

FNB CORP/FL/  
Form 10-Q  
August 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

(Mark One)

☒ **Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934  
For the quarterly period ended June 30, 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 001-31940**

**F.N.B. CORPORATION**

(Exact name of registrant as specified in its charter)

**Florida**

**25-1255406**

(State or other jurisdiction of incorporation or  
organization)

(I.R.S. Employer Identification No.)

**One F.N.B. Boulevard, Hermitage, PA**

**16148**

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: **724-981-6000**

(Former name, former address and former fiscal year, if changed since last report)

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 requirements 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.

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 Exchange Act). Yes ☐ No ☒

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at July 31, 2006
Common Stock, \$0.01 Par Value	60,220,896 Shares

**F.N.B. CORPORATION**  
**FORM 10-Q**  
June 30, 2006  
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CONSOLIDATED BALANCE SHEETS**

Dollars in thousands, except par value

	<b>June 30, 2006 (Unaudited)</b>	<b>December 31, 2005</b>
<b>Assets</b>		
Cash and due from banks	\$ 136,748	\$ 131,604
Interest bearing deposits with banks	362	627
Securities available for sale	291,092	279,219
Securities held to maturity (fair value of \$796,504 and \$867,122)	824,443	881,139
Mortgage loans held for sale	5,429	4,740
Loans, net of unearned income of \$25,618 and \$27,595	4,210,525	3,749,047
Allowance for loan losses	(53,041)	(50,707)
<b>Net Loans</b>	4,157,484	3,698,340
Premises and equipment, net	89,264	87,013
Goodwill	240,812	196,354
Bank owned life insurance	131,854	122,666
Other assets	195,251	188,624
<b>Total Assets</b>	\$ 6,072,739	\$ 5,590,326
<b>Liabilities</b>		
Deposits:		
Non-interest bearing demand	\$ 669,838	\$ 688,391
Savings and NOW	1,939,823	1,675,395
Certificates and other time deposits	1,768,887	1,648,157
<b>Total Deposits</b>	4,378,548	4,011,943
Other liabilities	61,384	59,634
Short-term borrowings	384,736	378,978
Junior subordinated debt owed to unconsolidated subsidiary trusts	151,031	128,866
Long-term debt	562,460	533,703
<b>Total Liabilities</b>	5,538,159	5,113,124
<b>Stockholders Equity</b>		
Common stock \$0.01 par value		
Authorized 500,000,000 shares		
Issued 60,236,542 and 57,513,586 shares	599	575
Additional paid-in capital	502,490	454,546
Retained earnings	29,366	24,376
Accumulated other comprehensive income	2,898	3,597
Deferred stock compensation		(4,154)
Treasury stock 45,824 and 94,545 shares at cost	(773)	(1,738)

<b>Total Stockholders' Equity</b>	534,580	477,202
<b>Total Liabilities and Stockholders' Equity</b>	\$ 6,072,739	\$ 5,590,326

See accompanying Notes to Consolidated Financial Statements

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**Table of Contents****F.N.B. CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME**

Dollars in thousands, except per share data

Unaudited

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Interest Income</b>				
Loans, including fees	\$ 69,867	\$ 59,827	\$ 133,887	\$ 115,892
Securities:				
Taxable	12,002	12,705	24,253	24,628
Nontaxable	1,149	1,038	2,261	1,915
Dividends	140	175	312	372
Other	307	4	373	15
<b>Total Interest Income</b>	<b>83,465</b>	<b>73,749</b>	<b>161,086</b>	<b>142,822</b>
<b>Interest Expense</b>				
Deposits	25,465	15,923	46,444	30,235
Short-term borrowings	3,624	3,523	7,221	6,340
Junior subordinated debt owed to unconsolidated subsidiary trusts	2,759	2,004	5,190	3,820
Long-term debt	4,924	4,885	9,719	9,430
<b>Total Interest Expense</b>	<b>36,772</b>	<b>26,335</b>	<b>68,574</b>	<b>49,825</b>
<b>Net Interest Income</b>	<b>46,693</b>	<b>47,414</b>	<b>92,512</b>	<b>92,997</b>
Provision for loan losses	2,497	2,686	5,455	5,017
<b>Net Interest Income After Provision for Loan Losses</b>	<b>44,196</b>	<b>44,728</b>	<b>87,057</b>	<b>87,980</b>
<b>Non-Interest Income</b>				
Service charges	10,634	9,960	20,804	19,014
Insurance commissions and fees	3,239	3,127	7,339	6,896
Securities commissions and fees	1,308	1,095	2,255	2,499
Trust	1,859	1,756	3,703	3,661
Gain on sale of securities	340	564	887	1,171
Gain on sale of mortgage loans	400	295	698	609
Bank owned life insurance	823	864	1,600	1,727
Other	2,181	1,133	3,607	1,960
<b>Total Non-Interest Income</b>	<b>20,784</b>	<b>18,794</b>	<b>40,893</b>	<b>37,537</b>
<b>Non-Interest Expense</b>				
Salaries and employee benefits	21,141	19,735	42,459	40,918
Net occupancy	3,474	3,167	6,840	6,302
Equipment	3,281	3,209	6,593	6,591
Amortization of intangibles	1,029	951	1,960	1,811

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Other	12,244	11,157	23,568	22,935
<b>Total Non-Interest Expense</b>	<b>41,169</b>	<b>38,219</b>	<b>81,420</b>	<b>78,557</b>
<b>Income Before Income Taxes</b>	<b>23,811</b>	<b>25,303</b>	<b>46,530</b>	<b>46,960</b>
Income taxes	7,176	7,762	14,093	14,509
<b>Net Income</b>	<b>\$ 16,635</b>	<b>\$ 17,541</b>	<b>\$ 32,437</b>	<b>\$ 32,451</b>
<b>Net Income per Common Share</b>				
Basic	\$ .29	\$ .31	\$ .56	\$ .59
Diluted	\$ .28	\$ .31	\$ .56	\$ .59
<b>Cash Dividends per Common Share</b>	<b>\$ .235</b>	<b>\$ .23</b>	<b>\$ .47</b>	<b>\$ .46</b>

See accompanying Notes to Consolidated Financial Statements

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**Table of Contents****F.N.B. CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

Dollars in thousands

Unaudited

	Compre- hensive Income	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumu- lated Other Compre- hensive Income	Deferred Stock Compen- sation	Treasury Stock	Total
<b>Balance at January 1, 2006</b>		\$ 575	\$ 454,546	\$ 24,376	\$ 3,597	\$ (4,154)	\$ (1,738)	\$ 477,202
Net income	\$ 32,437			32,437				32,437
Change in other comprehensive income (loss)	(699)				(699)			(699)
Comprehensive income	\$ 31,738							
Cash dividends declared:								
Common stock \$0.47/share				(27,022)				(27,022)
Purchase of common stock							(3,188)	(3,188)
Issuance of common stock		27	51,257	(425)			4,153	55,012
Restricted stock compensation			566					566
Tax benefit of stock-based compensation			272					272
Reclassification arising from the adoption of FAS 123R		(3)	(4,151)			4,154		
<b>Balance at June 30, 2006</b>		\$ 599	\$ 502,490	\$ 29,366	\$ 2,898		\$ (773)	\$ 534,580
<b>Balance at January 1, 2005</b>		\$ 502	\$ 300,555	\$ 22,847	\$ 4,965	\$ (1,428)	\$ (3,339)	\$ 324,102
Net income	\$ 32,451			32,451				32,451
Change in other comprehensive	(4,436)				(4,436)			(4,436)



income (loss)

Comprehensive  
income

\$ 28,015

Cash dividends  
declared:

Common stock  
\$0.46/share

(25,883)

(25,883)

Purchase of  
common stock

(6,453)

(6,453)

Issuance of  
common stock

62

133,487

(845)

8,455

141,159

Change in  
stock-based  
compensation

(1,121)

(1,121)

**Balance at**

**June 30, 2005**

\$ 564

\$ 434,042

\$ 28,570

\$ 529

\$ (2,549)

\$ (1,337)

\$ 459,819

See accompanying Notes to Consolidated Financial Statements

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**Table of Contents****F.N.B. CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

