

STORAK, INC. 1986

ANNUAL REPORTS

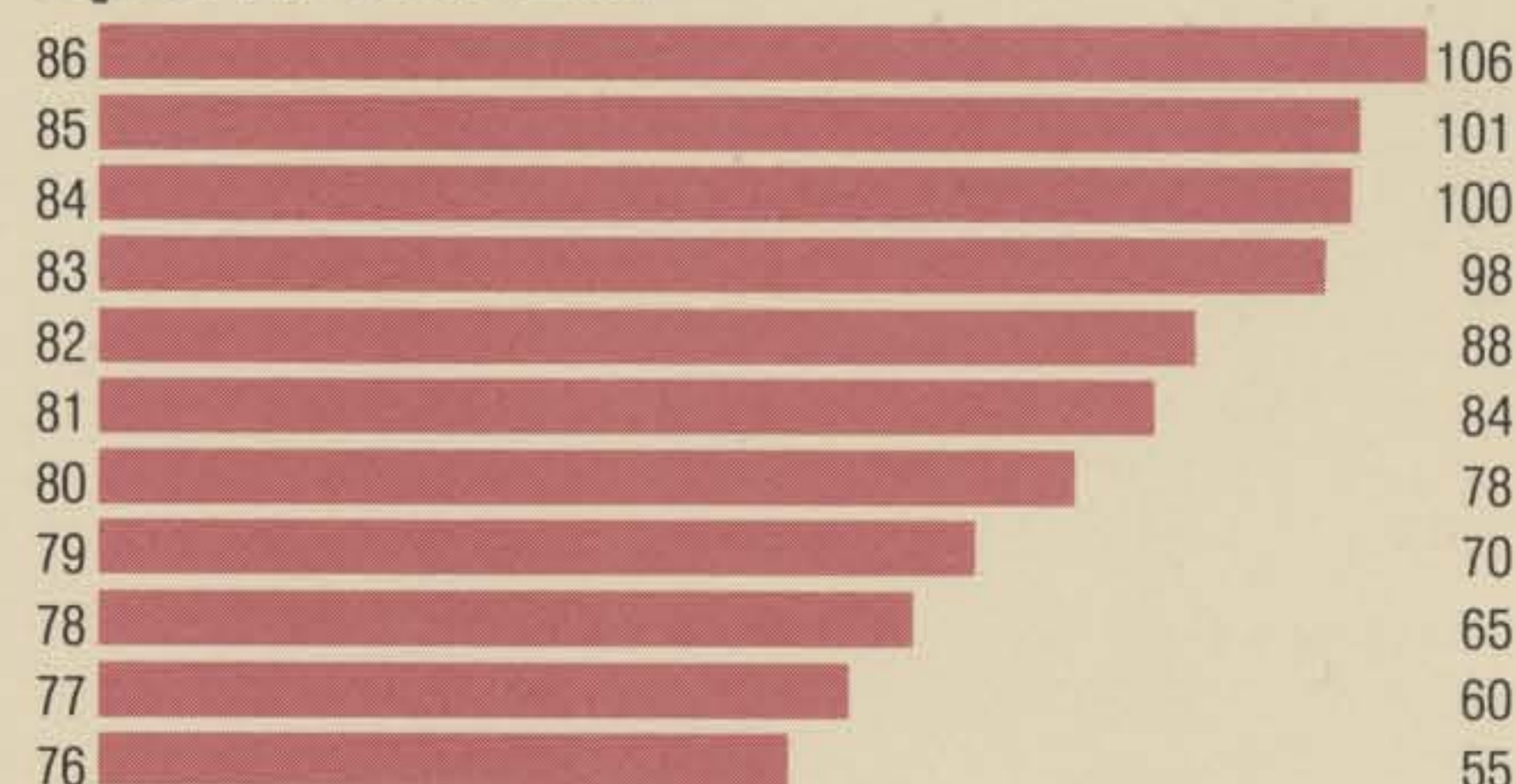
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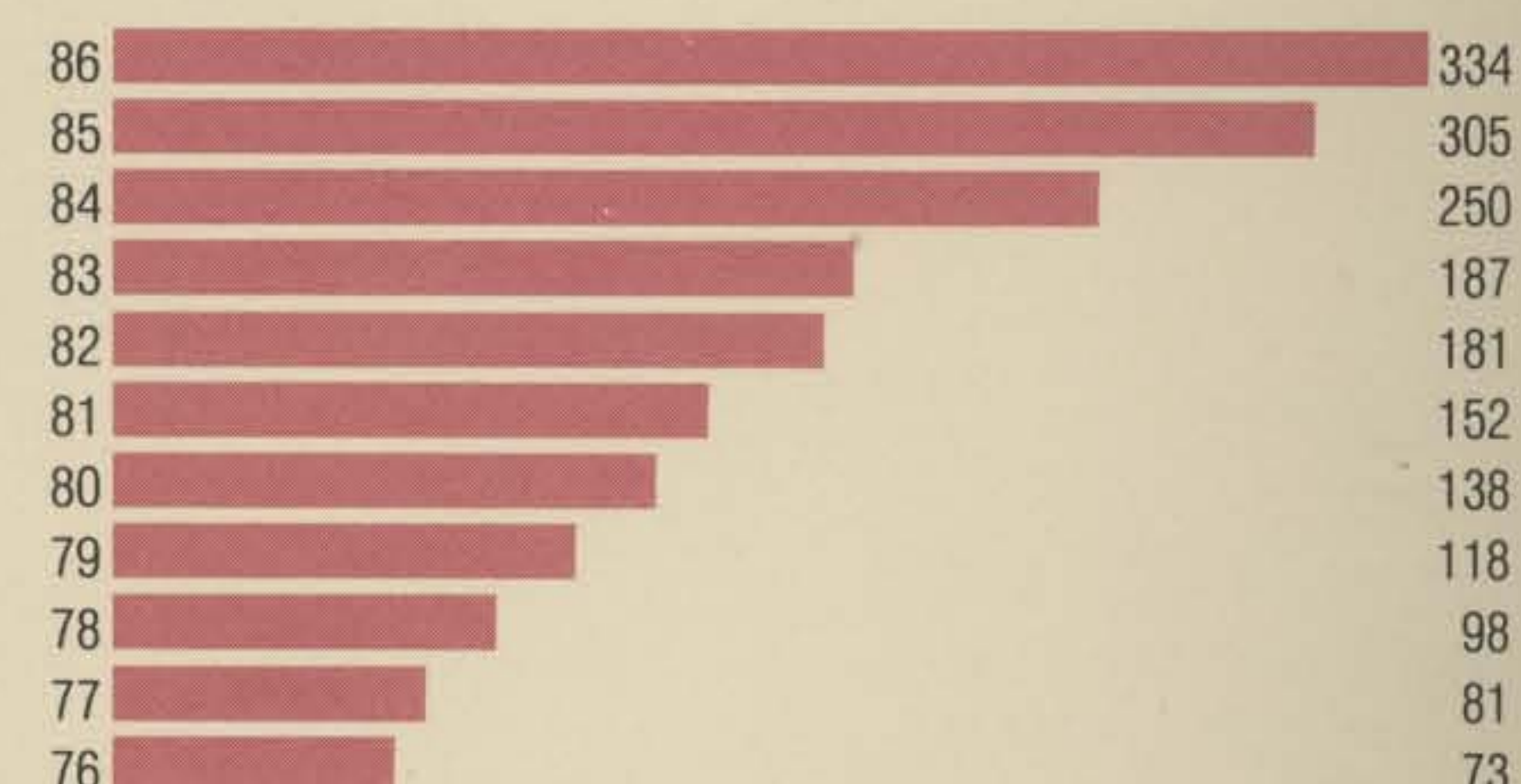
About the Company

Pay 'N Pak operates 106 retail home improvement centers located in 17 states throughout the western United States, including Alaska and Hawaii. Incorporated in 1961, the company sells electrical products, plumbing supplies and building materials to do-it-yourself home improvement and home maintenance customers.

Number Of Stores Open At Year-End



Revenues (in \$ millions)



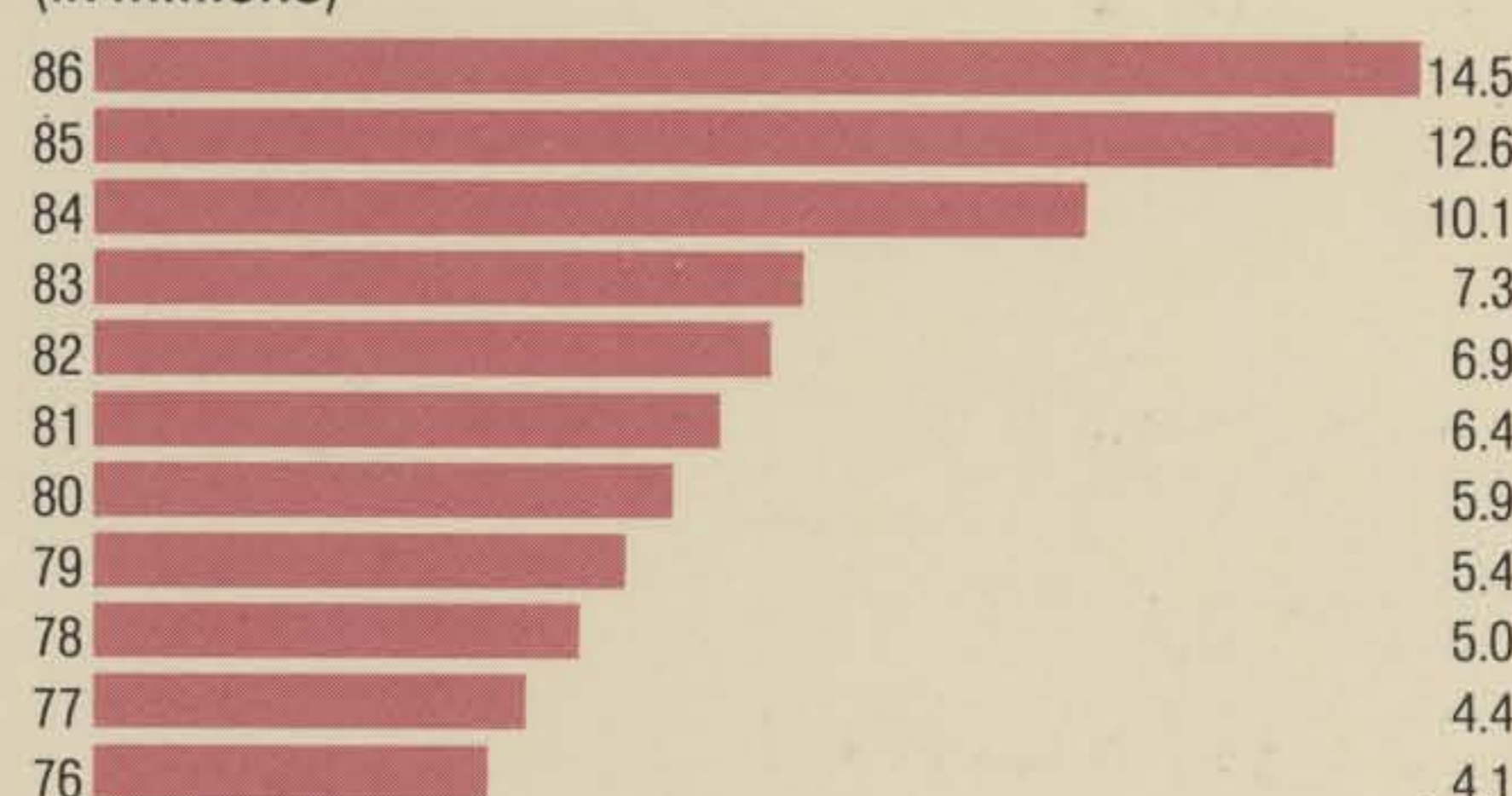
Average Sales Per Store (in \$ millions)



Net Income As A Percentage of Sales



Number of Customers Served (in millions)



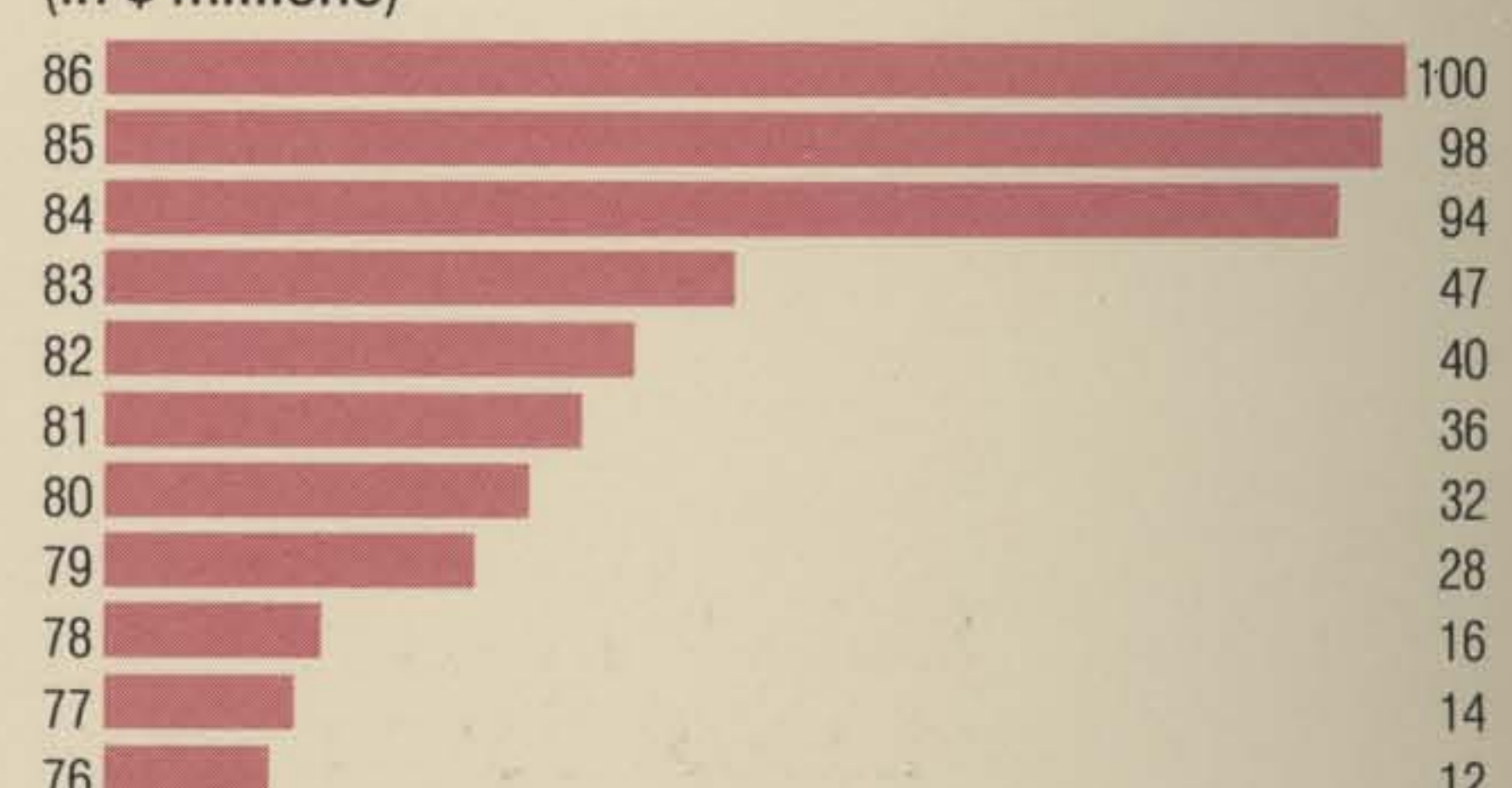
Earnings Per Share (in \$)



