

# **THE SKOR FOOD GROUP INC.**

## **MANAGEMENT DISCUSSION AND ANALYSIS**

**DATE OF PREPARATION:** April 27, 2007

**PERIOD:** THE THREE AND SIX MONTH PERIOD ENDED FEBRUARY 28, 2007

### **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 and six month period ended February 28, 2007. This discussion and analysis should be read in conjunction with the consolidated financial statements and accompanying notes. Any reference herein to 2007 shall mean the three and six month period ended February 28, 2007 and any reference herein to 2006 shall mean the three and six month period ended February 28, 2006.

### **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 is a vertically integrated regional based food Company that manufactures and distributes products through its two operating divisions. Additionally and to a significantly lesser extent, the firm is a retail brand owner through its franchise operations.

The 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 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 at April 27, 2007 there are five 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 Skor Culinary Concepts Inc. which then acquired 100% of the issued and outstanding shares of three Greater Toronto Area food manufacturing and processing companies for a total consideration of \$3.1 million plus adjustments for working capital. These acquired companies are in the business of creating and distributing ready to eat sandwiches and meals for the catering, vending and institutional market.

## **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 is mature but is extremely fragmented with no dominant, industry leader. The market offers considerable opportunity for consolidation in the GTA market over the next few years as existing operators seek out viable and attractive exit strategies.

### **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 through Euler Hermes 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- Three and Six Months Ended February 28, 2007**

### **Revenue**

For the quarter, consolidated revenue increased by 121% on a year over year basis from \$18,354,074 to \$40,536,162. On a year to date basis, revenue increased by 120% from \$38,868,959 to \$85,512,517. 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 as it represents less than 1% of overall group revenue. The acquisition of Skor Culinary Concepts was completed on January 19, 2007 and accordingly, revenue from the acquisition represented less than 4% of overall revenue.

Food service revenue was negatively impacted in the most recent period by poor early winter snow conditions in Ontario. The lack of snow, together with warmer than normal temperatures, resulted in lower sales to the resort and recreational business segment in Ontario.

Food service revenue was positively impacted by the inclusion of seven weeks worth of revenue for distribution to the 241 Pizza chain. This chain was acquired by one of our existing clients and the distribution business was granted to SKOR in early 2007.

Skor Culinary operates in a seasonal business which experiences traditional slower sales periods from December 1 to March 31 of each year. With available capacity and plans to consolidate operations at new facilities in the near term, management's objective is to diversify its customer base in an attempt to minimize these seasonal fluctuations in sales volumes.

Skor Cash and Carry revenue declined in the most recent quarter as tobacco related sales continued to be under competitive pressure. Furthermore, seasonality and a reduced number of selling days, due to the timing of the holidays, negatively impacted revenue for the period. Operating issues in the wholesale and retail grocery marketplace have been well documented in the past six months in the marketplace. As an example, Loblaws recently announced the closure of a substantial number of its wholesale National Grocer locations which is Skor Cash and Carry's primary competitor in the wholesale distribution segment. In summary, grocery wholesaling and retailing is currently facing extreme price competition, lack of customer loyalty and increasing costs of operation. SKOR is managing the operations by prudently watching costs, reducing its reliance on the convenience channel market and focusing on expanding its food service offerings to the independent food service operator.

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

In the quarter, gross profit margins decreased on an absolute basis by 4.9% from 19.1% in 2006 to 14.2% in 2007. Margins were negatively impacted by the exposure to tobacco sales at the Cash and Carry level, which accounted for approximately 25% of consolidated revenue at margins of less than 0.5%.

On a year to date basis, margins declined by 5.0% percent to 13.0% of revenue, a function of the product mix and the inclusion of the cash and carry business in the current period.

On a forward looking basis, gross profit margins are expected to be in the 12-15% 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.

The inclusion of Skor Culinary will positively impact gross margins going forward with the expectations of margins in this business exceeding 25%.

### **Expenses**

In the quarter, operating expenses increased by 90% to \$5,367,776 from \$2,818,683 in the comparable prior year period.

On a consolidated basis, operating expenses for the first six months of fiscal 2007, excluding the provision for income taxes, interest and amortization increased by 83% to \$9,719,410 from \$5,309,084 in 2006.

Costs increased due to the inclusion of the acquisitions completed in the past year together with increases associated with operating in a larger head office facility.

For the six month period, total operating expenses, including interest and amortization increased by 87% to \$10,318,473 from \$5,517,171. Negatively impacting expenses was higher amortization (\$351,276 increase) which is reflective of the increased investment in fixed assets attributable to the acquisition of the Cash and Carry operations, moving costs of \$31,484 and associated internal labour costs of approximately \$18,000 for the consolidation of the two Cash and Carry Vaughan facilities into a single location at Corporate Head Office. Furthermore, more than \$50,000 in incremental internal labour costs was expensed to re-align all Cash and Carry locations to become more "food service oriented" which

will provide the opportunity to more aggressively promote and attract food service business in each market area that SKOR competes.

### Stock Based Compensation (“SBC”)

The company applies a fair value based method of accounting to all stock-based payments. In the current period, 100,000 director options were issued and as a result, there was a \$9,850 (2006-\$0.00) charge for stock based compensation which is reflected in operating expenses.

