UNIVERSAL CORP /VA/
Form 424B5
March 15, 2006
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**The information in this preliminary prospectus supplement and the accompanying prospectus is not complete and may be changed. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell these securities and they are not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

**Filed Pursuant to Rule 424(b)(5)**

**Registration No 333-130061**

**Subject to completion, dated March 14, 2006**

**Prospectus Supplement to Prospectus Dated December 1, 2005**

# Universal Corporation

## 200,000 Shares

## % Convertible Perpetual Preferred Stock

(Liquidation Preference $1,000 per share)

We are offering 200,000 shares of % convertible perpetual preferred stock (the preferred stock ). Cash dividends on the preferred stock are payable when, as and if declared by our board of directors, out of funds legally available therefore, at the rate of % per annum, quarterly in arrears on each March 15, June 15, September 15 and December 15, commencing June 15, 2006. Dividends on the preferred stock are not cumulative. Each share of preferred stock will have a liquidation preference of $1,000 and will be convertible at any time into shares of our common stock at a conversion rate of shares per share of preferred stock, subject to specified adjustments, which is currently equal to a conversion price of approximately $ per share of common stock.

Beginning March 15, 2018, we may redeem all or a portion of the preferred stock by paying cash in an amount equal to the liquidation preference. In addition, if at any time between March 15, 2013 and March 15, 2018, inclusive, the closing price of our common stock exceeds 135% of the prevailing conversion price for 20 trading days during any consecutive 30 trading day period, we may cause the preferred stock to be automatically converted into the number of shares that are issuable at the then prevailing conversion rate.

If a fundamental change occurs on or before March 15, 2018, we will pay a make-whole premium on preferred stock converted in connection therewith. Also, if we become subject to a fundamental change, holders may require us to redeem any or all of their shares of preferred stock at the liquidation preference, and we may choose to pay the redemption price in cash, shares of our common stock, or a combination thereof.

Our common stock is traded on the New York Stock Exchange under the symbol UVV. On March 14, 2006, the closing price of our common stock was $39.50 per share. We do not intend to apply for listing of the preferred stock on any securities exchange or for inclusion of the preferred stock in any automated quotation system.

**Investing in the preferred stock involves risks. See Risk Factors beginning on page S-11.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.**

| | Per Share | Total |
|---|---|---|
| Public offering price | $ | $ |
| Underwriting discounts and commissions | $ | $ |
| Proceeds, before expenses, to Universal Corporation | $ | $ |

We have granted the underwriters a 30-day option to purchase up to 20,000 additional shares of preferred stock solely to cover over-allotments.

**Deutsche Bank Securities**
(Sole Book-Running Manager)

**Wachovia Securities**
(Co-Lead Manager)

**UBS Securities LLC**

**LaSalle Capital Markets**

**Rabo Securities USA, Inc.**

**The date of this prospectus supplement is March , 2006**

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### Prospectus Supplement



### Prospectus



## ABOUT THIS PROSPECTUS SUPPLEMENT

This document is in two parts. The first part is this prospectus supplement, which describes the terms of the offering of preferred stock and also adds to and updates information contained in the accompanying prospectus and the documents incorporated by reference into the accompanying prospectus. The second part is the accompanying prospectus, which provides more general information. To the extent there is a conflict between the information contained in this prospectus supplement, on the one hand, and the information contained in the accompanying prospectus or any document incorporated by reference therein, on the other hand, you should rely on the information in this prospectus supplement.

You should rely only on the information contained in this prospectus supplement, the accompanying prospectus and the documents we incorporate by reference in this prospectus supplement. The list of documents incorporated by reference into the accompanying prospectus is superseded by the list of documents incorporated by reference into this prospectus supplement. The only documents incorporated by reference into this document (including both this prospectus supplement and the accompanying prospectus) are the documents listed under Where You Can Find More Information in this prospectus supplement. We have not authorized anyone to provide you with information that is different. We are offering our preferred stock only in jurisdictions where such offers are permitted. The information contained in this prospectus supplement and the accompanying prospectus is accurate only as of their respective dates, regardless of the time of delivery of this prospectus supplement or of any sale of our preferred stock. It is important for you to read and consider all information contained in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference in this prospectus supplement in making your investment decision. You should also read and consider the information in the documents to which we have referred in Where You Can Find More Information below.

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## PROSPECTUS SUPPLEMENT SUMMARY

*The following summary may not contain all the information that is important to you. You should read the entire prospectus supplement, as well as the information to which we refer you and the information incorporated by reference, before making an investment decision. When used in this prospectus supplement, the terms  Universal,   issuer,   we,   our  and  us  refer to Universal Corporation and its consolidated subsidiaries, unless otherwise specified.*

### Universal Corporation

We are one of the world s leading leaf tobacco merchants and processors, based on the volume we handle. We also have operations in lumber and building products distribution and agri-products. Our consolidated revenues and total segment operating income were approximately $3.3 billion and $254 million, respectively, for the fiscal year ended March 31, 2005, and $2.7 billion and $159 million, respectively, for the nine months ended December 31, 2005.

We are a holding company that operates through numerous directly and indirectly owned subsidiaries. Our two primary subsidiaries are Universal Leaf Tobacco Company, Incorporated ( Universal Leaf ) and Deli Universal, Inc. ( Deli ). We operate our tobacco business primarily through Universal Leaf and our non-tobacco business through Deli, although Deli also owns some minor tobacco business interests and approximately 10% of Universal Leaf s major tobacco operations in Brazil. We also participate in the sale of oriental tobacco through ownership of a 49% equity interest in Socotab, L.L.C.

Our business strategy is to enhance shareholder value by achieving several key objectives, such as operating as a single entity worldwide with strong local management, fostering strategic alliances with our customers, increasing market share in traditional areas while developing new areas, maintaining diversified sources of leaf tobacco and maintaining our financial strength.

We conduct operations in numerous foreign countries. In fiscal year 2005, approximately 24% and 21% of our revenue was derived from products delivered to customer locations in the Netherlands and the United States, respectively. As of March 31, 2005, approximately 33% of our long-lived assets were in the United States, while approximately 23% were in the Netherlands, and approximately 11% were in Brazil. During the nine-month period ended December 31, 2005, we invested about $61 million in our fixed assets, with the largest portion spent in Africa, where we completed the construction of a processing facility in Mozambique.

We employed more than 28,000 employees throughout the world during the fiscal year ended March 31, 2005. Because the majority of our employees are seasonal, this figure is only an estimate.

Our executive offices are located at 1501 North Hamilton Street, Richmond, Virginia 23230, and our telephone number and website address are (804) 359-9311 and www.universalcorp.com.

**Current Developments**

*Revolving Credit Facility*

In February 2006, we determined that certain restructuring and impairment charges, combined with lower than expected operating results for the quarter ended December 31, 2005, and a decrease in committed tobacco inventories caused by shipments during the quarter, caused a covenant breach under our revolving credit agreement and a secured term loan. Waivers of the covenant violation were received from a sufficient number of the banks participating in the revolving credit facility, and no event of default occurred under the agreement. We decided to repay the secured term loan on February 7, 2006, using borrowings under the revolving credit facility. No covenants were breached in any of our other debt obligations. However, unless we obtain another waiver or we amend the revolving credit agreement prior to March 31, 2006, we will be in default thereunder. We are currently working with our bank group and expect to amend our revolving credit agreement to allow greater room under the waived covenant into the next fiscal year. Proceeds from the preferred stock will be used to repay a portion of our borrowings under the revolving credit facility and to repay certain other debt.

*Enhancing Shareholder Value*

We recently announced that as part of our strategy for enhancing shareholder value, we routinely evaluate alternatives, including acquisitions, divestitures and strategic alliances, in each of our business units. We have received and recently considered an offer for a substantial portion of our non-tobacco operations and have been in discussions on the offer. We will continue to consider such alternatives, which could include the continuation of those discussions. However, there can be no assurance that such discussions will ultimately result in a transaction.

*U.S. Foreign Corrupt Practices Act*

We also recently announced that as a result of a posting to our Ethics Complaint hotline alleging improper activities involving or related to certain of our tobacco subsidiaries, the Audit Committee of our Board of Directors engaged an outside law firm to conduct an investigation of the alleged activities. That investigation revealed that there have been payments that may have violated the U.S. Foreign Corrupt Practices Act. At this time, the payments involved appear to have approximated $1 million over a five-year period. In addition, the investigation revealed activities in foreign jurisdictions that may have violated the competition laws of such jurisdictions, but we believe those activities did not violate U.S. antitrust laws. We have voluntarily reported these activities to the appropriate U.S. authorities. We have initiated and are continuing to take corrective action.

If the U.S. authorities determine that there have been violations of the Foreign Corrupt Practices Act, or if the U.S. authorities or the authorities in foreign jurisdictions determine there have been violations of other laws, they may seek to impose sanctions on us or our subsidiaries that may include injunctive relief, disgorgement, fines, penalties and modifications to business practices. It is not possible to predict at this time whether the authorities will determine that violations have occurred, and if they do, what sanctions they might seek to impose. It is also not possible to predict how governmental investigations or any resulting sanctions may affect our business, financial condition, results of operations or financial performance, although such sanctions, if imposed, could be material to our results of operations in any quarter. We will continue to cooperate with the authorities in these matters.

*Moody s Downgrade*

On March 14, 2006, citing our earnings and cash flow pressures, Moody s Investors Service downgraded our long-term credit rating from Baa3 to Ba1 and our short-term credit rating from P-3 to Not Prime, assigned a corporate family rating of Ba1, and left our long-term ratings under review for further possible downgrade. The reduction in our credit rating below investment grade may lead to increased interest costs and limit our access to capital markets. Our management communicates regularly with the rating agencies and intends to continue to take actions to improve the company s financial status.

**Tobacco Operations**

Since our founding in 1918, we have focused principally on tobacco operations, and for the fiscal year ended March 31, 2005, such operations accounted for 51% of revenues and 77% of segment operating income. For the nine months ended December 31, 2005, such operations accounted for 52% of revenues and 78% of segment operating income, although tobacco segment operating income was lower compared to last year due to continued weakness in South American results from lower operating margins on the poor quality, more-expensive Brazilian crop, as well as a decline in demand for our blended strip products. Our tobacco business includes selecting, buying, shipping, processing, packing, storing and financing of leaf tobacco in tobacco growing countries for sale to, or for the account of, manufacturers of tobacco products throughout the world. We do not manufacture cigarettes or other consumer tobacco products.

We conduct our tobacco business in varying degrees in a number of countries, including Argentina, Belgium, Brazil, Canada, Colombia, the Dominican Republic, France, Germany, Guatemala, Hungary, India, Indonesia, Italy, Malawi, Mexico, Mozambique, the Netherlands, Paraguay, the People s Republic of China, the Philippines, Poland, Portugal, Russia, Singapore, South Africa, Spain, Switzerland, Tanzania, Uganda, the United Kingdom, the United States, Zambia and Zimbabwe. In addition, Socotab, L.L.C. has oriental tobacco operations in Bulgaria, Greece, Macedonia and Turkey.

We normally operate our processing plants for approximately seven to nine months of the year. During this period, inventories of green tobacco, inventories of redried tobacco and trade accounts receivable normally reach peak levels in succession. Tobacco inventories at December 31, 2005, were $712 million, up $103 million from the level at March 31, 2005, and down $85 million from the level at September 30, 2005. Current liabilities, particularly short-term notes payable to banks, commercial paper and customer advances, are means of financing this expansion of current assets and normally reach their peak during processing periods.

A material part of our tobacco business is dependent upon a few customers. For the year ended March 31, 2005, Altria Group, Inc. and its affiliates accounted for more than 10% of our revenues. The loss of, or substantial reduction in business from, Altria or any other significant customer would have a material adverse effect. We have maintained long-standing relationships with these customers.

**Agri-Products Operations**

For the fiscal year ended March 31, 2005, our agri-products operations accounted for 23% of our revenues and 5% of segment operating income, and for the nine-month period ended December 31, 2005, accounted for 24% of our revenues and 5% of segment operating income. The agri-products segment reported a loss in the third quarter of fiscal year 2006 due to approximately $12 million in inventory write-downs and losses on firm purchase commitments for almonds and sunflower seeds. Our agri-products business involves selecting, buying, processing, storing, shipping, financing and distributing as well as importing and exporting a number of products, including tea, rubber, sunflower seeds, nuts, dried fruit, and canned and frozen foods. We source products from numerous countries, including Argentina, China, Egypt, Indonesia, Kenya, Malawi, Mexico, Sri Lanka, Thailand, Turkey and the United States.

**Lumber and Building Products Operations**

We are engaged in the lumber and building products distribution and processing business in the Netherlands and other countries in Europe, and such operations accounted for 26% of revenues and 18% of segment operating income for the fiscal year ended March 31, 2005, and for 24% of

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revenues and 17% of segment operating income for the nine-month period ended December 31, 2005. Earnings from the lumber and building products distribution segment were lower for the nine-month period ended December 31, 2005, due to ongoing price pressure from do-it-yourself retailers, which negatively affected margins in the retail supply division. This decline was partly offset by improved results in the construction supply division.

Our activities in this segment are conducted through two business units: construction supply and retail supply. The construction supply unit, with its customer base in the Dutch building construction sector, sells a broad range of lumber and related building products through a network of regional outlets. The construction supply unit also includes specialized units that manufacture window frames and prefabricated elements and doors and units that distribute related products. Our construction supply sales for the fiscal year ended March 31, 2005, accounted for about 12% of the market volume for similar products in the Netherlands. This is similar to the market share of its largest competitor in this sector, PontMeyer N.V.

The retail supply unit has a strong customer base in the Benelux. It supplies do-it-yourself retailers, home improvement stores and garden center outlets with a broad range of lumber and related products, including company-manufactured garden timbers and garden houses.

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**The Offering**

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| Issuer | Universal Corporation |
| Securities offered | 200,000 shares of % Convertible Perpetual Preferred Stock, no par value (220,000 shares if the underwriters exercise in full their option to purchase additional shares of preferred stock). |
| Liquidation preference | $1,000 per share of preferred stock. |
| Dividends | Holders of preferred stock will be entitled to receive, when, as and if declared by our board of directors, out of funds legally available therefor, cash dividends at the rate of % per annum of the liquidation preference, payable quarterly on March 15, June 15, September 15 and December 15 of each year commencing June 15, 2006 (each, a dividend payment date ). |
| | A dividend period is the period from and including a dividend payment date to but excluding the next dividend payment date, except that the initial dividend period will commence on and include the original issuance date of the preferred stock and will end on and exclude the June 15, 2006, dividend payment date. Dividends payable on the preferred stock will be computed on the basis of a 360-day year consisting of twelve 30-day months. |
| | Dividends on the preferred stock are not cumulative. If our board of directors has not declared a dividend before the dividend payment date for any dividend period, then such dividend will not accumulate and holders of the preferred stock will have no right to receive, and we will have no obligation to pay, a dividend for that dividend period on the related dividend payment date or at any future time, whether or not we declare dividends on the preferred stock for any future dividend period. |
| | Subject to certain restrictions, we may pay any dividend on the preferred stock in cash, by delivery of shares of our common stock or through any combination of cash and shares of our common stock. |
| | For so long as the preferred stock remains outstanding, (1) we will not declare, pay or set apart funds for the payment of any dividend or other distribution with respect to any junior stock and (2) neither we nor any of our subsidiaries will, subject to certain exceptions, redeem, purchase or otherwise acquire for consideration junior stock through a sinking fund or otherwise, in each case unless we have paid or set apart funds for the payment of the full dividends with respect to the shares of preferred stock and all parity stock for the latest completed dividend period. These restrictions will continue following any such failure to pay dividends until full dividends on all outstanding shares of the preferred stock and parity stock for four consecutive dividend periods have been declared and paid. |

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| | For any dividend period in which dividends are not paid in full upon the preferred stock and any parity stock, all dividends declared for such dividend period with respect to the preferred stock and such parity stock shall be declared on a pro rata basis.<br><br>See Description of the Preferred Stock Dividends. |
| Dividend Payment Restrictions | The Certificate of Designation for the preferred stock prohibits the declaration of dividends on the preferred stock if we fail to meet specified levels of shareholders equity and net income. The prohibition is subject to an exception permitting us to declare dividends payable in shares of our common stock or out of the net proceeds of common stock issued by us during the 90 days prior to the date of declaration even if we fail to meet the specified levels of shareholders equity and net income.<br><br>See Description of the Preferred Stock Dividends Restrictions on Declaration and Payment of Dividends. |
| Use of proceeds | We expect to receive approximately $193.6 million in net proceeds from this offering ($213 million if the option to purchase additional preferred stock is exercised in full), after deducting the underwriters discounts and commissions and our estimated offering expenses. We intend to use the net proceeds from this offering to repay debt outstanding under our revolving credit facility and to repay certain other debt. See Use of Proceeds. |
| Conversion | The preferred stock is convertible, at the option of the holder, at any time into shares of our common stock at a conversion rate of shares of our common stock per $1,000 liquidation preference of preferred stock, which represents an initial conversion price of approximately $ per share of common stock.<br><br>In lieu of delivering shares, we may, at our option, deliver cash to satisfy all or a portion of the conversion value. We intend that, if we elect to settle a portion of these conversions in cash, the cash portion will not exceed the net proceeds to us of sales of shares of certain types of securities having sufficient equity characteristics, in each case that are issued within six months (or, in the case of common stock issued upon the exercise of options, within 12 months) before the conversion.<br><br>The conversion rate may be adjusted for certain reasons as described under the caption Description of Preferred Stock Adjustments to the Conversion Rate. If a fundamental change occurs, we will adjust the conversion price as described under Description of Preferred Stock Fundamental Change Make Whole Payment Upon the Occurrence of a Fundamental Change.<br><br>If we declare a distribution consisting exclusively of cash to holders of our common stock (excluding (1) dividends or distributions in connection with our liquidation, dissolution or winding up and (2) any quarterly cash dividend on our shares of common stock to the extent that the aggregate cash dividend per share amount of our common stock in any quarter does not exceed $0.43, which amount we refer to as the Dividend |

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| | Threshold Amount ), the conversion rate will be adjusted by multiplying the applicable conversion rate by the following fraction: |

$$\frac{\text{Pre Dividend Stock Price}}{\text{Pre Dividend Stock Price - Dividend Adjustment Amount}}$$

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| | Pre Dividend Stock Price means the average common stock price for the three consecutive trading days ending on the trading day immediately preceding the ex date for such dividend or distribution. Dividend Adjustment Amount means the full amount of the dividend or distribution to the extent payable in cash applicable to one common share less the Dividend Threshold Amount. If an adjustment is required to be made as a result of a distribution that is not a quarterly dividend, the dividend threshold amount will be deemed to be zero. |
| | See Description of Preferred Stock Adjustments to the Conversion Rate for additional discussion of adjustments that may be made to the conversion rate. |
| Mandatory conversion | On or after March 15, 2013 and on or before March 15, 2018, we may, at our option, cause the preferred stock to be automatically converted into that number of shares of common stock that are issuable at the then prevailing conversion rate. We may exercise our conversion right only if, for 20 trading days within any period of 30 consecutive trading days (including the last trading day of such period), the closing price of our common stock exceeds 135% of the then prevailing conversion price of the preferred stock. |
| | In lieu of delivering shares, we may, at our option, deliver cash to satisfy all or a portion of the conversion value. We intend that, if we elect to settle a portion of these conversions in cash, the cash portion will not exceed the net proceeds to us of sales of shares of certain types of securities having sufficient equity characteristics, in each case that are issued within six months (or, in the case of common stock issued upon the exercise of options, within 12 months) before the conversion. |
| Optional redemption | On or after March 15, 2018, we will have the option from time to time to redeem all or a portion of the outstanding shares of preferred stock. The redemption price will be equal to the liquidation preference and will be paid in cash. We intend that, if we redeem the preferred stock, we will redeem it only to the extent that the aggregate liquidation preference of the preferred stock redeemed is less than the amount, if any, of the net proceeds to us of sales of shares of certain types of securities having sufficient equity characteristics, in each case that are issued within six months (or, in the case of common stock issued upon the exercise of options, within 12 months) before the redemption. |
| Fundamental change | If a fundamental change (as described under Description of Preferred Stock Fundamental Change A Fundamental Change Requires Us to Redeem Shares of Preferred Stock at the Option |

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| | of the Holder ) occurs prior to March 15, 2018, each holder of shares of preferred stock will, subject to legally available funds, have the right to require us to redeem any or all of its shares at a redemption price equal to 100% of the liquidation preference. We may, subject to legally available funds, choose to pay the redemption price in cash, shares of common stock, or a combination thereof. Holders will have no other right to require us to redeem the preferred stock at any time. Our ability to redeem all or a portion of the preferred stock for cash is subject to our obligation to repay or repurchase any outstanding debt that may be required to be repaid or repurchased in connection with a fundamental change and to any contractual restrictions contained in the terms of any indebtedness that we have outstanding at that time. If a fundamental change occurs at a time when we are prohibited from redeeming shares of preferred stock for cash, we could seek the consent of our lenders to redeem the preferred stock or attempt to refinance the debt containing such prohibition. If, following a fundamental change, we are prohibited from paying the redemption price of the preferred stock in cash under the terms of any indebtedness or by applicable law, we will, if permitted under the terms of such indebtedness and applicable law, elect to pay the redemption price of the preferred stock in shares of common stock or, in the case of a merger in which we are not the surviving corporation, common stock of the surviving corporation or its direct or indirect parent corporation.<br><br>In addition, holders of shares of preferred stock shall not have the right to require us to repurchase shares of preferred stock upon a fundamental change (1) unless such purchase complies with our indentures and credit facilities and (2) unless and until our board of directors has approved such fundamental change or elected to take a neutral position with respect to such fundamental change. |
| Voting rights | Holders of preferred stock will not have any voting rights except as set forth below or as otherwise from time to time required by law. Whenever (1) dividends on the preferred stock or any other class or series of stock ranking on a parity with the preferred stock with respect to the payment of dividends shall have not been declared and paid for the equivalent of any four dividend periods, whether or not consecutive, or (2) we fail to pay the redemption price on the date shares of preferred stock are called for redemption (whether the redemption is pursuant to the optional redemption provisions or the redemption is in connection with a fundamental change) then, immediately prior to the next annual meeting of shareholders or special meeting of shareholders called by holders |

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| | of the preferred stock, the total number of directors constituting the entire board will automatically be increased by two and, in each case, the holders of preferred stock (voting separately as a class with all other series of preferred stock upon which like voting rights have been conferred and are exercisable) will be entitled to vote for the election of such directors at the next annual meeting of stockholders or special meeting of shareholders called by holders of the preferred stock and at each subsequent meeting until dividends on the preferred stock shall have been fully paid for at least four consecutive dividend periods. Directors elected by the holders of the preferred stock shall not be divided into classes of the board of directors and the term of office of all directors elected by the holders of preferred stock will terminate immediately upon the termination of the right of the holders of preferred stock to vote for directors and upon such termination the total number of directors constituting the entire board will automatically be reduced by two.<br><br>The affirmative consent of holders of at least 66 2/3% of the outstanding preferred stock (voting separately as a class with all other series of preferred stock upon which like voting rights have been conferred and are exercisable) will be required for the issuance of any class or series of stock (or security convertible into such stock) ranking senior to the preferred stock as to dividend rights or rights upon our liquidation, winding-up or dissolution and for amendments to our certificate of incorporation that would affect adversely the rights of holders of the preferred stock.<br><br>Holders of shares of preferred stock will have one vote for each share of preferred stock held. |
| Ranking | The preferred stock will be, with respect to dividend rights and rights upon liquidation, winding up or dissolution:<br><br>junior to all our existing and future debt obligations;<br><br>junior to senior stock, which is all classes or series of our capital stock, other than (1) our common stock and any other class or series of our capital stock the terms of which provide that such class or series will rank junior to the preferred stock and (2) any other class or series of our capital stock the terms of which provide that such class or series will rank on a parity with the preferred stock;<br><br>on a parity with parity stock, which is any class or series of our capital stock that has terms which provide that such class or series will rank on a parity with the preferred stock;<br><br>senior to junior stock, which is our common stock and each class or series of our capital stock that has terms which provide that such class or series will rank junior to the preferred stock; and<br><br>effectively junior to all of our subsidiaries (1) existing and future liabilities and (2) capital stock held by others. |
| Absence of a public market for the preferred stock | The shares of preferred stock are new securities for which there is currently no public market. We cannot assure you that any active or liquid market will develop for the preferred stock. |
| Trading | We have not applied and do not intend to apply for the listing of the preferred stock on any national securities exchange or for their inclusion in any automated quotation system. |
| NYSE symbol for our common stock | Our common stock is traded on the New York Stock Exchange under the symbol UVV. |

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For further information regarding the preferred stock, including, among other things, more complete descriptions of our dividend obligations, the conversion of the preferred stock, and the anti-dilution adjustments and voting rights applicable to the preferred stock, please see Description of Preferred Stock.

