

Core-Mark Holding Company, Inc.

Form 10-Q

May 22, 2006

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

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**FORM 10-Q**

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(MARK ONE)

**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2006

**.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-51515

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**CORE-MARK HOLDING COMPANY, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of incorporation or organization)

**20-1489747**  
(IRS Employer Identification No.)

**395 Oyster Point Boulevard, Suite 415**  
(Address of principal executive offices)

**94080**  
(Zip Code)

**(650) 589-9445**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirement for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

Indicate by check mark whether the registrant has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by the court. Yes  No

As of April 30, 2006, 9,915,346 shares of the registrant's common stock, \$0.01 par value per share, were outstanding.

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FOR THE THREE MONTHS ENDED MARCH 31, 2006

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**CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES**

**SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS**

This quarterly report on Form 10-Q and other materials we will file with the Securities and Exchange Commission (the SEC) contain, or will contain, disclosures which are forward-looking statements. Forward-looking statements include all statements that do not relate solely to historical or current facts, and can generally be identified by the use of words such as may, believe, will, expect, project, estimate, anticipate, plan or continue. These forward-looking statements are based on the current plans and expectations of our management and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated. These factors include, but are not limited to: economic conditions affecting the cigarette and consumable goods industry; the adverse effect of legislation and other matters affecting the cigarette industry; financial risks associated with purchasing cigarettes and other tobacco products from certain product manufacturers; increases in excise and other taxes on cigarettes and other tobacco products; increased competition in the distribution industry; our reliance on income from rebates, allowances and other incentive programs; our dependence on the convenience store industry; our dependence on certain customers; the risk that we may not be able to retain and attract customers; our inability to borrow additional capital; failure of our suppliers to provide products; the negative affects of product liability claims; the loss of key personnel, our inability to attract and retain new qualified personnel or the failure to renew collective bargaining agreements covering certain of our employees; currency exchange rate fluctuations; government regulation; and the residual effects of the Fleming Company's Inc. (Fleming) bankruptcy on our customer, supplier and employee relationships, and our results of operations.

These forward-looking statements speak only as of the date of this Form 10-Q. Except as provided by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. You should also read, among other things, the risks and uncertainties described in the section of this registration statement entitled Factors That May Affect Future Operating Results.

**Restatements of Previously Issued Financial Statements**

On March 23, 2006 the Audit Committee of the Board of Directors of the Company and management concluded that our audited consolidated financial statements as of December 31, 2004 and for the period from August 23, 2004 to December 31, 2004 and our unaudited condensed consolidated financial statements as of and for the six months ended June 30, 2005, each included in our registration statement on Form 10 initially filed with the Securities and Exchange Commission on September 6, 2005 (and thereafter amended in Amendment No. 1 on October 21, 2005 and Amendment No. 2 on November 7, 2005) should no longer be relied upon because of errors in those financial statements relating to the accounting for foreign currency translation adjustments related to intercompany balances.

Accordingly, this Form 10-Q reflects the restatement of the Company's financial statements for the three months ended March 31, 2005 as presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. For further information about the restatement, see the Company's Form 10-K filed on April 14, 2006.

No balance sheet or statement of cash flows as of and for the period ended March 31, 2005 have been previously filed.

**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In millions, except share data)****(Unaudited)**

|  | March 31,<br>2006 | December 31,<br>2005 |
|--|-------------------|----------------------|
| <b>Assets</b>  |                   |                      |
| Current assets:  |                   |                      |
| Cash and cash equivalents  | \$ 19.8           | \$ 30.0              |
| Restricted cash  | 13.1              | 10.8                 |
| Accounts receivable, net of allowance for doubtful accounts of \$ 6.1 and \$6.5, respectively  | 130.6             | 128.6                |
| Other receivables, net   | 25.1              | 27.2                 |
| Inventories, net   | 157.0             | 199.7                |
| Deposits and prepayments   | 21.9              | 18.6                 |
| <b>Total current assets</b>  | <b>367.5</b>      | <b>414.9</b>         |
| Property and equipment, net  | 40.5              | 40.9                 |
| Deferred income taxes  | 2.1               | 2.1                  |
| Other non-current assets, net  | 54.0              | 52.5                 |
| <b>Total assets</b>  | <b>\$ 464.1</b>   | <b>\$ 510.4</b>      |
| <b>Liabilities and Stockholders Equity</b>   |                   |                      |
| Current liabilities:   |                   |                      |
| Accounts payable   | \$ 47.0           | \$ 46.3              |
| Book overdrafts  | 6.8               | 20.2                 |
| Cigarette and tobacco taxes payable  | 53.8              | 64.0                 |
| Accrued liabilities  | 54.9              | 59.3                 |
| Income taxes payable   | 6.1               | 6.0                  |
| Deferred income taxes  | 13.2              | 13.3                 |
| <b>Total current liabilities</b>   | <b>181.8</b>      | <b>209.1</b>         |
| Long-term debt, net  | 37.0              | 59.6                 |
| Other tax liabilities  | 3.9               | 3.9                  |
| Claims liabilities, net of current portion   | 41.2              | 41.0                 |
| Pension liabilities  | 12.2              | 12.2                 |
| <b>Total liabilities</b>   | <b>\$ 276.1</b>   | <b>325.8</b>         |
| Commitments and Contingencies  |                   |                      |
| Stockholders equity:   |                   |                      |
| Common stock; \$0.01 par value (50,000,000 shares authorized 9,840,706 and 9,809,929 shares issued and outstanding at March 31, 2006 and December 31, 2005 respectively) | 0.1               | 0.1                  |
| Additional paid-in capital   | 167.8             | 166.1                |
| Retained earnings  | 21.3              | 19.6                 |
| Accumulated other comprehensive loss   | (1.2)             | (1.2)                |
| <b>Total stockholders equity</b>   | <b>188.0</b>      | <b>184.6</b>         |

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|   |          |          |
|---|----------|----------|
| Total liabilities and stockholders equity | \$ 464.1 | \$ 510.4 |
|---|----------|----------|

See accompanying notes to condensed consolidated financial statements.

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**CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In millions, except per share data)

(Unaudited)

|  | Three Months Ended |             |
|--|--------------------|-------------|
|  | March 31,<br>2006  | 2005        |
| Net sales                                    | \$ 1,178.9         | \$ 1,079.8  |
| Cost of goods sold                           | 1,114.4            | 1,016.8     |
| <b>Gross profit</b>                          | <b>64.5</b>        | <b>63.0</b> |
| Warehousing and distribution expenses        | 33.1               | 31.2        |
| Selling, general and administrative expenses | 27.2               | 27.6        |
| Amortization of intangible assets            | 0.3                | 0.3         |
| <b>Total operating expenses</b>              | <b>60.6</b>        | <b>59.1</b> |
| Income from operations                       | 3.9                | 3.9         |
| Interest expense, net                        | 0.7                | 3.2         |
| Foreign currency transaction losses, net     | 0.1                | 0.3         |
| Amortization of debt issuance costs          | 0.1                | 0.3         |
| Income before income taxes                   | 3.0                | 0.1         |
| Provision for income taxes                   | 1.3                | 0.1         |
| Net income                                   | \$ 1.7             | \$ 0.0      |
| Basic income per common share                | \$ 0.18            | \$ 0.01     |
| Diluted income per common share              | \$ 0.16            | \$ 0.01     |
| Basic weighted average shares                | 9.8                | 9.8         |
| Diluted weighted average shares              | 10.9               | 10.2        |

See accompanying notes to condensed consolidated financial statements.

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**CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In millions)

(Unaudited)

|   | Three Months Ended |                   |
|---|--------------------|-------------------|
|   | 2006               | March 31,<br>2005 |
| Cash flows from operating activities:   |                    |                   |
| Net income  | \$ 1.7             | \$ 0.0            |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |                   |
| LIFO and inventory reserves   | 1.6                | 1.8               |
| Amortization of stock-based compensation expense                                  | 1.1                | 1.0               |
| Allowance for doubtful accounts   | (0.8)              | 0.5               |
| Depreciation and amortization   | 2.9                | 3.3               |
| Foreign currency transaction losses, net  | 0.1                | 0.3               |
| Deferred income taxes   | (0.1)              |                   |
| Changes in operating assets and liabilities:                                      |                    |                   |
| Accounts receivable   | (2.1)              | (2.5)             |
| Other receivables   | 3.0                | 9.4               |
| Inventories   | 41.3               | 10.6              |
| Deposits, prepayments and other non-current assets                                | (5.8)              | (0.3)             |
| Accounts payable  | 0.7                | (0.5)             |
| Cigarette and tobacco taxes payable   | (10.3)             | 8.7               |
| Pension, claims and other accrued liabilities and income taxes payable            | (4.1)              | (8.6)             |
| Net cash provided by operating activities   | 29.2               | 23.7              |
| Cash flows from investing activities:   |                    |                   |
| Restricted cash   | (2.3)              | (2.0)             |
| Additions to property and equipment, net  | (1.5)              | (1.5)             |
| Net cash used in investing activities   | (3.8)              | (3.5)             |
| Cash flows from financing activities:   |                    |                   |
| Borrowings under 2004 revolving credit facility, net                              |                    | 1.1               |
| Repayments under 2005 revolving credit facility, net                              | (22.6)             |                   |
| Principal payments on long-term debt  |                    | (10.0)            |
| Cash proceeds from exercise of common stock options                               | 0.4                |                   |
| Excess tax deductions associated with stock-based compensation                    | 0.2                |                   |
| Decrease in book overdrafts   | (13.4)             | (3.8)             |
| Net cash used in financing activities   | (35.4)             | (12.7)            |
| Effects of changes in foreign exchange rates                                      | (0.2)              | (0.3)             |
| Increase (decrease) in cash and cash equivalents                                  | (10.2)             | 7.2               |
| Cash and cash equivalents, beginning period                                       | 30.0               | 26.1              |



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|  |  |         |
|--|--|---------|
| Cash and cash equivalents, end of period | \$ 19.8  | \$ 33.3 |
| Supplemental disclosures:                |  |         |
| Cash paid during the period for:         |  |         |
| Income Taxes                             | \$ 1.0   | \$ 1.3  |
| Interest                                 | \$ 1.1   | \$ 3.4  |
|  | See accompanying notes to condensed consolidated financial statements. |         |

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**CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Summary Company Information**

**Business**

Core-Mark Holding Company, Inc. and subsidiaries (collectively the Company or Core-Mark) is one of the leading wholesale distributors to the convenience store industry in North America, providing sales and marketing, distribution and logistics services to customer locations across the United States and Canada. The Company operates a network of 24 distribution centers in the United States and Canada, distributing a diverse line of national and private label convenience store products to approximately 19,000 customer locations. The Company's products include cigarettes, tobacco, candy, snacks, fast food, grocery products, non-alcoholic beverages, general merchandise, and health and beauty care products. Core-Mark services a variety of store formats including traditional convenience stores, grocery stores, drug stores, liquor stores and other stores that carry convenience products.

Core-Mark operated as a privately-held company until June 2002 when it was acquired by Fleming Company Inc. (Fleming). On April 1, 2003 Fleming filed for protection under Chapter 11 of the U.S. Bankruptcy Code. The debtor-in-possession entities comprising Core-Mark were included in the Chapter 11 proceedings as Core-Mark had guaranteed Fleming's debt. The Plan of reorganization (the Plan), which became effective on August 23, 2004, provided for the reorganization of the debtors around Core-Mark. Fleming's other assets and liabilities were transferred to two special-purpose trusts, and are being liquidated. Under certain conditions, Core-Mark may be required to fulfill certain guarantees related to the trusts (*see Note 10 Commitments*). On August 20, 2004 Core-Mark Holding Company, Inc. was incorporated and on August 23, 2004 Core-Mark emerged from the Fleming bankruptcy.

**Basis of Presentation and Principles of Consolidation**

In the opinion of the Company's management, the accompanying unaudited condensed consolidated financial statements of Core-Mark Holding Company, Inc. and subsidiaries for the three months ended March 31, 2006 and 2005 have been prepared on the same basis as the Company's audited consolidated financial statements and include all adjustments (consisting of only normally recurring adjustments) necessary for the fair presentation of its consolidated results of operations, financial position and cash flows. Results for the interim periods are not necessarily indicative of results to be expected for the full year or any other future period.

The significant accounting policies and certain financial information that are normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States, but which are not required for interim reporting purposes, have been omitted. The unaudited consolidated interim financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2005 which are included in the Company's Annual Report on Form 10-K.

**Consolidation of Variable Interest Entities**

As a result of the Fleming bankruptcy, and in order to protect a Canadian province from credit related exposure, the province requires that the Company deposit excise taxes collected from the Company's customers in a trust account. The excise taxes collected by the Company are being deposited in trust as stipulated in a trust agreement between the province and the Company.

As part of the trust agreement, a trust was created on July 29, 2003. The trust identified the province as the sole beneficiary. The formation of the trust required the Company to evaluate the accounting guidelines of the

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**CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

Financial Accounting Standards Board Financial Interpretation No. 46R (FIN 46R) *Consolidation of Variable Interest Entities into the Company's Financial Statements*. In compliance with FIN 46R, the Company determined the trust was eligible for variable interest entity status.

