

# THE SKOR FOOD GROUP INC.

## MANAGEMENT DISCUSSION AND ANALYSIS

**DATE OF PREPARATION:** January 25, 2007

**PERIOD:** THE FIRST QUARTER ENDED NOVEMBER 30, 2006

### General

The following discussion and analysis provides a review of the consolidated financial conditions and operating performance of The Skor Food Group Inc. (the "Company" or "SKOR") and its subsidiaries for the three month period ended November 30, 2006. This discussion and analysis should be read in conjunction with the consolidated financial statements and accompanying notes. Any reference herein to 2006 shall mean the three month period ended November 30, 2006 and any reference herein to 2005 shall mean the three month period ended November 30, 2005.

### Compliance with General Accepted Accounting Principles

Unless otherwise indicated, the financial information presented is expressed in Canadian dollars and prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). SKOR utilizes earnings before interest and taxes, depreciation and amortization ("EBITDA") as a measurement tool. This measure is a widely accepted financial indicator but it is not a measurement determined in accordance with GAAP and may not be similar to the EBITDA presented by other companies.

### Overview

SKOR, through its recently amalgamated Skor Food Service Ltd. operating division is a full service, wholesale food distributor to the food service industry, offering more than 7,000 items from its 200,000 square foot warehouse in Vaughan, Ontario. Skor Cash and Carry is a wholesaler to the independent retail grocer and convenience industry with 11 locations throughout Southern Ontario selling more than 10,000 private label and name brand, frozen goods, refrigerated products and dry goods including confectionary and tobacco. SKOR services a wide range of multi location food retailers, Quick Service Restaurant chains, day care facilities, government institutions, independent food service operators as well as vending operators and convenience stores in Ontario from these two divisions.

SKOR, through its Skor Franchise Inc. division is a franchisor of the regionally based seven-location Galaxie Diner chain. The Galaxie Diner locations are generally free standing 2-4,000 ft<sup>2</sup> facilities located within 60 miles of the Greater Toronto Area. As of January 25, 2007 there are seven franchise locations and no corporate locations.

Revenue from franchise locations are generated from royalty and franchise fees, sales of turn key projects, re-sales and other income generated from exclusive supplier agreements.

On January 19, 2007, SKOR incorporated a wholly owned subsidiary named Skor Culinary Concepts Inc. which then acquired 100% of the issued and outstanding shares of three Greater Toronto Area food manufacturing and processing companies. These acquired companies are in the business of producing sandwiches and meals for the catering and vending industries.

### Overall Performance

#### The Industry

The food service industry is characterized as a mature industry growing at a level consistent with the geographical population expansion. There are a limited number of food service distributors providing country-wide service to the

restaurant and hospitality industry with the majority of food service firms focused on servicing niche geographic, product or ethnic markets. Successful food distributors compete on high quality service, competitive prices and breadth and depth of product offering. SKOR is considered a mid size regional provider of products focused on the institutional and regional based quick service restaurant chains located throughout Ontario.

The wholesale cash and carry business in Ontario is also a mature industry. The marketplace is dominated by large firms such as National Grocers (Loblaws) and Sam's Club (Walmart) and Costco, who supply both retailers and consumers from the same locations. SKOR Cash and Carry is positioned as the largest independent cash and carry operator servicing the independent retail market. SKOR competes with numerous smaller geographic and ethnic focused competitors with single locations offering a limited breadth of products. Customers are price sensitive on certain key product lines (tobacco, confectionary and name brand beverages) where margins are historically very competitive.

The franchise business is a growth market as individuals seek opportunities to secure their future with proven business concepts. The Quick Service Restaurant (QSR) space which Galaxie Diner competes (nostalgic value-oriented diner style) is not presently dominated by any one large Franchisor. Well known names in the Greater Toronto Area market segment include Golden Griddle, Sunset Grill and Angel's Diner.

The food manufacturing industry is also a mature business, growing at rates consistent with geographical population expansion. Specifically focusing on manufactured product for the vending and catering industry in the Greater Toronto Area, the business would be considered mature but is extremely fragmented with no dominant, industry leader.

## **Risks**

### **Risks and Uncertainties**

Management is focused on maximizing profits and enhancing shareholder value by proactively managing the internal and external risks of the business. Some of these risk factors are summarized below;

- Credit risk associated with selling to independent food service operators and convenience store retailers;

SKOR manages its accounts receivable diligently, nonetheless, a material component of the business is transacted with independent operators (i.e. family owned and operated). Typically, family owned firms are not well capitalized and may experience a higher level of failure in the initial years of operation. The risk of non payment is mitigated by obtaining additional security where appropriate and restricting the terms to industry standards. As an additional tool to reduce overall credit risk, third party accounts receivable insurance was instituted in the first quarter of fiscal 2007.

