North Atlantic Holding Company, Inc.
Form 10-K
March 31, 2005
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS

PURSUANT TO SECTIONS 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 2004

OR

¨ **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 333-115587

NORTH ATLANTIC HOLDING COMPANY, INC.

(Exact name of registrant as specified in its charter)

Delaware	**20-0709285**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

257 PARK AVENUE SOUTH, NEW YORK, NEW YORK 10010-7304

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (212) 253-8185

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: None

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 x No ¨.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy materials or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ¨ No x.

As of March 29, 2005, the only class of voting or non-voting common equity issued and outstanding was the Registrant s Voting Common Stock, par value $.01 per share. There is no trading market for the Voting Common Stock.

As of March 29, 2005, 588,578 shares of the Registrant s Voting Common Stock, par value $.01 per share were outstanding.

Table of Contents

North Atlantic Holding Company, Inc.

2004 Form 10-K Annual Report

TABLE OF CONTENTS

Table of Contents

PART I

Item 1. Business

Overview

North Atlantic Holding Company, Inc. (the Company) is a holding company which owns North Atlantic Trading Company, Inc. (NATC) and its subsidiaries, National Tobacco Company, L.P. (NTC), North Atlantic Operating Company, Inc. (NAOC), North Atlantic Cigarette Company, Inc. (NACC), National Tobacco Finance Corporation and its recently acquired subsidiaries, Fred Stoker & Sons, Inc., RBJ Sales, Inc. and Stoker, Inc. (collectively, Stoker). Except where the context otherwise requires, references to the Company include the Company and its subsidiaries. NTC is the third largest manufacturer and marketer of loose leaf chewing tobacco in the United States, selling its products under the ***Beech-Nut®***, ***Trophy®***, ***Havana Blossom®, Durango®, Stoker***, ***Our Pride ,*** and other brand names. NAOC is the largest importer and distributor in the United States of premium cigarette papers and related products, which are sold under the ***ZIG-ZAG®*** brand name pursuant to an exclusive long-term distribution agreement with Bolloré, S.A. NAOC also manufactures and distributes Make-Your-Own (MYO) cigarette tobaccos under the ***ZIG-ZAG®, Stoker No. 2***, ***Old Hillside,*** and other brand names, pursuant to its trademarks. NACC markets and distributes ***ZIG-ZAG*** Premium Cigarettes.

Evolution of the Company

In 1988, Thomas F. Helms, Jr., Chairman and Chief Executive Officer of the Company, and an investor group led by Lehman Brothers, formed NTC to acquire the smokeless tobacco division of Lorillard Tobacco Company (Lorillard). Lorillard had manufactured and sold the popular ***Beech-Nut*** brand of loose leaf chewing tobacco since 1897.

In 1997, NATC was formed to facilitate a corporate reorganization undertaken in connection with the acquisition (the 1997 Acquisition) of NATC Holdings USA, Inc., which owned the exclusive rights to market and distribute ***ZIG-ZAG*** premium cigarette papers in the United States, Canada and certain other international markets. Upon consummation of the 1997 Acquisition and the related reorganization, NATC became the holding company of NTC, which operates the Company s smokeless tobacco business, and NAOC, which operates the Company s premium cigarette paper and MYO cigarette business.

On November 17, 2003, NATC consummated the acquisition of Stoker. Through the acquisition, NATC acquired the Stoker family of brands and the related business operations, including the equipment used to manufacture and package the Stoker products. The Stoker family consists of 18 loose leaf chewing tobacco products and five brands of MYO tobacco and related products, as well as a number of moist snuff and pipe tobacco brands. NATC also acquired the Stoker catalog business which principally sells tobacco products.

The Company s principal executive offices are located at 257 Park Avenue South, 7th Floor, New York, New York 10010, and its telephone number is (212) 253-8185.

Effective as of February 9, 2004, NATC consummated a holding company reorganization, whereby the Company became the parent company of NATC. The holding company reorganization was consummated in part to allow the Company to issue senior discount notes in

1

Table of Contents

connection with NATC s refinancing of its existing debt and preferred stock, as more fully discussed below.

The holding company reorganization was effected pursuant to an Agreement and Plan of Merger (the Merger Agreement), dated as of February 9, 2004, among NATC, the Company, and NATC Merger Sub, Inc., a Delaware corporation and direct wholly-owned subsidiary of the Company (Merger Sub). The Merger Agreement provided for, among other things, the merger of Merger Sub with and into NATC, with NATC being the surviving corporation (the Merger). In accordance with Section 228(a) of the Delaware General Corporation Law, NATC received the required written approval of the Merger by the holders of a majority of the outstanding shares of NATC s voting common stock.

As a result of the Merger, (i) NATC became a direct, wholly-owned subsidiary of the Company; (ii) each issued and outstanding share of NATC Stock, was converted into the right to receive one share of common stock of the Company, par value $0.01 per share (Company Common Stock); (iii) each issued and outstanding share of common stock of Merger Sub was converted into one issued and outstanding share of common stock of NATC and Merger Sub ceased to exist; and (iv) all of the issued and outstanding shares of the Company Common Stock held by NATC were cancelled.

In connection with the Merger, the Company assumed all of NATC s obligations under NATC s outstanding warrants and stock options which were converted into rights to purchase an identical number of shares of the Company Common Stock. The subsidiaries of the Company were unaffected by the reorganization.

On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock, as well as a general corporate reorganization. The refinancing consisted principally of (1) the offering and sale of $200.0 million principal amount of senior notes by NATC, (2) NATC entering into an amended and restated loan agreement that provided a $50.0 million senior secured revolving credit facility and (3) the concurrent offering and sale of $97.0 million aggregate principal amount at maturity of senior discount notes of the Company. Both the senior notes and the senior discount notes were offered pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended.

Concurrently with the closing of the refinancing, NATC also called for redemption all of its outstanding 11% senior notes due 2004, in accordance with the terms of the indenture governing such notes, at the applicable redemption price of 100.0% of the principal amount thereof, plus interest accrued to the redemption date of April 2, 2004.

On March 18, 2004, NATC redeemed all outstanding shares of its 12% senior exchange payment-in-kind preferred stock, at the applicable redemption price equal to the liquidation preference of the preferred stock ($22.00 per share), plus an amount in cash equal to all accumulated and unpaid dividends.