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

Excluding one time events such as relocation costs, stock based compensation and the loss on the disposal of equipment, normalized EBITDA for the six month period decreased by \$320,400 to \$1,383,476 from \$1,703,876 the prior year. EBITDA was \$0.05 per basic common share outstanding for the period compared to \$0.09 the prior year. For the most recent quarter, EBITDA decreased by \$304,174 to \$431,583 (\$0.02/ share) from \$735,757 (\$0.04/share) in the comparable prior year period.

The decline in EBITDA was a function of a significant seasonal decline in business due to poor weather conditions and as a result a more competitive wholesale/retail environment.

### Net Earnings

In the quarter, earnings declined by 87.0% to \$30,120 (\$0.00/ share) from \$229,215 (\$0.01/ share) the prior year.

For the year to date period, net earnings, after tax and relocation costs, decreased by 27.5% to \$509,580 (\$0.02/ share) from \$703,154 (\$0.04/ share) the prior year.

As mentioned earlier, the decline in earnings is a function of a greater than expected seasonal decline in revenue, increased operating costs associated with infrastructure (i.e. facility rental, property taxes) and a competitive labour market which has increased labour costs.

### Summary of Quarterly Results

	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006	Q4 2005	Q3 2005
Revenue(\$)	40,536,162	44,976,355	64,581,997	49,934,439	18,354,074	20,514,885	22,335,456	20,701,165
Earnings before tax and extraordinary items(\$)	86,522	688,041	808,003	845,453	626,049	853,252	815,262	747,906
Net Earnings(\$)	30,119	479,461	493,854	531,939	229,215	473,939	518,630	490,953
EPS-Basic	.00	.02	.02	.02	.01	.03	0.03	.03
EPS-Diluted	.00	.02	.02	.02	.01	.03	0.03	.03
Outstanding Shares-Basic	25,748,670	25,703,340	25,491,279	24,969,105	17,938,757	17,938,757	17,938,757	17,822,614

All amounts are in CDN Dollars.

The most recent four quarter results include the acquisition of the Cash and Carry operations, which was completed March 31, 2006 and the inclusion of Skor Culinary Concepts, which was completed January 19, 2007. 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 six month period, \$311,503 was invested in property plant and equipment in the normal course of business. A further investment of \$3,150,492 was primarily attributable to the acquisition of the three companies which comprise Skor Culinary Concepts Inc., and to a lesser extent additional closing costs associated with the acquisition of the Galaxie Diner

Franchise assets. Total costs associated with the three Skor Culinary acquisitions may be adjusted when the final closing statements and documents have been received and finalized by all parties to the agreement.

## **Liquidity and Capital Resources**

### **Working Capital**

Working capital consists primarily of inventory and accounts receivable. As at February 28, 2007, SKOR had a working capital ratio of 1.73:1, and working capital of \$10,112,536. Working capital was negatively impacted by the inclusion of \$3,065,485 in current portion of long term debt which matures in the third quarter of this year. A commitment has been received by SKOR's Bank to extend the term of the facility for a further three years which will positively impact working capital by more than \$2,000,000 beginning in third quarter. 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 30 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 \$1,565,485. 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.

SKOR obtained new term debt financing authorizations of \$3,000,000 to complete the acquisition of the companies acquired by Skor Culinary Concepts Inc. The facility includes a \$1,500,000 portion which will be termed out in conjunction with the maturity of the existing term facility and the second portion of \$1,500,000 will be interest only for a period of 1 year after which time the drawn down portion will be converted to a reducing term facility.

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

### **Capital Expenditure Commitments**

SKOR has no new capital commitments outstanding as at quarter end.

## **Capital Resources**

SKOR's conservative long term debt to equity ratio of 0.23:1 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 \$2,000,000.00, each 25 basis point change in borrowing costs impacts quarterly interest expense by \$1,250.00. 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 \$2,344, based upon projected average utilization of \$3,750,000 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 February 28, 2007, there were \$20,000 worth of letters of credit issued and outstanding.

### **Transactions with Related Parties**

In the most recent period and in the normal course of business, SKOR purchased approximately \$290,098 (2006-\$424,386) and sold \$455 (2006-\$15,576) 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 activity on the outstanding claims reported at year end. The amount of any potential loss is indeterminable at this time and accordingly, no provision has been made in these financial statements.

### **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 February 28, 2007, 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 April 27, 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 7, 2007)	450,000
Issuance of Shares (Exercise of Options)	<u>125,000</u>
Diluted	27,063,670

## Significant Events during the Quarter

As outlined above, SKOR completed the acquisition of three manufacturing firms under the Skor Culinary Concepts Division and successfully consolidated and re-branded its food service distribution operations as Skor Food Service Ltd.

## Subsequent Events

Nil

## Outlook

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. Management is focused on cost containment, rationalization of products and the development of the necessary systems to be more proactive, consistent and timely with its retail pricing structure.

The Food Service unit will continue to aggressively seek out new customers while building business with its existing customers through a more aggressive and proactive sales approach. At the same time, supplier partnerships will be managed with the expectation of improving the overall pricing structure of our purchases. Historically, revenue increase in the third and fourth quarter of the fiscal year and we expect that based upon sales opportunities in the pipeline, we should experience significant improvements going forward. SKOR will focus aggressively on managing its costs with the utilization of new technology which is expected to be implemented in the third quarter of this year. It is expected that technological improvements together with route and trucking consolidation will provide two avenues of cost reduction commencing in the third quarter.

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, 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.