- Certain operating costs may not be passed on to customers;

In light of the competitive operating and low-inflationary environment, it is difficult to pass on price increases to offset higher costs for such items as fuel, utilities and property taxes. SKOR manages this risk by reviewing its operations and associated costs on a continual basis.

- Economic reliance on discretionary cash flow of the consumer for a portion of the business;

SKOR services a broad range of customers including government institutions, municipalities, quick service restaurants, retailers and independent food service operators. In tougher economic times, consumers may spend less of their discretionary income on dining out which could cause a contraction in the market size to which SKOR sells. Management believes that SKOR is somewhat sheltered from this market fluctuation, given its solid foundation of institutional business together with its focus on the quick service restaurant market, which tends to be less sensitive to consumer spending.

- Competitive marketplace;

SKOR is a well positioned regional competitor in a marketplace which has three distinct segments; large national, broad-line distributors; the family owned niche providers of product focused on either a geographic or ethnic market; or the mid-tier regional firms which are focused on providing broad-line product coverage to a regional market. SKOR competes in the Ontario regional segment against firms of all sizes. Given the market dominance of three large well capitalized firms

(Loblaws, Walmart and Costco), SKOR does not attempt to compete head on with these firms, however, certain product lines must be kept competitive to maintain traffic flow and customer loyalty. As such, certain product lines such as tobacco operate on extremely low gross margins; however, SKOR is attempting to reduce the reliance on these product categories by focusing its energies on expanding its higher margin product lines.

- Product obsolescence and spoilage;

SKOR is a distributor of a broad range of products and as such does not feel that product obsolescence or spoilage is an issue which could materially impact financial results. Inventory is well managed and as such, products which are extremely sensitive and therefore have a limited shelf life are purchased on a just-in-time basis for specific customer orders.

- Low Margin and Inflation;

Profit levels may be negatively impacted during periods of price deflation as margins remain consistent, however, revenue may decline. During periods of inflation, it is possible that customers may resist paying higher prices for product costs passed on by the manufacturer to the distributor.

- Changes to distribution channels initiated by Suppliers

During the course of normal business operations, suppliers may attempt to reduce, eliminate or change the distribution channels or pricing to those channels. These distribution channel changes may result in a reduction in business through SKOR which could have a material effect on revenue and gross margin.

- Seasonality and weather

The franchise business may experience fluctuations resulting from a number of factors such as economic conditions, effects of severe weather and seasonality at certain locations due to their proximity to traditional vacation destinations.

- Maintaining and growing existing franchise locations with qualified franchisees and attractive locations

The growth of the franchise network is dependent on maintaining the current franchise system which is subject to the renewal of existing leases at sustainable rates and obtaining and retaining qualified franchisees to grow the business.

## **Results of Operation- Quarter Ended November 30, 2006**

### **Revenue**

Consolidated revenue increased by 119.25% on a year over year basis from \$20,514,885 to \$44,976,355. The revenue increase is attributed primarily to the inclusion of revenue from the Cash and Carry acquisition, which was completed on March 31, 2006. The Galaxie Diner acquisition completed on August 24, 2006 provided very little financial impact on these financial statements.

### **Cost of Sales and Gross Profit**

Gross profit margins decreased on an absolute basis by 4.98% from 16.77% in 2005 to 11.79% in 2006. Margins were negatively impacted by the exposure to tobacco sales at the Cash and Carry, which accounted for more than 50% of revenue at margins of less than 0.5%.

On a forward looking basis, gross profit margins are expected to be in the 12-14% range as tobacco margins continue to negatively impact the overall returns. Margins may also fluctuate dependent upon the mix of products sold to customers throughout the year.

## Expenses

On a consolidated basis, operating expenses for 2006, excluding the provision for income taxes, interest and amortization increased by 74.73% to \$4,351,634 from \$2,490,401 in 2005.

Total operating expenses, including interest and amortization increased by 78.8% to \$4,615,486 from \$2,581,506. Negatively impacting expenses was higher amortization (\$163,030 increase) which is reflective on the increased investment in fixed assets attributable to the acquisition of the Cash and Carry operations. The increased operating costs are due primarily to additional employees and overhead expenses incurred in conjunction with the acquisitions completed in the past year.

## Stock Based Compensation (“SBC”)

The company applies a fair value based method of accounting to all stock-based payments. In the current quarter, no options were issued and as a result, there was no stock based compensation expense. In the prior comparable year’s comparable period, there was an expense of \$23,505. The expenses are reflected in operating expenses.