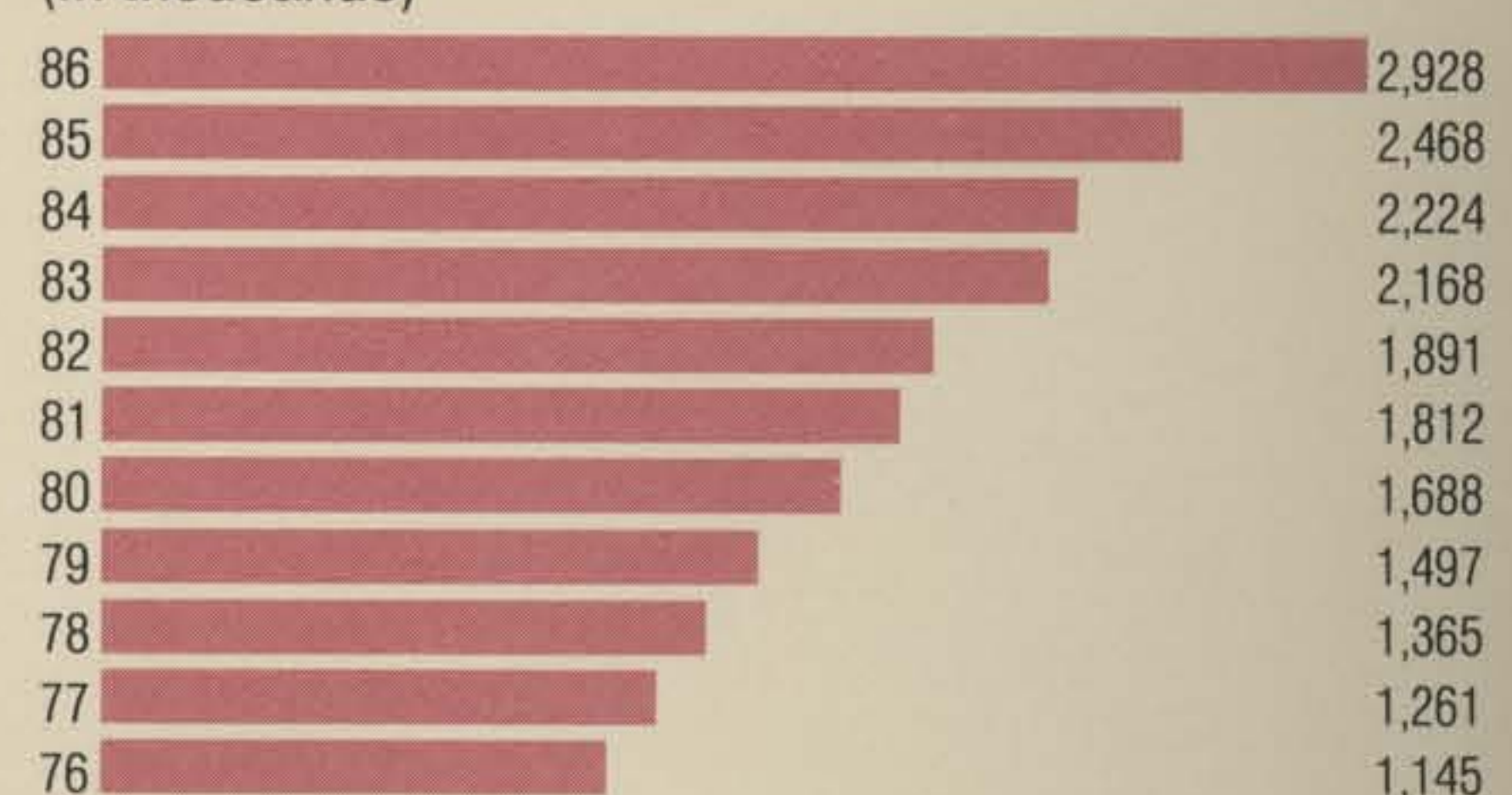
Sales Per Full-Time Employee At Year-End (in \$ thousands)



Stockholders' Equity (in \$ millions)



Stores — Square Footage (in thousands)



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Financial Highlights

Pay 'N Pak
Stores, Inc.

Fiscal years ended February 28

	1986	1985	% Change
	<i>(dollar amounts in thousands, except per share data)</i>		
Revenues	\$333,782	\$305,185	+9
Income before income taxes	\$ 14,463	\$ 18,420	-21
Net income	\$ 8,168	\$ 10,105	-19
Per share of common stock:			
Net income	\$.82	\$ 1.01	-19
Dividends	\$.63	\$.60	+5
Weighted average number of shares outstanding	10,003	10,003	—
Stockholders' equity	\$ 99,643	\$ 97,776	+2

Quarterly Financial Information (Unaudited)

For the year ended February 28, 1986

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	<i>(dollar amounts in thousands, except per share data)</i>			
Revenues	\$82,733	\$90,503	\$86,002	\$74,544
Gross profit on sales	\$27,919	\$31,271	\$28,347	\$25,325
Net income	\$ 2,096	\$ 3,011	\$ 1,760	\$ 1,301
Net income per share	\$.21	\$.30	\$.18	\$.13

For the year ended February 28, 1985

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	<i>(dollar amounts in thousands, except per share data)</i>			
Revenues	\$74,437	\$87,802	\$81,600	\$61,346
Gross profit on sales	\$25,878	\$30,799	\$27,141	\$20,527
Net income	\$ 2,386	\$ 3,842	\$ 2,678	\$ 1,199
Net income per share	\$.24	\$.38	\$.27	\$.12

Quarterly Low and High Common Stock Prices

For the fiscal years

	1986	1985
First quarter	11½-13⅞	12¾-16
Second quarter	12¾-15¼	13½-17½
Third quarter	11⅝-13⅜	14⅛-16⅜
Fourth quarter	12⅛-15	11½-14¾

The fiscal year ended February 28, 1986 was a difficult one for Pay 'N Pak, but it had a happy ending in that all of the work that has gone into expansion during the past three years began to pay off. First of all, your company finally opened its four new stores in the San Francisco Bay Area, and these, coupled with the six stores acquired in the Bonanza purchase in 1983, have given Pay 'N Pak a strong and profitable presence in northern California. Additionally, the acquisition of the three Handyman stores in the Portland, Oregon, market has proved to be a good one. Add to the foregoing the excellent results beginning to emerge from converting 29 existing stores to the company's warehouse-type store and your management has reason to be optimistic for the future.

As to specifics, revenues for the fiscal year ended February 28, 1986, were \$333,782,000, up 9.4% from \$305,185,000 in fiscal 1985. This was our fifteenth consecutive year of increase in revenue. Store for store sales (stores three years old and older) were up 5.3% in fiscal 1986 as compared to the previous year. Earnings were \$8,168,000 for the year as compared to \$10,105,000 in fiscal 1985, a decrease of 19.2%. On a per share basis earnings were \$.82 versus \$1.01 the previous year.

Going back to the optimism expressed in the first sentence of this message, it should be pointed out that revenues increased 21.7% in the fourth quarter and profits began to turn around in January and February with the result that the quarter ended with an 8.5% increase in earnings over the same period last year. At this writing, sales and earnings are continuing their upward trend. It should be pointed out that earnings for last year were adversely affected by the following:

1. Interest expense increased from \$3.7 million dollars in fiscal 1985 to \$6.1 million dollars in fiscal 1986 — an increase of approximately 13 cents per share. This increase was basically caused by real estate acquisition and construction costs.

2. Due to increased real estate holdings our depreciation expense went from \$6.9 million in fiscal 1985 to \$8.3 million dollars last year. This had a negative effect of 7 cents per share on earnings year-to-year although it did provide more cash flow.

3. As a result of the world-wide decrease in oil prices our Alaska operations were hurt both in sales and profit.

4. Price cutting has been severe in our business but it appears that the industry is "coming to its senses" so to speak. Competition is still intense and weaker companies are falling by the wayside.

5. Deflation, about which we spoke last year, has had a moderating effect on profitability because it results in lower profit margins. Overall, however, well-run businesses that take inventory mark-downs as they occur should not be hurt by deflation as much as those that do not.

For the thirteenth consecutive year your Board of Directors continued its policy of increasing dividends despite the downturn in earnings. As you may judge, your Board considered the downturn to be temporary, and voted quarterly cash dividends totalling \$.63 in fiscal 1986 compared with \$.60 the previous year.

During fiscal 1986 your company added 460,000 square feet of floor space to the chain, a substantial increase of 19%. This included the purchase of the three stores in Portland, Oregon, and the four new stores opened in the San Francisco Bay Area. Additionally, your company converted 10 more stores to its new warehouse format bringing the total number of conversions to 29. Two small stores were closed. During next year it is anticipated that your company will complete its warehouse conversion program, and will open as many as four new stores depending on real estate availability. Your company will continue to be alert to acquisition opportunities as they may arise.

Financially Pay 'N Pak is in excellent condition. During fiscal 1986 we arranged \$24 million dollars in new long-term financing, and we have adequate short-term bank lines available when needed. Additionally, we continuously work to sell and lease back properties which we have acquired. Pay 'N Pak is in the retail business — not in the real estate business — and its capital should go into its basic business.

Each year we like to point out that the success of Pay 'N Pak is due to its employees. Our Employee Stock Ownership Plan now owns 12.1% of all Pay 'N Pak stock and is its single largest shareholder. After three years of service all employees automatically become members of the Plan and receive up to \$3,000 worth of stock annually, paid for by the company. We believe that this fosters an entrepreneurial spirit in the employee group and adds to its desire for company success.

As far as management is concerned, Halvor Knudtson, Jr., secretary/treasurer and a director, elected to take early retirement after long and faithful service to Pay 'N Pak. His responsibilities were assumed by Fred R. Brotherton who was named vice president and controller, and by Douglas G. Southern who became vice president/finance. Mr. Southern joined us from Arthur Young & Company while Mr. Brotherton has been with Pay 'N Pak since 1982.

As stated last year, we expected fiscal 1986 to be a year of gradually increasing profit, and while it came to pass, it took longer to happen than we anticipated. Your company is optimistic about fiscal 1987 and thanks its employees and shareholders for their continuing support.

David J. Heerensperger

David J. Heerensperger
Chairman and
Chief Executive Officer

Jerry L. Marlow

Jerry L. Marlow
President and
Chief Operating Officer



David J. Heerensperger (left) and Jerry L. Marlow

Capitalizing on Unique Growth Opportunities

In fiscal 1986 Pay 'N Pak expanded its position in the Portland, Oregon, market and entered California's San Francisco Bay Area. An opportunistic expansion program, supported by the company's strong financial position, allowed Pay 'N Pak to take advantage of an acquisition opportunity in Portland and open four new stores in the San Francisco Bay Area in Northern California.

Acquisition of three stores in the Portland area increases market presence

In October 1985 Pay 'N Pak increased to 10 the number of its stores in the Portland area with the purchase of three stores formerly owned by the Handyman Corporation. The stores, which are located in Portland, Milwaukie and Beaverton, average approximately 50,000 square feet in size. It is anticipated that the conversion of all three stores to Pay 'N Pak's warehouse store concept will be completed by the end of May 1986.

The acquisition of the Handyman stores was completed smoothly, with no disruption of service to customers. Pay 'N Pak's corporate training staff spent several weeks at each of the stores training its new employees on Pay 'N Pak's comprehensive approach to serving the retail home improvement customer.

Company opens four new stores in San Francisco Bay Area

Late in fiscal 1986 Pay 'N Pak entered the Northern California market in San Francisco, South San Francisco, San Leandro and El Cerrito by opening four new stores averaging approximately 50,000 square feet in size. All are warehouse type stores, ideally suited to the Bay Area marketplace.

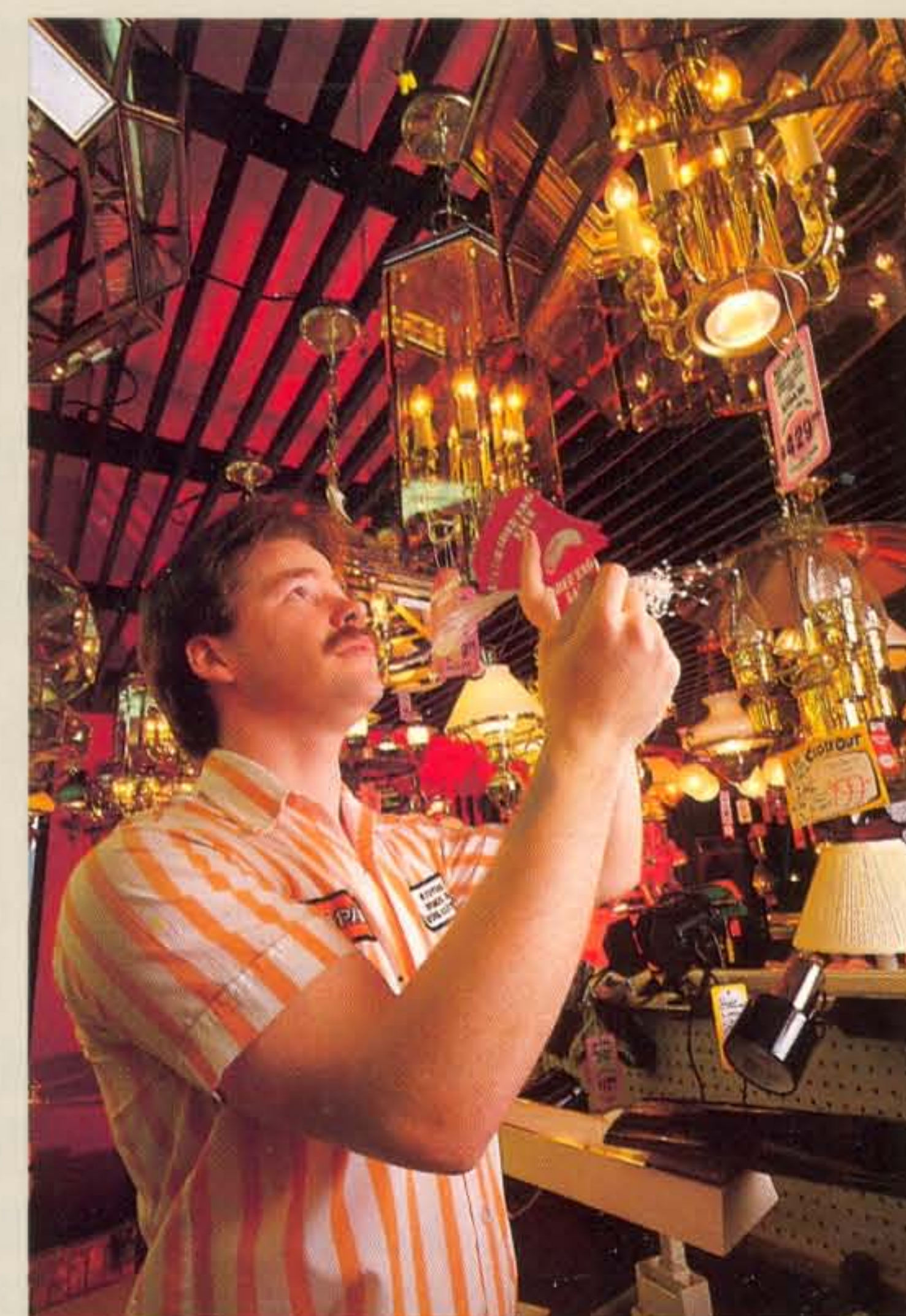
Anticipating customer needs is essential to any company's success

One of Pay 'N Pak's strengths is its ability to anticipate, and meet, the needs of the home improvement customer. The company's successful warehouse type home improvement centers are a prime example. These centers offer customers the best of all worlds: low prices, lots of inventory and a knowledgeable, well-trained sales staff. The company's message to the marketplace is simply that customers do not have to sacrifice service in order to get low prices.