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## RISK FACTORS

*The foregoing discussion contains certain forward-looking statements. The following important factors, and those set forth in our annual report on Form 10-K for the fiscal year ended March 31, 2005, among other things, in some cases have affected, and in the future could affect, our actual results and could cause our actual results for a fiscal year and any interim period to differ materially from those expressed or implied in any forward-looking statements made by, or on behalf of, Universal. You should read these risk factors in conjunction with the risk factors under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations Factors That May Affect Future Results in our annual report on Form 10-K for the fiscal year ended March 31, 2005, incorporated herein.*

### Risks Related to the Preferred Stock

**The preferred stock will rank junior to all of our existing and future debt obligations and will not limit our ability to incur future indebtedness that will rank senior to or equally with the preferred stock.**

The preferred stock ranks junior to all of our existing and future debt obligations. In the event of our bankruptcy, liquidation or winding-up, our assets will be available to pay obligations on the preferred stock, including the redemption of your shares of the preferred stock for cash upon a fundamental change, only after all our indebtedness and other liabilities have been paid. The preferred stock will also rank junior to our senior stock and pari passu with our parity stock, as those terms are defined under Description of Preferred Stock Ranking.

In addition, the preferred stock will effectively rank junior to all existing and future liabilities of our subsidiaries and any capital stock of our subsidiaries held by others. The rights of holders of the preferred stock to participate in the distribution of assets of our subsidiaries will rank junior to the claims of that subsidiary s creditors and any such other equity holders. Consequently, if we are forced to liquidate our assets to pay our creditors, we may not have sufficient assets remaining to pay amounts due on any or all of the preferred stock then outstanding. We and our subsidiaries may incur substantial amounts of additional debt and other obligations that will rank senior to the preferred stock and the terms of the preferred stock will not limit the amount of such debt or other obligations that we may incur.

We may issue additional series of preferred stock that would rank equally to the preferred stock as to dividend payments and liquidation preference. The issuances of other series of preferred stock could have the effect of reducing the amounts available to the preferred stock in the event of our liquidation. It may also reduce dividend payments on the preferred stock if we do not have sufficient funds to pay dividends on all outstanding preferred stock and outstanding parity stock.

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**We may not be able to pay the redemption price of the preferred stock in cash upon a fundamental change.**

In the event of a fundamental change, you will have the right to require us to redeem any or all of your shares of preferred stock. We may, subject to legally available funds, choose to pay the redemption price in cash, shares of common stock, or a combination thereof. Our ability to redeem shares of preferred stock upon the occurrence of a fundamental change is subject to important limitations. Because we are a holding company, our ability to redeem the preferred stock for cash may be limited by restrictions on our ability to obtain funds for such redemption through dividends from our subsidiaries and the terms of our current and then-existing borrowing agreements. Our ability to redeem the preferred stock is also subject to restrictions under Virginia law. If a fundamental change were to occur, we may not have sufficient legally available funds to pay the redemption price in cash for all tendered shares of preferred stock. In addition, holders of shares of preferred stock shall not have the right to require us to repurchase shares of preferred stock upon a fundamental change (1) unless such purchase complies with our indentures and credit facilities and (2) unless and until our board of directors has approved or elected to take a neutral position with respect to such fundamental change. Our current revolving credit facilities do, and any future credit agreements or other agreements relating to our indebtedness may, contain provisions prohibiting the redemption of the preferred stock under certain circumstances, or expressly prohibit our redemption of the preferred stock upon a fundamental change or may provide that a fundamental change constitutes an event of default under that agreement. If a fundamental change occurs at a time when we are prohibited from redeeming shares of preferred stock for cash, we could seek the consent of our lenders to redeem the preferred stock or attempt to refinance this debt. If we do not obtain such consent, we would not be permitted to redeem the preferred stock for cash.

**We may be prevented from paying dividends on shares of the preferred stock.**

Our current credit facilities do, and any future credit agreements or other agreements relating to our indebtedness may, contain provisions prohibiting the payment of dividends on the shares of preferred stock under certain circumstances. Even if the terms of the instruments governing our indebtedness allow us to pay cash dividends, we can only make dividend payments from legally available funds, as determined by our board of directors, and such funds may not be available to pay cash dividends to you. Dividends on the preferred stock will only be paid when, as and if declared by our board of directors. The board of directors may elect not to declare dividends on the preferred stock. In addition, to maintain our credit ratings, we may be limited in our ability to pay dividends so that we can maintain an appropriate level of debt.

**Dividends on the preferred stock are non-cumulative.**

Dividends on the preferred stock are non-cumulative. Consequently, if our board of directors does not authorize and declare a dividend for any dividend period, holders of the preferred stock would not be entitled to receive any such dividend, and such unpaid dividend will cease to accrue and be payable. We will have no obligation to pay dividends accrued for a dividend period after the dividend payment date for such period if our board of directors has not declared such dividend before the related dividend payment date, whether or not dividends are declared for any subsequent dividend period with respect to the preferred stock or any other preferred stock we may issue.

**Our ability to declare and pay dividends on the preferred stock will be limited if we fail to achieve specified net income and shareholders equity levels.**

We are prohibited from declaring or paying dividends on the preferred stock if we fail to meet specified levels of shareholders equity and net income. The prohibition is subject to an exception permitting us to declare dividends payable in shares of our common stock or out of the net proceeds of common stock issued by us during the 90 days prior to the date of declaration even if we fail to meet the specified levels of shareholders equity and net income. If we fail to satisfy this test on any dividend declaration date, the restrictions on dividends will continue until we are able again to satisfy the test on a dividend declaration date. See Description of Preferred Stock Dividends Restrictions on Declaration and Payment of Dividends for more information on these restrictions.

**We are a holding company and, as a result, rely on the receipt of funds from our operating subsidiaries in order to meet our cash needs.**

We are a holding company and our principal assets consist of the shares of capital stock or other equity instruments of our operating subsidiaries. As a holding company without independent means of generating operating revenues, we depend on dividends, distributions, loans and other payments from our subsidiaries to fund our obligations and meet our cash needs. The payment of these dividends, distributions and other payments from our operating subsidiaries to us may be subject to regulatory or contractual restrictions. We cannot assure you that the operating results of our operating subsidiaries at any given time will be sufficient to make distributions to us to allow us to make payments on the preferred stock.

**An active trading market for the preferred stock may not develop, and you may be unable to resell your shares of preferred stock at or above the purchase price.**

No trading market for the preferred stock currently exists, and we have not applied and do not intend to apply for the listing of the preferred stock on any securities exchange or for the inclusion of the preferred stock in any automated quotation system. Consequently, a liquid trading market for the preferred stock may not develop, and the market price of the preferred stock may be volatile. As a result, you may be unable to sell your shares of preferred stock at a price equal to or greater than that which you paid, if at all.

**If you convert your shares of preferred stock into shares of common stock immediately after this offering, you will experience dilution.**

If you convert your shares of preferred stock into shares of common stock immediately after this offering, you will experience dilution, because the per-share conversion price of the preferred stock will be higher than the net tangible book value per share of the outstanding common stock. In addition, you will also experience dilution when and if we issue additional shares of common stock, which we may be required to issue pursuant to options, warrants, our stock option plan or other employee or director compensation plans.

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**The conversion rate of the preferred stock may not be adjusted for all dilutive events, which may adversely affect the trading price of the preferred stock.**

The conversion rate of the preferred stock is subject to adjustment for certain events. However, the conversion rate will not be adjusted for other events that may adversely affect the trading price of the preferred stock or the common stock. An event that adversely affects the value of the preferred stock may occur, and that event may not result in an adjustment to the conversion rate.

**The price of our common stock, and therefore of the preferred stock, may fluctuate significantly, which may make it difficult for you to resell the preferred stock, or common stock issuable upon conversion or redemption of the preferred stock, when you wish to resell or at prices you find attractive.**

The price of our common stock on the New York Stock Exchange constantly changes. We expect that the market price of our common stock will continue to fluctuate. Because the preferred stock is convertible into our common stock, volatility or depressed prices for our common stock could have a similar effect on the trading price of the preferred stock. Holders who have received common stock upon conversion or redemption will also be subject to the risk of volatility and depressed prices.

Our stock price can fluctuate as a result of a variety of factors, many of which are beyond our control. These factors include:

- new laws or regulations or new interpretations of existing laws or regulations applicable to our business;
- our inability to raise additional capital;
- sales of common stock by us or members of our management team;
- changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors; and
- our dividend policy.

The price of our common stock could be affected by possible sales of our common stock by investors who view the preferred stock as a more attractive means of equity participation and by hedging or arbitrage activity that may develop involving our common stock. The arbitrage could, in turn, affect the trading prices of the preferred stock.

In addition, the stock market in general has experienced extreme volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations may adversely affect the market price of our common stock.

**The additional shares of our common stock payable on our preferred stock in connection with a fundamental change may not adequately compensate you for the lost option time value of your shares of our preferred stock as a result of such fundamental change.**

If a fundamental change occurs on or prior to March 15, 2018, we will, in certain circumstances, increase the conversion rate of our preferred stock by a number of additional shares of common stock. The number of additional shares of our common stock will be determined based on the date on which the fundamental change becomes effective and the price of our common stock as described under Description of Preferred Stock Fundamental Change Make Whole Payment Upon the Occurrence of a Fundamental Change. While the increase in the conversion rate upon conversion is designed to compensate you for the lost option time value of your shares of preferred stock as a result of the fundamental change, the increase is only an approximation of this lost value

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and may not adequately compensate you for your loss. If the stock price is less than $ per share or above $ per share, there will be no increase in the conversion rate. In addition, in the event of a public acquirer fundamental change, as such term is defined under Description of Preferred Stock Fundamental Change Make Whole Payment Upon the Occurrence of a Fundamental Change, we may elect to adjust the conversion rate and the related conversion obligation rather than increase the conversion rate by a number of additional shares as described above. If we make such an election, you may not be adequately compensated for the lost option time value of your shares of preferred stock, even in circumstances under which the adjustment described above would have otherwise provided adequate compensation.

**Future issuances of preferred or cumulative preferred stock may adversely affect the market price for our common stock, or adversely affect the rights of holders of the preferred stock.**

Additional issuances and sales of preferred or cumulative preferred stock, or the perception that such issuances and sales could occur, may cause prevailing market prices for our common stock to decline and may adversely affect our ability to raise additional capital in the financial markets at a time and price favorable to us. Our future issuance of any series of preferred or cumulative preferred stock could therefore effectively diminish or supersede dividends on, and the liquidation preference and voting rights of, the preferred stock we are offering hereby.

**If you hold preferred stock, you will not be entitled to any rights with respect to our common stock, but you will be subject to all changes made with respect to our common stock if you convert your preferred stock into common stock or your preferred stock is redeemed for common stock.**

If you hold preferred stock, you will not be entitled to any rights with respect to our common stock (including, without limitation, voting rights and rights to receive any dividends or other distributions on our common stock, other than extraordinary dividends that our board of directors designates as payable to the holders of the preferred stock), but if you convert your preferred stock into common stock or your preferred stock is redeemed for common stock as a result of a fundamental change, you will be subject to all changes affecting the common stock. You will have rights with respect to our common stock only if and when we deliver shares of common stock to you upon conversion or redemption of your preferred stock and, to a limited extent, under the conversion rate adjustments applicable to the preferred stock. For example, in the event that an amendment is proposed to our certificate of incorporation or bylaws requiring stockholder approval and the record date for determining the stockholders of record entitled to vote on the amendment occurs prior to delivery of common stock to you, you will not be entitled to vote on the amendment, although you will nevertheless be subject to any changes in the powers or rights of our common stock that result from such amendment.

**We may not have sufficient earnings and profits for distributions on the preferred stock to be treated as dividends.**

The dividends paid by us may exceed our current and accumulated earnings and profits, as calculated for U.S. federal income tax purposes. This could result in the amount of the dividends that exceeds such earnings and profits being treated first as a return of capital to the extent of the holder s adjusted tax basis in the preferred stock, and the excess as capital gain. Such treatment will generally be unfavorable for corporate holders and may also be unfavorable to certain other holders. See Certain United States Federal Income Tax Consequences.

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**Our corporate documents and Virginia law contain provisions that could discourage, delay or prevent a change in control of our company even if some stockholders might consider such a development favorable, which may adversely affect the price of our common stock, or deprive you of an opportunity to obtain a takeover premium for shares of our common stock.**

Provisions in our restated articles of incorporation and bylaws may discourage, delay or prevent a merger or acquisition involving us that our stockholders may consider favorable. For example, our restated articles of incorporation provide that, in the event holders of common stock are entitled to vote on certain transactions, including certain mergers or sales, a supermajority of at least 80% of all the votes that the holders of common stock are entitled to cast thereon are required for the approval. Such provisions may have the effect of discouraging certain unsolicited offers for our capital stock or depriving our stockholders of an opportunity to sell their shares at a premium over market prices. We are also subject to the anti-takeover provisions of the Virginia Stock Corporation Act.

Further, upon any change in control, the lenders under our revolving credit facility will have the right to require us to repay all of our outstanding obligations under the facility.

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## FORWARD-LOOKING STATEMENTS

This prospectus supplement and the accompanying prospectus include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. We caution readers that any statements contained herein regarding earnings and expectations for our performance are forward-looking statements based upon management s current knowledge and assumptions about future events, including anticipated levels of demand for and supply of our products and services; costs incurred in providing these products and services; timing of shipments to customers; changes in market structure; and general economic, political, market and weather conditions. Lumber and building products earnings are also affected by changes in exchange rates between the U.S. dollar and the euro. Actual results, therefore, could vary from those expected. A further list and description of these risks, uncertainties and other factors can be found under the heading Risk Factors above and in our Annual Report on Form 10-K for the fiscal year ended March 31, 2005 under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations Factors That May Affect Future Results, which is incorporated by reference herein. We do not intend to update these forward-looking statements after the completion of this offering.

## USE OF PROCEEDS

We expect to receive approximately $193.6 million in net proceeds from this offering ($213 million, if the option to purchase additional preferred stock is exercised in full), after deducting the underwriters discounts and commissions and our estimated offering expenses. We intend to use the proceeds from this offering to repay outstanding debt under our revolving credit facility and two demand notes. On the portion of the revolving credit facility that will be repaid, the current interest rate is 6.45%, and the maturity date is January 7, 2010. The current interest rate on the two demand notes is 5.17%. As of March 14, 2006, we have outstanding borrowings under our revolving credit facility in the amount of $266.8 million, of which approximately $170 million was borrowed to repay the current portion of long-term debt during the fourth quarter of the fiscal year ending March 31, 2006.

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## PRICE RANGE OF OUR COMMON STOCK

Our common stock is traded on the New York Stock Exchange ( NYSE ) under the symbol UVV. The following table sets forth the high and low closing prices per share of the common stock on the NYSE Composite Tape, based upon published financial sources, and the dividends declared on each share of common stock for the quarter indicated.

| | | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|---|
| **Fiscal year ending March 31, 2006 (through March 14, 2006)** | | | | | |
| Cash dividends declared | | $ 0.42 | $ 0.42 | $ 0.43 | $ 0.43[1] |
| Market price range | High | 48.03 | 47.70 | 43.99 | 48.21 |
| | Low | 43.08 | 38.83 | 36.31 | 38.13 |
| **Fiscal year ended March 31, 2005** | | | | | |
| Cash dividends declared | | $ 0.39 | $ 0.39 | $ 0.42 | $ 0.42 |
| Market price range | High | 53.01 | 50.14 | 49.80 | 50.57 |
| | Low | 46.20 | 42.25 | 43.31 | 45.77 |
| **Fiscal year ended March 31, 2004** | | | | | |
| Cash dividends declared | | $ 0.36 | $ 0.39 | $ 0.39 | N/A[2] |
| Market price range | High | 43.85 | 44.28 | 52.32 | N/A |
| | Low | 41.20 | 40.78 | 44.41 | N/A |
| **Fiscal year ended June 30, 2003** | | | | | |
| Cash dividends declared | | $ 0.34 | $ 0.36 | $ 0.36 | $ 0.36 |
| Market price range | High | 39.23 | 37.52 | 39.28 | 43.01 |
| | Low | 31.81 | 32.85 | 35.40 | 37.69 |

Notes:

1. Declared February 7, 2006.
2. We changed our fiscal year end to March 31 effective March 31, 2004. Fiscal year 2005 covers the twelve-month period from April 1, 2004, through March 31, 2005. Fiscal year 2004 covers the nine-month transition year from July 1, 2003, through March 31, 2004. Results for prior fiscal years cover the twelve-month period from July 1 to June 30.

## DIVIDEND POLICY

Our current dividend policy anticipates the payment of quarterly dividends in the future. However, the declaration and payment of dividends to holders of common stock is at the discretion of the Board of Directors and will be dependent upon our future earnings, financial condition, and capital requirements. Under certain of our credit facilities, we must meet financial covenants relating to minimum tangible net worth and maximum levels of debt. If we were not in compliance with these financial covenants, they would restrict our ability to pay dividends. See also the discussion of our credit facilities under Summary Universal Corporation Current Developments. As of March 1, 2006, there were 1,965 holders of record of our common stock.

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## CAPITALIZATION

The following table sets forth our capitalization as of December 31, 2005, based on amounts reported in our quarterly report on Form 10-Q for the quarter ended December 31, 2005:

on an actual basis; and

on an as adjusted basis to reflect (1) the sale of the preferred stock (assuming the underwriters over-allotment is not exercised) and the application of the proceeds therefrom to repay outstanding debt under our revolving credit facility and two demand notes (each of which is classified as notes payable) as described in Use of Proceeds and (2) the payment of the current portion of long-term debt during February 2006 using borrowings under the revolving credit facility, which is classified as notes payable.

You should read this table in conjunction with Use of Proceeds as well as our Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements, including the related notes, incorporated by reference into this prospectus supplement from our annual report on Form 10-K for the fiscal year ended March 31, 2005, and our quarterly report on Form 10-Q for the quarter ended December 31, 2005.

| | As of December 31, 2005 | |
|---|---|---|
| | Actual | As adjusted |
| | (dollars in millions) | |
| Notes payable | $ 454.8 | $ 430.6 |
| Current portion of long-term debt | 169.4 | 0.0 |
| Long-term debt | 771.8 | 771.8 |
| Total debt | 1,396.0 | 1,202.4 |
| Minority interest | 32.5 | 32.5 |
| Stockholders equity: | | |
| Convertible preferred stock | | 193.6 |
| Common stock | 118.9 | 118.9 |
| Retained earnings | 733.8 | 733.8 |
| Accumulated other comprehensive loss | (44.5) | (44.5) |
| Total stockholders equity | 808.2 | 1,001.8 |
| Total capitalization | $ 2,236.7 | $ 2,236.7 |

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## DESCRIPTION OF PREFERRED STOCK

The terms of the preferred stock are contained in a certificate of designation that will amend our articles of incorporation. You may request a copy of the certificate of designation by writing or telephoning us at: Universal Corporation, 1501 North Hamilton Street, Richmond, Virginia 23230; (804) 359-9311; Attention: Corporate Secretary.

The following description is a summary of the material provisions of the preferred stock and the certificate of designation. It does not purport to be complete. We refer you to the provisions of the certificate of designation, including the definitions of terms used in the certificate of designation, a copy of which is available from us at the address or telephone number set forth above. We urge you to read the certificate of designation because it, and not this description, defines your rights as a holder of shares of preferred stock.

As used in this Description of Preferred Stock section, references to Universal, we, our or us refer solely to Universal Corporation and not to subsidiaries.