## Earnings before Interest, Taxes, Depreciation and Amortization (“EBITDA”)

Excluding one time events such as relocation costs, stock based compensation, loss on the disposal of equipment and one time events related to uncollectible bad debts, normalized EBITDA decreased by \$23,243 to \$951,893 from \$975,136 the prior year. EBITDA was \$0.04 per basic common share outstanding for the period compared to \$0.05 the prior year.

## Net Earnings

Net earnings, after tax and relocation costs, increased by 1.0% to \$479,461 from \$473,939 the prior year.

## Summary of Quarterly Results

	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006	Q4 2005	Q3 2005	Q2 2005
Revenue(\$)	44,976,355	64,581,997	49,934,439	18,354,074	20,514,885	22,335,456	20,701,165	17,832,822
Earnings before tax and extraordinary items(\$)	688,041	808,003	845,453	626,049	853,252	815,262	747,906	529,487
Net Earnings(\$)	479,461	493,854	531,939	229,215	473,939	518,630	490,953	325,633
EPS-Basic	.02	.02	.02	.01	.03	0.03	.03	.02
EPS-Diluted	.02	.02	.02	.01	.03	0.03	.03	.02
Outstanding Shares-Basic	25,703,340	25,491,279	24,969,105	17,938,757	17,938,757	17,938,757	17,822,614	15,048,187

All amounts are in CDN Dollars.

The most recent three quarter results for fiscal 2006 include the acquisition of the Cash and Carry operations, which was completed March 31, 2006. The food service business is affected by seasonality with traditionally weaker revenue experienced in the first and second quarter of the fiscal year.

## Capital Investments and Acquisitions

During the period \$176,158 was invested in property plant and equipment. The majority of this investment was devoted to the construction of an expanded cooler at our head office facility. The investment in capital equipment provides the necessary infrastructure to support or near term and mid-term growth.

No acquisitions were completed in the first quarter.

## **Liquidity and Capital Resources**

### **Working Capital**

Working capital consists primarily of inventory and accounts receivable. As at November 30, 2006, SKOR had a working capital ratio of 2.22:1, and working capital of \$12,041,985. SKOR has adequate working capital and available lines of credit to support projected near term growth.

Day's sales outstanding (DSO) are in line with managements' expectations. Management continually reviews credit policies and collection procedures with an objective to maintain its DSOs to 25 days or less for food service customers and 7 days for valued customers of the Cash and Carry.

SKOR maintained approximately 28 days worth of inventory at quarter end, an amount which is considered adequate to effectively service its customers. The year over year inventory increase is a function of the more traditional higher levels maintained at the Cash and Carry operations. Tighter inventory controls and consolidation of the systems and inventory at the food service operation should result in a more efficient operation with reduced inventory levels and an improved cash conversion cycle.

Based upon the level of business being transacted by SKOR, the strict management of inventory and the close scrutiny of accounts receivable, working capital is deemed adequate to support near term organic growth. As income is retained in the business and recognizing that capital expenditures are expected to return to historical levels, working capital is expected to strengthen. The firm manages its working capital and draws on its bank operating facility to maximize supplier early payment discounts and special pricing opportunities where deemed appropriate.

### **Bank Debt**

At quarter end, SKOR had an operating line of credit of \$6,000,000 with a Schedule A Canadian Chartered Bank, (secured by a charge on the assets of the company), which was deemed sufficient to meet the near term operating requirements of the business. The operating facility was less than 10% utilized at period end.

The term facilities originally funded in fiscal 2004 are being amortized over a period of 5 and 7 years respectively, requiring total monthly principal payments of \$44,833 plus accrued interest. All payments are current and the balance outstanding at quarter end was \$1,699,805. The term facilities mature in the third quarter of fiscal 2007 and management has an agreement from its lender to extend the term facilities for a further 3 years upon expiry.

The existing credit facilities are deemed adequate to support the organic growth of the consolidated group, providing additional flexibility to fund expected growth.

### **Capital Expenditure Commitments**

Skor has no capital commitments outstanding as at quarter end.

### **Capital Resources**

SKOR's conservative long term debt to equity ratio of 0.09:1 provides flexibility to add additional leverage to the balance sheet to complete further acquisitions.

At the present time, the Company has approved lease facilities with its lenders that are yet to be funded. These available credit facilities are deemed sufficient to support SKOR's near term lease requirements.

### **Financial Instruments and Other Instruments**

The company is exposed to certain interest rate risks, which have been identified earlier under the bank debt section and are summarized below.