Based on the specific criteria of the trust agreement and consistent with the guidelines of FIN 46R, the Company concluded that the cash related to the trust should be consolidated into the Company's financial statements and classified as restricted cash.

**Restatements of Previously Issued Financial Statements**

On March 23, 2006 the Audit Committee of the Board of Directors of the Company and management concluded that our audited consolidated financial statements as of December 31, 2004 and for the period from August 23, 2004 to December 31, 2004 and our unaudited condensed consolidated financial statements as of and for the six months ended June 30, 2005, each included in our registration statement on Form 10 initially filed with the Securities and Exchange Commission on September 6, 2005 (and thereafter amended in Amendment No. 1 on October 21, 2005 and Amendment No. 2 on November 7, 2005) should no longer be relied upon because of errors in those financial statements relating to the accounting for foreign currency translation adjustments related to intercompany balances.

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No balance sheet or statement of cash flows as of and for the period ended March 31, 2005 have been previously filed.

**Use of Estimates**

These financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. This requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company's management considers the allowance for doubtful accounts, the allowance related to other receivables, inventory valuation allowance, recovery of other long-lived assets, trust guarantees, the realizability of deferred income taxes, pension benefits and self-insurance reserves, and the fair value of the Company's common stock and stock volatility to be those estimates which involve a higher degree of judgment and complexity. Actual results could differ from those estimates.

**Distribution Assets**

Cost of goods sold excludes depreciation and amortization expense attributable to distribution assets of \$1.1 million and \$1.6 million, which have been included in warehousing and distribution expenses for the three months ended March 31, 2006 and March 31, 2005, respectively.

**New Accounting Pronouncements**

In December, 2004, the FASB issued SFAS No. 123 (revised 2004) (SFAS No. 123R), *Share-Based Payment*. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes

**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

APB Opinion No. 25. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123 for fair value. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values and prohibits pro forma disclosure as an alternative to financial statement recognition. SFAS No. 123(R) is effective for interim or annual reporting periods beginning after December 15, 2005. The adoption of SFAS No. 123(R) in the first quarter of fiscal year 2006 has not had a material impact on the Company's financial statements.

**2. Excise Taxes**

State and provincial cigarette and tobacco excise taxes paid by the Company are included in both sales and cost of goods sold and totaled \$280.3 million and \$261.8 million for the three months ended March 31, 2006 and 2005, respectively.

**3. Inventories**

Inventories consist of finished goods and include tobacco products, food and other products, and related consumable products held for re-sale and are valued at the lower of cost or market. In the United States, cost is determined primarily on a last-in, first-out (LIFO) basis using producer price indices as determined by the Department of Labor. Under the LIFO method, current costs of goods sold are matched against current sales. Inventories in Canada are valued on a first-in, first-out (FIFO) basis as LIFO is not a permitted inventory valuation method in Canada.

Inventories consist of the following (in millions):

|                                      | <b>March 31,</b> | <b>December 31,</b> |
|--------------------------------------|------------------|---------------------|
|                                      | <b>2006</b>      | <b>2005</b>         |
| Inventories at FIFO, net of reserves | \$ 167.7         | \$ 209.0            |
| Less: LIFO reserve                   | (10.7)           | (9.3)               |
| <b>Inventories, net</b>              | <b>\$ 157.0</b>  | <b>\$ 199.7</b>     |

The Company provides inventory valuation adjustments for spoiled, aged and unrecoverable inventory based upon amounts on hand and historical shrinkage experience. This valuation allowance was \$1.1 million and \$1.2 million as of March 31, 2006 and December 31, 2005.

During periods of rising prices, the LIFO method of costing inventories generally results in higher current costs being charged against income while lower costs are retained in inventories. Conversely, during periods of decreasing prices, the LIFO method of costing inventories generally results in lower current costs being charged against income and higher stated inventories. The Company recorded LIFO expense of \$1.4 million and \$1.6 million for the three months ended March 31, 2006 and 2005.

**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****4. Comprehensive Income**

Comprehensive income consists of net income, minimum pension liability adjustments, and foreign currency translation adjustments. The components of comprehensive income for the three months ended March 31, 2006 and 2005, respectively, are as follows (in millions):

|   | For the three months<br>ended March 31, 2006 | For the three months<br>ended March 31, 2005 |
|---|--|--|
| Components of comprehensive income:     |  |  |
| Net income                              | \$ 1.7                                       | \$ 0.0                                       |
| Foreign currency translation adjustment |  | 0.1  |
| Total comprehensive income              | \$ 1.7                                       | \$ 0.1                                       |

**5. Long-term Debt**

All obligations under the 2005 Credit Facility are secured by a first priority interest in and liens upon substantially all of our present and future assets. The terms of the 2005 Credit Facility permit prepayment without penalty at any time (subject to customary breakage costs with respect to LIBOR or CDOR based loans prepaid prior to the end of an interest period).

In fiscal year 2005, the Company paid a total of approximately \$2.1 million in financing costs in connection with the 2005 Credit Facility, which are being deferred and amortized over the life of the facility. Unamortized debt issuance costs were \$1.9 and \$2.0 million at March 31, 2006 and December 31, 2005, respectively.

For the three months ended March 31, 2006, the weighted average interest rate for the revolving credit facility was 5.9% and the Company paid total unused facility fees of \$0.1 million.

During the three months ended March 31, 2006, the maximum amount of borrowing and letters of credit facilities were \$59.6 million and \$55.0 million, respectively.

As of March 31, 2006, there were \$37.0 million in total borrowings outstanding and \$55.0 million in letters of credit outstanding under the 2005 Credit Facility, net borrowing capacity under the 2005 Credit Agreement was \$83.6 million, and the Company was in compliance with all of the covenants under the 2005 Credit Agreement.

**6. Income Taxes**

The Company is subject to United States federal, state, local and foreign income taxes and accounts for income taxes under an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

In assessing the potential realization of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. At each balance sheet date, a valuation allowance has been established against the deferred tax assets

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based on management's assessment whether it is more likely than not that these deferred tax assets would not be realized.

**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

As of March 31, 2006, after taking into account a valuation allowance of \$1.9 million, the Company had a net deferred tax liability of \$11.1 million, of which an amount of \$13.2 million is shown as a current deferred tax liability and \$2.1 million as a non-current deferred tax asset in the consolidated balance sheet. The effective income tax rate for the three months ended March 31, 2006 was 43.1% and is based on the federal statutory income tax rate, adjusted by the effect of state income taxes, net of federal benefit, changes in valuation allowances, effect of foreign operations and other permanent items.

**7. Earnings Per Share**

The following tables set forth the computation of basic and diluted net income per share (in millions, except per share amounts):

|   | <b>For the Three<br/>months ended<br/>March 31, 2006</b> | <b>For the Three<br/>months ended<br/>March 31, 2005</b> |
|---|--|--|
| Net income                                  | \$ 1.7   | \$ 0.0   |
| Basic weighted-average shares outstanding   | 9.8  | 9.8  |
| Dilutive common equivalent shares:          |  |  |
| Unvested restricted stock                   | 0.1  | 0.0  |
| Stock options                               | 0.4  | 0.1  |
| Class 6 (b) warrants                        | 0.4  | 0.2  |
| Tranche B warrants                          | 0.2  | 0.1  |
| Diluted weighted-average shares outstanding | 10.9   | 10.2   |
| Basic net income per share                  | \$ 0.18  | \$ 0.01  |
| Diluted net income per share                | \$ 0.16  | \$ 0.01  |

**8. Stock-Based Compensation Plans**

Effective January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment (SFAS 123(R) an amendment of SFAS No. 123, Accounting for Stock Based Compensation, using the modified prospective method.

Under this method, compensation cost is recognized beginning with the effective date based on (a) the requirements of SFAS No. 123(R) for all share-based payment awards granted after the effective date and (b) based on the requirements of SFAS No. 123 for awards granted to employees prior to the effective date that remain unvested on the effective date. Accordingly, prior period amounts are not restated. SFAS No. 123(R) requires all share-based payments to be recognized in the income statement based on their fair values.

Prior to the adoption of SFAS 123(R), the Company accounted for its stock-based compensation plans using the fair value method as prescribed in SFAS No. 123, whereby stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as

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an expense over the vesting period. The Company did not have a stock-based compensation plan in place prior to August 23, 2004.

Total stock-based compensation cost recognized on the accompanying consolidated statements of operations was \$1.1 million and \$1.0 million for the three months end March 31, 2006 and 2005, respectively. Total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the



**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Plan was \$7.1 for the three months ended March 31, 2006. That cost is expected to be recognized over a weighted average period of 1.7 years.

The Company uses the Black-Scholes multiple option-pricing model to determine the grant date fair value for each stock option and restricted stock unit grant. There is limited historical information available to support the estimate of certain assumptions required to value the employee stock options. The Company shares began trading in April 2005. The expected volatility of the Company's stock is based on a variety of factors including the volatility measures of other companies in relatively similar industries and the measures of companies which recently emerged from bankruptcy. The risk free rate for periods within the contractual life of the option is based on the U.S Treasury yield curve in effect at the time of grant. The expected term of options granted represents the period of time we estimate that options granted are expected to be outstanding.

The weighted-average assumptions are as follows:

|                          | <b>Three months<br/>Ended March 31,</b> |             |
|--------------------------|---|-------------|
|                          | <b>2006</b>                             | <b>2005</b> |
| Expected Volatility      | 30%                                     | 30%         |
| Expected dividends       | 0.0%                                    | 0.0%        |
| Expected term (in years) | 4                                       | 4           |
| Risk-free rate           | 4.44%                                   | 3.00%       |

Employee stock-based compensation expense recognized in the three months ended March 31, 2006 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. The Company's forfeiture experience since inception of its plans has been approximately 0.9% of the total grants and the historical rate of forfeiture is deemed to be a reasonable predictor of the future rate of forfeitures due to the limited period of time that the plans have been in place and the limited number of plan participants, approximately 50. The transition impact related to forfeitures was not material. Restricted stock units issued during the three months ended March 31, 2006 were recorded at fair value. The Company expects to issue shares under these stock based Compensation Plans from newly issued shares.

The Company maintains four stock-based compensation plans, the 2004 Long-Term Incentive Plan, the 2004 Directors' Equity Incentive Plan, the 2005 Long-Term Incentive Plan and the 2005 Directors' Equity Incentive Plan which were established on and after the date of emergence from the Fleming bankruptcy. All plans carry a term of seven years.

The weighted-average grant-date fair value of restricted stock units granted was \$0.2 million and \$4.9 million, for the three months ended March 31, 2006 and 2005, respectively.

As of March 31, 2006, the aggregate intrinsic value of stock options and restricted stock exercised during the three months ended March 31, 2006 was \$0.8 million. As of March 31, 2006 the aggregate intrinsic value of stock options and restricted stock vested during the three months ended March 31, 2006 was \$4.2 million. The aggregate fair value of total shares vested as of March 31, 2006 was \$5.4 million.

The aggregate intrinsic value of the Company's stock, for purposes of this calculation, represents, on a pretax basis, the difference between the Company's closing stock price as of the end of the first quarter of 2006 and 2005, respectively, and the stock option or restricted stock exercise price, multiplied by the number of stock options and restricted stock outstanding or exercisable. Stock options and restricted stock with exercise prices which are greater than the closing quarter end stock price are excluded from this calculation.

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**CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

***2004 Long-Term Incentive Plan***

The 2004 Long-Term Incentive Plan units (2004 LTIP), has of two components consisting of 1,114,444 stock options and 200,000 restricted stock units. For each option, the exercise price equals the fair value of the Company's common stock on the date of grant. One third of the option shares vest on the first anniversary of the vesting commencement date and the remaining shares vest in equal monthly installments over the two year period following the first anniversary of the vesting commencement date. Restricted common stock is available for grant to officers and key employees, vesting over three years, with a one-year cliff vesting on the anniversary of the date of grant and the remaining shares vest in equal quarterly installments. The stock-based compensation is being recognized ratably over the three-year vesting period of the restricted common shares using the straight-line method.

***2004 Directors' Equity Incentive Plan***

Under the Company's 2004 Directors' Equity Incentive Plan (2004 Directors' Plan), the Company's Board of Directors may from time to time grant options to non-employee board members to purchase up to 7,500 shares of the Company's common stock in aggregate. On August 23, 2004, the Company granted 30,000 options to purchase common stock to the non-employee Directors of the Company. This plan has terms and vesting requirements similar to those of the 2004 LTIP, except options vest quarterly under the 2004 Directors' Plan.

***2005 Long Term Incentive Plan***

The 2005 LTIP provides for the granting of shares of restricted common stock to officers and key employees. Restricted common stock issued under the 2005 LTIP generally vests over three years, with a one-year cliff vesting period beginning on February 1, 2005, followed by vesting ratably over the remaining 8 quarters.

***2005 Directors' Equity Incentive Plan***

The 2005 Directors Plan permits granting of non-qualified stock options to non-employee directors. The terms of the 2005 Directors Plan are substantially similar to the 2004 Directors Plan the options vest over three years, one third will vest on August 12, 2006. The remaining options vest in equal quarterly installments over the two year period commencing on August 12, 2006, for each consecutive quarter that the grantee remains a director.

