

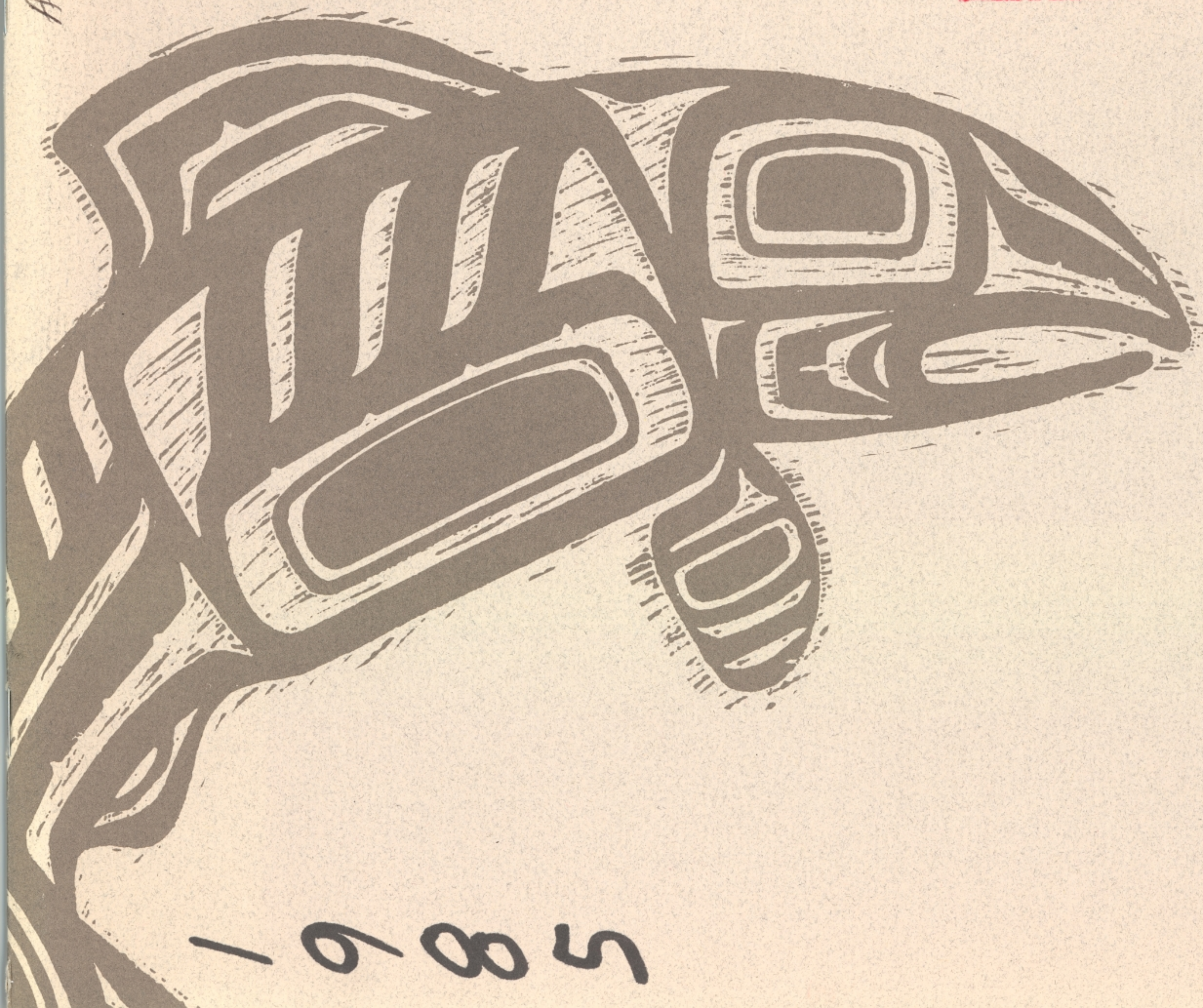
Annual Report
Stack

1985

SHIPBOARDING

1985 Annual Report

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1985

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FINANCIAL HIGHLIGHTS

Restaurant Sales:

Company-operated

Franchised

Systemwide Total

Revenues

Income Before Provision for Income Taxes

Income Tax (Benefit) Provision

Net Income

Earnings per Common Share

Restaurants Open:

Company-operated

Franchised

Systemwide Total

For the 52
Weeks Ended
December 29,
1985

For the 53
Weeks Ended
December 30,
1984

\$71,244,000	\$62,306,000
15,857,000	11,545,000
87,101,000	73,851,000
72,292,000	63,067,000
633,000	3,731,000
(230,000)	1,199,000
863,000	2,532,000
.32	.93
162	147
35	26
197	173

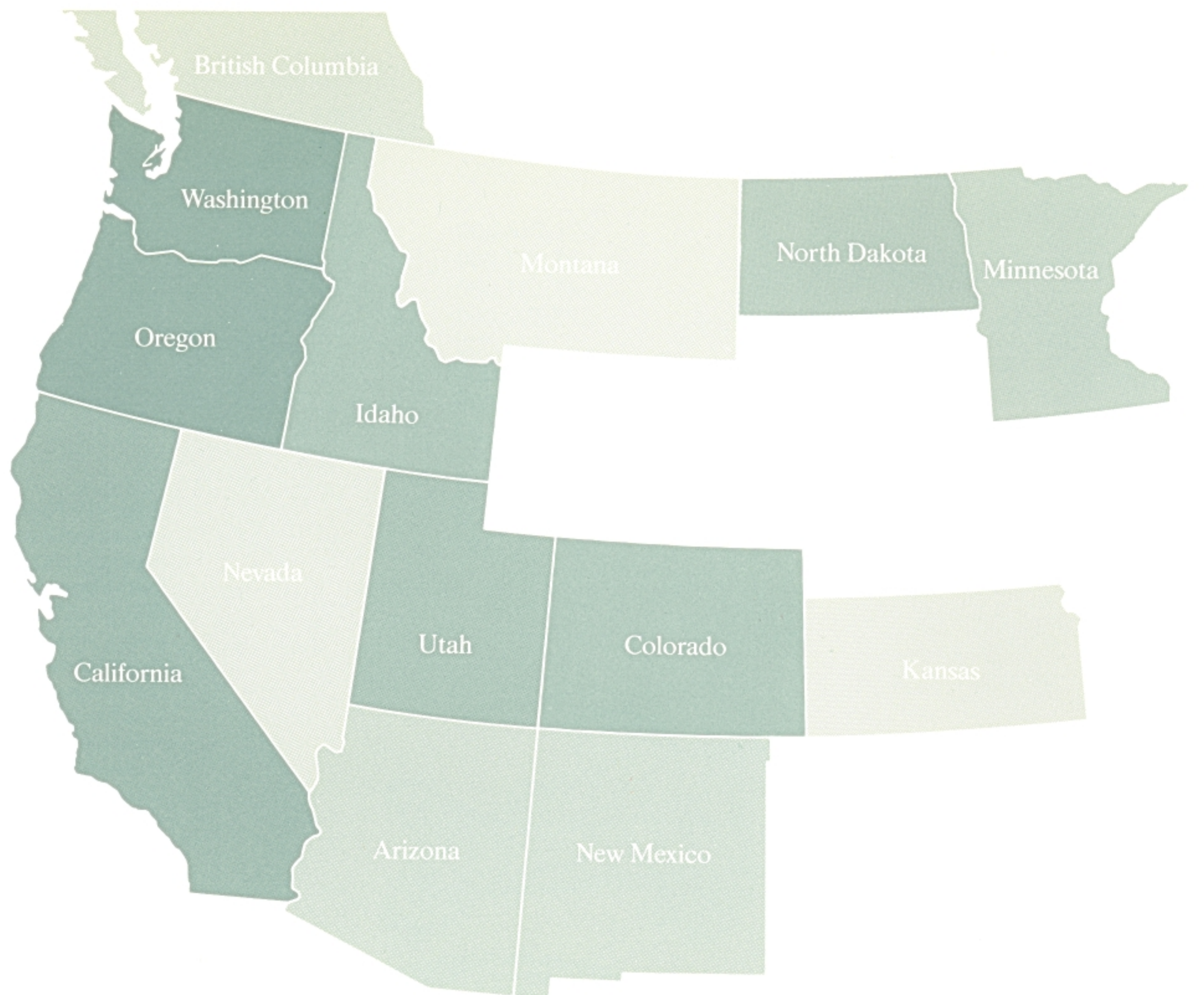
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BUS/SCI ORG

Skipper's foundation comes from a market that understands fish — knowledge that goes back many years when Native Americans fished Northwest waters. This heritage is reflected in the illustrations throughout this year's annual report. Contemporary interpretations of our most popular products are based on carvings by Northwest Indian coastal tribes.