### General

We are authorized to issue 75,000 shares of 8% Cumulative Preferred Stock, $100 par value, and 5,000,000 shares of Additional Preferred Stock, without par value. Under our articles of incorporation, the board of directors, without shareholder approval, is authorized to issue shares of Additional Preferred Stock in one or more series. The creation and issuance of any series of preferred stock and the relative rights and preferences of any such series will be determined in the judgment of the board of directors and pursuant to our articles of incorporation.

Upon consummation of this offering, we will issue 200,000 shares, or up to 220,000 shares if the underwriters exercise in full their option to purchase additional shares, of our convertible perpetual preferred stock, no par value and $1,000 liquidation preference per share. When issued against the consideration therefor, the shares of preferred stock will be validly issued, fully paid and nonassessable.

The holders of the shares of preferred stock will have no preemptive rights or preferential rights to purchase or subscribe for stock, obligations, warrants or any other of our securities.

### Ranking

The preferred stock, with respect to dividend rights and upon liquidation, winding up and dissolution, ranks:

- junior to all our existing and future debt obligations;

- junior to senior stock, which is all classes or series of our capital stock, other than (1) our common stock and any other class or series of our capital stock the terms of which provide that such class or series will rank junior to the preferred stock and (2) any other class or series of our capital stock the terms of which provide that such class or series will rank on a parity with the preferred stock;

- on parity with parity stock, which is any class or series of our capital stock that has terms which provide that such class or series will rank on a parity with the preferred stock;

senior to junior stock, which is our common stock and each class or series of our capital stock that has terms which provide that such class or series will rank junior to the preferred stock; and

effectively junior to all of our subsidiaries (1) existing and future liabilities and (2) capital stock held by others.

The term senior stock includes warrants, rights, calls or options exercisable for or convertible into that type of stock. Any other class or series of our preferred stock that would otherwise be considered parity stock will not be deemed to be senior stock solely because such other class or series of preferred stock does not include the limitation on payment of dividends described in Restrictions on Declaration and Payment of Dividends.

We currently have no shares of parity stock or senior stock outstanding.

**Dividends**

Dividends on the preferred stock will be payable, on a non-cumulative basis, in cash, common stock or a combination of cash and common stock, when, as and if declared by our board of directors out of funds legally available for the payment of dividends at the annual rate of % of the $1,000 liquidation preference per share of preferred stock with respect to the dividend period, or portion thereof, ending on the day preceding the respective dividend payment date. We will pay dividends when, as and if declared by our board of directors out of funds legally available for the payment of dividends on the preferred stock quarterly on March 15, June 15, September 15 and December 15 of each year, commencing on June 15, 2006 (each, a dividend payment date ). If any dividend payment date is not a business day (as defined below), then dividends will be payable on the first business day following such dividend payment date, without accrual to the actual dividend payment date.

A dividend period is the period from and including a dividend payment date to but excluding the next dividend payment date, except that the initial dividend period will commence on and include the original issuance date of the preferred stock and will end on and exclude the June 15, 2006, dividend payment date. Dividends payable on the preferred stock will be computed on the basis of a 360-day year consisting of twelve 30-day months, and for any period other than a full dividend period will be computed on the basis of the actual number of days elapsed during the period.

We will pay dividends on the preferred stock to record holders as they appear on our register at 5:00 p.m. (New York City time) on the immediately preceding March 1, June 1, September 1 and December 1 (each, a dividend record date ). These dividend record dates will apply regardless of whether a particular dividend record date is a business day.

Dividends on the preferred stock will not be cumulative. Accordingly, if for any reason our board of directors does not declare a dividend on the preferred stock payable in respect of any dividend period, such dividend will not accumulate and holders of the preferred stock will have no right to receive, and we will have no obligation to pay, a dividend for that dividend period on the related dividend payment date or at any future time, whether or not we declare dividends on the preferred stock for any future dividend period.

The preferred stock will rank senior to our junior stock (including our common stock) with respect to the payment of dividends. As a result, unless the full dividends for the most recently ended dividend period on all outstanding shares of the preferred stock and parity stock have been declared and paid (or declared and a sum (or, if elected, common stock) sufficient for the payment thereof has been set aside):

we cannot declare or pay a dividend (or declare and set aside a sum sufficient for the payment thereof) on our junior stock, including our common stock; and we cannot purchase, redeem or otherwise acquire for consideration, directly or indirectly, any junior stock (other than as a result of a reclassification of junior stock for or into other junior stock or the exchange or conversion of one share of junior stock for or into another share of junior stock).

These restrictions will continue following any such failure to pay dividends until full dividends on all outstanding shares of the preferred stock and parity stock for four consecutive dividend periods have been declared and paid (or declared and a sum (or, if elected, common stock) sufficient for the payment thereof has been set aside for payment).

For any dividend period in which dividends are not paid in full upon the preferred stock, all dividends declared for such dividend period with respect to the preferred stock and other parity stock shall be declared pro rata based on the respective aggregate liquidation preferences of such securities.

Business day means a day that is a Monday, Tuesday, Wednesday, Thursday or Friday and is not a day on which banking institutions in New York City generally are authorized or obligated by law or executive order to close.

*Method of Payment of Dividends*

Subject to certain restrictions, we may pay any dividend on the preferred stock:

in cash;

by delivery of our common stock; or

through any combination of cash and our common stock.

We will make each dividend payment on the preferred stock in cash, except to the extent we elect to make all or any portion of such payment in our common stock. We will give the holders of the preferred stock notice of any such election and the portion of such payment that will be made in cash and the portion that will be made in common stock 10 trading days prior to the dividend record date for such dividend payment.

If we elect to make any dividend payment, or any portion thereof, in our common stock, such shares of common stock shall be valued for such purpose at 97% of the average volume weighted average price (as defined under Certain Definitions ) of our common stock for a period of five consecutive trading days (as defined under Certain Definitions ) ending on the third trading day immediately prior to the dividend payment date for such dividend; provided, however, that we have a sufficient number of authorized shares of common stock.

No fractional shares of common stock will be delivered to the holders of the preferred stock. We will deliver cash in lieu of any fractional shares of common stock based on the value of the common stock determined pursuant to the preceding paragraph.

Notwithstanding the above, we will not pay any portion of a dividend on the preferred stock by delivery of common stock unless, prior to 5:00 p.m. (New York City time) on the business day immediately preceding the dividend payment date, the common stock to be delivered as payment therefor:

is freely transferable by the recipient without further action on its behalf, other than by reason of the fact that such recipient is our affiliate;

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has been qualified or registered under applicable state securities laws, if required; and

has been approved for listing on the NYSE (or if our common stock is not listed on the NYSE, on the principal other U.S. national or regional securities exchange on which our common stock is then listed or, if our common stock is not listed on a U.S. national or regional securities exchange, on the Nasdaq National Market) (collectively, the Common Stock Settlement Conditions ).

*Restrictions on Declaration and Payment of Dividends*

We are prohibited from declaring dividends payable in cash for payment on the preferred stock on any dividend payment date (commencing with the December 15, 2006, dividend payment date) in an aggregate amount exceeding the New Common Equity Amount, if on that declaration date:

1. the Total Shareholders Equity Amount was less than $585 million based on the financial statements for the fiscal quarter ended prior to the most recently completed quarter prior to such dividend payment date; and

2. for each of the two most recently completed quarterly periods ending prior to the most recently completed quarter prior to such dividend payment date, the Consolidated Net Income Amount was less than or equal to $0.

If we fail to satisfy the above test for any dividend payment date, the restrictions on dividends will continue until we are able again to satisfy the test for a dividend payment date. The above test will not restrict our ability to pay dividends in shares of our common stock.

For purposes of this test:

our Total Shareholders Equity Amount as of December 31, 2005, was $808.2 million; and

for the quarters ended on December 31, 2005, and September 30, 2005, our Consolidated Net Income Amounts were a loss of $5.7 million and income of $26.5 million, respectively.

Although the foregoing tests would not restrict our board of directors from declaring dividends on the preferred stock currently, there can be no assurance that future financial results will not result in these tests restricting the declaration of dividends payable in cash.

As used in this section:

Consolidated Net Income Amount means, for any quarter, our consolidated net income before extraordinary items, changes in accounting principles and discontinued operations (all as determined in accordance with GAAP) for such quarter.

GAAP means, at any date or for any period, U.S. generally accepted accounting principles as in effect on such date or for such period.

New Common Equity Amount means, at any date, the net proceeds (after underwriters or placement agents fees, commissions or discounts and other fees relating to the issuances) received by us from new issuances of our common stock (whether in one or more public offerings registered under the Securities Act or private placements or other transactions exempt from

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registration under the Securities Act) during the period commencing on the 90th day prior to such date, and which are designated by our board of directors at or before the time of issuance as available to pay dividends on the preferred stock, less the aggregate amount of dividends and distributions on, and redemptions and repurchases of, junior stock during the period commencing on the 90th day prior to such date.

Securities Act means the Securities Act of 1933, as amended.

Total Shareholders Equity Amount means, as of any quarter end, our shareholders equity (determined in accordance with GAAP and in any event including the proceeds of this offering of preferred stock), as reflected on our consolidated balance sheet as of such quarter end.

By not later than the 10th trading day prior to each dividend record date for which dividends are being suspended because we have failed the test set forth above and we are not (1) electing to pay dividends in shares of our common stock or (2) able to pay dividends out of the New Common Equity Amount, we will give notice of such suspension by first class mail, postage prepaid, addressed to the holders of record of the preferred stock, and will file a copy of such notice on Form 8-K with the Securities and Exchange Commission.

In order to give effect to the foregoing, the terms of the preferred stock prohibit our board of directors or any committee of the board from declaring dividends on the preferred stock on a date that is (i) more than 60 days prior to the related dividend payment date or (ii) earlier than the date on which our financial statements for the most recently completed quarter prior to the most recently completed quarter immediately preceding the related dividend payment date have been filed with or furnished to the Securities and Exchange Commission for example, on a Form 10-K, 10-Q or 8-K or have otherwise been made publicly available. The limitation in clause (ii) of the preceding sentence is subject to the exception that if the board of directors determines to delay filing our financial statements with the Securities and Exchange Commission to a date later than the date on which, under the Securities and Exchange Commission s rules, we would normally be required to file such financial statements, for example because of concerns over the accuracy of such financial statements or their compliance with GAAP, then the board of directors or a committee of the board will be permitted to determine the ability of the board of directors or a committee of the board to declare dividends under the test outlined above based upon our financial statements as most recently filed with the Securities and Exchange Commission or otherwise made publicly available.

**Conversion Rights**

Holders of the preferred stock may, at any time, convert shares of preferred stock into fully paid and nonassessable shares of our common stock initially at a conversion rate of shares of common stock per $1,000 liquidation preference of preferred stock, subject to adjustments as described below. This represents an initial conversion price of approximately $ per share of common stock.

Upon conversion, we may choose to deliver, in lieu of shares of our common stock, cash or a combination of cash and shares of our common stock, as described below. We intend that, if we elect to settle a portion of these conversions in cash, the cash portion will not exceed the net proceeds to us of sales of shares of certain types of securities having sufficient equity characteristics, in each case that are issued within six months (or, in the case of common stock issued upon the exercise of options, within 12 months) before the conversion.

A holder of shares of the preferred stock may convert any or all of those shares by surrendering to us at our principal office or at the office of the conversion agent, as may be designated by our board of directors, the certificate or certificates for those shares of the preferred stock accompanied by a written conversion notice stating that the holder elects to convert all or a specified whole number of those shares in accordance with the provisions described in this prospectus supplement and specifying the name or names in which the holder wishes the certificate or certificates for shares of common stock to be issued. In case the notice specifies a name or names other than that of the holder, the notice will be accompanied by payment of all transfer taxes payable upon the issuance of shares of common stock in that name or names. Other than those taxes, we will pay any documentary, stamp or similar issue or transfer taxes that may be payable in respect of any issuance or delivery of shares of common stock upon conversion of shares of the preferred stock.

If we choose to satisfy all or any portion of our conversion obligation in cash, we will notify you of the dollar amount to be satisfied in cash (which must be expressed either as 100% of the conversion obligation or as a fixed dollar amount) at any time on or before the date that is two business days following receipt of your notice of conversion (the cash settlement notice period ). If we timely elect to pay cash for any portion of the shares of common stock otherwise issuable to you, you may retract the conversion notice at any time during the two business day period beginning on the day after the final day of the cash settlement notice period (the conversion retraction period ). No such retraction can be made (and a conversion notice shall be irrevocable) if we do not elect to deliver cash in lieu of shares (other than cash in lieu of fractional shares). If the conversion notice has not been retracted, settlement (in cash and/or shares) will occur on the business day following the final day of the ten-trading-day period beginning on the day after the final day of the conversion retraction period (the cash settlement averaging period ). Settlement amounts will be calculated as follows:

If we elect to satisfy the entire conversion obligation in shares of common stock, we will deliver to you a number of shares of common stock equal to (1) the number of shares of preferred stock to be converted multiplied by (2) the conversion rate.

If we elect to satisfy the entire conversion obligation in cash, we will deliver to you cash in an amount equal to the product of: (x) a number equal to (1) the number of shares of preferred stock to be converted multiplied by (2) the conversion rate; and (y) the average volume weighted average price of our common stock during the cash settlement averaging period.

If we elect to satisfy a fixed portion other than 100% of the conversion obligation in cash, we will deliver to you such cash amount (the cash amount ) and a number of shares of common stock equal to the greater of (1) zero and (2) the excess, if any, of (A) the number of shares of common stock equal to (i) the number of shares of preferred stock to be converted multiplied by (ii) the conversion rate over (B) the number of shares of common stock equal to the sum, for each day of the cash settlement averaging period, of (x) 10% of the cash amount, divided by (y) the volume-weighted average price of our common stock on such day.

In the case that any portion of the conversion obligation will be satisfied with common stock, as promptly as practicable after the surrender of a certificate or certificates of preferred stock and the receipt of the notice relating to the conversion and payment of all required transfer taxes, if any, or the demonstration to our satisfaction that those taxes have been paid, we will deliver or cause to be delivered (1) certificates representing the whole number of validly issued, fully paid and nonassessable shares of our common stock to which the holder, or the holder s transferee, of shares of the preferred stock being converted will be entitled and (2) if less than the full number of shares of preferred stock evidenced by the surrendered certificate or certificates is being converted, a new certificate or certificates, of like tenor, for the number of shares of preferred stock evidenced by the surrendered certificate or certificates less the number of shares being converted, along with cash payment for any fractional shares.

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This conversion will be deemed to have been made at the close of business on the date of the last of the giving of the notice of conversion, the receipt of payment of all required transfer taxes, if any, and of surrendering the certificate or certificates representing the shares of preferred stock to be converted so that the rights of the holder thereof as to the shares being converted will cease except for the right to receive shares of common stock or cash, and the person entitled to receive any such shares of common stock will be treated for all purposes as having become the record holder of those shares of common stock at that time.

In lieu of the foregoing procedures, if the preferred stock is held in global form, you must comply with The Depository Trust Company ( DTC ) procedures to convert your beneficial interest in preferred stock.

Holders of shares of preferred stock who convert their shares into our common stock will not be entitled to, nor will the conversion rate be adjusted for, any declared and unpaid dividends. Accordingly, shares of preferred stock surrendered for conversion after the close of business on any record date for the payment of dividends declared and before the opening of business on the dividend payment date relating to that record date must be accompanied by a payment in cash of an amount equal to the dividend payable in respect of those shares of preferred stock for the dividend period in which the shares are converted. A holder of shares of preferred stock on a dividend payment record date who converts such shares into shares of our common stock on the corresponding dividend payment date will be entitled to receive the dividend payable on such shares of preferred stock on such dividend payment date, and the converting holder need not include payment of the amount of such dividend upon surrender of shares of preferred stock for conversion.

Notwithstanding the preceding paragraph, if (1) shares of preferred stock are converted during the period between the close of business on any dividend payment record date and the opening of business on the corresponding dividend payment date, in each case with respect to which a dividend has been declared and (2) we have called such shares of preferred stock for redemption during such period, then the holder who so tenders such shares for conversion will receive the dividend payable on such dividend payment date and need not include payment of the amount of such dividend upon surrender of shares of preferred stock for conversion.

In case any shares of preferred stock are to be redeemed, the right to convert those shares of the preferred stock will terminate at 5:00 p.m., New York City time, on the business day immediately preceding the date fixed for redemption unless we default in the payment of the redemption price of those shares.

In connection with the conversion of any shares of preferred stock, no fractional shares of common stock will be issued, but we will pay a cash adjustment in respect of any fractional interest in an amount equal to the fractional interest multiplied by the closing sale price of our common stock on the date the shares of preferred stock are surrendered for conversion. If more than one share of preferred stock will be surrendered for conversion by the same holder at the same time, the number of whole shares of common stock issuable on conversion of those shares will be computed on the basis of the total number of shares of preferred stock so surrendered.

We will at all times reserve and keep available, free from preemptive rights, for issuance upon the conversion of shares of preferred stock a number of our authorized but unissued shares of common stock that will from time to time be sufficient to permit the conversion of all outstanding shares of preferred stock.

Before the delivery of any securities that we will be obligated to deliver upon conversion of the preferred stock, we will comply with all applicable federal and state laws and regulations that require action to be taken by us. All shares of common stock delivered upon conversion of the preferred stock will upon delivery be duly and validly issued, fully paid and nonassessable, free of all liens and charges and not subject to any preemptive rights.

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**Fundamental Change**

*A Fundamental Change Requires Us to Redeem Shares of Preferred Stock at the Option of the Holder*

If a fundamental change (as defined below) occurs, you will have the right, exercisable at your option, subject to legally available funds and to the terms and conditions of our articles of incorporation, to require us to redeem any or all of your shares of preferred stock. We will redeem the preferred stock at a price equal to 100% of the liquidation preference of the preferred stock to be redeemed plus an amount equal to any declared and unpaid dividends, unless such fundamental change redemption date falls after a record date for which a dividend has been declared and on or prior to the corresponding dividend payment date, in which case (1) we will pay the full amount of declared and unpaid dividends, if any, payable on such dividend payment date only to the holder of record at the close of business on the corresponding record date and (2) the redemption price payable on the fundamental change redemption date will include only the liquidation preference, but will not include any amount in respect of dividends declared and payable on such corresponding dividend payment date. We will be required to redeem the preferred stock as of a date (which we refer to as the fundamental change redemption date) that is not more than 30 calendar days after we mail to all holders of the preferred stock a notice regarding the fundamental change as described below. If such 30th calendar day is not a business day, the fundamental change redemption date will be the next succeeding business day.

We may, subject to legally available funds, choose to pay the redemption price in cash, shares of common stock, or a combination thereof. If we elect to pay all or a portion of the redemption price in shares of common stock, the shares of common stock will be valued at the price per share of our common stock determined during the ten consecutive trading days ending on the fifth trading day prior to the redemption date (such period, the redemption averaging period with respect to such redemption date) as the sum of the daily price fractions, whereby daily price fraction means for each trading day during the averaging period, 10% multiplied by the daily volume-weighted average price per share of our common stock for such day. However, we may not pay the redemption price in shares of common stock or a combination of shares of common stock and cash unless we satisfy certain conditions prior to the redemption date as provided in the certificate of designation.

If we will pay all or a portion of the redemption price in shares of common stock, we will notify you of such payment in our notice regarding the fundamental change. Because the volume-weighted average price of our shares of common stock will be determined prior to the fundamental change redemption date, holders of preferred stock bear the market risk that our shares of common stock will decline in value between the date the average closing sale is calculated and the redemption date. In addition, because the number of our shares of common stock that you will receive is based on the volume-weighted average price for a ten-trading-day period, the market value of those shares on the date of receipt may be less than the value of those shares based on the average closing sale price. However, in no event will we be required to deliver more than the number of our authorized shares of common stock.

A fundamental change will be deemed to have occurred upon the occurrence of any of the following:

(1) the consolidation or merger of us with or into any other person (other than any merger primarily for the purpose of changing our jurisdiction of incorporation and resulting in a reclassification, conversion or exchange of outstanding common stock solely into common

stock of the surviving entity) or (2) the sale, lease or transfer, in one or a series of related transactions, of all or substantially all of our assets (determined on a consolidated basis) to any person or group (as such term is used in Section 13(d)(3) of the Securities Exchange Act of 1934, as amended (the Exchange Act )) other than a sale, lease or transfer to the Company or any of its subsidiaries;

- the adoption of a plan the consummation of which would result in our liquidation or dissolution;

- the acquisition, directly or indirectly, by any person or group (as such term is used in Section 13(d)(3) of the Exchange Act) of more than 50% of the aggregate voting power of our voting stock; or

- during any period of two consecutive years, individuals who at the beginning of such period comprised our board of directors (together with any new directors whose election by such board of directors or whose nomination for election by our shareholders was approved by a vote of 66 2/3% of our directors then still in office who were either directors at the beginning of such period or whose election or nomination for election was previously so approved) cease for any reason to constitute a majority of our board of directors then in office.

However, a fundamental change will not be deemed to have occurred in the case of a merger or consolidation, if (i) at least 90% of the consideration (excluding cash payments for fractional shares and cash payments pursuant to dissenters appraisal rights) in the merger or consolidation consists of common stock of a United States company traded on a national securities exchange or quoted on the Nasdaq National Market (or which will be so traded or quoted when issued or exchanged in connection with such transaction) and (ii) as a result of such transaction or transactions the shares of the preferred stock become convertible solely into such common stock.

In addition, holders of shares of preferred stock shall not have the right to require us to repurchase shares of preferred stock upon a fundamental change (1) unless such purchase complies with our indentures and credit facilities and (2) unless and until our board of directors has approved such fundamental change or elected to take a neutral position with respect to such fundamental change.

Within 30 calendar days after the occurrence of a fundamental change, we are obligated (1) to mail to all holders of preferred stock at their addresses shown in the register of the registrar and to beneficial owners as required by applicable law (2) or to cause DTC to send a notice to its participants that own preferred stock (and issue a press release and publish on our website) a notice regarding the fundamental change, stating, among other things:

- the event causing a fundamental change;

- the date of such fundamental change;

- the last date on which the redemption right triggered by such fundamental change may be exercised;

- the fundamental change redemption price;

- the fundamental change redemption date;

- the name and address of the paying agent and the conversion agent;

- the conversion rate and any adjustments to the conversion rate;
- that the preferred stock with respect to which a fundamental change redemption notice (as described below) is given by the holder may be converted only if the fundamental change redemption notice has been withdrawn in accordance with the terms of the preferred stock; and
- the procedures that holders must follow to exercise these rights.