Not all of Pay 'N Pak's markets are suited for large home improvement stores. The company's traditional stores are ideal for small markets that cannot support the higher inventory levels of the warehouse type store. The company currently has 70 traditional stores, some of which will be converted to the larger home improvement center concept in the future. This combination of traditional and warehouse stores gives Pay 'N Pak the flexibility to solve the needs of each market on an individual basis.

Ten stores were converted to warehouse type stores in fiscal 1986

During fiscal 1986 Pay 'N Pak converted 10 stores to large warehouse home improvement centers. Units in Boise, Idaho; Salt Lake City, Utah; and Yakima and Spokane Valley, Washington, were converted in the first quarter. Stores converted during the last nine months of the year are located in Pueblo, Colorado, along with Kennewick, Bellingham, White Center, Spanaway and Everett, in Washington state. In fiscal 1987 the company anticipates converting another six stores to the warehouse concept.



Pay 'N Pak converted its first store to the home improvement warehouse concept in October 1983. At the close of fiscal 1985 the company had 19 warehouse stores and today they account for 36 of the company's 106 stores. The warehouse stores are ideally suited to larger metropolitan areas with higher traffic volumes. Pay 'N Pak's 70 other stores give the company a presence in small and mid-size markets. Those stores use an efficient traditional format which includes gondolas up to 84 inches in height to maximize the number of stock keeping units available in each store. This balance of warehouse and traditional stores increases Pay 'N Pak's options in entering new markets and allows the company to reformat stores as individual market needs change.



Q
A

Several of the leading retailers in the home improvement industry use a warehouse format for their stores. How do Pay 'N Pak's home improvement centers compare with warehouse stores operated by competitors?

Traditional warehouse stores typically offer the customer higher inventories and lower prices in a "no-frills" environment — lots of merchandise stacked to the ceiling on steel shelving. Generally speaking, these stores force the customer to sacrifice service in return for low prices. Pay 'N Pak's home improvement centers offer customers the best of all worlds: low prices, high inventories and a knowledgeable, highly trained, full-service sales staff.

Q
A

If Pay 'N Pak warehouse home improvement centers offer so many benefits to the customer, why doesn't the company convert all of its traditional stores to warehouse type stores?

The inventory levels of the company's large home improvement centers are targeted to the high volume marketplace in large population areas. Rather than limit Pay 'N Pak's presence to larger markets, management uses a mid-size, more traditional format store for smaller cities. This combination allows Pay 'N Pak to provide proper service to large and small communities.

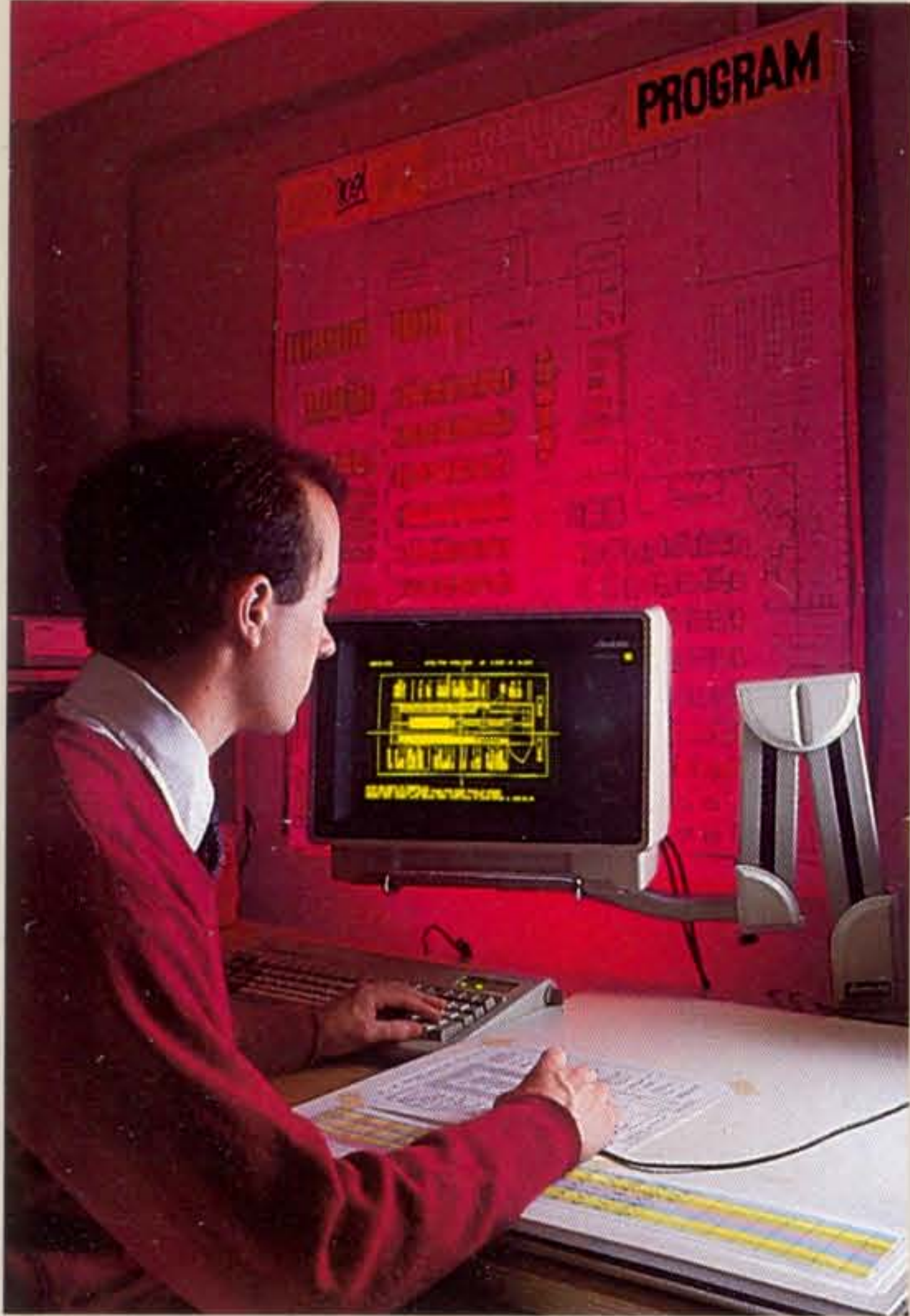
Pay 'N Pak often talks about the importance of its purchasing and distribution systems. How do Pay 'N Pak's methods differ from other home improvement retailers and how does that difference benefit the customer?

The traditional method of purchasing electrical and plumbing supplies, building materials and hardware merchandise is through a two-step process, involving a middleman. Pay 'N Pak has developed a system that allows the company to purchase over 90% of its merchandise directly from the manufacturer. The company's regional distribution system, with three strategically located distribution centers, allows the company to buy in container-load quantities and ship to stores on a weekly basis. This keeps store inventory at proper levels and prices low.

What marketing and advertising programs has Pay 'N Pak found to be most effective in reaching customers and generating sales?

The company has developed a comprehensive approach that includes the use of weekly newspaper ads, special newspaper multi-page inserts, television and direct mail. All media advertising is coordinated to provide the greatest impact at the lowest possible cost. Go into any Pay 'N Pak store when a powerful advertising campaign is released and you can see the results — the cash registers never stop.





One of the keys to Pay 'N Pak's long-term success in the home improvement industry is the company's innovative approach to merchandising. Pay 'N Pak strives to always stay one step ahead of the customer by anticipating changes in customer attitudes and buying habits, and responding accordingly — ahead of industry competitors. One example of Pay 'N Pak's expertise in this area is its approach to merchandising kitchen and bath products using room displays designed and decorated to simulate the home environment. These displays enable the customer to see how merchandise will look at home before it is purchased, an extremely effective strategy in stimulating purchases of big-ticket items such as appliances, cabinets and fixtures.

At the end of fiscal 1986 Pay 'N Pak was operating a total of 106 stores: 36 warehouse type home improvement centers and 70 traditional stores. Two stores were closed during the year, both in Tulsa, Oklahoma.

New distribution center designed for long-term efficiency

In a move to ensure long-term efficiency of the company's Northwest distribution system, Pay 'N Pak relocated its Kent, Washington, distribution center. The May 1985 move consolidated three separate Kent locations and increased the size of the operation from 252,000 square feet to 361,000 square feet. The Kent facility currently serves 52 stores in the Pacific Northwest and Alaska.

The company's 178,000 square foot distribution center in Hayward, California, continues to increase in efficiency with the addition of the new stores in the San Francisco Bay Area. The Hayward center, opened in fiscal 1984, currently serves 24 stores, including Hawaii, and is a key factor in the company's future plans for the Northern California market.

Denver, Colorado, is the site of Pay 'N Pak's third distribution center. With 154,000 square feet, this facility serves 30 stores in the Midwest.

Purchasing & distribution systems keep in-store inventory at proper levels

More than 90 percent of Pay 'N Pak's merchandise is purchased directly from the manufacturer, typically in container-load quantities. This process of eliminating the middleman is in direct contrast to the traditional two-step method of purchasing electrical and plumbing supplies, building materials and hardware merchandise. Pay 'N Pak's unique purchasing strategy enables the company to discount merchandise at the retail level while maintaining acceptable gross margins.

More than 85 percent of Pay 'N Pak's merchandise is shipped to the company's stores from its distribution centers in the company's own fleet of trucks. Stores receive products on a weekly basis, which keeps the fluctuation of store inventory levels to a minimum.

Knowledgeable sales staff is vital to company success

The efficiency with which Pay 'N Pak operates is directly attributable to the high caliber of personnel throughout the company. Pay 'N Pak's outstanding sales team, in particular, continues to play a key role in the company's success. The sales team is the company's most visible connection to the marketplace.

The staff's expertise in serving the home improvement customer has a direct impact on the company's sales volume, and ultimately the company's profitability. Industry research has shown that customer loyalty is influenced by the knowledge shown by the sales staff, particularly in today's highly competitive market where customers want it all — low prices, lots of inventory and helpful service.

Pay 'N Pak invests one million dollars annually in employee training

Fifteen years ago Pay 'N Pak pioneered sales staff training in the home improvement industry with a training program based on 16 millimeter films. Under development two years, the company's state-of-the-art interactive computerized video training system was put into operation this past year. This system is directed by the corporate training department and provides a complete training station in every store.

This system takes employees step-by-step through instructional tapes that teach them how to use products sold in the stores. Each employee is tested on a regular and continuing plan, and individual test results, including time required to complete each test, are stored on computer for review and analysis by both store managers and the company's training department.

Customer loyalty is strengthened by sales staff expertise

Given the importance of a knowledgeable sales staff, Pay 'N Pak approaches employee training aggressively. In addition to the computerized training system, the company holds weekly store meetings to polish sales skills and increase product understanding on the part of the staff. The company also has a mobile training coach which visits most stores twice yearly to teach employees various aspects of plumbing and electrical installation, as well as other do-it-yourself needs. This concentrated training program provides store employees the expertise to help customers with all types of home improvement projects.

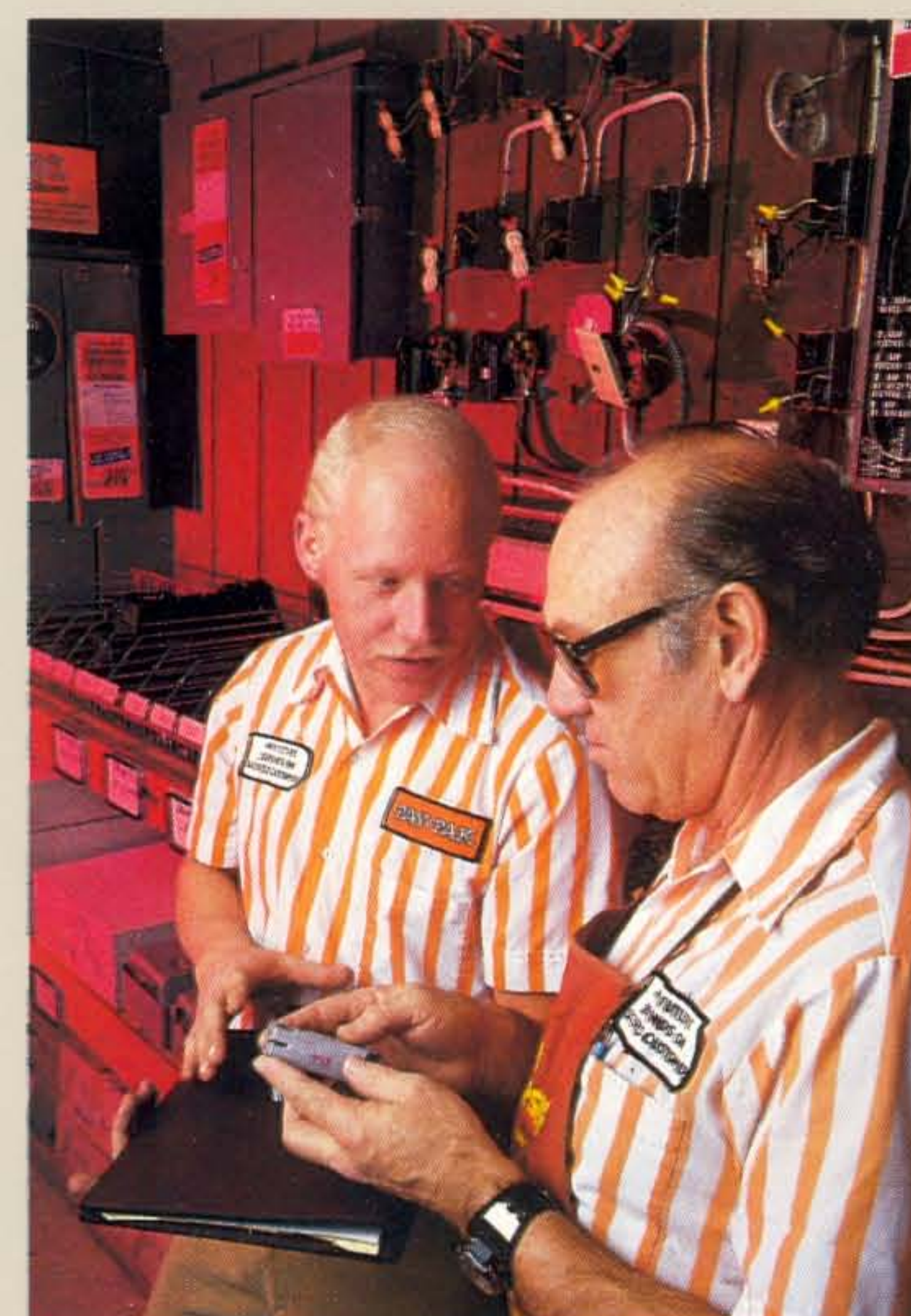
Pay 'N Pak employees have an ongoing challenge to stay up-to-date on the complex assortment of features and benefits of products sold in the stores. Monthly presentations by manufacturers' representatives also provide Pay 'N Pak employees the opportunity to keep abreast of product development so they can better advise customers as to their needs.