**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table summarizes information about restricted stock units and stock option activity, and restricted stock and stock options outstanding for the 2004 LTIP and 2004 Directors Equity Incentive Plan and 2005 Directors Equity Incentive Plan for the three months ended March 31, 2006:

|                                  | 2004 LTIP                        |                                 | 2004 LTIP/Directors Plan |                                 | 2005 LTIP                        |                                 | 2005 Directors Plan     |                                 |
|----------------------------------|----------------------------------|---------------------------------|--------------------------|---------------------------------|----------------------------------|---------------------------------|-------------------------|---------------------------------|
|                                  | Number of Restricted Stock Units | Weighted Average Exercise Price | Number of Option Shares  | Weighted Average Exercise Price | Number of Restricted Stock Units | Weighted Average Exercise Price | Number of Option Shares | Weighted Average Exercise Price |
| Outstanding at December 31, 2005 | 196,301                          | \$ 0.01                         | 1,079,934                | \$ 15.50                        | 153,455                          | \$ 0.01                         | 15,000                  | \$ 27.03                        |
| Units granted                    | 5,000                            | 0.01                            |                          |                                 | 1,671                            | 0.01                            |                         |                                 |
| Units exercised                  | (8,562)                          | 0.01                            | (22,222)                 | 15.50                           |                                  |                                 |                         |                                 |
| Units canceled                   |                                  | 0.01                            |                          |                                 |                                  | 0.01                            |                         |                                 |
| Outstanding at March 31, 2006    | 192,739                          | \$ 0.01                         | 1,057,712                | \$ 15.50                        | 155,126                          | \$ 0.01                         | 15,000                  | \$ 27.03                        |

| Name of Plan                        | Exercise Prices | Options/Units Outstanding |  | Weighted-Average Exercise Price | Options/Units Exercisable |                                 |
|-------------------------------------|-----------------|---------------------------|--|---------------------------------|---------------------------|---------------------------------|
|                                     |                 | Options/Units             | Weighted-Average Remaining Contractual |                                 | Options/Units             | Weighted-Average Exercise Price |
| <b>Restricted Stock Units under</b> |                 |                           |  |                                 |                           |                                 |
| 2004 LTIP                           | \$ 0.01         | 180,426                   | 5.4 years                              | \$ 0.01                         | 95,225                    | \$ 0.01                         |
| 2004 LTIP                           | \$ 0.01         | 5,000                     | 6.8 years                              | \$ 0.01                         |                           | \$ 0.01                         |
| 2005 LTIP                           | \$ 0.01         | 762                       | 6.8 years                              | \$ 0.01                         |                           | \$ 0.01                         |
| 2005 LTIP                           | \$ 0.01         | 909                       | 6.8 years                              | \$ 0.01                         | 303                       | \$ 0.01                         |
| 2004 LTIP                           | \$ 0.01         | 7,313                     | 6.7 years                              | \$ 0.01                         | 3,860                     | \$ 0.01                         |
| 2005 LTIP                           | \$ 0.01         | 153,455                   | 5.8 years                              | \$ 0.01                         | 51,152                    | \$ 0.01                         |
| <b>Options Granted under</b>        |                 |                           |  |                                 |                           |                                 |
| 2004 LTIP and Director s            | \$ 15.50        | 1,057,712                 | 5.4 years                              | \$ 15.50                        | 558,237                   | \$ 15.50                        |
| 2005 Director s Plan                | \$ 27.03        | 15,000                    | 6.4 years                              | \$ 27.03                        |                           | \$ 27.03                        |

**9. Employee Benefit Plans**

The Company sponsors a qualified defined benefit pension plan and a post-retirement benefit plan for employees hired before September 1986. There have been no new entrants to the pension or non-pension post retirement benefit plans after those benefit plans were frozen on September 30, 1989. Pursuant to the Plan, on the Effective Date, the Company was assigned the obligation for three former Fleming defined-benefit pension plans. The Predecessor Company's frozen pension benefit plans and post-retirement benefit plan and the three former Fleming pension plans are collectively referred to as the Pension Plans. Pension costs and other post-retirement benefit costs charged to operations are estimated on the basis of annual valuations with the assistance of an independent actuary. Adjustments arising from plan amendments, changes in assumptions and experience gains and losses are amortized over the expected average remaining service life of the

employee group.

The Company maintains defined contribution plans in the United States, subject to Section 401(k) of the Internal Revenue Code, and in Canada, subject to the Department of National Revenue Taxation Income Tax Act.

**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following tables provide the components of the net periodic pension and other post-retirement benefit costs for the three months ended March 31, 2006 and 2005 (in millions):

|                                       | For the three months ended | For the three months ended |
|---------------------------------------|----------------------------|----------------------------|
|                                       | March 31, 2006             | March 31, 2005             |
| <b>PENSION BENEFITS</b>               |                            |                            |
| Interest cost                         | \$ 0.5                     | \$ 0.5                     |
| Expected return on plan assets        | (0.5)                      | (0.5)                      |
| <b>Net periodic benefit cost</b>      | <b>\$</b>                  | <b>\$</b>                  |
| <br>                                  |                            |                            |
|                                       | For the three months ended | For the three months ended |
|                                       | March 31, 2006             | March 31, 2005             |
| <b>OTHER POST-RETIREMENT BENEFITS</b> |                            |                            |
| Interest cost                         | \$ 0.1                     | \$ 0.1                     |
| <b>Net periodic benefit cost</b>      | <b>\$ 0.1</b>              | <b>\$ 0.1</b>              |

The Company contributed \$0.3 million and \$0.4 million to its pension and other post-retirement benefit plans during the three months ended March 31, 2006 and 2005, respectively.

During the second quarter of 2006, the Company expects to contribute approximately \$0.3 million to its pension and other post-retirement benefit plans. The Company does not expect to make a contribution to its defined contribution plan during this period.

**10. Commitments****Trust Guarantees**

Pursuant to the Plan, the Company guarantees the payment of all Post Confirmation Trust, or PCT administrative claims in excess of \$56 million. In addition, if the assets of the Reclamation Creditor's Trust (RCT) are inadequate to satisfy all of the allowed Trade Lien Vendor (TLV) claims in the RCT, the Company must pay such claims in full plus any accrued interest. The Company also guarantees all eligible but unpaid non-TLV claims in the RCT up to a maximum of \$15 million. The Plan limits the combined RCT guarantee amounts of the TLV and non-TLV claims to no more than \$137 million. FASB Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, requires that an entity issuing a guarantee must recognize, at the inception of the guarantee, a liability equal to the fair value of the guarantee. Based on the estimates provided by the Trusts and the Company's analysis of the assets of the Trusts are sufficient to satisfy the claims against it; therefore, the Company believes that the fair value of its guarantee liability as of August 23, 2004 was not significant. In accordance with SFAS 5 *Accounting for Contingencies*, the Company deemed remote the likelihood that a liability existed as of March 31, 2006 to satisfy the trust claims. However, if the assets of the Trust prove insufficient to pay the claims in the future, the Company could be required to satisfy the guarantees.

**11. Segment and Geographic Information**

Core-Mark is one of the largest wholesale distributors to the convenience retail industry in North America, providing sales and marketing, distribution and logistics services to customer locations across the United States and Canada. The Company distributes consumable goods including cigarettes, tobacco, candy, snacks, fast food, grocery products, non-alcoholic beverages, general merchandise and health and beauty care products to customers in the United States and Canada. The Company services a variety of store formats, including traditional convenience stores, grocery stores, drug stores, liquor stores, gift shops, specialty stores and other stores that carry convenience products.

**Table of Contents****CORE-MARK HOLDING COMPANY, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The Company has identified two reportable segments, United States and Canada, based on the differing economic characteristics of each. For management reporting purposes, the Company evaluates business segment performance before income taxes, and other items that do not reflect the underlying business performance. Inter-segment revenues are not significant and no single customer accounted for 10% or more of the Company's total revenues.

Information about the Company's operations by business segment and geographic areas is as follows (in millions):

|   | <b>For the three months ended</b> |                | <b>For the three months ended</b> |                |
|---|-----------------------------------|----------------|-----------------------------------|----------------|
|   | <b>March 31, 2006</b>             |                | <b>March 31, 2005</b>             |                |
| <b>Net sales:</b>                         |                                   |                |                                   |                |
| United States                             | \$                                | 942.4          | \$                                | 849.7          |
| Canada                                    |                                   | 231.6          |                                   | 226.0          |
| Corporate adjustments and eliminations    |                                   | 4.9            |                                   | 4.1            |
| <b>Total</b>                              | <b>\$</b>                         | <b>1,178.9</b> | <b>\$</b>                         | <b>1,079.8</b> |
| <b>Income (loss) before income taxes:</b> |                                   |                |                                   |                |
| United States                             | \$                                | 0.6            | \$                                | 4.3            |
| Canada                                    |                                   | 0.2            |                                   | 0.5            |
| Corporate adjustments and eliminations    |                                   | 2.2            |                                   | (4.7)          |
| <b>Total</b>                              | <b>\$</b>                         | <b>3.0</b>     | <b>\$</b>                         | <b>0.1</b>     |
| <b>Interest (income) expense:</b>         |                                   |                |                                   |                |
| United States                             | \$                                | 4.8            | \$                                | 6.1            |
| Canada                                    |                                   | (0.3)          |                                   | (0.4)          |
| Corporate adjustments and eliminations    |                                   | (3.8)          |                                   | (2.5)          |
| <b>Total</b>                              | <b>\$</b>                         | <b>0.7</b>     | <b>\$</b>                         | <b>3.2</b>     |
| <b>Depreciation and amortization:</b>     |                                   |                |                                   |                |
| United States                             | \$                                | 2.4            | \$                                | 0.7            |
| Canada                                    |                                   | 0.2            |                                   | 0.1            |
| Corporate adjustments and eliminations    |                                   | 0.3            |                                   | 2.5            |
| <b>Total</b>                              | <b>\$</b>                         | <b>2.9</b>     | <b>\$</b>                         | <b>3.3</b>     |

Identifiable assets by geographic area (in millions):

**March 31,****December 31,**

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|                      | 2006     | 2005     |
|----------------------|----------|----------|
| Identifiable assets: |          |          |
| United States        | \$ 397.3 | \$ 416.1 |
| Canada               | 66.8     | 94.3     |
| Total                | \$ 464.1 | \$ 510.4 |

The corporate adjustments and eliminations identified above include amounts not reflected in our United States and Canada operating segment information such as differences between allocated and incurred costs for interest, corporate expense, depreciation and amortization and net sales relating to corporate activities unallocated to the operating segments.



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### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following is a discussion and analysis of our business, consolidated results of operations and financial condition. Following an introduction and overview is an executive summary providing significant highlights of the operations and business initiatives. The information in this Management's Discussion and Analysis contains certain forward-looking statements, which reflect our current view with respect to future events and financial performance. Any such forward looking statements are subject to risks and uncertainties that could cause our actual results of operations to differ materially from historical results or current expectations. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section entitled "Factors That May Affect Future Operating Results." We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document. This discussion and analysis should be read in conjunction with Core-Mark's consolidated financial statements and related notes thereto, included in our Form 10-K.*

#### **Overview**

Core-Mark is one of the leading wholesale distributors to the convenience store industry in North America in terms of annual sales, providing sales and marketing, distribution and logistics services to customer locations across the United States and Canada. Our headquarters are located in South San Francisco, California, and we operate a network of 24 distribution centers in the United States and Canada, including two distribution centers that we operate as a third-party logistics provider. The products we distribute include cigarettes, tobacco, candy, snacks, fast food, grocery products, non-alcoholic beverages, general merchandise, and health and beauty care products. We service a variety of store formats including traditional convenience stores, grocery stores, drug stores, liquor stores and other stores that carry convenience products.

We derive our net sales primarily from sales to convenience store customers. Our gross profit is derived primarily by applying a markup to the cost of the product at the time of the sale and from cost reductions derived from vendor credit term discounts received and other vendor programs. Our operating expenses are comprised primarily of: sales personnel costs; warehouse personnel costs related to receiving, stocking, and selecting product for delivery; delivery costs such as delivery personnel, truck leases and fuel; costs relating to the rental and maintenance of our facilities, and other general and administrative costs.

#### **Background**

Core-Mark operated as a privately-held company until June 2002 when it was acquired by Fleming. On April 1, 2003 Fleming filed for protection under Chapter 11 of the U.S. Bankruptcy Code. The debtor-in-possession entities comprising Core-Mark were included in the Chapter 11 proceedings as Core-Mark had guaranteed Fleming's debt. The Plan of reorganization (the Plan), which became effective on August 23, 2004, provided for the reorganization of the debtors around Core-Mark. Fleming's other assets and liabilities were transferred to two special-purpose trusts, and are being liquidated. Under certain conditions, Core-Mark may be required to fulfill certain guarantees related to the trusts (*See Note 10- Commitments*). On August 20, 2004 Core-Mark Holding Company, Inc. was incorporated and on August 23, 2004, Core-Mark emerged from the Fleming bankruptcy.

As a result of the Fleming bankruptcy, and in order to protect a Canadian province from credit related exposure, the province requires that we deposit excise taxes collected from our customers in a trust account. The excise taxes we collect is deposited in a trust created on July 29, 2003, as stipulated in a trust agreement between the province and Core-Mark. The trust identifies the province as the sole beneficiary.