To exercise this right, you must deliver a written notice to the transfer agent prior to the close of business on the business day immediately before the fundamental change redemption date. The required redemption notice upon a fundamental change must state:

- if certificated shares of preferred stock have been issued, the preferred stock certificate numbers, or if not, such information as may be required under applicable DTC procedures;
- the number of preferred shares to be redeemed; and
- that we are to redeem such preferred stock pursuant to the applicable provisions of the preferred stock and our amended and restated certificate of incorporation.

You may withdraw any fundamental change redemption notice by a written notice of withdrawal delivered to the transfer agent prior to the close of business on the business day before the fundamental change redemption date. The notice of withdrawal must state:

- the number of the withdrawn shares of preferred stock;
- if certificated shares of preferred stock have been issued, the preferred stock certificate numbers, or if not, such information as may be required under applicable DTC procedures; and
- the number, if any, of shares of preferred stock that remain subject to your fundamental change redemption notice.

A holder must either effect book-entry transfer or deliver the preferred stock to be redeemed, together with any necessary endorsements, to the office of the transfer agent after delivery of the fundamental change redemption notice to receive payment of the fundamental change redemption price. You will receive payment in cash or shares of common stock, as applicable, on the later of the fundamental change redemption date or the time of book-entry transfer or the delivery of the preferred stock. If the transfer agent holds cash or shares of common stock, as applicable, sufficient to pay the fundamental change redemption price of the preferred stock on the business day following the fundamental change redemption date, then, immediately after the fundamental change redemption date:

- the shares of preferred stock will cease to be outstanding; and
- all other rights of the holder will terminate.

This will be the case whether or not book-entry transfer of the preferred stock is made or whether or not the preferred stock is delivered to the transfer agent.

The fundamental change redemption feature of the preferred stock may in certain circumstances make more difficult or discourage a takeover of our company. The fundamental change redemption feature, however, is not the result of our knowledge of any specific effort:

- to accumulate shares of common stock;
- to obtain control of our company by means of a merger, tender offer, solicitation or otherwise; or
- by management to adopt a series of anti-takeover provisions.

Instead, the terms of the fundamental change redemption feature resulted from negotiations between the underwriters and us.

We could, in the future, enter into certain transactions, including certain recapitalizations, that would not constitute a fundamental change with respect to the fundamental change redemption feature of the preferred stock but that would increase the amount of our (or our subsidiaries ) outstanding indebtedness.

Our ability to redeem shares of preferred stock upon the occurrence of a fundamental change is subject to important limitations. Because we are a holding company, our ability to redeem the preferred stock for cash may be limited by restrictions on our ability to obtain funds for such redemption through dividends from our subsidiaries and the terms of our current and then existing borrowing agreements. Our ability to redeem the preferred stock is also subject to restrictions under Virginia law. If a fundamental change were to occur, we may not have sufficient legally available funds to pay the redemption price in cash for all tendered shares of preferred stock. Our current revolving credit facilities do, and any future credit agreements or other agreements relating to our indebtedness may, contain provisions prohibiting the redemption of the preferred stock under certain circumstances, or expressly prohibit our redemption of the preferred stock upon a fundamental change or provide that a fundamental change constitutes an event of default under that agreement. If a fundamental change occurs at a time when we are prohibited from redeeming shares of preferred stock for cash, we could seek the consent of our lenders to redeem the preferred stock or attempt to refinance this debt. If we do not obtain such consent, we would not be permitted to redeem the preferred stock for cash.

If, following a fundamental change, we are prohibited from paying the redemption price of the preferred stock in cash under the terms of any indebtedness or by applicable law, we will, if permitted under terms of such indebtedness and under applicable law, elect to pay the redemption price of the preferred stock in shares of common stock or, in the case of a merger in which we are not the surviving corporation, common stock of the surviving corporation or its direct or indirect parent corporation.

We will comply with any applicable provisions of Rule 13e-4 and any other tender offer rules under the Exchange Act in connection with any offer by us to redeem the preferred stock.

*Make Whole Payment Upon the Occurrence of a Fundamental Change*

If you elect to convert your preferred stock upon the occurrence of a fundamental change (as defined above) that occurs prior to March 15, 2018, in certain circumstances, you will be entitled to receive, in addition to a number of shares of common stock equal to the applicable conversion rate (or cash as described under Conversion Rights above), an additional number of shares of common stock (the additional shares ) upon conversion as described below.

We must give notice to all holders and to the conversion agent at least 15 trading days prior to the anticipated effective date of such fundamental change. We must also give notice to all holders and to the conversion agent that such fundamental change has become effective. Holders may surrender preferred stock for conversion and receive the additional shares described below at any time from and after the effective date of such fundamental change until and including the date that is 30 days after the effective date (or, if such transaction also results in holders having a right to require us to redeem their preferred stock, until the fundamental change redemption date).

The number of additional shares will be determined for the preferred stock by reference to the table below, based on the date on which the fundamental change becomes effective (the effective date ) and the share price. If holders of our common stock receive only cash in the transaction constituting a fundamental change, the share price shall be the cash amount paid per share. Otherwise, the share price shall be the average of the closing sale prices of our common stock on the five trading days prior to but not including the effective date of the transaction constituting a fundamental change.

The stock prices set forth in the first row of each table below (i.e., the column headers) will be adjusted as of any date on which the conversion rate of the preferred stock is adjusted. The adjusted stock prices will equal the stock prices applicable immediately prior to such adjustment, multiplied by a fraction, the numerator of which is the conversion rate immediately prior to the adjustment giving rise to the stock price adjustment and the denominator of which is the conversion rate as so adjusted. The number of additional shares will be adjusted in the same manner as the conversion rate as set forth under Adjustments to the Conversion Rate.

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The following table sets forth the number of additional shares to be received per $1,000 liquidation preference per share of preferred stock:

| Fundamental Change date in years | Stock price on the Effective Date[1] | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | $38.96 | $40.00 | $42.00 | $45.00 | $50.00 | $55.00 | $60.00 | Continued Below |
| 15-Mar-06 | 4.71 | 4.71 | 4.37 | 3.87 | 3.24 | 2.77 | 2.42 | |
| 15-Mar-07 | 4.71 | 4.65 | 4.25 | 3.74 | 3.09 | 2.61 | 2.26 | |
| 15-Mar-08 | 4.71 | 4.54 | 4.12 | 3.59 | 2.92 | 2.43 | 2.08 | |
| 15-Mar-09 | 4.66 | 4.41 | 3.98 | 3.43 | 2.73 | 2.22 | 1.87 | |
| 15-Mar-10 | 4.52 | 4.27 | 3.83 | 3.26 | 2.51 | 1.98 | 1.61 | |
| 15-Mar-11 | 4.38 | 4.12 | 3.65 | 3.05 | 2.26 | 1.68 | 1.28 | |
| 15-Mar-12 | 4.23 | 3.97 | 3.49 | 2.87 | 2.01 | 1.34 | 0.88 | |
| 15-Mar-13 | 4.07 | 3.80 | 3.33 | 2.72 | 1.87 | 1.14 | 0.48 | |
| 15-Mar-14 | 3.88 | 3.60 | 3.13 | 2.53 | 1.73 | 1.05 | 0.44 | |
| 15-Mar-15 | 3.64 | 3.35 | 2.87 | 2.27 | 1.53 | 0.93 | 0.39 | |
| 15-Mar-16 | 3.34 | 3.03 | 2.51 | 1.91 | 1.23 | 0.75 | 0.31 | |
| 15-Mar-17 | 3.03 | 2.67 | 2.07 | 1.40 | 0.77 | 0.46 | 0.20 | |
| 15-Mar-18 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | |
| | $70.00 | $80.00 | $100.00 | $125.00 | $150.00 | $200.00 | $250.00 | $300.00 |
| 15-Mar-06 | 1.94 | 1.63 | 1.22 | 0.91 | 0.71 | 0.46 | 0.31 | 0.00 |
| 15-Mar-07 | 1.80 | 1.50 | 1.12 | 0.84 | 0.65 | 0.42 | 0.29 | 0.00 |
| 15-Mar-08 | 1.62 | 1.34 | 1.01 | 0.75 | 0.59 | 0.38 | 0.26 | 0.00 |
| 15-Mar-09 | 1.42 | 1.16 | 0.87 | 0.65 | 0.51 | 0.33 | 0.23 | 0.00 |
| 15-Mar-10 | 1.17 | 0.95 | 0.71 | 0.53 | 0.42 | 0.27 | 0.19 | 0.00 |
| 15-Mar-11 | 0.85 | 0.67 | 0.50 | 0.38 | 0.30 | 0.20 | 0.14 | 0.00 |
| 15-Mar-12 | 0.46 | 0.35 | 0.26 | 0.20 | 0.16 | 0.11 | 0.07 | 0.00 |
| 15-Mar-13 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 15-Mar-14 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 15-Mar-15 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 15-Mar-16 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 15-Mar-17 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 15-Mar-18 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |

Note:

1. The hypothetical stock price and additional share amounts set forth are based on certain assumptions and are for illustrative purposes only. The final applicable stock price and additional share amounts will be set forth in the final form of this prospectus supplement and may differ from those set forth above.

The exact stock prices and fundamental change effective dates may not be set forth in the table above, in which case:

If the stock price is between two stock price amounts in the table or the effective date is between two effective dates in the table, the number of additional shares will be determined by a straight-line interpolation between the number of additional shares set forth for the higher and lower stock price amounts or the two dates, as applicable, based on a 365-day year.

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If the stock price is equal to or in excess of $ per share (subject to adjustment), no additional shares will be issued upon conversion.

If the stock price is less than $ per share (subject to adjustment), no additional shares will be issued upon conversion. Notwithstanding the foregoing, in no event will the total number of shares of common stock issuable upon conversion exceed per share of preferred stock, subject to adjustments in the same manner of the conversion rate as set forth under Adjustments to the Conversion Rate below.

Our obligation to deliver the additional shares could be considered a penalty under applicable law, in which case the enforceability thereof would be subject to general principles of reasonableness of economic remedies.

Notwithstanding the foregoing, in the case of a public acquirer fundamental change (as defined below), we may, in lieu of increasing the conversion rate by additional shares as described above, elect to adjust the conversion rate and the related conversion obligation such that, from and after the effective date of such public acquirer fundamental change, holders of the preferred stock who elect to convert will be entitled to convert their preferred stock into a number of shares of public acquirer common stock (as defined below) that have been registered, or the resale of which will be registered, under the Securities Act, by multiplying the conversion rate in effect immediately before the public acquirer fundamental change by a fraction:

the numerator of which will be (i) in the case of a consolidation, merger or binding share exchange, pursuant to which our common stock is converted into or exchanged for the right to receive cash, securities or other property, the value of all cash and any other consideration (as determined by our board of directors) paid or payable per share of common stock or (ii) in the case of any other public acquirer fundamental change, the average of the closing sale prices of our common stock for the five consecutive trading days prior to but excluding the effective date of such public acquirer fundamental change, and

the denominator of which will be the average of the last closing sale prices of the public acquirer common stock for the five consecutive trading days commencing on the trading day next succeeding the effective date of such public acquirer fundamental change.

A public acquirer fundamental change means any fundamental change that would otherwise obligate us to increase the conversion rate as described above and where the acquirer has a class of common stock traded on a national securities exchange or quoted on the Nasdaq National Market or which will be so traded or quoted when issued or exchanged in connection with such fundamental change (the public acquirer common stock ). If an acquirer does not itself have a class of common stock satisfying the foregoing requirement, it will be deemed to have public acquirer common stock if a corporation that directly or indirectly owns at least a majority of the acquirer has a class of common stock satisfying the foregoing requirement and all references to public acquirer common stock will be deemed to refer to such class of common stock. Majority owned for these purposes means having the beneficial ownership (as defined in Rule 13d-3 under the Exchange Act) of more than 50% of the total voting power of all shares of the respective entity s capital stock that are entitled to vote generally in the election of directors.

Upon our decision to adjust the conversion rate and related conversion obligation upon a public acquirer fundamental change, holders may convert their preferred stock at the adjusted conversion rate described in the preceding paragraph but will not be entitled to the additional shares as described above. The registered shares of public acquirer common stock, or the shares of public acquirer common stock registered for resale, as the case may be, shall be listed, or approved for listing subject only to the official notice of issuance, on a national securities exchange or the Nasdaq National Market.

**Adjustments to the Conversion Rate**

The conversion rate is subject to adjustment from time to time if any of the following events occurs:

- the issuance of our common stock as a dividend or distribution on our common stock;

- certain subdivisions and combinations of our common stock;

- the issuance to all holders of our common stock of certain rights or warrants to purchase our common stock (or securities convertible into our common stock) at less than (or at a conversion price per share less than) the current market price of our common stock, provided that no such adjustment shall be made for the rights of holders of our common stock to participate in any dividend reinvestment plan in existence on the date hereof and made available to all holders of our common stock or our employee stock benefit plans or the purchase of shares pursuant to any such plan;

- the dividend or other distribution to all holders of our common stock of shares of our capital stock (other than common stock) or evidences of indebtedness or assets (including securities, but excluding (1) those rights and warrants referred to above or (2) dividends or distributions paid exclusively in cash);

In the event that we make a dividend or distribution to all or substantially all holders of our common stock consisting of capital stock of, or similar equity interest in, a subsidiary or other business unit of ours, unless we distribute such capital stock or equity interests to holders of the preferred stock in such distribution on the same basis as they would have reily by opening one store in primary and secondary metropolitan markets, and in late 2005 we began opening complementary stores in these existing markets. We believe our primary and secondary metropolitan markets will benefit from additional store locations, and of the 30 to 40 stores we plan to open during each of the next several years, we expect an approximately equal mix of stores in these existing markets and stores in new markets, similar to 2007. Our experience has shown that our store model is well suited for markets smaller than the primary and secondary metropolitan areas, and going forward, these will represent the majority of our new market stores. We generally consider a store comparable on the first day of the 13$^{th}$ month of operation, and stores in operation from 13 months to 36 months have historically shown greater net sales increases than our more mature stores. We expect our new locations and comparable store net sales increases to continue to drive our net sales growth.

Our gross profit is driven primarily by the cost of acquiring the products we sell from our suppliers, but also includes inbound transportation costs from those suppliers to our distribution center or stores, customs and duty charges, transportation charges from our distribution center to our stores and the cost of delivering product purchases to the customer. Our most significant operating expenses have historically been our advertising expenses and our labor costs. Our annual advertising costs have generally declined as a percentage of net sales as we have expanded, but may vary from quarter to quarter with shifts in marketing strategy and the timing of our marketing campaigns. Our in-store labor costs will increase as a result of new store openings, but generally decline as a percentage of net sales. Our 2007 labor costs were significantly impacted by the substantial completion of our investment in the store support infrastructure, primarily enhancements to our senior management team. We expect that our aggregate operating expenses will decline as a percentage of our net sales as our business continues to grow.

**2007 Highlights**

***Initial Public Offering.*** On November 9, 2007, we completed our initial public offering of 3,800,000 shares of common stock at a per share price of $11, receiving net proceeds of $36.2 million. Immediately prior to the offering, TA Associates converted 7,952,018 shares of Series A Convertible Preferred Stock to shares of common stock on a one-to-one basis. Tom Sullivan, the sole holder of our common stock prior to the IPO, and TA Associates collectively sold an additional 6,200,000 shares of common stock in the IPO.

***Investment in Our Store Support Infrastructure.*** We have substantially completed a significant investment in our store support infrastructure, primarily our senior management team, which we believe will support our continued growth for multiple years. Beginning in late 2005 and continuing through 2007, we assembled an experienced executive team, including our CEO in September 2006 and six senior executives with significant experience in the specialty retail industry and/or retail operations. We also restructured our regional store operations by increasing the number of regional managers from eight to 15 to support future growth and assist in maintaining pricing and cost discipline and operational controls.

***Expansion of Our Product Assortment.*** In both 2007 and 2006, we expanded our product offerings to include a broader assortment of key product lines and narrow our price point differentials. In addition, we increased our emphasis on moldings and accessories, which enable us to generate valuable add-on sales. In 2007, we introduced a number of premium products within such key lines as handscraped solid and engineered hardwood by our Virginia Mill Works Co. brand, stained and strand bamboos by our Morningstar brand, and laminates with heavier-wear layer and foam backing by our Dream Home brand. In 2006, we significantly expanded our solid and engineered hardwoods brands within our Dura-Wood product line. We believe that presenting customers with a broader assortment of quality products with narrower price point differentials encourages customers to trade up to our premium products, where we believe our prices present the greatest value versus our competitors.

***Enhanced Merchandising and Logistics Management.*** As a part of our infrastructure investment, our merchandising team, with extensive product knowledge, was bolstered by a new Senior Vice President of Merchandising and buyers with more traditional merchandising skills, enhancing both merchandise purchase planning and inventory management disciplines. Greater coordination of our merchandise purchase planning with our vendor mills including historic and projected sales on the product level drove gross margin improvement through lower product costs and resulted in more consistent in-stock positions for key product lines. Our sales volume increased, as more consistent in-stock positions allowed us to satisfy our customers varying delivery needs. In the third quarter of 2007, our new Senior Vice President of Logistics implemented a program to improve the efficiency of our warehouse-to-store deliveries, exchanging road miles with intermodal rail miles, partially offsetting increases in fuel costs. As we seek to control all inbound shipping from our vendors and explore alternatives to moving product through our warehouse in Toano, Virginia, we expect additional cost reductions will be available to offset some increases in fuel and other transportation costs, including customs duties.

**External Factors Impacting Our Business**

The wood flooring market which serves the homeowner is highly fragmented and dependent on a number of complex economic and demographic factors that impact home-related discretionary spending, and these factors may vary locally, regionally, and nationally. We are impacted by home remodeling activity, employment levels, housing turnover, real estate prices, new housing starts, consumer confidence, credit availability, and the general health of consumer discretionary spending. In the latter half of 2006 and continuing through 2007, a number of economic indicators associated with the flooring market weakened, and many economic indicators generally associated with consumer discretionary spending weakened in the fourth quarter of 2007. We will continue to monitor demand indicators for our segment of the flooring market, but we do not anticipate significant improvement in the general wood flooring market at least through the first half of 2008.

Although the hardwood flooring market is projected to experience long-term growth, industry sources report an overall decline in the demand for flooring in 2006 and 2007. We believe the number of retailers serving the homeowner-based segment of the wood floor market declined in 2007, and our results benefited from increased market share. Though we are likely to be adversely impacted by decreased consumer demand for wood flooring, we believe we will continue to benefit from the additional market share that we expect to gain through new store openings. In addition, we should benefit from longer term favorable industry trends and characteristics, including increased home improvement spending resulting from aging housing stock, increasing home ownership, increasing average home size and favorable demographic trends as well as the expansion and evolution of the hardwood flooring market and the greater perceived attractiveness of hardwood flooring among consumers. See Item 1A. Risk Factors Risks Related to Our Business and Industry.

**Assessing the Performance of Our Business**

In assessing the performance of our business, we consider a variety of performance and financial measures. The key measures we use to determine how our business is performing are net sales and comparable store net

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sales. Some of the operational metrics that we consider in evaluating net sales include our sales mix, future demand as measured by open orders and the related customer deposits, the average number of days an order/customer deposit is outstanding, requests for samples and catalogs, new store performance levels and our new store pipeline. In assessing the overall performance of our business, we also consider gross profit and selling, general and administrative expenses.

***Net Sales.*** We derive net sales primarily from sales of solid and engineered hardwoods, laminate, bamboo and cork flooring products, moldings and flooring accessories made through our stores, call center, website and catalog. Net sales, which include freight costs billed to customers, are net of any returns by customers. Net sales from customer orders placed through the call center, our website or our catalog are recorded by the store where the customer picks up the merchandise or schedules delivery. Several factors affect our net sales in any period, including the number of stores in operation and comparable store net sales for any given store or group of stores, which can be influenced by our operational effectiveness, pricing, marketing and promotional efforts, brand recognition levels, local competition and trade area demographics.

***Growth In Our Store Base.*** We opened 25 stores in 2007, 16 stores in 2006 and 19 stores in 2005, which contributed substantially to the growth of our net sales in those years. We plan to open between 30 and 40 new stores during each of the next several years. The cost required to open a typical new store is approximately $240,000, of which inventory, net of trade payables, represents approximately $190,000. Our new stores have historically opened with an initial ramp-up period typically lasting from 36 to 48 months or more, during which they generated net sales below the levels at which we expect them to normalize. Our average new store across our markets has, however, historically become profitable within three months of beginning operations and generally returned its initial cash investment within seven months. See Item 1A. Risk Factors Risks Related to Our Business and Industry.

***Comparable Store Net Sales.*** The other important driver of growth in our net sales has been increased comparable store net sales, which accounted for a substantial portion of our historical net sales growth. Stores generally enter the comparable store base on the first day of the thirteenth full calendar month after they open. Various factors affect comparable store net sales, including:

- consumer preferences, buying trends and overall economic trends and our ability to anticipate and respond effectively to changes therein;
- changes in product assortment and the overall sales mix;
- the number of stores we open in existing markets;
- the maturity of a comparable store;
- competition;
- pricing;
- product availability and quality;
- the timing of our advertising promotional events and/or timing of three-day Holiday weekends; and
- weather and other climatological effects.

We believe that future comparable store net sales will likely increase at rates slower than those achieved over the past several years, due to increases in baseline store volumes and an increase in the number of new stores opened in existing markets, which tend to open at a higher base level of net sales. See Item 1A. Risk Factors Risks Related to Our Business and Industry.

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***Gross Profit and Gross Margin.*** Gross profit is equal to our net sales minus our cost of sales, and gross margin is equal to gross profit as a percentage of net sales. Our gross profit has historically been affected by, among other things:

- our sales volumes and the margins on products we sell;
- the mix of our products sold and the related cost of that merchandise, including in particular the cost of hardwood and other flooring products and accessories;
- transportation costs, both from our suppliers to our distribution center or stores and from our distribution center to our stores, which may vary with factors such as fuel costs;
- customs and duty charges on international purchases;
- the cost of third-party carrier services providing customer deliveries;
- in-house finishing costs, particularly for our Bellawood brand;
- the costs of providing samples requested by our customers;
- inventory adjustments, including shrinkage;
- the extent of any retail price reductions and the volume of inventory impacted by sales and promotional events; and
- competition.

