



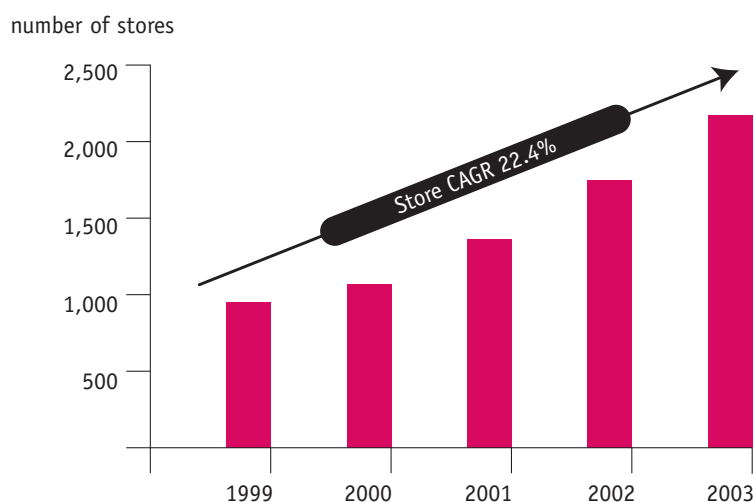
2003 Annual Report

Movie Gallery, Inc.

ABOUT OUR COMPANY

We are the leading home video specialty retailer primarily focused on rural and secondary markets. We own and operate approximately 2,200 retail stores, located throughout North America, that rent and sell DVDs, videocassettes and video games. Our target markets are small towns and suburban areas of cities with populations generally between 3,000 and 20,000 where our primary competitors are typically independently owned stores and small regional chains. Since our initial public offering in August 1994, we have grown from 97 stores to our present size through acquisitions and new store openings.

Store Growth



INVESTMENT HIGHLIGHTS

- Only major chain with primary focus on rural and secondary markets
- Compelling industry dynamics
- Lowest cost operator
- Significant new store growth opportunities
- Proven acquisition and integration strategy
- Self-funded growth
- Significant free cash flow generation

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FINANCIAL HIGHLIGHTS

(In thousands, except per share data)

Operating Results	Fiscal Year Ended		
	January 6, 2002 ⁽¹⁾	January 5, 2003	January 4, 2004
Revenues	\$ 369,131	\$ 528,988	\$ 692,395
Adjusted EBITDA ⁽²⁾	\$ 61,581	\$ 82,260	\$ 109,416
Net income	\$ 14,356	\$ 20,934	\$ 49,436
Plus (minus) reconciling items (after tax):			
Amortization policy change	—	16,741	3,634
Stock option compensation	4,919	1,367	903
Legal settlement	—	2,400	—
Supply contract amendment	954	—	—
Early debt extinguishment	177	—	—
Adjusted net income ⁽²⁾	\$ 20,406	\$ 41,442	\$ 53,973
Net income per diluted share (GAAP basis)	\$ 0.53	\$ 0.67	\$ 1.48
Plus (minus) reconciling items (after tax):			
Amortization policy change	—	\$ 0.53	\$ 0.11
Stock option compensation	0.18	\$ 0.04	\$ 0.03
Legal settlement	—	\$ 0.08	—
Supply contract amendment	0.04	—	—
Early debt extinguishment	0.01	—	—
Adjusted net income per diluted share ⁽²⁾	\$ 0.75	\$ 1.32	\$ 1.62
Weighted average diluted shares outstanding	27,220	31,436	33,370
Financial Position			
Cash and cash equivalents	\$ 16,349	\$ 39,526	\$ 53,720
Rental inventory, net	\$ 88,424	\$ 82,880	\$ 102,479
Total assets	\$ 270,132	\$ 363,574	\$ 464,289
Long term debt, less current maturities	\$ 26,000	\$ —	\$ —
Stockholders' equity	\$ 162,182	\$ 259,051	\$ 320,116

(1) Results for fiscal 2001 reflect a 53-week year and include 17 days of operations for Video Update, Inc., which we acquired out of bankruptcy on December 21, 2001. All other fiscal years presented reflect 52-week years.

(2) Adjusted net income, adjusted net income per diluted share and adjusted EBITDA (the "adjusted items") are non-GAAP financial measures. The Company believes its calculation of adjusted net income per diluted share provides a better measure of the Company's ongoing performance and better comparability to prior periods, because it excludes items not related to the Company's core business operations and items dependent upon fluctuations in the Company's stock price. The Company discloses adjusted EBITDA because it is a widely accepted financial indicator in the home video retail industry of a company's ability to finance its operations and meet its growth plans, in that it treats rental inventory as being expensed upon purchase instead of being capitalized and amortized. This measure is also used by the Company internally to make new store and acquisition investment decisions and to calculate awards under incentive-based compensation programs. The Company believes it is useful to investors to provide disclosures of its operating results on the same basis as that used by management and industry analysts. The adjusted items should not be considered in isolation or as a substitute for net income or net income per diluted share as determined in accordance with accounting principles generally accepted in the United States. [See Selected Financial Data for a reconciliation of operating income to Adjusted EBITDA.]

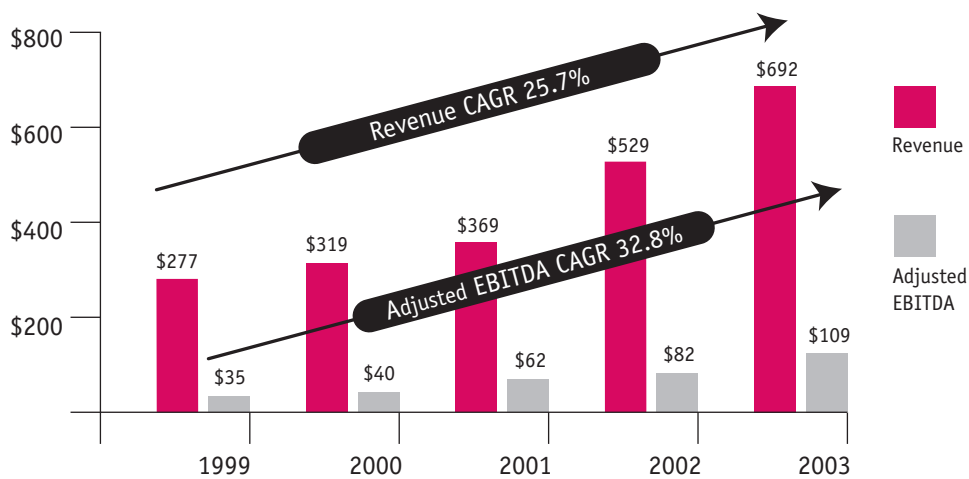
FELLOW STOCKHOLDERS:

Fiscal 2003 was an exceptional year for Movie Gallery. We achieved record financial results for the year, representing our fifth consecutive year of substantial profitable growth. With stronger-than-expected results, we also exceeded our 2003 guidance and long-term growth targets. During 2003 we opened our 2,000th store, launched operations in our 50th state, and established new records for internally developed stores opened in both a single quarter and year. Equally impressive, we were able to internally finance 100% of our operating and growth capital expenditures. In addition, same store revenues for 2003 rose at the fastest rate in nine years, we declared our first quarterly cash dividend and our stock price reached a record high.

Movie Gallery's continued profitable growth again demonstrated the strength of the Company's business model and market positioning. Our significant earnings momentum reflects proven operating and growth strategies that have been developed and continually refined through our expansion over the past decade from 73 stores at the end of 1993 to 2,158 stores at the end of 2003. Our confidence in our prospects for further substantial long-term growth is based on a clear appraisal of our ability to manage and finance the ongoing implementation of these strategies in our core small town and rural markets within the context of a growing, yet fragmented, industry. Quite simply, we have created a strong, unique position as the leader in our marketplace and have the experience and the resources to leverage our position to drive further profitable growth and increase stockholder value.

Revenue and Adjusted EBITDA growth

(Dollars in millions)



The key elements of our growth strategy are to:

- drive same store revenues and enhance operating margins
- develop new stores in attractive markets
- pursue opportunistic acquisitions

Movie Gallery's **revenues increased 30.9%** for 2003 to \$692.4 million from \$529.0 million for 2002, exceeding expectations discussed in last year's annual report for revenues in a range of \$635 million to \$655 million. We primarily attribute this growth to the **21% expansion of the number of stores in operation** to 2,158 at year-end from 1,784 at the end of 2002. Our new stores for 2003 included the net impact of opening 241 internally developed stores, acquiring 170 stores and closing 37 stores. Our new internally developed stores for 2003 significantly exceeded our original expectations of opening 175 to 200 stores and were two-thirds greater than the previous annual record of 145 internally developed stores opened for 2002.

The Company's revenue growth also reflected a **7% increase in same store revenues** for 2003 over 2002. This increase was not only above our guidance for same store revenue growth for the year of 2% to 5%, but also represents our seventh consecutive year of positive same store revenue performance. This relatively strong growth for 2003 was driven by the continuing transition of the market to DVD, which accounted for more than 70% of our movie rental revenues by the end of 2003 compared with 45% at the end of 2002. In addition to generating increased rental revenues, our expanding inventory of DVD titles has also had a positive impact on sales of previously viewed movies, which are an important element of the value proposition we offer customers seeking DVD product. These customers can either rent DVD titles or buy new high-intent-to-own titles through Movie Gallery when the titles are first released, but they also know they can purchase these titles, previously viewed, at a much reduced cost shortly thereafter. The continued market penetration of new game hardware and our corresponding increase in game title selection and copy depth were among other factors that also contributed to our same store revenue results.

Movie Gallery's revenue growth produced a **30% increase in adjusted net income** to \$54.0 million for 2003 from \$41.4 million for 2002. **Adjusted net income per diluted share grew 23%** for 2003 to \$1.62 from \$1.32 for 2002, compared with our initial target range for 2003 of \$1.34 to \$1.44. **Adjusted EBITDA also exceeded expectations for 2003, growing 33%** to \$109.4 million – compared with our original expectation of \$95 million to \$100 million – from \$82.3 million for 2002. *(For a reconciliation of adjusted net income and adjusted net income per diluted share, please see the Financial Highlights on page 1 of this annual report and for a reconciliation of adjusted EBITDA, please see the Selected Financial Data on page 7 of this annual report).*

The substantial growth in our 2003 revenues, free cash flow and net income continued to strengthen our overall financial position and enabled us to maintain a balance sheet

with no long-term debt. Furthermore, we completed 2003 with cash and cash equivalents of \$53.7 million, up from \$39.5 million at the end of 2002, and stockholders' equity increased 24% to \$320 million from \$259 million.

As we look to the future, we expect to continue our successful store opening and acquisition strategies in 2004. While we do not include the impact of any future acquisitions in our financial guidance for 2004, our assumptions include plans to open between 275 and 300 internally developed stores during the year. We also expect same store revenues for 2004 in a range of flat to positive 3%, consistent with our long-term experience of same store revenues increases in the low single digits. Capital expenditures for new internally developed stores are estimated at approximately \$40 million, and we anticipate other continuing capital expenditures of approximately \$25 million. Based on these assumptions, among others, our 2004 financial guidance includes revenues in a range of \$775 to \$800 million for the year, adjusted net income per diluted share in a range of \$1.76 to \$1.86 and a 15% to 20% increase in adjusted EBITDA. The comparable GAAP measurement for net income per diluted share depends on future stock option exercises and the Company's stock price, which will not be available until after the completion of the year.

