the purchaser, the purchaser may transfer the shares for cash (only) to a third party, subject to The Pantry's right of first refusal with respect to such sale. Finally, under certain circumstances, a purchaser of shares under the subscription plan may be forced to sell all or part of the shares purchased under such plan if Freeman Spogli finds a third-party buyer for all or part of the shares of common stock held by Freeman Spogli. No issuances of shares under the subscription plan had been made at September 24, 1998. On September 25, 1998 and November 30, 1999, 134,436 shares, net of subsequent repurchases of 6,273 shares, were sold under the subscription plan. These shares were sold at fair value ($11.27), as determined by the most recent equity investment (July 1998). In connection with these sales, The Pantry received $722,000 of secured promissory notes receivable, bearing an interest rate of 8.5%, due August 31, 2003.

In December 1996, in connection with its purchase of 17,500 shares of Series B preferred stock, Freeman Spogli acquired warrants to purchase 2,346,000 shares of common stock. The warrants are exercisable at $7.45 per share until December 30, 2006, and contain adjustment

provisions in the event The Pantry declares dividends or distributions, makes stock splits, or engages in mergers, reorganizations or reclassifications. The fair value of the warrants at date of issuance approximated $600,000 and is included in additional paid-in capital. None of these warrants had been exercised at September 30, 1999.

13 RELATED PARTIES:

Transactions With Affiliates

Stock Issuances. In December 1996, Freeman Spogli purchased 17,500 shares of Series B preferred stock and warrants to purchase 2,346,000 shares of common stock for approximately $17.5 million. The purchase price for the Series B preferred stock was $1,000.00 per share and the purchase price for each of the two warrants was $1.00. The warrants are exercisable at $7.45 per share until December 30, 2006 and contain adjustment provisions in the event The Pantry declares dividends or distributions, makes stock splits or engages in mergers, reorganizations or reclassifications. In connection with the IPO, The Pantry repurchased the Series B preferred stock from Freeman Spogli for $17.5 million, plus approximately $6.5 million in accrued dividends. See also Note 11—Preferred Stock.

In October 1997, in connection with the Lil' Champ acquisition, Freeman Spogli purchased 3,030,471 shares of common stock and Chase purchased 596,190 shares of common stock for an aggregate purchase price of approximately $32.0 million. Peter J. Sodini, The Pantry's Chief Executive Officer, purchased 45,339 shares of common stock for an aggregate purchase price of $400,050, payable $185,000 in cash and $215,050 in the form of a secured promissory note in our favor. The purchase price for the common stock was $8.82 per share. All of the outstanding Series A preferred stock was contributed back to The Pantry and cancelled at this time.

In July 1998, in connection with the acquisition of Quick Stop and the acquisition of Stallings, Freeman Spogli purchased 1,845,690 shares of common stock and Chase purchased 371,688 shares of common stock for an aggregate purchase price of $25.0 million. The purchase price for the common stock was $11.27 per share.

In November 1998, Peter Starrett, a director of The Pantry, purchased 22,185 shares of common stock for a purchase price of $250,125. Freeman Spogli has the right to require the sale of Mr. Starrett's shares in the event it sells all of its holdings of common stock.

Payments to Freeman Spogli. Transaction fees of $1.5 million and $3.0 million, for the fiscal years ended September 25, 1997 and September 24, 1998, respectively, were paid to Freeman Spogli in connection with previous investments and assistance with analyzing acquisition candidates and obtaining financing.

Stockholders' Agreement. The Pantry has a stockholders' agreement, as amended July 1998, with Freeman Spogli, Chase and Peter J. Sodini in which:

- Freeman Spogli has a right of first offer enabling it to purchase shares held by Chase or Mr. Sodini prior to transfers of shares of common stock to non-affiliates, other than transfers pursuant to a registration statement or under Rule 144
- Freeman Spogli has the right to require Chase and Mr. Sodini to sell their shares of common stock to a third-party buyer on the same terms as Freeman Spogli if Freeman Spogli is selling all of its shares
- Freeman Spogli, Chase and Mr. Sodini have rights to be included in sales of common stock by the other stockholders
- Freeman Spogli has agreed, as long as Chase holds 10% of The Pantry's common stock, to vote for a director nominated by Chase
- Transactions with affiliates will be on terms no less favorable to The Pantry than would be obtained in an arm's-length transaction and to limit the fees payable to Freeman Spogli

Notes to Consolidated Financial Statements

continued

14 EARNINGS PER SHARE:

The Pantry computes earnings per share data in accordance with the requirements of SFAS No. 128, Earnings Per Share. Basic earnings per share is computed on the basis of the weighted-average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted-average number of common shares outstanding plus the effect of outstanding warrants and stock options using the “treasury stock” method. The following table reflects the calculation of basic and diluted earnings per share (see also Note 11—Preferred Stock):