Dollars in thousands

Unaudited

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Operating Activities</b>		
Net income	\$ 32,437	\$ 32,451
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation, amortization and accretion	7,505	7,164
Provision for loan losses	5,455	5,017
Deferred taxes	720	1,568
Gain on sale of securities	(887)	(1,171)
Gain on sale of loans	(698)	(609)
Proceeds from sale of loans	46,110	41,625
Loans originated for sale	(46,101)	(40,917)
Net change in:		
Interest receivable	(978)	1,065
Interest payable	272	(7,739)
Other, net	12,297	(22,369)
Net cash flows provided by operating activities	56,132	16,085
<b>Investing Activities</b>		
Net change in:		
Interest bearing deposits with banks	265	1,432
Loans	(170,340)	(57,665)
Bank owned life insurance	(1,219)	
Securities available for sale:		
Purchases	(3,551)	(128,957)
Sales	23,950	87,681
Maturities	3,618	60,811
Securities held to maturity:		
Purchases		(79,217)
Maturities	56,038	56,664
Increase in premises and equipment	(1,981)	(2,962)
Net cash (paid) received for mergers and acquisitions	(16,935)	8,799
Net cash flows used in investing activities	(110,155)	(53,414)
<b>Financing Activities</b>		
Net change in:		
Non-interest bearing deposits, savings and NOW accounts	118,497	(74,877)
Time deposits	(8,330)	57,701
Short-term borrowings	(34,259)	72,735

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Proceeds from the issuance of junior subordinated debt owed to unconsolidated subsidiary trusts	22,165	
Increase in long-term debt	17,957	41,954
Decrease in long-term debt	(27,122)	(16,509)
Purchase of common stock	(3,188)	(6,453)
Issuance of common stock	197	11,512
Tax benefit of stock-based compensation	272	
Cash dividends paid	(27,022)	(25,883)
Net cash flows provided by financing activities	59,167	60,180
<b>Net Increase in Cash and Due from Banks</b>	5,144	22,851
Cash and due from banks at beginning of period	131,604	100,839
<b>Cash and Due from Banks at End of Period</b>	\$ 136,748	\$ 123,690

See accompanying Notes to Consolidated Financial Statements

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**F.N.B. CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

June 30, 2006

**BUSINESS**

F.N.B. Corporation (the Corporation) is a diversified financial services company headquartered in Hermitage, Pennsylvania. Its primary businesses include commercial and retail banking, consumer finance, asset management and insurance. The Corporation operates its retail and commercial banking business through a full service branch network in Pennsylvania and Ohio and loan production offices in Florida, and conducts selected consumer finance business in Pennsylvania, Ohio and Tennessee.

**BASIS OF PRESENTATION**

The accompanying consolidated financial statements include the accounts of the Corporation and its subsidiaries. The Corporation owns and operates First National Bank of Pennsylvania (FNBPA), First National Trust Company, First National Investment Services Company, LLC, F.N.B. Investment Advisors, Inc., First National Insurance Agency, LLC (FNIA), Regency Finance Company and F.N.B. Capital Corporation, LLC.

The accompanying consolidated financial statements include all adjustments, consisting only of normal recurring accruals that are necessary, in the opinion of management, to fairly reflect the Corporation's financial position and results of operations. All significant intercompany balances and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

The Corporation's consolidated financial statements include subsidiaries in which the Corporation has a controlling financial interest. Investments in companies in which the Corporation controls operating and financing decisions (principally defined as owning a voting or economic interest greater than 50%) are consolidated. Variable interest entities are consolidated if the Corporation is exposed to the majority of the variable interest entity's expected losses and/or residual returns (i.e., the Corporation is considered to be the primary beneficiary).

**USE OF ESTIMATES**

The accounting and reporting policies of the Corporation conform with U.S. generally accepted accounting principles (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could materially differ from those estimates.

**MERGERS AND ACQUISITIONS**

On May 26, 2006, the Corporation completed its acquisition of The Legacy Bank (Legacy), a commercial bank and trust company headquartered in Harrisburg, Pennsylvania, with \$375.1 million in assets, including \$300.3 million in loans, and \$256.5 million in deposits. Consideration paid by the Corporation totaled \$72.4 million comprised primarily of 2,682,053 shares of the Corporation's common stock and \$21.1 million in exchange for 3,831,505 shares of Legacy common stock. At the time of the acquisition, Legacy was merged into FNBPA. The Corporation recorded \$45.0 million in goodwill and \$4.9 million in core deposit intangible as a result of the acquisition. As of June 30, 2006, the purchase price is still subject to final adjustment because certain components of the purchase price were based on preliminary valuation studies and estimates.

On November 1, 2005, the Corporation's existing insurance agency, FNIA, acquired the assets of Penn Group Insurance, Inc. (Penn Group), an established life and employee benefits agency located in Pittsburgh, Pennsylvania.

On October 7, 2005, the Corporation completed its acquisition of North East Bancorp, Inc. (North East) (Pink Sheets: NEBI), a bank holding company headquartered in North East, Pennsylvania, with \$68.0 million in assets, including \$49.4 million in loans, and \$61.2 million in deposits. Consideration paid by the Corporation totaled \$15.4 million comprised of 862,611 shares of the Corporation's common stock and \$169,800 in exchange for 145,168 shares

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of North East common stock. North East's banking subsidiary, The National Bank of North East, was merged into FNBPA.

On February 18, 2005, the Corporation completed its acquisition of NSD Bancorp, Inc. (NSD) (Nasdaq: NSDB), a bank holding company headquartered in Pittsburgh, Pennsylvania, with \$503.0 million in assets, including \$308.9 million in loans, and \$378.8 million in deposits. The acquisition was a stock transaction valued at approximately \$127.5 million. The Corporation issued 5,944,343 shares of its common stock in exchange for 3,302,485 shares of NSD common stock. NSD's banking subsidiary, NorthSide Ban= "left"> 200,000 shares reserved for future issuance under the selling agent's warrant.

	<b>June 30, 2004</b>	<b>As adjusted</b>
	<b>(unaudited)</b>	
Current liabilities:		
Current portion of long-term debt	\$ 383,000	
Lines of credit	1,015,327	
Other liabilities	1,986,426	
	<u>3,384,753</u>	
Total current liabilities	3,384,753	
	<u>3,384,753</u>	
Long-term liabilities		
Long-term debt	937,466	
Notes payable to related parties	259,894	
	<u>1,197,360</u>	
Total long-term liabilities	1,197,360	
	<u>1,197,360</u>	
Proceeds received prior to the issuance of preferred stock	310,900	
	<u>310,900</u>	
Stockholders' equity:		
Common stock - par value \$.0001 per share:		
Authorized - 50,000,000 shares		
Issued and outstanding - 4,726,091 shares	472	
Additional paid-in capital	2,429,824	
Accumulated deficit	(1,708,823)	
	<u>721,473</u>	
Total stockholders' equity	721,473	
	<u>721,473</u>	
Total capitalization	\$ 5,614,486	
	<u>\$ 5,614,486</u>	

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Our net tangible book value at June 30, 2004 was \$(149,829), or \$(0.03) per share. Our net tangible book value per share is determined by subtracting the total amount of our liabilities from the total amount of our tangible assets and dividing the remainder by the weighted average number of shares of our common stock outstanding.

The as adjusted net tangible book value after this offering will be \$6,615,171, after deducting estimated expenses of this offering, or \$0.98 per share, if all the shares in this offering are sold at an assumed offering price of \$4.00 per share. Therefore, purchasers of shares of common stock in this offering will realize a minimum dilution of \$3.02 per share, or about 75% of their investment. If fewer than all shares offered hereby are sold, the dilution will be greater. The following table illustrates this dilution, assuming all 2,000,000 shares in this offering are sold:

Offering price per share of common stock	\$4.00
Net tangible book value per common share at June 30, 2004	(0.03)
Increase per common share attributable to new investors	1.01
	<hr/>
Net tangible book value per share of common stock after the offering	.98
	<hr/>
Dilution per share of common stock to new investors	\$3.02
	<hr/>

If only 1,000,000 shares of common stock (50%) are sold in this offering, the as adjusted book value per share after the offering will be \$0.55, and purchasers in this offering will realize an immediate dilution of \$3.45 per share (approximately 86% of their investment). If only 200,000 shares of common stock (10%) are sold in this offering, the as adjusted book value per share after the offering will be \$0.07, and purchasers in this offering will realize an immediate dilution of \$3.93 per share (approximately 98% of their investment).

During the five years prior to the date of the prospectus, the Company sold shares of common stock for prices ranging from \$1.00 to \$4.00 per share.

Additional dilution, not reflected in the foregoing table, will result to the extent that outstanding options and warrants to purchase our common stock are exercised, or convertible debt or our Series A convertible preferred stock is converted into shares of our common stock. As of June 30, 2004, we had outstanding options and warrants to purchase an aggregate of 921,376 shares of common stock at a weighted average exercise price of \$2.04 per share.