Movie Gallery's successful record of -and substantial prospects for- profitable growth are dependent upon thousands of team members throughout North America who give their best in performing their duties every day. We recognize and commend their efforts and we are proud that they are the face of Movie Gallery in their communities. We also thank the members of our Board of Directors for their continuing guidance and the integrity with which they fulfill their responsibilities. Finally, we thank you, our fellow stockholder for your investment in Movie Gallery. We remain enthusiastic about our Company's future and dedicated to increasing the value of your investment.

Sincerely,

A handwritten signature in black ink, appearing to read "J.T. Malugen". The signature is fluid and cursive, with a large loop at the beginning and end.

J.T. Malugen
Chairman, President and Chief Executive Officer

MOVIE GALLERY, INC.
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SELECTED FINANCIAL DATA

(in thousands, except per share data)

	Fiscal Year Ended ⁽¹⁾				
	January 2, 2000	December 31, 2000	January 6, 2002	January 5, 2003	January 4, 2004
STATEMENTS OF INCOME DATA:					
Revenues:					
Rentals	\$ 253,000	\$ 294,298	\$ 347,464	\$ 490,836	\$ 629,793
Product sales	23,945	24,638	21,667	38,152	62,602
Total revenues	276,945	318,936	369,131	528,988	692,395
Cost of sales:					
Cost of rental revenues	79,305	94,105	108,732	164,818 ⁽²⁾	184,439 ⁽²⁾
Cost of product sales	16,295	19,066	17,715	29,852	50,143
Gross margin	181,345	205,765	242,684	334,318	457,813
Operating costs and expenses:					
Store operating expenses	137,128	153,665	171,409	253,865	325,916
General and administrative	21,403	24,945	29,288 ⁽³⁾	40,995 ⁽⁴⁾	46,522
Amortization of intangibles	8,452	7,465	6,656	1,298	2,003
Stock option compensation ⁽⁵⁾	—	—	8,161	2,279	1,481
Operating income	14,362	19,690	27,170	35,881	81,891
Interest expense, net	(3,349)	(3,779)	(3,026)	(1,024)	(468)
Income before income taxes, extraordinary item and cumulative effect of accounting change	11,013	15,911	24,144	34,857	81,423
Income taxes	4,615	6,425	9,788	13,923	31,987
Income before extraordinary item and cumulative effect of accounting change	6,398	9,486	14,356	20,934	49,436
Extraordinary loss on early extinguishment of debt	(682)	—	—	—	—
Cumulative effect of accounting change	(699)	—	—	—	—
Net income	\$ 5,017	\$ 9,486	\$ 14,356	\$ 20,934	\$ 49,436
Basic earnings per share:					
Income before extraordinary item and cumulative effect of accounting change	\$ 0.21	\$ 0.37	\$ 0.56	\$ 0.69	\$ 1.53
Extraordinary loss on early extinguishment of debt	(0.02)	—	—	—	—
Cumulative effect of accounting change	(0.02)	—	—	—	—
Net income per share - basic	\$ 0.17	\$ 0.37	\$ 0.56	\$ 0.69	\$ 1.53
Diluted earnings per share:					
Income before extraordinary item and cumulative effect of accounting change	\$ 0.21	\$ 0.37	\$ 0.53	\$ 0.67	\$ 1.48
Extraordinary loss on early extinguishment of debt	(0.02)	—	—	—	—
Cumulative effect of accounting change	(0.02)	—	—	—	—
Net income per share - diluted	\$ 0.17	\$ 0.37	\$ 0.53	\$ 0.67	\$ 1.48
Weighted average shares outstanding:					
Basic	29,509	25,801	25,837	30,273	32,406
Diluted	30,083	25,868	27,220	31,436	33,370
BALANCE SHEET DATA (at end of period):					
Cash and cash equivalents	\$ 6,970	\$ 7,029	\$ 16,349	\$ 39,526	\$ 53,720
Rental inventory, net	52,357	61,773	88,424	82,880	102,479
Total assets	209,527	217,536	270,132	363,574	464,289
Long-term debt, less current maturities	44,377	40,600	26,000	—	—
Stockholders' equity	125,421	129,209	162,182	259,051	320,116

SELECTED FINANCIAL DATA *(continued)*
(dollars in thousands)

	Fiscal Year Ended ⁽¹⁾				
	January 2, 2000	December 31, 2000	January 6, 2002	January 5, 2003	January 4, 2004
Other Data:					
Number of stores at end of period	963	1,020	1,415	1,784	2,158
Average revenues per store ⁽⁶⁾	\$ 313	\$ 328	\$ 342	\$ 337	\$ 355
Adjusted EBITDA ⁽⁷⁾	\$ 35,494	\$ 39,744	\$ 61,581	\$ 82,260	\$ 109,416
Increase in same store revenues ⁽⁸⁾	0.4%	3.8%	2.7%	3.2%	7.0%

(1) Results for fiscal 2001 reflect a 53-week year and include 17 days of operations for Video Update, Inc., which we acquired out of bankruptcy on December 21, 2001. All other fiscal years presented reflect 52-week years.

(2) Effective October 7, 2002, we changed the estimates used to amortize rental inventory resulting in a non-cash charge of approximately \$27.9 million in the fourth quarter of fiscal 2002, and \$5.9 million throughout fiscal 2003.

(3) Includes a \$1.6 million charge related to the amendment of our supply agreement with Rentrak Corporation.

(4) Includes a \$4.0 million charge related to a legal settlement in the second quarter of fiscal 2002.

(5) Represents non-cash compensation expense associated with stock options that were repriced in March 2001 and are subsequently required to be accounted for as variable stock options (see Note 7 to our consolidated financial statements).

(6) Calculated as total revenues divided by the weighted average number of stores open in each fiscal year. Results for the fiscal year ended January 6, 2002 include approximately \$9,000 per store related to the extra fifty-third week.

(7) Adjusted EBITDA is defined as earnings before interest, taxes, depreciation and amortization, non-cash compensation and nonrecurring items, less purchases of rental inventory exclusive of rental inventory purchases specifically for new store openings. Adjusted EBITDA is presented not as an alternative measure of operating results or cash flow from operations (as determined in accordance with accounting principles generally accepted in the United States), but because it is a widely accepted financial indicator in the home video specialty retail industry of a company's ability to incur and service debt assuming rental inventory is expensed upon purchase instead of being capitalized and amortized. Our calculation of Adjusted EBITDA is not necessarily comparable to reported EBITDA and/or Adjusted EBITDA of other companies due to lack of uniform definitions of EBITDA and Adjusted EBITDA. Our calculation of Adjusted EBITDA for the periods indicated is set forth below:

	Fiscal Year Ended ⁽¹⁾				
	January 2, 2000	December 31, 2000	January 6, 2002	January 5, 2003	January 4, 2004
Operating income	\$ 14,362	\$ 19,690	\$ 27,170	\$ 35,881	\$ 81,891
Rental inventory amortization and non-cash cost of rental inventory sold	59,097	66,078	80,703	128,300	132,978
Depreciation and intangibles amortization	21,691	22,327	22,332	19,346	23,569
Stock option compensation	—	—	8,161	2,279	1,481
Legal settlement	—	—	—	4,000	—
Supply contract amendment	—	—	1,600	—	—
Purchases of rental inventory	(62,842)	(74,829)	(83,840)	(117,753)	(147,205)
DVD catalog investment	—	—	—	—	5,421
New store rental inventory purchases	3,186	6,478	5,455	10,207	11,281
Adjusted EBITDA	\$ 35,494	\$ 39,744	\$ 61,581	\$ 82,260	\$ 109,416

(8) Same store revenues are calculated based on the aggregate revenues from stores we have operated for at least 13 months.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations

Overview

We operate approximately 2,200 home video retail stores that rent and sell movies and video games, primarily in rural and secondary markets throughout North America. We compete with the other two national chains (Blockbuster and Hollywood Entertainment) in only approximately one-third of our store locations. We believe that we are the market leader in the majority of our target markets. We estimate that there are approximately 3,000 to 4,000 markets still available for expansion in rural America, as well as opportunities throughout Canada and Mexico. We currently plan to open between 275 and 300 new stores in 2004 and, subject to market and industry conditions, to continue to open new stores on a similar pace over the next several years.

We believe the most significant dynamic in our industry is the relationship our business maintains with the movie studios. The studios have historically maintained an exclusive window for home video distribution (packaged goods) which provides mass merchants and video retailers approximately a 45 day period during which they can sell and rent new releases before they are made available on pay-per-view or other distribution channels. The home video distribution channel currently provides over 60% of studio revenue. For this reason, we believe movie studios have a significant interest in maintaining a viable home video business. For a more detailed discussion of our business and the home video industry, see the Business discussion contained in Part I, Item 1 of our annual report on Form 10-K for the fiscal year ended January 4, 2004 and filed with the Securities and Exchange Commission on March 19, 2004.

Our strategies are designed to achieve reasonable, moderate and consistent growth in same store revenues and profitability, in a mature industry. We foster a corporate culture of cost control, striving to minimize the operating and overhead costs associated with our business which allows us to maximize profitability and which has proven to be a successful operating model for us. Our balance sheet reflects \$53.7 million in cash and cash equivalents as of the end of fiscal 2003 and we have not had any outstanding long-term debt

since May 2002. Our store base has increased in excess of 20% in each of the last three fiscal years.

In addition to the relationship between our industry and the movie studios, our operating results are driven by revenue, inventory, rent and payroll. Given those key factors, we believe that by monitoring the five operating performance indicators described below, we can continue to be successful in executing our operating plans and our growth strategy.

Revenues. Our business is a cash business with initial rental fees paid upfront by the customer. Our management team constantly works with inventory levels, marketing and sales promotions, real estate strategies and personnel issues in order to maximize profitable revenues at each location. Additionally, our team monitors revenue performance on a daily basis to quickly identify trends or issues in our store base or in the industry as a whole.

Product purchasing economics. In order to maintain the desired profit margin in our business, purchases of inventory for both rental and sale must be carefully managed. Our purchasing models are designed to analyze the impact of the economic factors inherent in the various pricing strategies employed by the studios. We believe that we are able to achieve purchasing levels tailored for the customer demographics of each of our markets and to maximize the return on investment for our inventory purchase dollars.

Store level cost control. The most significant store expenses are payroll and rent, followed by all other supply and service expenditures. Our fundamental philosophy with respect to store level expenses is to exercise extreme conservatism in spending. This is achieved primarily through budgeting systems and centralization of purchases into the corporate support center. This enables us to measure performance carefully against expectations and to leverage our purchasing power. Our rural focus also provides the benefit of reduced labor and real estate costs in the secondary markets we serve versus the costs associated with larger urban markets.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

Leverage of overhead expenses. We apply the same principles of budgeting, accountability and conservatism in our overhead spending that we employ in managing our store operating costs. Our general and administrative expenses include the costs to maintain our corporate support center as well as the overhead costs of our field management team.