	1999	1998	1997
Net income (loss) applicable to common shareholders:			
Income (loss) before extraordinary loss	$14,000	$ 4,673	$ (975)
Preferred stock dividend requirement	(2,070)	(2,942)	(5,304)
Redemption of preferred stock in excess of carrying amount	(2,113)	—	—
Income (loss) applicable to common shareholders before extraordinary loss	9,817	1,731	(6,279)
Extraordinary loss	(3,584)	(7,998)	—
Net income (loss) applicable to common shareholders	$ 6,233	(6,267)	$(6,279)
Earnings per share—basic:			
Weighted-average shares outstanding	13,768	9,732	5,815
Income (loss) before extraordinary loss per share—basic	$ 0.71	$ 0.18	$ (1.08)
Extraordinary loss per share—basic	(0.26)	(0.82)	—
Net income (loss) per share—basic	$ 0.45	$ (0.64)	$ (1.08)
Earnings per share—diluted:			
Weighted-average shares outstanding	13,768	9,732	5,815
Dilutive impact of options and warrants outstanding	1,308	1,280	—
Weighted-average shares and potential dilutive shares outstanding	15,076	11,012	5,815
Income (loss) before extraordinary loss per share—diluted	$ 0.65	$ 0.16	$ (1.08)
Extraordinary loss per share—diluted	(0.24)	(0.73)	—
Net income (loss) per share—diluted	$ 0.41	$ (0.57)	$ (1.08)

15 SUPPLEMENTAL DISCLOSURE OF CASH FLOW:

Year Ended	September 30, 1999	September 24, 1998	September 25, 1997
Cash paid (refunded) during the year:			
Interest	$43,064	$21,826	$12,863
Taxes	$ 34	$ 784	$ (917)

SUPPLEMENTAL NONCASH INVESTING AND FINANCING ACTIVITIES

During fiscal 1998 and 1999, The Pantry entered into several business acquisitions and divestitures. See Note 2—Business Acquisitions and Note 10—Common Stock. In 1998 and in connection with the Lil’ Champ acquisition, the holders of The Pantry’s Series A preferred stock contributed all outstanding shares of Series A preferred stock and related accrued and unpaid dividends to the capital of The Pantry, resulting in an increase in paid-in capital of $6,508.

16 SUBSEQUENT EVENTS:

In four separate transactions subsequent to fiscal year end 1999, the Company acquired 64 stores located in Georgia (49), North Carolina (7), South Carolina (7) and Florida (1). These transactions were primarily funded from borrowings under the Company's bank credit facility, as amended, and cash on hand.

On October 27, 1999, the Company entered into an amendment to its bank credit facility which increased the borrowing capacity to include an additional $75.0 million term loan. The term loan bears interest, at the Company's option, based on margins over a base rate or an adjusted Eurodollar rate. Proceeds from the term loan were used to prepay amounts outstanding under the acquisition facility and to fund acquisitions closed subsequent to September 30, 1999.

17 QUARTERLY FINANCIAL DATA (unaudited):

Summary quarterly financial data for 1998 and 1999 is as follows:

	Year Ended September 30, 1999				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Total revenue	$315,607	$359,792	$456,704	$546,767	$1,678,870
Gross profit	$ 72,380	$ 83,561	$100,431	$114,456	$ 370,828
Income (loss) before income taxes and extraordinary loss	$ 1,397	$ 398	$ 9,119	$ 13,836	$ 24,750
Net income (loss)	$ 1,065	$ (3,545)	$ 5,210	$ 7,686	$ 10,416
Earnings per share before extraordinary loss:					
Basic	$ 0.03	$ (0.06)	$ 0.19	$ 0.42	$ 0.71
Diluted	$ 0.03	$ (0.06)	$ 0.18	$ 0.40	$ 0.65
Earnings per share:					
Basic	$ 0.03	$ (0.36)	$ 0.19	$ 0.42	$ 0.45
Diluted	$ 0.03	$ (0.36)	$ 0.18	$ 0.40	$ 0.41

	Year Ended September 24, 1998				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Total revenue	$195,171	$220,670	$254,577	$314,466	$ 984,884
Gross profit	$ 45,365	$ 53,287	$ 60,365	$ 74,334	$ 233,351
Income (loss) before income taxes and extraordinary loss	$ (501)	$ (2,084)	$ 3,136	$ 4,122	$ 4,673
Net income (loss)	$ (6,889)	$ (1,580)	$ 2,509	$ 2,635	$ (3,325)
Earnings per share before extraordinary loss:					
Basic	$ (0.12)	$ (0.23)	$ 0.19	$ 0.30	$ 0.18
Diluted	$ (0.12)	$ (0.23)	$ 0.18	$ 0.27	$ 0.16
Earnings per share:					
Basic	$ (0.93)	$ (0.23)	$ 0.19	$ 0.17	$ (0.64)
Diluted	$ (0.93)	$ (0.23)	$ 0.18	$ 0.15	$ (0.57)

Independent Auditors' Report

To the Board of Directors and Shareholders of
The Pantry, Inc.
Sanford, North Carolina

We have audited the accompanying consolidated balance sheets of The Pantry, Inc. ("The Pantry") and subsidiaries as of September 24, 1998 and September 30, 1999, and the related consolidated statements of operations, shareholders' equity (deficit), and cash flows for each of the three years in the period ended September 30, 1999. These financial statements are the responsibility of The Pantry'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 The Pantry, Inc. and subsidiaries as of September 24, 1998 and September 30, 1999, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 1999 in conformity with generally accepted accounting principles.