As of June 30, 2004, we had outstanding an aggregate \$238,022 of convertible debt, including accrued and unpaid interest, to purchase an aggregate of 118,261 shares of common stock at a weighted average exercise price of \$2.13 per share. In October 2004, \$255,000 of debt was converted into 25,500 shares of Series A convertible preferred stock. In October 2004, we also issued 33,790 shares of Series A convertible preferred stock to investors who purchased such shares for \$10.00 per share. Each share of our Series A convertible preferred stock can be converted into four shares of common stock, meaning that the aggregate of 59,290 shares of Series A convertible preferred stock currently outstanding can be converted into an aggregate of 237,160 shares of common stock, at a weighted average price of \$2.50 per share. Those issuances are not shown above, because their effect is to increase the tangible book value per share and, therefore, are not dilutive to purchasers of shares of common stock in this offering. However, if the holders of Series A convertible preferred stock convert such stock to common stock, such conversion would have a dilutive effect at such time.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS**

You should read the following discussion and analysis in conjunction with our consolidated financial statement and related notes included elsewhere in this prospectus. Except for historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. See **Forward Looking Statements**, beginning at page 8 of this prospectus.

**Overview**

We develop, manufacture, market and sell alternative or New Age beverages and assorted foods. We currently manufacture, market and sell six unique product lines:

Reed's Ginger Brews

Virgil's Root Beer

China Cola

Reed's Ginger Juice Brews

Reed's Ginger Candies

Reed's Ginger Ice Creams

We currently distribute and sell our products through a network of natural, gourmet and independent distributors, as well as through our growing in-house direct sales and distribution team, throughout the United States and, to a lesser extent, in Canada. In 2003, we implemented direct sales to several large national retail accounts. These accounted for approximately 3% of our sales in 2003 and approximately 8% of our sales in the first six months of 2004. In addition, in 2003 we created our own distribution system in southern California. This accounted for approximately 2% of our sales in 2003 and approximately 4% of our sales in the first half of 2004.

New products, or SKUs, that we launched in 2003 include a 5-liter party keg version of our Virgil's Root Beer and Virgil's Cream Soda in 12-ounce long neck bottles. Both of these high-margin items continue to contribute to growth of our sales for 2003 and 2004.

In 2003, we expanded our marketing from our historical focus on natural and gourmet foods to include more mainstream markets. These efforts include selling our products directly to accounts, primarily Costco, BJ Wholesale and Cost Plus World Markets. In addition, through our current North American natural and gourmet distributors, we have focused sales to the natural food section of mainstream supermarket chains. This has resulted in our products now being sold in Safeway, Kroger's and numerous other national supermarket chains. Our local distribution in southern California is placing our products directly into accounts locally, including Ralph's, Bristol Farms and many independent accounts.

We gauge the financial success of our company by a number of different parameters. Because our industry typically values companies on a top-line basis, one of our main company goals is to increase net sales. We continue to increase net sales each year. Net sales have increased from \$6.2 million in 2001 to \$6.4 million in 2002 to \$6.8 million in 2003 and are on track for further year-over-year growth in 2004. We believe that the increase in net sales comes from three sources: successes in our new local distribution, increases in our core business and our new direct sales to large retailers.

Almost as important as increasing our net sales is increasing our gross margins. We continue to work to reduce costs related to production of our products. In 2002, we purchased and outfitted a West Coast production facility, the Brewery, in part to help reduce both production costs and freight costs associated with our West Coast sales. Gross profits declined after the construction of the Brewery. Gross margins decreased from 24.8% in 2002 to 19.5% in 2003, and remained at 19.4% for the first six months of 2004. We believe that the inefficiencies commensurate with a start-up period for the Brewery have been a principal cause of the decline of our gross margins since the Brewery's acquisition. We expect gross margins to begin increasing in





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the second half of 2004, as the Brewery attains greater functionality and efficiencies. As the Brewery continues to become more fully operational, we believe that we will see greater margin improvements due to freight and production savings.

In addition, through the Brewery, we have increased our capability to offer specialty beverage packaging options not typically available in the marketplace, such as our new 5-liter party keg line and our new 750 ml. champagne bottle line. We also intend to continue to work at keeping the growth of general and administrative and selling expenses lower, in order to improve our profitability.

As oil prices continue to rise, our freight rates, which run at approximately 8% of net sales, have been increasing. We currently see freight rates increasing by an additional 5%-to-10% in the near term. On the other hand, we expect that the Brewery will counter this trend, at least in part, by reducing our need for cross-country freight services.

Consumers have been demanding lower carbohydrate products. This trend does not seem to have affected our sales growth in 2004. We are watching this trend closely and have started developing low-carbohydrate versions of some of our beverages.

The trend towards continued consolidation of the beverage distribution industry through mergers and acquisitions has inspired us to start our own direct distribution locally in southern California and nationally to key large retailers. Consolidation among natural foods industry distributors has not had an affect on our sales. However, this consolidation may limit the distributor options outside natural foods to service mass-market food accounts.

## **Critical Accounting Policies**

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. GAAP requires the Company to make estimates and assumptions that affect the reported amounts in our consolidated financial statements including various allowances and reserves for accounts receivable and inventories, the estimated lives of long-lived assets and trademarks and trademark licenses, as well as claims and contingencies arising out of litigation or other transactions that occur in the normal course of business. The following summarize the most significant accounting and reporting policies and practices of the Company:

*Trademark License and Trademarks.* Trademark license and trademarks primarily represent the costs paid by the Company for exclusive ownership of the Reed s® trademark in connection with the manufacture, sale and distribution of beverages and water and non-beverage products. The Company also owns the Virgil s® trademark and the China Cola® trademark. In addition, the Company owns a number of other trademarks in the United States as well as in a number of countries around the world. During 2002, the Company adopted SFAS No. 142, Goodwill and Other Intangible Assets. Under the provisions on SFAS No. 142, the Company discontinued amortization on indefinite-lived trademark licenses and trademarks while continuing to amortize remaining trademark licenses and trademarks over one to 25 years.

In accordance with SFAS No. 142, we evaluate our non-amortizing trademark license and trademarks annually for impairment. We measure impairment by the amount that the carrying value exceeds the estimated fair value of the trademark license and trademarks. The fair value is calculated by reviewing net sales of the various beverages and applying industry multiples. Based on our annual impairment analysis performed in the fourth quarter of 2003 and our analysis of the trademark license and trademarks for the quarter ended June 30, 2004, the estimated fair values of trademark license and trademarks exceeded the carrying value.

*Long-Lived Assets.* Management regularly reviews property, equipment and other long-lived assets, including identifiable amortizing intangibles, for possible impairment. This review occurs annually, or more frequently if events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. If there is indication of impairment of property and equipment or amortizable intangible assets, then management prepares an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows are less than the

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carrying amount of the asset, an impairment loss is recognized to write down the asset to its estimated fair value. The fair value is estimated at the present value of the future cash flows discounted at a rate commensurate with management's estimates of the business risks. Annually, or earlier, if there is indication of impairment of identified intangible assets not subject to amortization, management compares the estimated fair value with the carrying amount of the asset. An impairment loss is recognized to write down the intangible asset to its fair value if it is less than the carrying amount. Preparation of estimated expected future cash flows is inherently subjective and is based on management's best estimate of assumptions concerning expected future conditions. No impairments were identified as of June 30, 2004.

Management believes that the accounting estimate related to impairment of its long lived assets, including its trademark license and trademarks, is a critical accounting estimate because: (1) it is highly susceptible to change from period to period because it requires management to estimate fair value, which is based on assumptions about cash flows and discount rates; and (2) the impact that recognizing an impairment would have on the assets reported on our consolidated balance sheet, as well as net income, could be material. Management's assumptions about cash flows and discount rates require significant judgment because actual revenues and expenses have fluctuated in the past and are expected to continue to do so.

In estimating future revenues, we use internal budgets. Internal budgets are developed based on recent revenue data for existing product lines and planned timing of future introductions of new products and their impact on our future cash flows.

*Advertising and Promotional Allowances.* The Company accounts for advertising production costs by expensing such production costs the first time the related advertising is run. In addition, the Company supports its customers, including distributors, with promotional allowances, a portion of which is utilized for marketing and indirect advertising by them. In certain instances, a portion of the promotional allowances payable to customers based on the levels of sales to such customers, the Company estimates promotion requirements or expected use of the allowances. If the level of sales, promotion requirements or use of the allowances are different from such estimates, the promotional allowances could, to the extent based on estimates, require adjustments.