Operating cash flows. We have generated significant levels of cash flow for several years. We are generally able to fund the majority of our store growth and

acquisitions, as well as ongoing inventory purchases, from cash flow generated from operations. Cash flow has been sufficient to allow us to maintain a debt-free balance sheet since May 2002.

The following detailed discussion of our results of operations, liquidity and capital resources will provide further insight into our performance over the last three years.

Results of Operations

Selected Financial Statement and Operational Data:

(\$ in thousands, except per share and store data)	Fiscal Year Ended					
	January 6, 2002		January 5, 2003		January 4, 2004	
Revenues:						
Rental	\$ 347,464	94.1%	\$ 490,836	92.8%	\$ 629,793	91.0%
Product sales	21,667	5.9%	38,152	7.2%	62,602	9.0%
Total revenues	369,131	100.0%	528,988	100.0%	692,395	100.0%
Cost of sales:						
Rental	108,732	29.5%	164,818	31.2%	184,439	26.6%
Product sales	17,715	4.8%	29,852	5.6%	50,143	7.3%
Total gross margin	\$ 242,684	65.7%	\$ 334,318	63.2%	\$ 457,813	66.1%
Store operating expenses	\$ 171,409	46.4%	\$ 253,865	48.0%	\$ 325,916	47.1%
G&A expenses	\$ 29,288	7.9%	\$ 40,995	7.8%	\$ 46,522	6.7%
Operating income	\$ 27,170	7.4%	\$ 35,881	6.8%	\$ 81,891	11.8%
Net income	\$ 14,356	3.9%	\$ 20,934	4.0%	\$ 49,436	7.1%
Net income per diluted share	\$ 0.53		\$ 0.67		\$ 1.48	
Same store revenues	2.7%		3.2%		7.0%	
Gross margin percentage:						
Rental	68.7%		66.4%		70.7%	
Product sales	18.2%		21.8%		19.9%	
Total gross margin	65.7%		63.2%		66.1%	
Store Count:						
Beginning of period	1,020		1,415		1,784	
New store builds	77		145		241	
Stores acquired	355		265		170	
Stores closed	37		41		37	
End of period	1,415		1,784		2,158	

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

The following table itemizes certain non-cash or nonrecurring items that are included in our operating results for the fiscal years presented and which are referenced throughout this discussion of our results of operations and financial condition:

	Fiscal Year Ended					
	January 6, 2002	January 5, 2003	January 4, 2004	January 6, 2002	January 5, 2003	January 4, 2004
	<i>(\$ in thousands, before tax)</i>			<i>(\$ per diluted share, after tax)</i>		
Rental amortization policy change	\$ —	\$ 27,900	\$ 5,900	\$ —	\$ 0.53	\$ 0.11
Legal settlement	—	4,000	—	—	0.08	—
Supply contract amendment	1,600	—	—	0.04	—	—
Stock option compensation	8,161	2,279	1,481	0.18	0.04	0.03
	\$ 9,761	\$ 34,179	\$ 7,381	\$ 0.22	\$ 0.65	\$ 0.14

Revenue. For fiscal 2002 and 2003, total revenues increased 43.3% and 30.9%, respectively, from the prior years. The increases were primarily due to same store revenue growth of 3.2% in fiscal 2002 and 7.0% in fiscal 2003 as well as overall growth in the average number of stores operated in fiscal 2002 of 45.5% and 24.0% in fiscal 2003. The increases in same store revenues primarily resulted from:

- Continued growth of DVD rental and sales revenue, offset partially by corresponding declines in revenue from VHS products due to the consumer transition to DVD;
- Increases in the sales of previously viewed inventory;
- Higher video game rental revenues driven by our increased commitment to our game library, and growth resulting from overall video game industry increases and consumer acceptance of new platforms released late in 2001;
- Fiscal 2003 benefited from increased product sales revenue as a result of a significant expansion of new movie inventory available in the stores beginning during the latter half of 2002;
- Fiscal 2003 reflects continued revenue growth in the Video Update stores we acquired in December 2001 and other acquisitions and new stores built over the last two years; and
- Fiscal 2002 also benefited from a favorable new movie release schedule versus fiscal 2001.

The increases in same store revenues for fiscal 2002 were partially offset by:

- Unfavorable weather during the first half of 2002 as compared to the first half of 2001;
- The broadcast of the Winter Olympics during the first quarter of 2002; and
- An extra week of revenues (totaling approximately \$10.0 million) in fiscal 2001.

Cost of Sales. The cost of rental revenues includes the amortization of rental inventory, revenue sharing expenses incurred and the cost of previously viewed rental inventory sold. The gross margin on rental revenue for fiscal 2001, 2002 and 2003 was 68.7%, 66.4% and 70.7%, respectively. The most significant factors that impacted growth in the gross margin on rental revenue were:

- The increasing shift of movie rentals from VHS to DVD - DVD rentals constituted approximately 13%, 34% and 54%, of total movie rentals in fiscal 2001, 2002 and 2003, respectively; DVD has a lower cost structure than VHS has traditionally had, and the acceptance of DVD has influenced reductions in studio pricing of the VHS format during the last year; and,
- The purchase price allocation of Video Update that produced lower than normal rental inventory amortization in the first half of 2002.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

Rental margins were negatively impacted by:

- A change in estimate related to our amortization policy for rental inventory during the fourth quarter of fiscal 2002 (see Note 1 to our consolidated financial statements);
- Opportunities taken to increase the overall quantity of rental units purchased for our stores as a result of the lower cost structure associated with DVD versus historical VHS pricing;
- Amortization of our investment in DVD catalog inventory that took place in the first quarter of 2003 in order to satisfy increasing consumer demand for movies on the DVD format; and
- Investments in our video game rental library to provide significant copy depth of all game platforms in our stores.

Cost of product sales includes the costs of new DVDs, videocassettes, concessions and other goods sold. The gross margin on product sales is subject to fluctuation based on the relative mix of low margin new movie inventory sales versus higher margin sales of concessions and other items. The gross margin on product sales for fiscal 2001, 2002 and 2003 was 18.2%, 21.8% and 19.9%, respectively. The product sales margin reflects the following trends in inventory mix:

- Fiscal 2001 margins were reduced by significant discounting that was designed to facilitate the liquidation of older titles and other slow moving inventory;
- The results achieved in fiscal 2002 reflect our reduced levels of low margin catalog inventory that was liquidated in fiscal 2001; and,
- Fiscal 2003 margins are representative of an increase in our mix of new movie sales in order to accommodate an increased consumer demand for retail movies and to complement our rental business as consumers transition to DVD.

Operating Costs and Expenses. Store operating expenses include store-level expenses such as lease payments and in-store payroll. Store operating expenses as a percentage of total revenue was 46.4%, 48.0% and

47.1% in fiscal 2001, 2002 and 2003, respectively. The increase in store operating expenses as a percentage of total revenue in fiscal 2002 was primarily due to a higher cost structure associated with the 324 Video Update stores acquired in December 2001 and the benefits in fiscal 2001 of an extra week of revenues. The following factors partially offset the increase in fiscal 2002 and contributed to a reduction of store operating expenses as a percentage of revenues in fiscal 2003:

- Continued initiatives to reduce operating costs;
- Strong performance of new stores;
- Continued closure of under-performing units; and
- Same store revenues increase of 3.2% in fiscal 2002 and 7.0% in fiscal 2003.

Additionally, store operating expenses as a percentage of revenues in fiscal 2003 were reduced by leverage from our Video Update transaction against same store revenue increases and were increased slightly as a result of the large number of immature stores in our store base that are absorbing the start-up expenses associated with a new store while the revenue levels are still ramping up.

General and administrative expenses as a percentage of revenue were 7.9%, 7.8% and 6.7% in fiscal 2001, 2002 and 2003, respectively. General and administrative expenses include the following items which have offset the leverage obtained against the increased revenues associated with the growth in our store base:

- Fiscal 2001 – a charge of \$1.6 million related to an amendment of our supply agreement with Rentrak Corporation;
- Fiscal 2002 – a legal settlement charge of \$4.0 million regarding our extended viewing fee policy;
- Fiscal 2002 – costs and expenses associated with the conversion of the Video Update stores point of sale system; and
- Fiscal 2003 – overhead increases to support new initiatives and our future growth plans, which include expansion into new geographic areas where our market penetration is lower.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

Amortization of intangibles declined significantly in fiscal 2002 due to goodwill no longer being amortized pursuant to the adoption of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, as of the beginning of fiscal 2002.

Stock option compensation expense represents the non-cash charge associated with certain stock options that were repriced during the first quarter of fiscal 2001 and are subsequently accounted for as variable stock options (see Note 7 to our consolidated financial statements). We expect to continue to record adjustments to income from stock option compensation in future periods. Due to the relatively small number of these options that remain outstanding, we expect future adjustments to be insignificant.

Operating Income. As a result of the impact of the above factors on revenues and expenses, operating income increased by 32% in fiscal 2002 and by 128% in fiscal 2003.

Interest Expense. Interest expense includes fees for the unused borrowings available under our credit facility and amortization of the associated debt issue costs, as well as the costs of any outstanding borrowings under our credit facility, net of interest income. Interest expense declined significantly in fiscal 2002 and again in fiscal 2003 due to the repayment of all outstanding debt in May 2002 and our ability to maintain a debt-free balance sheet throughout 2003.

Income Taxes. We had federal and state net operating loss carryforwards at January 4, 2004 resulting primarily from the Video Update acquisition (see Note 6 to our consolidated financial statements) of approximately \$103.4 million that expire in years 2007 through 2021. We have recorded a valuation allowance of \$34.4 million related to the deferred tax assets of \$40.6 million resulting from the net operating loss carryforwards. This valuation allowance has been established as there exists uncertainty regarding our ability to realize these net operating losses in their entirety. If facts and circumstances in the future should warrant

an increase in the net operating loss carryforwards expected to be realized, a reduction in the valuation allowance could occur and may result in a reduction in our effective income tax rate, which was 40%, 40% and 39% for fiscal 2001, 2002 and 2003, respectively.

Deferred income tax liabilities have increased significantly during fiscal 2003. This is primarily the result of a significant acceleration in the tax depreciation of newly purchased assets since the fourth quarter of 2001. We anticipate this liability will continue to increase unless we stop or significantly slow our new store growth, or until the acceleration provisions are discontinued. The acceleration on tax depreciation is a result of special provisions implemented after the events of September 11, 2001 and is currently scheduled to be discontinued for assets placed in service after January 1, 2005. If the special provisions are not extended, the cumulative excess tax depreciation levels we currently have will begin to decline.