Company names new senior vice president, adds seven vice presidents

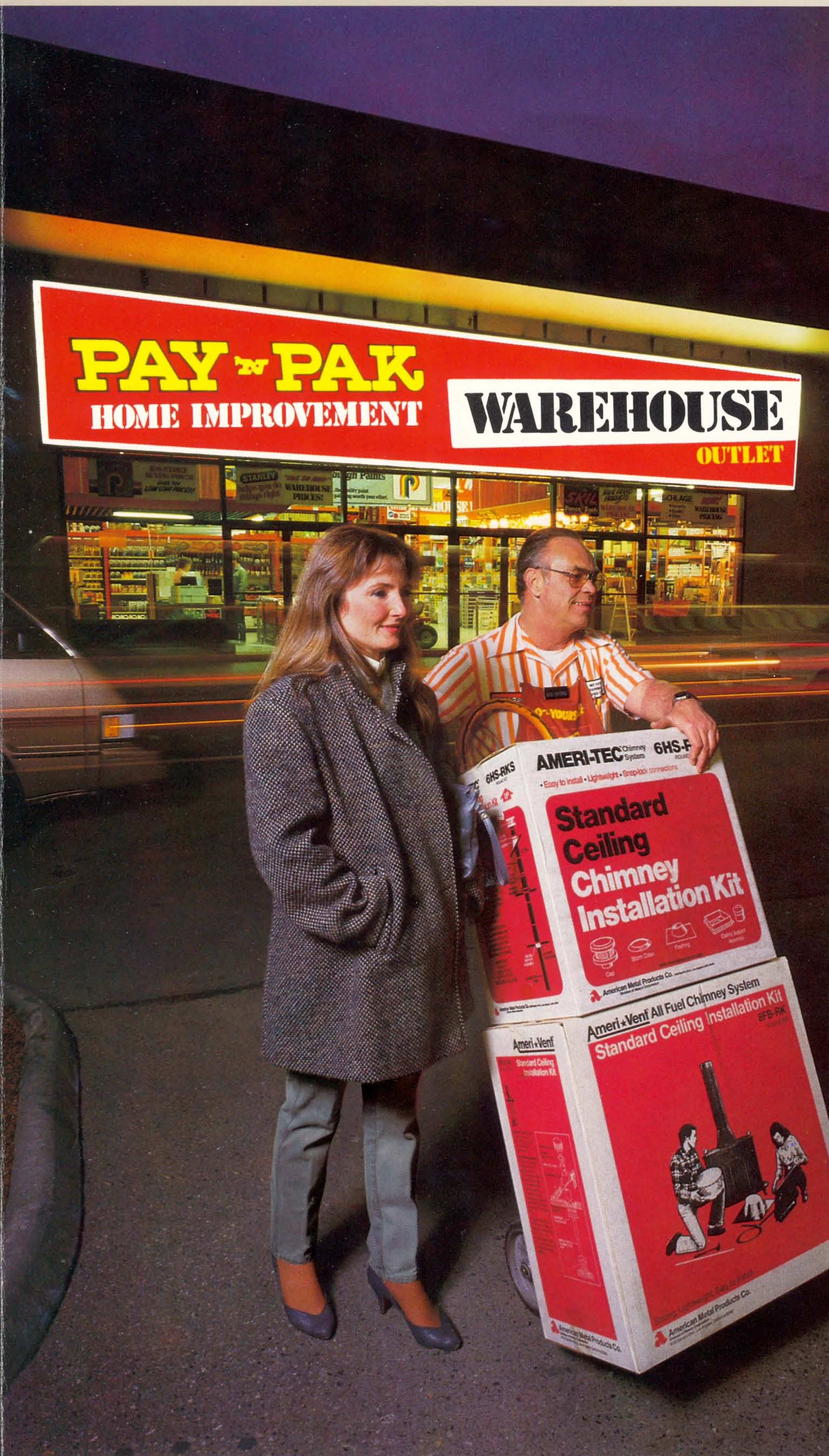
During fiscal 1986 Pay 'N Pak recognized the accomplishments and contributions of several key members of the corporate staff. Peter W. Gallina, formerly vice president of real estate and store development, was elected senior vice president of real estate and store development by the company's board of directors. Gallina has been with the company since 1968.

Fred R. Brotherton, who has been with Pay 'N Pak since 1982, was named vice president and controller. To further strengthen financial management, Douglas G. Southern, formerly with Arthur Young & Company, joined the company in December 1985 as vice president, finance and secretary/treasurer. Barbara I. Collett, who joined the company in 1975, became vice president of personnel and labor relations. Marvin C. Iverson was appointed vice president of construction and has been with the company since 1969. Herbert E. McCleary was designated vice president of advertising. He joined Pay 'N Pak in 1978.

The board also named Paul B. Morris vice president of store planning and design, and Steven C. Unash vice president of store merchandising. Morris has been with the company since 1978 and Unash since 1970.



Even though today's home improvement marketplace is highly competitive, Pay 'N Pak continues to attract a loyal customer following. The low prices, wide selection, depth of inventory and helpful service offered by Pay 'N Pak are all top priorities for home improvement do-it-yourselfers. Pay 'N Pak, unlike many retailers, does not force customers to sacrifice service in order to get the other benefits. Because customer loyalty is so strongly influenced by a knowledgeable, well-trained sales staff, Pay 'N Pak spends one million dollars annually on employee training. The company's comprehensive training program gives employees the product understanding and the project expertise to assist customers with a wide range of home improvement and home maintenance projects.



Many home improvement retailers seem to talk about employee training. What is so special about the Pay 'N Pak program and how does it benefit the customer?

The company's training program revolves around an interactive computerized video training station that is installed in every store. Employees are taught by video tape and take exams on all subjects. Management also holds weekly meetings in all stores and schedules twice-yearly visits by the company's mobile training coach, as well as monthly presentations by manufacturer's representatives. Employees use this training to advise customers on product selection, as well as all aspects of home improvement and home maintenance projects.

Pay 'N Pak stresses the importance of employee training, and spends lots of money to run an effective program. Why so much emphasis on this phase of the business?

There have been many national surveys concerning customer attitudes toward home improvement retailers. Respondents overwhelmingly cite lack of knowledgeable, well-trained sales people as their primary complaint about companies in our business. Pay 'N Pak pioneered sales staff training and has a loyal following of customers who regularly shop Pay 'N Pak as a result.

Pay 'N Pak devotes quite a bit of valuable retail selling space to attractively decorated kitchen and bath displays. What are the benefits of having these displays in each store?

Since their inception, the company's kitchen and bath displays have been a popular attraction for home improvement customers. They allow customers to see how merchandise will look in a home environment before it is purchased. It takes the guesswork out of remodeling or installing a new bathroom or kitchen — and this, of course, leads to more "big ticket" sales.

After two years of flat or declining earnings, is Pay 'N Pak ready to turn things around — and if so, why?

Pay 'N Pak has worked hard to revamp its operation to compete in an industry that has changed dramatically in the past few years. All stores have been remerchandised and/or remodeled to a new warehouse format; warehousing has been expanded and improved and new markets have been opened. Sales are moving ahead dramatically and increased earnings are beginning to follow.





Pay 'N Pak continues to reward employees for hard work and loyalty

More than 52 percent of Pay 'N Pak's employees are members of the Employee Stock Ownership Plan (ESOP). After three years of full-time service, every employee automatically becomes a member of the ESOP and receives up to \$3,000 worth of stock annually — fully paid for by the company. This stock is held in trust until the employee retires. Currently the ESOP owns 12.1 percent of the company's stock and is the company's largest shareholder.

Training and advancement opportunities are another benefit afforded Pay 'N Pak employees. The company's commitment to management training is evidenced by the fact that every store manager and 90% of the staff members (including senior executives) have come up through company ranks. The company also rewards employees with high wages, outstanding benefits, sales and service awards, and bonuses based on profits.

Kitchen and bath displays attract do-it-yourselfers

One of the company's most successful merchandising innovations are its in-store kitchen and bath displays. Fully decorated kitchen and bath displays in every store give customers valuable decorating ideas, as well as the opportunity to see how merchandise will look in their homes before they buy. Warehouse type stores have seven complete kitchens and seven baths, while traditional format stores contain four kitchens and six baths.

Marketing and merchandising programs are effective

The company's marketing and merchandising programs are continually changing with its marketplace. Pay 'N Pak's current advertising program includes weekly newspaper ads, four month-long sale tabloids and television spots which feature a very personable corporate spokesperson. These commercials have been very effective.

The company's advertising programs are tailored to provide maximum coverage at reasonable cost. The more stores in a market, the more cost effective the advertising.

Company-wide efficiency vital component of Pay 'N Pak's success

As the home improvement marketplace becomes more and more competitive, Pay 'N Pak is in a strong position to make selective acquisitions. The company has the programs and procedures in place to facilitate growth. It is proud of its employees, and has the financial strength to expand.

The efficiency with which Pay 'N Pak operates its retail units can be attributed to the sophisticated network of programs that have been developed and implemented by Pay 'N Pak personnel over the years. The company's purchasing and distribution systems are one example of this efficiency. With three strategically located distribution centers providing nearly 700,000 square feet of warehouse space, Pay 'N Pak is able to purchase more than 90 percent of its merchandise directly from manufacturers. This high-volume buying allows the company to discount prices to customers without sacrificing gross margins. To keep in-store inventory levels constant, products are shipped to the retail units on a weekly basis, using the company's own fleet of trucks.

Ten Year Summary of Growth Highlights

Pay 'N Pak
Stores, Inc.

Years ended February 28 or 29

	1986	1985	1984	1983	1982	1981	1980	1979	1978	1977	1976
Operations											
Revenues	\$333,782,000	\$305,185,000	\$250,040,000	\$187,338,000	\$180,974,000	\$151,765,000	\$138,361,000	\$117,688,000	\$98,052,000	\$80,643,000	\$73,280,000
Income before income taxes	\$ 14,463,000	\$ 18,420,000	\$ 17,851,000	\$ 11,085,000	\$ 13,049,000	\$ 11,575,000	\$ 11,471,000	\$ 10,199,000	\$ 7,882,000	\$ 5,464,000	\$ 4,605,000
Net income	\$ 8,168,000	\$ 10,105,000	\$ 10,025,000	\$ 6,368,000	\$ 7,199,000	\$ 6,449,000	\$ 6,313,000	\$ 5,403,000	\$ 4,006,000 ²	\$ 2,871,000	\$ 2,430,000
Common Stock											
Average number of common shares	10,002,832	10,002,832	9,033,023	7,327,392	7,303,464	7,303,464	7,303,464	6,688,990	6,372,865	6,372,865	6,577,114
Net income per common share ³	\$.82	\$1.01	\$1.11	\$.87	\$.99	\$.88	\$.86	\$.81	\$.63 ²	\$.45	\$.37
Stock dividends and stock splits	—	—	50%	10%	—	—	20%	33⅓%	50%	10%	10%
Cash dividend paid per common share ³	\$.63	\$.60	\$.56	\$.507	\$.461	\$.412	\$.363	\$.299	\$.209	\$.137	\$.106
Financial Position											
Total assets	\$223,014,000	\$190,769,000	\$164,481,000	\$119,531,000	\$ 97,800,000	\$ 90,273,000	\$ 81,902,000	\$ 70,314,000	\$50,483,000	\$45,833,000	\$39,127,000
Stockholders' equity	\$ 99,643,000	\$ 97,776,000	\$ 93,673,000	\$ 47,430,000	\$ 40,162,000	\$ 36,213,000	\$ 32,224,000	\$ 28,228,000	\$16,447,000	\$13,566,000	\$11,617,000
Return on stockholders' equity ⁴	8.4%	10.8%	13.2%	15.9%	19.9%	20.0%	22.4%	32.9%	29.5%	24.7%	20.1%
Shares of common stock outstanding (end of year)	10,002,832	10,002,832	10,002,832	7,652,830	7,303,464	7,303,464	7,303,464	7,303,464	6,372,865	6,372,865	6,372,865
Net book value per share	\$9.96	\$9.77	\$9.36	\$6.20	\$5.50	\$4.96	\$4.48 ¹	\$4.00 ¹	\$2.74 ¹	\$2.31 ¹	\$2.01 ¹
Long-term debt	\$ 64,270,000	\$ 41,641,000	\$ 28,449,000	\$ 34,879,000	\$ 26,470,000	\$ 27,979,000	\$ 28,680,000	\$ 23,848,000	\$18,467,000	\$19,125,000	\$17,722,000
Stores In Operation											
Number of stores open	106	101	100	98	88	84	78	70	65	60	55
Number of stores sold or closed	2	1	0	1	0	0	0	1	0	0	3
Stores replaced with new stores	3	5	0	0	0	0	1	1	1	2	2
Number of states in which we operated	17	17	16	16	15	15	15	14	13	13	11
Square footage of stores	2,928,000	2,468,000	2,224,000	2,168,000	1,891,000	1,812,000	1,688,000	1,497,000	1,365,000	1,261,000	1,145,000
Average square footage per store	27,600	24,400	22,200	22,100	21,500	21,600	21,600	21,400	21,000	21,000	20,800
Average annual inventory in stores	\$ 68,242,000	\$ 62,970,000	\$ 50,464,000	\$ 35,485,000	\$ 36,247,000	\$ 31,419,000	\$ 28,610,000	\$ 23,302,000	\$20,226,000	\$17,952,000	\$14,815,000
Average annual inventory total (includes distribution centers)	\$ 99,305,000	\$ 92,651,000	\$ 74,352,000	\$ 54,175,000	\$ 53,429,000	\$ 43,724,000	\$ 39,143,000	\$ 31,253,000	\$24,617,000	\$21,007,000	\$16,847,000
Store Averages											
Average sales per store	\$ 3,137,000	\$ 3,020,000	\$ 2,495,000	\$ 2,009,000	\$ 2,050,000	\$ 1,806,000	\$ 1,768,000	\$ 1,676,000	\$ 1,508,000	\$ 1,343,000	\$ 1,331,000
Number of customers served	14,545,000	12,623,000	10,105,000	7,311,000	6,941,000	6,415,000	5,928,000	5,469,000	4,980,000	4,420,000	4,104,000
Average customer purchase	\$ 22.86	\$ 24.16	\$ 24.69	\$25.60	\$25.99	\$23.64	\$23.26	\$21.52	\$19.69	\$18.25	\$17.85
Sales per square foot	\$113.57	\$123.59	\$112.17	\$92.73	\$95.40	\$88.73	\$81.67	\$78.63	\$71.82	\$63.96	\$64.01
Sales per full time employee (end of year)	\$ 182,000	\$ 185,000	\$ 167,000	\$ 159,000	\$ 151,000	\$ 139,000	\$ 129,000	\$ 113,000	\$ 115,000	\$ 109,000	\$ 104,000

¹After giving effect to shares held by ESOT which had been allocated to employee accounts.

²Net income in 1978 includes a net reduction of \$191,000 (\$.03 per share) due to a change in the method of accounting for pre-opening costs to expensing them as incurred rather than amortizing them.

³Restated for stock dividends and stock splits in fiscal years 1984, 1983, 1980, 1979, 1978, 1977 and 1976.

⁴Computed using weighted average stockholders' equity in fiscal year 1984 and beginning of year stockholders' equity in all other years.