We try to minimize the volatility of hardwood prices which represents the largest portion of our cost of sales by relying on our close relationships with our suppliers and utilizing our financial flexibility to establish beneficial payment terms. Generally, we strive to match merchandise purchase lead times with anticipated demand to maximize sustainable gross margins, and those lead times currently range by product from approximately 90 to 180 days.

We work to improve gross profits and gross margin on an ongoing basis through inventory management improvements, logistics alternatives, pricing levels, promotional activities and vendor relationships, among other things. Several of our recent initiatives to position our business for more effective future growth have also had a significant impact on our gross margins, and we continue to assess various opportunities. We review our inventory levels and sales mix on a regular basis to identify slow-moving merchandise and products which do not meet our quality standards and cannot be sold at full price, and generally use promotional events and mark-downs to clear that inventory. We believe that, taken together, the changes we have made and intend to implement should enable us to sustain and gradually increase our gross margins in future periods. Our gross profits and gross margins may not be comparable to other companies that record different costs as components of cost of sales.

***Selling, General, Administrative and Other Operating Expenses.***

**Advertising Expenses.** The largest component of our selling, general and administrative (or SG&A ) expenses is advertising expenses at the national, regional and local level, as well as costs associated with publishing our catalogs and maintaining our website. We have made a significant investment in advertising to develop our national brands, including our portfolio of proprietary product offerings. We believe Lumber Liquidators is now recognized across the United States as a destination for high-quality hardwood flooring at everyday low prices. We have historically focused on national advertising, including buying ads in national publications, using targeted television advertising, co-sponsoring television shows, advertising on syndicated radio programs and sports marketing. In the future, we expect to place greater focus on local advertising to support targeted store growth and in connection with new store openings while maintaining appropriate levels of national advertising. We expect to see greater returns on our investment in national advertising as we open more stores near potential customers who have already been introduced to our brands. In addition, while our advertising costs may vary from quarter to quarter with shifts in marketing strategy and the timing of our marketing campaigns, we believe that the percentage of our net sales devoted to marketing and advertising will generally decline as we continue to grow. See Item 1A. Risk Factors Risks Relating to Our Business and Industry.

**Labor Costs.** The second-largest component of our SG&A expenses is expense relating to employees, consisting principally of salaries, commissions and benefits paid to employees in our stores which increase as we open more stores and employees in our distribution facility and headquarters which should increase more slowly as we grow. Most of our labor costs relate to staff at our stores and our distribution facility. However, labor costs have recently increased significantly as we improved our store support strategies and operational infrastructure, positioning our business for more effective and sustainable future growth. We believe that the percentage of our net sales devoted to labor costs will generally decline as we continue to grow.

**Other Expenses.** Our SG&A expenses also include occupancy costs for our stores, warehouse and headquarters (including rent, utilities, real estate taxes and maintenance charges); equity compensation expenses (including expenses relating to the Variable Plan); and other expenses such as credit and debit card discount and processing fees, costs relating to our delivery fleet (including payroll and maintenance), depreciation and amortization, bank fees, legal and professional fees and other corporate and administrative functions that support our stores. SG&A expenses also include store opening costs, which we expense as they are incurred.

**Other Significant Factors Affecting our Results**

Stock-based compensation expense presented in the table below has significantly impacted our total SG&A expenses, due primarily to three factors (each of which is described in more detail below):

- A Variable Plan between our founder Tom Sullivan and his brother, one of our regional managers;
- Stock options granted to employees; and
- The acceleration of the vesting of certain stock options granted in July and October 2006 as a result of our IPO.

Total stock-based compensation expenses included in SG&A for 2007, 2006 and 2005 were:

| | 2007 | % of Sales | 2006 | % of Sales | 2005 | % of Sales |
|---|---|---|---|---|---|---|
| | (in thousands, except percentages) | | | | | |
| Variable Plan | $ 3,220 | 0.8% | $ 1,040 | 0.3% | $ 3,133 | 1.3% |
| Stock Options, Restricted Stock and Other | 1,756 | 0.4% | 409 | 0.1% | 173 | 0.1% |
| Acceleration of Stock Options/Regional Manager Plan | 1,235 | 0.3% | | 0.0% | | 0.0% |
| Total | $ 6,211 | 1.5% | $ 1,449 | 0.4% | $ 3,306 | 1.4% |

***Variable Plan.*** We are party to a stock-based agreement between Tom Sullivan and his brother, Kevin Sullivan, a regional manager, accounted for as a variable performance plan. The Variable Plan was established in 1998 and modified in August 2005. The Variable Plan awarded Kevin the right (the Variable Right ) to an ownership percentage of common stock, contributed by Tom. The Variable Right fully vested in conjunction with the IPO. We recorded stock-based compensation expense related to the Variable Plan of $3.2 million, $1.0 million, and $3.1 million for 2007, 2006 and 2005, respectively.

The Variable Plan provided for a cash settlement of the Variable Right at a defined, performance based, value through put-call provisions, executed by Tom or Kevin, if an IPO or sale event, as defined, had not taken place prior to February 1, 2008. Tom was liable for the cash payment, and we guaranteed his performance. We have accounted for the Variable Plan in accordance with the provisions of SFAS 123(R), and at December 31,

2006, we had a long-term, Stock Compensation Liability of $9.1 million, representing the estimated cumulative value of shares earned under the Variable Right at an estimated fair value per share.

The Variable Right fully vested and became exercisable in connection with the IPO, and all cash settlement provisions via put-call rights terminated. In accordance with the terms of the Variable Plan, we calculated that 853,853 shares of common stock had vested and were exercisable under the Variable Right (the Vested Shares ). Cumulative stock-based compensation expense related to the Variable Plan was calculated utilizing the Vested Shares and the $11 per share IPO price to adjust the Stock Compensation Liability to $9.4 million, representing $0.3 million of 2007 stock-based compensation expense. The Stock Compensation Liability was reclassified to Additional Capital in accordance with the provisions of SFAS 123(R).

As described in Note 11 to the financial statements included in Item 8 of this report, Kevin filed for arbitration on December 7, 2007 disputing our share count calculation. Total stock-based compensation expense related to the Variable Plan was $3.2 million for the year ended December 31, 2007, which included our best estimate of the ultimate value of incremental shares (above the Vested Shares) that may be delivered to Kevin via settlement or arbitration. As the ultimate value that may be delivered to Kevin is not certain, we may be required to adjust stock-based compensation expense in 2008.

***Stock Options, Restricted Stock and Other Equity Equivalents***. As described in Note 6 to the financial statements included in Item 8 of this report, we maintain an equity incentive plan for employees, non-employee directors and other service providers, the Lumber Liquidators, Inc. 2007 Equity Compensation Plan (the 2007 Plan ), and a stock unit plan for regional store management (the 2006 Regional Plan ).

We adopted the 2007 Plan in August 2007 to consolidate the 2004 Stock Option and Grant Plan and the 2006 Equity Plan for Non-Employee Directors (collectively, the Prior Plans ). Our initial grants under the Prior Plans were 1,031,847 stock options in July 2006 and 765,000 stock options in October 2006. These initial grants represent the majority of the 1,966,847 stock options outstanding at December 31, 2007, and after the acceleration (as described below) will generally vest through July 2009 and October 2010, respectively.

Our May 2006 grant of stock units to certain regional managers was and will be the only grant under the 2006 Regional Plan. Tom placed in escrow the 85,000 shares of common stock necessary to provide for the exercise of the stock units upon vesting. The stock units would have expired without value unless a trigger event, as defined, occurred but the IPO was a defined trigger event. As of February 29, 2008, 34,000 shares had been transferred from Tom to certain regional managers.

***Acceleration of Stock Options and Initial Recognition of Stock Units.*** We recorded $1.0 million of stock-based compensation expense in the fourth quarter of 2007 related to the one-time acceleration, triggered by the IPO, of vesting provisions in certain stock option agreements resulting in the immediate vesting of 261,313 stock options.

In addition, we recorded $0.3 million of stock-based compensation expense in the fourth quarter of 2007 to cover the vesting period from May 2006 through December 31, 2007 related to 85,000 stock units granted under the 2006 Regional Plan and scheduled to vest over approximately a five year period. The remaining $0.4 million of stock compensation expense related to the Regional Plan will be recognized equally over the three years ending December 31, 2010.

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**Results of Operations**

The following tables set forth components of our results of operations for the periods indicated, both in dollars and as a percentage of net sales.

| | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| | (in millions, except percentages and number of stores) | | |
| Net sales | $ 405.3 | $ 332.1 | $ 244.9 |
| *Comparable store net sales increase from prior year* | *8.6%* | *17.3%* | *19.0%* |
| *Number of stores opened in period*(1) | *25* | *16* | *19* |
| Cost of sales | 270.2 | 221.9 | 158.8 |
| Gross profit | 135.1 | 110.1 | 86.1 |
| SG&A expenses | 116.3 | 88.7 | 67.9 |
| Operating income | 18.8 | 21.4 | 18.2 |
| Net income | 11.3 | 12.9 | 10.7 |

| | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| | (% of net sales) | | |
| Net sales | 100.0% | 100.0% | 100.0% |
| Cost of sales | 66.7% | 66.8% | 64.8% |
| Gross profit | 33.3% | 33.2% | 35.2% |
| SG&A expenses | 28.7% | 26.7% | 27.7% |
| Operating income | 4.6% | 6.4% | 7.4% |
| Net income | 2.8% | 3.9% | 4.4% |

(1) In May 2006, we closed a laminate flooring-only store that had been established to operate during the remaining lease period of a relocated store.

**Year Ended December 31, 2007 Compared to Year Ended December 31, 2006**

***Net Sales.*** Net sales increased approximately $73.2 million, or 22.1%, to $405.3 million in 2007 from $332.1 million in 2006. This increase was primarily driven by an increase of $44.7 million in non-comparable store net sales, including $19.5 million at the 25 stores opened in 2007, and an increase of $28.5 million, or 8.6%, in comparable store net sales. Generally strong consumer demand for our expanded product assortment continued to drive comparable store increases in sales volume, primarily measured in square footage, and changes in our sales mix which increased our average retail price per unit sold approximately 3.3%. Overall net sales increased due principally to the following factors:

In 2007, increased demand was driven in part by strength in the sales of the Bellawood line, particularly exotic hardwoods, and the broader assortment of engineered hardwoods, including an expanded offering of handscraped products, which offset declines in sales of liquidation deals and unfinished hardwoods.

Moldings and accessories increased 41% and represented 10% of net sales in 2007, up from 8% of net sales in 2006 as we broadened our assortment and committed to a more consistent in-stock position.

Increases in comparable store net sales were driven primarily by the continued maturation of stores in operation for 13 to 36 months at December 31, 2007, where comparable net sales increased $20.5 million, or 26.2%. Net sales at these comparable stores generally increase faster than at our mature stores.

***Gross Profit and Gross Margin.*** Gross profit increased approximately $25.0 million, or 22.7%, to $135.1 million in 2007 from $110.1 million for 2006, and gross margin increased to 33.3% from 33.2%. In 2007, gross

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margin benefited from the sales strength of new product lines introduced late in the second quarter, including handscraped solid and engineered hardwoods, more durable laminates and strand bamboo. These products typically carry a higher average retail price per unit and a higher gross margin than our average product and are a part of the initiative we began in 2006 to broaden our assortment and the price points available to our customers. In 2006, primarily in the fourth quarter, we took steps to optimize inventory levels, particularly in certain newly introduced engineered hardwood lines, and fully clear residual liquidation purchases, adversely impacting gross margin.

Increases in 2007 domestic and international transportation costs adversely impacted gross margin in comparison to 2006, as per-mile ground charges increased primarily due to higher fuel costs. In addition, a number of key tariffs assessed on imported products, most notably bamboo, were implemented or increased in 2007. These increases were partially offset by logistic initiatives, implemented in the third and fourth quarters of 2007, reducing the miles driven by trucks supplying our stores.

***Operating Income.*** Operating income in 2007 decreased $2.6 million, or 12.2%, to $18.8 million, as a $27.6 million increase in SG&A expenses was partially offset by the $25.0 million increase in gross profit. The increase in 2007 SG&A expenses compared to 2006 was principally due to the following factors:

- Salaries, commissions and benefits increased $10.5 million, or 35.5%, and as a percentage of net sales, increased to 9.9% for 2007 from 8.9% for 2006. In-store and regional store management salaries, commissions and benefits expense increased $6.3 million, primarily due to the 25 new store locations opened in 2007 and an increase of the number of regional managers from eight to 15. The investment we began in 2006 in our executive and operational store support infrastructure increased salaries, commissions and benefits expense by $3.4 million in 2007. This investment, substantially complete at December 31, 2007, included our new chief executive officer and six senior executive positions. In addition, we added more finance, compliance and information technology personnel in 2007 as we prepared to become, and operate as, a public company.

- Advertising expenses increased $5.4 million, or 14.9%, to $41.7 million, primarily due to the expansion of our national branding campaigns through television, radio, and sports marketing, coupled with internet search, local advertising and direct mail programs. As a percentage of net sales, however, advertising expenses decreased to 10.3% for 2007 from 10.9% for 2006 as we were able to leverage that expansion over increased net sales.

- Stock-based compensation expense increased $4.8 million, or 328.6%, to $6.2 million primarily due to a $2.2 million increase in the stock-based compensation calculated under the Variable Plan and $1.2 million related to a one-time acceleration in the vesting of certain stock options and recognition of certain stock units triggered by the IPO. In addition, the full year of expense recognition of stock options granted in July and October 2006 and April 2007 increased 2007 expense by $1.4 million.

- Occupancy costs increased $2.5 million, but remained consistent as a percentage of net sales at 3.1%, as costs related to the opening of 25 new store locations in 2007 and the full year impact of 16 new store locations opened in 2006 were offset by increases in net sales.

- Depreciation and amortization increased $0.7 million but remained a consistent 0.9% as a percentage of net sales.

- Certain other expenses, including legal and professional fees, increased $3.8 million, and as a percentage of net sales, from 2.5% to 3.0%, as we enhanced our financial reporting, legal and regulatory compliance, internal controls and corporate governance. Further, certain banking fees, including bankcard discounts, increased commensurate with net sales.

As a percentage of net sales, operating income declined to 4.6% in 2007 from 6.4% in 2006. This decrease was primarily due to the increase in SG&A expenses as a percentage of net sales to 28.7% in 2007 from 26.7% in 2006, partially offset by a slight increase in gross margin.

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***Net Income.*** Net income decreased $1.6 million to $11.3 million in 2007 from $12.9 million in 2006 and as a percentage of net sales decreased to 2.8% from 3.9%. Our effective income tax rate was approximately 38.8% in both 2007 and 2006.

**Year Ended December 31, 2006 Compared to Year Ended December 31, 2005**

***Net Sales.*** Net sales increased $87.1 million, or 36%, to $332.1 million in 2006 from $244.9 million in 2005. This increase was primarily driven by an increase of $42.0 million, or 17.3%, in comparable store net sales, and by a $28.7 million increase in non-comparable net sales at the 19 stores opened during 2005, and $16.4 million at the 16 new stores opened during 2006. Comparable store net sales increases were driven principally by maturation of new stores, optimization of our product mix to reflect customer demand and increased traffic across our store base. The average retail price per unit sold also increased slightly. Overall net sales increased due principally to the following factors:

In early 2006, we introduced a number of new prefinished engineered hardwood products over a range of retail price points not previously available, which increased sales in those product categories. We also continued to increase the percentage of our net sales represented by moldings and accessories, from 7% in 2005 to 8% in 2006.

Increases in comparable store net sales and non-comparable net sales also resulted from the continuing maturation of our store base, as net sales at stores open for less than 36 months (56% of our stores in operation as of December 31, 2006) increased faster than our more mature stores.

Net sales also increased due to improvements we made to our website that, among other things, made it easier to place orders over the Internet.

***Gross Profit and Gross Margin.*** Gross profit increased $24.0 million, or 28%, to $110.1 million in 2006 from $86.1 million in 2005, principally as a result of increases in net sales that were partially offset by higher average supplier costs and an increase in transportation costs. Gross margin decreased approximately 200 basis points to 33.2% in 2006 from 35.2% in 2005, which was principally due to the following factors:

The implementation of our 2006 initiative to broaden our product range increased net sales but caused our gross margin to decline. In particular, we expanded our sales mix to include some products, such as engineered hardwoods, that have a lower gross margin than our average product, which caused an approximately 120 basis point decline in gross margin. The introduction of additional products in our Dura-Wood line also caused an approximately 30 basis point decline in gross margin, as those products have a lower gross margin than our average product and because we implemented a retail pricing strategy designed to enable those products to gain market share.

As part of our efforts to optimize inventory levels, we implemented a number of price discounts (primarily during the fourth quarter of 2006) with respect to slower-moving inventory. We also were required to increase reserves for product warranties due to a purchase of defective merchandise from one supplier. These actions collectively resulted in an approximately 30 basis point decline in our gross margin.

Decreases in the prices of certain product categories, particularly laminates and bamboo, designed to increase net sales and optimize our product mix, which were further impacted by supplier unit cost increases that were not passed on proportionately to our customers, resulted in an approximately 25 basis point decline in gross margin.

Higher domestic and international transportation costs, primarily due to higher fuel and ocean freight costs, customs duties and per-mile ground charges, also caused a decline in gross margin.

These decreases were partially offset by increases in gross margin that resulted from increased efficiencies at our Toano finishing line, slightly higher sales volumes of moldings and accessories (as those products generally have a higher gross margin than our average product) and savings from new, longer-term international transportation contracts.

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***Operating Income.*** Operating income increased $3.2 million, or 18%, to $21.4 million in 2006, principally as a result of the $24.0 million increase in gross profit that was partially offset by a $20.8 million increase in SG&A expenses principally due to the following factors:

Advertising expenses increased $8.7 million, or 32%, in 2006 primarily due to the expansion of our national advertising campaign through television, radio and sports, as well as increased costs relating to online advertising and direct mail programs. As a percentage of net sales, advertising expenses declined to 10.9% in 2006 from 11.3% in 2005, principally due to our ability to leverage our national advertising over increased net sales across all our sales channels.

Salaries, commissions and benefits increased $6.1 million, or 26%, in 2006 primarily due to an increase in the store support infrastructure principally in the second half of 2006, including the hiring of our new chief executive officer and other executives and operational managers. As a percentage of net sales, salaries, commissions and benefits paid to our employees declined to 8.9% in 2006 from 9.6% in 2005, principally due to our ability to leverage our store support infrastructure over increased net sales, although several of the additional costs were not recognized over the full year.

Occupancy costs increased $2.3 million, or 28%, in 2006 principally due to 16 new stores opened in 2006 and the full-year impact of 19 stores opened in 2005. As a percentage of net sales, occupancy costs decreased to 3.1% in 2006 from 3.3% in 2005.

Professional expenses increased $0.8 million to support enhanced financial reporting, legal and regulatory compliance, internal controls and corporate governance functions.

Stock-based compensation expense decreased due to lower current-year expense associated with the Variable Plan, which was partially offset by expense related to stock options granted in 2006.

As a percentage of net sales, operating income declined to 6.4% in 2006 from 7.4% in 2005. This decrease was primarily due to the decline in gross margin, partially offset by a decline in SG&A expenses as a percentage of net sales to 26.7% in 2006 from 27.7% in 2005.

***Net Income.*** Net income increased $2.2 million to $12.9 million in 2006 from $10.7 million in 2005, but declined as a percentage of net sales to 3.9% in 2006 from 4.4% in 2005. Our effective income tax rate was approximately 38.8% for 2006 compared to 39.3% for 2005, reflecting slight variances in state income tax rates.

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**Quarterly Financial Data**

The following table sets forth our unaudited quarterly results of operations for 2006 and 2007. Information for each of these periods has been prepared on the same basis as the audited financial statements included elsewhere in this report. This information includes all adjustments, which consist only of normal and recurring adjustments, management considers necessary for the fair presentation of such data. This data should be read in conjunction with the audited financial statements included elsewhere in this report. The results of operations for historical periods are not necessarily indicative of results for any future period.

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31, 2007 | June 30, 2007 | September 30, 2007 | December 31, 2007 |
| | (dollar amounts in thousands) | | | |
| Net Sales | $ 92,022 | $ 105,725 | $ 102,050 | $ 105,510 |
| Gross Profit | $ 30,571 | $ 34,375 | $ 34,447 | $ 35,721 |
| Selling, General and Administrative Expenses(1) | $ 26,816 | $ 30,415 | $ 28,260 | $ 30,817 |
| Operating Income | $ 3,755 | $ 3,960 | $ 6,187 | $ 4,904 |
| Net Income | $ 2,231 | $ 2,345 | $ 3,701 | $ 3,049 |
| Number of Stores Opened in Quarter | 2 | 10 | 8 | 5 |
| Comparable Sales Increase | 8.5% | 9.0% | 8.4% | 8.6% |

(1) Selling, General and Administrative Expenses includes $403, $2,649, ($150) and $318 of variable plan stock compensation expense for the quarters ended March 31, June 30, September 30, and December 31, respectively, and the quarter ended December 31, 2007 includes $1,224 for the acceleration of stock options and the recognition of the expense associated with the 2006 Regional Plan due to the IPO.

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31, 2006 | June 30, 2006 | September 30, 2006 | December 31, 2006 |
| | (dollar amounts in thousands) | | | |
| Net Sales | $ 76,051 | $ 88,078 | $ 83,090 | $ 84,841 |
| Gross Profit | $ 26,409 | $ 29,453 | $ 27,402 | $ 26,865 |
| Selling, General and Administrative Expenses(1) | $ 20,537 | $ 21,487 | $ 22,587 | $ 24,105 |
| Operating Income | $ 5,872 | $ 7,966 | $ 4,815 | $ 2,760 |
| Net Income | $ 3,560 | $ 4,819 | $ 2,896 | $ 1,623 |
| Number of Stores Opened in Quarter(2) | 4 | 5 | 1 | 6 |
| Comparable Sales Increase | 24.1% | 21.6% | 12.8% | 12.2% |

(1) Selling, General and Administrative Expenses includes $260 of variable plan stock compensation expense for each of the quarters ended March 31, June 30, September 30, and December 31.

(2) We also closed a location, a laminate flooring-only store established to operate during the remaining lease period of a relocated store, in May 2006.