The formation of the trust required us to evaluate the accounting guidelines of FIN 46R *Consolidation of Variable Interest Entities* into our financial statements. In compliance with FIN 46R, Core-Mark determined the trust was eligible for variable interest entity status.

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Based on the specific criteria of the trust agreement and consistent with the guidelines of FIN 46R, we concluded that the cash related to the trust should be consolidated into our financial statements and classified as restricted cash.

### **Critical Accounting Policies and Estimates**

The Company's critical accounting policies were previously disclosed on Form 10-K filed with the SEC on April 14, 2006.

### **Restatements of Previously Issued Financial Statements**

On March 23, 2006 the Audit Committee of the Board of Directors of the Company and management concluded that our audited consolidated financial statements as of December 31, 2004 and for the period from August 23, 2004 to December 31, 2004 and our unaudited condensed consolidated financial statements as of and for the six months ended June 30, 2005, each included in our registration statement on Form 10 initially filed with the Securities and Exchange Commission on September 6, 2005 (and thereafter amended in Amendment No. 1 on October 21, 2005 and Amendment No. 2 on November 7, 2005) should no longer be relied upon because of errors in those financial statements relating to the accounting for foreign currency translation adjustments related to intercompany balances.

Accordingly, this Form 10-Q reflects the restatement of the Company's financial statements for the three months ended March 31, 2005 as presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. For further information about the restatement, see the Company's Form 10-K filed on April 14, 2006.

No balance sheet or statement of cash flows as of and for the period ended March 31, 2005 have been previously filed.

### **Executive Summary of Results of Operations**

For the three months ended March 31, 2006 net sales were \$1.2 billion, an increase of \$99.1 million, or 9.2%, compared to the three months ended March 31, 2005. More than 50% of this increase was due to three significant new customers, which we began servicing in the first quarter of 2005. Gross profit decreased as a percentage of sales due to the impact of cigarette excise taxes on sales, cigarette holding profits earned in the three months ended March 31, 2005 and lower margins earned related to sales to the three new significant customers. Tax increases are reflected as an increase in net sales while our gross profit dollars generally remained unaffected as a result of the tax increases.

For the three months ended March 31, 2006, warehousing and distribution expenses increased by \$1.9 million and selling, general and administrative expenses decreased by \$0.4 million compared to the three months ended March 31, 2005. As a percentage of sales, warehousing and distribution expenses decreased from 2.9% to 2.8%, while selling general and administrative expenses decreased from 2.6% to 2.3%. The improvements in operating expenses as a percentage of sales was primarily related to labor efficiencies gained and leveraging of fixed costs relative to the growth in sales. Salaries and benefits combined for all departments increased by 6.6%, while net sales increased by 9.2% in the 2006 period compared to the 2005 period. Selling, general and administrative expenses benefited from a \$1.1 million favorable settlement of previously written-off vendor and customer receivables for the three months ended March 31, 2006 compared to a \$1.0 million benefit from an unanticipated insurance recovery for the three months ended March 31, 2005. Additionally, selling, general and administrative expenses for the three months ended March 31, 2006 were positively impacted by a decline in consulting and legal costs of approximately \$0.4 million which were incurred primarily in support of our requirement to become a public company in the 2005 period.

In October 2005, we refinanced our prior revolving credit facility and term notes, and entered into a new \$250 million five-year credit facility. The 2005 Credit Facility provides significantly more favorable credit terms

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and increased borrowing flexibility, which along with cash generated from operations, we believe will provide the required capital resources to meet our working capital, capital expenditure and other cash needs for at least the next 12 months (*See Liquidity and Capital Resources section below*). During the first three months of 2006 we decreased our debt by approximately \$23 million, from \$60 million to \$37 million, due to a liquidation of inventories, earnings for the quarter and other improvements in working capital. Interest expense for the three months ended March 31, 2006 decreased by \$2.5 million compared to the three months ended March 31, 2005. The decrease resulted from lower effective interest rates due primarily to the replacement of our post-bankruptcy term debt which had a higher interest rate and lower average net borrowings for the three months ended March 31, 2006 compared to 2005.

On April 26, 2006, the Company announced that it is in exclusive negotiations to acquire substantially all the assets of Klein Candy Co. L.P. headquartered in Wilkes-Barre, Pennsylvania. The acquisition is subject to a number of conditions, including completion of due diligence, definitive documentation, receipt of necessary third party consents and final agreement on certain terms. If the acquisition is completed, the Company plans to fund the purchase of Klein Candy Co. L.P. using its existing 2005 Credit Facility. Certain assets acquired as part of the transaction would be added to the Company's borrowing base under the terms of the 2005 Credit Facility.

Our business is highly competitive and our future success will continue to depend on our ability to deliver high volumes of product efficiently and accurately, making it easy for our customers to do business with us by providing technology, merchandising and sales and marketing services, and helping our customers grow their business in a profitable manner. Continuing our sales growth and further improving operational efficiencies in our distribution centers, while containing our fixed costs will, if accomplished successfully, improve our profitability.

**Results of Operations****Comparison of the three months ended March 31, 2006 and 2005**

The following table sets forth the results of operations for the three months ended March 31, 2006 and compares those results to those of the three months ended March 31, 2005. The comparative table is presented solely to complement management's discussion and analysis of our results of operations.

| (in millions)                                    | 2006                  |                              | % of Net sales | % of Net sales, less excise taxes | 2005                         |                | % of Net sales, less excise taxes |
|--|-----------------------|------------------------------|----------------|-----------------------------------|------------------------------|----------------|-----------------------------------|
|  | 2006 compared to 2005 | Three months ended March 31, |                |                                   | Three months ended March 31, | % of Net sales |                                   |
| Net sales  | \$ 99.1               | \$ 1,178.9                   | 100.0%         |                                   | \$ 1,079.8                   | 100.0%         |                                   |
| Net sales - Cigarettes                           | 69.5                  | 843.3                        | 71.5           | 65.2                              | 773.8                        | 71.7           | 65.3                              |
| Net sales - Food/Non-food                        | 29.6                  | 335.6                        | 28.5           | 34.8                              | 306.0                        | 28.3           | 34.7                              |
| Net sales, less excise taxes                     | 80.6                  | 898.6                        | 76.2           | 100.0                             | 818.0                        | 75.8           | 100.0                             |
| Gross profit                                     | 1.5                   | 64.5                         | 5.5            | 7.2                               | 63.0                         | 5.8            | 7.7                               |
| Warehousing and distribution expenses            | 1.9                   | 33.1                         | 2.8            | 3.7                               | 31.2                         | 2.9            | 3.8                               |
| Selling, general and administrative expenses     | (0.4)                 | 27.2                         | 2.3            | 3.0                               | 27.6                         | 2.6            | 3.4                               |
| Income from operations                           | 0.0                   | 3.9                          | 0.3            | 0.4                               | 3.9                          | 0.4            | 0.5                               |
| Interest expense, net                            | (2.5)                 | 0.7                          | 0.1            | 0.1                               | 3.2                          | 0.3            | 0.4                               |
| Foreign currency transaction (gains) losses, net | (0.2)                 | 0.1                          | 0.0            | 0.0                               | 0.3                          | 0.0            | 0.0                               |
| Net income                                       | 1.7                   | 1.7                          | 0.1            | 0.2                               | 0.0                          | 0.0            | 0.0                               |

*Net sales.* Net sales overall for the three months ended March 31, 2006 increased \$99.1 million, or 9.2%, compared to the three months ended March 31, 2005. The increase was due primarily to three significant new

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customers, which we began servicing in the first quarter of 2005. These new customers represent approximately \$51.1 million or 52% of the increase in net sales inclusive of excise taxes. This increase was offset by the impact of the loss of two significant customers in the fourth quarter of 2005, which explains a decline in net sales of \$43.6 for the three months ended March 31, 2006 compared to 2005. The remaining increase in net sales of \$91.6 million was due to increases in net sales to existing customers and other customer wins and losses, the impact of cigarette excise tax increases, and increases in sales in our Canadian distribution centers due to foreign currency translation changes. The increase due to excise taxes increases was \$18.5 million in the 2006 period compared to 2005, while increases in our overall Canadian operations sales due to foreign currency translation rate changes were approximately \$13.6 million in the 2006 period compared to 2005.

Net sales of cigarettes for the three months ended March 31, 2006 increased \$69.5 million, or 9.0% compared to the three months ended March 31, 2005. An increase of \$37.6 million or 4.9% was attributable to the addition of the three significant new customers in 2005. The remaining increase in cigarette sales was attributable in part to increases in state and provincial taxes that occurred during these periods, which we passed on to our customers. Several states and provinces increased cigarette taxes during 2005 and the three months ended March 31, 2006. These increases are reflected in our net sales of cigarettes. In the three months ended March 31, 2006, cigarette carton sales increased by 4.8% compared to the three months ended March 31, 2005. This increase was primarily attributable to the three significant new customers in 2005. Cigarette net sales as a percent of total net sales remained unchanged at 72% for the three months ended March 31, 2006 and 2005.

Net sales of food and non-food products for the three months ended March 31, 2006 increased \$29.6 million or 9.7% compared to the same period in 2005. An increase of \$13.5 million, or 4.4%, is attributable to the three new customers mentioned above. The remaining increase of \$16.1 million, or 5.3%, is due primarily to increases in sales to existing customers and increases in sales related to new customers, partially offset by lost sales due to customer losses.

*Gross profit.* Gross profit for the three months ended March 31, 2006 increased by \$1.5 million, or 2.4%, compared to the three months ended March 31, 2005. The increase in gross profit dollars was caused primarily by an increase in sales volume, offset by a reduction in cigarette inventory holding profits discussed below. As a percentage of sales, gross profit decreased from 5.8% for the three months ended March 31, 2005 to 5.5% for the three months ended March 31, 2006.

Several factors impacted gross profit margins period over period. The decrease in gross profit as a percentage of sales was due primarily to a reduction in cigarette holding profits earned in the three months ended March 31, 2006 compared to the same period in 2005. Cigarette gross profit for the three months ended March 31, 2006 included \$0.6 million of cigarette inventory holding profits relating to manufacturer price increases, compared to \$2.5 million of cigarette inventory holding profits for the three months ended March 31, 2005, which related to cigarette tax increases and manufacturer price increases. A reduction in rebates and allowances received from our vendors as well as lower margins earned related to sales to the three new significant customers obtained in early 2005 impacted gross profit margins negatively in the 2006 period compared to 2005. In addition, cigarette gross profit margins were negatively impacted in the three months ended March 31, 2006, compared to the three months ended March 31, 2005 due to the impact of state and provincial excise taxes on sales. The significant tax increases are reflected as an increase in net sales, however, our gross profit dollars were unaffected as a result of tax increases in the three months ended March 31, 2006.

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The following table sets forth the notable components comprising the change in gross profit as a percentage of net sales for the three month periods.

| (in millions)                       | 2006                         |   |  | 2005                         |   |  |
|-------------------------------------|------------------------------|---|--|------------------------------|---|--|
|                                     | Three months ended March 31, | Three months ended March 31, % of Net sales | Three months ended March 31, % of Net sales, less excise taxes | Three months ended March 31, | Three months ended March 31, % of Net sales | Three months ended March 31, % of Net sales, less excise taxes |
| Net sales                           | \$ 1,178.9                   | 100.0%                                      |  | \$ 1,079.8                   | 100.0%                                      |  |
| Net sales, less excise taxes        | 898.6                        | 76.2  | 100.0%   | 818.0                        | 75.8  | 100.0%   |
| LIFO expense                        | (1.4)                        | (0.12)                                      | (0.16)   | (1.6)                        | (0.15)                                      | (0.20)   |
| Cigarette inventory holding profits | 0.6                          | 0.05  | 0.07   | 2.5                          | 0.23  | 0.31   |
| Remaining gross profit              | 65.3                         | 5.54  | 7.27   | 62.1                         | 5.75  | 7.59   |
| <b>Gross profit</b>                 | <b>\$ 64.5</b>               | <b>5.47%</b>                                | <b>7.18%</b>   | <b>\$ 63.0</b>               | <b>5.83%</b>                                | <b>7.70%</b>   |

*Operating expenses.* Our operating expenses include costs related to warehousing, distribution, and selling, general and administrative activities. For the three months ended March 31, 2006, operating expenses increased \$1.5 million or 2.5% to \$60.6 million from \$59.1 million for the three months ended March 31, 2005. Overall, costs related to labor and benefits comprised approximately 64% of warehousing, distribution and selling, general and administrative expenses for the three months ended March 31, 2006. A significant percentage of our labor costs are variable in nature and fluctuate relative to our sales volume.

*Warehousing and distribution expenses.* Warehousing and distribution expenses for the three months ended March 31, 2006 increased by \$1.9 million, compared to the three months ended March 31, 2005. As a percentage of sales these expenses decreased from 2.9% for the three months ended March 31, 2005 to 2.8% for the three months ended March 31, 2006. The decrease as a percent of sales in the three months ended March 31, 2006 is due to the leveraging of fixed costs in relation to net sales increases at our distribution centers. Increases in sales due to excise tax increases also contributed to the reduction in expenses as a percentage of sales.

