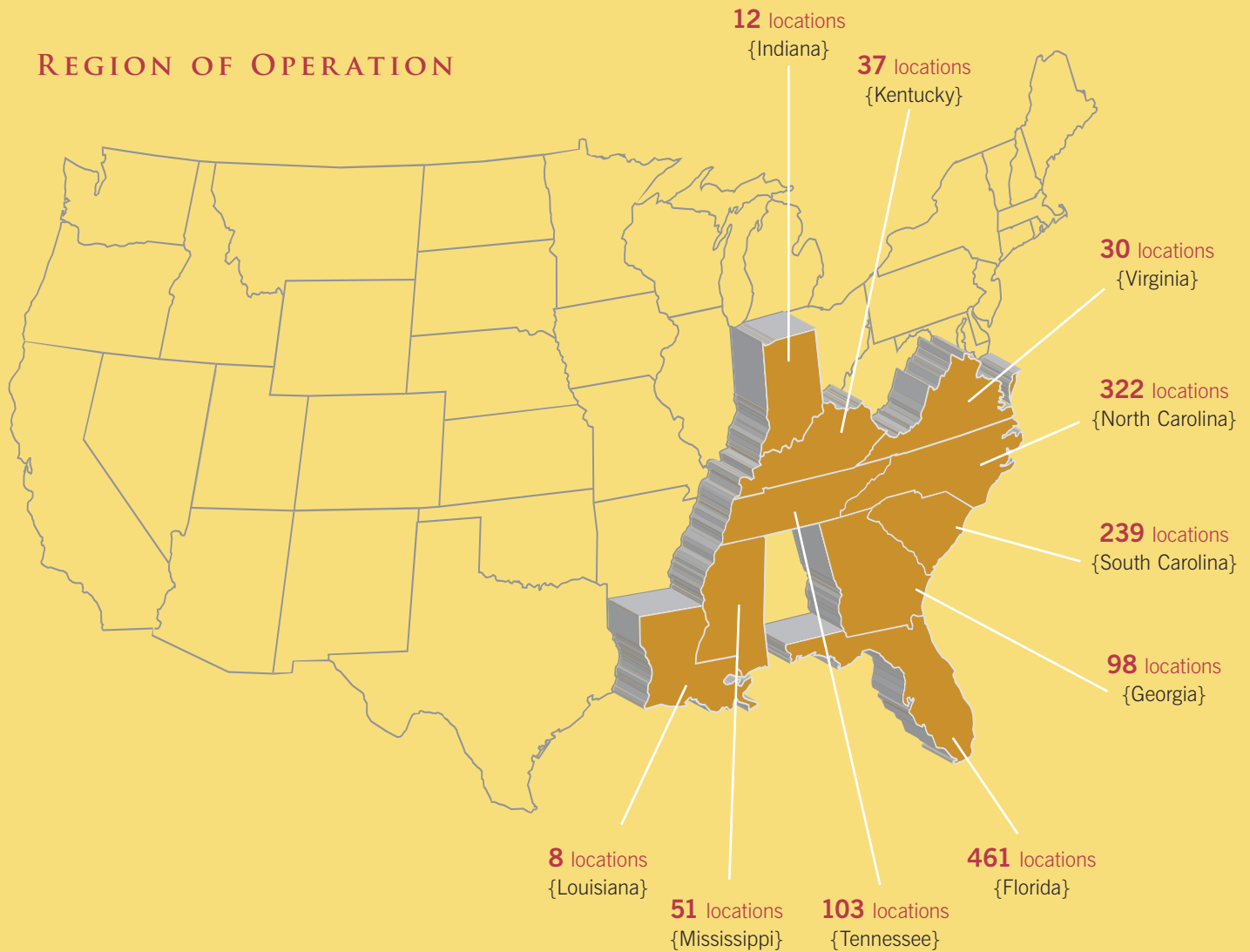


# THE PANTRY, INC.



## REGION OF OPERATION



## PROFILE

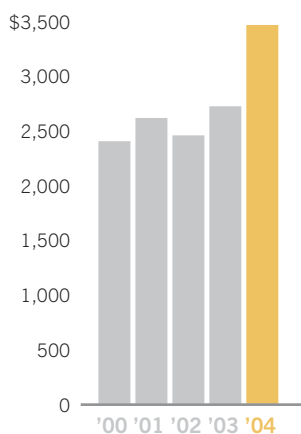
The Pantry, Inc. (NASDAQ: PTRY) is the leading independently operated convenience store chain in the southeastern United States and one of the largest in the country. As of September 30, 2004, the Company operated 1,361 stores in ten states under several banners including The Pantry®, Kangaroo Express<sup>SM</sup>, Golden Gallon®, and Lil' Champ Food Store®. Our stores offer a broad selection of merchandise, gasoline and ancillary products and services designed to appeal to the convenience needs of our customers.

## FINANCIAL HIGHLIGHTS

<i>(Dollars in thousands, except for per share information)</i>	2004	Fiscal Year 2003	2002
Total revenues	<b>\$3,493,085</b>	\$2,750,360	\$2,483,518
Gross profit	<b>590,843</b>	510,804	475,402
Depreciation and amortization	<b>56,302</b>	54,403	54,251
Income from operations	<b>96,515</b>	73,719	53,852
Interest expense	<b>47,206</b>	49,265	51,646
Net income	<b>17,553</b>	11,504	1,804
Earnings per share:			
Basic	<b>0.90</b>	0.64	0.10
Diluted	<b>0.85</b>	0.63	0.10
Comparable store sales growth:			
Merchandise	<b>3.4%</b>	0.9%	2.8%
Gasoline gallons	<b>2.0%</b>	0.7%	1.5%
Average sales per store:			
Merchandise sales	<b>856.7</b>	791.9	776.1
Gasoline gallons (in thousands)	<b>1,026.0</b>	940.7	924.2
Adjusted EBITDA	<b>154,493</b>	130,927	108,831
Store count, end of year	<b>1,361</b>	1,258	1,289

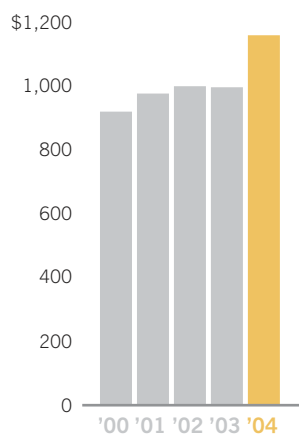
### TOTAL REVENUE

(in millions)



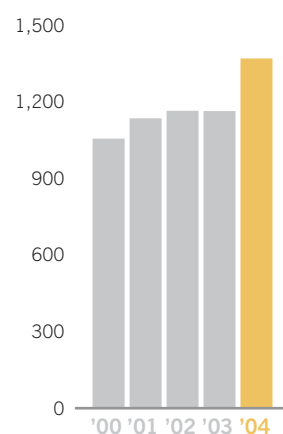
### MERCHANDISE REVENUE

(in millions)



### GASOLINE GALLONS

(in millions)





## Kangaroo Express<sup>SM</sup> Builds Momentum

To achieve a more consistent identity across the Southeast, we're moving aggressively to remodel and rebrand the merchandise operations at most of our stores under the Kangaroo Express<sup>SM</sup> banner. With a modern, clean look, most converted stores are immediately posting increased sales. More substantial returns are likely longer term as we begin leveraging our enhanced visibility among consumers.



### HIGHLIGHTS OF 2004

During fiscal 2004, more than 400 stores were converted to Kangaroo Express<sup>SM</sup> branding, bringing the total completed at year-end to 575. We are halfway to our goal of converting approximately 1,100 stores by the end of calendar 2005.

## The Science of Merchandising

When it comes to merchandising, The Pantry leaves nothing to chance. We are continually optimizing merchandise revenues and profitability by fine-tuning our product assortment, upgrading presentation in key categories, and reorganizing store layout to promote better flow. Our expanding line of private label products, including Celeste® spring water, soft drinks, sports and energy drinks, Celeste Stars™ candy, and Kangaroo® motor oil, is playing a growing role in our success.



### HIGHLIGHTS OF 2004

We sold 850,000 cases of Celeste® Spring Water and 820,000 cases of Celeste® soft drinks during fiscal 2004. With products like these, we can offer attractive prices to value-conscious consumers while still generating above-average profit margins.





## Leveraging Our **Strengths** in Gasoline Operations

To streamline our gasoline supply network and reap the benefits of our size and market presence, we negotiated new long-term supply agreements with BP®/Amoco® and Citgo® in fiscal 2003. We currently plan to convert about 1,100 of our stores to those two brands, or our own Kangaroo® brand (supplied by Citgo®). The terms on the new agreement—plus our sophisticated gasoline pricing and inventory technology—have enabled us to maintain attractive margins in a challenging market environment.



### HIGHLIGHTS OF 2004

Through our gasoline conversion and reimagining program, we increased the percentage of private label Kangaroo® gasoline sold at our stores by 35%. We also expanded our supply agreement with BP® to include approximately 70 additional stores, and locked in new terms for an additional 18 months.



## Making Convenience a Destination

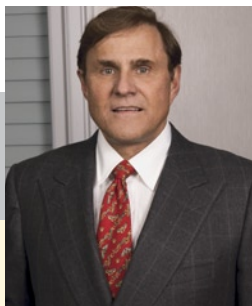
Changing demographics and lifestyles mean that more Americans are looking for meals-on-the-go. Our food service offerings—including the Bean Street Coffee Company®, The Chill Zone™ fountain and frozen drink stations, Deli Express™ sandwiches and a variety of quick service restaurant concepts—are great examples of our strategy of providing more high-quality choices at affordable prices. Increasingly, they're making our stores a “destination” for busy consumers.



### HIGHLIGHTS OF 2004

At year-end, we operated 211 quick service restaurants in our stores, including 64 Subway®s as well as Hardee's®, Church's®, and Aunt M's®. These operations generate attractive sales and profit margins in their own right, while stimulating sales in other product categories.





## LETTER TO OUR SHAREHOLDERS

In fiscal 2004, we delivered record operating results—by a wide margin. We achieved these results in the face of remarkable volatility in gasoline prices, as well as four major hurricanes that struck Florida and the Southeast during our fourth fiscal quarter. In addition, we made significant progress during the year toward a number of key strategic objectives. Overall, we believe our efforts have positioned us well for future growth, organically and through acquisition.

Total revenues for the year were \$3.5 billion, a 27% increase from fiscal 2003. Excluding financing-related charges, net income was \$33.6 million, double the previous year. On the same basis, diluted earnings per share were \$1.63, up 79% from \$0.91 in fiscal 2003; for a reconciliation to net income as reported, see page 54. Adjusted EBITDA for the year was \$154.5 million, an 18% increase. We believe these impressive results reflect the continued strong performance of our core stores, benefits from the acquisition of 138 Golden Gallon® stores, and the refinancing of virtually all our debt at significantly lower interest rates.

The Golden Gallon® acquisition, completed in October 2003, has many of the characteristics we will be looking for in potential purchases as we go forward. The Golden Gallon® stores are located in eastern Tennessee and northwest Georgia, fitting nicely into our existing geographic distribution. They are high-volume stores that are well established in their local

markets. There were a number of readily identifiable synergy opportunities, ranging from reducing corporate overhead to integrating the chain with The Pantry's favorable vendor agreements.

At the outset, we projected that Golden Gallon® would be accretive to earnings per share by \$0.40 to \$0.45 in fiscal 2004. We met that objective. The initial integration was virtually seamless, and we completed a merchandise reset of the Golden Gallon® stores less than two months after the closing. Additional benefits, including the full consolidation of the chain into our gasoline supply agreements and the rollout of additional quick service restaurants, are still to come.

### **Building Our Merchandise Momentum**

Our core convenience stores turned in another solid performance in fiscal 2004. Merchandise, the most profitable part of the business, accounted for 34% of our revenue for the year, but a full 72% of our gross profit. Taken together, our merchandise initiatives produced a 3.4% increase in comparable store sales, while total merchandise gross profit rose 16.4%. Our gross margin for the year was 36.3%, a 10 basis-point improvement over fiscal 2003.

For The Pantry, merchandising is truly a science, and our size and resources provide us with important advantages relative to many of our smaller competitors. We are continually fine-tuning our product assortment, presentation and

store layout to optimize merchandise revenues and profitability. Technology plays an important role; during fiscal 2004, we aggressively expanded our installations of checkout scanners to 939 stores, from 319 a year earlier. Scanners help us make faster and better decisions about inventory levels and product mix—customized for particular regions and even individual stores.

Our private label strategy is an important source of sales and profit growth. It allows us to offer high-margin products at an attractive price for value-conscious consumers. This year, we added Red Celeste® Energy Drinks, Sugar-Free Red Celeste® Energy Drinks, Diet Celeste® Cola, and Big Valley Beef Jerky to a line-up of private label and control label products that includes Celeste® spring water and soft drinks, and Kangaroo® motor oil. In 2005, we plan to roll out Celeste Stars™ candy and more beverages, including Celeste® Sports Drinks. The potential of our private label products is underscored by the fact that in 2004, we sold 850,000 cases of Celeste® spring water and another 820,000 cases of Celeste® soft drinks at very attractive profit margins.

We are also enthusiastic about our food service business. Bean Street Coffee Company®, The Chill Zone™ fountain and frozen drink stations, and the new Deli Express sandwich program are all examples of our strategy of making



more high-margin choices more accessible and appealing to our customers. For instance, we have added our Bean Street Coffee Company® concept in 550 stores, with another 200 planned for 2005. These upgrades have generated consistent 15% increases in category sales, as well as improved profitability. We believe the popularity of quick service restaurants (QSRs) represents yet another avenue for growth. QSRs add to our bottom line in a number of ways. In part because of their “destination” appeal to consumers, they not only generate significant sales and profits in their own right, but tend to stimulate spending in other categories. We have developed a portfolio of relationships with franchisors; currently, we have 211 QSR operations, including 64 Subway®, as well as Hardee’s®, Church’s® and our proprietary, Aunt M’s®. We continue to pursue new concepts to expand our food service offerings and are adding Quiznos Sub® in 2005.

### **A Stronger Brand Identity**

During the year, we continued to implement the gasoline conversion and reimagining programs that we launched as part of our comprehensive supply agreements with BP® Products and Citgo® Petroleum Corporation in fiscal 2003. Under those agreements, we are consolidating the gasoline operations at over 1,000 of our stores from 20 suppliers to just three: BP®/Amoco®, Citgo®, and our

own Kangaroo® gas (supplied by Citgo®). With these agreements, we agreed to either convert or reimage the stores under those brands over the subsequent two years. During fiscal 2004, we renegotiated our agreement with BP® to include 70 Golden Gallon® stores, and extended it to December 2009. This brought the total number of planned conversions or remodels to approximately 1,100. At year-end, we had completed work on 575 stores.

The new terms negotiated under our supply agreements—combined with our sophisticated proprietary pricing system—helped us to maintain our gasoline margin in fiscal 2004 at 12.0 cents per gallon (after deductions for credit card user fees and gas equipment maintenance costs). This was in line with our internal objectives and down only slightly from fiscal 2003’s 12.4 cent margin, despite the general uptrend in crude oil prices during the year from \$28 per barrel to almost \$50 and increased credit card fees. Comparable store gasoline gallons were up 2.0% for the year, and total gasoline gross profit increased 14%.

As we execute the gasoline upgrades store by store, we are also methodically rebranding the merchandise operations at these locations under our Kangaroo Express<sup>SM</sup> banner. We view this initiative as a critical component of our longer-term growth strategy. Two years ago, because

of our history of growth through acquisitions, our stores operated under nearly two dozen distinct brand names, which diluted our presence in the marketplace. When we complete the remodeling and conversion programs at the end of calendar 2005, the merchandise operations at about 1,100 of our stores—more than 80% of the total—will be unified under the Kangaroo Express<sup>SM</sup> brand. For the first time, we will be delivering a consistent and inviting experience for consumers regardless of store location. At Kangaroo Express<sup>SM</sup>, they can expect high-quality food service, hot and cold beverages, and a variety of merchandise selected to meet the needs of convenience shoppers—including both national and private label brands. We believe the emergence of Kangaroo Express<sup>SM</sup> has already raised our profile with customers and increased the impact of our promotions. Most importantly, we are seeing positive trends in merchandise sales at the remodeled stores.

### **Positioned for Future Growth**

During the year, we significantly enhanced our capability to complete more acquisitions. Thanks to our improved financial performance and the continued low interest rate environment, we were able to achieve a dramatic reduction in our interest expense while stretching out required principal payments and increasing our financial flexibility. During the second fiscal quarter, we refinanced



**Peter J. Sodini**  
*President and  
Chief Executive Officer*

**Joseph A. Krol**  
*Senior Vice President,  
Operations*

**David M. Zaborski**  
*Vice President,  
Marketing*

**Steven J. Ferreira**  
*Senior Vice President,  
Administration and  
Strategic Planning*

**Daniel J. Kelly**  
*Vice President,  
Finance and  
Chief Financial Officer*

almost all of the company's debt. First, we called our outstanding 10.25% senior-subordinated notes and issued new 10 year notes with a coupon of 7.75%. Then we renegotiated our bank facilities, achieving average savings of the same magnitude. Toward the end of the year, we negotiated another repricing of our bank debt, reducing our interest rate spread by an additional 50 basis points. Our interest expense savings in the second half of fiscal 2004 amounted to \$0.18 per share.

We finished the year with \$108 million in cash on the balance sheet, free cash flow on an annualized basis of more than \$60 million, and a leverage ratio under four times. We believe we have reduced our exposure in the event of further increases in short-term interest rates by fixing our interest rate on 80% of our debt. Overall, we believe we are very well positioned to complete additional acquisitions, and are continually reviewing a wide variety of potential opportunities. Our biggest challenge is not finding possible deals, but narrowing down the field to those that fit well with our existing store base and meet our economic criteria.

With the progress we have made across many fronts, The Pantry is a stronger, more efficient company as we move into fiscal 2005. We have clearly increased our ability to compete effectively in a dynamic industry that can be demanding, but that remains rich with opportunity. The opportunities are especially compelling in the Southeast, with its attractive demographics, and we have a strong market position across the region. We look forward to leveraging those strengths in fiscal 2005 and beyond.

With this report, we cordially welcome many new shareholders to The Pantry. In January 2004, we significantly expanded the company's ownership base and increased the stock's float with a secondary stock offering of 5.8 million shares. Shortly after the end of the fiscal year, we completed an offering of an additional 3.9 million secondary shares, as well as a forward sale agreement covering up to 1.5 million primary shares. This transaction essentially raised \$32.8 million of potential equity financing for future acquisitions.

In closing, we would like to thank all our shareholders for their ongoing loyalty and support. In addition, we want to recognize the substantial contributions of our employees and directors throughout a very successful year. Thanks to their dedication and hard work, we have achieved results beyond our expectations, and set the stage for a bright future.

Sincerely,

Peter J. Sodini  
President and Chief Executive Officer

## Selected Financial Data

The following table sets forth our historical consolidated financial data and store operating information for the periods indicated. The selected historical annual consolidated statement of operations and balance sheet data as of and for each of the five fiscal years presented are derived from, and are qualified in their entirety by, our consolidated financial statements. Historical results are not necessarily indicative of the results to be expected in the future. You should read the following data together with "Management's Discussion and Analysis of Financial Condition and Results of Operations," and our consolidated financial statements and the related notes appearing elsewhere in this report. In the following table, dollars are in millions, except per share, per store and per gallon data and as otherwise indicated.