**Skipper's
Restaurants
Year-End 1985**

Washington	65
Oregon	33
California	27
Colorado	18
Utah	16
Idaho	11
North Dakota	5
Alaska	5
Minnesota	4
Hawaii	4
New Mexico	2
British Columbia	2
Arizona	2
Nevada	1
Montana	1
Kansas	1
197	



S

kipper's Seafood 'n Chowder House restaurants feature a limited fast-food menu, consisting of deep-fried seafood and chicken, clam chowder, a salad bar and assorted beverages. In most areas, beer and wine are served. All menu items, except these two alcoholic beverages, are available for "eat-in" or "take-out" convenience. ■ The restaurants' nautical decor is casual, suitable for family dining. With the company's

limited-service format, all meal orders are taken centrally at the cash register, then prepared and delivered to

the customer by Skipper's employees. ■ Located in one-story buildings or in-line store fronts, the restaurants require approx-

imately 2,000 square feet and offer a seating capacity of 100-120 seats. ■ Skipper's, Inc. operated and franchised 197 Skipper's

Seafood 'n Chowder House restaurants at year-end 1985. The 162 company-operated restaurants are located in California, Colo-

rado, Idaho, Minnesota, Oregon, Utah and Washington; 35 franchised operations are in Alaska, Arizona, British Columbia, Cali-

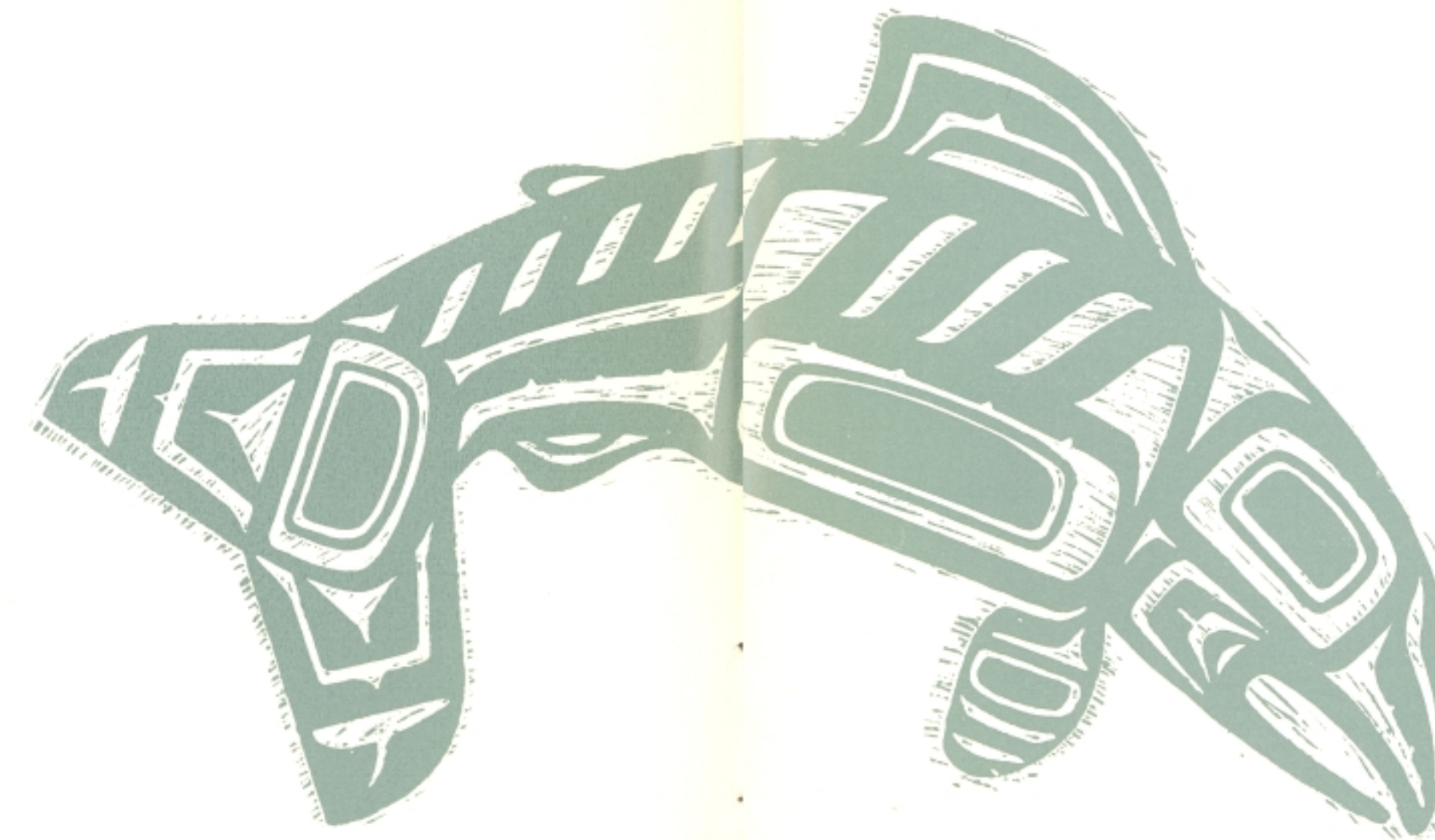
fornia, Colorado, Hawaii, Idaho, Kansas, Montana, Nevada, New Mexico, North Dakota, Oregon and Utah. ■ The company's

stock (SKIP) is traded over-the-counter on the NASDAQ system. There were approximately 2,500 shareholders of record as of

December 29, 1985.

Skipper's opened 29 new company-operated and franchised operations in 1985, adding restaurants in three states: Minnesota, Nevada and New Mexico. In addition, the company signed a record 11 franchise area-development agreements in 1985. If all the restaurants covered in new and prior agreements are developed as planned, there will be 103 franchised operations within seven years; 35 were in operation at year end.

Before his retirement, company founder and Senior Chairman of the Board Herbert I. Rosen regularly spoke with Skipper's employees: "I find it very pleasing to walk through and talk with the ambitious people who have been growing with the company, and who get fired up with a commitment to Skipper's. That to me is the essence of a living, growing, thriving business."



This year, Skipper's dedicates its Annual Report to founder and Senior Chairman of the Board Herbert I. Rosen, who retired from active company involvement on January 1, 1986. Rosen remains as Senior Chairman of Skipper's Board of Directors, and he will serve as consultant to the company. Gene Stone was promoted to Chairman-Chief Executive Officer from President-Chief Executive Officer; Chris LeSourd, formerly Executive Vice President, became President-Chief Operating Officer. ■ Rosen founded Skipper's in 1969 with the first restaurant in Bellevue, Washington. Since then, the company has become the nation's third largest fast-seafood chain. Forbes magazine recently named Skipper's one of the country's 200 best small companies. ■ As a tribute to Rosen's many contributions to the company, this year's Annual Report features some of Skipper's 1985 award-winning employees. These people — and many others like them — are carrying on Rosen's tradition of dedication to a successful Skipper's.



Skipper's carefully researches the market potential of an area before opening a restaurant. If all factors appear positive, it will take approximately six weeks to build one of our familiar nautical-theme operations. In 1986, we will focus on opening 20-25 new Skipper's restaurants, including 5-7 franchised ones.

Mark Sutey (foreground), restaurant manager in Auburn, Wash., was named 1985 Manager of the Year for the Northwest Washington region. Sutey's "can-do" attitude and openness to new ideas boosted his restaurant's profits by nearly 20 percent in 1985. Cliff Scarlett (background), district manager of South King County which includes Sutey's restaurant, was nominated for the 1985 District Manager of the Year award for the Northwest Washington region.