*Selling, general and administrative expenses.* Selling, general and administrative expenses for the three months ended March 31, 2006 decreased by \$0.4 million compared to the three months ended March 31, 2005. As a percentage of sales, these expenses decreased from 2.6% for the three months ended March 31, 2005 to 2.3% for the same period in 2006. In the three months ended March 31, 2006, we benefited from the reversal of a vendor payable determined not due totaling \$0.7 million and the favorable settlement of previously written-off vendor and customer receivables of \$0.4 million, both in the aggregate resulting in expense reductions of \$1.1 million. In the three months ended March 31, 2005, we benefited from an unanticipated insurance recovery totaling \$1.0 million. Selling, general and administrative expenses were negatively impacted in the 2005 period by costs such as legal and consulting, incurred primarily in support of our requirement to become a public company and our ongoing initiative to prepare for compliance with the regulations of the Sarbanes Oxley Act of 2002. These costs decreased by \$0.4 million in the 2006 period, compared to the 2005 period. Additionally, the decrease as a percent to sales in the three months ended March 31, 2006 is due to the leveraging of fixed costs in relation to net sales increases. Increases in sales due to excise tax increases also contributed to the reduction in expenses as a percentage of sales.

*Income from operations.* Income from operations for the three months ended March 31, 2006 and 2005 was \$3.9 million, attributable primarily to the items discussed in this section.

*Interest expense, net.* Interest expense for the three months ended March 31, 2006 decreased by \$2.5 million compared to the three months ended March 31, 2005. For the three months ended March 31, 2006, the



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effective interest rate and average net borrowings were significantly lower than the three months ended March 31, 2005. The higher effective interest rate for the 2005 period was due primarily to the post-bankruptcy higher interest rates charged under our term debt borrowings which were replaced with lower interest borrowings when we entered into our 2005 Credit Facility in October 2005.

*Foreign currency transaction (gains) losses, net.* We incurred foreign currency transaction losses of \$0.1 million for the three months ended March 31, 2006, compared to \$0.3 million of such losses for the three months ended March 31, 2005. The decrease in the loss was due primarily to intercompany activity related to our Canadian operations and changes in Canadian foreign exchange rates.

## **Liquidity and Capital Resources**

Our liquidity requirements arise primarily from the funding of our working capital, capital expenditure programs and debt service requirements with respect to our credit facilities. We have historically funded our capital requirements through our current operations and external borrowings.

As of March 31, 2006, our cash and restricted cash were \$19.8 million and \$13.1 million, respectively. Restricted cash represents funds that have been set aside in trust as required by Canadian provincial taxing authorities to secure amounts payable to these authorities for cigarette and tobacco excise taxes.

### *Cash flows from operating activities*

#### ***Three months ended March 31, 2006***

For the three months ended March 31, 2006, net cash provided by operating activities was \$29.2 million and consisted of cash generated from operations of \$6.5 million, and cash provided as a result of changes in assets and liabilities of \$22.7 million. Cash generated from operations includes net income of \$1.7 million coupled with the benefit of non-cash charges for depreciation and amortization, and the change in our LIFO inventory allowance.

The increase in cash from changes in assets and liabilities was due primarily to a decrease in inventories of \$41.3 million, offset by a decrease in cigarette and tobacco taxes payable of \$10.3 million and an increase in deposits, prepayments and other non-current assets of \$5.8 million. The decrease in inventories was due primarily to higher than normal cigarette inventory levels at December 31, 2005 as a result of purchases of cigarettes in connection with our LIFO tax planning strategy and the requirement to purchase additional cigarettes in Canada at year-end due to the Canadian cigarette manufacturers closing down during the holidays. Tobacco taxes payable were higher than normal at December 31, 2005 due primarily to the high level of purchases of Canadian cigarettes at year end, which result in a tax liability at the time of purchase. The increase in deposits, prepayments and other non-current assets was due primarily to upfront payments made to certain customers in the first quarter of 2006 that are amortized over the life of the customer agreement.

#### ***Three months ended March 31, 2005***

For the three months ended March 31, 2005, cash provided by operating activities was \$23.7 million and consisted of cash generated from operations totaling \$6.9 million and cash provided from changes in assets and liabilities of \$16.8 million. Cash generated from operations includes net income of \$0.0 million coupled with the benefit of non-cash charges for depreciation and amortization, and the change in our LIFO inventory allowance.

The increase in cash from changes in asset and liabilities was due primarily to a decrease in inventories of \$10.6 million, a decrease in other receivables of \$9.4 million and an increase in cigarette and tobacco taxes payable of \$8.7 million, all partially offset by a decrease in pension, claims and other accrued liabilities of \$8.6 million. The decrease in inventory levels of \$10.6 million was due primarily to the higher-than-normal levels of

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inventory in the U.S. at the end of 2004 when we purchased excess cigarette inventories in anticipation of U.S. cigarette manufacturer price changes. The decrease in other receivables of \$9.4 million is primarily the result of the collection of vendor receivables that were outstanding at December 31, 2004 related to the bankruptcy. The increase in cigarette and tobacco taxes payable was primarily due to significant excise tax rate increases in the U.S. that were effective in the first quarter of 2005 and resulted in additional cigarette taxes payable at March 31, 2005, compared to December 31, 2004. The decrease in pension, claims and other accrued liabilities of \$8.6 million was due primarily to a decrease in salary and benefit-related accruals and other miscellaneous accrued liabilities.

*Cash flows relating to investing activities*

***Three months ended March 31, 2006 and 2005***

For the three months ended March 31, 2006 and March 31, 2005, cash flows used in investing activities were \$3.8 million and \$3.5 million, respectively. For the three months ended March 31, 2006 and 2005 we had an increase in restricted cash of \$2.3 million and \$2.0 million, respectively. For each of the three-month periods we had \$1.5 million in capital spending, which related primarily to the scheduled replacement of delivery and warehouse equipment. Our capital expenditure plan is to spend approximately \$16 million during 2006, which includes equipping a replacement facility in Spokane, Washington, increasing our refrigerated product capabilities, and regularly scheduled replacement of delivery and warehouse equipment.

*Cash flows from financing activities*

***Three months ended March 31, 2006 and 2005***

For the three months ended March 31, 2006, net cash used in financing activities was \$35.4 million. We made payments on our revolving line of credit of \$22.6 million, due primarily to a decrease in inventories during the period, and our book overdrafts declined \$13.4 million from the balances at December 31, 2005 due to normal fluctuations.

For the three months ended March 31, 2005, net cash used in financing activities was \$12.7 million. The use of cash was due primarily to payments we made under our Tranche B notes payable of \$10.0 million, a decrease in our book overdrafts of \$3.8 million, and offset by net borrowings under our revolving line of credit of \$1.1 million.

We believe that our ability to generate cash from operations and funds available from the 2005 Credit Facility will be adequate to fund working capital, capital spending and other cash needs for at least the next 12 months. Our ability to generate adequate cash from operations in the future, however, will depend on, among other things, our ability to successfully implement our business strategies while continuing to tightly control our expenses and to manage the impact of changes in manufacturers' pricing. We can give no assurance that we will be able to successfully implement those strategies and cost control initiatives, or successfully manage our pricing to match increases from the manufacturers. In addition, changes in our operating plans, lower than anticipated sales, increased expenses, interest rate increases, acquisitions or other events may cause us to seek additional debt or equity financing in future periods. We can give no assurance that financing will be available on acceptable terms or at all. Additional equity financing could be dilutive to holders of our common stock; debt financing, if available, could impose additional cash payment obligations and additional covenants and operating restrictions.

**2005 Revolving Credit Facility**

All obligations under the 2005 Credit Facility are secured by a first priority interest in and liens upon substantially all of our present and future assets. The terms of the 2005 Credit Facility permit prepayment without penalty at any time (subject to customary breakage costs with respect to LIBOR or CDOR based loans prepaid prior to the end of an interest period).



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In fiscal year 2005, we paid a total of approximately \$2.1 million in financing costs in connection with the 2005 Credit Facility, which are being deferred and amortized over the life of the facility. Unamortized debt issuance costs were \$1.9 million and \$2.0 million at March 31, 2006 and December 31, 2005, respectively.

For the three months ended March 31, 2006, the weighted average interest rate for the revolving credit facility was 5.9% and we paid total unused facility fees of \$0.1 million.

During the three months ended March 31, 2006, the maximum amount of borrowing and letters of credit facilities were \$59.6 million and \$55.0 million, respectively.

As of March 31, 2006, there were \$37.0 million in total borrowings outstanding and \$55.0 million in letters of credit outstanding under the 2005 Credit Facility, our net borrowing capacity under the 2005 Credit Agreement was \$83.6 million, and we were in compliance with all of our covenants under the 2005 Credit Agreement.

## **Litigation**

In the ordinary course of our business, we are subject to certain legal proceedings, claims, investigations and administrative proceedings. In accordance with SFAS No. 5 *Accounting for Contingencies*, we record a provision for a liability when it is both probable that the liability has been incurred and the amount of the liability can be reasonably estimated. When applicable, these provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case. At both March 31, 2006 and December 31, 2005, we were not involved in any material litigation.

## **New Accounting Pronouncements**

In December, 2004, the FASB issued SFAS No. 123 (revised 2004) (SFAS No. 123R), *Share-Based Payment*. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123 for fair value. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values and prohibits pro forma disclosure as an alternative to financial statement recognition. SFAS No. 123(R) is effective for interim or annual reporting periods beginning after December 15, 2005. The adoption of SFAS No. 123(R) in the first quarter of fiscal year 2006 has not had a material impact on our financial statements.

## **FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS**

### **Risks Relating to Our Business**

#### **Cigarette and consumable goods distribution is a low-margin business sensitive to economic conditions.**

We derive most of our revenues from the distribution of cigarettes, other tobacco products, candy, snacks, fast food, grocery products, non-alcoholic beverages, general merchandise and health and beauty care products. Our industry is characterized by a high volume of sales with relatively low profit margins. Our non-cigarette sales are at prices that are based on the cost of the product plus a percentage markup. As a result, our profit levels may be negatively impacted during periods of cost deflation for these products, even though our gross profit as a percentage of the price of goods sold may remain relatively constant. Periods of product cost inflation may also have a negative impact on our profit margins and earnings with respect to sales of cigarettes. Gross profit on cigarette sales are generally fixed on a cents per carton basis. Therefore, as cigarette prices increase, gross profit generally decreases as a percent of sales. In addition, if the cost of the cigarettes that we purchase increase due to

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manufacturer price increases or increases in applicable excise tax rates, our inventory costs and accounts receivable could rise. To the extent that product cost increases are not passed on to our customers due to their resistance to higher prices, our profit margins and earnings could be negatively impacted.

The consumable goods distribution industry is sensitive to national and regional economic conditions. Inflation, fuel costs and other factors affecting consumer confidence generally may negatively impact our sales. Our operating results are also sensitive to, and may be adversely affected by, other factors, including difficulties with the collectability of accounts receivable, competitive price pressures, severe weather conditions and unexpected increases in fuel or other transportation-related costs. Due to the low- margins on the products we distribute, changes in general economic conditions could materially adversely affect our operating results.

### **Our sales volume is largely dependent upon the distribution of cigarette products, sales of which are declining.**

The distribution of cigarette and other tobacco products is currently a significant portion of our business. For the year ended December 31, 2005, approximately 72% of our revenues came from the distribution of cigarettes. During the same period, approximately 35% of our gross profit was generated from cigarettes. Due to increases in the prices of cigarettes and other tobacco products, restrictions on advertising and promotions by cigarette manufacturers, increases in cigarette regulation and excise taxes, health concerns, increased pressure from anti-tobacco groups and other factors, the U.S. and Canadian cigarette and tobacco market has generally been declining, and is expected to continue to decline. Notwithstanding the general decline in consumption, we have benefited from a shift of cigarette and tobacco sales to convenience stores. However, this favorable trend may not continue and may reverse.

### **Legislation and other matters are negatively affecting the cigarette and tobacco industry.**

The tobacco industry is subject to a wide range of laws and regulations regarding the advertising, sale, taxation and use of tobacco products imposed by local, state, federal and foreign governments. Various state and provincial governments have adopted or are considering legislation and regulations restricting displays and advertising of tobacco products, establishing fire safety standards for cigarettes, raising the minimum age to possess or purchase tobacco products, requiring the disclosure of ingredients used in the manufacture of tobacco products, imposing restrictions on public smoking, restricting the sale of tobacco products directly to consumers or other unlicensed recipients over the Internet, and other tobacco product regulation. For example, in British Columbia, Canada, legislation was adopted authorizing the provincial government to seek recovery of tobacco-related health care costs from the tobacco industry and a lawsuit under such legislation is underway. Other states and provinces may adopt similar legislation and initiate similar lawsuits. In addition, cigarettes are subject to substantial excise taxes in the United States and Canada. Significant increases in cigarette-related taxes have been proposed or enacted and are likely to continue to be proposed or enacted within the United States and Canada. These tax increases are likely to continue to have an adverse impact on sales of cigarettes due to lower consumption levels or sales outside of legitimate channels.