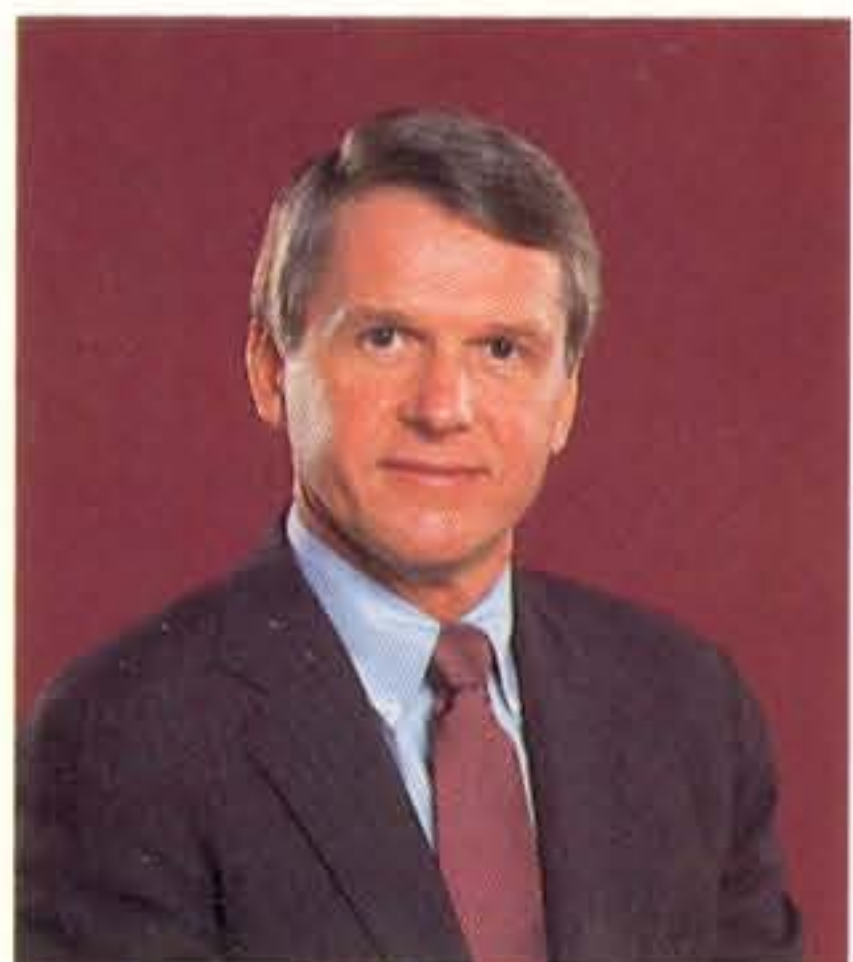
D. Heerensperger (left) & M. Weigel



J. Marlow



W. Button



J. Horn



M. Leen



D. Southern



V. Crosswhite



G. Smith



B. Collett



H. McCleary



P. Gallina



C. Karbowski



F. Brotherton



M. Iverson



P. Morris



S. Unash

Board of Directors

David J. Heerensperger
Chairman of the Board and Chief Executive Officer

Jerry L. Marlow
President and Chief Operating Officer

Monte A. Leen
Executive Vice President

Marshall J. Weigel
Vice Chairman of the Board and Independent Corporate Finance Specialist
San Francisco, CA

Woodrow C. Button
Retired Vice Chairman
Old National Bank
Seattle, WA

Jerry D. Horn
Chairman of the Board
President and Chief Executive Officer
General Nutrition, Inc.
Pittsburgh, PA

Officers

David J. Heerensperger
Chairman of the Board and Chief Executive Officer

Jerry L. Marlow
President and Chief Operating Officer

Marshall J. Weigel
Vice Chairman of the Board

Monte A. Leen
Executive Vice President

Douglas G. Southern
Vice President, Finance
Secretary-Treasurer

Peter W. Gallina
Senior Vice President,
Real Estate and
Store Development

Victor W. Crosswhite
Vice President,
Purchasing

Calvin E. Karbowski
Vice President,
Distribution

George E. Smith
Vice President,
Training

Fred R. Brotherton
Vice President,
Controller

Barbara I. Collett
Vice President,
Personnel and
Labor Relations

Marvin C. Iverson
Vice President,
Construction

Herbert E. McCleary
Vice President,
Advertising

Paul B. Morris
Vice President,
Store Planning
and Design

Steven C. Unash
Vice President,
Store Merchandising

District Managers

Bud Brown
Oregon, Washington

John Coogan
Mountain

Dale Craker
Southwestern Washington

Dan Fissel
Midwest, South

Gene Kasper
Midwest, North

Mel Kelley
Alaska, Hawaii

Mike Mandick
Oregon, California

Larry Marlow
Eastern Washington
Northern Idaho

Rick Noegel
California

John Schweitzer
California

Wally Tesch
Western Washington

Pay 'N Pak Stores, Inc. has combined the Company's annual report with its Form 10-K report that is filed annually with the Securities and Exchange Commission. The Form 10-K provides more detailed information about the Company than does the annual report.

The Form 10-K has not been approved or disapproved by the Securities and Exchange Commission nor has the Commission passed upon the accuracy or adequacy of the data included therein.

The common stock of Pay 'N Pak Stores, Inc. is listed and traded on the New York Stock Exchange. As of March 31, 1986, there were approximately 3,385 holders of record of the Company's common stock.

The range of high and low sales prices of the Company's stock on the New York Stock Exchange and quarterly cash dividends paid by the Company during the last two fiscal years are shown in Item 5 of the Form 10-K.

Banks

Old National Bank of Washington
Spokane, Washington

First Security Bank of Idaho
Boise, Idaho

Bankers Trust Company
New York, New York

Transfer Agent and Registrar

Security Pacific National Bank
Los Angeles, California

Legal Counsel

Davis, Wright & Jones
Seattle, Washington

Auditors

Arthur Young & Company
Seattle, Washington

Notice of Annual Meeting of Stockholders

The annual meeting of stockholders of Pay 'N Pak Stores, Inc. will be held on June 17, 1986, at 11 o'clock a.m. at the Marriott Hotel, 3201 South 176th Street, Seattle, Washington.

Responsibility for Financial Statements

The accompanying balance sheets of Pay 'N Pak Stores, Inc. at February 28, 1986 and 1985, and the related statements of income, stockholders' equity and changes in financial position for each of the three years in the period ended February 28, 1986, were prepared by management in conformance with generally accepted accounting principles appropriate in the circumstances.

The management of Pay 'N Pak Stores, Inc. is responsible for the integrity and objectivity of the financial statements, which are presented on the accrual basis of accounting and, accordingly, include some amounts based upon judgment. Other financial information in the annual report is consistent with that in the financial statements. The accounting plan and related system of internal controls are designed to assure that the books and records reflect the transactions of the Company in accordance with established policies and procedures as implemented by qualified personnel.

The board of directors monitors the financial and accounting operations of the Company, including the review and discussion of periodic financial statements and the basis of engagement and report of independent public accountants.

Arthur Young & Company, independent public accountants, have examined the above mentioned financial statements of Pay 'N Pak Stores, Inc. and their report is included herein. The auditors met with members of the audit committee of the board of directors to discuss the results of their examination, and were afforded an opportunity to present their opinions in the absence of management personnel with respect to the adequacy of internal controls and the quality of financial reporting of the Company.



David J. Heerensperger
Chairman of the Board
Chief Executive Officer



Douglas G. Southern
Vice President, Finance
Chief Financial Officer

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934

For the fiscal year ended February 28, 1986
Commission file number 0-4967

PAY 'N PAK STORES, INC.

Washington
(State of incorporation)

91-0729852
(I.R.S. Employer I.D. No.)

1209 South Central, Kent, Washington 98032
Telephone: (206) 854-5450

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of each class
Common Stock

Name of each exchange
on which registered
New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

Common Stock

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X

No _____

Aggregate market value of common stock held by nonaffiliates at April 30, 1986-\$132,645,917

Common stock outstanding at April 30, 1986 - 10,002,832 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Proxy statement to be filed in connection with Annual Meeting of Shareholders to be held on June 17, 1986, is incorporated into Part III.

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PART I

ITEM I - Business

(a) *General development of business.* Pay 'N Pak Stores, Inc. (the "Company") was incorporated in 1961 under the laws of the State of Washington, as the successor to a partnership formed in 1953 to engage in the retail sale of home improvement products, principally electric and plumbing supplies. The Company in its present form evolved from a merger in 1969 of three groups of similar stores in adjacent geographic areas. Immediately after the merger, the Company had 22 stores in three western states, Washington, California and Colorado. Following the merger, the Company undertook a store expansion program that has continued to the present time. The Company currently operates 106 stores in 17 states, all west of the Mississippi River, although over half of the stores are located on the West Coast with 31 stores in Washington, 16 stores in Oregon and 20 stores in northern California.

ITEM I - Business, continued

In March 1983, the Company began a program to remerchandise its entire chain of stores by raising the height of merchandise display racks, thereby allowing a 30% increase in the number of stock keeping units ("SKU's"). The decision to remerchandise the stores grew out of the Company's successful experience replacing auto and sporting goods merchandise in 11 stores with additional SKU's in the home improvement line. By February 1984, all of the Company's stores were completely remerchandised.

In the fall of 1983, the Company began to implement a "warehouse" concept for some of its larger stores. The Company based its decision to implement this concept in part upon the experience of other retailers who have successfully utilized this format. Warehouse stores are significantly larger than the Company's traditional stores, stocking greater quantities of merchandise. Merchandise which would otherwise be kept in storerooms is displayed in customer areas and stacked to the ceiling. In contrast to warehouse approaches used by some retailers, the Company's warehouse stores are well-lit, feature attractive merchandise displays and are fully staffed by trained employees to ensure the same level of service as the Company's traditional stores.

The conversion of the Company's Kent, Washington store into the first warehouse store was completed in October 1983. By the end of the past fiscal year ended February 28, 1986, the Company had replaced or converted 26 other traditional stores into warehouse stores and had also opened nine new warehouse stores. The Company currently intends to establish an additional 6 or so warehouse stores during the fiscal year ending February 28, 1987, for a total of 42 warehouse stores by fiscal year end. Of these 6 additional warehouse stores five will be replacements or conversions of traditional stores currently operated by the Company.

(b) Industry segments; lines of business. The Company has only one industry segment and is engaged in only one line of business - retail sales of home improvement products.

(c) (i) Description of business. The Company caters to the do-it-yourself home improvement market. Home improvement products include electrical products, plumbing supplies, building materials, kitchen cabinets and built-in appliances. The Company specializes in products and supplies for the remodeling and improvement of kitchens and bathrooms. For several years the Company operated sporting goods and automotive parts and accessories departments in 11 stores but during fiscal year 1983 these departments were phased out to provide additional space for home improvement products.

All but four stores are operated under the name "Pay 'N Pak". Three stores located in Idaho and Oregon are operated under the name "Eagle Electric & Plumbing Supply" and a warehouse store in Honolulu operates under the name "Home Improvement Warehouse."

The Company's sole method of distribution of merchandise to customers is through sales at its retail stores, all of which are operated by the Company.

The Company's marketing efforts are primarily directed toward homeowners and other do-it-yourself customers. The Company estimates that over 95% of sales of home improvement products were made to do-it-yourself customers in fiscal 1986, with professional builders and others accounting for less than 5%.

The approximate contribution, as a percent of the Company's net sales, of each of the major product categories during the last five fiscal years was as follows:

	1986	1985	1984	1983	1982
Electrical	21%	25%	28%	31%	31%
Plumbing	22	22	23	25	23
Building Materials	52	50	49	41	37
Garden Supplies	5	3	--	--	--
Automotive and Sporting Goods . . .	--	--	--	3	9
Total	100%	100%	100%	100%	100%

ITEM I - Business, continued

The Company uses modern merchandising and marketing techniques in the operation of its retail stores. Store lay-out, merchandise organization and merchandise signs are designed by the Company's corporate staff and are essentially consistent throughout its stores. Merchandise is conveniently arranged and displayed in well-lighted stores, with emphasis placed on displays which illustrate how the product will look in the customer's own home. Many brand name products are carried by the stores, particularly where the Company believes such brand names are recognized by the customer as indicative of quality and reliability. The Company also carries private label merchandise, some of which is the manufacturers' standard merchandise and some of which is designed and manufactured to the Company's specifications. The Company attempts to charge competitive prices with respect to the merchandise sold through its stores, particularly on high volume, commodity products. Such pricing is facilitated by the Company's ability to purchase certain products in volume directly from manufacturers. Sales are predominantly on a cash and carry basis, which includes sales made through the use of bank credit cards by customers. To a very limited extent, goods are also sold under installment sales contracts which are in turn sold to finance companies on a nonrecourse basis. The Company estimates that during fiscal 1986, sales on which it directly extended credit accounted for less than 1% of sales. The Company maintains a liberal merchandise return policy, with full refunds given under most circumstances to customers who return products.

The Company believes that a key feature in its marketing program is the ability of sales personnel to advise customers how to select, install and use products for home improvement and maintenance projects. The Company places particular emphasis on the training of its sales personnel to accomplish this objective. Although the Company does not deliver or install the products it sells, it continually trains its sales personnel so that they may advise customers regarding the selection and use of the products sold and so that they may give step-by-step instructions regarding the installation of such products. The Company has a Vice-President-Training and staff, and uses training film programs and meetings to qualify employees in product knowledge and selling skills. The Company also owns a 40-foot bus that is specially equipped and used as a mobile training classroom for its sales personnel.

The Company has a store expansion and development program to increase, replace, convert and expand its stores each year. The exact number of new stores opened in any period will depend on many factors, including the availability of suitable locations and general business conditions.

During the fiscal year ended February 28, 1986, the Company opened new warehouse concept stores in San Francisco, South San Francisco, El Cerrito and San Leandro, California and also either replaced or converted ten existing stores to the home improvement warehouse format. In addition, the Company acquired by purchase three stores in the Portland, Oregon area and closed its two stores in Tulsa, Oklahoma.

The following table summarizes the Company's growth in numbers of stores during the past five years:

	Years Ended February 28 or 29,				
	1986	1985	1984	1983	1982
Stores in operation at beginning of year	101	100	98	88	84
New stores opened or acquired . .	10	7	2	11	4
Stores replaced by new stores . . .	(3)	(5)			
Stores sold or closed	(2)	(1)		(1)	
Stores in operation at end of year	<u>106</u>	<u>101</u>	<u>100</u>	<u>98</u>	<u>88</u>

ITEM I - Business, continued

The Company is continually investigating locations for the establishment of new stores. Each location is investigated with respect to population and population trends, competition in the trading area and other pertinent factors in order to analyze its sales potential. The Company attempts to locate its stores in areas which are convenient to the do-it-yourself customer, principally in small cities and in suburban areas of larger cities. In selecting locations for future stores, the Company plans to concentrate on trading areas in the western part of the United States.

During the fiscal year ending February 28, 1987, the Company plans to open one or two new warehouse concept stores and also plans to replace or convert six existing traditional stores to warehouse concept stores.

(ii) *New product or industry segment.* The Company has not recently introduced a new product or begun to do business in a new industry segment which will require the investment of a material amount of the Company's assets.

(iii) *Raw materials.* The Company buys its merchandise from several hundred independent suppliers, including manufacturers and importers, none of which accounts for more than 8% of the Company's purchases.

Approximately one-fifth of the merchandise is shipped by suppliers directly to the Company's stores. The Company also warehouses merchandise and supplies its stores through three central warehouse locations; 360,889 square feet in Kent, Washington; 153,781 square feet in Denver, Colorado and 178,800 square feet in Hayward, California. The warehouse in Denver, Colorado, services the Company's 30 stores located in Colorado, Kansas, Iowa, Nebraska, Montana, Oklahoma, South Dakota, North Dakota, Utah, Idaho and Wyoming; the Hayward warehouse services the Honolulu store and 23 stores in northern California and Nevada, and the Kent, Washington, location services the remainder.

(iv) *Patents, etc.* The Company holds no material patents, trademarks, licenses, franchises or concessions.

(v) *Seasonal business.* No material portion of the Company's business is seasonal, except to the extent that sales of home improvement products tend to be slightly lower during the winter season.

ITEM I - Business, continued

(vi) *Working capital items.* The Company attempts to carry sufficient amounts of inventory in stock to meet customer demand and to allow sufficient delivery time for new orders from the factories. The Company engages in volume buying direct from factories as much as possible not only to obtain the benefit of lower unit prices, but also in anticipation of potential shortages and inflationary price increases. This helps to assure the Company of a continuous allotment of goods from suppliers and sometimes results in the Company carrying significant amounts of inventory.

The Company sells most of its goods on a cash or bank credit card basis and other than selling a limited amount of goods under installment sales contracts that are sold to finance companies on a nonrecourse basis, the company does not provide extended payment terms to customers.