Business Strategy

The Company s business strategy is to grow, both internally and through acquisitions, by responsibly marketing its products to adult consumers and by complying with all applicable laws, regulations and statutes. The Company intends to (i) capitalize on the strong brand identities of its products with a focus on product linkages and extensions; and (ii) improve the sales, marketing and operating efficiencies of its subsidiaries. The Stoker acquisition and the Company s recently launched ***ZIG-ZAG*** Premium Cigarette significantly enhance its product offerings to distributors, retailers and consumers. Through the elimination of certain administrative costs, the achievement of certain

Table of Contents

manufacturing synergies and through growth in distribution, the Company expects to meaningfully increase its sales and cash flows. In addition, the Company has tailored strategies for each of its product groups that are designed to maximize their profitability.

Expand the Company s leadership position in the premium cigarette papers business. Building upon its exclusive long-term distribution and license agreement with Bolloré in the United States and Canada, the Company expects to expand its market-leading ***ZIG-ZAG*** premium cigarette papers brand. The Company believes that it can manage its premium cigarette papers business for maximum profitability by focusing on its existing product lines and by increasing the distribution of its premium cigarette papers products into the large chain convenience store channel.

Enhance the profit contribution of the Company s loose leaf chewing tobacco segment. Historically, the Company has maintained the profit contribution of its loose leaf chewing tobacco segment by offsetting volume declines with price increases and by controlling costs. With the addition of the Stoker products, which target the growing value oriented category of the loose leaf chewing tobacco market, the Company expects to be able to slow its historical trend of volume declines. In addition, the Company believes it can expand sales of Stoker s value-oriented products by offering them through the Company s current distribution network. The Company also expects to further improve profitability through manufacturing cost synergies by consolidating operations.

Continue to benefit from the growth in the MYO tobacco and related products market. MYO tobacco and related products currently enjoy a significant price advantage over manufactured cigarettes, primarily due to a lower level of federal and state excise taxation on MYO tobacco and the higher level of Master Settlement Agreement (MSA) compliance costs associated with manufactured cigarettes. Other countries, such as the United Kingdom and Canada, indicate a strong correlation between rising manufactured cigarette prices and increasing consumption of MYO tobacco and related products. In 1999, the Company launched the industry s first fully-integrated MYO line of products, comprised of smoking tobaccos, tubes, injectors and starter kits under the ***ZIG-ZAG*** brand. The Company recently expanded its portfolio of MYO tobacco and related products by acquiring the Stoker brands. The Company believes its existing portfolio of ***ZIG-ZAG*** premium MYO tobacco and related products, supplemented by the recently acquired Stoker portfolio of value-oriented MYO tobacco and related products, will allow it to continue to benefit from the growth trend in this market. Furthermore, the Company expects overall category growth of MYO tobacco and related products to continue for the near future, and accordingly, it intends to focus on expanding distribution of its MYO tobacco and related products into the large chain convenience store channel. In addition, the Company has developed and placed innovative, highly visible point-of-purchase displays to enhance retail category merchandizing of its MYO products and to increase consumer awareness.

Grow sales of the Company s new **ZIG-ZAG** *Premium Cigarette*. During September 2003, the Company began a highly focused launch of its new premium manufactured cigarette under the ***ZIG-ZAG*** Premium Cigarette brand in Dallas, Los Angeles, Miami and Seattle. By leveraging its well-developed brand equity, the Company believes it can successfully market and increase the sales of this new premium product in the largest and most profitable segment of the cigarette industry. In 2004 the Company expanded distribution of its cigarette into Colorado, Montana, Georgia and Nevada.

Maintain lean, low cost culture. The Company s most significant cost of goods sold, other than federal excise taxes, are MSA escrow obligations, tobacco and packaging. The Company rigorously monitors these costs and has relationships with multiple suppliers to maintain competitive pricing. The Company operates an efficient manufacturing operation that requires a modest level of capital expenditures. The Company maintains a lean corporate staff and an operating company culture that seeks to minimize the overhead costs associated with its vertically integrated tobacco operations. The Company believes that the application of its efficient management and manufacturing processes to the recently acquired Stoker operations will generate significant short-term and ongoing cost savings.

Industry and Markets

The Company currently competes in three distinct markets within the overall tobacco industry: (1) the smokeless tobacco market, which includes loose leaf chewing tobacco; (2) the MYO products market, which is comprised of premium cigarette papers and MYO tobaccos and related products; and (3) the premium cigarette category of the manufactured cigarette market. The Company believes that the tobacco industry is characterized by non-cyclical demand, relative brand loyalty, meaningful barriers to entry, defined channels of distribution, modest capital expenditure requirements, relatively high profit margins, generally stable wholesale prices and the ability to generate significant and consistent free cash flows.

Smokeless Tobacco

Smokeless tobacco products, including loose leaf chewing tobacco, have a long, established tradition of use in the United States. An estimated 7.8 million Americans are regular users of smokeless tobacco products, according to the U.S. Department of Health and Human Services. The smokeless tobacco market is composed of the five product categories listed below:

Moist Snuff: Moist snuff made from dark, air-cured tobacco that is aged, flavored, finely ground and packaged in 1 ounce round fiber or plastic cans.

Loose Leaf Chewing Tobacco: Loose leaf chewing tobacco is typically made from air-cured leaf tobacco, using both domestic and imported tobaccos, that is aged, flavored and packed in foil pouches.

Plug Chewing Tobacco: Plug chewing tobacco is made from air-cured leaf tobacco, which is heavily flavored and pressed into small bricks or blocks.

Twist Chewing Tobacco: Twist chewing tobacco is made of dark, air-cured tobacco, which is twisted into strands that are dried and packaged like a dry, pliable rope.

Dry Snuff: Dry snuff is a very finely ground, powdered tobacco product, which is sometimes flavored and is packaged in a variety of containers.

The Company believes that many consumers of smokeless tobacco regularly use products in more than one of the aforementioned categories. Further, many of its competitors in the smokeless tobacco market offer products in more than a single smokeless tobacco category. In addition to the Company, other major manufacturers and marketers of smokeless tobacco include US Smokeless Tobacco Co., Swedish Match North America, Inc., Conwood Corporation and Swisher International, Inc.

According to information provided by the Smokeless Tobacco Council, manufacturers sales for the smokeless tobacco market increased to $2.268 billion in 2003 from $1.7 billion in 1995, representing an 8-year compound annual growth rate of 1%. The increase in sales is primarily related to an increase in manufacturers sales of moist snuff, which grew to $1.88 billion in 2003 from $1.3 billion in 1995, representing a compound annual growth rate of 5.1%. In contrast to the growth of moist snuff

4

Table of Contents

sales, there has been a decline in manufacturers sales of chewing tobacco products, including loose leaf chewing tobacco.