Our quarterly results of operations fluctuate depending on the timing of our advertising expenses and the timing of and income contributed by new stores. Our performance has also been impacted by certain of our initiatives to improve our infrastructure and to position our business to support sustainable growth and profitability in the future.

Our net sales also fluctuate slightly as a result of seasonal factors. We experience slightly higher net sales in spring and fall, when more home remodeling and home building activities are taking place, and slightly lower net sales in holiday periods and during the hottest summer months. These seasonal fluctuations, however, are minimized to some extent by our national presence, as markets experience different seasonal characteristics.

**Liquidity and Capital Resources**

Our principal liquidity requirements have been to meet our working capital and capital expenditure needs. Until our IPO, we funded these requirements primarily through cash flows from operations and short-term and long-term borrowings under our senior secured loan agreement. We completed our IPO in November 2007, receiving net proceeds of approximately $36.2 million. We used a portion of those proceeds to repay the $6.6 million outstanding under the term-loan portion of our senior secured loan agreement. We had no amounts outstanding under our $25.0 million revolving credit facility when we received the net proceeds.

Our principal sources of liquidity are $33.2 million of cash and cash equivalents at December 31, 2007, our cash flow from operations, and $24.7 million of availability under the revolving credit facility. We expect to use this liquidity for general corporate purposes, including providing additional long-term capital to support the growth of our business (primarily through opening new stores) and maintaining our existing stores. In 2008, we intend to:

- open between 30 and 40 new store locations;
- continue the remodeling of existing store showrooms to enhance consistency in presentation;
- upgrade our finishing line in Toano, Virginia;
- increase efficiency and enhance our information technology ( IT ) systems, including security, disaster recovery; and
- upgrade our customer service telephony intelligence.

Together with general capital requirements, we expect capital expenditures to total between $5 million and $7 million in 2008.

We believe that our cash flow from operations, together with our existing liquidity sources, will be sufficient to fund our operations and anticipated capital expenditures over at least the next 24 months.

***Cash and Cash Equivalents***

During 2007, cash and cash equivalents increased $29.2 million to $33.2 million. We received $36.2 million from our IPO in November 2007 and operating activities provided $8.5 million. These increases of cash and cash equivalents were partially offset by the use of $6.0 million to purchase property and equipment, and $9.2 million of net repayments of long-term debt. The primary contributors to the $2.1 million decrease in cash and cash equivalents during 2006 were the use of $2.7 million of cash for purchases of property and equipment and $1.8 million of cash to repay scheduled long-term debt outstanding under the term-loan portion of our senior secured loan agreement, partially offset by $1.4 million of cash provided by operating activities and borrowings of $1.5 million under our revolving loan agreement. In 2005, cash and cash equivalents increased $3.0 million, to $6.0 million, from $3.0 million at the end of 2004. The primary contributor to the increase in cash and cash equivalents during 2005 was $8.0 million of cash provided by operating activities and borrowings of $2.1 million under our senior secured loan agreement, partially offset by the use of $4.3 million of cash for purchases of property and equipment and $3.0 million of cash to repay long-term debt outstanding under our senior secured loan agreement.

***Cash Flows***

**Operating Activities.** Net cash provided by operating activities was $8.5 million for 2007 compared to $1.4 million for 2006 and $8.0 million for 2005. The $7.1 million increase from 2006 to 2007 was primarily attributable to more profitable operations, exclusive of the $4.8 million increase in non-cash stock-based compensation expense and a lesser net build in net operating assets. The decrease in the build of net operating assets was primarily a result of an increase in customer deposits and store credits and less of a build in

merchandise inventories, offset by a reduction in accounts payable. The 2007 merchandise inventory build occurred much earlier than in 2006, and together with a greater percentage of imported merchandise paid for while on the water in December 2007 resulted in a decline in accounts payable.

Net cash provided by operating activities decreased in 2006 compared to 2005 primarily because of increased merchandise inventory levels, partially offset by growth in net income and increases in accounts payable. The increase in inventory levels and increases in accounts payable resulted from our need to support additional net sales from newly opened stores and increasing comparable store net sales. In addition, we increased inventory, primarily in our Toano facility, to be in a better position to drive sales and meet customer demand.

**Investing Activities**. Net cash used in investing activities was $6.0 million for 2007, $2.7 million for 2006 and $4.3 million for 2005. Net cash used in investing activities during 2007 primarily related to capital purchases of truck trailers that we use to move our merchandise from our warehouse to our stores, new store capital needs (primarily store fixtures and leasehold improvements), and IT costs, including costs related to our new point of sale system and routine purchases of computer hardware and software. Net cash used in investing activities in 2006 primarily related to IT systems, including new hardware and upgrades to our telephone system and website, as well as new store capital needs. In 2006, we slowed the increase in new store locations as we expanded our store support infrastructure to better facilitate sustainable growth of our operations. Net cash used in investing activities in 2005 primarily related to purchases of truck trailers, IT system maintenance and new store capital needs.

**Financing Activities.** Net cash provided by financing activities was $26.7 million for 2007. Net cash provided by financing activities for 2007 was primarily from the $36.2 million net proceeds from our IPO in November 2007, offset by scheduled monthly principal payments under the term portion of our senior secured loan agreement prior to the IPO and the pay off of the $6.6 million balance remaining outstanding after the IPO. Net cash used in financing activities for 2006 was primarily attributable to the use of $1.8 million to make principal payments on our senior secured loan agreement, partially offset by an increase of $1.5 million in borrowings. Net cash used in financing activities during 2005 was primarily attributable to principal payments on our senior loan agreements, partially offset by an increase of $2.1 million in borrowings.

**Revolving Credit Agreement**

In August 2007, we entered into a new revolving credit agreement to replace the then-existing revolving credit facility under the senior secured loan agreement. We can borrow up to $25.0 million under the new agreement, which expires on August 10, 2012. We intend to use the revolving credit facility primarily to fund inventory purchases, including (as provided in the agreement) the support of up to $5.0 million for letters of credit and general operations. The revolving credit facility is secured by our inventory, has no mandated payment provisions and we pay a fee of 0.125% per annum, which may be increased in the future based on financial performance criteria, on any unused portion of the revolving facility. Amounts outstanding under the revolving credit facility would be subject to an interest rate of LIBOR (reset on the 10th of the month) + 0.50%, which may increase based on financial performance criteria. We had outstanding commitments under letters of credit of $0.3 million at December 31, 2007 and $24.7 million was available to borrow. The revolving credit agreement and related security agreement contain a number of restrictions that require us to maintain certain financial ratios and limit our ability, among other things, to borrow money, pledge our inventory or other assets as security in other borrowings or transactions, undergo a merger or consolidation, guarantee certain obligations of third parties, make or extend credit other than on ordinary terms in the course of our business or engage in any activity not reasonably related to those we presently conduct. We were in compliance with these financial covenants at December 31, 2007.

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**Senior Secured Loan Agreement**

In March 2006, we entered into an amended and restated senior secured loan agreement with Bank of America, N.A., and we amended it in July 2006. The agreement included a term loan with an original principal amount of $9.9 million. On November 15, 2007, we used $6.6 million of the net IPO proceeds to retire the principal balance of the term loan and interest accrued to date. The term loan had required principal payments in 60 equal monthly installments through scheduled expiration in March 2011, and bore interest, payable monthly in arrears, at the 30-Day LIBOR plus 0.90%. This senior secured loan agreement also included a revolving credit facility that initially permitted borrowings of up to $5.0 million, amended in July 2006 to increase the maximum borrowings to $10.0 million. That facility was replaced by a new revolving credit agreement in August 2007.

**Conversion of Preferred Stock**

In connection with our IPO, funds managed by TA Associates converted 7,952,018 shares of series A convertible preferred stock, par value $0.01, to shares of common stock, par value $0.001, on a one-to-one basis on November 8, 2007. These shares had been purchased in December 2004 for $35.0 million.

**Related Party Transactions**

See the discussion of related party transactions in Note 5 and Note 10 to the financial statements included in Item 8 of this report and within Related Party Transactions and Lease Arrangements in Item 13 of this report.

**Contractual Commitments and Contingencies**

Our significant contractual obligations and commitments as of December 31, 2007 are summarized in the following table:

| | | Payments Due by Period (in thousands) | | | |
|---|---|---|---|---|---|
| | Total | Less Than 1 Year | 1 to 3 Years | 3 to 5 Years | 5+ Years |
| **Contractual obligations** | | | | | |
| Operating lease obligations(1) | $ 46,537 | $ 7,980 | $ 13,644 | $ 8,893 | $ 16,020 |
| Other notes payable | 62 | 62 | | | |
| Capital lease obligations, including interest | 61 | 61 | | | |
| Supplier purchase commitments(2) | | | | | |
| Total contractual obligations | $ 46,660 | $ 8,103 | $ 13,644 | $ 8,893 | $ 16,020 |

(1) Included in this table is the base period or current renewal period for our operating leases. The operating leases generally contain varying renewal provisions.

(2) We have one long-term purchase agreement with a merchant vendor that we entered into in July 2006 that requires us to purchase approximately 27 million square feet of the vendor s assorted products over a four-year period, with the unit prices set at the time a purchase order is created/accepted. Issues have arisen with regard to the quality of the products provided by the vendor, the vendor s requests for changes in prices for the products and the vendor s failure to honor purchase orders that it had accepted. We are not currently receiving product under the agreement, and we intend to seek payment for our cover costs relating to purchase orders that were not delivered. The products ordered from the vendor that are not being delivered have been purchased from other suppliers and we expect the cover costs to be immaterial.

**Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements or other financing activities with special-purpose entities.

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**Inflation**

Inflationary factors such as increases in the cost of our product and overhead costs may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross profit and selling, general and administrative expenses as a percentage of net sales if the selling prices of our products do not increase with these increased costs.

**Critical Accounting Policies and Estimates**

Critical accounting policies are those that we believe are both significant and that require us to make difficult, subjective or complex judgments, often because we need to estimate the effect of inherently uncertain matters. We base our estimates and judgments on historical experiences and various other factors that we believe to be appropriate under the circumstances. Actual results may differ from these estimates, and we might obtain different estimates if we used different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements:

***Recognition of Net Sales***

We recognize net sales for products purchased at the time the customer takes possession of the merchandise. We recognize service revenue, which consists primarily of freight charges for in-home delivery, when the service has been rendered. We report revenue net of sales and use taxes collected from customers and remitted to governmental taxing authorities. Net sales are reduced by an allowance for anticipated sales returns that we estimate based on historical sales trends and experience. Any reasonably likely changes that may occur in the assumptions underlying our allowance estimates would not be expected to have a material impact on our financial condition or operating performance. In addition, customers who do not take immediate delivery of their purchases are generally required to leave a deposit of up to 50% of the sales amount with the balance payable when the products are delivered. These customer deposits benefit our cash flow and return on investment capital, since we receive partial payment for our customers purchases immediately. We record these deposits as a liability on our balance sheet under the line item Customer Deposits and Store Credits until the customer takes possession of the merchandise.

***Equity Compensation***

We currently maintain a single equity incentive plan under which we may grant non-qualified stock options, incentive stock options and restricted shares to employees and non-employee directors. Using the prospective-transition method, we adopted the provisions of SFAS 123(R) effective January 1, 2006. Prior to the adoption of SFAS 123(R), we used the intrinsic value method under the provisions of Accounting Principles Board Opinion No. 25 (or APB 25 ). There were no material differences in the calculations of stock-based compensation expense under APB 25 and SFAS 123, *Accounting for Stock-Based Compensation* in 2005. We recognize expense for our stock-based compensation based on the fair value of the awards that are granted. Measured compensation cost is recognized ratably over the service period of the related stock-based compensation award.

The fair value of stock options was estimated at the date of grant using the Black-Scholes-Merton valuation model. In order to determine the related stock compensation expense, we used the following assumptions for stock options granted during 2007:

- Expected life of 7.5 years;
- Expected stock price volatility of between 35% and 39%, based on the median volatility of companies in a peer group;
- Risk-free interest rates from 4.2% to 4.6%; and
- Dividends are not expected to be paid in any year.

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In addition, we are party to the Variable Plan, a stock-based agreement between Tom Sullivan and Kevin Sullivan. We account for that agreement as a variable performance plan. Under the Variable Plan, as amended, Kevin has the right to a fixed ownership percentage of Lumber Liquidators, Inc. on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria (primarily a comparison of the net income of the region under his management to our total net income on a trailing twelve-month basis). In order to determine the compensation expense to be recorded, we were required to determine the net income of the region under his management, which required us to make certain estimates.

Prior to our IPO, management had estimated the fair value of our common stock based on contemporaneous valuations utilizing a market-approach model. We used this approach to value our common stock in retrospectively determining stock-based compensation expense as of December 31, 2005, and to establish contemporaneous fair values of equity instruments for our equity grants in 2006 and April 2007. For the second and third quarters of 2007, however, management determined that the IPO process had progressed to such an extent that a different valuation methodology (based on estimating the company s fair value as a public entity, and then applying a marketability discount) could be used to measure fair value, and accordingly used that methodology in determining stock compensation expense.

A variety of qualitative and quantitative factors were considered in making these equity valuation determinations, including the state of the economy and the industry in which we operate, milestones that the company and its management had achieved and the appropriate marketability discount. A marketability discount was also applied in each case, which management determined to be reasonable for each period based on the company s prospects for liquidity at that time and developments in its business and operations. This discount decreased over time as we improved various aspects of our business and operations, including moving to a new facility, increasing the size of our product range, opening a significant number of new stores, hiring a number of key senior executives (including a new CEO), and implementing a number of operational, financial and governance policies to enhance our reporting and compliance functions.

After our IPO, we consider the fair value of our common stock to be the closing price of our common stock on the grant date. As of December 31, 2007, there were 1,966,847 stock options outstanding, with an aggregate intrinsic value of $2.0 million that will vest over approximately 2.4 years. Of these, 708,876 stock options with an intrinsic value of $1.0 million were exercisable at December 31, 2007. See Note 6 to the financial statements included in Item 8 of this report.

***Merchandise Inventories***

We value our merchandise inventories at the lower of merchandise cost or market value. We determine merchandise cost using the average cost method. All of the hardwood flooring we purchase from suppliers is either prefinished or unfinished, but is in immediate saleable form. To the extent that we finish and box unfinished products, we include those costs in the average unit cost of related merchandise inventory. In determining market value, we make judgments and estimates as to the market value of our products, based on factors such as historical results and current sales trends. Any reasonably likely changes that may occur in those assumptions in the future may require us to record charges for losses or obsolescence against these assets, but would not be expected to have a material impact on our financial condition or operating performance.

**New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board (or FASB ) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (or FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 describes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 was effective as of January 1, 2007. The adoption of FIN 48 did not have a material effect on our financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (or SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the impact of SFAS 157 on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (or SFAS 159 ). SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value ( fair value option ) and to report in earnings unrealized gains and losses on those items for which the fair value has been elected. SFAS 159 also requires entities to display the fair value of those assets and liabilities on the face of the balance sheet. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 will be effective for us as of the first quarter of 2008. Early adoption is permitted. We are currently evaluating the impact of SFAS 159 on our financial statements.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**
***Interest Rates.***

We are exposed to interest rate risk through the investment of our cash and cash equivalents. Since the completion of our IPO, we have invested our cash in short-term investments with maturities of three months or less. Changes in interest rates affect the interest income we earn, and therefore impact our cash flows and results of operation. In addition, any future borrowings under our revolving credit agreement would be exposed to interest rate risk due to the variable rate of the facility.

We currently do not engage in any interest rate hedging activity and currently have no intention to do so in the foreseeable future. However, in the future, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

**Item 8. Financial Statements and Supplementary Data.**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders of

Lumber Liquidators, Inc.

We have audited the accompanying balance sheets of Lumber Liquidators, Inc. as of December 31, 2007 and 2006, and the related statements of income, stockholders equity (deficit), and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lumber Liquidators, Inc. at December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

/s/ ERNST & YOUNG LLP

Richmond, Virginia

March 11, 2008

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**Lumber Liquidators, Inc.**

**Balance Sheets**

**(in thousands, except share data)**

| | December 31, 2007 | December 31, 2006 |
|---|---|---|
| **Assets** | | |
| **Current Assets:** | | |
| Cash and Cash Equivalents | $ 33,168 | $ 3,965 |
| Merchandise Inventories | 72,024 | 51,758 |
| Prepaid Expenses | 4,011 | 3,638 |
| Other Current Assets | 3,862 | 3,359 |
| **Total Current Assets** | **113,065** | **62,720** |
| Property and Equipment, net | 11,580 | 9,332 |
| Deferred Income Taxes | 1,220 | 3,737 |
| Other Assets | 2,559 | 2,231 |
| **Total Assets** | **$ 128,424** | **$ 78,020** |
| **Liabilities and Stockholders Equity (Deficit)** | | |
| **Current Liabilities:** | | |
| Accounts Payable | $ 15,654 | $ 16,296 |
| Customer Deposits and Store Credits | 9,609 | 6,804 |
| Accrued Compensation | 3,157 | 1,566 |
| Other Current Liabilities | 7,694 | 5,292 |
| Current Portions of Long-Term Debt and Capital Lease Obligations | 122 | 3,065 |
| **Total Current Liabilities** | **36,236** | **33,023** |
| Stock Compensation Liability | | 9,132 |
| Long-Term Debt and Capital Lease Obligations | | 6,538 |
| Redeemable Preferred Stock | | 34,795 |
| **Stockholders Equity (Deficit):** | | |
| Common Stock ($0.001 par value and no par value, respectively; 35,000,000 authorized; 26,752,118 and 15,000,100 issued and outstanding, respectively) | 27 | |
| Additional Capital | 87,553 | 1,250 |
| Retained Earnings (Deficit) | 4,608 | (6,718) |
| **Total Stockholders Equity (Deficit)** | **92,188** | **(5,468)** |
| **Total Liabilities and Stockholders Equity (Deficit)** | **$ 128,424** | **$ 78,020** |

*See accompanying notes to financial statements*

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**Lumber Liquidators, Inc.**

**Statements of Income**

**(in thousands, except share data and per share amounts)**

| | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| **Net Sales** | **$ 405,307** | **$ 332,060** | **$ 244,947** |
| Cost of Sales | 270,193 | 221,931 | 158,844 |
| **Gross Profit** | **135,114** | **110,129** | **86,103** |
| Selling, General and Administrative Expenses | 116,308 | 88,716 | 67,900 |
| Operating Income | 18,806 | 21,413 | 18,203 |
| Interest Expense | 722 | 722 | 638 |
| Other (Income) Expense | (413) | (368) | (96) |
| Income Before Income Taxes | 18,497 | 21,059 | 17,661 |
| Provision for Income Taxes | 7,171 | 8,161 | 6,948 |
| **Net Income** | **$ 11,326** | **$ 12,898** | **$ 10,713** |
| **Net Income per Common Share Basic** | **$ 0.68** | **$ 0.86** | **$ 0.71** |
| **Net Income per Common Share Diluted** | **$ 0.48** | **$ 0.56** | **$ 0.46** |
| Weighted Average Common Shares Outstanding: | | | |
| Basic | 16,646,674 | 15,000,100 | 15,000,100 |
| Diluted | 23,634,995 | 22,989,403 | 23,063,174 |

*See accompanying notes to financial statements*

**Lumber Liquidators, Inc.**

**Statements of Stockholders Equity (Deficit)**

**(in thousands, except share data)**

| | Common Stock | | | Retained | Total |
|---|---|---|---|---|---|
| | Shares | Par Value | Additional Capital | Earnings (Deficit) | Stockholders Equity (Deficit) |
| **Balance December 31, 2004** | **15,000,100** | **$** | **$ 87** | **$ (30,329)** | **$ (30,242)** |
| Contributions from Founder, net | | | 581 | | 581 |
| Stock-Based Compensation Expense | | | 173 | | 173 |
| Net Income | | | | 10,713 | 10,713 |
| **Balance December 31, 2005** | **15,000,100** | **$** | **$ 841** | **$ (19,616)** | **$ (18,775)** |
| Stock-Based Compensation Expense | | | 409 | | 409 |
| Net Income | | | | 12,898 | 12,898 |
| **Balance December 31, 2006** | **15,000,100** | **$** | **$ 1,250** | **$ (6,718)** | **$ (5,468)** |
| Reincorporation in Delaware | | 15 | (15) | | |
| Sale of Common Stock, net of issuance costs of $5,650 | 3,800,000 | 4 | 36,146 | | 36,150 |
| Conversion of Redeemable Preferred Stock into Common Stock | 7,952,018 | 8 | 34,830 | | 34,838 |
| Stock-Based Compensation Expense | | | 5,950 | | 5,950 |
| Reclassification of Stock Compensation Liability | | | 9,392 | | 9,392 |
| Net Income | | | | 11,326 | 11,326 |
| **Balance December 31, 2007** | **26,752,118** | **$ 27** | **$ 87,553** | **$ 4,608** | **$ 92,188** |

*See accompanying notes to financial statements*

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**Lumber Liquidators, Inc.**

**Statements of Cash Flows**

**(in thousands)**

| | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| Net Income | $ 11,326 | $ 12,898 | $ 10,713 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | | |
| Depreciation and Amortization | 3,627 | 2,908 | 2,240 |
| Deferred Income Taxes | 377 | (697) | (1,732) |
| Stock-Based Compensation Expense | 6,211 | 1,449 | 3,306 |
| Accretion of Redeemable Preferred Stock | 43 | 51 | 51 |
| Changes in Operating Assets and Liabilities: | | | |
| Merchandise Inventories | (20,266) | (21,749) | (7,502) |
| Accounts Payable | (642) | 7,884 | (1,261) |
| Customer Deposits and Store Credits | 2,805 | (556) | 2,245 |
| Prepaid Expenses and Other Current Assets | 1,264 | (2,590) | (2,026) |
| Other Assets and Liabilities | 3,767 | 1,812 | 1,954 |
| **Net Cash Provided by Operating Activities** | **8,512** | **1,410** | **7,988** |
| **Cash Flows from Investing Activities:** | | | |
| Purchases of Property and Equipment | (5,977) | (2,719) | (4,327) |
| **Net Cash Used in Investing Activities** | **(5,977)** | **(2,719)** | **(4,327)** |
| **Cash Flows from Financing Activities:** | | | |
| Net Proceeds from Sale of Common Stock | 36,150 | | |
| Repayments of Long-Term Debt | (15,648) | (1,825) | (3,009) |
| Proceeds from Long-Term Borrowings and Revolving Line | 6,426 | 1,464 | 2,140 |
| Principal Payments on Capital Lease Obligations | (260) | (396) | (500) |
| Contributions from Founder | | | 708 |
| **Net Cash Provided by (Used In) Financing Activities** | **26,668** | **(757)** | **(661)** |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | **29,203** | **(2,066)** | **3,000** |
| **Cash and Cash Equivalents, Beginning of Year** | **3,965** | **6,031** | **3,031** |
| **Cash and Cash Equivalents, End of Year** | **$ 33,168** | **$ 3,965** | **$ 6,031** |

*See accompanying notes to financial statements*

**Lumber Liquidators, Inc.**

**Notes to Financial Statements**

**(amounts in thousands, except share data and per share amounts)**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Nature of Business***

Lumber Liquidators, Inc. (the Company ) is a multi-channel specialty retailer of hardwood flooring, and hardwood flooring enhancements and accessories, operating as a single business segment. The Company offers an extensive assortment of exotic and domestic hardwood species, engineered hardwoods, and laminates direct to the consumer. The Company also features the renewable flooring products, bamboo and cork, and provides a wide selection of flooring enhancements and accessories, including moldings, noise-reducing underlay and adhesives. These products are primarily sold under the Company s private label brands, including the premium Bellawood brand floors. The Company sells primarily to homeowners or to contractors on behalf of homeowners through a network of 116 store locations in primary or secondary metropolitan areas in 43 states. In addition to the store locations, the Company s products may be ordered, and customer questions/concerns addressed, through both our call center in Toano, Virginia, and our website, www.lumberliquidators.com. The Company finishes the majority of the Bellawood products in Toano, Virginia, which along with the call center, corporate offices, and finishing and distribution facility represent the Corporate Headquarters.