### **In the United States, we purchase cigarettes primarily from manufacturers covered by the tobacco industry's Master Settlement Agreement (or MSA), which results in our facing certain financial risks including competition from lower priced sales of cigarettes produced by manufacturers who do not participate in the Master Settlement Agreement.**

In June 1994, the Mississippi attorney general brought an action against various tobacco industry members. This action was brought on behalf of the state to recover state funds paid for health-care, medical and other assistance to state citizens suffering from diseases and conditions allegedly related to tobacco use. Most other states, through their attorneys general or other state agencies, sued the major U.S. cigarette manufacturers based on similar theories. The cigarette manufacturer defendants settled the first four of these cases scheduled for

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trial Mississippi, Florida, Texas and Minnesota by separate agreements between each state and those manufacturers in each case. These states are referred to as non-MSA states.

In November 1998, the major U.S. tobacco product manufacturers entered into the MSA with the other 46 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa and the Northern Marianas to settle asserted and unasserted health care cost recovery and other claims. The MSA and the other state settlement agreements: settled all health-care cost recovery actions brought by, or on behalf of, the settling jurisdictions; released the major U.S. cigarette manufacturers from various additional present and potential future claims relating to past conduct arising out of the use, sale, distribution, manufacture, development, advertising, marketing or health effects of, the exposure to, or research, statements or warnings about, tobacco products; settled all monetary claims relating to future conduct arising out of the use of, or exposure to, tobacco products that have been manufactured in the ordinary course of business; imposed a stream of future payment obligations on major U.S. cigarette manufacturers; and placed significant restrictions on their ability to market and sell cigarettes. The payments required under the MSA result in the products sold by the participating manufacturers to be priced at higher levels than non-MSA manufacturers.

In order to limit our potential tobacco related liabilities, we do not purchase cigarettes from non-MSA manufacturers for sale in MSA states. The benefits of the MSA do not apply to sales of cigarettes manufactured by non-MSA manufacturers.

Competition among cigarette manufacturers for cigarette sales is primarily based on brand positioning, price, product attributes, consumer loyalty, promotions, advertising and retail presence. Cigarette brands produced by the major tobacco product manufacturers generally require competitive pricing, substantial marketing support, retail programs and other financial incentives to maintain or improve a brand's market position. Increased selling prices and higher cigarette taxes have resulted in the growth of deep-discount brands. Deep-discount brands are brands manufactured by companies that are not original participants to the MSA, and accordingly, do not have cost structures burdened with MSA-related payments to the same extent as the original participating manufacturers. Historically, major tobacco product manufacturers have had a competitive advantage in the United States because significant cigarette marketing restrictions and the scale of investment required to compete made gaining consumer awareness and trial of new brands difficult. However, since the MSA was signed in November 1998, the category of deep-discount brands manufactured by smaller manufacturers or supplied by importers has grown substantially.

As a result of purchasing premium and discount cigarettes for sale in MSA states exclusively from manufacturers that are parties to the MSA, we are adversely impacted by sales of brands from non-MSA manufacturers and deep-discount brand growth. We believe that small manufacturers, not subject to the MSA, of deep-discount brands have steadily increased their combined market share of cigarette sales. The premium and discount cigarettes subject to the MSA that we sell have been negatively impacted by widening price gaps in the prices between those brands and the deep-discount brands for the past several years. The growth in market share of the deep-discount brands since the MSA was signed in 1998 has had an adverse impact on the volume of the cigarettes that we sell. As a result, our operations may be negatively impacted as sales volumes of premium cigarettes and the other tobacco products erode.

### **We also face competition from illicit and other low priced sales of cigarettes.**

We also face competition from the diversion into the United States market of cigarettes intended for sale outside the United States, the sale of counterfeit cigarettes by third parties, the sale of cigarettes in non-taxable jurisdictions, inter-state and international smuggling of cigarettes, increased imports of foreign low priced brands, the sale of cigarettes by third parties over the Internet and by other means designed to avoid collection of applicable taxes. The competitive environment has been characterized by a continued influx of cheap products that challenge sales of higher priced and taxed cigarettes manufactured by parties to the MSA. Increased sales of

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counterfeit cigarettes, sales by third parties over the internet, or sales by means to avoid the collection of applicable taxes, could have an adverse effect on our results of operations.

### **If the tobacco industry's master settlement agreement is invalidated, or tobacco manufacturers cannot meet their obligations to indemnify us, we could be subject to substantial litigation liability.**

In connection with the MSA, we are indemnified by the tobacco product manufacturers from which we purchase cigarettes and other tobacco products for liabilities arising from our sale of the tobacco products that they supply to us. To date, litigation challenging the validity of the MSA, including claims that the MSA violates antitrust laws, has not been successful. However, if such litigation were to be successful and the MSA is invalidated, we could be subject to substantial litigation due to our sales of cigarettes and other tobacco products, and we may not be indemnified for such costs by the tobacco product manufacturers in the future. In addition, even if we continue to be indemnified by cigarette manufacturers that are parties to the MSA, future litigation awards against such cigarette manufacturers and us could be so large as to eliminate the ability of the manufacturers to satisfy their indemnification obligations. Our results of operations could be negatively impacted due to increased litigation costs and potential adverse rulings against us.

### **Cigarettes and other tobacco products are subject to substantial excise taxes and if these taxes are increased, our sales of cigarettes and other tobacco products could decline.**

Cigarettes and tobacco products are subject to substantial excise taxes in the United States and Canada. Significant increases in cigarette-related taxes and/or fees have been proposed or enacted and are likely to continue to be proposed or enacted within the United States and Canada. These tax increases are expected to continue to have an adverse impact on sales of cigarettes due to lower consumption levels and a shift in sales from the premium to the non-premium or discount cigarette segments or to sales outside of legitimate channels. In addition, state and local governments may require us to prepay for excise tax stamps placed on packages of cigarettes and other tobacco products that we sell. If these excise taxes are substantially increased, it could have a negative impact on our liquidity. Accordingly, we may be required to obtain additional debt financing, which we may not be able to obtain on satisfactory terms or at all. Our inability to prepay the excise taxes may prevent or delay our purchase of cigarettes and other tobacco products, which could materially adversely affect our ability to supply our customers.

### **We face competition in our distribution markets and if we are unable to compete effectively in any distribution market, we may lose market share and suffer a decline in sales.**

Our distribution centers operate in highly competitive markets. We face competition from local, regional and national tobacco and consumable products distributors on the basis of service, price and variety of products offered, schedules and reliability of deliveries, and the range and quality of services provided.

Some of our competitors, including a subsidiary of Berkshire Hathaway Inc., McLane Company, Inc., the largest convenience wholesale distributor in the U.S., have substantial financial resources and long standing customer relationships. In addition, heightened competition among our existing competitors or by new entrants into the distribution market could create additional competitive pressures that may reduce our margins and adversely affect our business. If any of our tobacco manufacturers or any of our other suppliers were to enter into the distribution business, our market share could erode significantly. For example, the largest tobacco manufacturer in Canada, Imperial Tobacco Canada, whose products constitute approximately 40% of our Canadian revenues, recently announced that it plans to begin direct-to-store delivery of its products. If we fail to successfully respond to these or other competitive pressures or to implement our strategies effectively, we may lose market share and our results of operations could suffer.

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**If the costs to us of the products we distribute increase, or excise stamp taxes increase, and we cannot pass these increases on to our customers, our results of operations could be adversely affected.**

If we cannot pass along to our customers increases in our cost of goods sold which we experience when manufacturers or taxing authorities increase prices or taxes invoiced or reduce or eliminate discounts, rebates, allowances and other incentive programs, our profit margins could erode. Our industry is characterized by a high volume of sales with relatively low profit margins. If we cannot pass along cost increases to our customers due to resistance to higher prices, our relatively narrow profit margins and earnings could be negatively affected.

**We rely on funding from manufacturer discounts, rebates, allowances and incentives programs and cigarette excise stamping allowances and material changes in these programs could adversely affect our results of operations.**

We receive payments from the manufacturers of the products we distribute for allowances, discounts, volume rebates, and other merchandising incentives in connection with various incentive programs. These payments are a substantial benefit to us and the amount and timing of these payments are affected by changes in the programs by the manufacturers, our ability to sell specified volumes of a particular product or attaining specified levels of purchases by our customers, and the duration of carrying a specified product. In addition, we receive discounts from states in connection with the purchase of excise stamps for cigarettes. If the manufacturers or states change or discontinue these programs or we are unable to maintain the volume of our sales, our results of operations could be negatively affected.

**We are dependent on the convenience store industry for our revenues, and our results of operations would suffer if there is an overall decline in the convenience store industry.**

The majority of our sales are made under purchase orders and short-term contracts with convenience stores which inherently involve significant risks. These risks include the uncertainty of general economic conditions in the convenience store industry, credit exposure from our customers and termination of customer relationships without notice, consolidation of our customer base, and consumer movement toward purchasing from club stores. Any of these factors could negatively affect the convenience store industry which would negatively affect our results of operations.

**Some of our distribution centers are dependent on a few relatively large customers, and our failure to maintain our relationships with these customers could substantially harm our business and prospects.**

Some of our distribution centers are dependent on relationships with a single customer or a few customers, and we expect our reliance on these relationships to continue for the foreseeable future. Any termination or non-renewal of customer relationships could severely and adversely affect the revenues generated by certain of our distribution centers. For example, in connection with Fleming's bankruptcy, our customer relationships with Target and K-Mart were terminated resulting in a significant loss of revenue and the closure of four distribution centers located in the Eastern United States. Any future termination, non-renewal or reduction in services that we provide to these select customers would cause our revenues to decline and our operating results would be harmed.

**If we are not able to attract new customers, our results of operations could suffer.**

Increasing the growth and profitability of our distribution business is particularly dependent upon our ability to retain existing customers and capture additional distribution customers. The ability to capture additional customers through our existing network of distribution centers is especially important because it enables us to leverage our distribution centers and other fixed assets. Our ability to retain existing customers and attract new customers is dependent upon our ability to provide industry-leading customer service, offer competitive products at low prices, maintain high levels of productivity and efficiency in distributing products to our customers while integrating new customers into our distribution system, and offer marketing, merchandising and ancillary

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services that provide value to our customers. If we are unable to execute these tasks effectively, we may not be able to attract a significant number of new customers and our existing customer base could decrease, either or both of which could have an adverse impact on our results of operations.

### **We may not be able to borrow the additional capital to provide us with sufficient liquidity and capital resources necessary to meet our future financial obligations.**

We expect that our principal sources of funds will be cash generated from our operations and, if necessary, borrowings under our \$250 million 2005 Credit Facility. While we believe our sources of liquidity are adequate, we cannot assure you that these sources will provide us with sufficient liquidity and capital resources required to meet our future financial obligations, or to provide funds for our working capital, capital expenditures and other needs for the foreseeable future. We may require additional equity or debt financing to meet our working capital requirements or to fund our capital expenditures. We may not be able to obtaining financing on terms satisfactory to us, or at all.

### **We depend on relatively few suppliers for a large portion of our products, and any interruptions in the supply of the products that we distribute could adversely affect our results of operations.**

We obtain the products we distribute from third party suppliers. At December 31, 2005, we had approximately 3,800 vendors, and during 2005 we purchased approximately 51% of our products from our top 20 suppliers, with our top two suppliers, Philip Morris and R. J. Reynolds, representing approximately 26% and 15% of our purchases, respectively. We do not have any long-term contracts with our suppliers committing them to provide products to us. Although our purchasing volume can provide leverage when dealing with suppliers, suppliers may not provide the products we distribute in the quantities we request or on favorable terms. Because we do not control the actual production of the products we distribute, we are also subject to delays caused by interruption in production based on conditions outside our control. These conditions include job actions or strikes by employees of suppliers, inclement weather, transportation interruptions, and natural disasters or other catastrophic events. Our inability to obtain adequate supplies of the products we distribute as a result of any of the foregoing factors or otherwise, could cause us to fail to meet our obligations to our customers.

### **We may be subject to product liability claims which could materially adversely affect our business.**

Core-Mark, as with other distributors of food and consumer products, faces the risk of exposure to product liability claims in the event that the use of products sold by us causes injury or illness. With respect to product liability claims, we believe that we have sufficient liability insurance coverage and indemnities from manufacturers. However, product liability insurance may not continue to be available at a reasonable cost, or, if available, may not be adequate to cover all of our liabilities. We generally seek contractual indemnification and insurance coverage from parties supplying the products we distribute, but this indemnification or insurance coverage is limited, as a practical matter, to the creditworthiness of the indemnifying party and the insured limits of any insurance provided by suppliers. If we do not have adequate insurance or if contractual indemnification is not available or if the counterparty can not fulfill its indemnification obligation, product liability relating to defective products could materially adversely impact our results of operations.

### **We depend on our senior management and key personnel.**

We substantially depend on the continued services and performance of our senior management and other key personnel, particularly J. Michael Walsh, our President and Chief Executive Officer. We do not maintain key person life insurance policies on these individuals or any of our other executive officers, and we do not have employment agreements with any of our executive officers. The loss of the services of any of our executive officers or key employees could harm our business.