Loose leaf chewing tobacco, although a mature product category, remains popular in the Southeast, Southwest and rural Northeast and North Central regions of the United States. Consistent with a general trend in the tobacco industry, however, unit volumes of loose leaf chewing tobacco products have been declining and decreased at a compound annual decline rate of 4% from 1995 to 2003. Manufacturers and marketers of loose leaf chewing tobacco products have partially offset the impact of this decline with increases in the prices of loose leaf chewing tobacco products. While there has been an overall decline in volume, the Company estimates that the volume of sales of the large-sized, value-oriented category of loose leaf chewing tobacco products has grown. Large-sized, value-oriented loose leaf chewing tobacco products are packaged in 8 oz. or 16 oz. bag sizes (as compared to the 3 oz. bag size in which other loose leaf chewing tobacco products are usually sold) and are generally sold at a lower price per ounce of product than other loose leaf chewing tobacco products.

The Company estimates it has a current share of approximately 16.5% of the loose leaf chewing tobacco market. The other three principal competitors in the loose leaf chewing tobacco product category, together with the Company, represented nearly all of the loose leaf chewing tobacco category in the United States in 2004. The Company s market share and those of its principal competitors in the loose leaf chewing tobacco products market have remained relatively consistent over the past five years, with Swedish Match North America, Inc. holding an approximate 43% market share; Conwood Corporation, an approximate 33% market share; and Swisher International, Inc., an approximate 6% market share.

Loose leaf chewing tobacco products are typically sold through mass merchandisers, chain and independent convenience stores, tobacco outlets, food stores and chain and independent drug stores. Tobacco outlets are becoming an increasingly important distribution channel for all tobacco products, including loose leaf chewing tobacco. Some retailers purchase loose leaf chewing tobacco direct from manufacturers although most purchase through wholesale distributors.

MYO Products

The MYO products market consists of several different product categories, with each product designed to work with the others to allow the consumer to make their own cigarettes. Among the products are premium cigarette papers, MYO tobacco, which is cigarette smoking tobacco in loose form, packaged typically in canisters, pouches or bags, and products relating to MYO tobacco, which include cigarette tubes (papers with a filter fashioned into an empty cigarette), cigarette rolling machines, used to roll cigarette papers and tobacco into a cigarette, and cigarette injector machines, used to insert the smoking tobacco into the empty cigarette tubes.

Premium Cigarette Papers. The production and sale of premium cigarette papers long preceded the invention of machine-made mass manufactured filtered cigarettes and cigarette tubes. Overall market sales of premium cigarette papers have been historically stable and during the past six years have benefited to a slight degree from the increasing growth of MYO tobacco and related products.

There are two principal paper categories: premium, interleaved paper and discount flat or non-interleaved paper. Premium cigarette papers are made primarily from rice, flax or combinations of other natural fibers. Characteristics used to distinguish various papers include size, stability and cut, all of which affect the ease of making your own cigarettes, and variations of material and flavor, which impact taste. Premium cigarette papers are sold in booklets in various sizes and are also segmented by price and quality.

Table of Contents

The Company s principal competitors in the premium cigarette paper market are Republic Tobacco L.P., which markets JOB®; Robert Burton Associates, Inc., a wholly-owned subsidiary of Imperial Tobacco Group plc, which markets EZ Wider®; and VCT B.V., which markets the Bambu® brand. While market information is not officially compiled, the Company estimates that it, together with these three companies, collectively have a market share in excess of 95% of the premium cigarette papers market.

Premium cigarette papers are typically sold through the following retail distribution channels: convenience stores, chain and independent drug stores, mass merchandisers, food stores and tobacco outlets. Retailers purchase premium cigarette papers primarily from wholesale distributors.

MYO tobacco and related products. If viewed as a part of a total cigarette market, which includes both manufactured cigarettes and MYO tobacco and related products, the Company believes that on a cigarette-equivalent basis, aggregate MYO tobacco and related products sales would have represented an estimated U.S. market share of 0.7% in 1998 and 1.65% in 2003, doubling its share of the market. Based on MSA calculations, this would equate to an estimated 3.5 billion cigarette equivalents sold in 1998, increasing to an estimated 6.0 billion cigarette equivalents sold in 2003 in the United States.

The MYO tobacco and related products market has been one of the fastest growing markets in the tobacco industry over the past five years. The Company believes this growth has been driven primarily by the increasing price differential between the cost of a consumer making cigarettes using MYO products and the prices of manufactured cigarettes. Manufactured cigarette prices have risen during this period primarily as a result of increased state excise and sales taxes and the pass through by cigarette manufacturers of the cost of complying with the MSA. U.S. growth in sales of MYO tobacco and related products is consistent with sales trends that have occurred for these products in Canada and Europe. For example, in the United Kingdom, following significant increases in specific excise and ad-valorem sales (VAT) taxes on manufactured cigarettes, sales of MYO products on a cigarette-equivalent basis grew from representing 5% of the cigarette market in 1993 to 13% of the market in 2002.

The other principal U.S. competitors in the MYO tobacco and related products market are Republic Tobacco, L.P., and its TOP Tobacco, L.P. subsidiary, which markets the Top® brand; and Lane Limited, a subsidiary of Reynolds America, which markets the Bugler® and Kite® brands. Many other companies also compete in this market, such as, Peter Stokkebye International A/S, which markets the Bali Shag® brand, and Santa Fe Natural Tobacco Company Inc., a Division of Reynolds America, which markets the Natural America Spirit® brand.

MYO tobacco and related products are typically sold through mass merchandisers, chain and independent convenience stores, tobacco outlets, food stores and chain and independent drug stores. Some retailers purchase MYO tobacco and related products direct from manufacturers although most purchase through wholesale distributors.

Manufactured Cigarettes

The U.S. tobacco industry has faced substantial challenges in recent years, including large price increases to pay for litigation, increased federal and state excise taxes, the advent of the MSA, the tobacco quota buyout for farmers, large-scale media campaigns run by anti-smoking groups, increased restrictions on cigarette marketing and a decrease in the number and types of locations where smoking is permitted. Despite these challenges, U.S. cigarette consumption has only declined modestly in recent years. Further, overall industry dollar sales have grown due to strong price increases and the ability to pass excise taxes and other costs through to consumers.

6

Table of Contents

For a number of years, major U.S. cigarette manufacturers have been faced with lawsuits by private plaintiffs and governmental entities. In response to the growing number of lawsuits, the major cigarette manufacturers settled several claims with the state attorneys general. On November 23, 1998, the major U.S. cigarette manufacturers entered into the MSA with attorneys general representing 46 states, the District of Columbia, Puerto Rico, Guam, the Virgin Islands, American Samoa and the Northern Mariana Islands (the Settling States) to settle the asserted and unasserted health care cost recovery and certain other claims of those states and territories. Separately, the major cigarette manufacturers settled similar claims on an individual basis that were brought by Florida, Texas, Minnesota and Mississippi (the Non-MSA States).