(vii) *Dependence upon few customers.* The business of the Company is not dependent upon a single customer or a few customers, the loss of any one or more of whom would have an adverse effect on the Company.

(viii) *Backlog orders.* The Company does not at any time have a significant backlog of orders.

(ix) *Government contracts.* No portion of the Company's business is subject to renegotiation of profits or termination of contracts or subcontracts at the election of the U.S. Government.

(x) *Competitive conditions.* The retail sales business engaged in by the Company is highly competitive. Competition is based primarily on breadth of product line, service, advertising, price and convenience of location. The Company competes with numerous retail organizations, including integrated department stores such as Sears, home improvement centers and other building materials retailers, and, to a lesser extent, large and small hardware and lumber stores. The Company's competitors, some of which have substantially greater financial resources, are continually expanding and opening new stores in market areas in which the Company has existing stores as well as in new market areas in which the Company plans to expand. Because of the variety of products sold by the Company and the number and variety of its competitors, it is virtually impossible to determine a competitive position for the company.

(xi) *Research and development activities.* The Company has engaged in research and development activities relating to the improvement of services to its customers, through the development of product knowledge training films, a Retail Selling Skills program, the holding of in-store training meetings, and a 40-foot mobile training bus, all of which are designed to constantly update product knowledge and selling skills. The goal of the program is to have the Company's sales people completely qualified to explain to customers how to install or use all of the products that the Company sells. The amount spent by the Company on such activities during each of the last three fiscal years is approximately \$424,000 in 1986, \$408,000 in 1985 and \$358,000 in 1984.

(xii) *Environmental laws.* The Company is not aware of any environmental protection laws, compliance with which may have a material effect upon the capital expenditures, earnings and competitive position of the Company and its subsidiaries.

(xiii) *Number of employees.* The Company currently employs approximately 2,028 full-time persons and 104 part-time persons.

(d) *Foreign and domestic operations; export sales.* The Company's revenue, profitability and identifiable assets are attributable to only one geographic area, the western part of the United States, and although the Company is a large importer of foreign goods, it does not have any foreign operations or engage in any export sales.

ITEM 2 - Properties

Of the Company's 106 stores, 31 are located in the State of Washington, 16 in Oregon, 20 in California, 3 in Nevada, 4 in Idaho, 1 in Montana, 5 in Utah, 9 in Colorado, 4 in Kansas, 2 in Oklahoma, 2 in Alaska, 2 in Wyoming, 2 in South Dakota, 1 in North Dakota, 2 in Nebraska, 1 in Iowa and 1 in Hawaii. All of the Company's stores except 13 are leased under leases expiring at various times between July 1986 and January 2012. Many of these leases contain options to renew. Operations of the Company are directed from its head office in Kent, Washington, a Seattle suburb, where all administrative functions, including accounting, merchandising, purchasing and advertising, are performed. The head office is leased under a lease expiring in 1995. The Company also leases a new 360,889 sq. ft. warehouse in Kent which the Company recently constructed, sold and leased back under a long-term lease. The Company also leases regional warehouse space in Denver, Colorado, under leases that expire in 1987 and from which the Company's midwest merchandising is conducted. In addition, the Company leases regional warehouse space in Hayward, California, under a lease that expires in August 1993. These leases contain options to renew.

The Company owns its store properties in Fairbanks, Alaska; Pocatello, Idaho; Fort Collins, Colorado; North Platte, Nebraska; Honolulu, Hawaii; San Francisco and El Cerrito, California, Reno, Nevada; three stores in the Portland area purchased from Handyman in 1985 and stores in San Jose, California. The Fairbanks and Pocatello stores, the two San Jose stores, the Reno store and the Honolulu store are encumbered by mortgages but the remainder are not presently subject to any mortgages or other encumbrances.

All of the Company's buildings are of concrete masonry construction except for three stores, two of which are of frame construction and the other is a steel building. The buildings contain all of the fixtures and improvements which the Company believes are necessary in its business. Many of the Company's present stores were formerly supermarkets, as their size, structure and location made them easy and appropriate to convert to Pay 'N Pak stores. Adequate off-street parking is provided Adjacent to all stores.

ITEM 3 - Legal Proceedings

On September 5, 1984, an antitrust suit was brought against the Company in the United States District Court for the Western District of Washington by Thurman Industries, Inc., a small Seattle-based chain of competing stores owned by a former officer and director of the Company. The complaint alleges that Pay 'N Pak has engaged in predatory price reductions, has negotiated with suppliers to obtain favorable terms of dealing which discriminate against Thurman, has induced suppliers not to deal with Thurman through exclusive dealing arrangements and otherwise, and has interfered with Thurman's contractual and business relationships. This conduct is alleged to violate federal and state antitrust laws and common law principles. The complaint seeks both injunctive relief and damages, as well as costs and attorneys' fees. Plaintiff has claimed damages of approximately \$2,500,000 in the aggregate before trebling. Both plaintiff and the Company have engaged in extensive discovery and document production. The suit will be tried before a jury and the outcome is therefore unpredictable. However, management continues to believe the claim lacks substantial merit and is defending against it vigorously.

ITEM 4 - Submission of Matters to a Vote of Security Holders

No matter was submitted to a vote of security holders during the fourth quarter of the Company's fiscal year covered by this report.

Executive Officers of the Company

<u>Name</u>	<u>Age</u>	<u>Positions and Offices</u>
David J. Heerensperger	49	Chairman of the Board and Chief Executive Officer; Director
Marshall J. Weigel	65	Vice-Chairman of the Board; Director
Jerry L. Marlow	50	President and Chief Operating Officer; Director
Douglas G. Southern	43	Vice President-Finance and Secretary-Treasurer
Fred R. Brotherton	41	Vice President and Controller
Peter W. Gallina	50	Senior Vice President-Real Estate and Store Development
Victor W. Crosswhite	49	Vice President-Purchasing
Calvin E. Karbowski	48	Vice President-Distribution
George E. Smith	50	Vice President-Training
Barbara I. Collett	29	Vice President-Personnel and Labor Relations
Marvin C. Iverson	61	Vice President-Construction
Herbert E. McCleary	54	Vice President-Advertising
Paul B. Morris	44	Vice President-Store Planning and Design
Steven C. Unash	43	Vice President-Store Merchandising

The term of office of each of the above officers is until the next annual meeting of the Board of Directors of the Company following the annual meeting of shareholders held on the third Tuesday in June of each year. Mr. Heerensperger has served as Chairman of the Board since February 1970. Mr. Weigel was elected Vice-Chairman in March 1984. Mr. Marlow and Mr. Gallina have served in their respective offices since December 1977 although Mr. Gallina was promoted to Senior Vice President in April 1985. Mr. Crosswhite and Mr. Karbowski have served in their respective offices since February 1980. Mr. Smith was elected a Vice-President in June 1983. Mr. Southern and Mr. Brotherton were elected to the positions in December 1985. The other officers were elected Vice Presidents in April 1985. There are no arrangements or understanding between any of the above officers and any other person pursuant to which he or she was selected as an officer.

There are no family relationships among the officers except that Mr. Crosswhite's wife and Mr. Heerensperger are first cousins.

ITEM 4 - Submission of Matters to a Vote of Security Holders
continued

During the past five years, the business experience of the executive officers is as follows:

All of the above officers except Mr. Southern, Mr. Brotherton and Mr. Weigel have been employed by the Company during the past five years. David J. Heerensperger has served the Company as Chairman of the Board and Chief Executive Officer. Marshall J. Weigel is a self-employed corporate finance specialist. Jerry L. Marlow has served the Company as President and Chief Operating Officer. Douglas G. Southern was a Partner at Arthur Young & Company prior to joining the Company in December 1985 and Fred R. Brotherton was a Principal with the same firm prior to joining the Company in September, 1982. Peter W. Gallina prior to his election as Senior Vice President-Real Estate and Store Development in April 1985, served the company of Vice President-Real Estate and Store Development. Victor W. Crosswhite has served the Company as Vice President-Purchasing. Calvin E. Karbowski has served the Company as Vice President-Distribution. George E. Smith, prior to his election as Vice President-Training in June 1983, served the Company as director of its training department. Barbara I. Collett, Marvin C. Iverson, Herbert E. McCleary, Paul B. Morris and Steven C. Unash, prior to their election as Vice Presidents in April 1985, served the company in the areas of responsibility indicated by their respective titles.

Part II

ITEM 5 - Market for the Company's Common Equity and Related Stockholder Matters

The common stock of Pay 'N Pak Stores, Inc. is listed and traded on the New York Stock Exchange (NYSE). As of March 31, 1986, there were approximately 3,385 holders of record of the Company's common stock.

The range of the reported last sales prices of the Company's stock during each quarter of the last two fiscal years as reported by the NYSE is shown below. The quarterly cash dividends paid by the Company are also shown for each quarter of the last two fiscal years.

NYSE Symbol: PNP

Quarterly High and Low Sales Prices

	<u>Years ended February 28</u>	<u>1986</u>	<u>1985</u>
1st quarter		\$13 7/8 - 11 1/2	\$16 - 12 3/4
2nd quarter		\$15 1/4 - 12 3/4	\$17 1/2 - 13 1/2
3rd quarter		\$13 3/8 - 11 5/8	\$16 3/8 - 14 1/8
4th quarter		\$15 - 12 1/8	\$14 3/4 - 11 1/2

Quarterly Dividends

	<u>Years ended February 28</u>	<u>1986</u>	<u>1985</u>
1st quarter		\$.15	\$.15
2nd quarter		\$.16	\$.15
3rd quarter		\$.16	\$.15
4th quarter		\$.16	\$.15

ITEM 6 - Selected Financial Data

In thousands, except per share data.

	<u>Years Ended February 28 or 29,</u>				
	<u>1986</u>	<u>1985</u>	<u>1984</u>	<u>1983</u>	<u>1982</u>
Operating results:					
Net sales	\$332,546	\$305,026	\$249,491	\$187,172	\$180,387
Income before					
income taxes	\$ 14,463	\$ 18,420	\$ 17,851	\$ 11,085	\$ 13,049
Net income	\$ 8,168	\$ 10,105	\$ 10,025	\$ 6,368	\$ 7,199
Per common share(1):					
Net income	\$.82	\$1.01	\$1.11	\$.87	\$.99
Cash dividends	\$.63	\$.60	\$.56	\$.507	\$.461
At year-end:					
Total assets	\$223,014	\$190,769	\$164,481	\$119,531	\$ 97,800
Long-term debt	\$ 64,270	\$ 41,641	\$ 28,448	\$ 34,879	\$ 26,470

(1) See Note 2 in the Notes to Consolidated Financial Statements in Item 8.

ITEM 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of operations

Net sales increased from \$305.0 million in fiscal 1985 to \$332.5 million in fiscal 1986, an increase of 9%. The increase in net sales is primarily attributable to increased volume in existing stores, due in part to the conversion of ten stores into warehouse outlets and the addition of seven new stores during the last four months of the fiscal year. The company feels the increase in sales would have been greater had it not been for the delays in getting four new San Francisco Bay area stores open. Two of the stores opened in November 1985 and the other two opened in January 1986; all four had been scheduled to open earlier in the fiscal year. Fiscal 1985 sales increased by 22% over fiscal 1984 sales due primarily to a remerchandising program.

Increases in net sales during the three-year period were attributable to the following:

	1985 to 1986	1984 to 1985
	(In thousands)	
Net sales of stores opened during the fiscal year*	\$12,081	\$22,192
Increase in net sales over the preceding year of stores in their first full fiscal year of operation	5,906	2,752
Increase in net sales over the preceding year of stores open for over two fiscal years	13,892	30,935
Decrease in net sales for stores closed or sold	(4,359)	(344)
	<u>\$27,520</u>	<u>\$55,535</u>

Cost of sales increased as a percentage of net sales due to decreased gross profit margins realized. The gross profit margin has declined as the company has engaged in price competition with competitors in certain of its market areas. The industry remains extremely competitive but the company does not expect margins to decrease at the same rate during fiscal year 1987.

Selling and administrative expenses increased as a percentage of sales over the preceding year in fiscal 1986 due to increases in advertising costs because of the competitive environment mentioned above and new store opening costs incurred during the year. The size of the new stores being opened by the company as warehouse outlets is larger than stores opened in the past, thus the preopening expenses are larger. Depreciation expense increased due to the increased investment in property, plant and equipment related to the San Francisco Bay Area stores, the Portland Handyman stores acquisition and conversion costs as part of the warehouse outlet conversion program. These costs were not fully offset by increased sales during the year. Interest expense on both long and short term debt increased in fiscal 1986 over fiscal 1985. The increase was caused primarily by interest on the capital requirements of the new San Francisco Bay Area stores and the Handyman Corporation stores acquired in the Portland Oregon area in the third fiscal quarter. The private placement of \$24,000,000 of long term debt late in the year had the effect of moving part of the interest expense to long term as did interest for most of the fiscal year on the new Honolulu property mortgage. The effective income tax rate for fiscal 1986 decreased over that for fiscal 1985 due to an increase in allowable investment tax credits as compared to the prior year.

Net income for the year decreased due to the effect of all of the factors discussed above.

*Does not include net sales of replacement stores. Net sales of such replacement stores are treated as if the stores were equivalent in age to the older stores they replaced.

ITEM 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations,
continued

Liquidity and Capital Resources

The Company's principal sources of funds to finance expansion and acquisition of assets have been provided by long term and short term debt. In addition, sale/leaseback transactions generated \$19.9 million and the sale of some property held for development generated \$1.3 million.

The Company currently intends to establish approximately six additional warehouse outlets during fiscal year 1987. Management of the Company anticipates that future needs for capital resources will be provided from its available bank lines, sale/leaseback transactions and operations. The company currently has available credit facilities totaling \$54 million consisting of bank lines, letter of credit arrangements and a revolving credit agreement, of which \$20.5 of short term notes and \$3.2 million of letters of credit were outstanding at February 28, 1986 leaving \$30.3 million unused. Under restrictions included in current loan agreements, no more than \$30 million of the available short term debt facilities may be used concurrently and letters of credit are to be no more than \$12 million at any one time outstanding.

Effects of Inflation

For a discussion of the effects of inflation on the Company, see Supplementary Data, pages 22-24 herein.

ITEM 8 - Financial Statements and Supplementary Data

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ITEM 9 - Disagreements on Accounting and Financial Disclosure

None.

PAY 'N PAK STORES, INC.

REPORT OF CERTIFIED PUBLIC ACCOUNTANTS

The Board of Directors and Stockholders
Pay 'N Pak Stores, Inc.

We have examined the accompanying consolidated financial statements of Pay 'N Pak Stores, Inc. listed in the index to consolidated financial statements and financial statement schedules in Item 14(a). Our examinations 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.

In our opinion, the consolidated financial statements listed in the index to consolidated financial statements and financial statement schedules in Item 14(a) present fairly the consolidated financial position of Pay 'N Pak Stores, Inc. at February 28, 1986 and 1985, and the consolidated results of its operations and changes in its financial position for each of the three years in the period ended February 28, 1986, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company

Seattle, Washington
March 26, 1986

PAY 'N PAK STORES, INC.
CONSOLIDATED STATEMENTS OF INCOME
Years ended February 28 or 29, 1986, 1985 and 1984

	<u>1986</u>	<u>1985</u>	<u>1984</u>
REVENUES:			
Net sales	\$332,546,000	\$305,026,000	\$249,491,000
Interest	56,000	34,000	344,000
Rentals and other	1,180,000	125,000	205,000
	<u>333,782,000</u>	<u>305,185,000</u>	<u>250,040,000</u>
COSTS AND EXPENSES:			
Cost of sales	219,684,000	200,681,000	157,962,000
Selling and administrative	77,763,000	69,167,000	60,268,000
Rent	7,524,000	6,297,000	4,620,000
Depreciation	8,260,000	6,873,000	5,999,000
Interest on long-term debt	5,432,000	3,161,000	3,340,000
Other interest	656,000	586,000	--
	<u>319,319,000</u>	<u>286,765,000</u>	<u>232,189,000</u>
INCOME BEFORE INCOME TAXES	14,463,000	18,420,000	17,851,000
PROVISION FOR INCOME TAXES (Note 4)	6,295,000	8,315,000	7,826,000
NET INCOME	<u>\$ 8,168,000</u>	<u>\$ 10,105,000</u>	<u>\$ 10,025,000</u>
PER COMMON SHARE:			
Net income	<u>\$.82</u>	<u>\$1.01</u>	<u>\$1.11</u>
Cash dividends paid	<u>\$.63</u>	<u>\$.60</u>	<u>\$.56</u>

See accompanying notes.