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### **We operate in a competitive labor market and a portion of our employees are covered by collective bargaining agreements.**

Our continued success will partly depend on our ability to attract and retain qualified personnel. We compete with other businesses in each of our markets with respect to attracting and retaining qualified employees. A shortage of qualified employees could require us to enhance our wage and benefits packages in order to compete effectively in the hiring and retention of qualified employees or to hire more expensive temporary employees. In addition, at December 31, 2005 approximately 6%, or approximately 220, of our employees are covered by collective bargaining agreements with labor organizations, which expire at various times over the course of the next two years.

We cannot assure you that we will be able to renew our respective collective bargaining agreements on favorable terms, that employees at other facilities will not unionize, that our labor costs will not increase, that we will be able to recover any increases in labor costs through increased prices charged to customers or that we will not suffer business interruptions as a result of strikes or other work stoppages. If we fail to attract and retain qualified employees, to control our labor costs, or to recover any increased labor costs through increased prices charged to our customers or offsets by productivity gains, our results of operations could be materially adversely affected.

### **Currency exchange rate fluctuations could have an adverse effect on our revenues and financial results.**

We generate a significant portion of our revenues in Canadian dollars, approximately 21% in 2005. We also incur a significant portion of our expenses, in Canadian dollars. To the extent that we are unable to match revenues received in Canadian dollars with costs paid in the same currency, exchange rate fluctuations in Canadian dollars could have an adverse effect on our revenues and financial results. During times of a strengthening U.S. dollar, our reported sales and earnings from our Canadian operations will be reduced because the Canadian currency will be translated into fewer U.S. dollars. Prior to August 23, 2004, we did not reflect foreign currency transaction gains or losses in our results of operations because intercompany balances between the U.S. and Canadian operations were determined to be of a permanent nature. After August 23, 2004 because such intercompany balances began fluctuating the balances were determined to be of a trading nature. GAAP requires that such foreign currency transaction gains or losses on intercompany transactions be recorded as a gain or loss within the income statement. To the extent we incur losses on such transactions our net income and earnings per share will be reduced.

### **We are subject to governmental regulation and if we are unable to comply with regulations that affect our business or if there are substantial changes in these regulations, our business could be adversely affected.**

As a distributor of food products, we are subject to the regulation by the U.S. Food and Drug Administration. In addition, our employees operate tractor trailers, trucks, forklifts and various other powered material handling equipment. Our operations are also subject to regulation by the Occupational Safety and Health Administration, the Department of Transportation, Drug Enforcement Agency and other federal, state and local agencies. Each of these regulatory authorities have broad administrative powers with respect to our operations. If we fail to adequately comply with government regulations or regulations become more stringent, we could experience increased inspections, regulatory authorities could take remedial action including imposing fines or shutting down our operations or we could be subject to increased compliance costs. If any of these events were to occur, our results of operations would be adversely affected.

### **Earthquake and natural disaster damage could have a material adverse affect on our business.**

We are headquartered in, and conduct a significant portion of our operations in, California. Our operations in California are susceptible to damage from earthquakes. In addition, two of our data centers are located in California and Oregon and may be susceptible to damage in the event of an earthquake. We believe that we maintain adequate insurance to indemnify us for losses. However, significant earthquake damage could result in losses in excess of our

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insurance coverage which would materially adversely affect our results of operations. We also have operations in areas that have been affected by natural disasters such as hurricanes, tornados, flooding, ice and snow storms. While we maintain insurance to indemnify us for losses due to such occurrences, our insurance may not be sufficient or payments under our policies may not be received timely enough to prevent adverse impacts on our business. Our customers could also be affected by like events, adversely impacting our sales.

### **Our information technology systems may be subject to failure or disruptions, which could seriously harm our business.**

Our business is highly dependent on our Distribution Center Management System, or DCMS. The convenience store industry does not have a standard information technology, or IT platform. Therefore, actively integrating our customers into our IT platform is a priority, and our DCMS platform provides our distribution centers with the flexibility to adapt to our customers' IT requirements. We also rely on our DCMS, and our internal information technology staff, to maintain the information required to operate our distribution centers and provide our customers with fast, efficient and reliable deliveries. While we have taken steps to increase redundancy in our IT systems, if our DCMS fails or is subject to disruptions, we may suffer disruptions in service to our customers and our results of operations could suffer.

### **Risks Relating to Our Recent Reorganization**

#### **We are guarantors of certain payments pursuant to the Plan of Reorganization.**

Pursuant to the Plan, two special purpose trusts, the Post Confirmation Trust, or PCT, and the Reclamation Creditor's Trust, or RCT, were established. We refer to the PCT and the RCT collectively as the Trusts. The Trusts are charged with administering certain responsibilities under the Plan, including liquidating certain assets, the pursuit and collection of litigation claims and causes of action and the reconciliation and payment of specific types of claims including trade lien vendor claims, or TLV claims, each as allocated between the PCT and the RCT pursuant to the Plan. Under the terms of the Plan, we guarantee the payment of PCT administrative claims in excess of \$56 million. In addition, if the assets of the RCT are inadequate to satisfy all of the allowed TLV claims, we must pay such claims in full plus any accrued interest. We also guarantee all eligible but unpaid non-TLV claims up to a maximum of \$15 million. The Plan limits the combined guarantee amounts of the RCT TLV and non-TLV claims to not greater than \$137 million. To the extent that we are required to fund amounts under the guarantees, our results of operations and our liquidity and capital resources could be materially adversely affected. In addition, we may not have sufficient cash reserves to pay the amounts required under the guarantees when they become due.

#### **The Fleming bankruptcy has negatively affected some of our relationships with customers, suppliers and employees and our results of operations and may continue to negatively affect such relationships and our results of operations.**

We estimate that the former Fleming convenience distribution centers, which included Core-Mark International and seven Fleming distribution centers, lost approximately \$1.2 billion in annualized sales after Fleming's Chapter 11 filing, with approximately \$360 million of such lost sales attributable to four closed distribution centers located in the Eastern United States and the balance attributable to the distribution centers now comprising Core-Mark. We cannot predict accurately or quantify the additional effects, if any, that the bankruptcy may continue to have on our operations.

#### **Our operating flexibility is limited in significant respects by the restrictive covenants in our 2005 Credit Facility.**

Our 2005 Credit Facility imposes restrictions on us that could increase our vulnerability to general adverse economic and industry conditions by limiting our flexibility in planning for and reacting to changes in our



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business and industry. Specifically, these restrictions limit our ability, among other things, to: incur additional indebtedness, pay dividends and make distributions, issue stock of subsidiaries, make investments, repurchase stock, create liens, enter into transactions with affiliates, merge or consolidate, or transfer and sell our assets.

In addition, under our 2005 Credit Facility, we are required to meet certain financial ratios and tests. Our ability to comply with these covenants may be affected by factors beyond our control. If we breach any of these covenants or restrictions, it could result in an event of default under our 2005 Credit Facility, which would permit our lenders to declare all amounts incurred thereunder to be immediately due and payable, and our lenders under our 2005 Credit Facility could terminate their commitments to make further extensions of credit under our 2005 Credit Facility.

**Our reorganization valuation is based in part on estimates of future performance. If our estimates are not accurate, the market price of our common stock could be adversely affected.**

Our financial statements reflect the adoption of American Institute of Certified Public Accountants Statement of Position 90-7, or SOP 90-7. In accordance with fresh-start accounting under SOP 90-7, all assets and liabilities were recorded at their respective fair values on the Effective Date of the Plan, August 23, 2004. These fair values represent our best estimates and are based on independent valuations where applicable. To calculate the fair value of our assets, or reorganization value as defined in SOP 90-7, on the effective date of the Plan, financial projections were prepared and the fair value of assets as well as our enterprise value was determined using various valuation methods based on these financial projections. The estimated enterprise value used for portions of this valuation analysis is highly dependent upon our achieving the future financial results set forth in the projections as well as the realization of certain other assumptions, which are not guaranteed. SOP 90-7 requires that the reorganization value be allocated to the assets in conformity with FASB Statement No. 141, *Business Combinations* (SFAS No. 141). Although we allocated our reorganization value among our assets in accordance with SFAS No. 141, our allocations were based on assumptions. Accordingly, these allocations are estimates only. Subsequent changes, if any, will be reflected in our operating results. The valuation, insofar as it relates to the enterprise value, necessarily assumes that we will achieve the estimates of future operating results in all material respects. If these results are not achieved, the resulting values could be materially different from our estimates, and the trading price of our common stock could be adversely affected.

**Our tax treatment of the reorganization may not be accepted by the IRS, which could result in increased tax liabilities.**

Deferred tax assets and liabilities as reflected at August 23, 2004 in connection with the application of fresh-start accounting are based on management's best estimate of the tax filing position that is probable of being accepted by the applicable taxing authorities. The Company intends to take an alternative position on its tax returns. Based on this alternative tax filing position, the Company has taken deductions on its tax returns that could be challenged by the taxing authorities. Although management believes that the Company's tax filing position will more likely than not be sustained in the event of an examination by applicable taxing authorities and we would contest any proposed adjustment vigorously, the outcome of such matters can not be predicted with certainty. As such, the Company has accrued approximately \$3.9 million in other tax liabilities on the accompanying December 31, 2005 consolidated balance sheet for this eventuality.

**Risks Relating to an Investment in Our Common Stock**

**Approximately 1.8 million of our outstanding shares held by Fleming have yet to be distributed pursuant to the Plan.**

Pursuant to the Plan, we issued an aggregate of 9.8 million shares of our common stock to Fleming. As of March 31, 2006, 8.0 million shares of our common stock and warrants to purchase 1.2 million shares of our common stock have been distributed by Fleming pursuant to the Plan. An aggregate of 1.8 million shares of our

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common stock are subject to future distribution pursuant to the Plan by Fleming. Future distributions of the remaining 1.8 million shares of common stock pursuant to the Plan by Fleming are at the discretion of the Post Confirmation Trust (PCT) and the bankruptcy court and are not in our control. In addition, as of March 31, 2006, restricted stock units, restricted stock and options issued pursuant to our stock incentive plans relating to 1.4 million shares of our common stock were outstanding.

The distribution of a significant amount of shares of common stock onto the market or the sale of a substantial number of shares at any given time could result in a decline in the price of our common stock, cause dilution, or increase volatility.

**We have identified eleven material weaknesses in our internal controls over financial reporting. If we fail to remedy these or any other material weaknesses in our internal controls over financial reporting that we may identify, such failure could result in material misstatements in our financial statements, cause investors to lose confidence in our reported financial information and have a negative effect on the trading price of our common stock.**

A material weakness is defined in standards established by the Public Company Accounting Oversight Board as a deficiency in internal control over financial reporting that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. As discussed below in Item 9.A. Controls and Procedures, we have identified eleven material weaknesses in our internal controls over financial reporting consisting of failures to:

- (i) maintain an effective control environment and a failure by management to extend the necessary rigor and commitment to disclosure controls and procedures,
- (ii) maintain effective controls over the financial reporting process due to an insufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the application of generally accepted accounting principles commensurate with the company's financial reporting requirements and the complexity of the company's operations and transactions,
- (iii) maintain effective controls to ensure the adequacy of debt discount and debt issuance costs,
- (iv) maintain effective controls to ensure the appropriate classification and presentation of deferred stock-based compensation within stockholders' equity,
- (v) maintain effective controls to ensure the accurate preparation and review of the cash flow statement,
- (vi) maintain effective controls to ensure the appropriate classification and presentation of accounts and disclosures in the consolidated financial statements,
- (vii) maintain effective controls to ensure there is adequate analysis, documentation, reconciliation, and review of accounting records and supporting data,
- (viii) maintain effective controls to ensure the appropriate valuation of insurance related contracts,
- (ix) maintain effective controls over the recording of journal entries to account for management fee contract amendments,
- (x) maintain effective controls over the accuracy of amounts subject to estimation with respect to other receivables, inventory, deposits and prepayments, other non-current assets, accrued liabilities, cost of sales and operating expenses,

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(xi) maintain effective controls over the accurate preparation, recording, and review of foreign exchange translation adjustments.

In order to address these material weaknesses, on March 23, 2006 our audit committee directed management to formulate an enhancement, with the assistance of an outside consultant, to our remediation plan initially approved by the audit committee following the identification of material weaknesses in connection with finalizing our third quarter 2005 results. However, we have yet to develop such an enhanced remediation plan nor implement it. If we fail to remediate these material weaknesses or any other material weaknesses we may identify, such failure could result in material misstatements in our financial statements.

**We will incur significant costs as a result of being a public company.**

As a public company, we will incur significant accounting, legal, governance, compliance and other expenses that private companies do not incur. In addition, the Sarbanes-Oxley Act of 2002 and the rules subsequently implemented by the Securities and Exchange Commission and the NASDAQ Stock Market, have required changes in corporate governance practices of public companies. We expect these rules and regulations to increase our legal, audit and financial compliance costs and to make some activities more time-consuming and costly. For example, as a result of becoming a public company, we are required to create additional board committees and adopt policies regarding internal controls and disclosure controls and procedures. In addition, we will incur additional costs associated with our public company reporting requirements. We also expect these rules and regulations to make it more difficult and more expensive for us to obtain director and officer liability insurance and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers.