Skipper's faced some extraordinary challenges during 1985. Many, such as industry-wide soft-sales trends and increasing competition were anticipated, and our investment in new technology was planned. However, other challenges, such as a \$2.4 million loan loss, proved more demanding. And after six years of consistently increased results, we saw our earnings decrease in 1985. ■ These disappointing results became a catalyst for a corporate-wide reassessment of our existing sales and profit programs. We acknowledged our mistakes and drew from our strengths and achievements. Now after making some of the toughest decisions in our corporate history and initiating some major changes, we have turned with renewed enthusiasm to the rest of this decade — looking forward to improved results for 1986. ■ Here is an overview of the year's activities and our plans for the future. ■ Company revenues in 1985 increased 14 percent over the prior year, from \$63 million to \$72 million. Real sales (sales, minus menu price increases and new-restaurant openings) improved 1 percent. Net income declined to \$863,000 from \$2.5 million in 1984. ■ Several factors — a lending loss, growth spending and severe weather — contributed to net income and real sales results. The major impact on our 1985 profit came from a lending loss suffered in connection with an agreement Skipper's made last June with CulCon Systems, Inc., a Florida restaurant company. Skipper's agreed to provide or guarantee financing for as much as \$8 million to CulCon. In return, Skipper's gained the right to acquire the restaurant firm. ■ When CulCon failed to meet the agreement's performance standards, we determined that it was unlikely we would recover the loan balance. We therefore declared the loan due and payable, terminated the merger agreement, and took a loan loss of \$2.4 million. ■ In settlement of the loan, we took over three Zackly's restaurants operated by CulCon in the Tampa/St. Petersburg, Florida area, and the franchise rights for Zackly's in six western states.



The Shrimp and Fish All-You-Can-Eat produced the company's most successful promotion ever in 1985. The offer chalked up several record-breaking weeks of sales systemwide. In response to customer demand, we added it to our regular menu at year end.

Kathleen Coleman, 1985 Hourly Employee award winner for the California region, was nominated for her positive attitude and flexibility. She has been described as the "backbone" of the Fairfield, Calif., Skipper's crew which produced a 20 percent sales increase in 1985. Behind her is Mike Mason, a Northwest Washington restaurant manager who has won several awards, and key hourly Phyllis Nieman.



We do not expect a significant profit from the three Zackly's restaurants in 1986. But we anticipate profitable operations thereafter and the potential to sell the restaurants. In addition, we foresee long-term benefits from the development of franchised Zackly's restaurants in the six western states. ■ Growth spending is another factor that affected our net income. We expanded our newest company markets in Colorado and Minnesota. Both areas have higher premise costs than our established markets and are affected by other expenses, such as advertising, which must be shared by a smaller base of restaurants. ■ The company also initiated two new corporate growth programs in 1985 aimed at improving sales and reducing costs. The first program, an energy management system quietly produced savings in our restaurants, while maintaining comfort levels for employees and customers. Skipper's also began installation of the second corporate program, a computerized point-of-sale cash register system, to assist in management planning and daily operations. The system tracks product sales, food and labor costs, inventory and generates weekly profit reports. More than one-third of Skipper's restaurants featured the system at year end. ■ Severe weather also significantly influenced company profitability. Our major markets suffered extremely poor sales during several prolonged periods of record-breaking winter weather. The Northwest region, with the greatest concentration of Skipper's restaurants, was particularly affected during the fourth quarter. ■ Our sales results for the year reflect an ever-changing consumer environment. Consumers broadened their dining experiences in 1985 — at the expense of the restaurant industry — with convenience-store purchases and gourmet take-out foods. The soft sales intensified competition among fast-food chains which discounted menu prices, introduced new products and increased advertising budgets to regain sales. New-restaurant openings by independents and other chains further diffused our sales and customer counts. As a result of these factors, sales increases were lower than anticipated.



Our new point-of-sale system gives us the potential to react more quickly to sales situations and become better equipped to respond to customer interests. As a management tool, it will also assist in the analysis of the company's strengths and weaknesses.

Operations Co-ordinator Carolyn Robertson (foreground) and Operations Secretary Doris Adams are vital contacts between the corporate office and field restaurant teams. Robertson was named 1985 National Office Supervisory Employee of the Year for her outstanding performance and attitude. Adams was selected as one of four 1985 National Office Employees of the Year, recognized for her good planning and ability to take on additional responsibility. She won the same award in 1984.



On the positive side, we opened 29 new Skipper's Seafood 'n Chowder House restaurants, signed 11 new franchise area-development agreements and produced the most successful promotion in company history. The "Shrimp and Fish All-You-Can-Eat" promotion, initially conceived and tested by our California restaurant team, was used systemwide during Lent and produced sales records for several weeks. We featured this popular special two more times in 1985. At year end, we incorporated the meal into our regular menu offering. This shrimp and fish menu item now represents nine percent of our restaurant sales. ■ Another positive aspect of 1985 was the strengthening of our commitment to product development and consumer research. Because of our disappointment with our financial results — along with shifting consumer spending — we've embarked on a research program aimed at maintaining our loyal customer base, while increasing market share. Following this objective, we developed a two-pronged approach: a short-term promotional strategy for 1986 and a long-range plan to update the Skipper's concept. ■ Our 1986 promotional strategy is designed to offer throughout the year exciting products on a limited-time basis. These new "Limited Catch" menu selections will address customer demands for new fast-food experiences. ■ The long-range research involves the identification of areas, such as products, service and decor, which will evolve with changing consumer tastes during the next five to ten years. A prototype restaurant showcasing these differences is scheduled to open late 1986 or early 1987. ■ There were many lessons learned in 1985. The key to 1986 and the years to come is Skipper's strength in recognizing our achievements as well as mistakes and moving aggressively to act on them. With this philosophy, we expect a satisfying year in 1986. Our resilient organization has sprung back to overcome its difficulties — and has grown stronger because of them. We will continue to focus our energies on improving the efficiency and the quality of our performance...and invest in creative new programs which will contribute to a profitable future.



Gene Stone
Chairman-Chief Executive Officer



Chris LeSourd
President-Chief Operating Officer

March 24, 1986



Changing customer demands were responsible for our 1986 Limited Catch menu, which offers specials such as this Chilled Crab on a limited-time basis. Chilled Crab is Skipper's first non-fried entree in its move towards innovative, fast-food experiences for its customers.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Results of Operations. Systemwide sales, which includes franchise restaurant sales, increased 18% to \$87,101,000 in 1985 from \$73,851,000 in 1984. Company sales increased 14% to \$71,244,000 from \$62,306,000. Such sales in 1985 included \$1,233,000 in equipment sales to franchisees. Discussions of percentage relationships for the balance of this item are based exclusively on restaurant sales. Net income decreased 66% to \$863,000 in 1985 from \$2,532,000 in 1984 primarily because of a provision for loan loss on advances to CulCon Systems, Inc. discussed below. Increased operating and administrative expenses also contributed to a decrease in income from operations.

Sales for company-operated restaurants experienced annual increases of 12% in 1985, 25% in 1984, and 33% in 1983. In 1985, this reflects a combination of a slight growth in real sales, the opening of new restaurants, and small menu price increases. Real sales (total sales minus menu price increases and new restaurant openings) increased 1.1% in 1985, 6.3% in 1984 and 12% in 1983. The effect of the industrywide sales slowdown that began in the fourth quarter of 1984 and continued during 1985, resulted in the much lower real sales growth.

During 1985, the company instituted three small menu price increases which resulted in weighted average increase in sales of company operated restaurants of just under 1%. The aggregate increase in 1985 was 3.2%. During 1984 and 1983 the company had aggregate menu price increases of 3.1% and 2.7% respectively.

During 1985, fifteen company-operated restaurants opened; four each in Minnesota and Colorado, three in Oregon, two in Washington and one each in Utah and California. These new restaurants represent a 4.1% sales increase over 1984 sales. Restaurants opened for only a part of 1984 but for all of 1985, account for the remainder of the sales increase in 1985. The company opened fifteen units each year during 1984 and 1983. With respect to the opening of new restaurants, the company's experience has been that break even operating levels are achieved after the third month of operations except in new market areas where reaching break even takes considerably longer. In 1985, the company expanded into two new markets, Minnesota and Colorado, and the loss on those operations was \$129,000. Management believes profitable operations will be achieved in those markets in mid 1986. The company did not undertake new market expansion to this extent in 1984 or 1983.

Franchised restaurant sales were \$15,857,000 in 1985, \$11,545,000 in 1984, and \$8,686,000 in 1983. In 1985 the company's corresponding franchise revenues

increased 38% as a result of royalty fees from the increased sales and license fees associated with the opening of fourteen new restaurants in 1985; two each in Colorado, Montana, North Dakota and New Mexico and one each in Nevada, Utah, Hawaii, Arizona, California and Alaska. Five franchised restaurants closed during 1985; one in Colorado and four in Montana. The company believes that three of the Montana restaurants will reopen during 1986 with new franchise owners or as company-operated restaurants.