***Organization and Basis of Financial Statement Presentation***

The Company was organized in 1994 as a Massachusetts corporation and the original equity interest was held solely by the founder and current chairman of the Board (the Founder ). On August 28, 2007, the Company was reincorporated in Delaware. As a Massachusetts corporation, the Company s stock had no par value. As a result of the reincorporation in Delaware, the par value was increased to $0.001 per share (the Common Stock ).

In 2004, a private investment group purchased 7,952,018 shares of Series A Convertible Preferred Stock with a par value of $0.01 (the Redeemable Preferred Stock ) for $35,000. All shares of Redeemable Preferred Stock were converted into shares of Common Stock on a one-to-one basis on November 8, 2007.

On November 9, 2007, the Company completed its offering of 3,800,000 shares of Common Stock in an initial public offering at a per share price of $11.00, receiving net proceeds of approximately $36,150 (the IPO ). The Founder and the private investment group sold an additional 6,200,000 shares of common stock in the IPO.

Certain prior year amounts have been reclassified to conform to the current year presentation.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

***Cash and Cash Equivalents***

The Company considers all highly liquid investments with a maturity date of three months or less when purchased to be cash equivalents. For those short-term investments, the carrying amount is a reasonable estimate of fair value. The Company accepts a range of debit and credit cards, and these transactions are generally transmitted to a bank for reimbursement within 24 hours. The payments due from the banks for these debit and credit card transactions are generally received, or settle, within 24-48 hours of the transmission date. The

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Company considers all debit and credit card transactions that settle in less than seven days to be cash and cash equivalents. Amounts due from the banks for these transactions classified as cash and cash equivalents totaled $2,065 and $2,791 at December 31, 2007 and 2006, respectively.

***Fair Value of Financial Instruments***

The carrying amounts of financial instruments such as cash and cash equivalents, notes receivable, accounts payable, and other liabilities approximate fair value because of the short-term nature of these items. The carrying amounts of the equipment financing obligations and long-term debt approximate fair value because the interest rates on these instruments change with, or approximate, market interest rates.

***Merchandise Inventories***

The Company values merchandise inventories at the lower of cost or market. Merchandise cost is determined using the average cost method. All of the hardwood flooring purchased from vendors is either prefinished or unfinished, and in immediate saleable form. The Company adds the finish to, and boxes, various species of unfinished product, to produce certain proprietary products, primarily Bellawood, at its finishing facility. These finishing and boxing costs are included in the average unit cost of related merchandise inventory. The Company maintains an inventory reserve for loss or obsolescence, based on historical results and current sales trends. This reserve was $644 and $674 at December 31, 2007 and 2006, respectively.

***Impairment of Long-Lived Assets***

The Company evaluates potential impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets may be impaired, and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amounts of those assets. If impairment exists and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those assets, an impairment loss is recorded based on the difference between the carrying value and fair value of the assets. No impairment charges were recognized in 2007, 2006 or 2005.

***Goodwill***

The Company has $1,050 of goodwill recorded in other assets and evaluates it for impairment on an annual basis, or whenever events or changes in circumstance indicate that the carrying value may be impaired. Based on the analysis performed, the Company has concluded that no impairment in the value of goodwill has occurred.

***Recognition of Net Sales***

The Company recognizes net sales for products purchased at the time the customer takes possession of the merchandise. Service revenue, primarily freight charges for in-home delivery, is recognized when the service has been rendered. The Company reports revenue net of sales and use taxes collected from customers and remitted to governmental taxing authorities. Net sales are reduced by an allowance for anticipated sales returns based on historical and current sales trends and experience. The sales returns allowance and related changes were not significant for 2007, 2006 or 2005.

The Company generally requires customers to pay a deposit, equal to approximately 50% of the retail sales value, when purchasing merchandise inventories not regularly carried in a given store location, or not currently in stock. These deposits are included in Customer Deposits and Store Credits until the customer takes possession of the merchandise.

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*Cost of Sales*

The cost of sales includes the actual cost of the merchandise sold, the transportation costs from vendor to the Company s distribution center or store location, any applicable finishing costs related to production of the Company s proprietary brand, the transportation costs from the distribution center to the store locations, and any inventory adjustments, including shrinkage.

The Company includes transportation costs for the delivery of products directly from stores to customers in cost of sales if delivered by third parties or in selling, general and administrative expenses (or SG&A ) if delivered by the Company s delivery fleet. Costs related to the Company s delivery fleet, which include delivery salaries, maintenance and depreciation, totaled approximately $1,600 in 2007 and 2006, and $2,600 in 2005.

The Company offers a range of prefinished products with warranties on the durability of the finish ranging from 10 to 50 years. Warranty reserves are based primarily on claims experience, sales history and other considerations, and warranty costs are recorded in the cost of sales. Warranty costs and changes to the warranty reserve were not significant for 2007, 2006 or 2005.

*Advertising Costs*

Advertising costs charged to SG&A were $41,693, $36,288 and $27,570 in 2007, 2006 and 2005, respectively. The Company uses various types of media to brand its name and advertise its products. Media production costs are generally expensed as incurred, except for direct mail, which is expensed when the finished piece enters the postal system. Media placement costs are generally expensed in the month the advertising occurs, except for contracted endorsements and sports agreements, which are generally expensed ratably over the contract period. Amounts paid in advance are included in prepaid expenses and totaled $1,935 and $2,667 at December 31, 2007 and 2006, respectively.

*Store Opening Costs*

Costs to open new store locations are charged to SG&A as incurred.

*Depreciation and Amortization*

Property and equipment is carried at cost and depreciated on the straight-line method over the estimated useful lives of the related assets. Vehicles and office equipment are depreciated over useful lives which range from three to five years, and finishing equipment is depreciated over five years. The estimated useful lives for leasehold improvements are the shorter of the estimated useful lives or the remainder of the lease terms. For leases with optional renewal periods, the Company uses the original lease term, excluding optional renewal periods to determine the appropriate estimated useful lives. Leasehold improvements are currently being amortized over useful lives which range from two to fifteen years.

Some of the Company s vehicles are leased under capital leases. These assets are recorded at the lower of fair value or the present value of net minimum lease payments and amortized over the shorter of their estimated useful life or the life of the lease. Amortization of capital leases is included within depreciation expense.

*Operating Leases*

The Company has operating leases for its stores, Corporate Headquarters and certain transportation equipment. The lease agreements for certain stores contain rent escalation clauses and rent holidays. For scheduled rent escalation clauses during the lease terms or for rental payments commencing at a date other than the date of initial occupancy, the Company records minimum rental expenses on a straight-line basis over the terms of the leases in SG&A.

***Stock-Based Compensation***

The Company adopted the provisions of Statement of Financial Accounting Standards (or SFAS ) No. 123 (revised in 2004), Share-Based Payment (or SFAS 123(R) ), using the prospective-transition method effective January 1, 2006. Prior to the adoption of SFAS 123(R), the Company used the intrinsic value method under the provisions of Accounting Principles Board Opinion No. 25 (or APB 25 ). There were no material differences in the calculations of the Company s stock-based compensation expense under APB 25 and SFAS 123, Accounting for Stock-Based Compensation in 2005.

The Company issues incentive awards in the form of stock options and restricted stock awards to employees and non-employee directors. The Company recognizes expense for its stock-based compensation based on the fair value of the awards that are granted. Measured compensation cost is recognized ratably over the requisite service period of the related stock-based compensation award.

***Income Taxes***

Income taxes are accounted for in accordance with SFAS No. 109, Accounting for Income Taxes (or SFAS 109 ). Income taxes are provided for under the asset and liability method and consider differences between the tax and financial accounting bases. The tax effects of these differences are reflected on the balance sheet as deferred income taxes and valued using the effective tax rate expected to be in effect when the differences reverse. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion of the deferred tax asset will not be realized. In evaluating the need for a valuation allowance, the Company took into account various factors, including the expected level of future taxable income. If actual results differ from the assumptions made in the evaluation of the valuation allowance, a change in the valuation allowance will be recorded through income tax expense in the period such determination is made.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board (or FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (or FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. FIN 48 describes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have a material effect on the Company s financial position or results of operations.

***Net Income per Common Share***

Basic net income per common share is determined by dividing net income by the weighted average number of common shares outstanding during the year. Diluted net income per common share is determined by dividing net income by the weighted average number of common shares outstanding during the year, plus the dilutive effect of common share equivalents, such as stock options, warrants and preferred stock. Common shares and common share equivalents included in the computation represent shares issuable upon assumed exercise of outstanding stock options and warrants and the conversion of redeemable convertible preferred stock, except when the effect of their inclusion would be antidilutive.

***Recent Accounting Pronouncements***

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (or SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact of this pronouncement on its financial statements.

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In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (or SFAS 159 ). SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (or fair value option ) and to report in earnings unrealized gains and losses on those items for which the fair value option has been elected. SFAS 159 also requires entities to display the fair value of those assets and liabilities on the face of the balance sheet. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for the Company as of the first quarter of 2008. Early adoption is permitted. The Company is currently evaluating the impact of this pronouncement on its financial statements.

**NOTE 2. NOTES RECEIVABLE**

The Company holds two notes receivable from a merchandise supplier with an outstanding balance due to the Company of $1,375 at December 31, 2007, of which $519 had been included in other current assets. In June 2007, the Company consolidated two outstanding notes receivable into one note with an aggregate value of $912 maturing in June 2010. A separate note, which matures in August 2009, was not modified. As of December 31, 2006, notes receivable from merchandise vendors had an outstanding balance due to the Company of $1,780, of which $1,009 had been included in other current assets.

**NOTE 3. PROPERTY AND EQUIPMENT**

Property and equipment consisted of:

| | December 31, | |
|---|---|---|
| | **2007** | **2006** |
| Vehicles | $ 9,045 | $ 7,633 |
| Finishing Equipment | 3,171 | 3,151 |
| Office Equipment and Other | 5,029 | 3,053 |
| Store Fixtures | 2,413 | 991 |
| Leasehold Improvements | 1,736 | 817 |
| | 21,394 | 15,645 |
| Less: Accumulated Depreciation and Amortization | 9,814 | 6,313 |
| Property and Equipment, net | $ 11,580 | $ 9,332 |

As of December 31, 2007 and 2006, property and equipment, net included assets under capital leases of $151 and $339, respectively, net of accumulated amortization of $1,598 and $1,410, respectively.

**NOTE 4. LONG-TERM DEBT**

Long-term debt consisted of the following:

| | December 31, | |
|---|---|---|
| | **2007** | **2006** |
| Other Notes Payable | $ 62 | $ 140 |
| Consolidated Term Note | | 8,398 |
| Revolving Line of Credit | | 745 |
| | 62 | 9,283 |
| Less: Current Portions of Long-Term Debt | 62 | 2,804 |
| Total Long-Term Debt | $ | $ 6,479 |

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On November 15, 2007 the Company paid $6,601 to retire the principal balance of Consolidated Term Note, which included monthly interest accrued to that date. The Consolidated Term Note had required 60 equal monthly principal payments through scheduled expiration in March 2011, and bore interest payable monthly in arrears, at the 30-Day London Interbank Offer Rate ( LIBOR ) + 0.90%.

The Company entered into a new revolving credit agreement (or 2007 Revolver ) to replace the existing revolving line of credit (the 2006 Revolver ), which provided for borrowings up to $10,000 and was set to expire on May 31, 2008. The 2007 Revolver provides for borrowings up to $25,000 and expires on August 10, 2012. The 2007 Revolver is primarily used to fund inventory purchases, including the support of up to $5,000 for letters of credit, and for general operations. The 2007 Revolver is secured by the Company s inventory, has no mandated payment provisions and the Company pays a fee of 0.125% per annum, which may be increased in the future based on financial performance criteria, on any unused portion of the 2007 Revolver. Amounts outstanding under the 2007 Revolver would be subject to an interest rate of LIBOR (reset on the 10th of the month) + 0.50%, which may increase based on financial performance criteria. The 2006 Revolver bore interest at the 30-Day LIBOR + 0.90%, and the Company paid a fee of 0.25% on any unused portion. The Company had outstanding commitments under letters of credit of $262 at December 31, 2007 and $24,738 was available to borrow. The Revolver has certain defined covenants and restrictions, including the maintenance of certain defined financial ratios. The Company is in compliance with these financial covenants at December 31, 2007.

Interest payments totaled $679, $672 and $574 in 2007, 2006 and 2005, respectively.

**NOTE 5. LEASES**

The Company leases all store locations, the Corporate Headquarters and certain transportation equipment. The store location leases are operating leases and generally have five-year base periods with multiple five-year renewal periods.

The Founder is also the sole owner of ANO LLC, DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and he has a 50% membership interest in BMT Holdings, LLC (collectively, ANO and Related Companies ). As of December 31, 2007 and 2006, the Company leased 26 of its locations from ANO and Related Companies representing 22.4% and 28.6% of the total number of store leases in operation, respectively. As of December 31, 2005 the Company leased 23 of its locations from ANO and Related Companies, representing 30.3% of the total number of store leases in operation. In addition, the Company leases the Corporate Headquarters from ANO LLC under an operating lease with a base period through December 31, 2019.

Rental expense for 2007, 2006 and 2005 was $6,853, $5,213 and $4,425, respectively, with rental expense attributable to ANO and Related Companies of $2,529, $2,261 and $2,110, respectively.

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The future minimum rental payments under capital leases and non-cancellable operating leases, segregating ANO and Related Companies leases from all other operating leases, were as follows at December 31, 2007:

| | | Operating Leases | | | |
|---|---|---|---|---|---|
| | | ANO and Related Companies | | | |
| | Capital Leases | Store Leases | Headquarters Lease | Store Leases | Total Operating Leases |
| 2008 | $ 61 | $ 1,276 | $ 1,003 | $ 5,701 | $ 7,980 |
| 2009 | | 996 | 1,033 | 5,197 | 7,226 |
| 2010 | | 799 | 1,064 | 4,555 | 6,418 |
| 2011 | | 425 | 1,096 | 3,705 | 5,226 |
| 2012 | | 140 | 1,129 | 2,398 | 3,667 |
| Thereafter | | 329 | 8,911 | 6,780 | 16,020 |
| Total minimum lease payments | 61 | $ 3,965 | $ 14,236 | $ 28,336 | $ 46,537 |
| Less: amounts representing interest costs | (1) | | | | |
| Present value of minimum lease payments | 60 | | | | |
| Less: current maturities | (60) | | | | |
| Long-term capital lease obligations | $ | | | | |

**NOTE 6. STOCK BASED COMPENSATION**

***Overview***

The Company recorded total stock-based compensation expense of $6,211, $1,449 and $3,306 for 2007, 2006 and 2005, respectively.

In August 2007, the Company adopted an equity incentive plan for employees, non-employee directors and other service providers, the Lumber Liquidators, Inc. 2007 Equity Compensation Plan (the 2007 Plan ), from which it grants stock options and restricted stock awards. The number of shares of Common Stock authorized for issuance with respect to awards granted under the 2007 Plan is 4.3 million, reduced by (i) any shares that have been issued under either the 2004 Stock Option and Grant Plan and the 2006 Equity Plan for Non-Employee Directors (collectively, the Prior Plans ), and (ii) any shares that are subject to outstanding awards under the Prior Plans that have not been forfeited or canceled. No additional options will be issued under the Prior Plans. Stock options granted under the 2007 Plan expire no later than ten years from the date of grant and the exercise price shall not be less than the fair market value of the shares on the date of grant. Vesting periods are assigned to stock options and restricted stock awards on a grant by grant basis at the discretion of the Board of Directors.

The Company recorded stock-based compensation expense related to stock options and restricted stock awards of $2,733 for 2007, which included $977 related to one-time acceleration of vesting provisions in certain stock option agreements triggered by the IPO and resulting in the immediate vesting of 261,313 stock options. The Company recorded stock-based compensation expense related to stock options of $668 for the year ended December 31, 2006.

The Company is party to a stock-based agreement between the Founder and his brother, Kevin Sullivan, a regional manager (or Kevin ), accounted for as a variable performance plan (the Variable Plan ). The Variable Plan was established in 1998 and modified in August 2005. The Variable Plan awarded Kevin the right (the Variable Right ) to an ownership percentage of Common Stock, contributed by the Founder. The Variable Right fully vested in conjunction with the IPO. The Company recorded stock-based compensation expense related to the Variable Plan of $3,220, $1,040 and $3,133 for 2007, 2006 and 2005, respectively.

In addition, the Company maintains a stock unit plan for regional store management, the 2006 Stock Unit Plan for Regional Managers (the 2006 Regional Plan ). In May 2006, certain Regional Managers were granted a total of 85,000 stock units that vest over approximately a five year period. The Founder will contribute 85,000 shares of Common Stock necessary to provide for the exercise of the stock units. No additional grants of stock units are available under the 2006 Regional Plan. The stock units would have expired without value unless a trigger event, as defined, occurred. The IPO was a trigger event, and the Company recorded $258 of stock-based compensation expense in the fourth quarter of 2007. The remaining $387 of stock compensation expense will be recognized over the next 3 years.

***Stock Options***

The following table summarizes activity related to our stock options:

| | Shares | Weighted Average Exercise Price | Remaining Average Contractual Term (Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Balance, December 31, 2005 | | | | |
| Granted | 1,796,847 | $ 7.69 | | |
| Exercised | | | | |
| Forfeited | | | | |
| Balance, December 31, 2006 | 1,796,847 | 7.69 | | |
| Granted | 175,000 | 10.78 | | |
| Exercised | | | | |
| Forfeited | 5,000 | 11.00 | | |
| Balance at December 31, 2007 | 1,966,847 | $ 7.95 | 8.8 | $ 2,038 |
| Exercisable at December 31, 2007 | 708,876 | $ 7.65 | 8.6 | $ 950 |

The aggregate intrinsic value is the difference between the exercise price and the closing price of the Company s Common Stock on December 31, 2007.

As of December 31, 2007, total unrecognized compensation cost related to unvested options was approximately $4,708, net of estimated forfeitures, which we expect to recognize over a weighted average period of approximately 2.4 years.

The fair value of each stock option award is estimated by management on the date of the grant using the Black-Scholes-Merton option pricing model. The weighted average fair value of options granted during 2007 and 2006 were $4.08 and $3.74, respectively.

The following are the ranges of assumptions for the periods noted:

| | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|---|---|
| Expected dividend rate | Nil | Nil |
| Expected stock price volatility | 35-39% | 35% |
| Risk-free interest rate | 4.2-4.6% | 4.6-5.2% |
| Expected life of options | 7.5 years | 7.5 years |

The expected stock price volatility range is based on the historical volatilities of companies included in a peer group that was selected by management whose shares or options are publicly available. The volatilities are estimated for a period of time equal to the expected life of the related option. The risk-free interest rate is based

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on the implied yield of U.S. Treasury zero-coupon issues with an equivalent remaining term. The expected life of the options was determined using a lattice model to estimate the expected term as an input into the Black-Scholes-Merton closed-form model.

Stock options outstanding and exercisable as of December 31, 2007 are summarized below:

| | Outstanding | | | Exercisable | |
|---|---|---|---|---|---|
| **Range of Exercise Prices** | **Number of Option Shares** | **Weighted Average Exercise Price** | **Weighted Average Remaining Contractual Life (Years)** | **Number of Option Shares** | **Weighted Average Exercise Price** |
| \$ 7.58    \$7.83 | 1,796,847 | \$ 7.69 | 8.7 | 708,876 | \$ 7.65 |
| \$10.26    \$11.00 | 170,000 | 10.78 | 9.7 | | |
| Balance, December 31, 2007 | 1,966,847 | \$ 7.95 | 8.8 | 708,876 | \$ 7.65 |

***Restricted Stock Awards***

| | Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Nonvested, December 31, 2006 | | \$ |
| Granted | 88,830 | 8.95 |
| Vested | | |
| Forfeited | 7,530 | 8.95 |
| Nonvested, December 31, 2007 | 81,300 | \$ 8.95 |

During 2007, the Company recognized \$16 related to restricted stock awards that were granted at the IPO. As of December 31, 2007, total unrecognized compensation cost related to unvested restricted stock awards was approximately \$279, net of estimated forfeitures, which will be recognized over a weighted average period of approximately 3.9 years.

***The Variable Plan***

The Variable Plan was originally established in 1998, and through an amendment in 2005, the Variable Right, as amended, was established to award Kevin a right to purchase an ownership position in Common Stock from the Founder for his service to the Company. The ownership position was defined as a fixed percentage of 2.5% of the Common Stock on a fully diluted basis, as defined in the agreement, plus an additional ownership percentage based on certain performance criteria, primarily a comparison of the net income of the region under Kevin s management to total Company net income on a trailing twelve-month basis. Under the Variable Plan agreement, the Company was required to determine the number of shares of Common Stock exercisable under the Variable Right at vesting. The Common Stock earned under the Variable Right would be contributed by the Founder, and 1.5 million shares of Common Stock were placed in escrow by the Founder, representing the maximum amount of shares the Founder and Kevin believed would be earned under the Variable Right.