	Fiscal Year Ended				
	September 30, 2004	September 25, 2003	September 26, 2002	September 27, 2001	September 28, 2000
<b>Statement of Operations Data:</b>					
Revenues:					
Merchandise revenue	<b>\$1,172.8</b>	\$1,009.7	\$1,012.8	\$ 990.3	\$ 933.5
Gasoline revenue	<b>2,320.2</b>	1,740.7	1,470.7	1,652.7	1,497.7
Total revenues	<b>3,493.1</b>	2,750.4	2,483.5	2,643.0	2,431.2
Gross profit:					
Merchandise gross profit	<b>425.4</b>	365.5	353.9	345.3	328.4
Gasoline gross profit	<b>165.4</b>	145.3	121.5	142.3	139.9
Total gross profit	<b>590.8</b>	510.8	475.4	487.6	468.3
Operating, general and administrative expenses	<b>438.0</b>	382.7	367.3	364.1	337.1
Restructuring and other charges	—	—	—	4.8 <sup>(a)</sup>	—
Depreciation and amortization <sup>(b)</sup>	<b>56.3</b>	54.4 <sup>(c)</sup>	54.3	63.5	56.1
Income from operations	<b>96.5</b>	73.7	53.9	55.2	75.2
Loss on debt extinguishment <sup>(d)</sup>	<b>23.1</b>	2.9	—	—	—
Interest expense	<b>47.2</b>	49.3	51.6	58.7	52.3
Income (loss) before cumulative effect adjustment	<b>17.6</b>	15.0	1.8	(2.7)	14.0
Cumulative effect adjustment, net of tax	—	(3.5) <sup>(e)</sup>	—	—	—
Net income (loss)	<b>17.6</b>	11.5	1.8	(2.7)	14.0
Earnings (loss) per share before cumulative effect adjustment:					
Basic	<b>\$ 0.90</b>	\$ 0.83	\$ 0.10	\$ (0.15)	\$ 0.77
Diluted	<b>\$ 0.85</b>	\$ 0.82	\$ 0.10	\$ (0.15)	\$ 0.74
Earnings (loss) per share:					
Basic	<b>\$ 0.90</b>	\$ 0.64	\$ 0.10	\$ (0.15)	\$ 0.77
Diluted	<b>\$ 0.85</b>	\$ 0.63	\$ 0.10	\$ (0.15)	\$ 0.74
Weighted average shares outstanding:					
Basic	<b>19,606</b>	18,108	18,108	18,113	18,111
Diluted	<b>20,669</b>	18,370	18,109	18,113	18,932
Dividends paid on common stock	—	—	—	—	—
<b>Other Financial Data:</b>					
Adjusted EBITDA <sup>(f)</sup>	<b>\$ 154.5</b>	\$ 130.9	\$ 108.8	\$120.5	\$133.2
Cash provided by (used in):					
Operating activities	<b>\$ 115.6</b>	\$ 68.3	\$ 54.0	\$ 76.7	\$ 88.2
Investing activities <sup>(g)</sup>	<b>(130.0)</b>	(22.4)	(20.3)	(93.9)	(148.7)
Financing activities	<b>49.5</b>	(15.2)	(42.0)	14.5	82.7
Gross capital expenditures <sup>(h)</sup>	<b>49.4</b>	25.5	26.5	43.6	56.4
Capital expenditures, net <sup>(i)</sup>	<b>32.8</b>	18.9	18.8	31.6	32.1
<b>Store Operating Data:</b>					
Number of stores (end of period)	<b>1,361</b>	1,258	1,289	1,324	1,313
Average sales per store:					
Merchandise revenue (in thousands)	<b>\$ 856.7</b>	\$ 791.9	\$ 776.1	\$ 747.4	\$ 734.5
Gasoline gallons (in thousands)	<b>1,026.0</b>	940.7	924.2	890.4	872.5
Comparable store sales <sup>(j)</sup> :					
Merchandise	<b>3.4%</b>	0.9%	2.8%	(0.8)%	7.1%
Gasoline gallons	<b>2.0%</b>	0.7%	1.5%	(3.8)%	(2.4)%

(continued on following page)

## Selected Financial Data (cont.)

	Fiscal Year Ended				
	September 30, 2004	September 25, 2003	September 26, 2002	September 27, 2001	September 28, 2000
<b>Operating Data:</b>					
Merchandise gross margin	<b>36.3%</b>	36.2%	34.9%	34.9%	35.2%
Gasoline gallons sold (in millions)	<b>1,376.9</b>	1,170.3	1,171.9	1,142.4	1,062.4
Average retail gasoline price per gallon	<b>\$ 1.69</b>	\$ 1.49	\$ 1.25	\$ 1.45	\$ 1.41
Average gasoline gross profit per gallon <sup>(k)</sup>	<b>\$ 0.120</b>	\$ 0.124	\$ 0.104	\$ 0.125	\$ 0.132
<b>Balance Sheet Data (end of period):</b>					
Cash and cash equivalents	<b>\$ 108.0</b>	\$ 72.9	\$ 42.2	\$ 50.6	\$ 53.4
Working capital (deficiency)	<b>62.9</b>	17.5	(43.4)	(29.8)	(4.9)
Total assets	<b>1,062.1</b>	914.2	909.7	945.4	930.9
Total debt and capital lease obligations	<b>582.8</b>	514.7	521.1	559.6	541.4
Shareholders' equity	<b>152.2</b>	128.7	115.2	111.1	118.0

- (a) During fiscal 2001, we recorded restructuring and other charges of \$4.8 million pursuant to a formal plan to centralize administrative functions.
- (b) During fiscal 2002, we adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, or SFAS No. 142, which eliminated the amortization of goodwill. Goodwill amortization expense was \$5.8 million and \$3.4 million for the fiscal years ended September 27, 2001 and September 28, 2000, respectively.
- (c) Effective March 28, 2003, we accelerated the depreciation on certain assets related to our gasoline and store branding. These changes were the result of our gasoline brand consolidation project that will result in either updating or changing the image of the majority of our stores by the end of fiscal 2005. Accordingly, we reassessed the remaining useful lives of these assets based on our plans and recorded an increase in depreciation expense of \$3.4 million.
- (d) During fiscal 2004, we recorded \$23.1 million in charges in connection with the refinancing of our senior credit facility and senior subordinated notes. These charges include the write-off of approximately \$11.8 million in unamortized deferred financing costs, the write-off of approximately \$3.5 million of original issue discount and call premiums of approximately \$7.8 million. On April 14, 2003, we entered into a new senior secured credit facility. In connection with the refinancing, we recorded a non-cash charge of approximately \$2.9 million related to the write-off of the unamortized deferred financing costs associated with the previous credit facility.
- (e) Effective September 27, 2002, we adopted the provisions of SFAS No. 143, *Accounting for Asset Retirement Obligations*, or SFAS No. 143, and, as a result, we recognize the future cost to remove an underground storage tank over the estimated useful life of the storage tank in accordance with SFAS No. 143. Upon adoption, we recorded a discounted liability of \$8.4 million, which is included in other noncurrent liabilities, increased net property and equipment by \$2.7 million and recognized a one-time cumulative effect adjustment of \$3.5 million (net of deferred income tax benefit of \$2.2 million).
- (f) Adjusted EBITDA is defined by us as net income before interest expense, income taxes, depreciation and amortization and cumulative effect of change in accounting principle. Adjusted EBITDA is not a measure of performance under accounting principles generally accepted in the United States of America, and should not be considered as a substitute for net income, cash flows from operating activities and other income or cash flow statement data. We have included information concerning Adjusted EBITDA as one measure of our cash flow and historical ability to service debt and because we believe investors find this information useful because it reflects the resources available for strategic opportunities including, among others, to invest in the business, make strategic acquisitions and to service debt. Adjusted EBITDA as defined by us may not be comparable to similarly titled measures reported by other companies.

The following table contains a reconciliation of Adjusted EBITDA to net cash provided by operating activities and cash flows from investing and financing activities (amounts in thousands):

	Fiscal Year Ended				
	September 30, 2004	September 25, 2003	September 26, 2002	September 27, 2001	September 28, 2000
Adjusted EBITDA	<b>\$ 154,493</b>	<b>\$ 130,927</b>	<b>\$ 108,831</b>	<b>\$ 120,491</b>	<b>\$ 133,163</b>
Interest expense and loss on extinguishment of debt	<b>(70,293)</b>	<b>(52,153)</b>	<b>(51,646)</b>	<b>(58,731)</b>	<b>(52,329)</b>
Adjustments to reconcile net income (loss) to net cash provided by operating activities (other than depreciation and amortization, provision for deferred income taxes and cumulative effect of change in accounting principle)	<b>30,959</b>	<b>9,016</b>	<b>3,983</b>	<b>8,592</b>	<b>1,089</b>
Changes in operating assets and liabilities, net:					
Assets	<b>(18,886)</b>	<b>(1,796)</b>	<b>(7,463)</b>	<b>9,778</b>	<b>(2,364)</b>
Liabilities	<b>19,314</b>	<b>(17,730)</b>	<b>279</b>	<b>(3,428)</b>	<b>8,600</b>
Net cash provided by operating activities	<b>\$ 115,587</b>	<b>\$ 68,264</b>	<b>\$ 53,984</b>	<b>\$ 76,702</b>	<b>\$ 88,159</b>
Net cash used in investing activities	<b>\$(129,965)</b>	<b>\$(22,357)</b>	<b>\$(20,313)</b>	<b>\$(93,947)</b>	<b>\$(148,691)</b>
Net cash provided by (used in) financing activities	<b>\$ 49,525</b>	<b>\$ (15,242)</b>	<b>\$ (42,046)</b>	<b>\$ 14,502</b>	<b>\$ 82,729</b>

- (g) Investing activities include expenditures for acquisitions.
- (h) Purchases of assets to be held for sale are excluded from gross capital expenditures.
- (i) Net capital expenditures include vendor reimbursements for capital improvements and proceeds from asset dispositions and sale-leaseback transactions.
- (j) The stores included in calculating comparable store sales growth are existing or replacement stores, which were in operation during the entire comparable period of both fiscal years. Remodeling, physical expansion or changes in store square footage are not considered when computing comparable store sales growth.
- (k) Gasoline gross profit per gallon represents gasoline revenue less costs of product and expenses associated with credit card processing fees and repairs and maintenance on gasoline equipment. Gasoline gross profit per gallon as presented may not be comparable to similarly titled measures reported by other companies.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

This discussion and analysis of our financial condition and results of operations should be read in conjunction with "Selected Financial Data" and our Consolidated Financial Statements and the related notes appearing elsewhere in this report.

### Safe Harbor Discussion

This report, including without limitation, our discussion and analysis of our financial condition and results of operations, contains statements that we believe are "forward-looking statements" under the meaning of the Private Securities Litigation Reform Act of 1995 and are intended to enjoy protection of the safe harbor for forward-looking statements provided by that Act. These forward-looking statements generally can be identified by use of phrases such as "believe," "plan," "expect," "anticipate," "intend," "forecast" or other similar words or phrases. Descriptions of our objectives, goals, targets, plans, strategies, costs and burdens of environmental remediation, anticipated capital expenditures, anticipated gasoline suppliers and percentages of our requirements to be supplied by particular companies, anticipated store banners and percentages of our stores that we believe will operate under particular banners, expected cost savings and benefits and anticipated synergies from the Golden Gallon® acquisition, anticipated costs of re-branding our stores, anticipated sharing of costs of conversion with our gasoline suppliers, and expectations regarding re-modeling, re-branding, re-imaging or otherwise converting our stores are also forward-looking statements. These forward-looking statements are based on our current plans and expectations and involve a number of risks and uncertainties that could cause actual results and events to vary materially from the results and events anticipated or implied by such forward-looking statements, including:

- Competitive pressures from convenience stores, gasoline stations and other non-traditional retailers located in our markets;
- Changes in economic conditions generally and in the markets we serve;
- Unfavorable weather conditions;
- Political conditions in crude oil producing regions, including South America and the Middle East;
- Volatility in crude oil and wholesale petroleum costs;
- Wholesale cost increases of tobacco products;
- Consumer behavior, travel and tourism trends;
- Changes in state and federal environmental and other regulations;
- Dependence on one principal supplier for merchandise and two principal suppliers for gasoline;
- Financial leverage and debt covenants;
- Changes in the credit ratings assigned to our debt securities, credit facilities and trade credit;
- Inability to identify, acquire and integrate new stores;
- The interests of our largest stockholder;

- Dependence on senior management;
- Acts of war and terrorism; and
- Other unforeseen factors.

For a discussion of these and other risks and uncertainties, please refer to "Risk Factors" beginning on page 28. The list of factors that could affect future performance and the accuracy of forward-looking statements is illustrative but by no means exhaustive. Accordingly, all forward-looking statements should be evaluated with the understanding of their inherent uncertainty. The forward-looking statements included in this report are based on, and include, our estimates as of December 7, 2004. We anticipate that subsequent events and market developments will cause our estimates to change. However, while we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if new information becomes available in the future.

### Introduction

We are the leading independently operated convenience store chain in the southeastern United States and the third largest independently operated convenience store chain in the country based on store count with 1,361 stores in ten states as of September 30, 2004. Our stores offer a broad selection of merchandise, gasoline and ancillary products and services designed to appeal to the convenience needs of our customers. Our strategy is to continue to improve upon our position as the leading independently operated convenience store chain in the southeastern United States by generating profitable growth through merchandising initiatives, sophisticated management of our gasoline business, upgrading our stores, leveraging our geographic economies of scale, benefiting from the favorable demographics of our markets and continuing to selectively pursue opportunistic acquisitions.

Fiscal 2004 was a successful year for our company as we realized benefits from several strategic and operating initiatives, which are highlighted below:

*Re-branding of Store Base.* During fiscal 2004, we made significant progress in our store re-branding/re-imaging initiative and as of September 30, 2004, have completed the gasoline conversions and/or image upgrades at a total of 575 locations, including 285 BP®/Amoco® locations, 144 Citgo® locations and 146 locations to our Kangaroo® private gas brand. All of these stores have also been converted to Kangaroo Express<sup>SM</sup> branding for their merchandise operations. We believe that a modern store base with more consistent branding under the Kangaroo Express<sup>SM</sup> banner contributed to our comparable store merchandise revenue and gasoline gallon increases of 3.4% and 2.0%, respectively, and positions us well for continued steady improvements in our comparable store performance in future periods. During fiscal 2004, we closed 37 locations due to a variety of factors, including underperformance and condemnations

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

by local departments of transportation. Historically, the stores we close are underperforming in terms of volume and profitability, and, generally, we benefit from closing the locations by reducing direct overhead expenses and eliminating certain fixed costs.

**Acquisition of Golden Gallon®.** On October 16, 2003, we completed the acquisition of 138 convenience stores operating under the Golden Gallon® banner from Ahold, USA, Inc. This acquisition included 90 stores in Tennessee and 48 stores in northwest Georgia and enhanced our strong regional presence. The integration of the Golden Gallon® stores into our base was successful and we believe that the acquisition was approximately \$0.45 accretive to fiscal 2004 earnings per share. The aggregate purchase price was approximately \$185.1 million. The acquisition included (1) the purchase of certain real estate assets (114 fee-owned stores), financed through a \$94.5 million sale-leaseback transaction and (2) the purchase of the Golden Gallon® operations and the balance of its real estate assets (17 fee-owned stores, corporate headquarters building and certain undeveloped properties) for approximately \$92.5 million in cash, financed with \$12.5 million of existing cash and \$80 million of debt through borrowings under our amended senior secured credit facility. The acquired assets also included a dairy plant and related assets and a fuel hauling operation, which we subsequently sold to two of our existing suppliers.

**Financial Restructuring and Stock Offerings.** During the second quarter of fiscal 2004, we completed a refinancing of virtually all of our long-term debt. Our new \$415.0 million senior secured credit facility, together with our offering of \$250.0 million in 10-year senior subordinated notes reduced our average borrowing rate by approximately 250 basis points. Primarily as a result of this refinancing, our interest expense for fiscal 2004 declined \$2.1 million from fiscal 2003 despite increased average outstanding borrowings as a result of the Golden Gallon® acquisition. On September 30, 2004, we amended our senior credit facility to reduce the effective rate on those borrowings by an additional 50 basis points and to increase the potential add-on term loan to fund acquisitions to \$75.0 million. In addition, we prepaid \$20.0 million in principal on the senior credit facility, which reduced our outstanding debt balance to \$567.0 million as of September 30, 2004. We believe these actions have enhanced our flexibility to further pursue our growth strategy.

During 2004, we also expanded our public stock float through two secondary offerings. In January, existing stockholders, primarily investments funds associated with Freeman Spogli & Co., or Freeman Spogli, our largest stockholder, sold 5.75 million shares of our common stock. Subsequent to

September 30, 2004, we completed another offering totaling 5.35 million shares of our common stock, with 3.85 million shares coming from funds associated with Freeman Spogli. We sold the remaining 1.5 million shares pursuant to a forward equity sale agreement with Merrill Lynch International, as forward purchaser. See Notes to Consolidated Financial Statements—Note 19—Subsequent Event. As a result of these two transactions, our shares held by non-affiliates have increased from approximately 6 million shares at the end of fiscal 2003 to approximately 16 million shares as of December 7, 2004.

### Results of Operations

Our operations for fiscal 2004 contained 53 weeks and fiscal 2003 and 2002 each contained 52 weeks. The following table presents for the periods indicated selected items in the consolidated statements of income as a percentage of our total revenue:

	September 30, 2004	Fiscal Year Ended September 25, 2003	September 26, 2002
Total revenue	<b>100.0%</b>	100.0%	100.0%
Gasoline revenue	<b>66.4</b>	63.3	59.2
Merchandise revenue	<b>33.6</b>	36.7	40.8
Cost of sales	<b>83.1</b>	81.4	80.9
Gross profit	<b>16.9</b>	18.6	19.1
Gasoline gross profit	<b>4.7</b>	5.3	4.9
Merchandise gross profit	<b>12.2</b>	13.3	14.2
Operating, general and administrative expenses	<b>12.5</b>	13.9	14.7
Depreciation and amortization	<b>1.6</b>	2.0	2.2
Income from operations	<b>2.8</b>	2.7	2.2
Loss on extinguishment of debt	<b>(0.7)</b>	(0.1)	—
Interest and miscellaneous expense	<b>(1.3)</b>	(1.8)	(2.1)
Income before income taxes	<b>0.8</b>	0.8	0.1
Income tax expense	<b>(0.3)</b>	(0.3)	—
Net income before cumulative effect adjustment	<b>0.5</b>	0.5	0.1
Cumulative effect adjustment, net of income tax	<b>—</b>	(0.1)	—
Net income	<b>0.5</b>	0.4	0.1

The table below provides a summary of our selected financial data for fiscal 2004, 2003 and 2002.

	Fiscal Year Ended		
	September 30, 2004	September 25, 2003	September 26, 2002
Merchandise margin	<b>36.3%</b>	36.2%	34.9%
Gasoline gallons (millions)	<b>1,376.9</b>	1,170.3	1,171.9
Gasoline margin per gallon	<b>\$0.1201</b>	\$0.1241	\$0.1037
Gasoline retail per gallon	<b>\$ 1.69</b>	\$ 1.49	\$ 1.25
<b>Comparable store data:</b>			
Merchandise sales %	<b>3.4%</b>	0.9%	2.8%
Gasoline gallons %	<b>2.0%</b>	0.7%	1.5%
<b>Number of stores:</b>			
End of period	<b>1,361</b>	1,258	1,289
Weighted average store count	<b>1,369</b>	1,275	1,305

### Fiscal 2004 Compared to Fiscal 2003

**Total Revenue.** Total revenue for fiscal 2004 was \$3.5 billion compared to \$2.8 billion for fiscal 2003, an increase of \$742.7 million, or 27.0%. The increase in total revenue is primarily due to \$411 million in revenue from the acquisition of the Golden Gallon® stores, approximately \$66.0 million in revenue from the fifty-third week, comparable store increases in merchandise sales of \$33.6 million and in gasoline gallons of 23.7 million, and a 13.4% increase in our average retail price of gasoline gallons sold. The impact of these factors was partially offset by lost volume from 37 closed stores.

**Merchandise Revenue.** Total merchandise revenue for fiscal 2004 was \$1.2 billion compared to \$1.0 billion for fiscal 2003, an increase of \$163.1 million, or 16.2%. This increase is primarily the result of \$125.5 million in revenue from the acquisition of the Golden Gallon® stores, \$19.9 million in revenue from the fifty-third week, and the comparable store merchandise sales increase of 3.4% offset by lost volume from closed stores of approximately \$17.1 million.

**Gasoline Revenue and Gallons.** Total gasoline revenue for fiscal 2004 was \$2.3 billion compared to \$1.7 billion for fiscal 2003, an increase of \$579.6 million, or 33.3%. The increase in gasoline revenue is primarily due to \$285.5 million in revenues from the Golden Gallon® acquisition, \$45.6 million in revenue from the fifty-third week, higher average gasoline retail prices and a comparable store gallon volume increase of 2.0%. In fiscal 2004, our average retail price of gasoline was \$1.69 per gallon, which represents a 20.0 cent per gallon, or 13.4%, increase in average retail price from fiscal 2003.

In fiscal 2004, gasoline gallon volume was 1.4 billion gallons, an increase of 206.6 million gallons, or 17.7%, from fiscal 2003. The increase in gasoline gallons was due to an additional 172.2 million gallons from the acquisition of the Golden Gallon® stores, 24.2 million gallons from the fifty-third week, and the comparable store gallon volume increase of 2.0%, partially offset by the lost volume from 37 closed stores of 15.4 million gallons. We believe that the fiscal 2004 comparable store gallon increase was driven by a more consistent and competitive gasoline pricing philosophy as well as the positive impact that our upgrade and remodel activity has had on gallon volume.

**Total Gross Profit.** Our fiscal 2004 gross profit was \$590.8 million compared to \$510.8 million for fiscal 2003, an increase of \$80.0 million, or 15.7%. The increase in gross profit is primarily attributable to \$63.5 million in gross profit from the Golden Gallon® acquisition, \$9.2 million in gross profit from the fifty-third week, as well as with comparable store volume increases discussed above.

**Merchandise Gross Profit and Margin.** Merchandise gross profit was \$425.4 million for fiscal 2004 compared to \$365.5 million for fiscal 2003, an increase of \$59.9 million, or 16.4%. This increase is primarily attributable to the increases in merchandise revenue discussed above and a 10 basis points improvement in merchandise gross margin.

**Gasoline Gross Profit and Margin Per Gallon.** Gasoline gross profit was \$165.4 million for fiscal 2004 compared to \$145.3 million for fiscal 2003, an increase of \$20.1 million, or 13.9%. The increase is primarily attributable to increased volumes as a result of the Golden Gallon® acquisition and comparable store sales gains discussed above, partially offset by the lost volume from closed stores. Gasoline gross profit per gallon was 12.0 cents in fiscal 2004 compared to 12.4 cents in fiscal 2003. The decrease in gasoline gross profit was primarily due to the significant increase in wholesale crude costs during fiscal 2004. We present gasoline gross profit per gallon inclusive of credit card processing fees and repairs and maintenance on gasoline equipment. These expenses totaled 2.9 cents per gallon and 2.7 cents per gallon for fiscal 2004 and fiscal 2003, respectively. The increase in expenses was primarily related to an increase in credit card fees associated with an increase in the retail price of gasoline.

**Operating, General and Administrative Expenses.** Operating expenses for fiscal 2004 were \$438.0 million compared to \$382.7 million for fiscal 2003, an increase of \$55.3 million, or 14.5%. The increase is primarily attributable to approximately \$41.8 million in operating, general and administrative expenses associated with the acquisition of the

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

Golden Gallon® stores, approximately \$6.1 million in additional expenses due to the fifty-third week, hurricane related losses of \$4.3 million, increased insurance costs of approximately \$2.0 million, and comparable store increases in labor and other variable expenses partially offset by a net gain related to the total of asset disposals and closed store activity. As a percentage of total revenue, operating, general and administrative expenses were 12.5% in fiscal 2004, and adjusted for the impact of gasoline inflation were 12.8% in fiscal 2003.

**Income from Operations.** Income from operations for fiscal 2004 was \$96.5 million compared to \$73.7 million for fiscal 2003, an increase of \$22.8 million, or 30.9%. The increase is primarily attributable to approximately \$18.6 million in operating income from the acquisition of the Golden Gallon® stores and \$2.1 million in operating income from the fifty-third week.

**Adjusted EBITDA.** Adjusted EBITDA is defined by us as net income before interest expense, income taxes, depreciation and amortization and cumulative effect of change in accounting principle. Adjusted EBITDA for fiscal 2004 was \$154.5 million compared to \$130.9 million for fiscal 2003, an increase of \$23.6 million, or 18.0%. The increase is primarily due to \$21.8 million from the acquisition of the Golden Gallon® stores, \$3.1 million from the fifty-third week, and the increases in comparable store sales partially offset by the increased operating, general and administrative expense items discussed above.