General Economic Trends, Quarterly Results of Operations and Seasonality

Our business is subject to fluctuations in operating results due to a number of factors, many of which are outside of our control. These fluctuations may be caused by, among other things:

- the number, timing and performance of new or acquired stores;
- public acceptance of, interest in, and availability of, newly released movies;
- our mix of products rented versus sold;
- marketing programs and new release acquisition costs;
- seasonality - compared to other months during the year, we experience peak revenues during the months of November, December and January due to the holidays in these months as well as inclement weather conditions. Additionally, revenues generally rise in the months of June, July and August when most schools are out of session, providing people with additional discretionary time to spend on entertainment; and
- special events, such as the Olympics or ongoing major news events of significant public interest.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

Liquidity and Capital Resources

Our primary capital needs are for opening and acquiring new stores and for purchasing inventory. Other capital needs include refurbishing, remodeling and relocating existing stores and refreshing, rebranding and supplying new computer hardware for acquired stores. We fund inventory purchases, remodeling, rebranding and relocation programs, new store opening costs and acquisitions primarily from cash flow from operations and, if necessary, loans under revolving credit facilities. At January 4, 2004, we had cash and cash equivalents of \$53.7 million, no long-term debt and \$63.8 million in available borrowings under our credit facility.

	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Statements of Cash Flow Data:			
Net cash provided by operating activities	\$ 143,966	\$ 186,719	\$ 231,801
Net cash used in investing activities	(125,229)	(206,744)	(224,993)
Net cash (used in) provided by financing activities	(9,384)	43,428	3,333
Other Data:			
Adjusted EBITDA	\$ 61,581	\$ 82,260	\$ 109,416
Adjusted EBITDA (percent of total revenue)	16.7%	15.6%	15.8%

The increases in net cash provided by operating activities were primarily attributable to revenue growth and continued efforts to maximize economies of scale within our expense structure. Net cash provided by operating activities continues to be sufficient to cover substantially all of our rental inventory replenishment and capital resource needs.

Net cash used in investing activities includes our operating purchases of rental inventory, as well as the costs of acquisitions and new store builds. The increases are primarily due to increased rental inventory purchases to support growth in the store base, the DVD catalog investment in the first quarter of 2003 and increasing levels of new store builds. The increase in fiscal 2003 was partially offset by a reduction in business acquisitions versus 2002.

Net cash provided by financing activities includes proceeds from the exercise of stock options and proceeds from our stock offering in May 2002, offset by the repayment of amounts outstanding under our credit facility in fiscal 2001 and 2002.

In December 2003, our board of directors instituted a new dividend policy under which it declared an initial quarterly cash dividend of \$0.03 per share. We currently intend to pay similar quarterly cash dividends on our common stock. However, the payment of future dividends is subject to the discretion of our board of directors. Future dividends may be increased, decreased or suspended from time to time based on a number of factors, including changes in tax laws related to dividends, our financial condition, capital requirements, future business prospects, the terms of any documents governing our indebtedness and other factors that our board of directors deems relevant.

Adjusted EBITDA in fiscal 2002 and 2003 increased 33.6% and 33.0%, respectively, over the prior years. These increases were primarily driven by the revenue increases during those periods and continued efforts to maximize economies of scale within our expense structure. Adjusted EBITDA is defined as earnings before interest, taxes, depreciation and amortization, non-cash stock option compensation and nonrecurring items, less our purchases of rental inven-

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

tory which excludes rental inventory purchases specifically for new store openings. Adjusted EBITDA is presented not as an alternative measure of operating results or cash flow from operations (as determined in accordance with accounting principles generally accepted in the United States), but because, in the home video specialty retail industry, it is a widely accepted financial indicator of a company's ability to finance its operations and meet its growth plans, in that it treats rental inventory as being expensed upon purchase instead of being capitalized and amortized. This measure is also used by us internally to make new store and acquisition investment decisions and to calculate awards under incentive based compensation programs. Our calculation of Adjusted EBITDA is not necessarily comparable to reported EBITDA and/or Adjusted EBITDA of other companies due to the lack of uniform definitions of EBITDA and Adjusted EBITDA. (See Selected Financial Data in Part II, Item 6 of our Form 10-K for our calculation of Adjusted EBITDA.)

On June 27, 2001, we entered into a credit agreement with a syndicate of banks, led by SouthTrust Bank, with respect to a revolving credit facility. Our

credit facility is unsecured and, as amended, provides for borrowings of up to \$65 million through final maturity on July 4, 2005. The interest rate on our credit facility is based on LIBOR plus an applicable margin percentage, which depends on cash flow generation and borrowings outstanding. In December 2001, as required by the credit facility, we entered into an interest rate swap agreement in order to hedge exposure to interest rate fluctuations on \$10 million of outstanding debt at a fixed rate of 3.5% plus an applicable margin percentage. In May 2002, we repaid all amounts outstanding under our credit facility with the proceeds from our stock offering and terminated the interest rate swap agreement. The costs to terminate the interest rate swap were expensed and were immaterial to our results of operations. As of January 4, 2004, there were no outstanding borrowings under our credit facility. The amounts available for borrowing were reduced by standby letters of credit outstanding of \$1.2 million and totaled \$63.8 million as of January 4, 2004.

The following table discloses our contractual obligations and commercial commitments as of January 4, 2004 (see Notes 5 and 8 to our consolidated financial statements):

<i>(in thousands)</i>	Payments Due by Period				
Contractual Obligations	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Credit facility – outstanding ⁽¹⁾	\$ —	\$ —	\$ —	\$ —	\$ —
Operating leases	299,725	10,287	208,098	51,769	29,571
Unconditional purchase obligations ⁽²⁾	10,838	4,000	6,838	—	—
Total contractual cash obligations	\$ 310,563	\$ 14,287	\$ 214,936	\$ 51,769	\$ 29,571

(1) The total commercial commitment under our credit facility is \$65 million, which expires on July 4, 2005. As of January 4, 2004, there were standby letters of credit outstanding under the credit facility of \$1,172,000, of which \$322,000 expires in 2004, and \$850,000 expires in 2005.

(2) Represents our commitment under a supply contract with Rentrak Corporation.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

At January 4, 2004, we had a working capital deficit of \$20.0 million, due to the accounting treatment of rental inventory. Rental inventory is treated as a noncurrent asset under accounting principles generally accepted in the United States because it is a depreciable asset and a portion of this asset is not reasonably expected to be completely realized in cash or sold in the normal business cycle. Although the rental of this inventory generates the major portion of our revenue, the classification of this asset as noncurrent results in its exclusion from working capital. The aggregate amount payable for this inventory, however, is reported as a current liability until paid and, accordingly, is reflected as a reduction in working capital. Consequently, we believe that working capital is not an appropriate measure of our liquidity and we anticipate that we will continue to operate with a working capital deficit.

We grow our store base through internally developed and acquired stores. We opened 241 internally developed stores during fiscal 2003 and expect to open between 275 and 300 new stores in 2004. Subject to market and industry conditions, we plan to continue to open new stores on a similar pace over the next several years. We acquired 170 stores during fiscal 2003. We will continue to evaluate acquisition opportunities in 2004 as they arise. To the extent available, new stores and future acquisitions may be completed using funds available under our credit facility, financing provided by sellers or alternative financing arrangements such as funds raised in public or private debt or equity offerings. However, we cannot assure you that financing will be available to us on terms which will be acceptable, if at all.

We believe our projected cash flow from operations, cash on hand, borrowing capacity under our credit facility and trade credit will provide the necessary capital to fund our current plan of operations, including our anticipated new store openings and acquisition program, through fiscal 2004. However, to fund a major acquisition, or to provide funds in the event that our need for funds is greater than expected, or if the financing sources identified above are not available to the extent anticipated or if we increase our

growth plan, we may need to seek additional or alternative sources of financing. This financing may not be available on satisfactory terms. Failure to obtain financing to fund our expansion plans or for other purposes could have a material adverse effect on our operating results.

Our ability to fund our current plan of operations and our growth plan will depend upon our future performance, which is subject to general economic, financial, competitive and other factors that are beyond our control. We cannot assure you that our business will continue to generate sufficient cash flow from operations in the future to fund capital resource needs, cover the ongoing costs of operating the business and service any debt incurred in the future. If we are unable to satisfy these requirements with cash flow from operations and cash on hand, we may be required to sell assets or to obtain additional financing. We cannot assure you that any such sales of assets or additional financing could be obtained.

Recently Issued Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*, effective for fiscal years beginning after December 15, 2002. EITF 02-16 generally requires that cash consideration received from a vendor be considered as a reduction of the prices of the vendor's products, reflected as a reduction of cost of sales in the customer's income statement. The presumption can be overcome if the vendor receives an identifiable benefit in exchange for the consideration, in which case the consideration should be recorded as revenue, or if the consideration represents a reimbursement of a specific identifiable incremental cost incurred by the customer in selling the vendor's products where the consideration should be characterized as a reduction of that cost. Our adoption of this standard as of January 6, 2003 did not have a material impact on our financial position or results of operations.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations (*continued*)

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51* ("the Interpretation"). The Interpretation requires the consolidation of entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Currently, entities are generally consolidated by an enterprise when it has a controlling financial interest through ownership of a majority voting interest in the entity. The Interpretation is effective as of December 31, 2003 for all qualifying interests in special purpose entities ("SPEs") in existence as of January 31, 2003 and as of February 1, 2003 for all qualifying SPEs obtained after January 31, 2003. We had no qualifying interests as of January 31, 2003. We have subsequently made equity investments in other entities during 2003 (none of which are SPEs). These investments are immaterial, and consolidation is not currently required under the Interpretation. The provisions of the Interpretation, as revised by the FASB in December 2003, must be applied to some of our investments in the first quarter of 2004. Based on our analysis to date, none of our current interests will have a significant impact on our financial statements upon adoption of the Interpretation's consolidation rules.

In May 2003, the Financial Accounting Standards Board issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. Statement 150 clarifies the classification and measurement of certain financial instruments with characteristics of both liabilities and equity, and is effective for financial instruments entered into or modified after May 31, 2003, or otherwise for the first interim period beginning after June 15, 2003. The adoption of Statement 150 had no material impact on our net earnings, cash flows or financial position.

Critical Accounting Policies and Estimates

Our significant accounting policies are described in Note 1 to our consolidated financial statements. Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of the financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate the estimates that we have made. These estimates have been based upon historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different conditions or using different assumptions. We believe our most critical accounting estimates include our policies with respect to rental inventory amortization, impairment of long-lived assets, purchase price allocation of acquired businesses and deferred income taxes.

A major component of our cost structure is based upon the method by which we amortize our rental inventory. Rental inventory is amortized to an estimated salvage value over an estimated useful life of up to two years. We amortize the cost of rental inventory using an accelerated method designed to approximate the rate of revenue recognition. This method is based on our historical experience and is dependent upon the net realizable value of our inventory and the demand patterns of the rental products we provide. We believe our estimated useful lives and salvage values are appropriately matched to our current rental business and are consistent with industry trends. However, should rental patterns of consumers change or should market values of existing inventory decline due to the acceptance of new formats (ongoing VHS transition to DVD, anticipated transition to high definition DVD within three to five years, release of new video game formats, etc.), this could necessitate an acceleration in our current rental amortization rates or a reduction in salvage values. We believe that any acceleration in the

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

rental amortization rates would not have a long-lasting impact as the majority of rental purchases are substantially depreciated within the first two to three months under our existing policy. We could be required to reduce salvage values that we currently carry on VHS inventory if we are unable to dispose of that inventory at a rate relatively consistent with the consumers' transition to DVD. As of January 4, 2004, we had \$102.5 million in rental inventory on our balance sheet.