Food cost, which is the primary component of cost of sales, increased as a percentage of restaurant sales to 35.2% in 1985 from 34.7% in 1984. The addition in 1985 of a "Shrimp n' Fish All You Can Eat" item contributed to this increase. In addition, the company has generally experienced a gradual shift in product mix away from higher margin menu items. Food costs decreased in 1984 as compared to 1983 as the company was able to negotiate more favorable distribution agreements.

Restaurant labor costs decreased as a percentage of company restaurant sales to 23.4% in 1985 from 23.9% in 1984. Emphasis on maintaining labor guidelines to improve labor efficiency con-



tributed to the decrease. This improvement was partially offset by increases in workers compensation insurance premiums and relatively high labor costs in the new market areas. Labor costs in 1984 and 1983 were relatively stable as a percentage of sales, largely due to no change in the minimum wage rate.

Other restaurant expense, which is comprised primarily of restaurant occupancy costs and insurance, increased as a percentage of restaurant sales to 20.6% in 1985 from 19.4% in 1984. This increase is due primarily to relatively higher rentals in new restaurants as the cost of real estate escalates and newer restaurants comprise a larger percentage of total restaurants. The increase is also due in part to a significant increase in insurance premiums. The company believes that future increases will be experienced in this area.

General and administrative expenses increased in 1985 by \$1,949,000, or 18% from 1984. This increase was due primarily to an \$800,000, or 23%, increase in advertising costs, an increase in interest expense, excluding interest on capital leases, of \$434,000 from \$214,000, a \$300,000 increase in administrative salaries, and generally to other increases relating to the expansion in restaurant operations. In 1984, such expenses had increased by \$2,175,000, or 25%, largely as a result of increases in advertising expenses and growth in the corporate staff commensurate with the rapid expansion experienced in 1983 and 1984.

The company's 1985 results of operations include a provision for loan loss of \$2,400,000. As background, on June 19, 1985, the company and CulCon Systems, Inc. (CulCon) entered into a loan agreement extending through 1987 under which the company agreed to extend up to \$8,000,000 in either direct loans to CulCon or guarantees of CulCon's obligations to third parties. On the same date, the company and CulCon entered into a merger agreement pursuant to which the company had the option to acquire CulCon. CulCon operates two restaurant concepts through its wholly owned subsidiaries. At December 29, 1985, the company had advanced approximately \$2,000,000 to CulCon and had guaranteed approximately \$400,000 of CulCon's obligations under two equipment leases. During January, 1986, additional advances were made to CulCon which increased the amount outstanding under the loan agreement to \$2,200,000. As of December 29, 1985, CulCon was in default of certain covenants contained in the loan agreement. As a result, the company elected, when 1985 financial statements for CulCon were available in February, 1986, to exercise its option to declare the amount outstanding under the loan agreement immediately due and payable and to terminate the merger agreement.

On March 2, 1986, the company and CulCon entered into a settlement agreement pursuant to which CulCon agreed to convey to the company all of its interests in three "Zackly's" restaurants on the west coast of Florida and to grant to the company franchise rights to operate additional Zackly's restaurants in that area and in a six state area in the western United States. In addition, the company received from the two principal shareholders of CulCon an unconditional guarantee of the obligations of CulCon under the two equipment leases that were previously guaranteed by the company. The company agreed to pay CulCon an additional \$385,000, to not enforce its rights under the loan agreement, to release its liens on assets of CulCon not conveyed under this settlement agreement, and to waive its rights under a guarantee dated June 19, 1985 by two of the principal shareholders of CulCon. As a result of this settlement agreement, the company recognized a provision for loan loss of \$2,400,000 in the December 29, 1985 Statement of Income. The company expects to operate the three restaurants at a break even level in 1986. It is currently not anticipated that the company will develop further Zackly's restaurants in 1986 and 1987.

As a result of the decrease in income from operations and the provision for loan loss, income before taxes decreased to \$633,000 in 1985 from \$3,371,000 in 1984. This relatively low pre-tax amount

(Continued)

MANAGEMENT'S DISCUSSION AND ANALYSIS

when combined with significant investment tax credits generated in 1985 from restaurant expansion resulted in the company recording a net benefit from income taxes in 1985 of \$230,000 as compared with a provision for income taxes in 1984 of \$1,199,000.

Liquidity. Due to costs of expansion and because restaurant businesses generally do not require significant investment in accounts receivable or inventory but often receive trade credit in purchasing food and supplies, many companies in this industry operate with working capital deficits, where current liabilities exceed current assets. The working capital deficits were \$2,462,000 and \$1,934,000 in 1985 and 1984, respectively. As an indication of the company's ability to operate with working capital deficits, during 1985, 1984 and 1983 the company generated working capital from operations of \$5,102,000, \$5,833,000 and \$4,610,000, respectively. The company anticipates similar amounts of working capital to be generated from operations in 1986.

To fund working capital deficits, the company can utilize a revolving credit line of \$10,000,000 with stipulated interest at prime. Borrowings under this bank agreement at December 29, 1985 were \$2,487,000.

Capital Resources. Of the total \$29,922,000 capital additions to property and equipment for the three years ended December 29, 1985, \$17,830,000 represents capital expenditures for the 45 restaurants opened during the period. Additionally, 50 restaurants were remodeled for a total expenditure of \$2,970,000. The major portion of these expenditures was internally financed through the use of working capital, the proceeds from a public stock offering in 1983 and obligations under capital leases totaling \$4,257,000.

The company's second public stock offering in May, 1983, provided net proceeds of \$5,816,000. Of this amount \$4,400,000 was utilized in 1983 for the construction and equipping of new restaurants and the remainder was invested in short term securities at various interest rates. The balance of the proceeds was fully utilized to finance expansion in 1984.

The company expects to continue the opening of new restaurants through and beyond 1986. During 1986, the company expects to open 15-20 new restaurants for a total commitment of \$7,500,000 to \$10,500,000 and to remodel 13 restaurants for \$950,000. Funding of the new restaurants and remodels will come from a variety of sources including the revolving line of credit, sale and lease-back transactions, and internally generated funding from operations.

During January 1985 and June 1985, the company entered into agreements with two limited partnerships under which it agreed to sell to the partnerships and then lease back certain restaurants. During 1985, ten restaurants were sold under these agreements for a total of \$5,175,000. At December 29, 1985, \$7,431,000 remained available under these agreements for the purchase of company operated and franchised restaurants and equipment.

Inflation. Because of the absence of receivables and inventory in the restaurant business, it is difficult to compute and evaluate the effects of inflation and changing prices upon the operations of the company. During 1985, 1984 and 1983, the company did experience modest increases in the cost of food, labor and other products. These rising costs were generally offset by menu prices increases.

Management partially controls inflation in occupancy costs either by owning the properties or by entering long-term fixed rate leases. However, most leases require Skipper's to pay taxes, maintenance, insurance, repairs and utility costs, all of which are subject to inflationary pressures.

SELECTED FINANCIAL DATA(Dollar amounts in thousands,
except earnings, dividends and book value per share)

	1985	1984	1983	1982	1981
Operating Results					
Company-operated sales	\$ 71,244	\$ 62,306	\$ 49,956	\$ 37,704	\$ 33,751
Franchised restaurant sales	15,857	11,545	8,686	5,649	3,929
Systemwide sales	87,101	73,851	58,642	43,353	37,680
Company sales	71,244	62,306	49,956	37,704	33,751
Franchise revenues	1,048	761	503	363	240
Total revenues	72,292	63,067	50,459	38,067	33,991
Income before provision for income taxes	633	3,731	2,956	1,443	1,418
Income tax (benefit) provision	(230)	1,199	936	396	465
Net income	863	2,532	2,020	1,047	953
Weighted average common shares outstanding	2,723,424	2,722,695	2,508,043	2,174,312	1,956,344
Earnings per common share	.32	.93	.81	.48	.49
Cash dividends declared per common share	.07	.06	.057	.053	.05
Depreciation and amortization expense	3,732	2,872	2,231	1,788	1,541
Capital expenditures	14,522	11,956	7,760	5,428	2,795
Financial Position (End of Year)					
Total assets	41,909	34,349	27,565	18,800	16,913
Working capital	(2,462)	(1,934)	1,057	(1,884)	672
Long-term debt	11,040	7,469	4,956	4,899	4,977
Stockholders' equity	20,462	19,734	17,401	9,695	8,793
Ratio Analysis					
Net income as a percentage of revenues	1.19	4.01	4.00	2.75	2.80
Percent return on average equity during the year	4.29	13.64	14.91	11.33	14.33
Current ratio	.70	.66	1.24	.50	1.23
Total liabilities to equity ratio	1.04	.74	.58	.94	.92
Book value per outstanding common share	7.50	7.26	6.40	4.47	4.05
Restaurants					
Number open (end of year)					
Company-operated	162	147	133	118	107
Franchised	35	26	18	15	10
Total restaurants	197	173	151	133	117
Average annual systemwide sales	468	460	420	361	333
Company Employment					
Number of employees (average)	2,419	2,216	1,864	1,487	1,341