Adjusted EBITDA is not a measure of performance under accounting principles generally accepted in the United States of America, and should not be considered as a substitute for net income, cash flows from operating activities and other income or cash flow statement data. We have included information concerning Adjusted EBITDA as one measure of our cash flow and historical ability to service debt and because we believe investors find this information useful because it reflects the resources available for strategic opportunities including, among others, to invest in the business, make strategic acquisitions and to service debt. Adjusted EBITDA as defined by us may not be comparable to similarly titled measures reported by other companies.

The following table contains a reconciliation of Adjusted EBITDA to net cash provided by operating activities and cash flows from investing and financing activities:

(Amounts in thousands)	Fiscal Year Ended	
	September 30, 2004	September 25, 2003
Adjusted EBITDA	\$ 154,493	\$130,927
Interest expense and loss on extinguishment of debt	(70,293)	(52,153)
Adjustments to reconcile net income to net cash provided by operating activities (other than depreciation and amortization, provision for deferred income taxes and cumulative effect of change in accounting principle)	30,959	9,016
Changes in operating assets and liabilities, net:		
Assets	(18,886)	(1,796)
Liabilities	19,314	(17,730)
Net cash provided by operating activities	\$ 115,587	\$ 68,264
Net cash used in investing activities	\$(129,965)	\$(22,357)
Net cash provided by (used in) financing activities	\$ 49,525	\$(15,242)

**Loss on Debt Extinguishment.** As a result of the retirement of our 10.25% subordinated notes and the refinancing of our senior credit facility during the second quarter of fiscal 2004, we incurred \$23.1 million in debt extinguishment costs that have been included as a component of interest expense. These charges include the write-off of approximately \$11.8 million in unamortized deferred financing costs, the write-off of approximately \$3.5 million of unamortized original issue discount and call premiums of approximately \$7.8 million. During the third quarter of fiscal 2003, we incurred \$2.9 million in debt extinguishment costs related to the refinancing of our then outstanding senior credit facility, which represented the write-off of unamortized deferred financing costs.

**Interest Expense (see—"Liquidity and Capital Resources").** Interest expense is primarily interest on borrowings under our senior credit facility and senior subordinated notes and the loss on debt extinguishment referred to above. Interest expense, excluding the loss on debt extinguishment, for fiscal 2004 was \$47.2 million compared to \$49.3 million for fiscal 2003, a decrease of \$2.1 million, or 4.2%. The decrease is primarily attributable to a reduction of approximately 250 basis points in our effective interest rate as a result of the refinancing of our senior credit facility and subordinated notes in February and March of fiscal 2004, partially offset by an increase in our weighted average borrowings as a result of the Golden Gallon® acquisition, a reduction in the

fair market value of derivative instruments of \$2.1 million, and additional interest from the fifty-third week of approximately \$600 thousand.

**Income Tax Expense.** We recorded income tax expense of \$10.3 million in fiscal 2004 compared to \$9.4 million for fiscal 2003. The increase in income tax expense was primarily attributable to the \$3.5 million increase in income before taxes. Our effective tax rate for fiscal 2004 was 37.1% compared to 38.5% for fiscal 2003. The decrease in the effective rate is primarily the result of the reversal of approximately \$400 thousand in tax reserves due to the expected utilization of various tax credits and net operating losses.

**Net Income.** As a result of the items discussed above, net income for fiscal 2004 was \$17.6 million compared to \$11.5 million for fiscal 2003.

### **Fiscal 2003 Compared to Fiscal 2002**

**Total Revenue.** Total revenue for fiscal 2003 was \$2.8 billion compared to \$2.5 billion for fiscal 2002, an increase of \$266.8 million, or 10.7%. The increase in total revenue is primarily due to a 19.2% increase in our average retail price of gasoline gallons sold, comparable store increases in merchandise sales of \$9.1 million and in gasoline gallons of 7.6 million. The impact of these factors was partially offset by lost volume from 35 closed stores.

**Merchandise Revenue.** Total merchandise revenue for each of fiscal 2003 and fiscal 2002 was \$1.0 billion. Merchandise revenue was consistent from fiscal 2002 to fiscal 2003 as a result of comparable store merchandise sales increase of 0.9% offset by lost volume from closed stores of approximately \$12.9 million. This comparable store sales increase was achieved despite significant retail price deflation in the cigarette category. With respect to the cigarette category, while the volume of cartons sold per store increased, the negative impact of cigarette retail price deflation was approximately 1.8% on merchandise sales. This deflation of cigarette retail prices during the period did not impact our gross dollar margin on the sale of cigarettes. Sales of tobacco products comprised approximately one-third of our merchandise sales during fiscal 2003.

**Gasoline Revenue and Gallons.** Total gasoline revenue for fiscal 2003 was \$1.7 billion compared to \$1.5 billion for fiscal 2002, an increase of \$269.9 million, or 18.4%. The increase in gasoline revenue is primarily due to higher average gasoline retail prices and a comparable store gallon volume increase of 0.7%. In fiscal 2003, our average retail price of gasoline was \$1.49 per gallon, which represents a 24.0 cent per gallon, or 19.2%, increase in average retail price from fiscal 2002.

In fiscal 2003, gasoline gallon volume was 1.2 billion gallons, a decrease of 1.7 million gallons, or 0.1%, from fiscal 2002. The decrease in gasoline gallons was primarily due to lost volume from 35 closed stores of 14.2 million gallons, partially offset by the comparable store gallon volume increase of 0.7%. We believe that the fiscal 2003 comparable store gallon increase was driven by a more consistent and competitive gasoline pricing philosophy as well as the positive impact that our upgrade and remodel activity has had on gallon volume.

**Total Gross Profit.** Our fiscal 2003 gross profit was \$510.8 million compared to \$475.4 million for fiscal 2002, an increase of \$35.4 million, or 7.4%. The increase in gross profit is primarily attributable to increases in gasoline gross profit per gallon and merchandise margin, coupled with comparable store volume increases.

**Merchandise Gross Profit and Margin.** Merchandise gross profit was \$365.5 million for fiscal 2003 compared to \$353.9 million for fiscal 2002, an increase of \$11.7 million, or 3.3%. This increase is primarily attributable to the increase in merchandise revenue discussed above, coupled with a 130 basis points increase in our merchandise margin. Our merchandise gross margin increased to 36.2% for fiscal 2003, primarily driven by the retail price deflation in the cigarette category.

**Gasoline Gross Profit and Margin Per Gallon.** Gasoline gross profit was \$145.3 million for fiscal 2003 compared to \$121.5 million for fiscal 2002, an increase of \$23.7 million, or 19.5%. The increase is primarily attributable to a 2.0 cents per gallon increase in gasoline margin, partially offset by the lost volume from closed stores. Gasoline gross profit per gallon was 12.4 cents in fiscal 2003 compared to 10.4 cents in fiscal 2002. The increase in gasoline gross profit was due to our more advantageous gas supply contracts, a more favorable retail gasoline environment and our ongoing initiatives to better manage gasoline pricing and inventories. We present gasoline gross profit per gallon inclusive of credit card processing fees and repairs and maintenance on gasoline equipment. These expenses totaled 2.7 cents per gallon and 2.3 cents per gallon for fiscal 2003 and fiscal 2002, respectively. The increase in expenses was primarily related to an increase in credit card fees associated with an increase in the retail price of gasoline.

**Operating, General and Administrative Expenses.** Operating expenses for fiscal 2003 were \$382.7 million compared to \$367.3 million for fiscal 2002, an increase of \$15.4 million, or 4.2%. The increase is primarily attributable to higher insurance costs of approximately \$3.1 million, larger losses on asset disposals and closed store activity of approximately \$5.9 million and increased employee benefit costs of approximately \$1.7 million. As a percentage of total revenue, operating, general and administrative expenses were 13.9% in fiscal 2003, and adjusted for the impact of gasoline inflation, were 13.3% in fiscal 2002.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

**Income from Operations.** Income from operations for fiscal 2003 was \$73.7 million compared to \$53.9 million for fiscal 2002, an increase of \$19.9 million, or 36.9%. The increase is primarily attributable to the increases in gasoline and merchandise gross margins. These increases were partially offset by a change in accounting estimate related to estimated useful lives of certain gasoline imaging assets and the increase in operating, general and administrative costs discussed above. The change in accounting estimate resulted in an increase in depreciation expense of approximately \$3.4 million in fiscal 2003.

**Adjusted EBITDA.** Adjusted EBITDA for fiscal 2003 was \$130.9 million compared to \$108.8 million for fiscal 2002, an increase of \$22.1 million, or 20.3%. The increase is primarily due to the items discussed above.

The following table contains a reconciliation of Adjusted EBITDA to net cash provided by operating activities and cash flows from investing and financing activities:

(Amounts in thousands)	Fiscal Year Ended	
	September 25, 2003	September 26, 2002
Adjusted EBITDA	\$130,927	\$108,831
Interest expense and loss on extinguishment of debt	(52,153)	(51,646)
Adjustments to reconcile net income to net cash provided by operating activities (other than depreciation and amortization, provision for deferred income taxes and cumulative effect of change in accounting principle)	9,016	3,983
Changes in operating assets and liabilities, net:		
Assets	(1,796)	(7,463)
Liabilities	(17,730)	279
Net cash provided by operating activities	\$ 68,264	\$ 53,984
Net cash used in investing activities	\$ (22,357)	\$ (20,313)
Net cash used in financing activities	\$ (15,242)	\$ (42,046)

**Loss on Debt Extinguishment.** During the third quarter of fiscal 2003, we incurred \$2.9 million in debt extinguishment costs related to the refinancing of our then outstanding senior credit facility, which represented the write-off of unamortized deferred financing costs.

**Interest Expense (see—"Liquidity and Capital Resources").** Interest expense is primarily interest on borrowings under our senior credit facility and senior subordinated notes and the loss on extinguishment of debt discussed above. Interest expense, excluding the loss on extinguishment of debt, for fiscal 2003 was \$49.3 million compared to \$51.6 million for fiscal 2002, a decrease of \$2.4 million, or 4.6%. The

decrease is primarily attributable to \$3.4 million in income from the fair market value changes in our non-qualifying derivatives for fiscal 2003 compared to \$926 thousand of expense in fiscal 2002.

**Income Tax Expense.** We recorded income tax expense of \$9.4 million in fiscal 2003 compared to \$1.1 million for fiscal 2002. The increase in income tax expense was primarily attributable to the \$21.4 million increase in income before taxes. Consistent with fiscal 2002, our effective tax rate for fiscal 2003 was 38.5%.

**Cumulative Effect Adjustment.** During the first quarter of fiscal 2003, we recorded a one-time cumulative effect charge of \$3.5 million (net of taxes of \$2.2 million) relating to the disposal of our underground storage tanks in accordance with the adoption of SFAS No. 143.

**Net Income.** As a result of the items discussed above, net income for fiscal 2003 was \$11.5 million compared to \$1.8 million for fiscal 2002.

### Liquidity and Capital Resources

**Cash Flows from Operations.** Due to the nature of our business, substantially all sales are for cash and cash provided by operations is our primary source of liquidity. We rely primarily upon cash provided by operating activities, supplemented as necessary from time to time by borrowings under our revolving credit facility, sale-leaseback transactions, and asset dispositions to finance our operations, pay interest and principal payments and fund capital expenditures. Cash provided by operations for fiscal 2004 totaled \$115.6 million, for fiscal 2003 totaled \$68.3 million and for fiscal 2002 totaled \$54.0 million. Our increase in net cash provided by operating activities for fiscal 2004 over fiscal 2003 is primarily attributable to the increase in gasoline and merchandise gross profit and its impact on operating income and Adjusted EBITDA. As a result of our net operating loss carryforwards, our cash paid for income taxes has been relatively insignificant in recent periods. We anticipate full utilization of our net operating loss carryforwards during fiscal 2005 and therefore expect an increase in our cash paid for income taxes. We had \$108.0 million of cash and cash equivalents on hand at September 30, 2004.

**Capital Expenditures.** Gross capital expenditures (excluding all acquisitions) for fiscal 2004 were \$51.9 million. Our capital expenditures are primarily expenditures for 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, proceeds from sale-leaseback transactions and asset dispositions and vendor reimbursements.

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 lease the property back to us under long-term leases. We retain ownership of all personal property and gasoline marketing equipment. Our leases are generally operating leases at market rates with lease terms between fifteen and twenty years plus several renewal option periods. The lease payment is based on market rates applied to the cost of each respective property. Our senior credit facility limits or caps the proceeds of sale-leasebacks that we can use to fund our operations or capital expenditures. We received \$96.7 million in proceeds from sale-leaseback transactions in fiscal 2004, including \$94.5 million related to the Golden Gallon® acquisition, and \$2.3 million during fiscal 2003.

In fiscal 2004, we had proceeds of \$19.1 million including asset dispositions (\$10.8 million), vendor reimbursements (\$6.1 million) and sale-leaseback transactions (\$2.2 million). As a result, our net capital expenditures, excluding all acquisitions, for fiscal 2004 were \$32.8 million. We anticipate that net capital expenditures for fiscal 2005 will be approximately \$55.0 million.

**Cash Flows from Financing Activities.** For fiscal 2004, net cash provided by financing activities was \$49.5 million. The net cash provided was primarily the result of additional net borrowings of \$57.6 million and proceeds from the exercise of incentive stock options, offset by additional financing costs paid during fiscal 2004 of approximately \$11.8 million. The \$57.6 million in net borrowings is primarily the result of the issuance of debt totaling \$80.0 million in connection with the Golden Gallon® acquisition offset by principal payments. At September 30, 2004, our long-term debt consisted primarily of \$317.0 million in loans under our senior credit facility and \$250.0 million of our 7.75% senior subordinated notes. See “—Contractual Obligations and Commitments” for a summary of our long-term debt principal amortization commitments.

**Senior Credit Facility.** On March 12, 2004, we entered into an Amended and Restated Credit Agreement, which consists of a \$345.0 million term loan that matures in March 2011 and a \$70.0 million revolving credit facility that expires in March 2010. Proceeds from the new senior secured credit facility were used to repay all amounts outstanding under our previous credit facility and loan origination costs. In connection with the amendment, we incurred debt extinguishment charges of \$12.4 million, which consisted of the \$3.5 million write-off of unamortized original issue discount, \$7.9 million in unamortized deferred financing costs and \$1.0 million in call premium. We incurred approximately \$2.2 million in costs associated with the amendment, which were deferred and will be amortized over the term of the loan agreement. As of September 30, 2004, our outstanding term loan balance was \$317.0 million.

Our \$70.0 million revolving credit facility is available to fund working capital, finance general corporate purposes and support the issuance of standby letters of credit. Borrowings under the revolving credit facility are limited by our outstanding letters of credit of approximately \$34.8 million. Furthermore, the revolving credit facility limits our total outstanding letters of credit to \$50.0 million. As of September 30, 2004, we had no borrowings outstanding under the revolving credit facility, we had approximately \$35.2 million in available borrowing capacity and \$34.8 million of standby letters of credit were issued under the facility.

The term loan portion of our senior credit facility bears interest at variable interest rates. Our senior credit facility permits us to choose between two basic rates for our term loan:

- a rate based on the greater of the prime rate of interest in effect on the day the loan is made or the federal funds rate in effect on the day the loan is made plus ½ of 1%, plus an additional margin, as described below; or
- a rate based on the London interbank offered rate, or LIBOR, plus an additional margin as described below.

Our senior credit facility requires us to pay, in addition to the basic interest rate, an additional margin of 2.25% on term loans that are based on a LIBOR interest rate. Our senior credit facility also requires us to pay, in addition to the basic interest rate (i) an additional margin of 2.75% on revolving credit loans that are based on a LIBOR interest rate or (ii) an additional margin of 1.50% on revolving credit loans that are based on a prime rate. We have from time to time entered into certain hedging agreements in an effort to mitigate the fluctuations in interest rates and manage our interest rate risk, and anticipate that we will continue to use hedging agreements for these purposes in the future.

Our senior credit facility is secured by substantially all of our assets, other than our leased real property, and guaranteed by our subsidiaries. Any redemption of our senior credit facility on or before September 30, 2005 would require repayment of outstanding loan amounts at 101% of par.

Our senior credit facility contains covenants restricting our ability and the ability of any of our subsidiaries to, among other things and subject to various exceptions:

- incur additional indebtedness;
- declare dividends or redeem or repurchase capital stock;
- prepay, redeem or purchase subordinated debt;
- incur liens;
- make loans and investments;
- make capital expenditures;
- engage in mergers, acquisitions, asset sales, or sale-leaseback transactions or similar fundamental corporate changes; and
- engage in transactions with stockholders or affiliates.

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Our senior credit facility also contains financial ratios and tests that must be met with respect to maximum total leverage ratios, minimum fixed charge coverage ratios, minimum pro forma EBITDA, each as defined in the agreement, and maximum capital expenditures. Specifically, the senior credit facility requires us to:

- comply with maximum consolidated pro forma leverage ratios on a sliding scale ranging from a high of 4.75 to 1.00 to a low of 3.50 to 1.00 over quarterly periods between March 12, 2004 and September 25, 2008 and thereafter;
- maintain a consolidated fixed charge coverage ratio of at least 1.00 to 1.00 on a quarterly basis;
- limit consolidated capital expenditures to \$55.0 million in fiscal 2004, \$50.0 million in fiscal 2005, and \$45.0 million in fiscal years after 2005 (plus unspent amounts that are permitted to be carried forward from prior fiscal years up to a limit of \$12.5 million).

As of September 30, 2004, we have satisfied all financial ratios and tests under our senior credit facility.

The senior credit facility requires that we remain in pro forma compliance with all of the financial covenants contained in the credit agreement after giving effect to an acquisition. In addition, the senior credit agreement includes customary events of default, including payment defaults on more than \$5.0 million of contingent obligations, judgments exceeding \$5.0 million, and upon a change of control. Under the credit agreement, a change of control occurs if among other things (a) any person or group of persons acting together, other than certain "permitted holders" (defined as our current largest stockholder), has acquired or holds 35% or more of the voting power (or economic interest) of our common stock unless the permitted holders beneficially own a greater percentage of our company than such other person or group, (b) the members of our board of directors who were in office at the time of entry into the credit agreement or their nominees do not continue to comprise a majority of our board of directors, or (c) a "change of control" as defined in the indenture for our senior subordinated notes, occurs.

**Senior Subordinated Notes.** On February 19, 2004, we completed the sale of \$250.0 million of 7.75% senior subordinated notes due February 19, 2014. Interest on the senior subordinated notes is due on February 19 and August 19 of each year. Proceeds from the sale of the senior subordinated notes were used to redeem \$200.0 million in outstanding 10 $\frac{1}{4}$ % senior subordinated notes, including a \$6.8 million call premium, pay principal of approximately \$28.0 million on our senior credit facility and pay related financing costs. We incurred debt extinguishment charges of \$10.7 million which consisted of the \$6.8 million call premium and \$3.9 million of unamortized deferred financing costs. We incurred approximately \$6.6 million in costs associated with the new notes,

which were deferred and will be amortized over the life of the new notes.

Our senior subordinated notes contain covenants that, among other things and subject to various exceptions, restrict our ability and any restricted subsidiary's ability to:

- pay dividends, make distributions or repurchase stock;
- issue stock of subsidiaries;
- make investments in non-affiliated entities;
- incur liens to secure debt which is equal to or subordinate in right of payment to the senior subordinated notes, unless the notes are secured on an equal and ratable basis (or senior basis) with the obligations so secured;
- enter into transactions with affiliates; or
- engage in mergers, consolidations or sales of all or substantially all of our properties or assets.

We can incur debt under the senior subordinated notes if the ratio of our pro forma EBITDA to fixed charges, after giving effect to such incurrence, is at least 2.0 to 1.0. Even if we do not meet this ratio we can incur:

- debt under our senior credit facility;
- capital leases or purchase money debt in amounts not to exceed the greater of \$35.0 million in the aggregate and 10% of our tangible assets at the time of incurrence;
- intercompany debt;
- debt existing on the date the senior subordinated notes were issued;
- up to \$25.0 million in any type of debt;
- debt related to insurance and similar obligations arising in the ordinary course of business; or
- debt related to guarantees, earn-outs, or obligations in respect of purchase price adjustments in connection with the acquisition or disposition of property or assets.

The senior subordinated notes also place conditions on the terms of asset sales or transfers and require us either to reinvest the cash proceeds of an asset sale or transfer, or, if we do not reinvest those proceeds, to pay down our senior credit facility or other senior debt or to offer to redeem our senior subordinated notes with any asset sale proceeds not so used. In addition, upon the occurrence of a change of control, we will be required to offer to purchase all of the outstanding senior subordinated notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of redemption. Under the indenture governing the senior subordinated notes, a change of control is deemed to occur if (a) any person, other than certain "permitted holders" (defined as our current largest stockholder or any member of the senior management of our company), becomes the beneficial owner of more than 50% of the voting power of our common stock, (b) any person, or group of persons acting together, other than a permitted holder, becomes the beneficial owner of more than 35% of the voting power of

our common stock and the permitted holders own a lesser percentage than such other person, or (c) the first day on which a majority of the members of our board of directors are not "continuing directors" (as defined in the indenture). At any time prior to February 15, 2007, we may redeem on any one or more occasions up to 35% of the aggregate principal amount of the senior subordinated notes with the net cash proceeds of one or more public equity offerings at a redemption price that is currently 107.75% of the principal amount thereof, plus accrued and unpaid interest. Except in this circumstance, the senior subordinated notes are not redeemable at our option prior to February 15, 2009. On or after February 15, 2009, we may redeem the senior subordinated notes in whole or in part at a redemption price that is 103.875% and decreases to 102.583% after February 15, 2010, 101.292% after February 15, 2011 and 100.0% after February 15, 2012.