PAY 'N PAK STORES, INC.
CONSOLIDATED BALANCE SHEETS
February 28, 1986 and 1985

ASSETS		
	<u>1986</u>	<u>1985</u>
CURRENT ASSETS:		
Cash	\$ 3,723,000	\$ 2,775,000
Receivables	2,954,000	1,762,000
Income taxes receivable	1,169,000	--
Merchandise inventories	107,127,000	96,253,000
Prepaid expenses	<u>1,535,000</u>	<u>2,407,000</u>
Total current assets	116,508,000	103,197,000
PROPERTY, PLANT AND EQUIPMENT, at cost (Notes 2 and 5):		
Land	16,750,000	8,939,000
Buildings	26,280,000	18,428,000
Leasehold rights and improvements	41,924,000	36,590,000
Store equipment	46,314,000	36,492,000
Transportation equipment	3,788,000	3,612,000
Construction in progress	<u>5,092,000</u>	<u>13,070,000</u>
	140,148,000	117,131,000
Less accumulated depreciation and amortization	<u>35,373,000</u>	<u>30,205,000</u>
	104,775,000	86,926,000
Properties held for development	<u>--</u>	<u>355,000</u>
Net property, plant and equipment	104,775,000	87,281,000
OTHER ASSETS	<u>1,731,000</u>	<u>291,000</u>
	<u><u>\$223,014,000</u></u>	<u><u>\$190,769,000</u></u>

See accompanying notes.

PAY 'N PAK STORES, INC.

CONSOLIDATED BALANCE SHEETS

February 28, 1986 and 1985

LIABILITIES AND STOCKHOLDERS' EQUITY

	1986	1985
CURRENT LIABILITIES:		
Payable to bank	\$ 6,325,000	\$ 5,637,000
Notes payable (Note 2)	20,475,000	11,602,000
Accounts payable	16,124,000	22,793,000
Income taxes (Note 4)	312,000	428,000
Accrued liabilities:		
Payroll and profit sharing	3,885,000	3,837,000
Taxes, other than income	2,103,000	1,958,000
Interest and other	1,657,000	932,000
	<u>7,645,000</u>	<u>6,727,000</u>
Long-term debt due within one year (Note 2)	1,801,000	1,687,000
Total current liabilities	52,682,000	48,874,000
LONG-TERM DEBT (Note 2)	64,270,000	41,641,000
DEFERRED INCOME TAXES (Note 4)	5,338,000	2,281,000
DEFERRED INCOME	1,081,000	197,000
COMMITMENTS AND CONTINGENCIES (Note 5)		
STOCKHOLDERS' EQUITY:		
Preferred stock, without par value, 1,000,000 shares authorized, none issued	--	--
Common stock, \$.10 par value, 20,000,000 shares authorized, 10,002,832 shares issued	67,722,000	67,722,000
Retained earnings (Note 2)	31,921,000	30,054,000
Total stockholders' equity	<u>99,643,000</u>	<u>97,776,000</u>
	<u>\$223,014,000</u>	<u>\$190,769,000</u>

PAY 'N PAK STORES, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
Years ended February 28 or 29, 1986, 1985 and 1984

	<u>Common stock</u>	<u>Retained earnings</u>	<u>Total</u>
BALANCE, February 28, 1983	\$26,525,000	\$20,905,000	\$47,430,000
Net income		10,025,000	10,025,000
Cash dividends		(4,979,000)	(4,979,000)
Issuance of 2,350,000 shares of common stock, net of offering costs	41,197,000		41,197,000
BALANCE, February 29, 1984	67,722,000	25,951,000	93,673,000
Net income		10,105,000	10,105,000
Cash Dividends		(6,002,000)	(6,002,000)
BALANCE, February 28, 1985	67,722,000	30,054,000	97,776,000
Net income		8,168,000	8,168,000
Cash dividends		(6,301,000)	(6,301,000)
BALANCE, February 28, 1986	<u>\$67,722,000</u>	<u>\$31,921,000</u>	<u>\$99,643,000</u>

See accompanying notes.

PAY 'N PAK STORES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
Years ended February 28 or 29, 1986, 1985 and 1984

	<u>1986</u>	<u>1985</u>	<u>1984</u>
OPERATING ACTIVITIES:			
Net income	\$ 8,168,000	\$10,105,000	\$10,025,000
Charges (credits) to earnings not affecting cash:			
Depreciation and amortization	8,354,000	6,913,000	6,035,000
Deferred income taxes	3,057,000	1,456,000	900,000
(Gain) loss on sale of assets	(962,000)	243,000	(21,000)
Increase in working capital (excluding cash and borrowings)	(18,230,000)	(1,746,000)	(26,861,000)
Cash provided (used) by operations	387,000	16,971,000	(9,922,000)
Additions to property, plant and equipment	(46,178,000)	(28,836,000)	(25,444,000)
Other	(1,041,000)	(110,000)	(14,000)
Decrease in cash before financing activities	(46,832,000)	(11,975,000)	(35,380,000)
FINANCING ACTIVITIES:			
Increase in short-term borrowings	9,561,000	6,039,000	2,200,000
Increase (decrease) in long-term debt (including current portion)	23,313,000	13,193,000	(6,927,000)
Issuance of common stock	--	--	41,197,000
Proceeds from sale of assets and sale and leaseback of properties	21,207,000	984,000	2,200,000
Cash dividends paid	(6,301,000)	(6,002,000)	(4,979,000)
Cash provided from financing activities	47,780,000	14,214,000	33,691,000
INCREASE (DECREASE) IN CASH	948,000	2,239,000	(1,689,000)
CASH, BEGINNING OF YEAR	2,775,000	536,000	2,225,000
CASH, END OF YEAR	<u>\$ 3,723,000</u>	<u>\$ 2,775,000</u>	<u>\$ 536,000</u>
DETAIL OF CHANGES IN WORKING CAPITAL (excluding cash and borrowings):			
Receivables	\$ 2,361,000	\$ (125,000)	\$ 445,000
Merchandise inventories	10,874,000	2,340,000	28,875,000
Prepaid expenses	(872,000)	1,059,000	104,000
Accounts payable	6,669,000	(1,480,000)	(1,678,000)
Income taxes	116,000	209,000	77,000
Accrued liabilities	(918,000)	(257,000)	(962,000)
INCREASE IN WORKING CAPITAL (excluding cash and borrowings)	<u>\$18,230,000</u>	<u>\$ 1,746,000</u>	<u>\$26,861,000</u>

See accompanying notes

PAY 'N PAK STORES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

February 28 or 29, 1986, 1985 and 1984

1. Description of the Company and significant accounting policies

The Company is engaged in retail selling of home improvement products, including electrical products, plumbing supplies, building materials, cabinets and built-in appliances.

(a) **Presentation**-The financial statements include the accounts of the parent company and its subsidiaries. All intercompany transactions and balances have been eliminated.

(b) **Inventories**-Merchandise inventories are stated at the lower of cost (first-in, first-out), or market.

(c) **Property, plant and equipment**-Depreciation of property, plant and equipment is provided principally on the straight-line method. Estimated useful lives are as follows: buildings-40 years; leasehold rights and improvements-the lesser of 10 to 20 years or life of the lease (principally 15 to 25 years) and equipment-3 to 10 years.

When assets are sold and leased back the gain/loss is deferred and credited/charged to income over the period of the lease.

(d) **Income taxes**-Deferred income taxes are provided in the accompanying consolidated financial statements for differences in the timing of reporting income and expenses for financial statement and income tax purposes (See Note 4).

Investment tax credits are deducted from the federal income tax provision using the flow-through method.

(e) **Pre-opening costs**-Pre-opening costs are charged to expense as incurred.

(f) **Interest capitalization**-The Company capitalizes interest incurred related to the construction of property, plant and equipment. Interest costs of \$1,142,000, \$864,000 and \$545,000 were capitalized in fiscal years 1986, 1985 and 1984, respectively. Total interest costs for the three years were \$7,230,000, \$4,611,000 and \$3,885,000, respectively.

(g) **Per share data**-Per common share amounts were determined on the weighted average number of shares outstanding during each period (1986-10,002,832; 1985-10,002,832 and 1984-9,033,022).

PAY 'N PAK STORES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
February 28 or 29, 1986, 1985 and 1984

2. Bank credit arrangements and long-term debt

At February 28, 1986, the Company had available unused lines-of-credit for working capital and letter of credit purchases of \$15,298,000 under agreements with banks, which expire from May through July 1986. Interest on borrowings under these agreements is charged at prime rate or less. The weighted average interest rate for notes payable at February 28, 1986 is 8.7%. The Company is charged a commitment fee of 1/4 to 3/8 of one percent per annum on the unused balance of certain lines-of-credit.

In December 1985, the Company entered into a credit agreement with a bank which allows borrowings of up to \$15,000,000 at interest rates based on the bank's cost of funds. The Company is charged a commitment fee of 1/2 of one percent per annum on the unused balance. The agreement terminates in December 1987 at which time the Company has the option to convert any outstanding borrowing into a term loan. There were no borrowings under this agreement at February 28, 1986.

Long-term debt outstanding at February 28, 1986, and February 28, 1985, is shown on the following summary:

	<u>1986</u>	<u>1985</u>
11 1/4% notes payable due 1995, interest due annually, first principal payment in 1990	\$24,000,000	--
10-1/8% note payable to insurance company, due \$1,075,000 annually to 1994, plus interest	\$ 9,675,000	\$10,750,000
Revolving line of credit, refinanced in April 1985	--	15,000,000
11-7/8% mortgage payable, due interest only until 1991, then \$3,860,000 annually until 1996	14,500,000	--
8-1/4% to 11.0% (average 10.1%) mortgage notes payable, due \$440,000 including interest in 1987 and reduced amounts to 2002; notes with a balance of \$1,747,000 are subject to call by holders in 1992	3,512,000	4,017,000
Capitalized lease obligations (\$32,645,000), less imputed interest (\$18,678,000) payable approximately \$2,082,000 per year including imputed interest, weighted average 12.3%, final payment in January 2012	13,967,000	13,410,000
Other	417,000	151,000
	<u>66,071,000</u>	<u>43,328,000</u>
Less amounts due within one year	<u>1,801,000</u>	<u>1,687,000</u>
	<u>\$64,270,000</u>	<u>\$41,641,000</u>

Payments on the principal of long-term debt and capitalized lease obligations for the four years ending February 28, 1991 are required as follows: 1988-\$1,870,000; 1989-\$1,904,000, 1990-\$4,347,000 and 1991-\$7,044,000

The loan agreement covering the note payable and one line of credit agreement contain among other matters, working capital, restrictions on the payment of cash dividends and redemption or reacquisition of the Company's stock. At February 28, 1986, retained earnings of approximately \$2,197,000 was not restricted.

Operating plant and equipment having a net book value of \$21,192,000 at February 28, 1986 are pledged as collateral for the mortgage notes and contracts payable.

PAY 'N PAK STORES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
February 28 or 29, 1986, 1985 and 1984

3. Employee benefit plan

After three years of employment, all employees participate in the Company's Employee Stock Ownership Plan. The Company contributes 10% of an employee's eligible compensation, with a maximum contribution of \$3,000 per employee per year. Total contribution was \$1,634,000, \$1,565,000, and \$1,420,000 for fiscal years 1986, 1985 and 1984, respectively.

4. Income taxes

The provision for income taxes is comprised of the following:

	Year ended February 28 or 29,		
	1986	1985	1984
Current federal income tax:			
Provision	\$3,225,000	\$6,639,000	\$6,979,000
Investment tax credit	(737,000)	(580,000)	(779,000)
	2,488,000	6,059,000	6,200,000
State income taxes	750,000	800,000	726,000
Deferred income taxes	3,057,000	1,456,000	900,000
	<u>\$6,295,000</u>	<u>\$8,315,000</u>	<u>\$7,826,000</u>

The effective tax rate differs from the statutory federal income tax rate due primarily to the effects of the investment tax credit, state income taxes and certain income being taxed at lower capital gain rates.

Deferred taxes result from the federal and state income tax effects of the following timing differences:

	1986	1985	1984
Depreciation deducted for			
tax in excess of book expense	\$2,861,000	\$1,344,000	\$990,000
Capitalized lease items	(14,000)	(133,000)	(141,000)
Installment sale (in 1986),			
capitalized interest and other	210,000	245,000	51,000
	<u>\$3,057,000</u>	<u>\$1,456,000</u>	<u>\$900,000</u>

PAY 'N PAK STORES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
February 28 or 29, 1986, 1985 and 1984

5. Leases and contingencies

The Company leases substantially all retail store facilities and its three warehouses. Certain of these leases have been capitalized (See Note 2). Leasehold rights and improvements included \$16,706,000 (\$16,079,000 at February 28, 1985) for capitalized leases for retail stores and computer equipment and accumulated depreciation and amortization included \$6,597,000 (\$6,415,000 at February 28, 1985) applicable thereto.

Most lease arrangements provide for minimum rental payments on the basis of lapse of time, with many leases providing for additional percentage rentals based on individual stores' annual sales in excess of a specified amount. The Company has options to renew most leases for three to five year periods at agreed amounts. In some cases, rent is subject to renegotiation in the event the Company exercises its option to renew. There are no existing options to purchase leased property.

Rental expense for operating leases, except those with terms of a year or less, was \$7,656,000, \$6,546,000, and \$4,812,000 for fiscal years 1986, 1985 and 1984, respectively. Included in expense for each of the three years was percentage rental of \$721,000, \$676,000 and \$485,000, respectively.

Minimum annual rental commitments, exclusive of insurance and property taxes, under non-cancellable operating leases are payable as follows:

Year ending February 28 or 29,	
1987	\$ 7,226,000
1988	6,895,000
1989	6,459,000
1990	6,365,000
1991	6,379,000
Later years	65,350,000
	<u>\$98,674,000</u>

In September 1984 an antitrust suit was brought against the Company by a competitor with stores located primarily in Western Washington. The complaint alleges that the Company has engaged in predatory price reductions, interfered with suppliers, as well as other matters. The complaint seeks injunctive relief and damages and has not reached the point where it can be scheduled for trial. Plaintiff has claimed damages of approximately \$2,500,000 in the aggregate before trebling. Various other claims, suits and complaints arising in the ordinary course of business are pending against the Company. In all of these cases the Company is defending them vigorously. In the opinion of management, all such matters are either adequately covered by insurance, are without substantial merit or involve such amounts as would not have a significant effect on the financial position or results of operations of the Company. However, the antitrust suit will be tried before a jury and the outcome is therefore unpredictable.