QUARTERLY FINANCIAL INFORMATION

(Unaudited)

**For the Year Ended
December 29, 1985**

First Quarter	Second Quarter	Third Quarter	Fourth Quarter
------------------	-------------------	------------------	-------------------

(Dollar amounts in thousands, except earnings per share)

Systemwide sales	\$ 18,438	\$ 19,341	\$ 21,474	\$ 27,848
Company sales and franchise revenue	15,443	16,064	17,217	23,568
Gross profit	3,404	3,749	3,916	4,644
Net income	452	650	594	(833)
Earnings per common share	.17	.24	.21	(.30)
Weighted average common shares outstanding	2,721,382	2,722,547	2,724,204	2,725,033

**For the Year Ended
December 30, 1984**

Systemwide sales	\$ 15,402	\$ 16,838	\$ 17,296	\$ 24,315
Company sales and franchise revenue	13,369	14,415	14,560	20,723
Gross profit	3,047	3,317	3,283	4,815
Net income	545	584	501	902
Earnings per common share	.20	.22	.18	.33
Weighted average common shares outstanding	2,723,227	2,724,032	2,724,032	2,720,292

	<u>1985</u>	<u>1984</u>
Annual Dividend Per Share-paid in April and October	<u>\$.07</u>	<u>\$.06</u>

**Quarterly Low & High Bid
Prices For the Fiscal Year**

	<u>1985</u>	<u>1984</u>
First Quarter	\$10.00-\$12.50	\$ 9.00-\$10.75
Second Quarter	9.50- 11.50	9.25- 11.75
Third Quarter	8.75- 11.25	8.00- 11.25
Fourth Quarter	9.13- 12.13	9.00- 10.88

(OTC market; NASDAQ Symbol: SKIP)

**Shareholders and Shares
at Fiscal Year End**

	<u>1985</u>	<u>1984</u>
Approximate shareholders of record	2,500	2,500
Shares outstanding	2,725,033	2,719,072

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Shareholders of Skipper's, Inc.:

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of income and of changes in financial position present fairly the financial position of Skipper's, Inc. and its subsidiaries at December 29, 1985 and December 30, 1984 and the results of their operations and the changes in their financial position for each of the three years in the period ended December 29, 1985, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.



Seattle, Washington
March 25, 1986

CONSOLIDATED STATEMENT OF INCOME

	For the Year Ended		
	December 29, 1985	December 30, 1984	December 25, 1983
Sales	\$71,244,000	\$62,306,000	\$49,956,000
Franchise revenues	1,048,000	761,000	503,000
	<u>72,292,000</u>	<u>63,067,000</u>	<u>50,459,000</u>
Cost of sales	25,766,000	21,630,000	17,560,000
Salaries, wages and benefits	16,386,000	14,885,000	11,856,000
Other restaurant expenses	14,427,000	12,090,000	9,531,000
	<u>56,579,000</u>	<u>48,605,000</u>	<u>38,947,000</u>
General and administrative expenses	12,680,000	10,731,000	8,556,000
	<u>69,259,000</u>	<u>59,336,000</u>	<u>47,503,000</u>
Income from operations before provisions for loan loss and income taxes	3,033,000	3,731,000	2,956,000
Provision for loan loss — Note 2	2,400,000		
	<u>633,000</u>	<u>3,731,000</u>	<u>2,956,000</u>
Provision for income taxes — Note 7:			
Current (benefit) provision	(718,000)	673,000	603,000
Deferred provision	488,000	526,000	333,000
	<u>(230,000)</u>	<u>1,199,000</u>	<u>936,000</u>
Net income	<u>\$ 863,000</u>	<u>\$ 2,532,000</u>	<u>\$ 2,020,000</u>
Earnings per common share	<u>\$.32</u>	<u>\$.93</u>	<u>\$.81</u>

See accompanying notes to consolidated financial statements

CONSOLIDATED BALANCE SHEET

	December 29, 1985	December 30, 1984
ASSETS		
Current Assets:		
Cash	\$ 977,000	\$ 963,000
Marketable securities	1,048,000	1,278,000
Receivables	1,207,000	498,000
Income tax receivable	1,194,000	
Inventories	807,000	637,000
Prepaid expenses	527,000	415,000
Total current assets	5,760,000	3,791,000
Property and Equipment – Note 3	35,320,000	29,818,000
Intangibles and Other Assets – Note 6	829,000	740,000
	<u>\$41,909,000</u>	<u>\$34,349,000</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Trade accounts payable	\$ 3,492,000	\$ 2,059,000
Salaries, wages and payroll taxes payable	1,851,000	1,716,000
Accrued liabilities	1,345,000	674,000
Accrued contingent rents – Note 5	577,000	559,000
Accrued sales tax	429,000	420,000
Current portion of long-term debt and capital leases – Notes 4 and 5	528,000	297,000
Total current liabilities	8,222,000	5,725,000
Noncurrent Obligations:		
Obligations under capital leases – Note 5	8,148,000	5,481,000
Long-term debt – Note 4	2,892,000	1,988,000
Deferred federal income taxes – Note 7	1,685,000	1,197,000
Deferred franchise revenues	274,000	224,000
Other	226,000	
Total noncurrent obligations	13,225,000	8,890,000
	<u>21,447,000</u>	<u>14,615,000</u>
Stockholders' Equity – Notes 8 and 9		
Preferred stock, 1,000,000 shares authorized; No shares issued		
Common stock, 10,000,000 shares authorized; 2,725,033 in 1985 and 2,719,072 in 1984 issued and outstanding	10,248,000	10,192,000
Retained earnings	10,214,000	9,542,000
	<u>20,462,000</u>	<u>19,734,000</u>
Commitments and contingent liabilities – Notes 2, 4, 5 and 11		
	<u>\$41,909,000</u>	<u>\$34,349,000</u>

See accompanying notes to consolidated financial statements

**CONSOLIDATED STATEMENT
OF CHANGES IN FINANCIAL POSITION**

	For the Year Ended		
	December 29, 1985	December 30, 1984	December 25, 1983
Financial resources were provided by:			
Net income	\$ 863,000	\$ 2,532,000	\$ 2,020,000
Add (deduct) income charges (credits) not affecting working capital in the period —			
Depreciation and amortization	3,732,000	2,872,000	2,231,000
Deferred income taxes	488,000	526,000	374,000
Loss on disposition of property and equipment	82,000	49,000	25,000
Deferred compensation	163,000		
Revenue from initial franchise fees	(226,000)	(146,000)	(40,000)
Working capital provided by operations	5,102,000	5,833,000	4,610,000
Proceeds from sales of property and equipment	5,590,000	1,092,000	379,000
Long-term obligations arising from capitalization of leases	3,132,000	820,000	305,000
Proceeds from long-term debt	1,048,000	1,963,000	
Proceeds from public stock offering			5,816,000
Proceeds from initial franchise fees	276,000	149,000	138,000
Other	119,000	23,000	217,000
Total financial resources provided	15,267,000	9,880,000	11,465,000
Financial resources were used for:			
Additions to property and equipment	11,390,000	11,071,000	7,461,000
Additions to property under capital leases	3,132,000	885,000	305,000
Current maturities and payments of long-term debt and capital lease obligations	610,000	233,000	242,000
Additions to intangibles	419,000	429,000	343,000
Payment of dividends	190,000	163,000	139,000
Other	54,000	89,000	34,000
Total financial resources used	15,795,000	12,870,000	8,524,000
Increase (decrease) in working capital	\$ (528,000)	\$ (2,990,000)	\$ 2,941,000

See accompanying notes to consolidated financial statements

(Continued)

**CONSOLIDATED STATEMENT
OF CHANGES IN FINANCIAL POSITION** (Continued)

**Analysis of Changes in Components
of Working Capital**

Increase (decrease) in current assets:

Cash

Marketable securities

Receivables

Income tax receivable

Inventories

Prepaid expenses

Increase (decrease) in current liabilities:

Trade accounts payable

Salaries, wages and payroll taxes payable

Accrued liabilities

Accrued contingent rents

Accrued sales tax

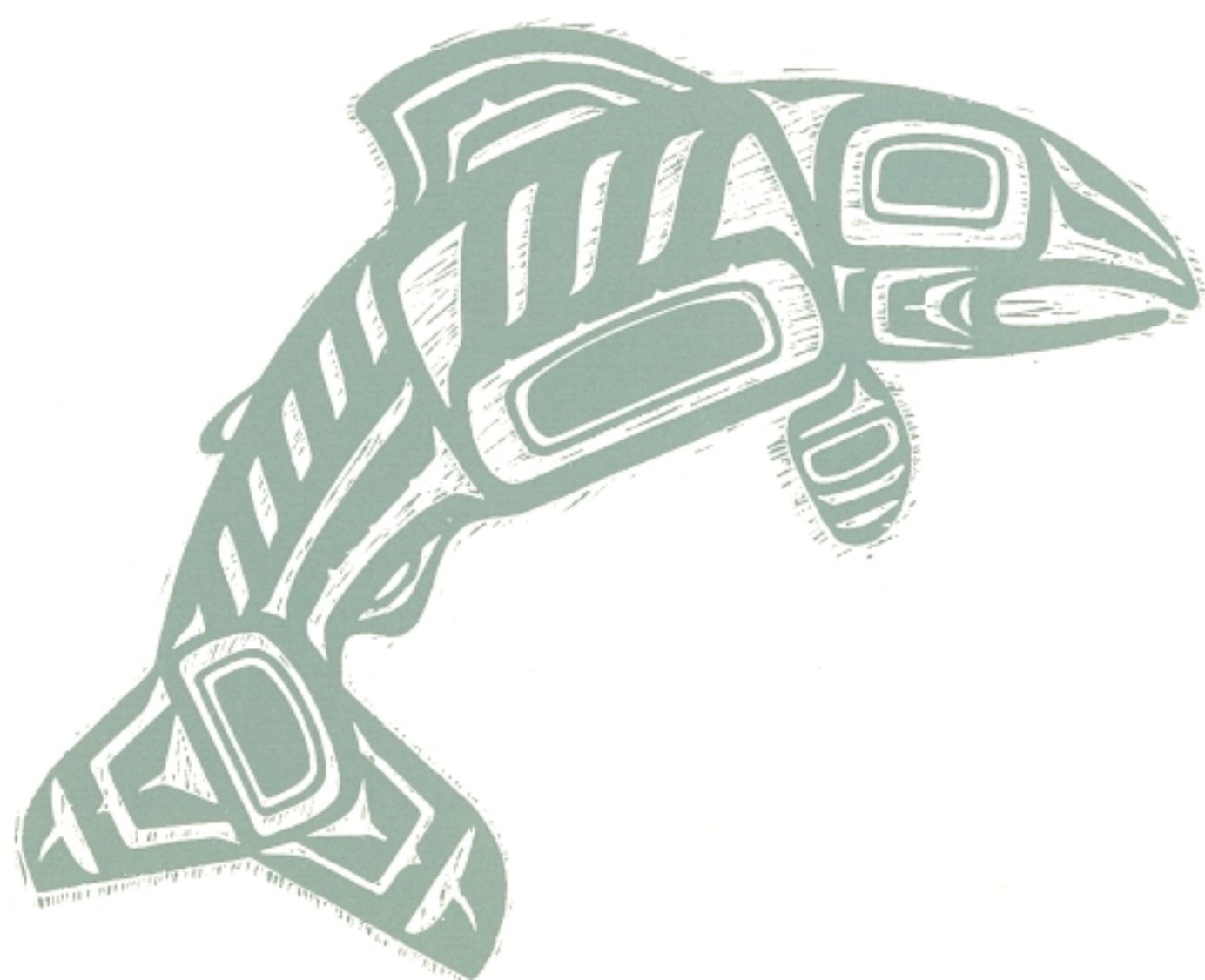
Current portion of long-term debt and capital leases

Increase (decrease) in working capital

For the Year Ended

December 29, 1985	December 30, 1984	December 25, 1983
\$ 14,000	\$(1,970,000)	\$2,348,000
(230,000)	262,000	1,016,000
709,000	2,000	(50,000)
1,194,000		
170,000	16,000	133,000
112,000	109,000	24,000
1,969,000	(1,581,000)	3,471,000
1,433,000	763,000	(260,000)
135,000	169,000	508,000
671,000	187,000	24,000
18,000	148,000	133,000
9,000	89,000	106,000
231,000	53,000	19,000
2,497,000	1,409,000	530,000
\$ (528,000)	\$(2,990,000)	\$2,941,000

See accompanying notes to consolidated financial statements



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—ACCOUNTING POLICIES:

Principles of Consolidation

The company operates and franchises Skipper's Seafood n' Chowder House Restaurants. The consolidated financial statements include the accounts of the company and its subsidiaries. Significant intercompany transactions have been eliminated from the consolidated financial statements.

The company operates on a 52 or 53 week year with three quarters of 12 weeks and a final quarter of 16 weeks ending on the Sunday closest to December 31.

Marketable Securities

Marketable securities are stated at the lower of cost or market. Investment income earned on such instruments was \$294,000, \$143,000 and \$345,000 in 1985, 1984 and 1983, respectively.

Inventories

Inventories consist primarily of food and beverages and are valued at the lower of cost or market. Cost is determined using the first in, first out method.

Property and Equipment

Property and equipment are stated at cost and are depreciated on a straight-line basis over the estimated useful lives of properties and equipment owned by the company or over the terms of leases capitalized. Estimated lives are generally 20 to 35 years for buildings and 7 to 10 years for equipment.

Interest costs associated with the acquisition phase of company owned property and equipment are capitalized as a cost of such assets.

Restaurant Preopening Costs

The company capitalizes costs incurred in preparation of opening new restaurants and amortizes such costs on a straight-line basis over a three-year period.

Franchise Operations

The company grants franchise rights for a term of 20 years to private operators in exchange for an initial franchise fee which is not recognized as income until the preopening obligations are satisfied and restaurants are opened. Royalties based on a percentage of gross sales are recognized on the accrual basis.

Deferred Compensation

The company has a deferred compensation agreement with corporate officers based on certain performance criteria. The agreement has a five year vesting period and compensation expense is recognized over the same period. During 1985, the company entered into a retirement agreement with a former officer providing for deferred compensation to be paid in five equal payments beginning January 1, 1994. The payments are fully vested and accordingly the company has recognized \$134,000 in compensation expense during 1985.

Income Taxes

Deferred income taxes arise primarily from the use of accelerated depreciation methods for income tax purposes and the capitalization of facilities leases and deferral of restaurant preopening costs for financial reporting purposes. Investment tax credits are recognized when the assets are placed in service under the flow-through method of accounting.

(Continued)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Earnings Per Common Share

Earnings per common share are calculated using the weighted average number of common shares outstanding during each year. Average shares were 2,723,424, 2,722,695, and 2,508,043 in 1985, 1984 and 1983, respectively.

NOTE 2 – LOANS TO CULCON SYSTEMS, INC.

On June 19, 1985, the company and CulCon Systems, Inc. (CulCon) entered into a loan agreement extending through December 31, 1987. The company agreed to extend financial accommodations to CulCon of up to \$8,000,000 in the form of either direct loans to CulCon or guarantees by the company of obligations of CulCon to third parties. On the same date, the company and CulCon also entered into a merger agreement pursuant to which the company had the option, upon the occurrence of certain conditions, to acquire CulCon at various dates through March 31, 1988 for the greater of \$4,000,000 or an amount based on the value of CulCon, as defined in the agreement. CulCon is a holding company that owns all of the outstanding stock of Zackly's Restaurant Systems, Inc. and Uno's Restaurant Systems, Inc., both of which operate restaurants. One of the principal shareholders of CulCon was a member of the company's Board of Directors through December 29, 1985.

At December 29, 1985, the company had advanced approximately \$2,000,000 to CulCon under the loan agreement and had guaranteed approximately \$400,000 of CulCon's obligations under two equipment leases. During January 1986 additional advances were made to CulCon which increased the amount outstanding under the loan agreement to approximately \$2,200,000.

As of December 29, 1985 CulCon was in default of certain covenants contained in the loan agreement. As a result, the company elected to exercise its option to declare the amount outstanding under the loan agreement immediately due and payable and to terminate the merger agreement.