Under the MSA and the settlement agreements with the Non-MSA States, the manufacturers that participated in the settlement are obligated to make annual payments to the states. In addition, pursuant to the terms of the MSA, industry participants agreed to various restrictions and limitations regarding the advertising, promotion and marketing of tobacco products in the United States. For a more detailed description of the business restrictions and annual payments due under the MSA, see State Attorney General Settlement Agreements.

The original major manufacturers that negotiated and initially signed the MSA are called the Original Participating Manufacturers (OPMs). Some smaller manufacturers who subsequently elected to participate in the MSA are called Subsequent Participating Manufacturers (SPMs). OPMs and SPMs are required to make annual MSA payments to the 46 signatory states based on their national sales volumes, regardless of the state in which cigarettes are sold. Manufacturers who elected to comply with the MSA through escrow deposits are referred to as Non-Participating Manufacturers (NPMs). NPMs are required to make annual or quarterly escrow deposits to each of the 46 states separately based upon units sold to a particular state and are not required to deposit escrow amounts related to sales in the Non-MSA states. For a more detailed description of signatory payment requirements of OPMs and SPMs and the escrow deposit requirements of NPMs, see State Attorney General Settlement Agreements.

In order to fund their payment obligations under the MSA, major cigarette manufacturers have instituted a series of price increases from 1997 through 2004. The average wholesale list price charged for a carton of premium cigarettes has increased at a 17.5% compound annual growth rate from 1997 to 2004.

There are four primary categories of manufactured cigarettes in the United States, commonly referred to as Tiers, that are generally determined based upon average price per carton and the level of marketing and promotional support provided at retail: Premium (Tier 1); Branded Savings (Tier 2); Generic (Tier 3); and Deep-Discount (Tier 4).

In general, premium brands contain higher-quality raw materials and packaging and are sold at a higher price point than the generally less established brands in the other tiers. Most of the premium brands are sold by four major cigarette manufacturers, which include Philip Morris USA, Inc., R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation and Lorillard Tobacco Company. These brands historically had considerable funds spent in their support through marketing and advertising, as well as through discounts, coupons and buy-downs. In September 2003, the Company launched its ***ZIG-ZAG*** Premium Cigarette to compete in the premium segment. The Company believes current brand switching trends among adult consumers highlight the opportunity for additional well-known premium entrants.

The discount categories are defined primarily by price. Tier 2 cigarettes are generally less well-recognized brands, sold nationally by major cigarette manufacturers, marketed at lower retail prices. Tier 3 cigarettes are sold at even lower retail prices, have less distribution, in general, than Tier 2 brands and are generally manufactured by SPMs. Tier 4 cigarettes are sold by smaller companies, many of whom are NPMs, and are sold at the lowest retail prices. Manufacturers of Tier 4 cigarettes are fragmented geographically. In the last 12 months, Reynolds American, an OPM, has increased its private label brand competition in the Tier 4 segment.

The premium category continues to make up the largest share of overall U.S. cigarette sales volumes, with a 73% market share in 2003. Of that amount, over 95% are related to sales of the top three major cigarette manufacturers. The discount category (Tiers 2 4) had an approximate 27% market share.

Overall industry volumes have decreased at a compound annual rate of 2.4% from 1995 to 2003. Competition is primarily based on brand recognition, consumer loyalty, distribution, retail display and promotion, quality and price. Meaningful market share shifts among the major manufacturers require significant discounting and other marketing expenses, however, the MSA contains provisions limiting the ability of OPMs and SPMs to market and advertise cigarettes.

In response to increased competition, large manufacturers have increased promotions and discounts in order to maintain, or at least slow their decline in market share, particularly in the premium category. Further, these premium manufacturers have realigned their strategy by focusing marketing expenditures on their core premium brands. Despite the decline in overall cigarette volumes and the shift toward discount brands, the Company believes that the size of the premium cigarette market still offers meaningful opportunities for a new premium cigarette product with a well-recognized brand name due to consumer behavior and attitudes toward brand switching.

Products

Currently, the Company manufactures, markets and distributes loose leaf chewing tobacco for the smokeless tobacco market and MYO smoking tobaccos and related products for the MYO cigarette market, which also includes the marketing and distribution of cigarette papers and related products. The Company is also a marketer and distributor of premium manufactured cigarettes.

Loose Leaf Chewing Tobacco

Loose leaf chewing tobacco is made from aged, air-cured tobacco, which is processed and flavored and then packaged in foil pouches. Loose leaf chewing tobacco products can be broadly characterized as either full-flavored or mild. According to Company estimates, in 2003, full-flavored products accounted for approximately 75% of the loose leaf volume and mild flavored products comprised an estimated 25%. The Company sells its loose leaf chewing tobacco products under the ***Beech-Nut***, ***Trophy***, ***Havana Blossom*** and ***Durango*** brand names. The ***Beech-Nut*** brands are available in two flavors: Regular and Wintergreen. ***Beech-Nut Regular*** is a full-flavored product, which the Company believes is ranked third in market share in both the full-flavored loose leaf chewing tobacco category, and in the overall loose leaf chewing tobacco market. ***Beech-Nut Wintergreen*** was introduced in 1979 and has the largest market share of any premium flavored loose leaf brand. The ***Trophy*** brand was introduced into the mild product category in 1992. The Company s ***Havana Blossom*** brand is a regional brand, sold primarily in West Virginia, Pennsylvania and Ohio. The ***Durango*** brand, which was introduced in March 1998, is a nationally distributed value brand.

The Company acquired additional brands (with a total of 18 distinct styles and flavors) of loose leaf chewing tobacco as a result of the Stoker acquisition. These brands include ***Tennessee Chew,***

Our Pride and ***Fred s Choice***. The Stoker brands appeal to value-conscious consumers. The Company believes the Stoker brands are the market leaders in the value-oriented category of the loose leaf chewing tobacco market. The Stoker brands are principally sold in 8 oz. and 16 oz. value-oriented packages as opposed to the industry standard of 3 oz. packages.

MYO Products

The Company s MYO products include ***ZIG-ZAG*** premium cigarette papers, MYO tobacco and related products, such as cigarette tubes, cigarette rolling and injector machines and MYO starter kits.

The Company sells its premium cigarette papers under the ***ZIG-ZAG*** brand. Although premium cigarette papers are sold in a variety of different widths and styles, the Company s primary styles are its standard width ***ZIG-ZAG*** White and ***ZIG-ZAG*** 1¼ sized French Orange premium cigarette papers. Other premium paper products sold under the ***ZIG-ZAG*** name are Kutcorners, which are designed for easier hand-rolling; 1½ sized; king-sized; and double-wide.