We assess the fair value and recoverability of our long-lived assets, including property, furnishings and equipment and intangible assets with finite lives, whenever events and circumstances indicate the carrying value of an asset may not be recoverable from estimated future cash flows expected to result from its use and eventual disposition. In doing so, we make assumptions and estimates regarding future cash flows and other factors in order to make our determination. The fair value of our long-lived assets is dependent upon the forecasted performance of our business, changes in the video retail industry, the market valuation of our common stock and the overall economic environment. When we determine that the carrying value of our long-lived assets may not be recoverable, we measure any impairment based upon the excess of the carrying value that exceeds the estimated fair value of the assets. We have not recognized any impairment losses on long-lived assets since fiscal 1996. If we do not meet our operating forecasts or if the market value of our stock declines significantly, we may have to record impairment charges not previously recognized.

We test goodwill for impairment on an annual basis. Additionally, goodwill is tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of an entity below its carrying value. These events or circumstances would include a significant change in the business climate, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business or other factors. We have not recorded any impairment losses on goodwill since a fiscal 2001 impairment charge of \$700,000. If we do not meet our operating

forecasts or if the market value of our stock declines significantly, we may have to record additional impairment charges not previously recognized. As of January 4, 2004, we have \$136 million in goodwill on our balance sheet.

We estimate the fair value of assets and liabilities of acquired businesses based on historical experience and available information at the acquisition date. We engage independent valuation specialists to assist when necessary. If information becomes available subsequent to the acquisition date that would materially impact the valuation of assets acquired or liabilities assumed in business combinations, we may be required to adjust the purchase price allocation. With the exception of the Video Update acquisition in 2001, we have not experienced any significant adjustments to the valuation of assets or liabilities acquired in business combinations in the last seven years. Our acquisitions are typically small businesses for which we generally do not assume liabilities and for which the assets acquired consist primarily of inventory, fixtures, equipment and intangibles.

We recognize deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. We regularly review our deferred tax assets for recoverability and establish a valuation allowance based upon historical losses, projected future taxable income and the expected timing of the reversals of existing temporary differences. As a result of this review, we have established a valuation allowance against our deferred tax assets related to net operating loss carryforwards that we acquired in the 2001 acquisition of Video Update. If facts and circumstances in the future should warrant elimination or reduction of the valuation allowance related to these acquired net operating loss carryforwards, our effective income tax rate, which was 40%, 40% and 39% for fiscal 2001, 2002 and 2003, respectively, could be reduced.

MANAGEMENT'S DISCUSSION AND ANALYSIS

of Financial Condition and Results of Operations *(continued)*

Related Party Transactions

Please refer to Note 9 to our consolidated financial statements for disclosures regarding our significant related party transactions.

Quantitative and Qualitative Disclosures About Market Risk

The market risk inherent in our financial instruments represents the increased interest costs arising from adverse changes in interest rates (primarily LIBOR and prime bank rates). We currently have no amounts outstanding under our credit facility and, thus, no exposure to adverse interest rate changes.

We are exposed to foreign exchange risks associated with our Canadian and Mexican operations. Historically, the Canadian exchange rates have been relatively stable and we believe the impact of fluctuations in the currency exchange rates will be immaterial to our financial position and results of operations. Based on fiscal 2003 results, a hypothetical 10% change in the Canadian exchange rate would impact our consolidated financial position and results of operations by less than 1%. Our Mexican operations are currently limited to one location. Growth in 2004 is not expected to be significant enough to result in a material impact from fluctuations in currency exchange rates.

Forward-Looking Statements

This annual report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which represent our expectations or beliefs about future events and financial performance. Forward-looking statements are identifiable by the fact that they do not relate strictly to historical information and may include words such as "believe," "anticipate," "expect," "intend," "plan," "will," "may," "estimate" or other similar expressions and variations thereof. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Our forward-looking statements are based on management's current intent, belief, expectations, estimates and projections

regarding our company and our industry. Forward-looking statements are subject to known and unknown risks and uncertainties. In addition, actual results could differ materially from those suggested by the forward-looking statements, and therefore you should not place undue reliance on the forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. We desire to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and in that regard we caution the readers of this annual report that these forward-looking statements are subject to various risks and uncertainties, which could cause actual results to differ materially from those stated or implied by such statements. Please review the disclosures set forth under "Cautionary Statements" in Item 1 of our annual report on Form 10-K for fiscal year ended January 4, 2004 and filed with the Securities and Exchange Commission on March 19, 2004.

CONSOLIDATED BALANCE SHEETS

(in thousands)

January 5, 2003

January 4, 2004

Assets

Current assets:

Cash and cash equivalents	\$ 39,526	\$ 53,720
Merchandise inventory	18,646	26,473
Prepaid expenses	1,533	1,377
Store supplies and other	7,585	11,019
Deferred income taxes	—	1,631
Total current assets	67,290	94,220

Rental inventory, net	82,880	102,479
Property, furnishings and equipment, net	86,993	114,356
Goodwill, net	116,119	136,008
Other intangibles, net	6,677	8,473
Deposits and other assets	3,615	8,753
Total assets	\$ 363,574	\$ 464,289

Liabilities and stockholders' equity

Current liabilities:

Accounts payable	\$ 66,996	\$ 77,344
Accrued liabilities	23,524	26,161
Deferred revenue	9,636	10,741
Deferred income taxes	742	—
Total current liabilities	100,898	114,246

Other accrued liabilities	249	142
Deferred income taxes	3,376	29,785

Stockholders' equity:

Preferred stock, \$.10 par value; 2,000 shares authorized, no shares issued or outstanding	—	—
Common stock, \$.001 par value; 65,000 shares authorized, 32,062 and 32,841 shares issued and outstanding, respectively	32	33
Additional paid-in capital	216,631	225,191
Retained earnings	42,647	91,098
Accumulated other comprehensive income (loss)	(259)	3,794
Total stockholders' equity	259,051	320,116
Total liabilities and stockholders' equity	\$ 363,574	\$ 464,289

See accompanying notes.

CONSOLIDATED STATEMENTS OF INCOME

	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
<i>(in thousands, except per share data)</i>			
Revenues:			
Rentals	\$ 347,464	\$ 490,836	\$ 629,793
Product sales	21,667	38,152	62,602
Total revenues	369,131	528,988	692,395
Cost of sales:			
Cost of rental revenues	108,732	164,818	184,439
Cost of product sales	17,715	29,852	50,143
Gross margin	242,684	334,318	457,813
Operating costs and expenses:			
Store operating expenses	171,409	253,865	325,916
General and administrative	29,288	40,995	46,522
Amortization of intangibles	6,656	1,298	2,003
Stock option compensation	8,161	2,279	1,481
Operating income	27,170	35,881	81,891
Interest expense, net	(3,026)	(1,024)	(468)
Income before income taxes	24,144	34,857	81,423
Income taxes	9,788	13,923	31,987
Net income	\$ 14,356	\$ 20,934	\$ 49,436
Earnings per share:			
Basic	\$ 0.56	\$ 0.69	\$ 1.53
Diluted	\$ 0.53	\$ 0.67	\$ 1.48
Weighted average shares outstanding:			
Basic	25,837	30,273	32,406
Diluted	27,220	31,436	33,370

See accompanying notes.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

<i>(in thousands)</i>	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at December 31, 2000	\$ 25	\$ 121,827	\$ 7,357	\$ —	\$ 129,209
Comprehensive Income:					
Net income	—	—	14,356	—	14,356
Foreign currency translation	—	—	—	(33)	(33)
Total comprehensive income					14,323
Exercise of stock options for 2,129 shares	2	5,214	—	—	5,216
Tax benefit of stock options exercised	—	5,273	—	—	5,273
Stock option compensation	—	8,161	—	—	8,161
Balance at January 6, 2002	27	140,475	21,713	(33)	162,182
Comprehensive Income:					
Net income	—	—	20,934	—	20,934
Foreign currency translation	—	—	—	(226)	(226)
Total comprehensive income					20,708
Issuance of 3,900 shares of common stock, net of issuance costs of \$4,406	4	66,765	—	—	66,769
Exercise of stock options for 947 shares	1	2,658	—	—	2,659
Tax benefit of stock options exercised	—	4,454	—	—	4,454
Stock option compensation	—	2,279	—	—	2,279
Balance at January 5, 2003	32	216,631	42,647	(259)	259,051
Comprehensive Income:					
Net income	—	—	49,436	—	49,436
Foreign currency translation	—	—	—	4,053	4,053
Total comprehensive income					53,489
Exercise of stock options for 779 shares	1	3,332	—	—	3,333
Tax benefit of stock options exercised	—	3,747	—	—	3,747
Stock option compensation	—	1,481	—	—	1,481
Dividends declared, \$0.03 per share	—	—	(985)	—	(985)
Balance at January 4, 2004	\$ 33	\$ 225,191	\$ 91,098	\$ 3,794	\$ 320,116

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	(in thousands)		
	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Operating activities:			
Net income	\$ 14,356	\$ 20,934	\$ 49,436
Adjustments to reconcile net income to net cash provided by operating activities:			
Rental inventory amortization and non-cash cost of rental inventory sold	80,703	128,300	132,978
Depreciation and intangibles amortization	22,332	19,346	23,569
Stock option compensation	8,161	2,279	1,481
Tax benefit of stock options exercised	5,273	4,454	3,747
Deferred income taxes	3,703	4,653	24,036
Changes in operating assets and liabilities:			
Merchandise inventory	3,436	(10,972)	(7,232)
Other current assets	(2,731)	(466)	(3,202)
Deposits and other assets	856	(1,222)	(5,085)
Accounts payable	5,493	15,446	10,348
Accrued liabilities and deferred revenue	2,384	3,967	1,725
Net cash provided by operating activities	143,966	186,719	231,801
Investing activities:			
Business acquisitions	(20,047)	(57,675)	(30,672)
Purchases of rental inventory	(83,840)	(117,753)	(147,205)
Purchases of property, furnishings and equipment	(21,342)	(31,316)	(47,116)
Net cash used in investing activities	(125,229)	(206,744)	(224,993)
Financing activities:			
Net proceeds from issuance of common stock	—	66,769	—
Proceeds from exercise of stock options	5,216	2,659	3,333
Net payments on long-term debt	(14,600)	(26,000)	—
Net cash (used in) provided by financing activities	(9,384)	43,428	3,333
Effect of exchange rate changes on cash and cash equivalents	(33)	(226)	4,053
Increase in cash and cash equivalents	9,320	23,177	14,194
Cash and cash equivalents at beginning of fiscal year	7,029	16,349	39,526
Cash and cash equivalents at end of fiscal year	\$ 16,349	\$ 39,526	\$ 53,720
Supplemental disclosures of cash flow information:			
Cash paid during the fiscal year for interest	\$ 3,434	\$ 905	\$ 254
Cash paid during the fiscal year for income taxes	1,461	2,716	4,974

See accompanying notes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

January 6, 2002, January 5, 2003 and January 4, 2004

NOTE 1: Accounting Policies

Principles of Consolidation and Description of Business

The accompanying financial statements present the consolidated financial position, results of operations and cash flows of Movie Gallery, Inc. and subsidiaries. All material intercompany accounts and transactions have been eliminated.