## **Foreign Exchange Risk**

SKOR purchases and sells more than 99.5% of its products in local currency and is therefore exposed to minimal foreign exchange risk.

## **Interest Rate Risk**

At quarter end, SKOR is exposed to interest rate risk as it relates to its operating credit. Based upon expected usage of \$1,000,000.00, each 25 basis point change in borrowing costs impacts quarterly interest expense by \$625.00. Equipment financing is set with fixed interest rates and will amortize to \$0 in due course.

The floating rate term facilities provided by a Schedule "A" Bank exposes SKOR to interest rate risk; however, the facility offers the ability for SKOR to convert to a fixed rate option at any time. At this time, a 25 basis point change in floating rate borrowing costs impacts quarterly interest expense by \$2,812, based upon projected average utilization of \$4,500,000 for the next twelve month period.

SKOR has not utilized derivatives to hedge or speculate on interest rate changes.

## **Off Balance Sheet Arrangements**

SKOR has issued indemnities in respect to letters of credit issued by its bank for letters of credit in favour of certain customers for future performance under specific contracts. As at November 30, 2006, there was \$20,000 worth of letters of credit issued and outstanding.

## **Transactions with Related Parties**

In the most recent quarter and in the normal course of business, SKOR purchased approximately \$160,984 worth of product at or below market rates, from/to a Company, which certain officers and directors of SKOR have a financial interest in.

SKOR has no other contractual obligations with respect to inter-company transactions.

## **Legal Proceedings**

There has been no change since year end.

## **Management Changes**

Nil

## **New Accounting Pronouncements**

Nil

## **Disclosure Controls**

The Company's Chief Executive Officer and Chief Financial Officer are responsible for establishing and maintaining the Company's disclosure controls and procedures, including adherence to the Disclosure Policy adopted by the Company.

The Chief Executive Officer and the Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures as of November 30, 2006, have concluded that the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its subsidiaries would have been known to them.

## **Capital Stock – Common Shares as at January 25, 2007**

Issued and Outstanding (August 31, 2006)	25,623,670
Add:	
Options (Expiry March 22, 2009)	140,000

Options (Expiry October 27, 2008)	145,000
Options (Expiry January 2009)	480,000
Options (Expiry December 2009)	100,000
Broker Warrants (Expiry September 30, 2008)	450,000
Issuance of Share (Exercise of Options)	<u>125,000</u>
Diluted	27,088,670

## Significant Events during the Quarter

Nil

## Subsequent Events

On December 28, 2006, a total of 100,000 options were issued to Board of Director members.

On January 19, 2007, the Company incorporated a wholly owned subsidiary named Skor Culinary Concepts Inc. which then acquired 100% of the issued and outstanding common shares of three Greater Toronto Area food manufacturing and process companies for an aggregate price of \$3.15 million, subject to final adjustments. The purchase was financed using a combination of existing working capital and bank financing.

## Outlook

On December 31, 2006, Derry Foods Limited amalgamated with its wholly owned subsidiary, Gorman Distributing Ltd. to form Skor Food Service Ltd., a wholly owned subsidiary of The Skor Food Group Inc. At that time, accounting systems and operational procedures were consolidated, providing the foundation to aggressively focus on improving operating efficiencies while proactively building organic sales growth.

At the Cash and Carry level, management will continue to focus its energies in the near term on building brand awareness and aggressively promoting its food service focus.

At the newly acquired manufacturing and processing division, the near term focus over the next three quarters will be the consolidation of three facilities into one centralized federally regulated, HACCP recognized, food production facility that will service its existing customers as well as the requirements currently outsourced to third parties by Skor Food Service and Skor Cash and Carry.

## Additional Information

Additional information relating to the Corporation is available under the Corporation's profile on the SEDAR website at [www.sedar.com](http://www.sedar.com). Shareholders may contact the Corporation to request copies of the financial statements and MD&A by: (i) mail to 10 Ronrose Drive, Vaughan Ontario L4K 4R3 or (ii) fax to (905) 660-4848.

## Forward-Looking Information

The Company and its representatives periodically make written and oral forward-looking statements, including those contained in this document and all documents and reports disseminated to shareholders and the public. Forward-looking statements involve significant risk, uncertainties and assumptions that could result in actual results being different from anticipated performance. SKOR cautions readers to the risks, uncertainties and assumptions of forward-looking statements. Although the forward-looking statements the Company makes are based on what management believes to be reasonable assumptions at the time the statements are made, the Company cannot guarantee or assure prospective investors that actual results will be consistent with SKOR's forward looking statements.