**Shareholders' Equity.** As of September 30, 2004, our shareholders' equity totaled \$152.2 million. The increase of \$23.5 million in shareholders' equity from September 25, 2003 is primarily attributable to fiscal 2004 net income of \$17.6 million and additional paid-in capital as a result of option exercises of \$4.9 million.

**Long-Term Liquidity.** We believe that anticipated cash flows from operations, funds available from our existing revolving credit facility, and funds available under the forward sale agreement entered into in October 2004 with Merrill Lynch International, together with cash on hand and vendor reimbursements, will provide sufficient funds to finance our operations at least for the next 12 months. As of September 30, 2004, we had \$35.2 million available under our revolving credit facility. Additionally, if we elect to physically settle the forward sale agreement, we would receive aggregate proceeds of \$32.8 million. For further discussion of the forward sale agreement, see "Notes to Consolidated Financial Statements—Note 19—Subsequent Event." Changes in our operating plans, lower than anticipated sales, increased expenses, additional acquisitions or other events may cause us to need to seek additional debt or equity financing in future periods. There can be no guarantee that financing will be available on acceptable terms or at all. Additional equity financing could be dilutive to the holders of our common stock; debt financing, if available, could impose additional cash payment obligations and additional covenants and operating restrictions. We have no current plans to seek any such additional financing.

## Contractual Obligations and Commitments

**Contractual Obligations.** The following table summarizes by fiscal year our expected long-term debt payment schedule, future capital lease commitments and future operating lease commitments as of September 30, 2004:

### Contractual Obligations

(Dollars in thousands)	Fiscal 2005	Fiscal 2006	Fiscal 2007	Fiscal 2008	Fiscal 2009	Thereafter	Total
Long-term debt <sup>(1)</sup>	\$ 12,029	\$ 16,010	\$ 16,000	\$ 16,000	\$ 16,000	\$ 491,000	\$ 567,039
Interest <sup>(2)</sup>	33,994	32,621	31,121	30,447	29,774	98,720	256,677
Capital leases <sup>(3)</sup>	3,271	3,050	2,994	2,740	2,596	20,062	34,713
Operating leases <sup>(4)</sup>	64,801	61,415	58,861	56,600	52,849	410,649	705,175
Total contractual obligations	\$114,095	\$113,096	\$108,976	\$105,787	\$101,219	\$1,020,431	\$1,563,604

(1) Included in long-term debt are amounts owed on our senior subordinated notes and senior credit facility. These borrowings are further explained in "Notes to Consolidated Financial Statements—Note 6—Long-Term Debt." The table assumes our long-term debt is held to maturity.

(2) Included in interest are expected payments on our senior subordinated notes, senior credit facility and interest rate swap agreements. Variable interest on the senior credit facility and swap agreements is set at the October 29, 2004 rate.

(3) Included in capital leases is both principal and interest.

(4) Some of our retail store leases require percentage rentals on sales and contain escalation clauses. The minimum future operating lease payments shown above, do not include contingent rental expense. Some lease agreements provide us with an option to renew. Our future operating lease obligations will change if we exercise these renewal options and if we enter into additional operating lease agreements.

**Letter of Credit Commitments.** The following table summarizes by fiscal year the expiration dates of our standby letters of credit issued under our senior credit facility as of September 30, 2004:

(Dollars in thousands)	Fiscal 2005	Fiscal 2006	Fiscal 2007	Fiscal 2008	Fiscal 2009	Thereafter	Total
Standby letters of credit	\$34,729	\$93	\$—	\$—	\$—	\$—	\$34,822

At maturity, we expect to renew a significant number of our standby letters of credit.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

**Environmental Considerations.** Environmental reserves of \$14.1 million and \$13.8 million as of September 30, 2004 and September 25, 2003, respectively, represent our estimates for future expenditures for remediation, tank removal and litigation associated with 251 and 236 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. We estimate that approximately \$13.1 million of our environmental obligations will be funded by state trust funds and third-party insurance; as a result, we may spend up to \$1.0 million for remediation, tank removal and litigation. Also, as of September 30, 2004 and September 25, 2003 there were an additional 503 and 487 sites, respectively, that are known to be contaminated sites and that are being remediated by third parties, and therefore, the costs to remediate such sites are not included in our environmental reserve. Remediation costs for known sites are expected to be incurred over the next one to ten years. Environmental reserves have been established with remediation costs based on internal and external estimates for each site. Future remediation for which the timing of payments can be reasonably estimated are discounted using an appropriate rate to determine the reserve.

Florida environmental regulations require all single-walled underground storage tanks to be upgraded/replaced with secondary containment by December 31, 2009. In order to comply with these Florida regulations, we will be required to upgrade or replace underground storage tanks at approximately 185 locations. We anticipate that these capital expenditures will be approximately \$18.0 million and will begin during fiscal 2005. The ultimate number of locations and costs incurred will depend on several factors including future store closures, changes in the number of locations upgraded or replaced and changes in the costs to upgrade or replace the underground storage tanks.

**Merchandise Supply Agreement.** We have a distribution service agreement with McLane pursuant to which McLane is the primary distributor of traditional grocery products to our stores. We also purchase a significant percentage of the cigarettes we sell from McLane. The agreement with McLane continues through October 10, 2008 and contains no minimum purchase requirements. We purchase products at McLane's cost plus an agreed upon percentage, reduced by any promotional allowances and volume rebates offered by manufacturers and McLane. In addition, we received an initial service allowance, which is being amortized over the term of the agreement, and also receive additional per store service allowances, both of which are subject to adjustment based on the number of stores in operation. Total purchases from McLane exceeded 50% of total merchandise purchases in fiscal 2004.

**Gasoline Supply Agreements.** We have historically purchased our branded gasoline and diesel fuel under supply agreements with major oil companies, including BP®, Chevron®, Citgo®, Shell®, Mobil® and Texaco®. The fuel purchased has generally been based on the stated rack price, or market price, quoted at each terminal as adjusted per applicable contracts. The initial terms of these supply agreements range from three to ten years and contain provisions for various payments to us based on volume of purchases and vendor allowances. These agreements also, in certain instances, give the supplier a right of first refusal to purchase certain assets that we may want to sell.

During February 2003, we signed new gasoline supply agreements with both BP Products, N.A., or BP®, and Citgo® to brand and supply most of our gasoline products for the next five years. Also, during the third quarter of fiscal 2004, we negotiated an expansion of the scope and extension of the term of our gasoline supply agreement with BP®, which will now expire in 2009. We intend to re-brand and/or upgrade images for gasoline offerings at approximately 1,100 locations by the end of calendar 2005, with 575 locations completed as of September 30, 2004. We expect that, after the conversion has been completed, BP® will supply approximately 30% of our total gasoline volume, which will be sold under the BP®/Amoco® brand, and Citgo® will supply approximately 60% of our total gasoline volume. Citgo® will supply both our private brand gasoline, which will be sold under our own Kangaroo® and other brands, and Citgo® branded gasoline. The remaining locations, primarily in Florida, will remain branded by Chevron®. We entered into these branding and supply agreements to provide a more consistent operating identity while helping us in our efforts to maximize our gasoline gallon growth and gasoline gross profit dollars. In order to receive certain benefits under these contracts, we must first meet certain purchase levels. To date, we have met these purchase levels and expect to continue to do so.

**Other Commitments.** We make various other commitments and become subject to various other contractual obligations that we believe to be routine in nature and incidental to the operation of the business. Management believes that such routine commitments and contractual obligations do not have a material impact on our business, financial condition or results of operations. In addition, like all public companies, we expect that we may face increased costs in order to comply with new rules and standards relating to corporate governance and corporate disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Stock Market rules. We intend to devote all reasonably necessary resources to comply with evolving standards.

## Quarterly Results of Operations and Seasonality

The following table sets forth certain unaudited financial and operating data for each fiscal quarter during fiscal 2004, fiscal 2003 and fiscal 2002. The unaudited quarterly information includes all normal recurring adjustments that we consider necessary for a fair presentation of the information shown. This information should be read in conjunction with our consolidated financial statements and the related notes appearing elsewhere in this report. Due to the nature of our business and our reliance, in part, on consumer spending patterns in coastal, resort and tourist markets, we typically generate higher revenues and gross margins during warm weather months in the southeastern United States, which fall within our third and fourth fiscal quarters. In the following table, dollars are in thousands, except per gallon data.

	Fiscal 2004				Fiscal 2003				Fiscal 2002			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total Revenue	<b>\$744,441</b>	<b>\$786,353</b>	<b>\$928,327</b>	<b>\$1,033,964</b>	\$645,353	\$666,697	\$704,486	\$733,824	\$577,357	\$558,858	\$677,564	\$669,739
Merchandise revenue	<b>270,149</b>	<b>270,073</b>	<b>302,879</b>	<b>329,745</b>	243,420	234,978	263,393	267,907	243,044	236,843	267,871	265,028
Gasoline revenue	<b>474,292</b>	<b>516,280</b>	<b>625,448</b>	<b>704,219</b>	401,933	431,719	441,093	465,917	334,313	322,015	409,693	404,711
Gross Profit	<b>140,110</b>	<b>133,227</b>	<b>153,710</b>	<b>163,796</b>	125,991	113,129	135,017	136,667	115,479	108,100	127,025	124,798
Merchandise gross profit	<b>99,174</b>	<b>99,486</b>	<b>109,255</b>	<b>117,512</b>	86,477	84,320	94,974	99,749	83,135	82,708	93,602	94,408
Gasoline gross profit	<b>40,936</b>	<b>33,741</b>	<b>44,455</b>	<b>46,284</b>	39,514	28,809	40,043	36,918	32,344	25,392	33,423	30,390
Income from operations	<b>20,909</b>	<b>14,251</b>	<b>30,880</b>	<b>30,475</b>	20,343	7,708	21,870	20,910	13,111	4,626	20,503	15,612
Income (loss) before cumulative effect	<b>4,937</b>	<b>(14,082)</b>	<b>13,674</b>	<b>13,024</b>	4,920	(2,353)	6,085	6,334	475	(4,138)	4,064	1,403
Income from operations as a percentage of full year	<b>21.7%</b>	<b>14.8%</b>	<b>32.0%</b>	<b>31.5%</b>	28.7%	10.9%	30.9%	29.5%	24.3%	8.6%	38.1%	29.0%
Comparable store merchandise sales increase (decrease)	<b>2.4%</b>	<b>3.4%</b>	<b>3.9%</b>	<b>3.8%</b>	1.5%	0.8%	(0.5)%	2.2%	1.7%	1.3%	3.7%	3.5%
Comparable store sales gasoline gallons increase (decrease)	<b>3.4%</b>	<b>1.2%</b>	<b>0.2%</b>	<b>3.2%</b>	(0.7)%	(0.2)%	0.6%	3.1%	0.8%	0.2%	4.4%	0.7%
Merchandise gross profit as a percentage of total revenue	<b>13.3%</b>	<b>12.7%</b>	<b>11.8%</b>	<b>11.4%</b>	13.4%	12.6%	13.5%	13.6%	14.4%	14.8%	13.8%	14.1%
Gasoline gross profit per gallon	<b>0.126</b>	<b>0.105</b>	<b>0.130</b>	<b>0.120</b>	0.139	0.104	0.133	0.120	0.112	0.090	0.111	0.101
Gasoline gallons	<b>325,580</b>	<b>321,805</b>	<b>342,818</b>	<b>386,657</b>	283,834	277,129	301,473	307,832	287,907	281,030	302,080	300,905

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

### Inflation

During fiscal 2004, wholesale gasoline fuel prices remained volatile, hitting a high of approximately \$50 per barrel in September 2004 and a low of approximately \$28 per barrel in September 2003. Generally, we pass along wholesale gasoline cost changes to our customers through retail price changes. Gasoline price volatility has had an impact on total revenue, gross profit dollars and gross profit percentage.

General CPI, excluding energy, increased 2.2% during fiscal 2004 and food at home CPI, which is most indicative of our merchandise inventory, increased slightly more than general CPI. While we have generally been able to pass along these price increases to our customers, we can make no assurances that continued inflation will not have a material adverse effect on our sales and gross profit dollars.

### Recently Adopted Accounting Standards

No recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by us have occurred during the year ended September 30, 2004, other than the items described below.

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation ("FIN") 46, *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51* (revised December 2003, FIN 46R). This interpretation provides guidance related to identifying variable interest entities (previously known as special purpose entities or SPEs) and determining whether such entities should be consolidated. Certain disclosures are required if it is reasonably possible that a company will consolidate or disclose information about a variable interest entity when it initially applies FIN 46. This interpretation was effective beginning in our second fiscal quarter ending March 25, 2004. We have no investment in or contractual relationship or other business relationship with a variable interest entity and therefore the adoption of FIN 46 did not have any impact on our results of operations and financial condition. However, if we enter into any such arrangement with a variable interest entity in the future (or an entity with which we currently have a relationship is reconsidered based on guidance in FIN 46R to be a variable interest entity), our results of operations and financial condition may be impacted.

### Recently Issued Accounting Standards

In March 2004, the FASB issued an exposure draft on "Share-Based Payment." The proposed Statement addresses the accounting for transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled

by the issuance of such equity instruments. This proposed Statement would eliminate the ability to account for share-based compensation transactions using Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method. This Statement, if approved, was scheduled to be effective for awards that are granted, modified, or settled in periods beginning after December 15, 2004 for public entities. On October 16, 2004, the FASB delayed the effective date of this proposal by six months and anticipates it will be effective for the fourth quarter of fiscal 2005. Retrospective application of this Statement is not permitted. The adoption of this Statement, if approved, could have an impact on our financial position or results of operations.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on our consolidated financial statements upon adoption.

### Critical Accounting Policies

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Critical accounting policies are those we believe are both most important to the portrayal of our financial condition and results, and require our most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Judgments and uncertainties affecting the application of those policies may result in materially different amounts being reported under different conditions or using different assumptions. We believe the following policies to be the most critical in understanding the judgments that are involved in preparing our consolidated financial statements.

**Revenue Recognition.** Revenues from our two primary product categories, gasoline and merchandise, are recognized at the point of sale. We derive service revenue from lottery ticket sales, money orders, car washes, public telephones, amusement and video gaming and other ancillary product and service offerings, which are included in merchandise revenue.

**Insurance Liabilities.** We self-insure a significant portion of expected losses under our workers' compensation, general liability and employee medical programs. Accrued liabilities have been recorded based on our estimates of the ultimate costs to settle incurred and incurred but not reported claims. Our accounting policies regarding self-insurance programs include judgments and actuarial assumptions regarding economic conditions, the frequency and severity of claims, claim development patterns and claim management and settlement practices. Significant changes in actual expenditures compared to historical experience rates as a result of increased medical costs or incidence rates could significantly impact our statement of operations and financial position.

**Long-Lived Assets and Closed Stores.** Long-lived assets are reviewed for impairment whenever events or 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 of that store to determine if a write-down to fair value is required.

Property and equipment of stores we are closing are written down to their estimated net realizable value at the time we close such stores. If applicable, we provide for future estimated rent and other exit costs associated with the store closure, net of sublease income, using a discount rate to calculate the present value of the remaining rent payments on closed stores. We estimate the net realizable value based on our experience in utilizing or disposing of similar assets and on estimates provided by our own and third-party real estate experts. Changes in real estate markets could significantly impact the net realizable value from the sale of assets and rental or sublease income.

**Goodwill Impairment.** We have adopted the provisions of SFAS No. 142, which requires allocating goodwill to each reporting unit and testing for impairment using a two-step approach. Based on our current reporting structure, we have determined that we operate as one reporting unit and therefore have assigned goodwill at the enterprise level. Fair value is measured using a valuation based on market multiples, comparable transactions and discounted cash flow methodologies. The goodwill impairment test is performed annually or whenever an event has occurred that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Should the enterprise carrying value exceed the estimated fair market value we would have to perform additional valuations to determine if any goodwill impairment exists. Any impairment recognized will be recorded as a component of operating expenses.

Changes in the long-term economics of the gasoline and convenience store markets, fluctuations in capital markets and competition could impact our fair value measurements, which could significantly impact our statement of operations and financial position.

**Derivative Financial Instruments.** We enter into interest rate swap agreements to modify the interest characteristics of our outstanding long-term debt, and we have designated each qualifying instrument as a cash flow hedge. We formally document our hedge relationships, including identifying the hedge instruments and hedged items, as well as our risk management objectives and strategies for entering into the hedge transaction. At hedge inception, and at least quarterly thereafter, we assess whether derivatives used to hedge transactions are highly effective in offsetting changes in the cash flow of the hedged item. We measure effectiveness by the ability of the interest rate swaps to offset cash flows associated with changes in the variable LIBOR rate associated with our term loan facilities using the hypothetical derivative method. To the extent the instruments are considered to be effective, changes in fair value are recorded as a component of other comprehensive income. To the extent there is any hedge ineffectiveness, any changes in fair value relating to the ineffective portion are immediately recognized in earnings as interest expense. When it is determined that a derivative ceases to be a highly effective hedge, we discontinue hedge accounting, and subsequent changes in fair value of the hedge instrument are recognized in earnings.

The fair values of our interest rate swaps and collars are obtained from dealer quotes. These values represent the estimated amount that we would receive or pay to terminate the agreement taking into account the difference between the contract rate of interest and rates currently quoted for agreements of similar terms and maturities.

**Asset Retirement Obligation.** Since fiscal 2003, we have recognized the estimated future cost to remove an underground storage tank over the estimated useful life of the storage tank in accordance with the provisions of SFAS No. 143, *Accounting for Asset Retirement Obligations*. We record a discounted liability for the fair value of an asset retirement obligation with a corresponding increase to the carrying value of the related long-lived asset at the time an underground storage tank is installed. We amortize the amount added to property and equipment and recognize accretion expense in connection with the discounted liability over the remaining life of the tank. We base our estimates of the anticipated future costs for removal of an underground storage tank on our prior experience with removal. See also, "Notes to Consolidated Financial Statements—Note 9—Asset Retirement Obligations."

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

**Vendor Allowances and Rebates.** We receive payments for vendor allowances, volume rebates and other supply arrangements in connection with various programs. Some of these vendor rebate, credit and promotional allowance arrangements require that we make assumptions and judgments regarding, for example, the likelihood of attaining specified levels of purchases or selling specified volumes of products, and the duration of carrying a specified product. Payments are recorded as a reduction to cost of sales or expenses to which the particular payment relates. Unearned payments are deferred and amortized as earned over the term of the respective agreement.

**Environmental Liabilities and Related Receivables.** We account for the cost incurred to comply with federal and state environmental regulations as follows:

- Environmental reserves reflected in the financial statements are based on internal and external estimates of costs to remediate sites relating to the operation of underground storage tanks. Factors considered in the estimates of the reserve are the expected cost and the estimated length of time to remediate each contaminated site.
- Deductibles and remediation costs 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 an appropriate rate.
- Reimbursement under state trust fund programs or third-party insurers are recognized as receivables and a provision for uncollectible reimbursements is recorded based on historical and expected collection rates. All recorded reimbursements are expected to be collected within a period of twelve to eighteen months after submission of the reimbursement claim. 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.

Changes in laws and government regulation, the financial condition of the state trust funds and third-party insurers and actual remediation expenses compared to historical experience could significantly impact our statement of operations and financial position.

### Risk Factors

You should carefully consider the risks described below before making a decision to invest in our securities. The risks and uncertainties described below and elsewhere in this report are not the only ones facing us. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, could negatively impact our results of operations or financial condition in the future. If any of such risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that

case, the trading price of our securities could decline, and you may lose all or part of your investment.

### Risks Related to Our Industry

**The convenience store industry is highly competitive and impacted by new entrants.**

The industry and geographic areas in which we operate are highly competitive and marked by ease of entry and constant change in the number and type of retailers offering the products and services found in our stores. We compete with other convenience store chains, gasoline stations, supermarkets, drugstores, discount stores, club stores and mass merchants. In recent years, several non-traditional retailers, such as supermarkets, club stores and mass merchants, have impacted the convenience store industry by entering the gasoline retail business. These non-traditional gasoline retailers have obtained a significant share of the motor fuels market and their market share is expected to grow. In some of our markets, our competitors have been in existence longer and have greater financial, marketing and other resources than we do. As a result, our competitors may be able to respond better to changes in the economy and new opportunities within the industry. To remain competitive, we must constantly analyze consumer preferences and competitors' offerings and prices to ensure we offer a selection of convenience products and services consumers demand at competitive prices. We must also maintain and upgrade our customer service levels, facilities and locations to remain competitive and drive customer traffic to our stores. Major competitive factors include, among others, location, ease of access, gasoline brands, pricing, product and service selections, customer service, store appearance, cleanliness and safety.

**Volatility of wholesale petroleum costs could impact our operating results.**

Over the past three fiscal years, our gasoline revenue averaged approximately 63.4% of total revenues and our gasoline gross profit averaged approximately 27.4% of total gross profit. Crude oil and domestic wholesale petroleum markets are marked by significant volatility. General political conditions, acts of war or terrorism, and instability in oil producing regions, particularly in the Middle East and South America, could significantly impact crude oil supplies and wholesale petroleum costs. In addition, the supply of gasoline and our wholesale purchase costs could be adversely impacted in the event of a shortage, which could result from, among other things, lack of capacity at United States oil refineries or the fact that our gasoline contracts do not guarantee an uninterrupted, unlimited supply of gasoline. Significant increases and volatility in wholesale petroleum costs could result in significant increases in the retail price of petroleum products and in lower gasoline gross margin per gallon. Increases in the retail price of petroleum products could impact consumer demand

for gasoline. This volatility makes it extremely difficult to predict the impact future wholesale cost fluctuations will have on our operating results and financial condition. These factors could materially impact our gasoline gallon volume, gasoline gross profit and overall customer traffic, which in turn would impact our merchandise sales.

**Wholesale cost increases of tobacco products could impact our operating results.**

Sales of tobacco products have averaged approximately 10.7% of our total revenue over the past three fiscal years and our tobacco gross profit accounted for approximately 16.3% of total gross profit for the same period. Significant increases in wholesale cigarette costs and tax increases on tobacco products, as well as national and local campaigns to discourage smoking in the United States, may have an adverse effect on unit demand for cigarettes domestically. In general, we attempt to pass price increases on to our customers. However, due to competitive pressures in our markets, we may not be able to do so. These factors could materially impact our retail price of cigarettes, cigarette unit volume and revenues, merchandise gross profit and overall customer traffic.