**We may be unable to meet our obligation to conform to the rules adopted by the Securities and Exchange Commission under Section 404 of the Sarbanes-Oxley Act of 2002.**

We are engaged in the process of assessing the effectiveness of our internal control over financial reporting in connection with the rules adopted by the Securities and Exchange Commission under Section 404 of the Sarbanes-Oxley Act of 2002. Compliance with Section 404 of the Sarbanes-Oxley Act of 2002 is required in connection with the filing of our annual Report on Form 10-K of the fiscal year ending December 31, 2006. While our management is expending significant resources in an effort to complete this important project, there can be no assurance that we will be able to achieve our objective on a timely basis. There also can be no assurance that our auditors will be able to issue an unqualified opinion on management's assessment of the effectiveness of our internal control over financial reporting.

Any failure to complete our assessment of our internal control over financial reporting, to remediate the eleven material weaknesses we have identified or any other material weaknesses that we may identify or to implement new or improved controls, or difficulties encountered in their implementation, could harm our operating results, cause us to fail to meet our reporting obligations or result in material misstatements in our financial statements. Any such failure also could adversely affect the results of the periodic management evaluations of our internal control over financial reporting that are required under Section 404 of the Sarbanes-Oxley Act of 2002. Inadequate internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our common stock.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company's market risk disclosures set forth in Item 7A of the Annual Report on Form 10-K, for the year ended December 31, 2005, filed on April 14, 2006 did not change materially during the three months ended March 31, 2006.

**ITEM 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, referenced herein as the Exchange Act. These disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to Company's management, including its chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

The Company carried out, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures performed pursuant to Rule 13a-15 under the Exchange Act. Based on their evaluation, the Company's Chief Executive Officer and its Chief Financial Officer concluded that, as of March 31, 2006, the Company's disclosure controls and procedures were not effective because of the material weaknesses discussed below. Notwithstanding the existence of the material weaknesses described below, management has concluded that the consolidated financial statements in this Form 10-Q fairly present, in all material respects, the Company's financial position, results of operations and cash flows for the periods and dates presented.

**Material Weaknesses in Internal Control Over Financial Reporting**

A material weakness is a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The material weaknesses in our internal control over financial reporting as of March 31, 2006 are as follows:

- 1) *The Company did not maintain an effective control environment and management did not extend the necessary rigor and commitment to disclosure controls and procedures.* Specifically, elements of the Company's finance organization were not structured with sufficient resources to ensure the consistent execution of their responsibility to provide independent and pro-active leadership in the areas of monitoring of controls, disclosure reviews and financial reporting. This material weakness contributed to the material weaknesses discussed in items 2 to 11 below.
- 2) *The Company did not maintain effective controls over the financial reporting process due to an insufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the application of generally accepted accounting principles ( GAAP ) commensurate with its financial reporting requirements and the complexity of the Company's operations and transactions.* Additionally, the Company did not maintain effective controls to ensure there is adequate monitoring and oversight of the work performed by accounting and financial reporting personnel to ensure the accuracy and completeness of the consolidated financial statements in accordance with GAAP. This material weakness contributed to the material weaknesses discussed in items 3 to 11 below.
- 3) *The Company did not maintain effective controls to ensure the accuracy of debt discount and debt issuance costs.* Specifically, the Company did not maintain effective controls to ensure the timely write-off of debt discount and debt issuance costs, in accordance with GAAP. This control deficiency resulted in audit

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adjustments to other non-current assets, long-term debt, interest expense, and the extinguishment of debt expense in the Company's 2005 annual consolidated financial statements and interim unaudited condensed consolidated financial statements for the third quarter of 2005.

- 4) *The Company did not maintain effective controls to ensure the appropriate classification and presentation of deferred stock-based compensation within stockholders' equity.* Specifically, the Company did not maintain effective controls to ensure the accurate presentation of deferred stock-based compensation as a separate component within the stockholders' equity section of the consolidated balance sheet. This control deficiency resulted in an audit adjustment to additional paid-in capital and deferred stock-based compensation accounts in the Company's 2005 annual consolidated financial statements and the interim unaudited condensed consolidated financial statements for the third quarter of 2005.
  
- 5) *The Company did not maintain effective controls to ensure the accurate preparation and review of the cash flow statement.* Specifically, the Company did not maintain effective controls to ensure the impact of foreign currency translation, accrued fixed asset purchases and fixed asset dispositions were appropriately presented in the cash flow statement. This control deficiency resulted in audit adjustments to the cash flows related to purchases and sales of property, plant and equipment, cigarette and tobacco taxes payable, accounts payable, pension liability, accrued and other liabilities and effects of changes in foreign currency exchange in the Company's 2005 annual consolidated financial statements and the interim unaudited condensed consolidated financial statements for the third quarter of 2005.
  
- 6) *The Company did not maintain effective controls to ensure the appropriate classification and presentation of accounts and disclosures in the consolidated financial statements.* Specifically, the Company did not maintain effective controls to ensure the appropriate balance sheet classification and presentation based upon the nature of the account or balance. This control deficiency resulted in audit adjustments to cash, accounts receivable, other receivables, deposits and prepayments, other non-current assets, accounts payable, book overdrafts, cigarette and tobacco taxes payable, and operating expenses in the Company's 2005 annual consolidated financial statements.
  
- 7) *The Company did not maintain effective controls to ensure there is adequate analysis, documentation, reconciliation, and review of accounting records and supporting data.* Specifically, the Company did not maintain effective controls over the completeness and accuracy of the payroll expense and payroll accrual, and did not maintain effective controls to ensure the timely reconciliation of the payroll registers to the general ledger. Additionally, the Company did not maintain effective controls over the preparation, review, and monitoring of the accounts payable clearing account and the inventory pricing variance account to ensure the account balances were accurate and agreed to appropriate supporting calculations and documentation. This control deficiency resulted in a restatement of the Company's 2004 annual consolidated financial statements and the six month period ended June 30, 2005 unaudited condensed consolidated financial statements to correct an error in the inventory pricing variance account, as well as audit adjustments in the Company's 2005 annual consolidated financial statements.
  
- 8) *The Company did not maintain effective controls to ensure the appropriate valuation of insurance related contracts.* Specifically, the Company did not maintain effective controls to appropriately value a security deposit relating to an insurance contract. This control deficiency resulted in audit adjustments to other non-current assets, long-term claims liabilities, accrued liabilities and other income in the Company's 2005 annual consolidated financial statements.
  
- 9) *The Company did not maintain effective controls over the recording of journal entries to account for management fee contract amendments.* Specifically, effective controls were not designed and in place to ensure adequate evidence of an arrangement is provided prior to recording a journal entry for contract amendments.
  
- 10) *The Company did not maintain effective controls over the accuracy of amounts subject to estimation.* Specifically, the Company did not maintain effective controls to ensure timely reconciliation of estimated vendor receivables recorded in the general ledger to actual amounts received. This control deficiency

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resulted in audit adjustments to other receivables, inventory, deposits and prepayments, other non-current assets, accrued liabilities, cost of sales, and operating expenses in the Company's 2005 annual consolidated financial statements.

- 11) *The Company did not maintain effective controls over the accurate preparation, recording, and review of foreign exchange translation adjustments.* Specifically, the Company did not maintain effective controls to address the appropriateness of the assertion that the intercompany balance was permanently invested so as to ensure that the related translation adjustments were accurately prepared and recorded in accordance with GAAP. This control deficiency resulted in a restatement of the Company's 2004 annual consolidated financial statements and the interim condensed consolidated financial statements as of and for the periods ended March 31, 2005, June 30, 2005 and September 30, 2005 as well as an audit adjustment to the foreign exchange gain or loss, currency translation account, and other comprehensive income in the Company's 2005 annual consolidated financial statements.

Additionally, these material weaknesses could result in a misstatement of significant accounts and disclosures, that would result in a material misstatement to the Company's interim or annual consolidated financial statements that would not be prevented or detected.

The material weaknesses described in paragraphs 2,3,4,5 and 7 above were initially identified in connection with preparing the Company's unaudited condensed consolidated financial statements as of and for the three and nine month periods ended September 30, 2005. The material weaknesses described in paragraphs 1,6,8,9,10, 11 above were thereafter identified in connection with preparing the Company's audited consolidated financial statements as of and for the year ended December 31, 2005.

**Remediation of Material Weaknesses**

To address the material weaknesses discussed above, the Audit Committee has directed management, with the assistance of an outside consultant, to formulate an enhancement of the Company's remediation plan initially developed to address deficiencies identified at the time of filing of the Company's Form 10-Q for the third quarter of 2005.

**Changes in Internal Control Over Financial Reporting**

There have been no changes in the Company's internal control over financial reporting during the most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

**Proceedings Under Chapter 11 of the Bankruptcy Code**

On April 1, 2003, Fleming filed for protection under Chapter 11 of the U.S. Bankruptcy Code. The debtor entities comprising Core-Mark were included in the Chapter 11 proceedings. The Plan, pursuant to which the debtors were reorganized around Core-Mark International and Fleming's one remaining convenience store wholesale distribution center, was confirmed on July 26, 2004 and became effective on August 23, 2004. Pursuant to the Plan, two special purpose trusts, the Post Confirmation Trust, or PCT, and the Reclamation Creditors Trust, or RCT, were established. These trusts are charged with administering certain responsibilities under the Plan, including liquidating certain assets, the pursuit and collection of litigation claims and causes of action and the reconciliation and payment of specific types of claims, including trade lien vendor claims, or TLV claims, each as allocated between the PCT and the RCT pursuant to the Plan. Under the terms of the Plan, in the event that the amount of PCT administrative claims exceeds \$56 million, we guarantee the payment of all such claims. In addition, if the assets of the RCT are inadequate to satisfy all of the allowed TLV claims, we must pay such claims in full plus any accrued interest. We also guarantee all eligible but unpaid non-TLV claims up to a maximum of \$15 million. The Plan limits the amounts of the TLV and non-TLV claims to not greater than \$137 million.

**ITEM 1A. RISK FACTORS**

The Company has made the following changes to its Factors that May Affect Future Operating Results since such factors were disclosed in the Company's Form 10-K filed on April 14, 2006:

In light of the engagement of Deloitte & Touche LLP as the Company's independent registered public accounting firm for fiscal 2006 and the timely filing of this Form 10-Q, the Company eliminated the risk factor that was included in its Form 10-K for the fiscal year ending December 31, 2005 relating to engagement of a successor auditor and the impact of an untimely SEC filing.

The Company also determined that the risk that Fleming may not vote undistributed shares was no longer a material concern for the Company.

The Company also revised the risk factor below as follows:

**We face competition in our distribution markets and if we are unable to compete effectively in any distribution market, we may lose market share and suffer a decline in sales.**

Our distribution centers operate in highly competitive markets. We face competition from local, regional and national tobacco and consumable products distributors on the basis of service, price and variety of products offered, schedules and reliability of deliveries, and the range and quality of services provided.

Some of our competitors, including a subsidiary of Berkshire Hathaway Inc., McLane Company, Inc., the largest convenience wholesale distributor in the U.S., have substantial financial resources and long standing customer relationships. In addition, heightened competition among our existing competitors or by new entrants into the distribution market could create additional competitive pressures that may reduce our margins and adversely affect our business. If any of our tobacco manufacturers or any of our other suppliers were to enter into the distribution business, our market share could erode significantly. For example, the largest tobacco manufacturer in Canada, Imperial Tobacco Canada, whose products constitute approximately 40% of our Canadian revenues, recently announced that it plans to begin direct-to-store delivery of its products. If we fail to successfully respond to these or other competitive pressures or to implement our strategies effectively, we may lose market share and our results of operations could suffer.

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**ITEM 6. EXHIBITS**

**Exhibit**

| <b>No.</b> | <b>Description</b>  |
|------------|---|
| 2.1        | Third Amended and Revised Joint Plan of Reorganization of Fleming Companies, Inc. and its Subsidiaries Under Chapter 11 of the Bankruptcy Code, dated May 25, 2004. (incorporated by reference to Exhibit 2.1 of the registrant's Registration Statement on Form 10 filed on September 6, 2005) |
| 3.1        | Certificate of Incorporation of Core-Mark Holding Company, Inc. (incorporated by reference to Exhibit 3.1 of the registrant's Registration Statement on Form 10 filed on September 6, 2005)   |
| 3.2        | Amended and Restated Bylaws of Core-Mark Holding Company, Inc. (incorporated by reference to Exhibit 3.2 of the registrant's Registration Statement on Form 10 filed on September 6, 2005)  |
| 4.1        | Form of Class 6(B) Warrant (incorporated by reference to Exhibit 4.1 of the registrant's Registration Statement on Form 10 filed on September 6, 2005)  |
| 11.1       | Statement of Computation of Earnings Per Share (required information contained within this Form 10-Q)   |
| 31.1       | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2       | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 32.1       | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350   |
| 32.2       | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350   |



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CORE-MARK HOLDING COMPANY, INC.

Date: May 19, 2006

By: /s/ J. MICHAEL WALSH  
Name: **J. Michael Walsh**  
Title: **President and Chief Executive Officer**

CORE-MARK HOLDING COMPANY, INC.

Date: May 19, 2006

By: /s/ JAMES WALL  
Name: **James Wall**  
Title: **Chief Financial Officer**