*Accounts Receivable.* The Company evaluates the collectibility of its trade accounts receivable based on a number of factors. In circumstances where the Company becomes aware of a specific customer's inability to meet its financial obligations to the Company, a specific reserve for bad debts is estimated and recorded which reduces the recognized receivable to the estimated amount the Company believes will ultimately be collected. In addition to specific customer identification of potential bad debts, bad debt charges are recorded based on the Company's historical losses and an overall assessment of past due trade accounts receivable outstanding.

*Inventories.* Inventories are stated at the lower of cost to purchase and/or manufacture the inventory or the current estimated market value of the inventory. The Company regularly reviews its inventory quantities on hand and records a provision for excess and obsolete inventory based primarily on the Company's estimated forecast of product demand and/or its ability to sell the product(s) concerned and production requirements. Demand for the Company's products can fluctuate significantly. Factors that could affect demand for the Company's products include unanticipated changes in consumer preferences, general market conditions or other factors, which may result in cancellations of advance orders or a reduction in the rate of reorders placed by customers. Additionally, management's estimates of future product demand may be inaccurate, which could result in an understated or overstated provision required for excess and obsolete inventory.

*Income Taxes.* Current income tax expense is the amount of income taxes expected to be payable for the current year. A deferred income tax asset or liability is established for the expected future consequences of temporary differences in the financial reporting and tax bases of assets and liabilities. The Company considers future taxable income and ongoing, prudent and feasible tax planning strategies, in assessing the value of its deferred tax assets. If the Company determines that it is more likely than not that these assets will not be realized, the Company will reduce the value of these assets to their expected realizable value, thereby decreasing net income. Evaluating the value of these assets is necessarily based on the Company's judgment. If the Company subsequently determined that the deferred tax assets, which had been written down, would be

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realized in the future, the value of the deferred tax assets would be increased, thereby increasing net income in the period when that determination was made.

### **Recent Accounting Pronouncements**

In January 2003, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 46, Consolidation of Variable Interest Entities , an interpretation of Accounting Research Bulletin ( ARB ) No. 51 Consolidated Financial Statement . In December 2003, the FASB issued a revised version of FIN 46 (FIN 46R) that replaced the original FIN 46.

Interpretation No. 46R addresses consolidation by business enterprises of variable interest entities, which have one or both of the following characteristics: (i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated support from other parties, which is provided through other interest that will absorb some or all of the expected losses of the entity; (ii) the equity investors lack one or more of the following essential characteristics of a controlling financial interest, the direct or indirect ability to make decisions about the entities activities through voting rights or similar rights; or the obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities; the right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected loss.

Interpretation No. 46R, also requires expanded disclosures by the primary beneficiary (as defined) of a variable interest entity and by an enterprise that holds a significant variable interest in a variable interest entity but is not the primary beneficiary. Interpretation No. 46 as revised, applies to small business issues no later than the end of the first reporting period that ends after December 15, 2004.

This effective date includes those entities to which Interpretation No. 46R had previously been applied. However, prior to the required application of Interpretation No. 46R, a public entity that is a small business issuer shall apply Interpretation No. 46R or this Interpretation to those entities that are considered to be special-purpose entities no later than as of the end of the first reporting period that ends after December 15, 2003.

Interpretation No. 46R may be applied prospectively with a cumulative-effect adjustment as of the date on which it is first applied or by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

In June 2003, the FASB issued an Exposure Draft for a proposed statement of financial accounting standards ( SFAS ) entitled Qualifying Special Purpose Entities ( QSPE ) and Isolation of Transferred Assets , an amendment of SFAS No. 140 ( The Exposure Draft ). The Exposure Draft is a proposal that is subject to change and as such is not yet authoritative. If the proposal is enacted in its current form, it will amend and clarify SFAS 140. The Exposure Draft would prohibit an entity from being a QSPE if it enters into an agreement that obligated a transferor of financial assets, its affiliates or its agents to deliver additional cash or other assets to fulfill the special-purposes entity's obligation to beneficial interest holders.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities . SFAS No. 149 amends and clarifies financial accounting reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities . The changes in SFAS No. 149 improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. This statement is effective for contracts entered into or modified after June 30, 2003 and all of its provisions should be applied prospectively.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . SFAS No. 150 changes the accounting for certain financial instruments with characteristics of both liabilities and equity that, under previous pronouncements, issuers could account for as equity. The new accounting guidance contained in SFAS No. 150 requires that those instruments be classified as liabilities in the balance sheet.

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SFAS No. 150 affects the issuer's accounting for three types of freestanding financial instruments. One type is mandatorily redeemable shares, which the issuing company is obligated to buy back in exchange for cash and other assets. A second type includes put options and forward purchase contracts, which involves instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets. The third type of instruments that are liabilities under this Statement is obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuer's shares.

SFAS No. 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. Most of the provisions of SFAS No. 150 are consistent with the existing definition of liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements. The remaining provisions of this SFAS are consistent with the FASB's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own shares. This SFAS shall be effective for financial instruments entered into or modified after May 31, 2003 and otherwise shall be effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatory redeemable financial instruments of a non-public entity, as to which the effective date is for fiscal periods beginning after December 15, 2003.

The Company does not believe that the adoption of the above recent pronouncements will have a material effect on the Company's consolidated financial position or results of operations.

## **Results of Operations**

### ***Six Months Ended June 30, 2004 Compared to Six Months Ended June 30, 2003***

Net sales increased by \$1,232,918, or 37.8%, from \$3,262,426 in the first six months of 2003 to \$4,495,344 in the first six months of 2004. This increase was primarily a result of sales growth of existing products (21.2%) and the introduction of new products (16.6%).

As a percentage of net sales, gross profit decreased from 22.4% in the first six months of 2003 to 19.4% in the first six months of 2004. This decrease was primarily the result of inefficiencies with the start-up of the Brewery, increased freight costs related to fuel costs increases and the colder winter caused by the need to have more freight shipped by more expensive, and temperature controlled trucks to avoid freezing product.

Selling expenses increased by \$44,995, or 15.4%, from \$291,283, in the first six months of 2003, to \$336,278 in the first six months of 2004, and decreased as a percentage of net sales from 8.9% in the first six months of 2003, to 7.5% in the first six months of 2004. The increase in selling expenses was primarily attributable to the increase in the sales force (7.1%) and increased advertising and promotional expenses (8.8%).

General and administrative expenses increased by \$74,267, or 19.3%, from \$385,056 in the first six months of 2003 to \$459,323 in the first six months of 2004, and decreased as a percentage of net sales from 11.8% in the first six months of 2003 to 10.2% in the first six months of 2004. The increase is primarily attributable to increased payroll expenses due to increases in staff to handle the growth in our operations.

Interest expense decreased from \$128,152 in the first six months of 2003, to \$114,013 in the first six months of 2004. This decrease is primarily attributable to the fact that the Company had lower interest expenses in the first six months of 2004 due to refinancing its receivable line of credit at lower interest rates with a new lender, Bay Business Credit. In addition, in 2003, the Company expensed \$426,546 for a public offering of its common stock, which offering was withdrawn.

### ***Twelve Months Ended December 31, 2003 Compared to Twelve Months Ended December 31, 2002***

Net sales increased by \$353,034, or 5.5%, from \$6,428,742 in 2002 to \$6,781,776 in 2003. The net sales increase was primarily the result of sales growth of existing products in existing accounts (1.4%), and the new products (4.1%).

As a percentage of net sales, gross profit decreased from 24.8% in 2002 to 19.5% in 2003. This decrease was due to increased depreciation from bringing our West Coast facility online (0.5%), freight costs increase

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for raw materials (1.1%) and the labor and material losses due to the start-up of our West Coast facility (3.7%).

Selling expenses increased by \$79,296, or 13.7% from \$578,964 in 2002 to \$658,260 in 2003 and increased as a percentage of net sales from 9.0% in 2002 to 9.7% in 2003. The increase in selling expenses was primarily due to an increased use of outside food brokers (6.4%) and the increased size of the direct hired sales force (7.3%)

General and administrative expenses increased by \$395, from \$757,863 in 2002 to \$758,258 in 2003 and decreased as a percentage of net sales from 11.8% in 2002 to 11.2% in 2003. Accounting expenses decreased 82% from 2002 to 2003. This is primarily due to the fact that the Company incurred significant accounting expenses in 2002 in connection with the preparation of a registration statement for a public offering of common stock, which was filed in 2002; that registration statement was later withdrawn. In 2003, utilities increased 268% and insurance increased 47% due to the opening of our West Coast facility.