The Company s MYO tobacco products include its ***ZIG-ZAG*** Classic American Blend and its recently acquired ***Stoker s Number 2*** and ***Old Hillside*** brands of value-oriented MYO tobaccos, both of which appeal to the price-conscious consumer. ***Stoker s Number 2*** was the first brand of MYO tobacco to be sold in 16 oz. bags, thus contributing to the growth of the value-oriented category.

Premium Cigarettes

During September 2003, the Company introduced a new, premium manufactured cigarette under the ***ZIG-ZAG*** brand in the cities of Dallas, Los Angeles, Miami and Seattle. The cigarette is now also marketed and sold in Georgia, Nevada, Montana and Colorado. The Company currently offers both king-size full flavor and light versions of ***ZIG-ZAG*** Premium Cigarettes.

Other Products

In connection with the Stoker acquisition, the Company acquired the Stoker catalog business, which principally sells tobacco and tobacco related products.

Sales and Marketing

The Company has a nationwide sales organization of approximately 100 people, which is divided into a national accounts group, a field sales organization and a sales administration staff. The field sales organization focuses on the Company s loose leaf chewing tobacco and MYO products and was re-organized in 2002-2003, primarily to allow the Company to more effectively provide sales coverage and to penetrate the distribution channel of the chain convenience stores, where tobacco product sales are significant. The national accounts group focuses on large national convenience store headquarters and district offices as well as other major accounts, such as, Couche-Tard/Circle K, Valero, Mapco, Wal-Mart, Sam s Club, Costco, K-Mart, Walgreens and others. The Company is utilizing various marketing and sales promotional partnerships with respect to the sales and marketing surrounding the launch and distribution of its ***ZIG-ZAG*** Premium Cigarettes.

The Company has focused and will continue to focus its sales efforts for both its loose leaf chewing tobacco and MYO products on both wholesale distributors and retail merchants in the independent and chain convenience store, drug store and mass merchandising channels as well as the food

Table of Contents

store and tobacco outlet channels. Since the 1997 Acquisition, NATC has expanded and intends to continue to expand the sales of its loose leaf chewing tobacco and MYO products into geographic markets and retail channels that had previously been underdeveloped. The Company has established relationships with approximately 1,000 wholesale customers and its products are sold in approximately 100,000 retail locations through the United States. The Company intends to capitalize on its existing distribution channels for loose leaf chewing tobacco and MYO products by selling its ***ZIG-ZAG*** Premium Cigarettes through those channels in selected markets. The Company also expects to sell its ***ZIG-ZAG*** Premium Cigarettes through alternative distribution channels in those markets, such as, upscale hotels, bars and specialty tobacconists.

At the retail level, the Company s loose leaf chewing tobacco products are promoted through volume and price-discount programs and the use of innovative, high visibility point-of-purchase floor and shelf displays, banners and posters. The Company has neither relied upon nor conducted any advertising in the consumer media for its loose leaf chewing tobacco products.

The majority of ***ZIG-ZAG*** premium cigarette papers promotional activity is at the wholesale distributor level and consists of distributor promotions, trade shows and trade advertising. The MYO smoking tobaccos and related products promotional activity is more focused at the retail level with spending on point-of-sale displays and at the consumer level with price-off promotions, primarily through the use of coupons.

The Company provides to its distributor customers, for redistribution to retailers, point-of-sale materials, such as, posters, pole signs, display racks and counter top and floor displays. The Company also produces marketing materials for use by distributors and their direct sales force to promote the sale of its products to their retail customers. The Company responsibly focuses its marketing efforts on adult consumers, and is committed to full legal compliance in the sale and marketing of its products.

The Company s largest customers, COD Company and the McLane Company, accounted for approximately 18.25% and 8.64%, respectively, of its net sales in 2004. The loss of either of these customers could have a material adverse effect on the results of operations, financial position and cash flows of the Company. The Company does not believe that the loss of any other customer would have a material effect on the results of operations, financial position or cash flows of the Company either in the intermediate or long term.

Distribution Agreements

NAOC is party to two long-term distribution and licensing agreements with Bolloré with respect to sales of premium cigarette papers, cigarette tubes and cigarette injector machines (collectively the Products) in the United States and Canada (collectively, the Distribution Agreements). Under the Distribution Agreements, Bolloré granted NAOC the exclusive right to purchase the Products bearing the ***ZIG-ZAG*** brand name from Bolloré for resale in the United States and Canada. NAOC has the sole right to determine the price and other terms upon which NAOC may resell any products purchased from Bolloré, including the right to determine the distributors of such products within these countries.

The Distribution Agreements establish the purchase pricing mechanism for premium cigarette papers through 2004, which allows certain adjustments to reflect increases in the U.S. and Canadian Consumer Price Indices and to account for material currency fluctuations. The Distribution Agreements provide that, in order to assure each of the parties commercially reasonable profits in light of inflationary trends and currency translation factors, prior to December 31, 2004 and each fifth-year anniversary from such date thereafter, the parties would enter into good faith negotiations to agree on an

10

Table of Contents

index and currency adjustment formula to replace the index and formula currently in effect. If the parties are unable to agree, the dispute is to be submitted to binding arbitration. The Company and Bolloré have agreed to extend the existing pricing mechanisms for a new five year term.

Pursuant to the Distribution Agreements, export duties, insurance and shipping costs are the responsibility of Bolloré and import duties and excise taxes are the responsibility of NAOC. Bolloré s terms of sale are 45 days from the bill of lading date and its invoices are payable in Euros. The Distribution Agreements reduce catastrophic foreign exchange risk by providing that Bolloré will bear certain exchange rate risks at levels fixed through 2004, which terms have been extended through 2009.

According to the Distribution Agreements, NAOC must purchase the Products from Bolloré, subject to Bolloré fulfilling its obligations under these agreements. Bolloré is required by the agreements to provide NAOC with the quantities and quality of the products that it desires. The Distribution Agreements provide NAOC with certain safeguards to help ensure that NAOC will be able to secure a steady supply of product. Such safeguards include (i) granting NAOC the right to seek third party suppliers with continued use of the ***ZIG-ZAG*** trademark if Bolloré is unable to perform its obligations or ceases its cigarette paper manufacturing operation, in each case as set forth in the Distribution Agreements, and (ii) maintaining a two month supply of safety stock inventory of the premium papers, tubes and injector machines in the United States at Bolloré s expense.