On March 2, 1986 the company and CulCon entered into an agreement pursuant to which CulCon agreed to convey to the company all of its interests in three Zackly's restaurants on the west coast of Florida, including its interest in all assets and all leases of real and personal property relating to the restaurants, and to grant to the company franchise and subfranchise rights to operate Zackly's restaurants in a seven state area. In addition, the company received from the two principal shareholders of CulCon an unconditional guarantee of the obligations of CulCon under the two equipment leases that were guaranteed by the company under the June 1985 loan agreement. The company agreed to pay \$385,000, to not enforce its rights under the loan agreement, to release its liens on the assets of CulCon and its subsidiaries not conveyed to the company under the agreement, and to waive its rights under the June 19, 1985 guarantee by the principal shareholders of CulCon. The minimum commitments under the leases of real and personal property relating to the three restaurants are summarized below. One of the restaurants is leased from one of the principal shareholders of CulCon.

<u>Fiscal Year</u>	
1986	\$ 235,000
1987	250,000
1988	243,000
1989	257,000
1990	250,000
Thereafter	<u>2,228,000</u>
	<u>\$3,463,000</u>

The three restaurants conveyed to the company have a very limited operating history and the assets and rights transferred to the company did not include significant tangible assets. Accordingly, at December 29, 1985 the company recorded a provision of \$2,400,000 as its estimate of the loss on settlement.

**NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS**

NOTE 3 – PROPERTY AND EQUIPMENT:

The company had property and equipment as follows:

	December 29, 1985	December 30, 1984
Buildings and leasehold improvements	\$14,647,000	\$13,024,000
Equipment	20,248,000	16,464,000
	<u>34,895,000</u>	<u>29,488,000</u>
Less-Accumulated depreciation and amortization	(11,116,000)	(8,887,000)
	<u>23,779,000</u>	<u>20,601,000</u>
Land	4,250,000	4,556,000
	<u>28,029,000</u>	<u>25,157,000</u>
Leased property under capital leases:		
Buildings and leasehold improvements	9,782,000	7,178,000
Equipment	563,000	155,000
	<u>10,345,000</u>	<u>7,333,000</u>
Less-Accumulated amortization	(3,195,000)	(2,813,000)
	<u>7,150,000</u>	<u>4,520,000</u>
Real estate held for sale	141,000	141,000
	<u>\$35,320,000</u>	<u>\$29,818,000</u>



**NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS**

NOTE 4 – LONG-TERM DEBT:

Long-term debt consists of the following:

	December 29, 1985	December 30, 1984
Payable to bank under revolving credit and term loan agreement	\$2,487,000	\$1,439,000
Contracts associated with purchase of equipment payable in monthly installments at interest rates ranging from 11 to 13% through August, 1994	488,000	503,000
Mortgages payable to bank in monthly installments at interest rates of 9 and 10% through 1995	62,000	77,000
	3,037,000	2,019,000
Current maturities	(145,000)	(31,000)
	<u>\$2,892,000</u>	<u>\$1,988,000</u>

In 1984 the company entered into a bank loan agreement. The loan is unsecured and bears interest at the prime lending rate which at December 29, 1985 was 9.5%. Under the terms of that agreement, the company can borrow on a revolving line of credit basis up to \$10,000,000. The line shall terminate between June 30, 1988 and 1989, depending on certain conditions. On the termination date the company can convert the then outstanding principal balance of the line to a term loan payable over a five year period. The agreement contains restrictive covenants relating to net income, net worth, debt-to-worth ratio, debt-service ratio and the level of dividends.

For purposes of the following schedule of annual principal payments, it has been assumed that the balance outstanding at December 29, 1985 of \$2,487,000 will be converted to a term loan at the earliest of the termination dates.

Annual principal payments required on long-term debt are as follows:

Fiscal Year	
1986	145,000
1987	147,000
1988	275,000
1989	332,000
1990	443,000
Thereafter	1,695,000
	<u>\$3,037,000</u>

In addition the company has issued standby letters of credit in the amount of \$523,000 in connection with worker's compensation insurance policies.

**NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS**

NOTE 5 – LEASES:

The company leases a majority of its restaurant facilities and its administrative offices. Certain leases require the company to pay property taxes and insurance and others require additional rental payments contingent upon sales exceeding specified amounts. The leases are generally for 20-year periods and frequently provide options to renew for 5-to-10 year periods.

Total minimum commitments under noncancelable leases in force at December 29, 1985 are as follows:

<u>Fiscal Year</u>	<u>Capital Leases</u>	<u>Operating Leases</u>	<u>Total</u>
1986	\$ 1,253,000	\$ 1,933,000	\$ 3,186,000
1987	1,253,000	1,946,000	3,199,000
1988	1,256,000	1,951,000	3,207,000
1989	1,256,000	1,947,000	3,203,000
1990	1,240,000	1,904,000	3,144,000
Thereafter	<u>10,278,000</u>	<u>21,553,000</u>	<u>31,831,000</u>
Total minimum lease commitments	16,536,000	<u>\$31,234,000</u>	<u>\$47,770,000</u>
Less-Amounts representing implicit interest	<u>(8,005,000)</u>		
Present value of net mini- mum lease commitments	8,531,000		
Less-Current portion	<u>(383,000)</u>		
	<u>\$ 8,148,000</u>		

Total rent expense under operating leases was \$2,375,000, \$2,062,000 and \$1,582,000 during 1985, 1984 and 1983, respectively, which included contingent rent expense of \$588,000, \$571,000 and \$421,000, respectively.

Total interest costs incurred, which primarily relate to capital leases, were \$962,000, \$723,000, and \$546,000 during 1985, 1984 and 1983, respectively. Interest costs capitalized in 1985 and 1984 amounted to \$103,000 and \$99,000 respectively.

NOTE 6 – INTANGIBLES AND OTHER ASSETS:

Intangibles and other assets are as follows:

	<u>December 29, 1985</u>	<u>December 30, 1984</u>
Restaurant preopening costs	\$1,035,000	\$ 962,000
Trademark and goodwill	370,000	209,000
Other	<u>137,000</u>	<u>83,000</u>
	1,542,000	1,254,000
Less-Accumulated amortization	<u>(713,000)</u>	<u>(514,000)</u>
	<u>\$ 829,000</u>	<u>\$ 740,000</u>

**NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS**

NOTE 7 – INCOME TAXES:

The company files consolidated federal and state income tax returns. The difference between the total “expected” income tax at a rate of 46% and the reported provision for taxes is as follows:

	<u>1985</u>	<u>1984</u>	<u>1983</u>
Federal income tax at 46%	\$ 291,000	\$1,716,000	\$1,360,000
Investment tax credits	(418,000)	(520,000)	(372,000)
Targeted jobs tax credit	(145,000)	(30,000)	(5,000)
Other, net	42,000	33,000	(47,000)
	<u>\$(230,000)</u>	<u>\$1,199,000</u>	<u>\$ 936,000</u>

State taxes were \$10,000, \$94,000 and \$83,000 in 1985, 1984 and 1983, respectively. The excess tax credits generated in 1985 were fully utilized against taxes paid in prior years.

Deferred tax expense was attributable to the following:

	<u>1985</u>	<u>1984</u>	<u>1983</u>
Excess tax depreciation	\$ 864,000	\$ 508,000	\$ 348,000
Capitalized leases	(82,000)	(60,000)	(60,000)
Restaurant preopening costs	(35,000)	94,000	113,000
Deferred compensation	(69,000)		
Gain on sale-leasebacks	(178,000)		
Other	(12,000)	(16,000)	(68,000)
	<u>\$ 488,000</u>	<u>\$ 526,000</u>	<u>\$ 333,000</u>

NOTE 8 – CAPITAL STOCK TRANSACTIONS:

On May 19, 1983, the company sold 550,000 shares of the company's common stock in a public offering, generating \$5,816,000 in contributed capital. During 1984, the company redeemed 5,000 shares of its common stock for \$47,000. Cash dividends amounting to \$190,000, \$163,000 and \$140,000 were paid in 1985, 1984 and 1983 respectively.

NOTE 9 – STOCK OPTIONS AND WARRANTS:

Under a nonqualified stock option plan adopted in 1977, the Board of Directors made available for grants to employees options to purchase up to 20,000 shares of the company's common stock at the market price as of the date of the grants. The plan terminates on June 30, 1987. Options are exercisable in five equal annual amounts commencing one year from the date of grant and expire ten years from the date they are granted to the employee. At December 29, 1985 there were unexercised options to purchase 6,306 shares at prices ranging from \$3.00 to \$3.50, and options to purchase 940 shares were available for future grants. No options were granted or canceled during the year ended December 29, 1985 and options to purchase 100 shares were exercised for \$3.00. During 1984 options to purchase 3,453 shares for \$11,383 were exercised and during 1983 options to purchase 3,372 shares were exercised resulting in proceeds to the company of \$10,116.