Interest expense was \$250,738 in 2003, compared to interest expense of \$309,594 in 2002. The Company had lower interest expenses in 2003 due to refinancing its receivable line of credit at lower interest rates with a new lender, Bay Business Credit. In 2003, the Company expensed a withdrawn public offering of its common stock, in the amount of \$426,682.

### ***Twelve Months Ended December 31, 2002 Compared to Twelve Months Ended December 31, 2001***

Net sales increased by \$240,521, or 3.9%, to \$6,428,742 in 2002 from \$6,188,221 in 2001. The net sales increase was primarily a result of sales growth of existing products in existing accounts (1.6%) and the new organic ginger juice line (2.3%).

As a percentage of net sales, gross profit increased to 24.8% in 2002 from 20.6% in 2001. This increase was primarily the result of cost cutting in packaging and raw materials.

Selling expenses decreased by \$79,025 or 12.0% to \$578,964 in 2002 from \$657,989 in 2001 and decreased as a percentage of net sales to 9.0% in 2002 from 10.6% in 2001. The decrease in selling expenses was due to a reduced sales staff (3.4%), a reduction in advertising and promotion expenses (4.1%), a reduced reliance on outside food brokers (2.6%) and the ending of the royalty payments with respect to the purchase of China Cola (1.9%).

General and administrative expenses decreased by \$179,666, or 19.2%, to \$757,863 in 2002 from \$937,529 in 2001 and decreased as a percentage of net sales to 11.8% in 2002 from 15.1% in 2001. This decrease was primarily attributable to a reduction of staff and general cost cutting measures in 2002.

Interest expense was \$309,594 in 2002, compared to interest expense of \$204,457 in 2001. In 2002, the Company had higher interest expense due to the new line of credit from its former lender, Alco Financial.

## **Liquidity and Capital Resources**

Historically, we have financed our operations primarily through private sales of common stock and convertible debt, a line of credit from a financial institution and cash generated from operations.

As of June 30, 2004, we had a working capital deficit of \$355,246, compared to a working capital deficit of \$589,659 as of December 31, 2003. This decrease in our working capital deficit was primarily attributable to increased cash, accounts receivable and inventory, as a result of increases in sales and cash flows from operations. These factors more than offset increases in accounts payable. In addition, working capital increased due to borrowings from our line of credit.

As of June 30, 2004, cash was \$173,075, compared to \$12,930 as of December 31, 2003. Net cash used in operating activities was approximately \$247,427 for the six months ended June 30, 2004, primarily due to an increase in the receivables and inventory, offset by an increase in accounts payable. We used \$57,214 in investing activities for the six months ended June 30, 2004, primarily for the purchase of equipment for our West Coast Brewery. Cash flow from financing activities was \$464,786 for the six months ended June 30, 2004

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as a result of increased borrowing from our line of credit and the collection of \$310,900 of net proceeds in connection with our offering of preferred stock in 2004.

Our trade accounts receivable, net, was \$1,329,729 at June 30, 2004, an increase of \$763,672 (134.9%) over our accounts receivable, net, of \$566,057 at December 31, 2003. The increase in accounts receivable was due primarily to an increase in sales and not to any change in our credit policy.

Of the aggregate principal amount of \$420,000 that the Company borrowed from various investors in 2001 and which loans have an extended maturity date in October 2004, \$116,000 was repaid by the Company on or before June 30, 2004, \$224,000 (\$255,000 including interest) was converted into shares of Series A preferred stock in October 2004 and \$80,000 remains outstanding. The Company has been in recent contact with these debt holders regarding these amounts and believes that the debt holders will cooperate with the Company in agreeing to a further extended maturity date.

We do not have any current material commitments for capital expenditures.

On June 25, 2004, we renewed our credit facility with Bay Business Credit. The credit facility consists of a one-year revolving line of credit of up to \$1,100,000, which expires on June 25, 2005. The amount available for borrowing from time to time under the revolving line of credit is dependent upon the levels of certain eligible accounts receivable and inventory. As of June 30, 2004, we had an outstanding balance of \$931,989 under the line of credit, based on eligible accounts receivable and inventory at that time. Borrowings under the credit facility bear interest at the prime rate plus 9% per annum (13.0% as of June 30, 2004).

This revolving line of credit is secured by all of our assets, including accounts receivable, inventory, trademarks and other intellectual property, and equipment. The credit facility does not impose any financial covenants on us.

On December 11, 2000, we borrowed \$748,000 from the U.S. Bank National Association, guaranteed by the U.S. Small Business Administration, which we used to finance the purchase of the Brewery. At the same time, we borrowed \$168,000 from U.S. Bank National Association, guaranteed by the U.S. Small Business Administration, which we used to make improvements at the Brewery. The interest for these loans is prime plus 1% (5.0% as of June 30, 2004), and the loans mature in 25 years. Our founder and CEO, Christopher J. Reed, has personally guaranteed these loans. Payments under the loans are current.

In the second quarter of 2004, we began a private placement of Series A convertible preferred stock. We raised \$337,900 (\$310,900, net of offering expenses), from the sale of 33,790 shares of Series A convertible preferred stock and a number of our debt holders converted an aggregate of approximately \$255,000 of debt to 25,500 shares of Series A preferred stock. As of June 30, 2004, the necessary filings to create the Series A preferred stock under Delaware law had not yet been completed. Therefore, these amounts are shown as debt on our balance sheet at such date but will be reclassified when the Series A preferred stock is actually issued.

On September 24, 2004, we obtained a line of credit in the amount of approximately \$280,000 with Merrill Lynch. The loan was co-signed by Robert T. Reed, Jr., our Vice President and National Sales Manager Mainstream and a brother of our founder and CEO, Christopher J. Reed. Robert Reed also pledged his stock account at Merrill Lynch as collateral. The line of credit bears interest at a rate of rate of 3.785% plus LIBOR (5.815% as of October 28, 2004). In consideration for Mr. Reed's pledging his stock account at Merrill Lynch as collateral, the Company pays Mr. Reed 5% per annum of the amount the Company borrows from Merrill Lynch. See Certain Relationships and Related Transactions .

On September 28, 2004, we obtained a loan for \$150,000 from Bay Business Credit secured by certain plant equipment. This loan bears interest at prime plus 10% (14.75% as of October 28, 2004) and matures in October 2007.

During the next six months, we expect to reduce our raw materials inventory by approximately \$150,000, resulting in additional revenue to the Company approximately in this amount. We built up this inventory by purchasing beverage bottles in a foreclosure proceeding of an unrelated party. We expect the Brewery to start utilizing this glass inventory in the fourth quarter of 2004.

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As a result of our cash reserves and the combination of the recent private stock offering and new borrowings, we believe that we have adequate resources to fund the operations of the Company, without implementing most of our business expansion plan, for at least the next 12 months.

**Inflation**

Although management expects that our operations will be influenced by general economic conditions, we do not believe that inflation has a material effect on our results of operations.

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**BUSINESS**

**Background**

We are a growing developer, manufacturer, marketer and seller of New Age beverages, as well as candies and ice creams. New Age beverages is a category that includes natural soda, fruit juices and fruit drinks, ready-to-drink teas, sports drinks and water.

We currently offer 14 beverages, including six varieties of Reed's Ginger Brews, Virgil's Root Beer and Cream Soda, China Cola and Cherry China Cola, and four varieties of a new line of non-carbonated ginger brews called Reed's Ginger Juice Brews. Our recent products include Reed's Crystallized Ginger Candy, Reed's Crystallized Ginger Baking Bits, Reed's Ginger Candy Chews, Reed's Original Ginger Ice Cream, Reed's Chocolate Ginger Ice Cream and Reed's Green Tea Ginger Ice Cream.

We sell the majority of our products primarily in upscale gourmet and natural food stores and supermarket chains in the United States and, to a lesser degree, in Canada. Historically, most of our beverages were sold in the natural food industry.

Our current business strategy is to maintain a firm marketing focus in the natural food marketplace while building a national direct sales and distribution force to take our proven products into mainstream market and distribution channels. Key elements of our business strategy include:

increased direct sales and distribution;

increased store placement in mass market;

strong national distributor relationships;

stimulating strong consumer demand for our existing brands and products;

developing additional unique alternative beverage brands and other products; and

specialty packaging like our 5-liter party kegs, our ceramic swing-lid bottle and our 750 ml. champagne bottle.