We own and operate video specialty stores located throughout North America.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The most significant estimates and assumptions relate to the amortization methods and useful lives of rental inventory, fixed assets and other intangibles, valuation allowances for deferred tax assets and the allocation of the purchase price of acquired businesses. These estimates and assumptions could change and actual results could differ from these estimates.

Fiscal Year

Our fiscal year ends on the first Sunday following December 30, which periodically results in a fiscal year of 53 weeks. Results for the fiscal year ended January 5, 2003 and January 4, 2004 reflect 52-week years. Results for the fiscal year ended January 6, 2002 reflect a 53-week year. Our fiscal year includes revenues and certain operating expenses, such as salaries, wages and other miscellaneous expenses, on a daily basis. All other expenses, primarily depreciation, amortization, rent and utilities, are calculated and recorded monthly, with twelve months included in each fiscal year.

Cash Equivalents

We consider all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Merchandise Inventory

Merchandise inventory consists primarily of new DVDs, videocassette tapes ("VHS"), video games, video accessories and concessions and is stated at the lower of cost, on a first-in first-out basis, or market.

Rental Inventory

In the fourth quarter of 2002, we made a strategic decision to make a portion of our base stock, or catalog, VHS rental inventory available for sale during the holiday period as previously viewed inventory. The sale of base stock VHS rental inventory was designed to make room on our store shelves for a significant investment in base stock DVD rental inventory which arrived in stores in the first quarter of 2003. Our decision to make this investment in base stock DVD was primarily driven by the continued growth in consumer acceptance of the DVD platform in our core markets throughout 2002. DVD rental revenue represented approximately 50% of movie rental revenue as of the end of fiscal 2002 versus approximately 20% as of the end of fiscal 2001. As a result of the significant shift from VHS to DVD that occurred in our rental inventory base, we changed the estimates used to amortize rental inventory in the fourth quarter of fiscal 2002 as discussed below. The revised estimates reflect a reduction in the estimated useful lives of the rental inventory and a reduced salvage value for both VHS and game inventory. We believe the revised estimated useful lives and salvage values are better matched to our current rental business and are consistent with industry trends.

Rental inventory is stated at cost and amortized over its economic useful life. The up-front fees and minimum costs of rental product purchased under revenue-sharing arrangements are capitalized and amortized in accordance with our rental inventory amortization policy. Revenue-sharing payments are expensed as incurred and are included in cost of rental revenues. Effective as of the beginning of the fourth quarter of 2002, the cost of base stock movie inventory is amortized on an accelerated basis over the first twelve months and then on a straight-line basis over the next twelve months to its salvage value, \$4 for DVD and \$2 for VHS. The cost of non-base stock, or new release,

movie inventory is amortized to its salvage value on an accelerated basis over six months. Video games are amortized on a straight-line basis to a \$5 salvage value over twelve months.

The changes in our estimates for rental inventory amortization were applied to all inventory held at the beginning of the fourth quarter of fiscal 2002. The changes were accounted for as a change in accounting estimate during the fourth quarter ended January 5, 2003. The change in estimate decreased rental inventory and increased depreciation expense for fiscal 2002 by approximately \$27.9 million and reduced net income by \$16.7 million, or \$0.53 per diluted share. The impact of the change in fiscal 2002 was net of a \$2.1 million reserve against rental inventory that was established in the fourth quarter of 2001 in order to reflect the impact of the consumer transition to DVD on the sale prices of previously viewed VHS product. For fiscal 2003, rental inventory was decreased and depreciation expense was increased by approximately \$5.9 million and net income was reduced by \$3.6 million, or \$0.11 per diluted share.

Prior to the fourth quarter of 2002, the cost of base stock movie inventory was amortized on an accelerated basis to a net book value of \$8 over six months and to a \$4 salvage value over the next thirty months. The cost of non-base stock movie inventory was amortized on an accelerated basis over six months to a net book value of \$4, which was then amortized on a straight-line basis over the next 30 months or until the movie was sold, at which time the unamortized book value was charged to cost of rental revenues. Video games were amortized on a straight-line basis to a \$10 salvage value over eighteen months or until the game was sold, at which time the unamortized book value was charged to cost of rental revenues.

Rental inventory consists of the following:

	Fiscal Year Ended	
	January 5, 2003	January 4, 2004
Rental inventory	\$ 202,012	\$ 217,420
Accumulated amortization	(119,132)	(114,941)
	\$ 82,880	\$ 102,479

Property, Furnishings and Equipment

Property, furnishings and equipment are stated at cost and include costs incurred in the construction of new stores. Depreciation is provided on a straight-line basis over the estimated lives of the related assets.

Business Combinations, Goodwill and Other Intangible Assets

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("Statement") No. 141, *Business Combinations*, and Statement No. 142, *Goodwill and Other Intangible Assets*. Statement 141 requires that all business combinations be accounted for by the purchase method, and requires all intangible assets acquired in a business combination to be recognized as assets apart from goodwill if they meet certain contractual-legal criterion or separability criterion. The provisions of Statement 141 apply to all business combinations with an acquisition date subsequent to June 30, 2001. The application of Statement 141 did not affect any of the previously reported amounts included in goodwill or other intangible assets. Under Statement 142, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed for impairment annually, or more frequently if impairment indicators arise. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. We adopted Statement 142 as of January 7, 2002. The adoption of Statement 142 did not have any impact on the classification of intangible assets. We completed the transitional impairment test and determined that none of the goodwill recorded was impaired as of January 7, 2002. Application of the nonamortization provisions of Statement 142 would have increased net income by approximately \$3,418,000 to \$17,774,000, or \$0.65 per diluted share, for fiscal 2001.

Amortization of intangibles for fiscal 2001 includes an impairment loss of \$700,000 to write-off the net book value of goodwill in excess of its estimated fair market value. No impairment loss was recognized in fiscal 2002 or fiscal 2003 under the provisions of Statement 142.

Impairment of Long-Lived Assets

Long-lived assets, including property, furnishings and equipment and intangible assets with finite lives, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. We use the discounted cash flow method to estimate the fair value of our long-lived assets. We have not recognized impairment losses on long-lived assets held for use in fiscal 2001, 2002 or 2003.

Income Taxes

We account for income taxes under the provisions of FASB Statement No. 109, *Accounting for Income Taxes*. Under Statement 109, deferred tax assets and liabilities are determined based upon differences between financial reporting and tax bases of assets and liabilities and are measured at the enacted tax rates and laws that will be in effect when the differences are expected to reverse. We record a valuation allowance to reduce deferred tax assets if it is more likely than not that some portion or all of the deferred tax assets will not be realized. We generally consider the earnings of our foreign subsidiaries to be permanently reinvested for use in those operations and, consequently, deferred federal income taxes, net of applicable foreign tax credits, are not provided on the undistributed earnings of foreign subsidiaries which are to be so reinvested.

Revenue Recognition

We recognize rental revenue when a movie or video game is rented by the customer. Revenue from extended viewing fees incurred on rentals when the customer chooses to keep the product beyond the initial rental period is recognized when payment is received from the customer. We recognize product sales revenue at the time of sale.

We periodically sell stored value cards in the form of electronic gift cards or discount rental cards. We record deferred revenue from the sale of stored value cards at the time of sale to the customer. The liability is relieved and revenue is recognized when the cards are redeemed by the customers.

Advertising Costs

Advertising costs are expensed when incurred. Advertising expense, exclusive of cooperative reimbursements from vendors, for fiscal 2001, 2002 and 2003 totaled \$2,219,000, \$2,703,000 and \$1,096,000, respectively.

Store Opening and Start-up Costs

Store opening costs, which consist primarily of payroll, advertising and other start-up costs are expensed as incurred.

Fair Value of Financial Instruments

At January 5, 2003 and January 4, 2004, the carrying value of financial instruments such as cash and cash equivalents and accounts payable approximated their fair values, calculated using discounted cash flow analysis at our incremental borrowing rate.

Foreign Currency Translation

Our foreign subsidiary records transactions using the local currency as the functional currency. In accordance with FASB Statement No. 52, *Foreign Currency Translation*, the assets and liabilities of the foreign subsidiary are translated into U. S. dollars using either the exchange rates in effect at the balance sheet dates or historical exchange rates, depending upon the account translated. Income and expenses are translated at average exchange rates each fiscal period. The translation adjustments that result from translating the balance sheets at different rates than the income statements are included in accumulated other comprehensive income or loss, which is a separate component of consolidated stockholders' equity.

Earnings Per Share

Basic earnings per share is computed based on the weighted average number of shares of common stock outstanding during the periods presented. Diluted earnings per share is computed based on the weighted average number of shares of common stock outstanding during the periods presented, increased by the effects of shares to be issued from the exercise of dilutive common stock options (1,383,000, 1,163,000 and 964,000 for fiscal 2001, 2002 and 2003, respectively).

No adjustments were made to net income in the computation of basic or diluted earnings per share. Because their inclusion would be anti-dilutive, 400,000, 238,000 and 225,000 options for fiscal 2001, 2002 and 2003, respectively, were excluded from the computation of the weighted average shares for diluted earnings per share.

Stock Option Plan

At January 4, 2004, we have a stock-based employee compensation plan, which is described more fully in Note 7. We account for the plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. Stock option compensation is reflected in net income for variable options outstanding under the plan (see Note 7). No stock option compensation is reflected in net income for the remaining options outstanding under the plan, as the exercise price was 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 if we had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

Recently Issued Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (“EITF”) reached a consensus on Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*, effective for fiscal years beginning after December 15, 2002. EITF 02-16 generally requires that cash consideration received from a vendor be considered as a reduction of the prices of the vendor’s products, reflected as a reduction of cost of sales in the customer’s income statement. The presumption can be overcome if the vendor receives an identifiable benefit in exchange for the consideration, in which case the consideration should be recorded as revenue, or if the consideration represents a reimbursement of a specific identifiable incremental cost incurred by the customer in selling the vendor’s products where the consideration should be characterized as a reduction of that cost. Our adoption of this standard as of January 6, 2003 did not have a material impact on our financial position or results of operations.