**Changes in consumer behavior, travel and tourism could impact our business.**

In the convenience store industry, customer traffic is generally driven by consumer preferences and spending trends, growth rates for automobile and truck traffic and trends in travel, tourism and weather. Changes in economic conditions generally or in the Southeast specifically could adversely impact consumer spending patterns and travel and tourism in our markets. Approximately 40% of our stores are located in coastal, resort or tourist destinations. Historically, travel and consumer behavior in such markets is more severely impacted by weak economic conditions. If visitors to resort or tourist locations decline due to economic conditions, changes in consumer preferences, changes in discretionary consumer spending or otherwise, our sales could decline.

**Risks Related to Our Business**

**Unfavorable weather conditions or other trends or developments in the Southeast could adversely affect our business.**

Substantially all of our stores are located in the southeast region of the United States. Although the Southeast is generally known for its mild weather, the region is susceptible to severe storms including hurricanes, thunderstorms, extended periods of rain, ice storms and heavy snow, all of which we experienced in fiscal 2004. Inclement weather conditions as well as severe storms in the Southeast could damage our facilities or could have a significant impact on consumer behavior, travel and convenience store traffic patterns as well as our ability to operate our locations. In addition, we typically generate higher revenues and gross margins during warmer weather months in the Southeast, which fall within our third and fourth quarters. If weather conditions are not

favorable during these periods, our operating results and cash flow from operations could be adversely affected. We would also be impacted by regional occurrences in the Southeast such as energy shortages or increases in energy prices, fires or other natural disasters.

**Inability to identify, acquire and integrate new stores could adversely affect our ability to grow our business.**

An important part of our historical growth strategy has been to acquire other convenience stores that complement our existing stores or broaden our geographic presence, such as our acquisition of 138 convenience stores operating under the Golden Gallon® banner on October 16, 2003. From April 1997 through September 2004, we acquired 1,304 convenience stores in 21 major and numerous smaller transactions. We expect to continue to selectively review acquisition opportunities as an element of our growth strategy.

Acquisitions involve risks that could cause our actual growth or operating results to differ adversely compared to our expectations or the expectations of securities analysts. For example:

- We may not be able to identify suitable acquisition candidates or acquire additional convenience stores on favorable terms. We compete with others to acquire convenience stores. We believe that this competition may increase and could result in decreased availability or increased prices for suitable acquisition candidates. It may be difficult to anticipate the timing and availability of acquisition candidates.
- During the acquisition process we may fail or be unable to discover some of the liabilities of companies or businesses that we acquire. These liabilities may result from a prior owner's noncompliance with applicable federal, state or local laws.
- We may not be able to obtain the necessary financing, on favorable terms or at all, to finance any of our potential acquisitions.
- We may fail to successfully integrate or manage acquired convenience stores.
- Acquired convenience stores may not perform as we expect or we may not be able to obtain the cost savings and financial improvements we anticipate.
- We face the risk that our existing systems, financial controls, information systems, management resources and human resources will need to grow to support significant growth.

**Our substantial indebtedness and capital lease obligations could adversely affect our financial health.**

We have a significant amount of indebtedness. As of September 30, 2004, we had consolidated debt, including capital lease obligations, of approximately \$582.8 million. As of September 30, 2004, our availability under our senior credit facility for borrowing or issuing additional letters of credit was approximately \$35.2 million.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

We are vulnerable to increases in interest rates because the debt under our senior credit facility is at a variable interest rate. Although in the past we have on occasion entered into certain hedging instruments in an effort to manage our interest rate risk, we cannot assure you that we will continue to do so, on favorable terms or at all, in the future.

Our substantial indebtedness could have important consequences to you. For example, it could:

- make it more difficult for us to satisfy our obligations with respect to our debt and our leases;
- increase our vulnerability to general adverse economic and industry conditions;
- require us to dedicate a substantial portion of our cash flow from operations to payments on our debt and lease obligations, thereby reducing the availability of our cash flow to fund working capital, capital expenditures and other general corporate purposes;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- place us at a competitive disadvantage compared to our competitors that have less indebtedness or better access to capital by, for example, limiting our ability to enter into new markets or renovate our stores; and
- limit our ability to borrow additional funds in the future.

If we are unable to meet our debt and lease obligations, we could be forced to restructure or refinance our obligations, seek additional equity financing or sell assets, which we may not be able to do on satisfactory terms or at all. As a result, we could default on those obligations.

In addition, the indenture governing our senior subordinated notes and our senior credit facility, which includes a term loan and a revolving credit facility, contain financial and other restrictive covenants that will limit our ability to engage in activities that may be in our long-term best interests. Our failure to comply with those covenants could result in an event of default which, if not cured or waived, could result in the acceleration of all of our indebtedness, which would adversely affect our financial health and could prevent us from fulfilling our obligations.

Despite current indebtedness levels, we and our subsidiaries may still be able to incur additional debt. This could further increase the risks associated with our substantial leverage.

We and our subsidiaries are still able to incur additional indebtedness. The terms of the indenture that governs our senior subordinated notes permit us to incur additional indebtedness under certain circumstances. In addition, our senior credit facility, as amended, permits us to potentially borrow up to an additional \$75.0 million for permitted acquisitions (assuming certain financial conditions are met at the time) beyond the \$70.0 million we can borrow under our revolving

credit facility. If we and our subsidiaries incur additional indebtedness, the related risks that we and they now face could intensify.

To service our indebtedness, we will require a significant amount of cash. Our ability to generate cash depends on many factors beyond our control.

Our ability to make payments on our indebtedness and to refinance our indebtedness and fund planned capital expenditures will depend on our ability to generate cash in the future. This, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control.

Based on our current level of operations, we believe our cash flow from operations, available cash and available borrowings under our revolving credit facility, will be adequate to meet our future liquidity needs for at least the next 12 months. We cannot assure you, however, that our business will generate sufficient cash flow from operations or that future borrowings will be available to us under our revolving credit facility in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs. We may need to refinance all or a portion of our indebtedness on or before maturity. We cannot assure you that we will be able to refinance any of our indebtedness on commercially reasonable terms or at all.

If we do not comply with the covenants in our senior credit facility and the indenture governing our senior subordinated notes or otherwise default under them, we may not have the funds necessary to pay all of our indebtedness that could become due.

Our senior credit facility and our indenture governing our senior subordinated notes require us to comply with certain covenants. In particular, our senior credit facility prohibits us from incurring any additional indebtedness except in specified circumstances or materially amending the terms of any agreement relating to existing indebtedness without lender approval. In addition, our senior credit facility limits our ability to make capital expenditures. Further, our senior credit facility restricts our ability to acquire and dispose of assets, engage in mergers or reorganizations, pay dividends, or make investments. Other restrictive covenants require that we meet fixed charge coverage and leverage tests, and also maximum capital expenditure limits as defined in the senior credit facility agreement. A violation of any of these covenants could cause an event of default under the senior credit facility. If we default under that facility because of a covenant breach or otherwise, all outstanding amounts could become immediately due and payable. We cannot assure you that we would have sufficient funds to repay all the outstanding amounts, and any acceleration of amounts due under our senior credit facility or our indenture governing our senior subordinated notes likely would have a material adverse effect on us.

We are subject to state and federal environmental and other regulations.

Our business is subject to extensive governmental laws and regulations including, but not limited to, environmental regulations, employment laws and regulations, regulations governing the sale of alcohol and tobacco, minimum wage requirements, working condition requirements, public accessibility requirements, citizenship requirements and other laws and regulations. A violation or change of these laws could have a material adverse effect on our business, financial condition and results of operations.

Under various federal, state and local laws, ordinances and regulations, we may, as the owner or operator of our locations, be liable for the costs of removal or remediation of contamination at these or our former locations, whether or not we knew of, or were responsible for, the presence of such contamination. The failure to properly remediate such contamination may subject us to liability to third parties and may adversely affect our ability to sell or rent such property or to borrow money using such property as collateral. Additionally, persons who arrange for the disposal or treatment of hazardous or toxic substances may also be liable for the costs of removal or remediation of such substances at sites where they are located, whether or not such site is owned or operated by such person. Although we do not typically arrange for the treatment or disposal of hazardous substances, we may be deemed to have arranged for the disposal or treatment of hazardous or toxic substances and, therefore, may be liable for removal or remediation costs, as well as other related costs, including governmental fines, and injuries to persons, property and natural resources.

Compliance with existing and future environmental laws regulating underground storage tanks may require significant capital expenditures and increased operating and maintenance costs. The remediation costs and other costs required to clean up or treat contaminated sites could be substantial. We pay tank registration fees and other taxes to state trust funds established in our operating areas and maintain private insurance coverage in Florida and Georgia in support of future remediation obligations.

These state trust funds or other responsible third parties including insurers are expected to pay or reimburse us for remediation expenses less a deductible. To the extent third parties do not pay for remediation as we anticipate, we will be obligated to make these payments, which could materially adversely affect our financial condition and results of operations. Reimbursements from state trust funds will be dependent on the maintenance and continued solvency of the various funds.

In the future, we may incur substantial expenditures for remediation of contamination that has not been discovered at existing locations or locations that we may acquire. We cannot assure you that we have identified all environmental liabilities at all of our current and former locations; that material environmental conditions not known to us do not exist; that future laws, ordinances or regulations will not impose material environmental liability on us; or that a material environmental condition does not otherwise exist as to any one or more of our locations. In addition, failure to comply with any environmental laws, ordinances or regulations or an increase in regulations could adversely affect our operating results and financial condition.

State laws regulate the sale of alcohol and tobacco products. A violation or change of these laws could adversely affect our business, financial condition and results of operations because state and local regulatory agencies have the power to approve, revoke, suspend or deny applications for, and renewals of, permits and licenses relating to the sale of these products or to seek other remedies. In addition, certain states regulate relationships, including overlapping ownership, among alcohol manufacturers, wholesalers and retailers and may deny or revoke licensure if relationships in violation of the state laws exist. While we are not aware of any alcoholic beverage manufacturers or wholesalers having a prohibited relationship with our company, an investment fund related to our largest stockholder recently acquired an interest in a wine wholesaler. Although we do not believe this relationship is prohibited by the laws of any state in which we operate, if a regulatory authority were to take a contrary view and revoke our retail alcohol license, it could have a material adverse effect on our business and results of operations. In addition, our ability to expand into certain states, should we desire to do so, may be adversely affected if the laws of any such state prohibit the type of relationship that exists among our largest stockholder, the investment fund affiliated with it, the wine wholesaler in which the fund invested, and us.

Any appreciable increase in the statutory minimum wage rate or income or overtime pay or adoption of mandated health benefits would result in an increase in our labor costs and such cost increase, or the penalties for failing to comply with such statutory minimums, could adversely affect our business, financial condition and results of operations.

From time to time, regulations are proposed that, if adopted, could also have an adverse effect on our business, financial condition or results of operations.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

We depend on one principal supplier for the majority of our merchandise.

We purchase over 50% of our general merchandise, including most tobacco products and grocery items, from a single wholesale grocer, McLane. We have a contract with McLane until October 2008, but we may not be able to renew the contract upon expiration. A change of suppliers, a disruption in supply or a significant change in our relationship with our principal suppliers could have a material adverse effect on our business, cost of goods, financial condition and results of operations.

We depend on two principal suppliers for the majority of our gasoline.

During February of 2003, we signed new gasoline supply agreements with BP® and Citgo®. We expect that BP® and Citgo® will supply approximately 90% of our future gasoline purchases after an approximately 27 to 33 month conversion process that began in March 2003. We have contracts with Citgo® until 2008 and BP® until 2009, but we may not be able to renew either contract upon expiration. A change of suppliers, a disruption in supply or a significant change in our relationship with our principal suppliers could have a material adverse effect on our business, cost of goods, financial condition and results of operations.

We expect to generate approximately \$10 to \$12 million of annualized cost savings and other benefits from our gasoline supplier and brand consolidation initiatives. While we believe our estimates of these cost savings and benefits to be reasonable, they are estimates which are difficult to predict and are necessarily speculative in nature. In addition, we cannot assure you that unforeseen factors will not offset the estimated cost savings and other benefits from these initiatives. As a result, our actual cost savings and other anticipated benefits could differ or be delayed, compared to our estimates and to the other information contained or incorporated by reference in this report.

We may not achieve the full expected cost savings and other benefits of our acquisition of Golden Gallon®.

We expect to achieve \$8 to \$10 million of cost savings and benefits within the 12 to 24 months following the acquisition of Golden Gallon®. These cost savings and benefits include, among others, savings associated with the elimination of duplicate overhead and infrastructure, benefits received by Golden Gallon® under our merchandise and gas supply agreements and the expansion of quick service restaurants in selected stores. While we believe our estimates of these cost savings and benefits to be reasonable, they are estimates, which are difficult to predict and are necessarily speculative in nature. There can be no assurance that we will be able to replicate the results that we achieved at our stores at the Golden Gallon® stores. In addition, we cannot assure you that unforeseen factors will not offset the estimated cost savings and other benefits from the acquisition. As a result, our actual

cost savings and other anticipated benefits could differ or be delayed, compared to our estimates and to the other information contained or incorporated by reference in this report.

Because we depend on our senior management's experience and knowledge of our industry, we would be adversely affected if senior management left The Pantry.

We are dependent on the continued efforts of our senior management team, including our President and Chief Executive Officer, Peter J. Sodini. Mr. Sodini's employment contract terminates in September 2006. If, for any reason, our senior executives do not continue to be active in management, our business, financial condition or results of operations could be adversely affected. We cannot assure you that we will be able to attract and retain additional qualified senior personnel as needed in the future. In addition, we do not maintain key personnel life insurance on our senior executives and other key employees. We also rely on our ability to recruit store managers, regional managers and other store personnel. If we fail to continue to attract these individuals, our operating results may be adversely affected.

### Other Risks

Future sales of additional shares into the market may depress the market price of our common stock.

If we or our existing stockholders sell shares of our common stock in the public market, including shares issued upon the exercise of outstanding options or upon settlement of the forward sale agreement recently entered into by us, or if the market perceives such sales or issuances could occur, the market price of our common stock could decline. As of December 7, 2004, there are 20,313,242 shares of our common stock outstanding; of these shares, 17,121,689 shares are freely tradable (unless held by one of our affiliates), and 3,884,369 shares are held by affiliate investment funds of Freeman Spogli & Co., or Freeman Spogli. Pursuant to Rule 144 under the Securities Act of 1933, as amended, or the Securities Act, during any three-month period our affiliates can resell up to the greater of (a) 1% of our aggregate outstanding common stock or (b) the average weekly trading volume for the four weeks prior to the sale. In addition, the Freeman Spogli investment funds have registration rights allowing them to require us to register the resale of their shares. Sales by our existing stockholders also might make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate or to use equity as consideration for future acquisitions.

In addition, we have filed registration statements with the Securities and Exchange Commission that cover up to 5,100,000 shares issuable pursuant to the exercise of stock options granted and to be granted under our stock option plans. Shares registered on a registration statement may be sold freely at any time after issuance.

The interests of our largest stockholder may conflict with our interests and the interests of our other stockholders.

As of December 7, 2004, Freeman Spogli owns 3,884,369 shares of our common stock and its beneficial ownership of our common stock is approximately 19.1%. In addition, three of the eight members of our board of directors are representatives of, or have consulting arrangements with, Freeman Spogli. As a result of its stock ownership and board representation, Freeman Spogli is in a position to affect our corporate actions such as mergers or takeover attempts of us or may take action on its own in a manner that could conflict with our interests or the interests of our other stockholders. In the past, from time to time, we have considered strategic alternatives, including a sale of The Pantry, at the request of Freeman Spogli and with the consent of our board of directors. Although we are not currently considering any strategic alternatives, we may do so in the future.

Any issuance of shares of our common stock in the future could have a dilutive effect on your investment.

We may sell securities in the public or private equity markets if and when conditions are favorable, even if we do not have an immediate need for capital at that time. We may also, either mandatorily or at our option, issue shares upon settlement of the forward sale agreement recently entered into by us. We may elect to settle the forward sale by means of a physical stock, cash or net stock settlement. If we elect to physically settle the forward sale agreement in total, we would be required to issue 1,500,000 shares of our common stock. In no event are we required to deliver more than 1,500,000 shares under the forward sale agreement.

Raising funds by issuing securities will dilute the ownership of our existing stockholders. Additionally, certain types of equity securities that we may issue in the future could have rights, preferences or privileges senior to your rights as a holder of our common stock. We could choose to issue additional shares for a variety of reasons including for investment or acquisitive purposes. Such issuances may have a dilutive impact on your investment.

The market price for our common stock has been and may in the future be volatile, which could cause the value of your investment to decline.

There currently is a public market for our common stock, but there is no assurance that there will always be such a market. Securities markets worldwide experience significant price and volume fluctuations. This market volatility could significantly affect the market price of our common stock without regard to our operating performance. In addition, the price of our common stock could be subject to wide fluctuations in response to the following factors, among others:

- A deviation in our results from the expectations of public market analysts and investors;
- Statements by research analysts about our common stock, our company or our industry;

- Changes in market valuations of companies in our industry and market evaluations of our industry generally;
- Additions or departures of key personnel;
- Actions taken by our competitors;
- Sales or other issuances of common stock by the company, senior officers or other affiliates; or
- Other general economic, political or market conditions, many of which are beyond our control.

The market price of our common stock will also be impacted by our quarterly operating results and quarterly comparable store sales growth, which may be expected to fluctuate from quarter to quarter. Factors that may impact our quarterly results and comparable store sales include, among others, general regional and national economic conditions, competition, unexpected costs and changes in pricing, consumer trends, the number of stores we open and/or close during any given period, costs of compliance with corporate governance and Sarbanes-Oxley requirements, and other factors discussed in “Risk Factors” beginning on page 28 and throughout “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” You may not be able to resell your shares of our common stock at or above the price you pay.

Our charter includes provisions that may have the effect of preventing or hindering a change in control and adversely affecting the market price of our common stock.

Our certificate of incorporation gives our board of directors the authority to issue up to five million shares of preferred stock and to determine the rights and preferences of the preferred stock, without obtaining stockholder approval. The existence of this preferred stock could make it more difficult or discourage an attempt to obtain control of The Pantry by means of a tender offer, merger, proxy contest or otherwise. Furthermore, this preferred stock could be issued with other rights, including economic rights, senior to our common stock, and, therefore, issuance of the preferred stock could have an adverse effect on the market price of our common stock. We have no present plans to issue any shares of our preferred stock.

Other provisions of our certificate of incorporation and bylaws and of Delaware law could make it more difficult for a third party to acquire us or hinder a change in management even if doing so would be beneficial to our stockholders. For example, our certificate of incorporation makes us subject to the anti-takeover provisions of Section 203 of the General Corporation Law of the State of Delaware. In general, Section 203 prohibits publicly-held Delaware corporations to which it applies from engaging in a “business combination” with an “interested stockholder” for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner. This provision could discourage others from bidding for our shares and could,

## Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

as a result, reduce the likelihood of an increase in our stock price that would otherwise occur if a bidder sought to buy our stock.

These governance provisions could affect the market price of our common stock. We may, in the future, adopt other measures that may have the effect of delaying, deferring or preventing an unsolicited takeover, even if such a change in control were at a premium price or favored by a majority of unaffiliated stockholders. These measures may be adopted without any further vote or action by our stockholders.

### Quantitative and Qualitative Disclosures About Market Risk

*Quantitative Disclosures.* 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 senior credit facility. We are exposed to 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 hold derivative instruments primarily to manage our exposure to these risks and all derivative instruments are matched against specific debt obligations. There have been no material changes in the primary risk exposures or management of the risks since the prior year. Our debt and interest rate swap instruments outstanding at September 30, 2004, including applicable interest rates, are discussed below and in "Notes to Consolidated Financial Statements—Note 7—Derivative Financial Instruments."

The following table presents the future principal cash flows and weighted average interest rates based on rates in effect at September 30, 2004 on our existing long-term debt instruments. Fair values have been determined based on quoted market prices as of September 30, 2004.

#### Expected Maturity Date as of September 30, 2004

(Dollars in thousands)	Fiscal 2005	Fiscal 2006	Fiscal 2007	Fiscal 2008	Fiscal 2009	Thereafter	Total	Fair Value
Long-term debt	\$12,029	\$16,010	\$16,000	\$16,000	\$16,000	\$491,000	\$567,039	\$580,857
Weighted average interest rate	6.06%	5.99%	5.88%	5.94%	5.99%	6.93%	6.31%	

In order to reduce our exposure to interest rate fluctuations, we have entered into interest rate swap arrangements in which we agree to exchange, at specified intervals, the difference between fixed and variable interest amounts calculated by reference to an agreed upon notional amount. The interest rate differential is reflected as an adjustment to interest expense over the life of the swaps. Fixed rate swaps are used to reduce our risk of increased interest costs during periods of rising interest rates. At September 30, 2004, the interest rate on 79.7% of our debt was fixed by either the nature of the obligation or through the interest rate swap arrangements compared to 80.8% at September 25, 2003. The annualized effect of a one percentage point change in floating interest rates on our interest rate swap agreements and other floating rate debt obligations at September 30, 2004 would be to change interest expense by approximately \$1 million.

The following table presents the notional principal amount, weighted average pay rate, weighted average receive rate and weighted average years to maturity on our interest rate swap contracts:

#### Interest Rate Swap Contracts

(Dollars in thousands)	September 30, 2004	September 25, 2003
Notional principal amount	\$202,000	\$202,000
Weighted average pay rate	2.72%	3.77%
Weighted average receive rate	1.84%	1.03%
Weighted average years to maturity	1.55	1.68

As of September 30, 2004, the fair value of our swap agreements represented a net liability of \$0.1 million.

*Qualitative Disclosures.* Our primary exposure relates to:

- interest rate risk on long-term and short-term borrowings;
- our ability to pay or refinance long-term borrowings 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 financing 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. We expect the interest rate swaps mentioned above will reduce our exposure to short-term interest rate fluctuations. 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 evaluates our financial position on an ongoing basis.