Our current sales efforts are focused in three areas. Our first area of focus is sales to natural and specialty food stores in the United States and, to a lesser degree, Canada, through our regional sales people in conjunction with regional food brokerage organizations. The second area of focus is our local direct store distribution program, using Company-owned trucks and drivers to service a majority of our retail accounts in southern California. The third area of focus is our sales effort selling directly to large retailers and to mainstream beverage distributors. We believe that all three sales efforts are contributing to our growth. We intend to continue to expand our sales personnel in each of these three sales efforts.

We are developing new packaging options of our most successful products. These new packaging options are 750 ml. champagne bottle versions, European swing lid-style bottles and 5-liter party kegs. These new packaging options are being utilized in all three sales efforts.

We create consumer demand for our products in the following ways: we support sampling programs of our products that sample approximately 30,000 people a week, we generate free press through our in house public relations, we advertise in national magazines targeting our customers, we maintain a company website and we participate in large public events as sponsors.

In addition, our Brewery recently started contracting, or co-packing, production for other companies' products, although this is a small part of our business. We do not maintain product recall insurance at the Brewery. Generally, we believe that we maintain adequate insurance coverage for our business as it is currently conducted.

Our business expansion plans are contingent to a great extent by the success of this offering. If all or most of the shares being offered hereby are sold, we will be able to increase substantially our marketing, advertising





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and distribution, as well as the number of products we offer. If only a smaller number of shares are sold, we will need to expand at a much slower rate.

Our principal executive offices are located at 13000 South Spring Street, Los Angeles, California 90061. Our telephone number is (310) 217-9400. Our Internet address is [www.reedsgingerbrew.com](http://www.reedsgingerbrew.com). Information contained on our website or that is accessible through our website should not be considered to be part of this prospectus.

We were incorporated in 1991 in Florida as Original Beverage Corporation. In October 2001, we changed our state of incorporation to Delaware and also changed our name to Reed's, Inc.

## **Development of Our Business**

### ***Founder's Statement***

When I first started thinking about starting a business in 1987, I wanted to do something that would be beneficial to the planet. My background as an herbalist and natural healing hobbyist gave me a deep respect for Mother Nature's remedies. I particularly respect ginger as a natural healing agent. I looked at the marketplace and saw that ginger products, particularly ginger ale, were missing any real ginger content and, with that, any real ginger health benefits. I decided to create a *real* ginger ale.

But first, I wanted to find out what people drank before all these high tech soft drinks existed. I wanted the whole wheat version of soft drinks, made fresh, without so much technology. My research brought me in contact with old texts showing brewed herbal beverages used as much for health as for drinking pleasure. These recipes included ginger ales from our log cabin days and even before. This inspired me to create my own beverages in a way that was not just considered natural because they avoided preservatives and artificial ingredients, but were brewed from real roots to give true function and health benefits. One thing led to another and soon our Original Ginger Brew was out the door and in the market.

My vision for our company is to keep growing the brands further and further into the mainstream. I want to see healthier beverage options more readily available throughout the United States and beyond. Many people already buy our drinks for their range of benefits and, in addition to offering them a delicious natural non-alcoholic beverage, I want to reach out and educate people on the benefits our beverages offer through the regular consumption of ginger.

Along the way, we have acquired some fun natural beverages to add to our family of products, such as China Cola and Virgil's Root Beer. They fit my standard as real natural beverages. These brands are consistent with my goal of keeping affordable natural options in the marketplace for those consumers who want a healthier choice. These brands also add breadth and dimension to our business and make our model for growth more efficient.

I am very excited about our new plant, the Brewery. It makes it very easy for me to create and improve our recipes. It has also been an inspiration, allowing all of us to consider new and creative packaging options that we can produce in-house, such as European swing-lid bottles, 5-liter kegs, 750 ml. champagne bottles and draft kegs.

I expect us to continue to innovate in terms of what new products we create, the markets we reach and how we distribute our products in the future. We have many exciting ideas. As the marketplace evolves, we hope to keep on the leading edge of beverage creation.

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***Recent Developments***

In June 1987, Christopher J. Reed, our founder and CEO, began development of Reed's Original Ginger Brew, his first beverage creation. After two years of development, it was ready for market in June 1989. Initial sales were in 11 southern California stores.

By 1990, we brought on the next three natural food distributors. Production moved to a larger facility in Boulder, Colorado. In 1991, we moved all of our production to our co-pack facility in Pennsylvania. We began exhibiting at the national natural and specialty food trade shows, which brought national distribution in natural, gourmet and specialty foods and the signing of the Company's first mainstream supermarket distributor. Sales topped \$500,000.

Also in 1991, the United States National Association of the Specialty Food Trade, or NASFT, and the Canadian Fancy Food Association, or CFFA, both gave us top honors as a new product that year. CFFA awarded us Best Imported Food Product at their annual show and Original Ginger Brew was a NASFT Outstanding Beverage Finalist in the United States.

Throughout the 1990's, we continued to develop and launch new ginger brew varieties. Reed's Ginger Brews reached over 90% placement in natural foods stores nationwide. The major natural food distributors and many specialty food and mainstream beverage distributors started carrying our beverages. In 1997, we began licensing the products of China Cola. In addition, we launched Reed's Crystallized Ginger Candy. We have the candy manufactured in Fiji under a proprietary, natural, non-sulfured process.

In 1999, we purchased the Virgil's Root Beer brand from Crowley Beverage Company. The brand has won numerous gourmet awards. Because the Virgil's brand is partially produced under our auspices in Europe, this purchase also secured our entry into the European Union for our entire line of products.

In connection with our acquisition of China Cola in 2000, we agreed to pay the seller royalties equal to \$0.75 per case sold. The minimum payments per agreement year were \$18,750 and the royalties expired on July 1, 2002.

Also in 2000, we launched Reed's Original Ginger Ice Cream and two more products: Reed's Cherry Ginger Brew and a beautiful designer 10-ounce gift tin of our Reed's Crystallized Ginger Candy. In December 2000, we acquired China Cola. Our sales broke through the \$5 million level, reaching \$5.7 million that year.

In December 2000, we also purchased an 18,000 square foot warehouse property, the Brewery, to house our West Coast production facility. The Brewery now also houses our executive offices and serves as our southern California warehouse facility.

In 2001, we saw the national launch of Reed's Chocolate Ginger Ice Cream and Reed's Green Tea Ginger Ice Cream. We also expanded our confectionary line with two new candy products: Reed's Crystallized Ginger Baking Bits and Reed's Ginger Candy Chews.

In 2002, we launched our Reed's Ginger Juice Brew line, with four flavors of organic juice blends. In November, we completed our first test runs of Reed's and Virgil's products at the new Brewery and in January 2003, our first commercially available products came off the Los Angeles line.

We launched our own direct distribution in Los Angeles in April 2003. In its first year, it has successfully opened hundreds of new accounts in stores that represent a completely new phase of expansion for our sales and distribution of our products. These include successes in industrial foodservice, hospitals, motion picture studios, local mom and pop groceries and mainstream supermarket chains, both large and small. In November, we launched the 5-liter Virgil's party keg and sales for that single SKU reached \$120,000 in the first month due to large, initial orders for from Costco Club stores in San Diego, Arizona, New England and Texas. Market expansion in this area continues to accelerate.

In 2004, we launched Virgil's Cream Soda, draft Virgil's Root Beer and draft Cream Soda from the Brewery, with installations at the Getty Center in Los Angeles, Fox Studios and other locations around Los Angeles. In May, our local southern California direct sales effort landed direct distribution of our products into

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Ralph's supermarkets. In October 2004, we launched our two newest products: Virgil's Cream Soda in a 5-liter keg and Reed's Spice Apple Brew in a 750 ml. champagne bottle.

### **Industry Overview**

Our beverages are classified as New Age beverages, a category that includes natural soda, fruit juices and fruit drinks, ready-to-drink teas, sports drinks and water. In just four years, manufacturers' sales of New Age beverages ballooned from \$8 billion in 1998 to more than \$13 billion in 2002. This represents an average growth of more than 11% per year. In 2004, dollar sales are expected to reach \$15 billion, reflecting average growth of 7.4% from 2002. Estimates are that sales will reach more than \$18 billion by 2008. (Source: Business Trends Analysts) The Alternative Beverage category is a small portion of the non-alcoholic beverage market, which has annual sales in excess of \$80 billion.

The candy industry in the United States exceeds \$23 billion in sales annually in 2003, of which approximately 40% is non-chocolate candy. The average American consumes over 25 pounds of candy per year. (Source: National Confectioners Association)

The ice cream industry in the United States generates more than \$20 billion in annual sales in 2003. (Source: International Dairy Foods Association and the United States Dairy Association) The packaged ice cream industry includes economy, regular, premium and super-premium products.