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51*

	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Net income, as reported	\$ 14,356	\$ 20,934	\$ 49,436
Add: Stock option compensation included in reported net income, net of tax	4,919	1,367	903
Deduct: Stock option compensation determined under fair value based methods for all awards, net of tax	(899)	(1,147)	(1,099)
Pro forma net income	\$ 18,376	\$ 21,154	\$ 49,240
Earnings per share:			
Basic	\$ 0.56	\$ 0.69	\$ 1.53
Diluted	\$ 0.53	\$ 0.67	\$ 1.48
Pro forma earnings per share:			
Basic	\$ 0.71	\$ 0.70	\$ 1.52
Diluted	\$ 0.68	\$ 0.67	\$ 1.47

(“the Interpretation”). The Interpretation requires the consolidation of entities in which an enterprise absorbs a majority of the entity’s expected losses, receives a majority of the entity’s expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Currently, entities are generally consolidated by an enterprise when it has a controlling financial interest through ownership of a majority voting interest in the entity. The Interpretation is effective as of December 31, 2003 for all qualifying interests in special purpose entities (“SPEs”) in existence as of January 31, 2003 and as of February 1, 2003 for all qualifying SPEs obtained after January 31, 2003. We had no qualifying interests as of January 31, 2003. We have subsequently made equity investments in other entities during 2003 (none of which are SPEs). These investments are immaterial, and consolidation is not currently required under the Interpretation. The provisions of the Interpretation, as revised by the FASB in December 2003, must be applied to some of our investments in the first quarter of 2004. Based on our analysis to date, none of our current interests will have a significant impact on our financial statements upon adoption of the Interpretation’s consolidation rules.

In May 2003, the Financial Accounting Standards Board issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. Statement 150 clarifies the classification and measurement of certain financial instruments with characteristics of both liabilities and equity, and was effective for financial instruments entered into or modified after May 31, 2003, or otherwise for the first interim period beginning after June 15, 2003. The adoption of Statement 150 had no material impact on our net earnings, cash flows or financial position.

NOTE 2: Acquisitions

During fiscal 2003, we purchased 170 stores in 34 separate transactions for approximately \$30.7 million and recorded approximately \$19.9 million in goodwill (\$16.2 million of which is deductible for tax purposes), \$2.4 million for customer lists and \$1.4 million for non-compete agreements related to these transactions.

During fiscal 2002, we purchased 265 stores in 34 separate transactions for approximately \$60.7 million and recorded approximately \$44.0 million in goodwill (all of which is deductible for tax purposes), \$3.3 million for customer lists and \$1.0 million for non-compete agreements related to these transactions.

Effective December 21, 2001, we acquired 100% of the newly issued common stock of the reorganized Video Update, Inc. under its plan of reorganization. Video Update had been operating under Chapter 11 of the United States Bankruptcy Code since its voluntary filing on September 18, 2000. The acquisition of the newly issued common stock of Video Update was in satisfaction of all amounts owed to us by Video Update under a \$6.5 million debtor-in-possession financing agreement. In addition, we purchased certain senior secured debt of Video Update in May 2001 for \$8.5 million, funded amounts due to secured and unsecured creditors in accordance with confirmation of the plan totaling approximately \$6.3 million, and assumed other post-bankruptcy filing liabilities of Video Update as disclosed in the following table. At the time of acquisition, Video Update operated 324 video specialty stores in the United States and Canada. Our acquisition of Video Update was made as a strategic expansion of our geographic markets in accordance with our growth plan.

Due to the Video Update acquisition occurring near the end of fiscal 2001, the closing of the final books and records of Video Update had not been completed as of the time our fiscal 2001 consolidated financial statements were prepared. As a result, we posted adjustments to the purchase price allocation during fiscal 2002 to reduce the fair value of assumed liabilities by \$4.3 million. The following table summarizes the preliminary estimated fair values of the assets acquired and liabilities assumed at the date of acquisition, the purchase price allocation adjustments made in fiscal 2002, and the final resulting purchase price allocation. Subsequent adjustments to the purchase price allocation are reflected as a component of net income and were immaterial in fiscal 2003.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

**Video Update, Inc.
Condensed Balance Sheet
As of December 21, 2001**

<i>(in thousands)</i>	Preliminary	Adjustments	Final
Current assets	\$ 3,017	\$ 10	\$ 3,027
Rental inventory, net	21,801	(2,801)	19,000
Property, furnishings and equipment, net	12,596	(1,514)	11,082
Deferred income taxes	8,468	—	8,468
Total assets acquired	45,882	(4,305)	41,577
Accruals for settlement of liabilities subject to compromise	6,253	—	6,253
Current liabilities and accrued expenses	24,669	(4,305)	20,364
Notes payable to parent	8,460	—	8,460
Total liabilities assumed	39,382	(4,305)	35,077
Net investment in common stock	\$ 6,500	\$ —	\$ 6,500

In addition to the Video Update acquisition, we purchased 31 stores in five separate transactions for approximately \$6.6 million during fiscal 2001 and recorded approximately \$3.5 million in goodwill (all of which is deductible for tax purposes) and \$1.0 million in other intangibles related to these transactions.

NOTE 3: Property, Furnishings and Equipment

Property, furnishings and equipment consists of the following :

<i>(in thousands)</i>	Useful Life	January 5, 2003	January 4, 2004
Land	—	\$ 1,959	\$ 2,970
Buildings	40 years	6,547	6,826
Furniture and fixtures	7 years	53,585	65,374
Equipment	5 years	52,382	65,263
Leasehold improvements and signs	7 years	61,947	83,262
		176,420	223,695
Accumulated depreciation		(89,427)	(109,339)
		\$ 86,993	\$ 114,356

NOTE 4: Intangible Assets

The components of goodwill and other intangibles are as follows:

	<i>(in thousands)</i>	January 5, 2003		January 4, 2004	
		Weighted-Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount
Goodwill	—	\$ 147,530	\$ (31,411)	\$ 167,419	\$ (31,411)
Non-compete agreements	8 years	\$ 9,492	\$ (6,493)	\$ 10,908	\$ (7,696)
Customer lists	5 years	3,996	(318)	6,385	(1,124)
Total other intangibles		\$ 13,488	\$ (6,811)	\$ 17,293	\$ (8,820)

Estimated amortization expense for other intangible assets for the five succeeding fiscal years is as follows:

<i>(in thousands)</i>	
2004	\$ 2,357
2005	1,883
2006	1,556
2007	1,415
2008	919

The changes in the carrying amounts of goodwill for the year ended January 4, 2004, are as follows:

<i>(in thousands)</i>	
Balance as of January 5, 2003	\$ 116,119
Goodwill acquired	19,889
Balance as of January 4, 2004	\$ 136,008

NOTE 5: Financing Obligations

On June 27, 2001, we entered into a credit agreement with a syndicate of banks, led by SouthTrust Bank, with respect to a revolving credit facility. Our credit facility is unsecured and, as amended, provides for borrowings of up to \$65 million through final maturity on July 4, 2005. The interest rate on our credit facility is based on LIBOR plus an applicable margin percentage, which depends on cash flow generation and borrowings outstanding. In December 2001, as required by the credit facility, we entered into an interest rate swap agreement in order to hedge exposure to interest rate fluctuations on \$10 million of outstanding debt at a fixed rate of 3.5% plus an applicable

margin percentage. In May 2002, we repaid all amounts outstanding under our credit facility with the proceeds from our stock offering (see Note 7) and terminated the interest rate swap agreement. The costs to terminate the interest rate swap were expensed and were immaterial to our results of operations. As of January 4, 2004, there were no outstanding borrowings under our credit facility. The amounts available for borrowing were reduced by standby letters of credit outstanding of \$1.2 million and totaled \$63.8 million as of January 4, 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 6: Income Taxes

The components of income from continuing operations before income taxes are as follows:

	(in thousands)		
	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
U. S. Federal	\$ 23,670	\$ 35,082	\$ 76,873
Foreign	474	(225)	4,550
Total	\$ 24,144	\$ 34,857	\$ 81,423

The following reflects actual income tax expense:

	(in thousands)		
	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Current payable:			
U.S. Federal	\$ 5,447	\$ 7,090	\$ 5,537
State	641	2,180	2,415
Total current	6,088	9,270	7,952
Deferred:			
U.S. Federal	3,243	5,313	20,589
Foreign	213	(101)	2,011
State	244	(559)	1,435
Total deferred	3,700	4,653	24,035
	\$ 9,788	\$ 13,923	\$ 31,987

A reconciliation of income tax expense at the federal income tax rate to our effective income tax provision is as follows:

	(in thousands)		
	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Income tax expense at statutory rate	\$ 8,450	\$ 12,200	\$ 28,499
State income tax expense, net of federal income tax benefit	576	1,054	2,503
Other, net	762	669	985
	\$ 9,788	\$ 13,923	\$ 31,987

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income taxes. Components of our deferred tax assets and liabilities are as follows:

<i>(in thousands)</i>	January 5, 2003	January 4, 2004
Deferred tax assets:		
Non-compete agreements	\$ 4,946	\$ 3,998
Alternative minimum tax credit carryforward	682	2,492
Net operating loss carryforwards	31,944	40,621
Accrued liabilities	1,456	512
Other	2,919	5,287
Total deferred tax assets	41,947	52,910
Valuation allowance	(24,953)	(34,444)
Net deferred tax assets	16,994	18,466
Deferred tax liabilities:		
Furnishings and equipment	(11,573)	(19,605)
Rental inventory	(4,635)	(18,891)
Goodwill	(2,621)	(5,784)
Other	(2,283)	(2,340)
Total deferred tax liabilities	(21,112)	(46,620)
Net deferred tax liabilities	\$ (4,118)	\$ (28,154)

We had federal and state net operating loss carryforwards at January 4, 2004 resulting primarily from the Video Update acquisition (see Note 2) of approximately \$103.4 million that expire in years 2007 through 2021. We have recorded a valuation allowance of \$34.4 million related to the deferred tax assets of \$40.6 million resulting from the net operating loss carryforwards. During 2003, management performed a detailed analysis to determine the available net operating loss carryforwards from Video Update, Inc. As a result, the valuation allowance has increased by \$9.5 million to reflect the increase in net operating loss carryforwards from Video Update. This valuation allowance has been established as there exists uncertainty regarding our ability to realize these net operating losses in their entirety.

NOTE 7: Stockholders' Equity

Common Stock

In May 2002, we closed a public offering of our common stock priced at \$18.25 per share. We sold 3,900,000 shares and received the proceeds from 350,000 stock options exercised in conjunction with the offering for total proceeds, net of expenses of the offering, of approximately \$67.6 million. A portion of the proceeds from the offering were used to repay outstanding borrowings under our credit facility. We are currently using the balance of the proceeds from the offering for new store openings, selective acquisitions, working capital and other general corporate purposes.

Stock Plan

In June 2003, our Board of Directors adopted, and our stockholders approved, the Movie Gallery, Inc. 2003 Stock Plan. The plan provides for the award of incentive stock options and stock appreciation rights to employees, directors and consultants. Prior to adoption of the 2003 plan, stock option activity was subject to our 1994 Stock Plan which will expire in 2004. No further option grants will be issued under the 1994 plan. A total of 4,167,749 shares are currently reserved for issuance under the plans, 697,159 of which have been issued as of January 4, 2004. Options granted under the plans have a ten-year term and generally vest over four years.

In accordance with the provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, we apply Accounting Principles Board Opinion No. 25 and related Interpretations in accounting for the plans and, accordingly, have not recognized compensation cost in connection with the plans, except for the variable options described below. If we had elected to recognize compensation cost based on the fair value of the options granted at the grant date as prescribed by Statement 123, net income and earnings per share would have been adjusted to the pro forma amounts indicated in Note 1. The effect on net income and earnings per share is not expected to be indicative of the effects on net income and earnings per share in future years.