Under the Distribution Agreements, NAOC has also agreed for a period of five years after the termination of such Distribution Agreements not to engage, directly or indirectly, in the manufacturing, selling, distributing, marketing or otherwise promoting in the United States and Canada, of premium cigarette paper or premium cigarette paper booklets of a competitor without Bolloré s consent, except for certain de minimis acquisitions of debt or equity securities of such a competitor and certain activities with respect to an alternative supplier used by NAOC as permitted under the Distribution Agreements.

Each of the Distribution Agreements was entered into on November 30, 1992. Each of the U.S. Distribution Agreement and the Canada Distribution Agreement was for an initial twenty year term commencing on the date of such agreement and will be renewed automatically for successive twenty year terms unless terminated in accordance with the provisions of such agreement. Each of the Distribution Agreements permits Bolloré to terminate such agreement (i) if certain minimum purchases (which, in the case of the U.S. Distribution Agreement and the Canada Distribution Agreement were significantly exceeded in 2004) of premium cigarette paper booklets have not been made by the Company for resale in the jurisdiction covered by such agreement within a calendar year; (ii) if the Company assigns such agreement without the consent of Bolloré (other than certain permissible assignments to wholly owned subsidiaries of the Company); (iii) upon a change of control of NAOC or any parent of NAOC without the consent of Bolloré; (iv) upon certain acquisitions of equity securities of NAOC or any parent of NAOC by a competitor of NAOC or certain investments by significant stockholders of the Company in a competitor of NAOC; and (v) certain material breaches, including NAOC s agreement not to promote, directly or indirectly, premium cigarette paper or premium cigarette paper booklets of a competitor. Additionally, the Canada Distribution Agreement is terminable by either NAOC or Bolloré upon the termination of the U.S. Distribution Agreement.

Patents, Trademarks and Trade Secrets

The Company has numerous registered trademarks relating to its loose leaf chewing tobacco and MYO tobacco products, including the trademarks for its ***Beech-Nut***, ***Trophy, Havana Blossom***, ***Durango*** and ***Tennessee Chew*** products. The Company is applying for registration of its

Table of Contents

Fred s Choice, ***Old Hillside***, ***Our Pride*** and ***Stoker s Number 2*** trademarks. The registered trademarks, which are significant to the Company s business, expire periodically and are renewable for additional 20-year terms upon expiration. Flavor and blend formulae trade secrets relating to NTC s and NAOC s tobacco products, which are key assets of their businesses, are maintained under strict secrecy. The ***ZIG-ZAG*** trade name and trademark for premium cigarette papers and related products are owned by Bolloré and have been exclusively licensed to NAOC in the United States and Canada. NAOC owns the ***ZIG-ZAG*** trademark with respect to tobacco products. The Company s catalog business is operated under the Fred Stoker & Sons, Inc. name.

Raw Materials, Product Supply and Inventory Management

Loose Leaf Chewing Tobacco

NTC s loose leaf chewing tobacco is produced from air-cured leaf tobacco. Each of the Company s brands has its own unique tobacco blend. NTC utilizes tobaccos grown domestically in Pennsylvania and Wisconsin as well as those imported from countries such as Argentina, Brazil, France, Germany, Indonesia, Italy, and the Philippines. Management does not believe that it is dependent on any single country source for tobacco. Pursuant to agreements with NTC, Lancaster Leaf Tobacco Company of Pennsylvania, a wholly owned subsidiary of Universal Corporation (Lancaster), (i) purchases and processes tobacco on an exclusive basis, (ii) stores tobacco inventory purchased on behalf of NTC and (iii) generally maintains a 12- to 24-month supply of NTC s various tobacco types at their facilities. NTC generally maintains up to a two-month operating supply of tobacco at its manufacturing facilities in Louisville, Kentucky.

In addition to raw tobacco, NTC s loose leaf chewing tobacco products include food grade flavorings, all of which have been approved by the Food and Drug Administration and/or other federal agencies. NTC is not dependent upon any single supplier for those raw materials or for the supply of its packaging materials.

NTC generally maintains up to a two-month supply of finished loose leaf chewing tobacco. This supply is maintained at the Louisville facility and in four regional bonded public warehouses to facilitate distribution.

MYO Products

Pursuant to NAOC s Distribution Agreements with Bolloré, NAOC must purchase its premium cigarette papers, cigarette tubes and cigarette injecting machines from Bolloré, subject to Bolloré fulfilling its obligations under these agreements. If Bolloré is unable or unwilling to perform its obligations or ceases its cigarette paper manufacturing operation, in each case as set forth in the Distribution Agreements, NAOC may seek third-party suppliers and continue the use of the ***ZIG-ZAG*** trademark. To ensure that NAOC has a steady supply of premium cigarette paper products as well as each style of cigarette tubes and injectors, Bolloré is required to maintain, at its expense, a two-month supply of inventory in a public warehouse in the United States. See Distribution Agreements.

To facilitate general distribution, in addition to the inventory maintained by Bolloré, NAOC also maintains a supply of its products at the Louisville facility and in four regional bonded public warehouses.

NAOC obtains their MYO smoking tobaccos primarily from international sources and are not dependent on any one type of tobacco for its blends. NAOC purchases these smoking tobaccos

Table of Contents

principally through multiple purchasing agents. The MYO related products are purchased in finished form from various suppliers at Bolloré s direction.

Bolloré has from time to time been unable to produce and supply the Company with sufficient quantities of cigarette tubes and injectors due, in part, to the rapid growth in NAOC s sales of those products. Bolloré has not, however, experienced any problems supplying the Company with sufficient quantities of its premium cigarette paper products. Management currently believes that the Company s other sources for its supplies are adequate for its projected needs.

Premium Cigarettes

The Company outsources the manufacture of its ***ZIG-ZAG*** Premium Cigarettes. The Company purchases all of the raw materials used in the manufacture of its ***ZIG-ZAG*** Premium Cigarettes, including the tobacco, papers, filters and packaging, and arranges for the raw materials to be delivered to the contract manufacturer who then assembles the finished product under the Company s supervision. Similar to the Company s arrangement with Lancaster Leaf Tobacco Company of Pennsylvania for its loose leaf chewing tobacco products, Blending Services International, Inc., a wholly-owned subsidiary of Universal Corporation, is the exclusive purchaser of the tobacco used in its ***ZIG-ZAG*** Premium Cigarettes. Kentucky Cut Rag, LLC processes the tobacco, and the Company stores the processed tobacco in its Louisville, Kentucky facility. The Company generally maintains a one-year supply of tobacco at its Louisville facility. The Company obtains the other raw materials for its ***ZIG-ZAG*** Premium Cigarettes from various other sources. The Company is not dependent on one single source for any of its other raw materials.