## Consolidated Balance Sheets

<i>(Dollars in thousands)</i>	September 30, 2004	September 25, 2003
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 108,048	\$ 72,901
Receivables (net of allowance for doubtful accounts of \$417 at September 30, 2004 and \$665 at September 25, 2003)	43,664	30,423
Inventories (Note 3)	95,228	84,156
Prepaid expenses	13,446	6,326
Property held for sale	5,939	2,013
Deferred income taxes (Note 11)	7,507	4,334
Total current assets	273,832	200,153
Property and equipment, net (Notes 4, 9 and 12)	411,501	400,609
Other assets:		
Goodwill (Note 5)	341,652	278,629
Deferred financing costs (net of accumulated amortization of \$563 September 30, 2004 and \$7,206 at September 25, 2003)	8,612	10,757
Environmental receivables (Note 13)	15,137	15,109
Other (Note 7)	11,406	8,908
Total other assets	376,807	313,403
Total assets	\$1,062,140	\$914,165
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Current maturities of long-term debt (Note 6)	\$ 16,029	\$ 27,558
Current maturities of capital lease obligations (Note 12)	1,197	1,375
Accounts payable	121,151	78,885
Accrued interest (Note 6)	2,742	11,924
Accrued compensation and related taxes	14,369	12,840
Other accrued taxes	18,849	16,510
Accrued insurance	17,228	12,293
Other accrued liabilities (Notes 7 and 13)	19,393	21,314
Total current liabilities	210,958	182,699
Long-term debt (Note 6)	551,010	470,011
Other liabilities:		
Environmental reserves (Note 13)	14,051	13,823
Deferred income taxes (Note 11)	63,257	50,015
Deferred revenue (Note 13)	35,051	37,251
Capital lease obligations (Note 12)	14,582	15,779
Other noncurrent liabilities (Notes 7, 9 and 13)	21,045	15,922
Total other liabilities	147,986	132,790
Commitments and contingencies (Notes 5, 6, 12 and 13)		
Shareholders' equity (Notes 8, 15 and 16):		
Common stock, \$.01 par value, 50,000,000 shares authorized; 20,271,757 and 18,107,597 issued and outstanding at September 30, 2004 and September 25, 2003, respectively (Notes 15 and 16)	204	182
Additional paid-in capital	132,879	128,002
Shareholder loans	—	(173)
Accumulated other comprehensive income (deficit) net of deferred income taxes of \$(129) at September 30, 2004 and \$432 at September 25, 2003 (Note 8)	206	(690)
Accumulated earnings	18,897	1,344
Total shareholders' equity	152,186	128,665
Total liabilities and shareholders' equity	\$1,062,140	\$914,165

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

## Consolidated Statements of Operations

	September 30, 2004	September 25, 2003	September 26, 2002
	(53 weeks)	(52 weeks)	(52 weeks)
<i>(Dollars in thousands, except per share amounts)</i>			
Revenues:			
Merchandise sales	<b>\$1,172,846</b>	\$1,009,698	\$1,012,786
Gasoline sales	<b>2,320,239</b>	1,740,662	1,470,732
Total revenues	<b>3,493,085</b>	2,750,360	2,483,518
Cost of sales:			
Merchandise	<b>747,419</b>	644,178	658,933
Gasoline	<b>2,154,823</b>	1,595,378	1,349,183
Total cost of sales	<b>2,902,242</b>	2,239,556	2,008,116
Gross profit	<b>590,843</b>	510,804	475,402
Operating expenses:			
Operating, general and administrative expenses	<b>438,026</b>	382,682	367,299
Depreciation and amortization	<b>56,302</b>	54,403	54,251
Total operating expenses	<b>494,328</b>	437,085	421,550
Income from operations	<b>96,515</b>	73,719	53,852
Other income (expense):			
Loss on extinguishment of debt (Note 10)	<b>(23,087)</b>	(2,888)	—
Interest expense (Note 10)	<b>(47,206)</b>	(49,265)	(51,646)
Miscellaneous	<b>1,676</b>	2,805	728
Total other expense	<b>(68,617)</b>	(49,348)	(50,918)
Income before income taxes	<b>27,898</b>	24,371	2,934
Income tax expense (Note 11)	<b>(10,345)</b>	(9,385)	(1,130)
Income before cumulative effect adjustment	<b>\$ 17,553</b>	\$ 14,986	\$ 1,804
Cumulative effect adjustment, net of tax (Note 9)	<b>—</b>	(3,482)	—
Net income	<b>\$ 17,553</b>	\$ 11,504	\$ 1,804
Earnings per share (Note 17):			
Basic:			
Income before cumulative effect adjustment	<b>\$ 0.90</b>	\$ 0.83	\$ 0.10
Cumulative effect adjustment	<b>—</b>	(0.19)	—
Net income	<b>\$ 0.90</b>	\$ 0.64	\$ 0.10
Diluted:			
Income before cumulative effect adjustment	<b>\$ 0.85</b>	\$ 0.82	\$ 0.10
Cumulative effect adjustment	<b>—</b>	(0.19)	—
Net income	<b>\$ 0.85</b>	\$ 0.63	\$ 0.10

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

## Consolidated Statements of Shareholders' Equity

(Shares and dollars in thousands)	Common Stock		Additional Paid-in Capital	Shareholder Loans	Accumulated Other Comprehensive Income/(Deficit)	Accumulated Earnings (Deficit)	Total
	Shares	Par Value					
Balance, September 27, 2001	18,115	\$182	\$128,043	\$(837)	\$(4,283)	\$(11,964)	\$111,141
Comprehensive income, net of tax:							
Net income	—	—	—	—	—	1,804	1,804
Unrealized gains on qualifying cash flow hedges	—	—	—	—	1,966	—	1,966
Amortization of cumulative effect of adoption of SFAS No. 133	—	—	—	—	205	—	205
Comprehensive income	—	—	—	—	2,171	1,804	3,975
Share repurchase	(7)	—	(41)	41	—	—	—
Repayment of shareholder loans	—	—	—	88	—	—	88
Balance, September 26, 2002	18,108	\$182	\$128,002	\$(708)	\$(2,112)	\$(10,160)	\$115,204
Comprehensive income, net of tax:							
Net income	—	—	—	—	—	11,504	11,504
Unrealized gains on qualifying cash flow hedges	—	—	—	—	1,264	—	1,264
Amortization of cumulative effect of adoption of SFAS No. 133	—	—	—	—	158	—	158
Comprehensive income	—	—	—	—	1,422	11,504	12,926
Repayment of shareholder loans	—	—	—	535	—	—	535
Balance, September 25, 2003	18,108	\$182	\$128,002	\$(173)	\$ (690)	\$ 1,344	\$128,665
Comprehensive income, net of tax:							
Net income	—	—	—	—	—	17,553	17,553
Unrealized gains on qualifying cash flow hedges	—	—	—	—	896	—	896
Comprehensive income	—	—	—	—	896	17,553	18,449
Exercise of stock options and warrants	2,164	22	4,877	—	—	—	4,899
Repayment of shareholder loans	—	—	—	173	—	—	173
<b>Balance, September 30, 2004</b>	<b>20,272</b>	<b>\$204</b>	<b>\$132,879</b>	<b>\$ —</b>	<b>\$ 206</b>	<b>\$ 18,897</b>	<b>\$152,186</b>

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

## Consolidated Statements of Cash Flows

<i>(Dollars in thousands)</i>	September 30, 2004	Year Ended September 25, 2003	September 26, 2002
	(53 weeks)	(52 weeks)	(52 weeks)
<b>Cash Flows from Operating Activities:</b>			
Net income	\$ 17,553	\$ 11,504	\$ 1,804
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	56,302	54,403	51,981
Provision for income taxes	10,345	9,385	1,130
Loss on extinguishment of debt	23,087	2,888	—
(Gain)/loss on sale of property and equipment	(2,929)	2,051	601
Impairment of long-lived assets	7,417	1,850	383
Fair market value change in non-qualifying derivatives	(1,310)	(3,381)	926
Provision for closed stores	1,933	2,469	2,073
Cumulative effect of change in accounting principle	—	3,482	—
Amortization of deferred loan costs	2,227	2,610	2,270
Amortization of long-term debt discount	534	529	—
Changes in operating assets and liabilities, net of effects of acquisitions:			
Receivables	(11,146)	563	(5,085)
Inventories	(977)	281	(2,705)
Prepaid expenses	(7,005)	(2,818)	(43)
Other noncurrent assets	242	178	370
Accounts payable	30,830	(14,973)	(311)
Other current liabilities and accrued expenses	(7,506)	9,532	12,688
Reserves for environmental expenses	(447)	538	1,078
Other noncurrent liabilities	(3,563)	(12,827)	(13,176)
Net cash provided by operating activities	115,587	68,264	53,984
<b>Cash Flows from Investing Activities:</b>			
Additions to property held for sale	(2,475)	(2,761)	(5,006)
Additions to property and equipment	(49,441)	(25,470)	(26,506)
Proceeds from sale of land, building and equipment	107,558	7,673	11,711
Acquisitions of related businesses, net of cash acquired	(185,607)	(1,799)	(512)
Net cash used in investing activities	(129,965)	(22,357)	(20,313)
<b>Cash Flows from Financing Activities:</b>			
Principal repayments under capital leases	(1,375)	(1,383)	(1,199)
Principal repayments of long-term debt	(617,412)	(306,577)	(40,000)
Proceeds from issuance of long-term debt	675,000	299,440	—
Proceeds from exercise of stock options, net of repurchases	4,899	—	(41)
Repayment of shareholder loans	173	535	129
Other financing costs	(11,760)	(7,257)	(935)
Net cash provided by (used in) financing activities	49,525	(15,242)	(42,046)
Net increase (decrease)	35,147	30,665	(8,375)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	72,901	42,236	50,611
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 108,048	\$ 72,901	\$ 42,236
<b>Supplemental Disclosure of Cash Flow</b>			
Cash paid (refunded) during the year:			
Interest	\$ 55,472	\$ 51,469	\$ 50,556
Taxes	\$ 62	\$ (214)	\$ (3,708)

### Supplemental Non-cash Investing and Financing Activities

During fiscal 2003 and 2002, we financed certain capital expenditures totaling \$1.9 million and \$2.7 million respectively, through the issuance of capital leases.

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

## Notes to Consolidated Financial Statements

### Note 1—History of Our Company and Summary of Significant Accounting Policies:

#### The Pantry

Our consolidated financial statements include the accounts of The Pantry, Inc. and its wholly-owned subsidiaries. Transactions and balances of each of our wholly-owned subsidiaries are immaterial to the consolidated financial statements. All intercompany transactions and balances have been eliminated in consolidation. As of September 30, 2004, we own and operate 1,361 convenience stores in Florida (461), North Carolina (322), South Carolina (239), Tennessee (103), Georgia (98), Mississippi (51), Kentucky (37), Virginia (30), Indiana (12), and Louisiana (8).

#### Accounting Period

We operate on a 52- or 53-week fiscal year ending on the last Thursday in September. Fiscal 2004 operated on a 53-week basis and fiscal years 2003 and 2002 each operated on a 52-week basis.

#### Acquisition Accounting

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 include the results of operations for each of the acquisitions from the date of acquisition only.

#### Cash and Cash Equivalents

For purposes of the consolidated financial statements, cash and cash equivalents include 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 for merchandise inventories and using the weighted average method for gasoline inventories.

#### Property Held for Sale

Property is classified as a current asset when management's intent is to sell these assets in the ensuing fiscal year and the criteria under Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, are met. The asset is then recorded at the lower of cost or fair value less cost to sell. We attempt to identify third parties with which to enter into sale-leaseback transactions prior to developing new stores in order to minimize our capital outlays. If we identify a store as one that we believe we can finance on a sale-leaseback transaction prior to developing a new store, or if we enter into such a transaction for our existing stores, the property is classified as held for sale. These assets primarily consist of land and buildings.

#### 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
Equipment, furniture and fixtures	3 to 30 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), whichever is less, using the straight-line method.

#### Goodwill

We have adopted the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*, which requires allocating goodwill to each reporting unit and testing for impairment using a two-step approach. Based on our current reporting structure, we have determined that we operate as one reporting unit and therefore have assigned goodwill at the enterprise level. Fair value is measured using a valuation based on market multiples, comparable transactions and discounted cash flow methodologies. The goodwill impairment test is performed annually or whenever an event has occurred that would more likely than not reduce the fair value of a reporting unit below its carrying amount. For future valuations, should the enterprise carrying value exceed the estimated fair market value we would have to perform additional valuations to determine if any goodwill impairment exists. Any impairment recognized will be recorded as a component of operating expenses. See Note 5—Goodwill and Other Intangible Assets.

#### Long-Lived Assets

Long-lived assets are reviewed annually for impairment and 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 are compared to the carrying value of the long-lived assets to determine if a write-down to fair value is required. We recorded a provision of approximately \$7.5 million, \$1.9 million and \$383 thousand for asset impairments for certain real estate, leasehold improvements and store and gasoline equipment at certain underperforming stores for fiscal 2004, 2003 and 2002, respectively. We record asset impairment as a component of operating, general and administrative expenses.

## Notes to Consolidated Financial Statements (cont.)

### Revenue Recognition

Revenues from our two primary product categories, gasoline and merchandise, are recognized at the point of sale. We derive service revenue, which is included in merchandise revenue, from sales of lottery tickets, money orders, and car washes and services such as public telephones, ATMs, amusement and video gaming and other ancillary product and service offerings.

### Cost of Goods Sold

The primary components of cost of sales are gasoline, merchandise, repairs and maintenance of customer delivery equipment (e.g., gasoline dispensers) and franchise fees for branded fast food service less vendor allowances and rebates. Vendor allowances and rebates are amortized into cost of sales in accordance with vendor agreements and as the related inventories are sold.

### Operating, General and Administrative Expenses

The primary components of operating, general and administrative expenses are store labor, store occupancy, operations management and administrative personnel, insurance, and other corporate costs necessary to operate the business.

### Deferred Financing Costs

Deferred financing costs represent expenses related to issuing our long-term debt, obtaining our lines of credit and obtaining lease financing. See Note 6—Long-Term Debt and Note 12—Leases. Such amounts are being amortized over the remaining term of the respective financing and are included in interest expense.

### Vendor Allowances, Rebates and Other Vendor Payments

We receive payments for vendor allowances, volume rebates and other supply arrangements in connection with various programs. Our accounting practices with regard to some of our most significant arrangements are as follows:

- Vendor allowances for price markdowns are credited to cost of sales during the period in which the related markdown was taken and charged to cost of sales.
- Store imaging allowances are recognized as a reduction of cost of sales in the period earned in accordance with the vendor agreement. Store imaging includes signage, canopies, and other types of branding as defined in our gasoline contracts.
- Volume rebates by the vendor in the form of a reduction of the purchase price of the merchandise reduce cost of sales when the related merchandise is sold. Generally, volume rebates under a structured purchase program with allowances awarded based on the level of purchases are recognized when realization is probable and reasonably estimable, as a reduction in the cost of sales in the appropriate monthly period based on the actual level of purchases in the period relative to the total purchase commitment.

- Slotting and stocking allowances received from a vendor to ensure that its products are carried or to introduce a new product at our stores are recorded as a reduction of cost of sales over the period covered by the agreement.

Some of these typical vendor rebate, credit and promotional allowance arrangements require that we make assumptions and judgments regarding, for example, the likelihood of attaining specified levels of purchases or selling specified volumes of products, and the duration of carrying a specified product. We routinely review the relevant, significant factors and make adjustments where the facts and circumstances dictate.

The amounts recorded as a reduction of cost of sales were \$96.9 million, \$92.6 million and \$96.6 million for fiscal 2004, 2003 and 2002, respectively.

### Environmental Costs

We account for the cost incurred to comply with federal and state environmental regulations as follows:

- Environmental reserves reflected in the financial statements are 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 and 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 an appropriate rate. All other environmental costs are provided for on an undiscounted basis.
- Amounts that are probable of reimbursement under state trust fund programs or third-party insurers, based on our 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 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 overflow/spill devices are capitalized and depreciated over the remaining useful life of the asset or the respective lease term, whichever is less.

### Income Taxes

All of our operations, including subsidiaries, are included in a consolidated federal income tax return. Pursuant to SFAS No. 109, *Accounting for Income Taxes*, we recognize deferred income tax liabilities and assets for the expected future income tax consequences of temporary differences between financial statement carrying amounts and the related income tax basis.

### Excise Taxes

We collect and remit various federal and state excise taxes on petroleum products. Gasoline sales and cost of sales included excise taxes of approximately \$550.6 million, \$497.6 million, and \$471.9 million for fiscal 2004, 2003 and 2002, respectively.

### Advertising Costs

Advertising costs are expensed as incurred. Advertising expense was approximately \$2.0 million, \$2.1 million and \$1.8 million for fiscal 2004, 2003 and 2002, respectively.

### Stock-Based Compensation

Our stock option plans are described more fully in Note 16—Stock Options and Other Equity Instruments. We account for stock options under the intrinsic value method recognition and measurement principles of Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share for each of the periods presented if we had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation:

	2004	2003	2002
Net income (in thousands):			
As reported	\$17,553	\$11,504	\$1,804
Deduct—Total stock-based compensation expense determined under fair value method for all awards, net of income tax	(324)	(287)	(278)
Pro forma	\$17,229	\$11,217	\$1,526
Basic earnings per share:			
As reported	\$ 0.90	\$ 0.64	\$ 0.10
Pro forma	\$ 0.88	\$ 0.62	\$ 0.08
Diluted earnings per share:			
As reported	\$ 0.85	\$ 0.63	\$ 0.10
Pro forma	\$ 0.83	\$ 0.61	\$ 0.08

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 for each of the periods presented:

	2004	2003	2002
Weighted average grant date fair value	\$6.48	\$0.87	\$1.71
Weighted average expected lives (years)	2.00	2.00	2.00
Weighted average grant date fair value—exercise price equals market price	\$6.48	\$0.87	\$1.71
Weighted average grant date fair value—exercise price greater than market price	—	—	—
Risk-free interest rate	1.8%	1.8%	3.0%
Expected volatility	77%	70%	60%
Dividend yield	0.00%	0.00%	0.00%

Due to the factors (assumptions) described above, the above pro forma disclosures are not necessarily representative of pro forma effects on reported net income for future years.

### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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

We provide segment reporting in accordance with 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. Our chief operating decision maker believes we operate in one segment due to the following: the sales of both gasoline and merchandise are interrelated, the target customers are the same for all products, and our stores are homogeneous in product offerings.

### Reclassifications

Certain amounts in the fiscal 2003 and 2002 consolidated financial statements have been reclassified to conform to the fiscal 2004 presentation. Amounts reclassified include a \$2.9 million loss on extinguishment of debt, which was reclassified from operating, general and administrative expenses in our fiscal 2003 financial statements.

## Notes to Consolidated Financial Statements (cont.)

### Recently Adopted Accounting Standards

No recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by us have occurred during the year ended September 30, 2004, other than the items described below.

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation ("FIN") 46, *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51* (revised December 2003, FIN 46R). This interpretation provides guidance related to identifying variable interest entities (previously known as special purpose entities or SPEs) and determining whether such entities should be consolidated. Certain disclosures are required if it is reasonably possible that a company will consolidate or disclose information about a variable interest entity when it initially applies FIN 46. This interpretation was effective beginning in our second fiscal quarter ending March 25, 2004. We have no investment in or contractual relationship or other business relationship with a variable interest entity and therefore the adoption of FIN 46 did not have any impact on our results of operations and financial condition. However, if we enter into any such arrangement with a variable interest entity in the future (or an entity with which we currently have a relationship is reconsidered based on guidance in FIN 46R to be a variable interest entity), our results of operations and financial condition may be impacted.

### Recently Issued Accounting Standards

In March 2004, the FASB issued an exposure draft on "Share-Based Payment." The proposed Statement addresses the accounting for transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. This proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method. This Statement, if approved, was scheduled to be effective for awards that are granted, modified, or settled in periods beginning after December 15, 2004 for public entities. On October 16, 2004, the FASB delayed the effective date of this proposal by six months and anticipates it will be effective for the fourth quarter of fiscal 2005. Retrospective application of this Statement is not permitted. The adoption of this Statement, if approved, could have an impact on our financial position or results of operations.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

### Note 2—Acquisition of Related Business:

On October 16, 2003, we completed the acquisition of 138 convenience stores operating in Tennessee and Georgia under the Golden Gallon® banner from Ahold USA, Inc. The acquired assets include 138 operating convenience stores, 131 of which are fee-owned stores, a dairy plant and related assets, a fuel hauling operation, corporate headquarters buildings and 25 undeveloped sites. Other than the dairy plant and related assets, the fuel hauling operation and the corporate headquarters buildings, we intend to use the acquired assets in the convenience store retail business. Simultaneous with the closing, we sold the dairy plant and related assets and the fuel hauling operation to our existing suppliers.

The acquisition was structured as two simultaneous transactions, whereby 114 of the 131 fee-owned stores were purchased and financed through a \$94.5 million sale-leaseback transaction, and the Golden Gallon® operations and the balance of the real estate assets were purchased with cash. We funded the second transaction with \$80.0 million of debt through borrowings under an amendment to our existing senior secured credit facility, see Note 6—Long-Term Debt, and available cash.

The following purchase price allocations for the Golden Gallon® acquisition are based on the fair values on the date of the acquisition (amounts in thousands):

Assets Acquired:	
Receivables	\$ 3,464
Inventories	10,018
Prepaid expenses	116
Property held for sale	101,566
Property and equipment	27,976
Total assets	143,140
Liabilities Assumed:	
Accounts payable	(11,436)
Other accrued liabilities	(12,731)
Total liabilities	(24,167)
Net tangible assets acquired	118,973
Trademarks	2,800
Goodwill	63,286
Total consideration paid, including direct costs, net of cash acquired	\$185,059

The following unaudited pro forma information presents a summary of our consolidated results of operations and the acquired assets as if the transaction occurred at the beginning of the fiscal year for each of the periods presented (amounts in thousands, except per share data):

	2004	2003
Total revenues	<b>\$3,504,934</b>	\$3,158,941
Net income before cumulative effect adjustment	<b>17,581</b>	24,691
Net income	<b>17,581</b>	21,209
Earnings per share before cumulative effect adjustment		
Basic	<b>\$ 0.90</b>	\$ 1.36
Diluted	<b>\$ 0.85</b>	\$ 1.34
Earnings per share		
Basic	<b>\$ 0.90</b>	\$ 1.17
Diluted	<b>\$ 0.85</b>	\$ 1.15

During fiscal 2004, we also acquired one store located in South Carolina in a separate acquisition.