Deloitte & Touche LLP

Raleigh, North Carolina
November 17, 1999

Market Data

(a) Market Information. We have one class of common equity, our common stock, $.01 par value per share. Our common stock represents our only voting securities. There are 18,111,474 shares of common stock issued and outstanding as of December 16, 1999. Our common stock is traded on The Nasdaq Stock Market® under the symbol "PTRY." The following table sets forth for each fiscal quarter the high and low sale prices per share of common stock since the IPO as reported on the Nasdaq National Market® System through September 30, 1999.

	Price Range		Dividends on
Fiscal 1999	High	Low	Common Stock
First quarter	N/A	N/A	—
Second quarter	N/A	N/A	—
Third quarter	13⅝	12⅞	—
Fourth quarter	18 11/16	10¾	—

(b) Holders. As of December 16, 1999, there were 70 holders of record of our common stock.

(c) Dividends. During the last two fiscal years, we have not paid any cash dividends on our common stock. We intend to retain earnings to support operations and to finance expansion and do not intend to pay cash dividends on the common stock for the foreseeable future. The payment of cash dividends in the future will depend upon our ability to remove certain loan restrictions and other factors such as our earnings, operations, capital requirements, financial condition and other factors deemed relevant by our Board of Directors. The payment of any cash dividends is prohibited under restrictions contained in the indentures relating to the senior subordinated notes and our bank credit facility.

(d) Recent Sales of Unregistered Securities. In November 1998, Peter Starrett, one of our directors, purchased 22,185 shares of our common stock for a purchase price of $250,125. The shares of common stock sold to Mr. Starrett were sold in reliance upon Section 4(2) of the Securities Act as a transaction not involving any public offering. Mr. Starrett represented to us that he is an "accredited investor" as such term is defined in Rule 501 of Regulation D promulgated under the Securities Act. No underwriter was engaged in connection with this sale of securities.

CORPORATE Information

DIRECTORS

Peter J. Sodini
President and Chief Executive Officer

Todd W. Halloran
Principal
Freeman Spogli & Co.

Jon D. Ralph (2)
Principal
Freeman Spogli & Co.

Charles P. Rullman (1) (2)
Principal
Freeman Spogli & Co.

Edfred L. Shannon (1)
Private Investor

Peter M. Starrett
Consultant

Hubert E. Yarborough III (1)
Shareholder
McNair Law Firm

Board Committees:
(1) Audit Committee
(2) Compensation Committee

EXECUTIVE OFFICERS

Peter J. Sodini
President and Chief Executive Officer

Dennis R. Crook
Senior Vice President,
Administration and Gasoline Marketing

William T. Flyg
Senior Vice President, Finance,
Chief Financial Officer and Corporate Secretary

Daniel J. McCormack
Senior Vice President, Marketing

Douglas M. Sweeney
Senior Vice President, Operations

EXECUTIVE OFFICES

1801 Douglas Drive
Sanford, North Carolina 27330
Phone: 919-774-6700
Fax: 919-774-3329

TRANSFER AGENT

First Union National Bank
Corporate Trust Division
Charlotte, North Carolina

INDEPENDENT ACCOUNTANTS

Deloitte & Touche LLP
Raleigh, North Carolina

INVESTOR RELATIONS FIRM

Morgen-Walke Associates
New York, New York

ANNUAL MEETING

The annual meeting of stockholders will be held on Thursday, March 23, 2000 at 10:00AM Eastern Standard Time at the North Raleigh Hilton, 3145 Wake Forest Road, Raleigh, North Carolina 27609.

INTERNET

Additional information on The Pantry is available on the Worldwide Web at: www.ThePantry.com

COMMON STOCK INFORMATION

The Pantry has one class of common stock. The Company's common stock is traded on The Nasdaq Stock Market® under the symbol "PTRY."

Trading for the Company's common stock began on June 9, 1999. As of December 16, 1999 there were 70 holders of record. The Company has never paid dividends on the common stock and does not anticipate doing so in the foreseeable future; instead it intends to retain earnings, if any, for growth and operations.

The following table sets forth the range of the common stock since it began trading on June 9, 1999.

Fiscal 1999	High	Low
Third Fiscal Quarter ended June 24, 1999	13⅝	12⅞
Fourth Fiscal Quarter ended Sept. 30, 1999	18¹¹⁄₁₆	10¾

FINANCIAL INFORMATION

Forms 10-K and 10-Q are available without charge. Direct requests to:

William T. Flyg
Senior Vice President, Finance
The Pantry
P.O. Box 1410
Sanford, North Carolina 27330
Phone: 919-774-6700
Fax: 919-774-3329

Designed by Curran & Connors, Inc. / www.curran-connors.com