The manufacturing agreement for the Company s ***ZIG-ZAG*** Premium Cigarettes provides that the contract manufacturer will manufacture the Company s requirements for the product on an as-needed basis. The contract is terminable by the Company upon 90 days written notice. The Company maintains quality control personnel at the contract manufacturer s facility to oversee the manufacturing process and to test the finished product. Once the manufacturing is completed, the contract manufacturer ships the finished goods to bonded public warehouses to facilitate distribution.

Manufacturing

The Company s subsidiaries manufacture their loose leaf chewing tobacco products at their manufacturing facility in Louisville, Kentucky. They also contract for the manufacture of their premium cigarette papers, cigarette tubes, rolling and injector machines, MYO smoking tobaccos and ***ZIG-ZAG*** Premium Cigarettes. In the case of its MYO smoking tobacco products, the subsidiaries complete the processing of and packaging of these products at their manufacturing facility in Louisville. The Company consolidated its manufacturing operations into its Louisville manufacturing facility in 2004, eliminating its manufacturing facility in Dresden Tennessee. The Company believes that its production capabilities, quality control procedures, research and development activities and overall facilities and equipment are adequate for its projected operations.

Production and Quality Control

The Company uses proprietary production processes and techniques, including strict quality controls. During the course of each day, NTC s quality control group periodically tests the quality of the tobacco; flavorings; application of flavorings; premium cigarette papers, tubes and injectors; and packaging materials. The Company utilizes sophisticated quality control and pilot plant production equipment to test and closely monitor the quality of its products. The quality of the Company s products

Table of Contents

is largely the result of using high grade tobacco leaf, food-grade flavorings and an ongoing analysis of tobacco cut, flavorings and moisture content.

Given the importance of contract manufacturing to the Company, the Company s quality control group ensures that established written procedures and standards are strictly adhered to by each of its contract manufacturers.

Research and Development

The Company has a Research and Development Department that reformulates existing loose leaf and MYO tobacco products in an effort to maintain a high level of product consistency and to facilitate the use of less costly raw materials without sacrificing product quality. The Company believes that for all of its tobacco products, including MYO, it has been and will continue to be able to develop cost effective blends of tobacco and flavorings that will maintain or reduce overall costs without compromising high product quality. The Research and Development Department is also responsible for new product development, which includes the development and testing of ***ZIG-ZAG*** Premium Cigarettes.

Approximately $539,000, $577,000 and $521,000 was spent on research and development and quality control efforts for the years 2002, 2003 and 2004, respectively.

Facilities

NTC s Louisville facility was formerly owned and used by Lorillard for the manufacture of cigarettes, little cigars and chewing tobacco. This approximately 600,000 square foot facility occupies a 26-acre urban site near downtown Louisville. The facility s structures occupy approximately one-half of the total acreage. The facilities are in very good condition and have received regular maintenance and capital improvements. The facility provides ample space to accommodate an expansion of the Company.

The Company believes its production capabilities, quality control procedures, research and development and overall facilities and equipment are adequate for its projected operations.

Competition

The Company, through NTC and Stoker, is the third largest manufacturer and marketer of loose leaf chewing tobacco in the United States. The other three principal competitors in the loose leaf chewing tobacco segment, which, together with the Company, generate approximately 98% of this segment s sales, are Swedish Match North America, Inc., Conwood Corporation and Swisher International Group Inc. Management believes that moist snuff products are used interchangeably with loose leaf products by many consumers and, as a result, US Smokeless Tobacco Company, the largest manufacturer of moist snuff (and of all smokeless tobacco products when taken as a whole) is also a significant competitor. As indicated above under Industry and Markets, sales of moist snuff have grown over the past decade while sales of loose leaf have declined during that same period. In addition, the Company s three principal competitors in the loose leaf chewing tobacco segment also manufacture and market moist snuff.

NAOC is the largest importer and distributor in North America of premium cigarette papers. NAOC s three major competitors for premium cigarette paper sales are Republic Tobacco, L.P., Robert Burton Associates, Inc., a wholly-owned subsidiary of Imperial Tobacco Group plc and VCT B.V. Although there is no source for comprehensive industry data, the Company believes that it, together with

Table of Contents

these three companies, collectively have a market share in excess of 95% of the premium cigarette papers market.

The Company s principal competitors in the MYO segment are Republic Tobacco, L.P., in conjunction with its TOP Tobacco, L.P. subsidiary, and Lane Ltd, a division of Reynolds America, Inc., the third largest cigarette company in the United States. Many other companies also compete in this segment, including Peter Stokebye International A/S, and Santa Fe Natural Tobacco, a Division of Reynolds America Inc. These competitors, unlike the Company, all are granted protected share under the cigarette MSA which allows them to avoid a substantial amount of their payment obligations under that agreement. The Company does not have protected share and therefore is at an economic disadvantage with respect to those competitors. (See State Attorney General Settlement Agreements .)

The Company s primary competitors in the manufactured cigarette market are the three majors : Philip Morris USA, Inc., the brands of which accounted for approximately 50% of all cigarette sales in the United States in 2004; R.J. Reynolds Tobacco Company Inc.; and Lorillard Tobacco Company, as well as Vector Group Ltd. (the parent company of Liggett Group Inc.).

Many of the Company s competitors are better capitalized than the Company and have greater financial and other resources than those available to the Company. The Company believes that its ability to effectively compete and its strong market positions in its principal product lines are due to its high brand recognition and the perceived quality of each of its products, its manufacturing and operating efficiencies, and its sales, marketing and distribution efforts.

Employees

As of March 15, 2005, the Company, through its subsidiaries, employed a total of 296 full-time employees. With the exception of 100 manufacturing employees, none of the Company s employees are represented by unions. The unionized employees are covered by three collective bargaining agreements. Two of these agreements, covering 98 employees, will expire in January 2008. The other agreement, covering two employees, will expire in April 2008.

Regulation

The tobacco industry, in particular, cigarette manufacturers has been under public scrutiny for over forty years. Industry critics include special interest groups, the U.S. Surgeon General and many legislators at the state and federal levels. Although smokeless tobacco companies have recently come under some scrutiny, the principal focus has been directed at the manufactured cigarette market due to its large size relative to the smokeless tobacco market and the MYO segment of the cigarette market.

Producers of tobacco products are subject to regulation in the United States at federal, state and local levels. Together with changing public attitudes towards tobacco consumption, the constant expansion of regulations, including increases in various taxes, requirements that tobacco products be displayed behind-the-counter and public smoking restrictions, has been a major cause of the overall decline in the consumption of tobacco products since the early 1970 s. Moreover, the future trend is toward increasing regulation of the tobacco industry.