The Variable Plan provided for a cash settlement of the Variable Right at a defined, performance based, value through put-call provisions, executed by the Founder or Kevin, if an IPO or sale event, as defined, had not taken place prior to February 1, 2008. The Founder was liable for the cash payment, and the Company guaranteed his performance. The Company has accounted for the Variable Plan in accordance with the provisions of SFAS 123(R), and at December 31, 2006, the Company had a long-term, Stock Compensation Liability of \$9,132, representing the estimated cumulative value determined by the Company s estimation of shares earned under the Variable Right at an estimated fair value per share.

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The Variable Right fully vested and became exercisable in connection with the IPO, and all cash settlement provisions via put-call rights terminated. In accordance with the terms of the Variable Plan, the Company calculated that 853,853 shares of Common Stock had vested and were exercisable under the Variable Right (the Vested Shares ). Cumulative stock-based compensation expense related to the Variable Plan was determined utilizing the Vested Shares and the $11 per share IPO price to adjust the Stock Compensation Liability to $9,392, representing $260 of 2007 stock-based compensation expense. The Stock Compensation Liability was reclassified to Additional Capital in accordance with the provisions of SFAS 123(R).

As described in Note 11, Kevin filed for arbitration on December 7, 2007 disputing the Company s share count calculation. The Company increased stock-based compensation expense related to the Variable Plan by $2,960 to $3,220 for the year ended December 31, 2007, representing the Company s best estimate of the ultimate value of incremental shares (above the Vested Shares) that may be delivered to Kevin via settlement or arbitration. As the ultimate value that may be delivered to Kevin is not certain, the Company may be required to adjust stock-based compensation expense in 2008.

***Stock Warrants***

The Company had a stock warrant plan (the Warrant Plan ), established in 2004, with a senior executive who separated from the Company in May 2006. As a result of the separation during the second quarter of 2006, the Company reversed the $259 of compensation expense that had been previously recognized.

**NOTE 7. INCOME TAXES**

The provision for income taxes consists of the following:

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2007** | **2006** | **2005** |
| Current | | | |
| Federal | $ 5,577 | $ 7,433 | $ 7,242 |
| State | 1,217 | 1,425 | 1,438 |
| Total Current | 6,794 | 8,858 | 8,680 |
| Deferred | | | |
| Federal | 310 | (627) | (1,444) |
| State | 67 | (70) | (288) |
| Total Deferred | 377 | (697) | (1,732) |
| Total Provision for Income Taxes | $ 7,171 | $ 8,161 | $ 6,948 |

The reconciliation of significant differences between income tax expense (benefit) applying the federal statutory rate of 35% and the actual income tax expense (benefit) at the effective rate are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2007** | **2006** | **2005** |
| Income Tax Expense at Federal Statutory Rate | $ 6,474 | $ 7,299 | $ 6,203 |
| Increases (Decreases): | | | |
| State Income Taxes, Net of Federal Income Tax Benefit | 838 | 855 | 745 |
| Other | (141) | 7 | |
| Total | $ 7,171 | $ 8,161 | $ 6,948 |

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The tax effects of temporary differences that result in significant portions of the deferred tax accounts are as follows:

| | December 31, 2007 | December 31, 2006 |
|---|---|---|
| Deferred Tax Liabilities: | | |
| Prepaid Expenses | $ 393 | $ 290 |
| Depreciation and Amortization | 333 | 241 |
| Total Deferred Tax Liabilities | 726 | 531 |
| Deferred Tax Assets: | | |
| Stock Compensation Expense | 2,565 | 3,797 |
| Reserves | 919 | 677 |
| Employee Benefits | 605 | |
| Other | 384 | 181 |
| Total Deferred Tax Assets | 4,473 | 4,655 |
| Net Deferred Tax Asset | $ 3,747 | $ 4,124 |

The Company made income tax payments of $7,383, $6,989 and $10,381 in 2007, 2006 and 2005, respectively.

**NOTE 8. PROFIT SHARING PLAN**

The Company maintains a profit-sharing plan, qualified under Section 401(k) of the Internal Revenue Code, for all eligible employees. Employees are eligible to participate following the completion of one year of service and attainment of age 21. The Company matches 50% of employee contributions up to 6% of eligible compensation. The Company s matching contributions, included in SG&A, totaled $231, $160 and $124 in 2007, 2006 and 2005, respectively.

**NOTE 9. NET INCOME PER COMMON SHARE**

The following table sets forth the computation of basic and diluted net income per common share:

| | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| Net Income | $ 11,326 | $ 12,898 | $ 10,713 |
| Weighted Average Common Shares Outstanding Basic | 16,646,674 | 15,000,100 | 15,000,100 |
| Effect of Dilutive Securities: | | | |
| Common Stock Equivalents | 150,460 | | |
| Redeemable Preferred Stock | 6,837,861 | 7,952,018 | 7,952,018 |
| Warrants | | 37,285 | 111,056 |
| Weighted Average Common Shares Outstanding Diluted | 23,634,995 | 22,989,403 | 23,063,174 |
| Net Income per Common Share Basic | $ 0.68 | $ 0.86 | $ 0.71 |
| Net Income per Common Share Diluted | $ 0.48 | $ 0.56 | $ 0.46 |

The Company s calculation of diluted net income per common share in 2006 and 2005 included the dilutive impact of Common Stock warrants under the Warrant Plan. For 2007, options to purchase 170,000 shares of Common Stock and 81,300 restricted stock awards were not included in the computation of Weighted Average Common Shares Outstanding Diluted because the effect would be antidilutive. For 2006, options to purchase

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1,796,847 shares of Common Stock were not included in the computation of Weighted Average Common Shares Outstanding Diluted because the effect would be antidilutive. There were no options outstanding prior to July 2006.

**NOTE 10. RELATED PARTY TRANSACTIONS**

As described in Note 5, the Company leases a number of its store locations and Corporate Headquarters from ANO and Related Companies.

As of December 31, 2006, other assets included $35 that the Founder owed the Company in the normal course of business. The amount was paid in the first quarter of 2007.

In 2005 and pursuant to the terms of the Preferred Sale, the Founder assumed a net liability related to a capitalized lease, and the Company recorded a $581 contribution from the Founder.

**NOTE 11. COMMITMENTS AND CONTINGENCIES**

***Purchase Commitments***

In July 2006, the Company entered into a purchase agreement with a vendor where the Company would purchase a total of approximately 27 million square feet of the vendor s assorted products over a four-year period, with the unit prices set at the time a purchase order is created/accepted. Issues have arisen with regard to the quality of the products provided by the vendor, the vendor s requests for changes in prices for the products and the vendor s failure to honor purchase orders that it had accepted. The Company is not currently receiving product under the agreement and intends to seek payment for the Company s cover costs relating to purchase orders that were not delivered. The products ordered from the vendor that are not being delivered have been purchased from other suppliers and we expect the cover costs to be immaterial.

***Legal Proceedings***

On January 4, 2007, Clifford Wayne Bassett and Clifford Wayne Bassett, MD, PC (together Dr. Bassett ) filed a lawsuit entitled *Clifford Wayne Bassett et al. v. Lumber Liquidators, Inc. et al.*, in the U.S. District Court for the Southern District of New York, against the Company, E.W. Scripps Company ( Scripps ) and others. The Company purchased an article from Scripps describing the benefits of hardwood flooring in relation to other types of flooring. The article contained a quote by Dr. Bassett, an allergist, who claims that the use of the quote was unauthorized. Dr. Bassett asserted damages in excess of $10 million. The parties reached a settlement and the case was dismissed with prejudice on January 18, 2008. The Company did not receive nor was required to pay any material amount in connection with the settlement.

On July 12, 2007, the Company received a copy of a demand for arbitration, dated July 11, 2007, in which a senior executive who separated from the Company in May 2006 (the Former Executive ) claimed that the Company breached its obligations to him upon his resignation of employment. The Former Executive alleged that he terminated his employment for good reason, as defined in his employment agreement and the Warrant Plan, based on, among other things, an allegedly substantial reduction in his responsibilities. He sought damages of approximately $0.7 million (plus the value of certain other specified benefits), as well as a declaration that he has owned 1% of the Company since he terminated his employment. As part of the arbitration process, the Company concluded that, among other things, the Former Employee breached certain provisions of the Employee Confidentiality and Non-Compete Agreement that he signed with the Company and violated certain statutory and common law duties. Accordingly, the Company asserted a counter-demand for arbitration against the Former Executive. On February 29, 2008, the arbitrator issued a ruling in which he found that the Former Executive was not entitled to any of the relief that he sought and ruled for the Company on some of its claims but did not award any monetary damages. Each party was ordered to bear its own attorneys fees and costs and the fees and expenses of the arbitrator will be split equally between the parties.

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On December 7, 2007, Kevin Sullivan filed a demand for arbitration naming the Founder and the Company as respondents. In his demand, Kevin seeks to recover the full number of shares due him under the Variable Plan agreement. In accordance with the terms of the Variable Plan, the Company determined and certified that 853,853 shares of Common Stock (the Vested Shares) were exercisable under the Variable Plan. Pursuant to the terms of the Variable Plan, the Founder had previously placed 1,500,000 shares of Common Stock in escrow for purposes of satisfying his obligations thereunder. In 2007, the Company recorded $3,220 in stock-based compensation expense related to the Variable Plan. That amount included a $2,960 provision representing the Company s best estimate of the ultimate value of the incremental shares (above the Vested Shares) that may be delivered to Kevin via settlement or arbitration. As the ultimate value that may be delivered to Kevin is not certain, the Company may be required to adjust stock-based compensation expense in 2008.

In addition, on March 11, 2008, the Company received a copy of a complaint that Kevin purportedly sent to the Fair Labor Division of the Office of the Attorney General of Massachusetts, which alleges that the Founder and the Company have unlawfully withheld wages from Kevin by not releasing to him a specified portion of the escrowed shares of common stock. The Company is not a party to the escrow arrangement between the Founder and Kevin. Kevin is seeking a prompt release of those shares, together with certain additional damages that could potentially be subject to trebling under relevant law. At this time, it is not possible to determine the ultimate resolution of, or reasonably estimate any potential liability from, this matter, and no provision for losses has been provided in connection with this complaint. We intend to defend this matter vigorously.

The Company is from time to time subject to claims and disputes arising in the normal course of business. In the opinion of management, while the outcome of any such claims and disputes cannot be predicted with certainty, the ultimate liability of the Company in connection with these matters is not expected to have a material adverse effect on the Company s results of operations, financial position or cash flows.

**NOTE 12. CONDENSED QUARTERLY FINANCIAL INFORMATION (unaudited)**

The following tables present our unaudited quarterly results for 2007 and 2006. We believe that the following information reflects all normal recurring adjustments for a fair presentation of the information for the periods presented. The operating results for any quarter are not necessarily indicative of results for any future period.

| | Quarter Ended | | | |
|---|---|---|---|---|
| | **March 31, 2007** | **June 30, 2007** | **September 30, 2007** | **December 31, 2007** |
| | (in thousands, except for per share amounts) | | | |
| Net Sales | $ 92,022 | $ 105,725 | $ 102,050 | $ 105,510 |
| Gross Profit | 30,571 | 34,375 | 34,447 | 35,721 |
| Selling, General and Administrative Expenses(1) | 26,816 | 30,415 | 28,260 | 30,817 |
| Operating Income | 3,755 | 3,960 | 6,187 | 4,904 |
| Net Income | $ 2,231 | $ 2,345 | $ 3,701 | $ 3,049 |
| Net Income per Common Share Basic | $ 0.15 | $ 0.16 | $ 0.25 | $ 0.14 |
| Net Income per Common Share Diluted | $ 0.10 | $ 0.10 | $ 0.16 | $ 0.12 |

(1) Selling, General and Administrative Expenses includes $403, $2,649, ($150) and $318 of variable plan stock compensation expense for the quarters ended March 31, June 30, September 30, and December 31, respectively, and the quarter ended December 31, 2007 includes $1,224 for the acceleration of stock options and the recognition of the expense associated with the 2006 Regional Plan due to the IPO.

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31, 2006 | June 30, 2006 | September 30, 2006 | December 31, 2006 |
| | (in thousands, except for per share amounts) | | | |
| Net Sales | $ 76,051 | $ 88,078 | $ 83,090 | $ 84,841 |
| Gross Profit | 26,409 | 29,453 | 27,402 | 26,865 |
| Selling, General and Administrative Expenses(1) | 20,537 | 21,487 | 22,587 | 24,105 |
| Operating Income | 5,872 | 7,966 | 4,815 | 2,760 |
| Net Income | $ 3,560 | $ 4,819 | $ 2,896 | $ 1,623 |
| Net Income per Common Share Basic | $ 0.24 | $ 0.32 | $ 0.19 | $ 0.11 |
| Net Income per Common Share Diluted | $ 0.15 | $ 0.21 | $ 0.13 | $ 0.07 |

(1) Selling, General and Administrative Expenses includes $260 of variable plan stock compensation expense for each of the quarters ended March 31, June 30, September 30, and December 31.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

*Evaluation of disclosure controls and procedures.* Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this annual report on Form 10-K. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in internal control over financial reporting.* There was no change in our internal control over financial reporting that occurred during the period covered by this annual report on Form 10-K that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

*Evaluation of internal control over financial reporting.* This annual report does not include a report of management s assessment regarding internal control over financial reporting or an attestation report of the company s registered public accounting firm due to a transition period established by rules of the SEC for newly public companies.

**Item 9B. Other Information.**

None.

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## PART III

**Item 10. Directors, Executive Officers and Corporate Governance.**

The information required by this Item is incorporated by reference to the sections captioned Proposal One Election of Directors, Executive Officers and Section 16(a) Beneficial Ownership Reporting Compliance in the proxy statement for our annual meeting of stockholders to be held on May 15, 2008.

During 2007, due to an administrative oversight, Macon F. Brock Jr., one of our directors, and Robert M. Morrison, one of our Section 16 officers, were each a day late in filing Form 4s to reflect a stock purchase.

**Code of Ethics**

We have a Code of Conduct, which applies to all employees, officers and directors of Lumber Liquidators, Inc. Our Code of Conduct meets the requirements of a code of ethics as defined by Item 406 of Regulation S-K, and applies to our Chief Executive Officer, Chief Financial Officer (who is both our principal financial and principal accounting officer), as well as all other employees. Our Code of Conduct also meets the requirements of a code of conduct under Marketplace Rule 4350(n) of the National Association of Securities Dealers, Inc. Our Code of Conduct is posted on our website at http://www.lumberliquidators.com in the Corporate Governance section of our Investor Relations home page.

**Item 11. Executive Compensation.**

The information required by this Item with respect to executive compensation is incorporated by reference to the section captioned Executive Compensation in the proxy statement for our annual meeting of stockholders to be held on May 15, 2008.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information required by this Item is incorporated by reference to the section captioned Security Ownership and Executive Compensation Equity Compensation Plan Information in the proxy statement for our annual meeting of stockholders to be held on May 15, 2008.

| | Number of Securities to be Issued Upon Exercise of Outstanding Options and Rights | Weighted-average Exercise Price of Outstanding Options and Rights | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans |
|---|---|---|---|
| Equity Compensation Plans Approved by Security Holders | **2,048,147** | **$ 7.63** | **2,251,853** |
| Equity Compensation Plans Not Approved by Security Holders | | | |
| Total | **2,048,147** | **$ 7.63** | **2,251,853** |

**Item 13. Certain Relationships, Related Transactions and Director Independence.**

**Related Party Transactions**

Tom Sullivan, the chairman of our board of directors, is the sole owner of ANO LLC, DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and he has a 50% membership interest in BMT Holdings, LLC (collectively, ANO and Related Companies ). We leased our Toano facility, which includes a store location,

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and 25, 25 and 22 of our other store locations from these entities as of December 31, 2007, 2006 and 2005, respectively, representing 22.4%, 28.6% and 30.3% of total store leases, respectively. The operating lease for our Toano facility has a base period through December 31, 2019.

The information required by this Item with respect to certain relationships and related-party transactions is incorporated by reference to the sections captioned Executive Compensation Post-Employment Compensation in the proxy statement for our annual meeting of stockholders to be held on May 15, 2008.

**Lease Arrangements**

As of December 31, 2007, we leased our Toano facility, which includes a store location, and 23 of our other store locations from ANO LLC ( ANO ), a company that is wholly owned by Tom Sullivan, our founder and the chairman of our board of directors. We leased 23, 22 and 19 of our other stores from ANO as of December 31, 2007, 2006 and 2005, respectively. These leases generally have five-year base periods and multiple five-year renewal periods. We also lease our Toano finishing, distribution and headquarters facility from ANO under an operating lease with a base period that runs through December 31, 2019. Our rent expense attributable to ANO was $2.4 million, $2.1 million and $2.0 million in 2007, 2006 and 2005, respectively. Our future minimum lease payments to ANO under all of our leases with them were $18.0 million as of December 31, 2007. These leases are described in more detail in Note 5 to our audited financial statements included in Item 8 of this report.

As of December 31, 2007, we leased one store location each from Wood on Wood Road, Inc. ( Wood on Wood ) and BMT Holdings, LLC ( BMT ). Wood on Wood is wholly owned by Tom Sullivan, and he has a 50% membership interest in BMT. Each lease is for a five-year base period and has a five-year renewal period. The lease with BMT is currently in the second year of its renewal period. Our rent expense attributable to Wood on Wood was $0.07 million in each of 2007, 2006 and 2005. Our rent expense attributable to BMT was $0.05 million in each of 2007, 2006 and 2005.

We believe that the leases that we have signed to date with ANO, Wood on Wood and BMT are on fair market terms.

In addition, of our leases with lessors that are not owned in whole or in part by Tom, three were guaranteed by Tom as of December 31, 2007.

**Item 14. Principal Accountant Fees and Services.**

The information required by this Item with respect to principal accountant fees and services is incorporated by reference to the section captioned Proposal Four Ratification of Independent Registered Public Accounting Firm in the proxy statement for our annual meeting of stockholders to be held on May 15, 2008.

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## PART IV

**Item 15. Exhibits and Financial Statement Schedules.**

**1. Financial Statements**

The following financial statements are submitted in Part II, Item 8 of this annual report:



**2. Financial Statement Schedules**

All financial statement schedules have been omitted because the required information is either included in the financial statements or the notes thereto or is not applicable.

**3. Exhibits**

The exhibits listed on the accompanying Exhibit Index are filed or incorporate by reference as part of this report.

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized in the city of Toano, state of Virginia, on March 12, 2008.

LUMBER LIQUIDATORS, INC.

By: /s/ JEFFREY W. GRIFFITHS
**Jeffrey W. Griffiths**

**President and Chief Executive Officer**

## POWER OF ATTORNEY

Each person whose individual signature appears below hereby authorizes and appoints Jeffrey W. Griffiths and Daniel E. Terrell, and each of them, with full power of substitution and resubstitution and full power to act without the other, as his or her true and lawful attorney-in-fact and agent to act in his or her name, place and stead and to execute in the name and on behalf of each person, individually and in each capacity stated below, and to file, any and all amendments to this report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing, ratifying and confirming all that said attorneys-in-fact and agents or any of them or their or his or her substitute or substitutes may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ JEFFREY W. GRIFFITHS<br>**Jeffrey W. Griffiths** | President, Chief Executive Officer and Director (Principal Executive Officer) | March 12, 2008 |
| /s/ DANIEL E. TERRELL<br>**Daniel E. Terrell** | Chief Financial Officer (Principal Financial and Principal Accounting Officer) | March 12, 2008 |
| /s/ THOMAS D. SULLIVAN<br>**Thomas D. Sullivan** | Chairman of the Board | March 12, 2008 |
| /s/ MACON F. BROCK, Jr.<br>**Macon F. Brock, Jr.** | Director | March 12, 2008 |
| /s/ DOUGLAS T. MOORE<br>**Douglas T. Moore** | Director | March 12, 2008 |
| /s/ JOHN M. PRESLEY<br>**John M. Presley** | Director | March 12, 2008 |
| /s/ MARTIN F. ROPER<br>**Martin F. Roper** | Director | March 12, 2008 |
| /s/ RICHARD D. TADLER | Director | March 12, 2008 |

**Richard D. Tadler**

**EXHIBIT INDEX**

| Exhibit Number | Exhibit Description |
|---|---|
| 3.01 | Amended and Restated Articles of Incorporation |
| 3.02 | Amended and Restated By-Laws |
| 4.01 | Form of Certificate of Common Stock of Lumber Liquidators, Inc.* |
| 10.01 | Lumber Liquidators 2006 Equity Plan for Non-Employee Directors#* |
| 10.02 | Lumber Liquidators 2004 Stock Option and Grant Plan#* |
| 10.03 | Employment Agreement with Jeffrey W. Griffiths#* |
| 10.04 | Employment Agreement with H. Franklin Marcus, Jr.#* |
| 10.05 | Offer Letter Agreement with Robert M. Morrison#* |
| 10.06 | Offer Letter Agreement with Marco Pescara#* |
| 10.07 | Form of Non-Qualified Employee Stock Option Agreement#* |
| 10.08 | Lease by and between ANO LLC and Lumber Liquidators (relating to Toano facility)* |
| 10.09 | Thomas D. Sullivan Stock Option Agreement and Lumber Liquidators, Inc. Guaranty Agreement, and amendment thereto#* |
| 10.10 | Form of Option Award Agreement |
| 10.11 | Form of Restricted Stock Agreement |
| 23.01 | Consent of Ernst & Young LLP |
| 24.01 | Power of Attorney (included on the signature page of this report) |
| 31.1 | Certification of Principal Executive Officer of Lumber Liquidators, Inc. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer of Lumber Liquidators, Inc. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Principal Executive Officer and Principal Financial Officer of Lumber Liquidators, Inc. pursuant to Section 906 of the Sarbanes-Oxley act of 2002 |

# Indicates a management contract or compensation plan, contract or agreement.
* Incorporated by reference of the Company s Registration Statement on Form S-1 (File No. 333-142309).