Super-premium ice cream such as Reed's Ginger Ice Creams is generally characterized by a greater richness and density than other kinds of ice cream. This higher quality ice cream generally costs more than other kinds and is usually marketed by emphasizing quality, flavor selection, texture and brand image. Based on supermarket sales, super-premium sales in the United States were \$700 million in 2003, or approximately 3.5% of all ice cream sales. (Source: AC Nielsen Scan Trak) The highest supermarket sales increases in 2003 were seen by the premium and super-premium higher fat varieties. Sales of super-premium ice cream grew by more than 12% in 2003 over 2002. (Source: International Dairy Foods Association)

### **Our Products**

We currently manufacture and sell 14 beverages, two candies and three ice creams. All of our products are made using premium all-natural ingredients.

According to Spence Information Services (SPINS), which is the only sales information service catering to the natural food trade, in 2000, the last year we paid for ratings data, Reed's Brews and Virgil's Root Beer held the number 1, 2, 3, 5, 7 and 9 positions based on dollar sales among all beverages in the natural foods industry. We believe that we maintain a similar position currently.

Our products include:

#### ***Beverages***

##### ***Reed's Ginger Brews***

Why ginger? We have found friends and advocates among alternative, holistic, naturopathic and homeopathic medical practitioners, dietitians and medical doctors. This is because our beverages contain a high volume of ginger. A number of practitioners have contacted us of their own accord, telling us of their habit of recommending Reed's Extra Ginger Brew for their patients as a simple way to ingest a known level of ginger. Reed's Ginger Brews contain between eight and 26 grams of fresh ginger in every 12-ounce bottle.

While we make no claim as to any medical or therapeutic benefits of our products, among the applications frequently cited in third-party medical studies on ginger are:

Recommended use for prevention and relief of motion sickness,

A preferred alternative to aspirin in heart attack prevention,

A safe and effective alternative to pharmaceutical anti-ulcer drugs,

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Anti-inflammatory treatment for arthritis,

Treatment for a variety of digestive disorders, including both constipation and diarrhea,

Natural therapy for menstrual discomfort, nausea, colds and influenza, and

Anti-cancer properties.

Ginger ale is the oldest known soft drink. Before modern soft drink technology existed, non-alcoholic beverages were brewed at home directly from herbs, roots, spices and fruits. These handcrafted brews were then aged like wine and highly prized for their taste and their tonic, health-giving properties. Reed's Brews are a revival of this home brewing art and we make them with care and attention to wholesomeness and quality, using the finest fresh herbs, roots, spices, and fruits. Our expert brew masters brew each batch and age it with great pride.

We believe that Reed's Ginger Brews are the only widely distributed fresh-brewed soft drink line in the world. Reed's Brews derive their distinctive tastes from the brewing of fresh herbs, roots and spices. We use no refined sugars as sweeteners. Our products differ from commercial soft drinks in three particular characteristics: sweetening, carbonation, and coloring. Reed's Ginger Brews present 20% less sweetness, for greater adult appeal. Instead of using injected-based carbonation, we produce our carbonation naturally, through slower, beer-oriented techniques. This process produces smaller, longer lasting bubbles that do not dissipate rapidly when the bottle is opened. We do not add coloring. The color of our products comes naturally from herbs, fruits, spices, roots and juices.

In addition, since Reed's Brews are pasteurized, they do not require or contain any preservatives. In contrast, modern commercial soft drinks generally are produced using natural and artificial flavor concentrates prepared by flavor laboratories, tap water and highly refined sweeteners. Typically, manufacturers make a centrally processed concentrate that will lend itself to a wide variety of situations, waters and filling systems. The final product is generally cold-filled and requires preservatives for stability. Colors are added that are either natural, although highly processed, or artificial.

We currently manufacture and sell six varieties of Reed's Ginger Brews:

*Reed's Original Ginger Brew* was our first creation, and is a Jamaican recipe for homemade ginger ale using 17 grams of fresh ginger root, lemon, lime, honey, fructose, pineapple, herbs and spices. Reed's Original Ginger Brew is 20% fruit juice.

*Reed's Extra Ginger Brew* is the same approximate recipe, with 26 grams of fresh ginger root for a stronger bite. Reed's Extra Ginger Brew is 20% fruit juice.

*Reed's Premium Ginger Brew* is the no-fructose version of Reed's Original Ginger Brew, and is sweetened only with honey and pineapple juice. Reed's Premium Ginger Brew is 20% fruit juice.

*Reed's Raspberry Ginger Brew* is brewed from 17 grams of fresh ginger root, raspberry juice, and lime. It is 20% raspberry juice and is sweetened with fruit juice and fructose.

*Reed's Spiced Apple Brew* uses 8 grams of fresh ginger root, the finest tart German apple juice, and such apple pie spices as cinnamon, cloves, and allspice. Spiced Apple Brew is 50% apple juice and sweetened with fruit juice and fructose.

*Reed's Cherry Ginger Brew* is the newest addition to our Ginger Brew family, and is naturally brewed from: filtered water, fructose, fresh ginger root, cherry juice from concentrate, and spices. Reed's Cherry Ginger Brew is 22% cherry juice.

All six Reed's Ginger Brews are offered in 12-ounce bottles are sold in stores as singles, in four-packs and in 24-bottle cases. Reed's Original Ginger Brew is sold in select Costco stores in a special 12-pack. Reed's Spiced Apple Brew is now available in a 750 ml. champagne bottle.

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*Virgil's Root Beer*

Over the years, Virgil's has won numerous awards and has a reputation among many as one of the best root beers made anywhere. Virgil's Root Beer won the Outstanding Beverage award at NASFT's International Fancy Food and Confection Show three times, in 1994, 1996 and 1997. *Bon Appetit* magazine has also named Virgil's Root Beer Best Beverage. Originally brewed in the north of England, Virgil's is now produced in the United States and Germany.

Virgil's is a premium root beer. We use these all-natural ingredients:

Filtered water

Unbleached cane sugar

Anise from Spain

Licorice from France

Bourbon vanilla from Madagascar

Cinnamon from Sri Lanka

Clove from Indonesia

Wintergreen from China

Sweet birch and molasses from the southern United States

Nutmeg from Indonesia

Pimento berry oil from Jamaica

Balsam oil from Peru, and

Cassia oil from China

We collect these ingredients worldwide and gather them together at the brewing and bottling facilities we use in the United States and Germany. At the breweries, we combine and brew these ingredients under strict specifications and finally heat-pasteurize Virgil's Root Beer, to ensure quality.

We sell Virgil's Root Beer in three packaging styles: 12-ounce bottles in a four-pack, a special ceramic-swing-lid Grolsch Beer-style pint bottle, and a 5-liter self-tapping party keg. We now make Virgil's available in draft pony kegs as well.

*Virgil's Cream Soda*

We launched Virgil's Cream Soda in January 2004 and initial sales have been strong. We make this product with the same attention to quality that makes Virgil's Root Beer so popular.

Virgil's is a gourmet cream soda. We use these all-natural ingredients:

Filtered water

Unbleached cane sugar

Bourbon vanilla from Madagascar

We brew Virgil's Cream Soda the same way we brew Virgil's Root Beer.

Virgil's Cream Soda is currently being sold in 12-ounce long neck bottles in colorful 4-packs and a 5-liter party keg version. We offer Virgil's Cream Soda in our draft format as well.

#### *China Cola*

An herb master in China developed the herb formula in both Original China Cola and Cherry China Cola. The formula was taken to an American beverage master who had worked on the original American colas in the early 1900's. The result is what we consider to be the best tasting and most natural cola in the world. Now sweetened with raw cane, we restored China Cola to its original delicious blend of imported Chinese



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herbs, essential oils and natural spices. China Cola contains no caffeine. It comes in two varieties, Original China Cola and Cherry China Cola.

Original China Cola is made from:

filtered water,

raw cane sugar,

Szechwan peony root,

cassia bark,

Malaysian vanilla,

oils of lemon,

oil of lime,

oil of orange,

nutmeg,

clove,

licorice,

cardamom,

caramel color,

citric acid and

phosphoric acid.

Cherry China Cola is made from the same ingredients as Original China Cola, with the addition of natural cherry flavor.

China Cola and Cherry China Cola sell as singles, in four-packs and in 24-bottle cases.

*Reed's Ginger Juice Brews*

In May 2002, we launched a new line of ginger brews called Reed's Ginger Juice Brews. They are 100% juice products that are non-carbonated and brewed from organic fresh ginger root and sweetened with organic juices. We did this in part in response to a strong trend we have seen toward organic ingredients and non-carbonated beverages in the marketplace. We wanted to extend our ginger brew line and believe that these new flavors will cater to the growing market for organic non-carbonated beverages.