Under a qualified employee incentive stock option plan adopted in 1984 the Board of Directors made available for grants to employees options to purchase up to 135,000 shares of the company's common stock at the market price as of the date of the grants. The plan terminates on March 16, 1994. Options are exercisable in three annual amounts commencing one year from the date of grant and expire ten years after the date they are granted to the employee. At December 29, 1985 there were unexercised options to purchase 131,260 shares at prices ranging from \$9.75 to \$10.50, and options to purchase 2,600 shares were available for future grants. During the year ended December 29, 1985 options to purchase 37,620 shares were granted at prices ranging from \$10.125 to \$10.50, options to purchase 4,050 shares were canceled, and options to purchase 1,140 shares were exercised resulting in proceeds to the company of \$11,115.

Under a qualified employee stock purchase plan adopted in 1984 the Board of Directors made available 80,000 shares of common stock for purchase by employees at 95% of the lower of the beginning or ending market price during each successive six month period. The difference between the market price at the date of issuance and the price charged to employees is recorded as compensation expense. On January 2, 1985 2,235 shares were sold to employees for \$9.26 per share and on June 30, 1985 2,486 shares were sold to employees for \$9.50 per share. At December 29, 1985 75,279 shares were available for sale to employees and \$20,000 was held by the company in connection with employee stock purchases; on January 2, 1986 2,064 shares were issued.

In connection with the company's initial public stock offering in 1981, warrants to purchase 66,450 shares of common stock were issued to the underwriter of the offering at an exercise price of \$8.88 per share. No warrants have been exercised and they expire on May 27, 1986.

**NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS**

NOTE 10 – RELATED PARTY TRANSACTIONS:

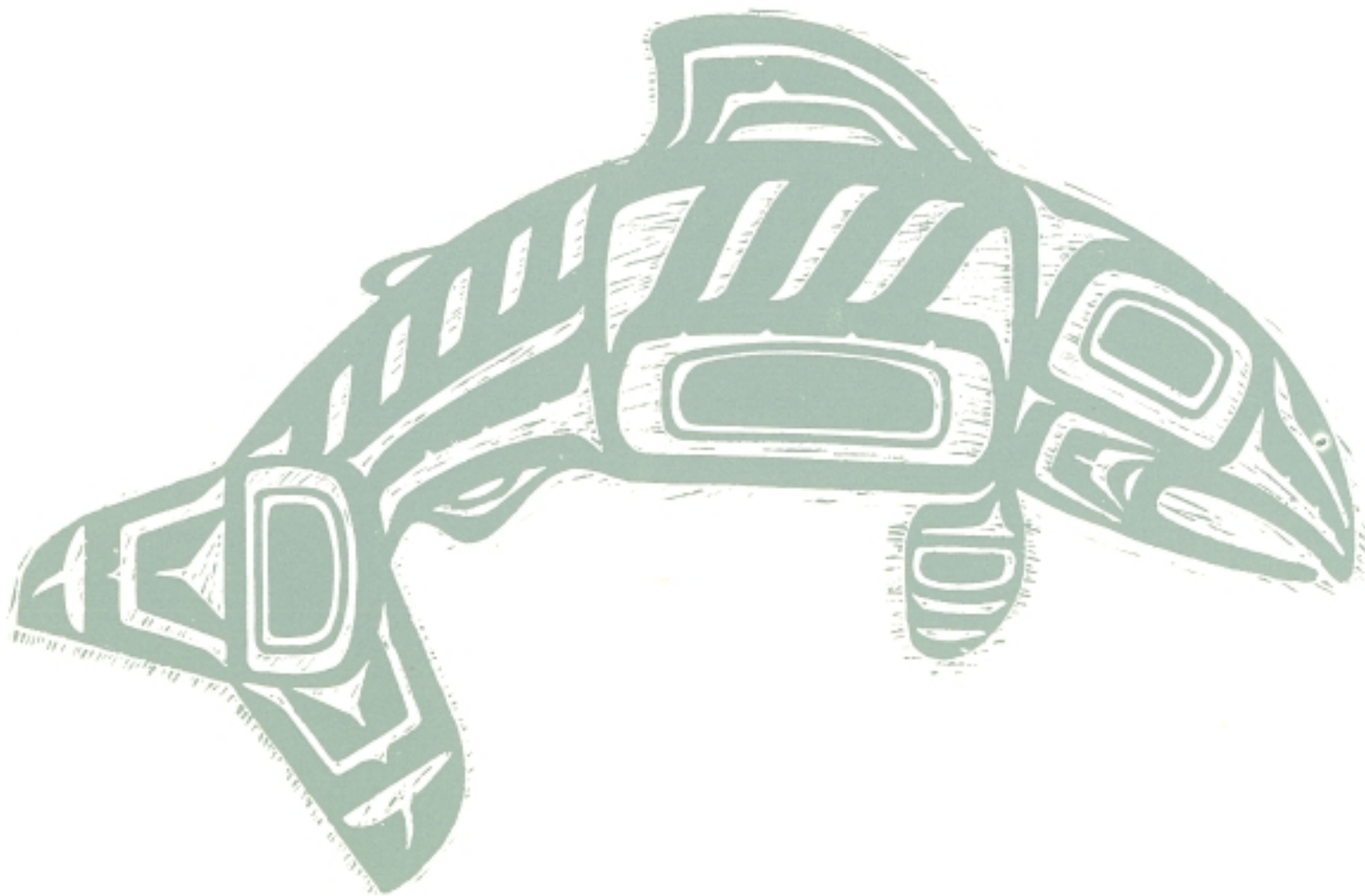
The company leases its administrative offices in a building in which a director has an ownership interest. Additionally, the company leases five of its restaurants from stockholders and two are leased from a company with which Skipper's has common stockholders. The remaining terms of these eight leases range from 5 to 13 years and will continue to require minimum annual payments of approximately \$344,000.

NOTE 11 – SALES AND LEASEBACKS:

During January, 1985 the company entered into an agreement with a limited partnership under which it sold to the partnership and then leased back five restaurants. The restaurants had a book value of \$2,797,000 and were sold for \$2,941,000; the gain on the sale has been deferred and will be recognized in income over the terms of the leases. The leases have terms of 20 years with three optional five-year renewal periods; lease payments in connection with the five restaurants aggregate \$394,000 annually. The lease obligations capitalized under this agreement amounted to \$1,827,000 as of the inception of the leases; ground leases are classified as operating leases and are not included in the amounts capitalized.

During June, 1985 the company entered into a similar agreement with another limited partnership providing for the sale and leaseback of both company owned and franchised restaurants. The company agreed to guarantee 90% of the lease payments to be made by franchise holders. The fees received by the company in connection with these guarantees will be recognized in income over the terms of the leases. Five restaurants were sold to the limited partnership during 1985 under the second agreement. These restaurants had a book value of \$2,172,000 and were sold for \$2,234,000; the gain on the sale has been deferred and will be recognized in income over the terms of the leases. The leases have terms similar to those described above; lease payments in connection with the five restaurants aggregate \$258,000 annually. The lease obligations capitalized under the second agreement amounted to \$1,257,000 as of the inception of the leases. Additionally, at December 29, 1985 the company had guaranteed the lease payments in connection with equipment sold to the limited partnership by a franchise holder for \$90,000.

At December 29, 1985 the limited partnership had \$7,431,000 available to finance further purchases from the company or its franchise holders.



OFFICERS

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Vice President Marketing

Chris R. LeSourd
President
Chief Operating Officer

Carol L. Nolan
Vice President Controller

M. Eugene Stone
Chairman
Chief Executive Officer

Jay W. Switzer
Vice President Finance
Secretary/Treasurer

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Chairman/Chief Executive Officer
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Transfer Agent
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1001 4th Avenue
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Annual Meeting
The 1986 annual meeting of stockholders will be held on Friday, May 30, 1986 at 4:00 pm at the Pacific Coca Cola Bottling Company Auditorium (Parking available along 124th) 1150-124th Avenue N.E. Bellevue, Washington 98009

For a copy of the Skipper's, Inc. Annual Report on Form 10-K write:

Jay W. Switzer
Vice President Finance
Secretary/Treasurer
Skipper's, Inc.
14450 N.E. 29th Place
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A copy will be provided at no charge.

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