### Note 3—Inventories:

At September 30, 2004 and September 25, 2003, inventories consisted of the following (in thousands):

	2004	2003
Inventories at FIFO cost:		
Merchandise	<b>\$ 75,292</b>	\$ 74,483
Gasoline	<b>29,881</b>	20,996
	<b>\$ 105,173</b>	\$ 95,479
Less adjustment to LIFO cost:		
Merchandise	<b>(9,945)</b>	(11,323)
Inventories at LIFO cost	<b>\$ 95,228</b>	\$ 84,156

The positive effect on cost of sales of LIFO inventory liquidations was \$42 thousand, \$1.2 million and \$692 thousand for fiscal 2004, 2003 and 2002, respectively.

### Note 4—Property and Equipment:

At September 30, 2004 and September 25, 2003, property and equipment consisted of the following (in thousands):

	2004	2003
Land	<b>\$ 79,691</b>	\$ 78,586
Buildings	<b>137,499</b>	138,857
Equipment	<b>423,601</b>	387,502
Leasehold improvements	<b>81,678</b>	72,221
Construction in progress	<b>15,655</b>	10,460
	<b>738,124</b>	687,626
Less—accumulated depreciation and amortization	<b>(326,623)</b>	(287,017)
Property and equipment, net	<b>\$ 411,501</b>	\$ 400,609

### Note 5—Goodwill and Other Intangible Assets:

Effective September 28, 2001, we adopted the provisions of SFAS No. 142 and as a result, our goodwill asset is no longer amortized but reviewed at least annually for impairment. Other intangible assets will continue to be amortized over their useful lives. We determined that we operate in one reporting unit based on the current reporting structure and have thus assigned goodwill at the enterprise level.

The changes in the balance of goodwill for the years ended September 30, 2004 and September 25, 2003 consisted of the following (in thousands):

	2004	2003
Beginning balance	<b>\$278,629</b>	\$277,874
Goodwill acquired during the year	<b>63,023</b>	755
Ending balance	<b>\$341,652</b>	\$278,629

We completed our annual goodwill impairment test as of January 22, 2004 by comparing the enterprise fair value to its carrying or book value. This valuation indicated an aggregate fair value in excess of our book value; therefore, we have determined that no impairment existed. On an ongoing basis, we will perform an annual goodwill impairment test at the end of January. At least quarterly, we will analyze whether an event has occurred that would more likely than not reduce our enterprise fair value below its carrying amount and, if necessary, we will perform a goodwill impairment test between the annual dates. Impairment adjustments recognized after adoption, if any, will be recognized as operating expenses.

Other intangible assets consist of noncompete agreements and a trademark. At September 30, 2004 and September 25, 2003, noncompete agreements consisted of the following (in thousands):

	2004	2003
Gross carrying value	<b>\$ 7,959</b>	\$ 8,559
Less—accumulated amortization	<b>(1,766)</b>	(1,938)
Noncompete agreements, net	<b>\$ 6,193</b>	\$ 6,621

Amortization expense related to noncompete agreements was \$428 thousand, \$626 thousand and \$725 thousand for fiscal 2004, 2003 and 2002, respectively. The weighted average amortization period of all noncompete agreements is 29.2 years. Additionally, as a result of the Golden Gallon® acquisition, we recorded \$2.8 million related to the trademark. This asset was determined to have an indefinite useful life and therefore no amortization was recorded, see also Note 2—Acquisition of Related Business. Estimated amortization expense for each of the five fiscal years following September 30, 2004 and thereafter is: \$351 thousand in fiscal 2005; \$305 thousand in fiscal 2006; \$206 thousand in fiscal 2007; \$197 thousand in fiscal 2008; \$197 thousand in fiscal 2009 and \$4.9 million thereafter. Other intangible assets are classified in other noncurrent assets in the accompanying consolidated balance sheets.

## Notes to Consolidated Financial Statements (cont.)

### Note 6—Long-Term Debt:

Long-term debt consisted of the following (amounts in thousands):

	September 30, 2004	September 25, 2003
Senior subordinated notes payable; due February 19, 2014; interest payable semi-annually at 7.75%	\$250,000	\$ —
Senior subordinated notes payable; due October 15, 2007; interest payable semi-annually at 10.25%	—	200,000
Senior Credit Facility; interest payable monthly at LIBOR plus 2.25%; principal due in quarterly installments through March 12, 2011	317,000	—
First lien term loan; interest payable monthly at LIBOR plus 4.25%; principal due in quarterly installments through March 31, 2007, net of unamortized original issue discount of \$3,347	—	247,153
Second lien term loan; interest payable monthly at LIBOR plus 6.5%; principal due in full on March 31, 2007, net of unamortized original issue discount of \$682	—	50,318
Other notes payable; various interest rates and maturity dates	39	98
Total long-term debt	<b>567,039</b>	497,569
Less—current maturities	<b>(16,029)</b>	(27,558)
Long-term debt, net of current maturities	<b>\$551,010</b>	\$470,011

On April 14, 2003, we entered into a new senior secured credit facility, which consisted of a \$253.0 million first lien term loan, a \$51.0 million second lien term loan and a \$52.0 million revolving credit facility, each maturing March 31, 2007. Proceeds from the new senior secured credit facility were used to repay all amounts outstanding under the previously existing senior credit facility and loan origination costs. The term loans were issued with an original issue discount of \$4.6 million. We incurred approximately \$7.2 million in costs associated with issuance of the new senior credit facility, which were deferred and will be amortized over the life of the new senior credit facility. In connection with the refinancing, we recorded a non-cash charge of approximately \$2.9 million related to the write-off of deferred financing costs associated with the previous credit facility and is included in loss on extinguishment of debt, see Note 10—Interest Expense and Loss on Extinguishment of Debt.

On October 16, 2003, we entered into an amendment to our then existing senior credit facility to increase the borrowing under the first lien term loan by \$80.0 million. The proceeds from the amendment to the term loan were used to fund the Golden Gallon® acquisition. We incurred approximately \$2.6 million in costs associated with the amendment, which were deferred and amortized over the life of the loan agreement.

On February 19, 2004, we called for redemption all of our outstanding \$200.0 million principal amount of 10.25% senior subordinated notes due 2007 and completed the sale of \$250.0 million of our 7.75% senior subordinated notes due 2014. The redemption was completed on March 22, 2004. We incurred approximately \$6.6 million in costs associated with the sale of the new notes, which were deferred and will be amortized over the life of the new notes.

On March 12, 2004, we entered into an Amended and Restated Credit Agreement (“senior credit facility”), which consists of a \$345.0 million term loan that matures in March, 2011 and a \$70.0 million revolving credit facility that expires in March, 2010, to replace all amounts outstanding under our previous senior secured credit facility. The senior credit facility is available for refinancing certain existing indebtedness of our company, working capital financing and general corporate purposes. In addition, the revolving credit facility is available for issuing commercial and standby letters of credit. We incurred approximately \$2.2 million in costs associated with the amendment, which were deferred and will be amortized over the term of the loan agreement.

We recorded a loss on the redemption of our 10.25% senior subordinated notes and refinancing of the senior credit facility of approximately \$23.1 million. See Note 10—Interest Expense and Loss on Extinguishment of Debt.

The senior secured credit facility contains various restrictive covenants including a maximum leverage ratio, minimum fixed charge coverage, maximum capital expenditures as well as other customary covenants, representations and warranties and events of default. At September 30, 2004, we were in compliance with all covenants and restrictions related to all outstanding borrowings. Substantially all of our net assets are restricted as to payment of dividends and distributions.

On September 30, 2004, we amended our senior credit facility to reduce the applicable margin for our LIBOR rate loans to 2.25%. We also amended the aggregate amount of incremental borrowing as permitted to \$75.0 million. Simultaneous with this amendment, we paid \$20.0 million toward the principal, which was applied to the final principal payment due March 2011.

At September 30, 2004, our senior credit facility consists of a \$317.0 million term loan and a \$70.0 million revolving credit facility, which bear interest at a rate of LIBOR plus 2.25%. Our senior credit facility is secured by substantially all of our assets, other than our leased real property and is guaranteed by our subsidiaries. As of September 30, 2004, there were no outstanding borrowings under the revolving credit facility and we had approximately \$34.8 million of standby letters of credit issued under the facility. As a result, we had approximately \$35.2 million in available borrowing capacity. Furthermore, the revolving credit facility limits our total outstanding letters of credit to \$50.0 million. The LIBOR associated with our senior credit facility resets periodically, and as of September 30, 2004, the effective LIBOR rate was 1.84.

The remaining annual maturities of our long-term debt as of September 30, 2004 are as follows (amounts in thousands):

Year Ended September:	
2005	\$ 12,029
2006	16,010
2007	16,000
2008	16,000
2009	16,000
Thereafter	491,000
<b>Total principal payments</b>	<b>\$567,039</b>

Payments due in fiscal 2005 do not include the \$4.0 million payment due September 30, 2005 as this date is in fiscal 2006; however, this amount is included in current maturities of long-term debt on the balance sheet as it is due within one year of the balance sheet date.

The fair value of our indebtedness approximated \$580.9 million at September 30, 2004.

#### Note 7—Derivative Financial Instruments:

We enter into interest rate swap agreements to modify the interest rate characteristics of our outstanding long-term debt and have designated each qualifying instrument as a cash flow hedge. We formally document our hedge relationships, including identifying the hedge instruments and hedged items, as well as our risk management objectives and strategies for entering into the hedge transaction. At hedge inception, and at least quarterly thereafter, we assess whether derivatives used to hedge transactions are highly effective in offsetting changes in the cash flow of the hedged item. We measure effectiveness by the ability of the interest rate swaps to offset cash flows associated with changes in the variable LIBOR rate associated with our term loan facilities using the hypothetical derivative method. To the extent the instruments are considered to be effective, changes in fair value are recorded as a component of other comprehensive income (loss). To

the extent there is any hedge ineffectiveness, changes in fair value relating to the ineffective portion are immediately recognized in earnings (interest expense). When it is determined that a derivative ceases to be a highly effective hedge, we discontinue hedge accounting, and subsequent changes in fair value of the hedge instrument are recognized in earnings. Interest income (expense) was \$1.3 million, \$3.4 million, and \$(926) thousand for fiscal 2004, 2003 and 2002, respectively, for the mark-to-market adjustment of those instruments that do not qualify for hedge accounting.

The fair values of our interest rate swaps are obtained from dealer quotes. These values represent the estimated amount we would receive or pay to terminate the agreement taking into consideration the difference between the contract rate of interest and rates currently quoted for agreements of similar terms and maturities. At September 30, 2004, other noncurrent liabilities included derivative liabilities of approximately \$700 thousand and other noncurrent assets include derivative assets of approximately \$600 thousand. At September 25, 2003, other accrued liabilities and other noncurrent liabilities include derivative liabilities of \$1.5 million and \$1.4 million, respectively. Cash flow hedges at September 30, 2004 have various settlement dates, the latest of which are April 2006 interest rate swaps with a notional amount of \$202.0 million that have a weighted average pay rate of 2.72%.

#### Note 8—Comprehensive Income (Deficit):

The components of accumulated other comprehensive income/(deficit), net of related income taxes, are as follows (amounts in thousands):

	2004	2003
Unrealized gains/(losses) on qualifying cash flow hedges (net of related income taxes of \$(129) and \$432, respectively)	<b>\$206</b>	\$(690)
Accumulated other comprehensive income/(deficit)	<b>\$206</b>	\$(690)

The components of other comprehensive income, net of income related taxes, for the periods presented are as follows (amounts in thousands):

	2004	2003	2002
Amortization of cumulative effect of adoption of SFAS No. 133 (net of deferred income taxes of \$—, \$93 and \$135, respectively)	\$ —	\$ 158	\$ 205
Net unrealized gains on qualifying cash flow hedges (net of deferred income taxes of \$561, \$708 and \$1,292, respectively)	<b>896</b>	1,264	1,966
Other comprehensive income	<b>\$896</b>	\$1,422	\$2,171

## Notes to Consolidated Financial Statements (cont.)

The components of unrealized gains on qualifying cash flow hedges, net of related income taxes, for the periods presented are as follows (amounts in thousands):

	2004	2003	2002
Unrealized gains on qualifying cash flow hedges	\$ 2,169	\$ 3,272	\$ 5,465
Less: Reclassification adjustment recorded as interest expense	(1,273)	(2,008)	(3,499)
Net unrealized gains on qualifying cash flow hedges	\$ 896	\$ 1,264	\$ 1,966

### Note 9—Asset Retirement Obligations:

Effective September 27, 2002, we adopted the provisions of SFAS No. 143 and, as a result, we recognize the future cost to remove an underground storage tank over the estimated useful life of the storage tank in accordance with SFAS No. 143. A liability for the fair value of an asset retirement obligation with a corresponding increase to the carrying value of the related long-lived asset is recorded at the time an underground storage tank is installed. We will amortize the amount added to property and equipment and recognize accretion expense in connection with the discounted liability over the remaining life of the respective underground storage tanks.

The estimated liability is based on historical experience in removing these tanks, estimated tank useful lives, external estimates as to the cost to remove the tanks in the future and federal and state regulatory requirements. The liability is a discounted liability using a credit-adjusted risk-free rate ranging from approximately 7.3% to 9.3%. Revisions to the liability could occur due to changes in tank removal costs, tank useful lives or if federal and/or state regulators enact new guidance on the removal of such tanks.

Upon adoption, we recorded a discounted liability of \$8.4 million, which is included in other noncurrent liabilities, increased net property and equipment by \$2.7 million and recognized a one-time cumulative effect adjustment of \$3.5 million (net of deferred income tax benefit of \$2.2 million).

We reviewed our estimate of this liability during the quarter ended September 30, 2004 due to changes in the estimate of future underground storage tank removal costs. The change in estimate resulted in an increase of \$3.8 million to the carrying amount of the liability and the carrying amount of the related long-lived assets. Since this revision is a change in estimates, we will depreciate the asset and amortize the liability over the remaining useful life of the related underground storage tanks.

A reconciliation of the changes in our liability is as follows (amounts in thousands):

	2004	2003
Beginning balance	\$ 9,240	\$8,443
Liabilities incurred	3,862	191
Liabilities assumed—acquisitions	1,236	—
Liabilities settled	(376)	(159)
Accretion expense	856	765
Ending balance	\$14,818	\$9,240

### Note 10—Interest Expense and Loss on Extinguishment of Debt:

The components of interest expense are as follows (amounts in thousands):

	2004	2003	2002
Interest on long-term debt, including amortization of deferred financing costs	\$43,180	\$41,572	\$39,577
Interest rate swap settlements	3,427	8,470	8,840
Interest on capital lease obligations	2,208	2,281	2,189
Fair market value change in non-qualifying derivatives	(1,312)	(3,381)	926
Miscellaneous	(297)	323	114
Subtotal: Interest expense	\$47,206	\$49,265	\$51,646
Loss on debt extinguishment	23,087	2,888	—
Total interest expense and loss on extinguishment of debt	\$70,293	\$52,153	\$51,646

The loss on debt extinguishment in fiscal year 2004 relates to the redemption of our \$200 million 10.25% senior subordinated notes and the refinancing of the senior credit facility. The loss includes the write-off of the unamortized portion of deferred financing costs of \$11.8 million, the call premium on the senior subordinated notes of \$6.8 million, the call premium on the second lien term loan of \$1.0 million, and the write-off of the unamortized original issue discount on the senior credit facility of \$3.5 million.

The loss on debt extinguishment during fiscal year 2003 relates to the April 14, 2003 refinancing of our senior credit facility. In connection with this refinancing, we recorded a non-cash charge of \$2.9 million related to the write-off of the unamortized portion of deferred financing charges associated with the previous credit facility.

**Note 11—Income Taxes:**

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

	2004	2003	2002
Current:			
Federal	\$ 272	\$ —	\$ —
State	4	—	—
	<b>\$ 276</b>	<b>\$ —</b>	<b>\$ —</b>
Deferred:			
Federal	\$ 8,890	\$8,286	\$ 998
State	1,179	1,099	132
	<b>10,069</b>	<b>9,385</b>	<b>1,130</b>
	<b>\$10,345</b>	<b>\$9,385</b>	<b>\$1,130</b>

As of September 30, 2004 and September 25, 2003, deferred income tax (liabilities) and assets are comprised of the following (in thousands):

	2004	2003
Property and equipment	<b>\$(61,086)</b>	\$(67,541)
Inventories	<b>(3,335)</b>	(3,430)
Amortization of intangibles	<b>(25,303)</b>	(15,275)
Environmental	<b>(1,533)</b>	(824)
Other	<b>(2,781)</b>	(67)
Gross deferred income tax liabilities	<b>(94,038)</b>	(87,137)
Accrued insurance	<b>6,534</b>	4,634
Asset retirement obligation	<b>3,024</b>	2,180
Deferred revenue	<b>10,602</b>	7,565
Reserve for closed stores	<b>2,128</b>	1,382
Impairment of long-lived assets	<b>1,924</b>	—
Other	<b>4,565</b>	4,865
Gross deferred income tax assets	<b>28,777</b>	20,626
Net operating loss carryforwards	<b>5,612</b>	17,065
General business credits	<b>1,239</b>	1,024
AMT credits	<b>2,660</b>	2,741
Net deferred income tax liability	<b>\$(55,750)</b>	\$(45,681)

As of September 30, 2004 and September 25, 2003, net current deferred income tax assets totaled \$7.5 million and \$4.3 million, respectively, and net noncurrent deferred income tax liabilities totaled \$63.3 million and \$50.0 million, respectively.

Reconciliations of income taxes at the federal statutory rate (34%) to actual income tax expense for each of the periods presented are as follows (in thousands):

	2004	2003	2002
Tax expense at federal statutory rate	\$ 9,486	\$8,286	\$ 998
Tax expense at state rate, net of federal tax expense	1,116	926	109
Permanent differences:			
Other permanent items, net	<b>(257)</b>	173	23
Net income tax expense	<b>\$10,345</b>	<b>\$9,385</b>	<b>\$1,130</b>

As of September 30, 2004, we had net operating loss carryforwards, general business credits and alternative minimum tax (AMT) credits that can be used to offset future federal income taxes. The benefit of these carryforwards is recognized as a deferred income tax asset. Loss carryforwards as of September 30, 2004 have the following expiration dates (in thousands):

Year of Expiration	Federal	State
2014	\$ —	\$ 846
2015	—	3,179
2016	—	3,847
2017	—	2,891
2018	—	3,515
2019	—	2,470
2020	—	2,836
2021	—	1,774
2022	10,419	2,443
Total loss carryforward	\$10,419	\$23,801

**Note 12—Leases:**

We lease store buildings, office facilities and store equipment under both capital and operating leases. The asset balances related to capital leases at September 30, 2004 and September 25, 2003 are as follows (in thousands):

	2004	2003
Buildings	<b>\$ 23,821</b>	\$ 24,837
Less—accumulated amortization	<b>(11,061)</b>	(10,580)
	<b>\$ 12,760</b>	\$ 14,257

Amortization expense related to capitalized leased assets was \$1.5 million, \$1.5 million and \$1.4 million for fiscal 2004, 2003 and 2002, respectively.

Future minimum lease payments as of September 30, 2004 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
2005	\$ 3,271	\$ 64,801
2006	3,050	61,415
2007	2,994	58,861
2008	2,740	56,600
2009	2,596	52,849
Thereafter	20,062	410,649
Net minimum lease payments	34,713	<b>\$705,175</b>
Amount representing interest (8% to 20%)	18,934	
Present value of net minimum lease payments	15,779	
Less—current maturities	1,197	
	<b>\$14,582</b>	

## Notes to Consolidated Financial Statements (cont.)

Rental expense for operating leases was approximately \$73.0 million, \$63.6 million and \$63.3 million for fiscal 2004, 2003 and 2002, respectively. We have facility leases with step rent provisions, capital improvement funding, and other forms of lease concessions. In accordance with generally accepted accounting principles, we record step rent provisions and lease concessions on a straight-line basis over the minimum lease term. Some of our leases require contingent rental payments; such amounts are not material for the fiscal years presented.

During fiscal 2004, 2003 and 2002, we entered into sale-leaseback transactions with unrelated parties with net proceeds of \$96.7 million, \$2.3 million and \$6.2 million, respectively. The assets sold in these transactions consisted of newly constructed or acquired convenience stores. Included in the fiscal 2004 sale-leaseback amount is \$94.5 million related to the Golden Gallon® transaction, see Note 2—Acquisition of Related Business. We retained ownership of all personal property and gasoline marketing equipment at these locations. 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.

### Note 13—Commitments and Contingencies:

As of September 30, 2004, we were contingently liable for outstanding letters of credit in the amount of \$34.8 million related primarily to several areas in which we are self-insured. The letters of credit are not to be drawn against unless we default on the timely payment of related liabilities.

We are 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 accounting principles generally accepted in the United States of America, service and supply allowances are amortized over the life of each agreement in accordance with the specific terms. At September 30, 2004, other accrued liabilities and other noncurrent liabilities include the unamortized liabilities associated with these payments of \$5.2 million and \$35.1 million, respectively. At September 25, 2003, other accrued liabilities and other noncurrent liabilities include the unamortized liabilities associated with these payments of \$7.7 million and \$37.3 million, respectively.

*McLane Company, Inc. ("McLane").* We purchase over 50% of our general merchandise from a single wholesaler, McLane. Our arrangement with McLane is governed by a five-year distribution service agreement, which was amended on October 5, 2002 and expires on October 10, 2008. We receive annual service allowances based on the number of stores operating on each contract anniversary date. If we were to default under the contract or terminate the distribution service agreement prior to October 10, 2008, we 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 and recognized as a reduction to cost of goods sold on a straight-line method over the life of the agreement.