All four of our Reed's Ginger Juice Brews start with:

filtered water,

organic fresh ginger root, and

organic white grape juice from concentrate.

*Reed's Lemon Guava Ginger Juice Brew* adds:

guava juice from concentrate, and

lemon juice from concentrate.

*Reed's Strawberry Kiwi Ginger Juice Brew* adds:

organic strawberry juice from concentrate, and

organic kiwi juice from concentrate.

*Pineapple Orange Ginger Juice Brew* adds:

organic pineapple juice from concentrate,

organic orange juice from concentrate, and

organic lime juice from concentrate.

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*Reed's Cranberry Raspberry Ginger Juice Brew* adds:

cranberry juice from concentrate, and

organic raspberry juice from concentrate.

Reed's Ginger Juice Brews drinks come in a 16-ounce juice bottle as singles or in cases of 12 and 24 bottles.

### ***Malibu Teaz***

Under a license agreement, we previously sold six different types of Malibu Teaz, a line of organic ready-to-drink teas and sweeteners. Under the license agreement, profits were split equally between Malibu Teaz and us. In 2002, we entered into discussions to purchase Malibu Teaz but no agreement was reached. At the end of 2002, we decided not to renew the license and we stopped selling Malibu Teaz products.

### ***Reed's Ginger Candies***

#### ***Reed's Crystallized Ginger Candy***

Reed's Crystallized Ginger was the first crystallized ginger on the market in the United States to be sweetened with raw cane instead of refined white sugar. Reed's Crystallized Ginger is custom-made for us in Fiji.

The process is an ancient one that has not changed much over time. After harvesting baby ginger (the most tender kind), the root is diced and then steeped in large vats filled with simmering raw cane syrup. Steeping for several days, the ginger is then removed and allowed to crystallize into soft, delicious nuggets. Many peoples of the islands have long enjoyed these treats for health and pleasure.

We sell this product in 3.5-ounce bags, 10-ounce enameled, rolled steel gift tins, 16-ounce resealable Mylar bags and in bulk. We also sell Reed's Crystallized Ginger Baking Bits in bulk.

#### ***Reed's Ginger Candy Chews***

For more than 100 years, residents of Southeast Asia from Indonesia to Thailand have enjoyed soft, gummy ginger candy chews. Individually wrapped, ten to a Lucky Strike style soft-pack, Reed's has taken them a step further, adding more ginger, using no gelatin (vegan-friendly) and making them slightly easier to unwrap than their Asian counterparts.

Reed's Ginger Candy Chews are made for us in Indonesia from sugar, maltose (malt sugar), ginger, and tapioca starch.

We sell Reed's Ginger Candy Chews individually wrapped in soft-packs of ten candies and as individually wrapped loose pieces in bulk.

### ***Reed's Ginger Ice Creams***

We make Reed's Ginger Ice Creams with 100% natural ingredients, using the finest GBH-free cream and milk. We combine fresh milk and cream with the finest natural ginger puree, Reed's Crystallized Ginger Candy and natural raw cane sugar to make a delicious ginger ice cream with a super premium, ultra-creamy texture and Reed's signature spicy-sweet bite. Our ice creams are made for us, according to our own recipes, at a dairy in upstate New York. The three Reed's Ginger Ice Creams are:

*Reed's Original Ginger Ice Cream* is made from milk; cream, raw cane sugar, Reed's Crystallized Ginger Candy (finest ginger root, raw cane sugar), ginger puree, and guar gum (a natural vegetable gum)

*Chocolate Ginger Ice Cream* is made from milk; cream, raw cane sugar, finest Belgian Cocoa (used to make Belgian Chocolate), Reed's Crystallized Ginger Candy (fresh baby ginger root, raw cane sugar), chocolate shavings (sugar, unsweetened chocolate, Belgian Cocoa, soy lecithin and real vanilla), ginger



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puree, and guar gum (a natural vegetable gum) combine creating the ultimate chocolate ginger ice cream.

*Reed's Green Tea Ginger Ice Cream* is made from milk, cream, the finest Green Tea, raw cane sugar, ginger puree, Reed's Crystallized Ginger Candy (fresh baby ginger root, raw cane sugar), and guar gum (a natural vegetable gum) combine to make the ultimate green tea ginger ice cream.

We sell Reed's Ginger Ice Creams in pint containers and cases of eight pints. We plan to supply Reed's Ginger Ice Creams in foodservice volume-packaging as well.

### ***New Product Development***

We plan to continue to expand the Reed's Ginger Brew, Reed's Ginger Juice Brew, Reed's Ginger Ice Cream and Reed's Ginger Candy product lines. Other Reed's Ginger Product concepts and lines are under consideration. We also plan to expand the Virgil's product line into additional new flavors and packaging styles.

Among the advantages of our owned and self-operated Brewery are the flexibility to try innovative packaging and the capability to experiment inexpensively with new product flavors with little risk to our operations or capital. For example, in what we believe is the first plant producing swing-lid bottled beverages in North America, we will soon produce several of our beverages in one-liter swing-lid bottles. Our Spiced Apple Brew is now available in a 750 ml. champagne bottle and other products are planned to be available with this packaging in the near future.

Currently, we sell a half-liter Virgil's Root Beer swing-lid bottle that is made for us in Europe. The new one-liter bottles will be filled at the Brewery, allowing us to provide a greater amount of product at a substantially lower price. We have received preliminary interest from several large national supermarket chains for this product.

Although we are always working on new products and designs, research and development expenses in the last two years have been nominal. We do not expect any significant increases in this research and development expenses.

### **Manufacture of Our Products**

At this time, we produce our carbonated beverages at two facilities. Our Brewery in Los Angeles handles the western half of the United States and we have a contract with The Lion Brewery, Inc., a packing, or co-pack, facility in Pennsylvania for the eastern United States. The current two-year term of the agreement expires on May 31, 2005 and renews automatically for successive two-years terms unless terminated by either party. The co-pack facility assembles our products and charges us a fee, generally by the case, for the products they produce.

Our Ginger Juice Brews are co-packed for us in Northern California. We supply all the ingredients and packaging. The co-pack facility assembles our products and charges us a fee, by the case. Our ice creams are co-packed for us at a dairy in upstate New York. We supply all the flavor additions and packaging and the dairy supplies the ice cream base. The co-pack facility assembles our products and charges us a fee, by the unit produced for us. We have half-liter swing-lid bottles of our Virgil's Root Beer line co-packed for us in Germany. The co-pack facility assembles our products and charges us a fee by the unit they produce for us.

We follow a fill as needed manufacturing model to the best of our ability and we have no significant backlog of orders.

Substantially all of the raw materials used in the preparation, bottling and packaging of our products are purchased by us or by our contract packers in accordance with our specifications. Reed's Crystallized Ginger is made to our specifications in Fiji. Reed's Ginger Candy Chews are made to our specifications in Indonesia, and we repackage them at the Brewery in Los Angeles.

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Generally, we obtain the ingredients used in our products from domestic suppliers and each ingredient has several reliable suppliers. We have no major supply contracts with any of our suppliers. As a general policy, we pick ingredients in the development of our products that have multiple suppliers and are common ingredients. This provides a level of insurance against a major supply constriction or calamity.

We believe that as the Company continues to grow, we will be able to keep up with increased production demands. We believe that the Brewery has ample capacity to handle increased West Coast business. To the extent that any significant increase in business requires the Company to supplement or substitute our current co-packers, we believe that there are readily available alternatives, so that there would not be a significant delay or interruption in fulfilling orders and delivery our products. In addition, we do not believe that growth will result in any significant difficulty or delay in obtaining raw materials, ingredients or finished product that is repackaged at the Brewery.

## **Our Primary Markets**

We target a niche in the soft drink industry known as New Age beverages. The soft drink industry generally characterizes New Age Beverages as being made more naturally, with upscale packaging, and often creating and utilizing new and unique flavors and flavor combinations. The New Age Beverage segment of our industry has grown from \$620 million in annual sales in 1989 to over \$15 billion in estimated annual revenues in 2004 (Source: Business Trend Analysts).

The New Age beverage segment is highly fragmented and includes such players as SoBe (acquired by PepsiCo), Snapple (acquired by Cadbury Schweppes in 2000), Arizona (2003 revenues over \$200 million), Hansen's (2003 revenues over \$110 million) and Jones Sodas (2003 revenues over \$23 million), among others. (Sources: BevNet, Beverage World, Yahoo Finance, and company filing