In 1996, the U.S. Food and Drug Administration (the FDA) promulgated regulations asserting jurisdiction over tobacco products. These regulations, among other things, included severe restrictions on the manufacture, distribution and sale of tobacco products and required compliance with a wide range of labeling, reporting, record keeping, manufacturing and other requirements, among other

Table of Contents

things. On March 21, 2000, the U.S. Supreme Court ruled that the FDA does not have the authority to regulate tobacco products without more explicit direction from Congress and that the FDA regulations were unconstitutional. The Company remains, however, subject to regulation by numerous other federal agencies, including the Federal Trade Commission (FTC). If Congress were to enact legislation granting the FDA specific authority over tobacco products, the FDA s exercise of jurisdiction could lead to more expansive FDA-imposed restrictions on tobacco operations than those set forth in the current regulations.

In 2004, Congress passed a federal buyout program for tobacco farmers. The costs associated with the quota buy-out will be borne by all importers and domestic manufacturers selling any form of tobacco product sold in the US. The buy-out provides for a $10 billion payment to farmers over a 10 year period, with payments based on a calculation of assessed market share in each tobacco product segment. Payments under the buyout scheme will be assessed quarterly on manufacturers beginning March 31, 2005 and ending March 31, 2015. The buyout initial assessment on individual manufacturers will be received during the first half of 2005, and at that time the Company will be in a position to provide better guidance on the financial implications of this program.

In recent years, a variety of bills relating to tobacco issues have been introduced in the U.S. Congress, including bills that would (i) prohibit the advertising and promotion of all tobacco products and/or restrict or eliminate the tax deductibility of such advertising expenses; (ii) increase labeling requirements on tobacco products to include, among other things, additional warnings and lists of additives and toxins; (iii) modify federal preemption of state laws to allow state courts to hold tobacco manufacturers liable under common law or state statutes; (iv) shift regulatory control of tobacco products and advertisements from the Federal Trade Commission to the Food and Drug Administration; (v) increase tobacco excise taxes; and (vi) require tobacco companies to pay for health care costs incurred by the federal government in connection with tobacco related diseases. Hearings have been held on certain of these proposals; however, to date, none of such proposals have been enacted by Congress. Future enactment of such proposals or similar bills, depending upon their content, could have a material adverse effect on the results of operations or financial condition of the Company.

While there are no current federal or state regulations that materially and adversely affect the sale of premium cigarette papers, there can be no assurance that federal, state or local regulations will not be enacted which will seek to regulate premium cigarette papers. In the event such regulations are enacted, depending upon their parameters, they could have a material adverse effect on the results of operations, financial position and cash flows of NAOC and the Company.

The Company s catalog business is also subject to various federal, state and local regulations, which, among other things, prohibit the sale of tobacco products to minors. Further regulations could have an adverse impact on the Company s catalog business.

State Attorney General Settlement Agreements

On November 23, 1998, the major U.S. cigarette manufacturers, Philip Morris USA, Inc., Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company and R.J. Reynolds Tobacco Company, entered into the MSA with attorneys general representing the Settling States. The MSA settled all the asserted and unasserted health-care cost recovery actions brought by, or on behalf of, the settling jurisdictions.

In the Settling States, the MSA released all signing parties from all claims of the Settling States and their respective political subdivisions and other recipients of state health-care funds, (i) relating

16

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 and (ii) 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.

The MSA also contains provisions restricting signatory companies in their advertising, promotion and marketing of cigarettes in the U.S. Among these are restrictions or prohibitions on the use of cartoon characters, brand name sponsorships, targeting of youth, outdoor advertising, event sponsorship (such as concerts and sporting events), payments for product placement, providing free samples, and branded apparel and merchandise.

Required Payments

The MSA required the four OPMs to make a series of initial payments over five years totaling $13.2 billion. The last of these five payments was paid on January 10, 2003. The MSA also requires annual industry payments for participating manufacturers which were $8.0 billion in 2004, but will increase to $8.13 billion in 2008, and to $9.0 billion in 2017 and thereafter in perpetuity. Ten additional payments of $861 million are due annually beginning in April 2008. All payments are to be allocated among the OPMs on the basis of relative national market share and most are subject to adjustments, including but not limited to, adjustments for inflation, volume, loss of market share to SPM s and NPM s, operating income, and payments to the four Non-MSA States.

National Public Education Fund

In addition, the MSA calls for the creation of a national foundation that would establish public education and other programs, and conduct or sponsor research, to reduce youth smoking, and to understand and educate the public about diseases associated with tobacco product use. OPMs agreed to fund the foundation with (i) ten annual payments of $25 million due by March 31 of each year until 2008 and (ii) five additional payments totaling $1.45 billion due by March 31 of each year that increased from $250 million in the first year to $300 million in each of the subsequent four years. The last of these five payments was paid on March 31, 2003. In addition, if for any calendar year beginning with 2003, the OPMs have an aggregate market share of 99%, the OPMs are obligated to pay $300 million to the Fund by April 15th of the following year. Each of these payments is to be allocated among the OPMs on the basis of relative market share. Other than the $25 million annual payments and the $250 million payment made on March 31, 1999, the payments for the foundation are subject to adjustments for changes in sales volume units, inflation and other factors.

MSA Fees and Litigation Costs

The OPMs also agreed to pay the litigation costs, including government attorneys fees, of the offices of the Attorneys General relating to the settled cases and, subject to certain quarterly and annual payment caps, the costs and fees of outside counsel to the jurisdictions.

Inflation Adjustment

The inflation adjustment applied to annual and strategic contribution payments and to payments for the benefit of the national public education fund established by the foundation. It increases payments on a compound annual basis by the greater of 3% or the actual total percentage change in the consumer price index for the preceding year. The inflation adjustment is measured starting with inflation for 1999.

Table of Contents

Volume Adjustment

The volume adjustment applies to initial payments, annual and strategic contribution payments and payments for the benefit of the national public education fund established by the foundation. It increases or decreases payments for OPMs based on the increase or decrease in the total number of cigarettes shipped in or to the 50 states, the District of Columbia and Puerto Rico by the OPMs during the preceding year, as compared to the 1997 base number of cigarettes shipped by the OPMs. When volume has increased, the volume adjustment increases payments by the same percentage as the number of cigarettes exceeds the 1997 base number. When volume has decreased, the volume adjustment decreases payments by a percentage equal to 98% of the percentage reduction in volume. There are also limits to the extent to which OPMs can benefit by volume decreases in years where OPMs achieve certain increases in aggregate operating income.

Subsequent Participating Manufacturers

Under the MSA each SPM is required to make payments in any year that equal, on a per-cigarette basis, the sum of the annual and st