The fair value of each option grant was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Expected volatility	0.706	0.705	0.700
Risk-free interest rate	5.41%	5.26%	4.81%
Expected life of option in years	5.5	5.1	4.9
Expected dividend yield	0.0%	0.0%	0.0%

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in our opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our employee stock options.

We repriced 864,000 stock options in March 2001, and reduced the exercise price to \$1.78 per share. The repriced stock options are accounted for as variable until the stock options are exercised, forfeited or expire unexercised. Assuming all repriced stock options are exercised, we will receive \$0.6 million less than if no repricing had occurred. The total variable compensation expense recognized under these repriced options was \$8.2 million, \$2.3 million and \$1.5 million in fiscal 2001, 2002 and 2003, respectively. As of January 4, 2004, approximately 44,000 of these options remained outstanding and they will expire, if not exercised or forfeited, in 2008 and 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

A summary of our stock option activity and related information is as follows:

	Outstanding Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2000	5,720,641	\$ 3.91
Granted	—	—
Exercised	(2,128,927)	2.26
Cancelled	(146,205)	4.99
Outstanding at January 6, 2002	3,445,509	4.71
Granted	456,250	14.61
Exercised	(946,935)	2.81
Cancelled	(43,531)	3.25
Outstanding at January 5, 2003	2,911,293	6.90
Granted	537,500	20.30
Exercised	(778,978)	4.29
Cancelled	(33,722)	10.50
Outstanding at January 4, 2004	2,636,093	\$ 10.36
Exercisable at January 6, 2002	2,236,021	\$ 6.39
Exercisable at January 5, 2003	1,873,068	\$ 6.92
Exercisable at January 4, 2004	1,643,236	\$ 7.74
Weighted-average fair value of options granted:		
Fiscal 2001	\$ —	
Fiscal 2002	\$ 7.62	
Fiscal 2003	\$ 9.84	

Options outstanding as of January 4, 2004 had a weighted-average remaining contractual life of 5.9 years and exercise prices ranging from \$1.00 to \$22.00 as follows:

	Exercise price of:		
	\$1.00 to \$3.00	\$6.00 to \$12.00	\$13.00 to \$22.00
Options outstanding	943,216	368,750	1,324,127
Weighted-average exercise price	\$1.61	\$7.81	\$17.29
Weighted-average remaining contractual life	6.1 years	1.8 years	6.9 years
Options exercisable	734,066	368,750	540,420
Weighted-average exercise price of exercisable options	\$1.66	\$7.81	\$15.96

NOTE 8: Commitments and Contingencies

Rent expense for fiscal 2001, 2002 and 2003 totaled \$50,985,000, \$82,597,000 and \$103,160,000, respectively. Future minimum payments under non-cancellable operating leases which contain renewal options and escalation clauses with remaining terms in excess of one year consisted of the following at January 4, 2004 (in thousands):

2004	\$ 83,997
2005	73,598
2006	50,503
2007	32,659
2008	19,110
Thereafter	29,571
	\$ 289,438

We have a supply contract with Rentrak Corporation which requires us to order rental inventory under lease sufficient to require an aggregate minimum payment of \$4 million per year in revenue sharing, handling fees, sell through fees and end-of-term buyout fees. The agreement expires in 2006. We have exceeded the minimum purchase requirement in each year through fiscal 2003. In March 2001, we amended the terms of our existing supply contract with Rentrak. We paid Rentrak \$1.6 million in connection with the amendment to the contract. Additionally, we prepaid approximately \$0.9 million to be applied over a three-year period against future amounts due under the contract.

In the second quarter of fiscal 2002, we obtained a preliminary court order approving a settlement agreement in certain putative class action lawsuits filed against us alleging that the extended viewing fees charged to our customers for keeping rental products beyond the initial rental period were penalties in violation of certain common law and equitable principles. Under the terms of the settlement agreement, we were required to give class members certificates with values ranging from \$9 to \$16, redeemable between January 30, 2003 and June 30, 2003, for movie rentals, game rentals, and non-food purchases in our stores. We also agreed to pay the plaintiffs' attorneys up to \$850,000 in fees. The terms of the settlement were approved in a fairness hearing on November 22, 2002.

The settlement is non-appealable and released all claims made by all class members in all the pending class actions, other than a de minimis number of members who chose not to participate in the settlement. We incurred a one-time charge to our earnings of approximately \$4 million in the second quarter of 2002 as a result of the settlement, which amount includes \$850,000 of plaintiffs' attorneys' fees.

We are occasionally involved in litigation in the ordinary course of business, none of which, individually or in the aggregate, is material to our business or results of operations.

NOTE 9: Related Party Transactions

We hold a one-third interest in ECHO, LLC, a supply sales and distribution company. We purchase office and store supplies and other business products from ECHO. We believe that this relationship enables us to substantially reduce the retail mark-up that occurs between the wholesaler and the retailer on products we source through ECHO. Transactions with ECHO are as follows:

	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Purchases from ECHO	\$ 422	\$ 6,422	\$ 13,056
Distributions from ECHO	—	40	161
Interest from ECHO	3	6	5
Note receivable from ECHO	—	125	125
Accounts payable to ECHO	—	469	309

Air Conditioning Associates, Inc. ("ACA") is owned by the father-in-law and brother-in-law of our Chairman of the Board, President, and Chief Executive Officer. ACA administers the repair and maintenance function for our store base and corporate offices in addition to providing other HVAC materials and related services. We have achieved overall cost savings under this management agreement and have improved our system for managing company-wide repair and maintenance needs. We paid ACA approximately \$243,000, \$470,000 and \$633,000 during fiscal 2001, 2002 and 2003, respectively. We had outstanding accounts payable to ACA of approximately \$157,000 and \$75,000 as of January 5, 2003 and January 4, 2004, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

J. Todd, Inc. ("Todd & Sons") is owned by the brother of our Executive Vice President, Secretary and General Counsel. Todd & Sons supplies us with certain clothing and promotional items on an as needed basis. We have no minimum purchase requirements or

contractual obligations with Todd & Sons. We paid Todd & Sons approximately \$127,000, \$49,000 and \$259,000 during fiscal 2001, 2002 and 2003, respectively. We had outstanding accounts payable to Todd & Sons of approximately \$1,000 and \$7,000 as of January 5, 2003 and January 4, 2004, respectively.

10. Foreign Operations

The following table sets forth our consolidated revenues, operating income and assets by geographic area. All intercompany balances and transactions have been eliminated.

	(in thousands)		
	Fiscal Year Ended		
	January 6, 2002	January 5, 2003	January 4, 2004
Revenues:			
United States	\$ 367,637	\$ 505,807	\$ 648,428
Canada	1,494	23,181	43,967
Total Revenues	\$ 369,131	\$ 528,988	\$ 692,395
Operating Income:			
United States	26,696	36,111	77,346
Canada	474	(230)	4,545
Total Operating Income	\$ 27,170	\$ 35,881	\$ 81,891
Assets (at end of fiscal year):			
United States		\$ 342,787	\$ 429,523
Canada		20,787	34,766
Total Assets		\$ 363,574	\$ 464,289

11. Summary of Quarterly Results of Operations (Unaudited)

The following is a summary of our unaudited quarterly results of operations (in thousands, except per share data):

	Thirteen Weeks Ended			
	April 7, 2002	July 7, 2002	October 6, 2002	January 5, 2003
Revenue	\$ 123,130	\$ 122,578	\$ 130,435	\$ 152,845
Gross margin	86,833	84,219	90,403	72,863
Net income (loss)	9,874	5,600	9,392	(3,932)
Basic earnings (loss) per share	0.36	0.19	0.29	(0.12)
Diluted earnings (loss) per share	0.35	0.18	0.29	(0.12)
	Thirteen Weeks Ended			
	April 6, 2003	July 6, 2003	October 5, 2003	January 4, 2004
Revenue	\$ 168,649	\$ 160,998	\$ 167,239	\$ 195,509
Gross margin	108,394	108,404	112,675	128,340
Net income	13,284	9,477	9,215	17,460
Basic earnings per share	0.41	0.29	0.28	0.53
Diluted earnings per share	0.40	0.28	0.28	0.52

REPORT OF INDEPENDENT AUDITORS
Ernst & Young LLP, Independent Auditors

Board of Directors and Stockholders
Movie Gallery, Inc.

We have audited the accompanying consolidated balance sheets of Movie Gallery, Inc. as of January 5, 2003 and January 4, 2004, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended January 4, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the 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, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Movie Gallery, Inc. at January 5, 2003 and January 4, 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 4, 2004, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the consolidated financial statements, in fiscal 2002 the Company changed its method of accounting for goodwill.

Ernst & Young LLP

Birmingham, Alabama
February 13, 2004

EXECUTIVE OFFICERS AND DIRECTORS

J.T. Malugen

*Chairman of the Board, President
and Chief Executive Officer*

H. Harrison Parrish

*Vice Chairman of the Board
Senior Vice President*

Jeffrey S. Stubbs

*Executive Vice President Operations
and Chief Operating Officer*

Mark S. Loyd

*Executive Vice President
Purchasing and Product Management
and Chief Administrative Officer*

S. Page Todd

*Executive Vice President
Secretary/General Counsel
and Chief Compliance Officer*

Keith A. Cousins

*Executive Vice President
Development*

Ivy M. Jernigan

*Senior Vice President
and Chief Financial Officer*

Outside Directors

John J. Jump

Sanford C. Sigoloff

William B. Snow

CORPORATE INFORMATION

Auditors

Ernst & Young LLP
1901 6th Avenue North, Suite 1900
Birmingham, AL 35203

Annual Meeting of Stockholders

Our Annual Meeting of Stockholders will be held at 10:00 a.m. (Eastern Time) on Tuesday, June 15, 2004 at:

The Ritz-Carlton - Buckhead
3434 Peachtree Road, NE
Atlanta, GA 30326

All stockholders are cordially invited to attend.

Investor Information

A copy of our annual report on Form 10-K, filed with the Securities and Exchange Commission, is available without charge by writing:

Thomas Johnson
Senior Vice President-Investor Relations
Movie Gallery, Inc.
900 West Main Street
Dothan, AL 36301
(334) 677-2108

Registrar and Transfer Agent

American Stock Transfer & Trust Company
59 Maiden Lane
New York, NY 10038
(800) 937-5449

Stock Price and Dividend Information

Our common stock is listed on the Nasdaq National Market under the symbol "MOVI". The prices shown below are the high and low closing prices for our common stock as reported on the Nasdaq National Market for the calendar quarters presented in the following table:

	Dividends	High	Low
2003			
Fourth	\$.03	\$ 22.44	\$ 17.15
Third	—	22.50	18.96
Second	—	19.91	17.04
First	—	17.76	13.38
2002			
Fourth	—	\$ 18.56	\$ 12.26
Third	—	18.95	12.81
Second	—	21.20	15.49
First	—	17.17	10.07

The last sale price of our common stock on April 16, 2004 as reported on the Nasdaq National Market was \$19.92 per share. As of April 16, 2004, we had approximately 10,300 stockholders, including 55 stockholders of record.