*Major Oil Companies.* We have entered into product brand imaging agreements with numerous oil companies to buy gasoline at market prices. These contracts range in length from three to ten years. In connection with these agreements, we may receive upfront vendor allowances, volume incentive payments and other vendor assistance payments. If we were to default under the terms of any contract or terminate the supply agreement prior to the end of the initial term, we must reimburse the respective oil company for the unearned, unamortized portion of the payments received to date. In accordance with accounting principles generally accepted in the United States of America, these payments are amortized and recognized as a reduction to cost of goods sold 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.

### Environmental Liabilities and Contingencies

We are subject to various federal, state and local environmental laws. We make financial expenditures in order to comply with regulations governing underground storage tanks adopted by federal, state and local regulatory agencies. In particular, at the federal level, the Resource Conservation and Recovery Act of 1976, as amended, requires the EPA to establish a comprehensive regulatory program for the detection, prevention and cleanup of leaking underground storage tanks.

Federal and state regulations require us to provide and maintain evidence that we are taking financial responsibility for corrective action and compensating third parties in the event of a release from our underground storage tank systems. In order to comply with these requirements, as of September 30, 2004, we maintain letters of credit in the aggregate amount of approximately \$1.3 million in favor of state environmental agencies in North Carolina, South Carolina, Virginia, Georgia, Indiana, Tennessee, Kentucky and Louisiana.

We also rely upon the reimbursement provisions of applicable state trust funds. In Florida, we meet our financial responsibility requirements by state trust fund coverage for releases occurring through December 31, 1998 and meet such requirements for releases thereafter through private commercial liability insurance. In Georgia, we meet our financial responsibility requirements by state trust fund coverage for releases occurring through December 29, 1999 and meet such requirements for releases thereafter through private commercial liability insurance and a letter of credit.

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; and
- maintaining evidence of financial responsibility for taking corrective action and compensating third parties for bodily injury and property damage resulting from releases.

These regulations permit states to develop, administer and enforce their own regulatory programs, incorporating requirements which are at least as stringent as the federal standards. In 1998, Florida developed their own regulatory program, which incorporated requirements more stringent than the 1988 EPA regulations. We believe our facilities in Florida meet or exceed those regulations developed by the state of Florida in 1998. We believe all company-owned underground storage tank systems are in material compliance with these 1988 EPA regulations and all applicable state environmental regulations.

All states in which we operate or have 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. We have paid underground storage tank registration fees and gasoline taxes to each state where we operate to participate in these trust fund programs. We have filed claims and received reimbursements in North Carolina, South Carolina, Kentucky, Indiana, Georgia, Florida, Tennessee, Mississippi and Virginia. The coverage afforded by each state fund varies but generally provides up to \$1.0 million per site or occurrence for the cleanup of environmental contamination, and most provide

coverage for third-party liabilities. Costs for which we do not receive reimbursement include:

- the per-site deductible;
- costs incurred in connection with releases occurring or reported to trust funds prior to their inception;
- removal and disposal of underground storage tank systems; and
- costs incurred in connection with sites otherwise ineligible for reimbursement from the trust funds.

The trust funds generally require us to pay deductibles ranging from \$5 thousand to \$150 thousand per occurrence depending on the upgrade status of our underground storage tank system, the date the release is discovered and/or reported and the type of cost for which reimbursement is sought. The Florida trust fund will not cover releases first reported after December 31, 1998. We obtained private insurance coverage for remediation and third-party claims arising out of releases reported after December 31, 1998. We believe that this coverage exceeds federal and Florida financial responsibility regulations. In Georgia, we opted not to participate in the state trust fund effective December 30, 1999. We obtained private coverage for remediation and third-party claims arising out of releases reported after December 29, 1999. We believe that this coverage exceeds federal and Georgia financial responsibility regulations.

In addition to immaterial amounts to be spent by us, a substantial amount will be expended for remediation on behalf of us by state trust funds established in our operating areas or other responsible third parties (including insurers). To the extent such third parties do not pay for remediation as anticipated by us, we will be obligated to make such payments, which could materially adversely affect our 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 \$14.1 million and \$13.8 million as of September 30, 2004 and September 25, 2003, respectively, represent our estimates for future expenditures for remediation, tank removal and litigation associated with 251 and 236 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. We estimate that approximately \$13.1 million of our environmental obligations will be funded by state trust funds and third-party insurance; as a result, we may spend up to \$1.0 million for remediation, tank removal and litigation. Also, as of September 30, 2004 and September 25, 2003, there were an additional 503 and 487 sites, respectively, that are known to be contaminated

## Notes to Consolidated Financial Statements (cont.)

sites that are being remediated by third parties, and therefore, the costs to remediate such sites are not included in our environmental reserve. Remediation costs for known sites are expected to be incurred over the next one to ten years. Environmental reserves have been established with remediation costs based on internal and external estimates for each site. Future remediation for which the timing of payments can be reasonably estimated are discounted using an appropriate rate to determine the reserve. The undiscounted amount of future estimated payments for which we do not expect to be reimbursed for each of the five fiscal years and thereafter at September 30, 2004 and other cost amounts covered by responsible third parties are as follows (in thousands):

Fiscal Year	Expected Payments
2005	\$ 517
2006	517
2007	391
2008	185
2009	46
Thereafter	68
Total undiscounted amounts	
not covered by a third party	1,724
Other current cost amounts	15,446
Amount representing interest	(3,119)
Environmental reserves	\$14,051

We anticipate that we will be reimbursed for expenditures from state trust funds and private insurance. As of September 30, 2004, anticipated reimbursements of \$15.1 million are recorded as long-term environmental receivables and \$3.2 million are recorded as current receivables related to all sites. In Florida, remediation of such contamination reported before January 1, 1999 will be performed by the state (or state approved independent contractors) and substantially all of the remediation costs, less any applicable deductibles, 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. 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 expenditures, some or all of which may not be eligible for reimbursement from state trust funds.

Several of the locations identified as contaminated are being remediated by third parties who have indemnified us as to responsibility for clean up 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.

### Note 14—Benefit Plans:

We sponsor a 401(k) Employee Retirement Savings Plan for eligible employees. Employees must be at least twenty-one 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 100% of their annual compensation, and contributions are matched by us on the basis of 50% of the first 5% contributed. Matching contribution expense was \$709 thousand, \$731 thousand and \$719 thousand for fiscal 2004, 2003 and 2002, respectively.

### Note 15—Common Stock:

On June 8, 1999, we completed an initial public offering of 6,250,000 shares of our 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 of fiscal 1999 and \$2.4 million was reserved to pay fees and expenses associated with the IPO.

Upon completion of the IPO, Freeman Spogli & Co. ("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). Prior to fiscal 2004, Freeman Spogli had purchased an additional 2,466,014 shares from other stockholders. On December 9, 2003, Freeman Spogli exercised the warrants to purchase 2,346,000 shares of common stock at an exercise price of \$7.45 per share. The exercise was cashless whereby shares of common stock received were reduced by the number of shares having an aggregate fair market value equal to the exercise price, or approximately \$17.5 million. The aggregate fair market value was based on the average closing price on each of the ten days prior to December 9, 2003, or \$23.68 per share. Consequently, upon exercise, Freeman Spogli received 1,607,855 shares of common stock.

During January 2004, we completed a secondary stock offering in which Freeman Spogli and other selling stockholders sold 5,750,000 shares at a public offering price of \$20.00 per share, reducing Freeman Spogli's beneficial ownership to approximately 38.2% of our outstanding common stock.

### Note 16—Stock Options and Other Equity Instruments:

On January 1, 1998, we adopted an incentive and non-qualified stock option plan. Pursuant to the provisions of the plan, options may be granted to officers, key employees, consultants or any of our subsidiaries and certain members of the board of directors to purchase up to 1,275,000 shares

of common stock. On June 3, 1999, we 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 and up to 3,825,000 shares of our common stock available for grant. The plans are 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. All options granted vest over a three-year period, with one-third of each grant vesting on the anniversary of the initial grant and have contractual lives of seven years. Additionally, the terms and conditions of awards under the plans may differ from one grant to another. Under the

plans, 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.

On January 15, 2003, the board of directors amended the 1999 plan to increase the number of shares of common stock that may be issued under the plan by 882,505 shares. This number of shares corresponded to the number of shares that remained available at that time for issuance under the 1998 plan, which the board of directors terminated (except for the purpose of continuing to govern options outstanding under that plan) on January 15, 2003.

A summary of the status of the plans for the three fiscal years ended September 30, 2004, September 25, 2003, and September 26, 2002 and changes during the years ending on those dates is as follows:

	Shares	Option Price Per Share	Weighted Average Exercise Price Per Share
September 27, 2001	1,021,283	\$8.82–\$13.00	\$10.30
Options granted	240,000	4.00– 5.12	4.94
Options forfeited	(136,078)	5.12– 13.00	10.54
Options exercisable	709,538	4.00– 13.00	10.30
September 26, 2002	1,125,205	4.00– 13.00	9.13
Options granted	430,000	1.66– 8.09	2.23
Options forfeited	(249,313)	5.12– 13.00	9.15
Options exercisable	670,558	4.00– 13.00	9.82
September 25, 2003	1,305,892	4.00– 13.00	6.85
Options granted	244,000	14.80– 19.95	15.33
Options forfeited	(56,834)	1.70– 14.80	6.74
Options exercised	(556,305)	1.70– 13.00	8.81
Options exercisable	455,544	1.66– 13.00	7.14
<b>September 30, 2004</b>	<b>936,753</b>	<b>\$1.66–\$19.95</b>	<b>\$ 7.90</b>

The following table summarizes information about stock options outstanding at September 30, 2004:

Date Granted	Exercise Prices	Number Outstanding September 30, 2004	Weighted Average Remaining Contractual Life	Number of Options Exercisable
1/15/98	\$ 8.82	207,111	3 years	207,111
8/31/98	11.27	57	4 years	57
6/8/99, 9/30/99	13.00	41,100	2 years	41,100
12/29/00	10.00	31,600	3 years	31,600
11/26/01	5.12	76,143	4 years	50,762
3/26/02	4.00	20,000	5 years	13,333
10/22/02	1.66	20,000	5 years	6,667
11/13/02	1.70	244,742	5 years	81,581
1/6/03	3.97	35,000	5 years	11,667
3/25/03	4.50	25,000	6 years	8,333
7/23/03	8.09	10,000	6 years	3,333
10/22/03	14.80	201,000	6 years	—
3/31/04	19.95	25,000	7 years	—
	Total	936,753		455,544

As of September 30, 2004, we have approximately 3.5 million shares available for stock option grants.

## Notes to Consolidated Financial Statements (cont.)

### Note 17—Earnings (Loss) Per Share:

We compute 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 (dollars in thousands, except per share data):

	2004	2003	2002
Income before cumulative effect adjustment	\$17,553	\$14,986	\$1,804
Cumulative effect adjustment	—	(3,482)	—
Net income	\$17,553	\$11,504	\$1,804
Earnings per share—basic:			
Weighted average shares outstanding	19,606	18,108	18,108
Income per share before cumulative effect adjustment—basic	\$ 0.90	\$ 0.83	\$ 0.10
Loss per share on cumulative effect adjustment—basic	—	(0.19)	—
Net income per share—basic	\$ 0.90	\$ 0.64	\$ 0.10
Earnings per share—diluted:			
Weighted average shares outstanding	19,606	18,108	18,108
Dilutive impact of options and warrants outstanding	1,063	262	1
Weighted average shares and potential dilutive shares outstanding	20,669	18,370	18,109
Income per share before cumulative effect adjustment—diluted	\$ 0.85	\$ 0.82	\$ 0.10
Loss per share on cumulative effect adjustment—diluted	—	(0.19)	—
Net income per share—diluted	\$ 0.85	\$ 0.63	\$ 0.10

Options and warrants to purchase shares of common stock that were not included in the computation of diluted earnings per share, because their inclusion would have been antidilutive, were 3.0 million and 3.4 million for fiscal 2003 and 2002, respectively.

### Note 18—Quarterly Financial Data (unaudited):

Summary quarterly financial data for fiscal 2004 and 2003, respectively, is as follows (dollars in thousands, except per share amounts):

	Year Ended September 30, 2004					Year Ended September 25, 2003				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter <sup>(1)</sup>	Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Total revenue	\$744,441	\$786,353	\$928,327	\$1,033,964	\$3,493,085	\$645,353	\$666,697	\$704,486	\$733,824	\$2,750,360
Gross profit	\$140,110	\$133,227	\$153,710	\$ 163,796	\$ 590,843	\$125,991	\$113,129	\$135,017	\$136,667	\$ 510,804
Income (loss) before income taxes	\$ 8,029	\$(22,897)	\$ 22,234	\$ 20,532	\$ 27,898	\$ 8,004	\$(3,827)	\$ 9,894	\$ 10,300	\$ 24,371
Net income (loss)	\$ 4,937	\$(14,082)	\$ 13,674	\$ 13,024	\$ 17,553	\$ 1,438	\$(2,353)	\$ 6,085	\$ 6,334	\$ 11,504
Earnings per share:										
Basic	\$ 0.27	\$(0.71)	\$ 0.68	\$ 0.65	\$ 0.90	\$ 0.08	\$(0.13)	\$ 0.34	\$ 0.35	\$ 0.64
Diluted	\$ 0.24	\$(0.71)	\$ 0.66	\$ 0.63	\$ 0.85	\$ 0.08	\$(0.13)	\$ 0.33	\$ 0.33	\$ 0.63

(1) The fourth quarter of fiscal 2004 was a 14-week period due to the 53-week year, rather than a 13-week period as it was in fiscal 2003, which was a 52-week year.

**Note 19—Subsequent Event:**

Subsequent to the end of fiscal 2004, we completed a secondary stock offering in which Freeman Spogli sold 3,850,000 shares of our stock at a public offering price of \$22.96 per share. As a result of this sale, Freeman Spogli beneficially owns 3,884,369 shares, or approximately 19.1%, of our common stock as of December 7, 2004. In connection with this secondary stock offering, we sold 1,500,000 shares of our common stock under a forward sale agreement with Merrill Lynch International, an affiliate of Merrill Lynch & Co., as forward purchaser, under which, at our request, Merrill Lynch International borrowed 1,500,000 shares of our common stock from stock lenders and sold such borrowed shares at a price of \$21.8694 per share to certain underwriters pursuant to a purchase agreement.

We may elect to settle the forward sale by means of a physical stock, cash or net stock settlement. The forward sale will settle in twelve months, or earlier at our option. At any time during that period (up to a maximum of four settlement dates in total), we have the option to settle the forward sale in whole or in part. We may physically settle the forward sale by delivering all or a portion of the shares to Merrill Lynch International for cash proceeds approximately equal to the product of the applicable number of shares and our share price as of the date of the forward sale, plus an imputed interest rate of the Federal Funds Rate minus 1.0%. The actual proceeds to be received by us will vary depending upon the settlement date, the portion of the shares designated by us for settlement on that settlement date and the method of settlement.

If we elect to physically settle all of the 1,500,000 shares subject to the forward sale with stock, based on an initial forward price of \$21.8694, which is the public offering price less the underwriting discount, we will receive aggregate proceeds of approximately \$32.8 million. The forward sale agreement provides that the initial forward sale price will be subject to increase based on a floating interest factor equal to the Federal Funds Rate, less a spread of 1.0%. However, because the spread may be greater than the Federal Funds Rate for at least part of the term of the forward sale agreement, the actual forward sale price received at settlement

may be less than the initial forward sale price. In no event are we required to deliver more than 1,500,000 shares under the forward sale agreement.

If we elect cash or net stock settlement, Merrill Lynch International or one of its affiliates will purchase shares of our common stock in secondary market transactions over a period of time for delivery to Merrill Lynch International's stock lenders in order to unwind its hedge. In connection with a cash or net stock settlement election by us, if the price paid by Merrill Lynch International or its affiliates in secondary market transactions to unwind its hedge exceeds the price that Merrill Lynch International would have been obligated to pay us had we instead elected a physical stock settlement under the forward sale agreement with respect to such shares, then we would pay Merrill Lynch International an amount in cash equal to such difference in the case of a cash settlement or would deliver a number of shares of our common stock having a market value equal to such difference in the case of a net stock settlement. On the other hand, if Merrill Lynch International or one of its affiliates is able to unwind its hedge by purchasing shares in secondary market transactions for an amount less than the price that Merrill Lynch International would have been obligated to pay us in connection with a physical stock settlement, Merrill Lynch International would pay us such difference in cash in the case of a cash settlement or in shares of our common stock having a market value equal to such difference in the case of a net stock settlement.

Prior to settlement, Merrill Lynch International will utilize the aggregate net proceeds from the sale of the borrowed shares as cash collateral for the borrowing of shares described above. We have not received any proceeds from the sale of the borrowed shares and will not do so until settlement of all or a portion of the forward sale.

Under limited circumstances related to our default or certain other extraordinary or otherwise unanticipated events, Merrill Lynch International also will have the ability to require us to settle the forward sale prior to the maturity date.

## Report of Independent Registered Public Accounting Firm

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. and subsidiaries ("The Pantry") as of September 30, 2004 and September 25, 2003, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three fiscal years in the period ended September 30, 2004. These financial statements are the responsibility of The Pantry's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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 as of September 30, 2004 and September 25, 2003, and the results of their operations and their cash flows for each of the three fiscal years in the period ended September 30, 2004 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 9 to the consolidated financial statements, in 2003, The Pantry adopted Statement of Financial Accounting Standards ("SFAS") No. 143, *Accounting for Asset Retirement Obligations*.

*Deloitte & Touche LLP*

Raleigh, North Carolina  
December 10, 2004

## Market for Our Common Equity and Related Stockholder Matters

(a) Market Information—Our common stock, \$.01 par value, represents our only voting securities. There are 20,313,242 shares of common stock issued and outstanding as of December 7, 2004. Our common stock is traded on the Nasdaq National Market under the symbol "PTRY." The following table sets forth for each fiscal quarter the high and low sale prices per share of our common stock over the last two fiscal years as reported on the Nasdaq National Market through September 30, 2004, based on published financial sources.

Quarter	Fiscal 2004		Fiscal 2003	
	High	Low	High	Low
First	\$27.45	\$10.22	\$ 4.32	\$0.83
Second	\$29.64	\$17.27	\$ 5.05	\$3.65
Third	\$22.60	\$17.56	\$ 9.45	\$3.78
Fourth	\$25.35	\$18.49	\$11.25	\$6.42

(b) Holders—As of December 7, 2004, there were approximately 32 holders of record of our common stock. This number does not include beneficial owners of our common

stock whose stock is held in nominee or "street" name accounts through brokers.

(c) Dividends—During the last two fiscal years, we have not paid any cash dividends on our common stock, and we do not expect to pay cash dividends on our common stock for the foreseeable future. We intend to retain earnings to support operations, to reduce debt and to finance expansion. 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. Currently, the payment of cash dividends is prohibited under restrictions contained in the indenture relating to our senior subordinated notes and our senior credit facility. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources" and "Notes to Consolidated Financial Statements—Note 6—Long-Term Debt."

## Reconciliation of Non-GAAP Financial Measure

(Amounts in thousands, except per share data)

	Twelve Months Ended			
	September 30, 2004	EPS	September 25, 2003	EPS
Net income before cumulative change in accounting principle	\$17,553	\$0.85	\$14,986	\$0.82
Financing-related charges, net of tax:				
Loss on extinguishment of debt	14,199	0.69	1,776	0.10
Secondary stock offering expenses	800	0.04	—	—
Duplicate interest, senior subordinated notes	1,046	0.05	—	—
Net income, excluding financing-related charges	\$33,597	\$1.63	\$16,762	\$0.91

# Corporate Directory

## Directors

Peter J. Sodini  
*President and Chief Executive Officer*

Byron E. Allumbaugh<sup>(1)(2)</sup>  
*Consultant*

Paul L. Brunswick<sup>(1)(3)</sup>  
*President*  
*General Management Advisory*

Todd W. Halloran<sup>(3)</sup>  
*Principal*  
*Freeman Spogli & Co.*

Bryan E. Monkhouse  
*Consultant*

Thomas M. Murnane<sup>(1)(3)</sup>  
*Consultant*

Charles P. Rullman<sup>(2)</sup>  
*Principal*  
*Freeman Spogli & Co.*

Peter M. Starrett<sup>(2)</sup>  
*Consultant*

Hubert E. Yarborough III<sup>(1)</sup>  
*The Yarborough Group of South Carolina LLC*

### Board Committees:

(1) *Audit Committee*

(2) *Compensation Committee*

(3) *Corporate Governance and  
Nominating Committee*

## Executive Officers

Peter J. Sodini  
*President and Chief Executive Officer*

Steven J. Ferreira  
*Senior Vice President, Administration and  
Strategic Planning*

Daniel J. Kelly  
*Vice President, Chief Financial Officer and  
Corporate Secretary*

Joseph A. Krol  
*Senior Vice President, Operations*

David M. Zaborski  
*Vice President, Marketing*

## Financial Information

Forms 10-K and 10-Q are available  
without charge.

Direct requests to:

Daniel J. Kelly  
Vice President and Chief Financial Officer  
The Pantry, Inc.  
Post Office Box 1410  
Sanford, North Carolina 27330  
Phone: 919-774-6700  
Fax: 919-774-3329

## Internet

Additional information on The Pantry, Inc.  
is available on the World Wide Web at:  
[www.thepantry.com](http://www.thepantry.com).

## Executive Office

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

## Transfer Agent

Wachovia Bank, NA  
Equity Services  
Charlotte, North Carolina

## Independent Accountants

Deloitte & Touche LLP  
Raleigh, North Carolina

## Annual Meeting

*The annual meeting of stockholders will be  
held on Wednesday, March 29, 2005 at  
10:00 AM Eastern Standard Time at the  
Sheraton Imperial Hotel, 4700 Emperor  
Boulevard, I-40 at Exit 282 (Page Road),  
Durham, North Carolina 27730 (approximately  
3 miles from RDU airport).*



## **The Pantry, Inc.**

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