PAY 'N PAK STORES, INC.
SUPPLEMENTARY DATA
February 28 or 29, 1986, 1985 and 1984

Quarterly financial data (unaudited)

	Quarter ended			
	<u>May 31</u>	<u>Aug. 31</u>	<u>Nov. 30</u>	<u>Feb. 28</u>
	(In thousands, except per share amounts)			
1986				
Revenues	\$82,733	\$90,503	\$86,002	\$74,544
Gross profit on sales	\$27,919	\$31,271	\$28,347	\$25,325
Net income	\$ 2,096	\$ 3,011	\$ 1,760	\$ 1,301
Net income per share	\$.21	\$.30	\$.18	\$.13
1985				
Revenues	\$74,437	\$87,802	\$81,600	\$61,346
Gross profit on sales	\$25,878	\$30,799	\$27,141	\$20,527
Net income	\$ 2,386	\$ 3,842	\$ 2,678	\$ 1,199
Net income per share	\$.24	\$.38	\$.27	\$.12

Supplementary information on changing prices (unaudited)

The Company is providing the following supplementary information as required by Financial Accounting Standard (FAS) 33. The Company respectfully questions the meaningfulness and reliability of the hypothetical assumptions and methods used to derive the amounts presented below; accordingly, it is the Company's belief that this information may be of limited value. Because the information deals only with certain aspects of inflation and certain elements of the basic financial statements, and because the compilation of the data by its nature is imprecise, these disclosures should be viewed only as an attempt to estimate the approximate effects of inflation on the Company and not as a precise measurement. An analysis of the Company's performance and any assessment of its future prospects based solely on the information given would very likely be misleading.

The decline in net income under the current cost method is the result of increased cost of sales and depreciation expense, reflecting the higher values for inventories and property, plant and equipment. It should be noted, however, that FAS 33 does not permit any adjustment of historical income tax expense. As a result, the effective income tax rates for the inflation adjusted data vary significantly from the Company's historical rate.

As indicated below, the Company recognized a purchasing power gain, since the Company held net monetary liabilities during fiscal year 1986, a period in which the purchasing power of the dollar declined. However, since this gain does not represent a receipt of cash, it should not be considered as providing funds for reinvestment or dividend distribution.

The information presented below is a calculation of the estimated effects of inflation on inventories, cost of sales, property, plant and equipment and depreciation expense measured under the current cost method. This method adjusts for changes in specific prices (current cost) related to individual assets and expenses. The objective of this method is to reflect the effects of changes in specific prices of the resources used in the Company's operations.

Current Cost Method: Inventories were adjusted based on costs in effect during the fourth quarter of fiscal year 1986 which relates to turnover of inventory. Cost of sales was estimated using Producer Price Indices for the various product categories, taking into account the approximate time lag between incurring costs and their subsequent conversion into sales revenue. The current cost of property, plant and equipment was estimated using various approaches, including specific pricing, indexing, engineering cost estimates, property tax valuations and use of the actual costs of the most recently completed stores. Depreciation expense on a current cost basis was estimated by computing the ratio of historical depreciation to historical cost and applying it to the current cost of assets.

Purchasing Power Gain: Monetary assets and liabilities are items that are or will be converted into, or will require for settlement, a fixed number of dollars regardless of changes in prices. Examples of monetary items are cash, receivables, payables and long-term debt.

PAY 'N PAK STORES, INC.

SUPPLEMENTARY DATA

February 28 or 29, 1986, 1985 and 1984

Supplementary information on changing prices (unaudited), continued

	As Reported In The Primary Statements (Historical Cost)	Adjusted For Changes in Specific Prices (Cur- rent Cost)
Revenues	\$333,782,000	\$333,782,000
Cost of sales	219,684,000	221,309,000
Depreciation	8,260,000	11,054,000
Other operating expenses	85,287,000	85,287,000
Interest	6,088,000	6,088,000
Total expenses	319,319,000	323,738,000
Income before income taxes	14,463,000	10,044,000
Provision for income taxes	6,295,000	6,295,000
Net income	\$ 8,168,000	\$ 3,749,000
Effective income tax rate	43.5%	62.7%
Purchasing power gain from holding net monetary liabilities during the year		\$ 2,962,000
Increase in specific prices (current cost) of inventories and property, plant and equipment during the year*		\$ 16,599,000
Effect of increase in general price level		8,367,000
Excess of increase in specific prices over increase in general price level		\$ 8,232,000

*At February 28, 1986, current cost of inventory was \$107,245,000 and current cost of property, plant and equipment, net of accumulated depreciation was \$133,570,000.

PAY 'N PAK STORES, INC.
SUPPLEMENTARY DATA
February 28 or 29, 1986, 1985 and 1984

Supplementary information on changing prices (unaudited), continued

**FIVE-YEAR COMPARISON OF SELECTED FINANCIAL DATA
ADJUSTED FOR THE EFFECTS OF CHANGING PRICES
IN AVERAGE FISCAL 1986 DOLLARS**

	<u>1986</u>	<u>1985</u>	<u>1984</u>	<u>1983</u>	<u>1982</u>
Revenues	\$333,782,000	\$316,109,000	\$269,677,000	\$208,790,000	\$212,590,000
<u>Current cost information</u>					
Net income	\$ 3,749,000	\$ 4,166,000	\$ 2,137,000		
Net income per common share	\$.37	\$.42	\$.24		
Excess of increase in specific prices over increase in general price level	\$ 8,232,000	\$ 7,062,000	\$ 2,712,000		
Stockholders' equity at year-end	\$128,556,000	\$124,869,000	\$117,700,000		
<u>Other information</u>					
Purchasing power gain from holding net monetary liabilities during the year	\$ 2,962,000	\$ 2,568,000	\$ 2,928,000		
Cash dividends per common share	\$.63	\$.621	\$.604	\$.565	\$.542
Market price per share at year-end	\$13.75	\$14.242	\$16.313	\$16.996	\$9.789
Average Consumer Price Index for the fiscal year	324.1	312.9	300.5	290.8	275.9

The five-year supplementary financial data show the effect of adjusting selected historical and current cost data to average fiscal year 1986 dollars, as measured by the CPI-U Index. In addition, sales, cash dividends per share and market prices per share for the fiscal years 1982 through 1986 have been restated in average fiscal year 1986 dollars. The Company is not required to present certain information for fiscal years prior to 1984.

Purchasing Power Gain: Monetary assets and liabilities are items that are or will be converted into, or will require for settlement, a fixed number of dollars regardless of changes in prices. Examples of monetary items are cash, receivables, payables and long-term debt.

PART III

Item 10 - Directors and Executive Officers of the Company

Incorporated by reference from the definitive proxy statement to be filed with the Securities and Exchange Commission, except information regarding executive officers which appears under Part I, on page 8.

Item 11 - Executive Compensation

Incorporated by reference from the definitive proxy statement to be filed with the Securities and Exchange Commission.

Item 12 - Security Ownership of Certain Beneficial Owners and Management

Incorporated by reference from the definitive proxy statement to be filed with the Securities and Exchange Commission.

Item 13 - Certain Relationships and Related Transactions

Incorporated by reference from the definitive proxy statement to be filed with the Securities and Exchange Commission.

PART IV

Item 14 - Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) *Financial Statements.*

The financial statements and schedules listed in the accompanying index to consolidated financial statements and financial statement schedules are filed as part of the Annual Report on Form 10-K.

(b) *Exhibits.* See page 31 for index to exhibits.

(c) *Reports on Form 8-K.* No reports on Form 8-K were filed during the last quarter of the period covered by this report.

PAY 'N PAK STORES, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES

(Item 14(a))

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Consolidated statements of stockholders' equity for each of the three years in the period ended February 28, 1986	16
Consolidated statements of changes in financial position for each of the three years in the period ended February 28, 1986	17
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Supplementary data (unaudited)	22-24
Schedules for each of the three years in the period ended February 28, 1986:	
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VI - Accumulated depreciation of property, plant and equipment	28
VIII - Valuation and qualifying accounts	29
IX - Short-term borrowings	29
X - Supplementary income statement information	29

All other schedules are omitted since the required information is not present or is not present in amounts sufficient to require submission of the schedule, or because the information required is included in the consolidated financial statements and notes thereto.

PAY 'N PAK STORES, INC.
SCHEDULE V - PROPERTY, PLANT AND EQUIPMENT
Years ended February 28 or 29, 1986, 1985 and 1984

	<u>Balance at beginning of year</u>	<u>Additions, transfers at cost</u>	<u>Retirements or sales</u>	<u>Balance at end of year</u>
1986:				
Land	\$ 8,939,000	\$13,955,000	\$ 6,144,000	\$16,750,000
Buildings	18,428,000	20,292,000	12,440,000	26,280,000
Leasehold rights and improvements	36,590,000	7,797,000	2,463,000	41,924,000
Store equipment	36,492,000	11,664,000	1,842,000	46,314,000
Transportation equipment	3,612,000	448,000	272,000	3,788,000
Construction in progress	13,070,000	(7,978,000)	--	5,092,000
	117,131,000	46,178,000	23,161,000	140,148,000
Properties held for development ..	355,000	--	355,000	--
	<u>\$117,486,000</u>	<u>\$46,178,000</u>	<u>\$23,516,000</u>	<u>\$140,148,000</u>
1985:				
Land	\$ 2,567,000	\$ 6,707,000	\$ 335,000	\$ 8,939,000
Buildings	9,119,000	9,875,000	566,000	18,428,000
Leasehold rights and improvements	32,857,000	4,844,000	1,111,000	36,590,000
Store equipment	30,334,000	7,530,000	1,372,000	36,492,000
Transportation equipment	3,373,000	244,000	5,000	3,612,000
Construction in progress	11,465,000	1,605,000	--	13,070,000
	89,715,000	30,805,000	3,389,000	117,131,000
Properties held for development ..	2,324,000	(1,969,000)	--	355,000
	<u>\$92,039,000</u>	<u>\$28,836,000</u>	<u>\$ 3,389,000</u>	<u>\$117,486,000</u>
1984:				
Land	\$ 2,529,000	\$ 335,000	\$ 297,000	\$ 2,567,000
Buildings	10,480,000	(203,000)	1,158,000	9,119,000
Leasehold rights and improvements	29,446,000	3,531,000	120,000	32,857,000
Store equipment	20,868,000	10,074,000	608,000	30,334,000
Transportation equipment	3,581,000	907,000	1,115,000	3,373,000
Construction in progress	676,000	10,789,000	--	11,465,000
	67,580,000	25,433,000	3,298,000	89,715,000
Properties held for development ..	2,313,000	11,000	--	2,324,000
	<u>\$69,893,000</u>	<u>\$25,444,000</u>	<u>\$ 3,298,000</u>	<u>\$92,039,000</u>

PAY 'N PAK STORES, INC.
SCHEDULE VI - ACCUMULATED DEPRECIATION OF
PROPERTY, PLANT AND EQUIPMENT
Years ended February 28 or 29, 1986, 1985 and 1984

Description	Balance at beginning of year	Additions, charged to income	Retirements or sales	Balance at end of year
1986:				
Buildings	\$ 1,305,000	\$ 546,000	\$ 458,000	\$ 1,393,000
Leasehold rights and improvements	12,965,000	2,428,000	794,000	14,599,000
Store equipment	14,262,000	4,811,000	1,652,000	17,421,000
Transportation equipment	1,673,000	475,000	188,000	1,960,000
	<u>\$30,205,000</u>	<u>\$8,260,000</u>	<u>\$3,092,000</u>	<u>\$35,373,000</u>
1985:				
Buildings	\$ 970,000	\$ 337,000	\$ 2,000	\$ 1,305,000
Leasehold rights and improvements	11,755,000	2,092,000	882,000	12,965,000
Store equipment	11,619,000	3,921,000	1,278,000	14,262,000
Transportation equipment	1,151,000	523,000	1,000	1,673,000
	<u>\$25,495,000</u>	<u>\$6,873,000</u>	<u>\$2,163,000</u>	<u>\$30,205,000</u>
1984:				
Buildings	\$ 856,000	\$ 241,000	\$ 127,000	\$ 970,000
Leasehold rights and improvements	10,024,000	1,864,000	133,000	11,755,000
Store equipment	8,676,000	3,422,000	479,000	11,619,000
Transportation equipment	1,106,000	472,000	427,000	1,151,000
	<u>\$20,662,000</u>	<u>\$5,999,000</u>	<u>\$1,166,000</u>	<u>\$25,495,000</u>

PAY 'N PAK STORES, INC.
SCHEDULE VIII - VALUATION AND QUALIFYING ACCOUNTS
Years ended February 28 or 29, 1986, 1985 and 1984

	Balance at beginning of year	Additions, charged to income	Deductions*	Balance at end of year
Allowance for doubtful accounts deducted from the asset to which it applies:				
1986	\$65,000	\$224,000	\$224,000	\$65,000
1985	\$60,000	\$242,000	\$237,000	\$65,000
1984	\$53,000	\$171,000	\$164,000	\$60,000

* Represents accounts written off against the reserve.

PAY 'N PAK STORES, INC.
SCHEDULE IX - SHORT-TERM BORROWINGS

Years ended February 28 or 29, 1986, 1985 and 1984

	Balance at end of year	Weighted average interest rate at end of year	Maximum amount outstanding at any month- end during the year	Average amount outstanding during the year	Weighted average interest rate during the year
Notes payable to banks:					
1986	\$20,475,000	8.7%	\$26,591,000	\$12,491,000	8.8%
1985	\$11,602,000	9.2%	\$14,600,000	\$8,594,000	11.5%
1984	\$ 9,700,000	9.8%	\$12,700,000	\$2,469,000	10.7%
Revolving line of credit:					
1986	\$ --	-- %	\$15,000,000	\$5,910,000	10.23%
1985	\$ --	-- %	\$ 8,000,000	\$1,372,000	14.9%
1984	\$ --	-- %	\$ --	\$ --	-- %
Bankers acceptances:					
1986	\$ --	-- %	\$ --	\$ --	-- %
1985	\$ --	-- %	\$ --	\$ --	-- %
1984	\$ --	-- %	\$ 4,000,000	\$ 239,000	9.5%

Notes payable to banks represent obligations payable under several credit agreements to various banks.

The average amount outstanding for each period was computed by averaging the daily balances during the year. The weighted average interest rate for each period was computed by dividing interest incurred by the average amount outstanding.

PAY 'N PAK STORES, INC.
SCHEDULE X - SUPPLEMENTARY INCOME STATEMENT INFORMATION


Years ended February 28 or 29, 1986, 1985 and 1984

	Charged to costs and expenses		
	1986	1985	1984
Advertising costs	\$12,767,000	\$10,468,000	\$9,300,000

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.


PAY 'N PAK STORES, INC. (Registrant)

By 
Douglas G. Southern
Vice President-Finance and
Secretary-Treasurer

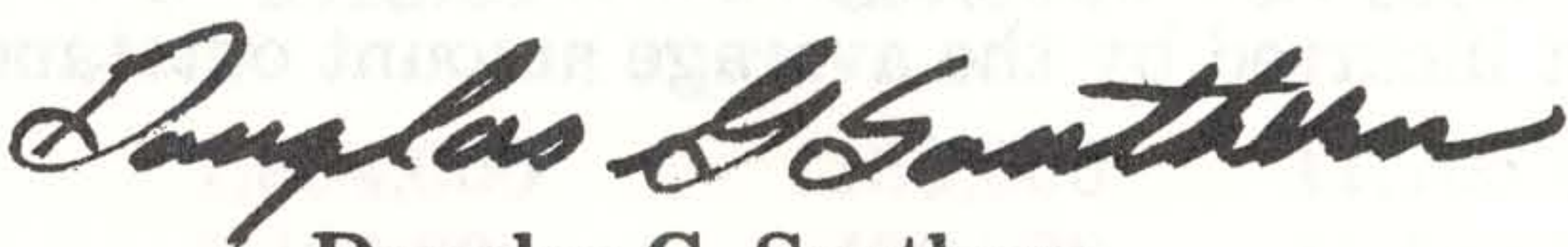
Dated: April 30, 1986

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 Company in the capacities and on the dates indicated.

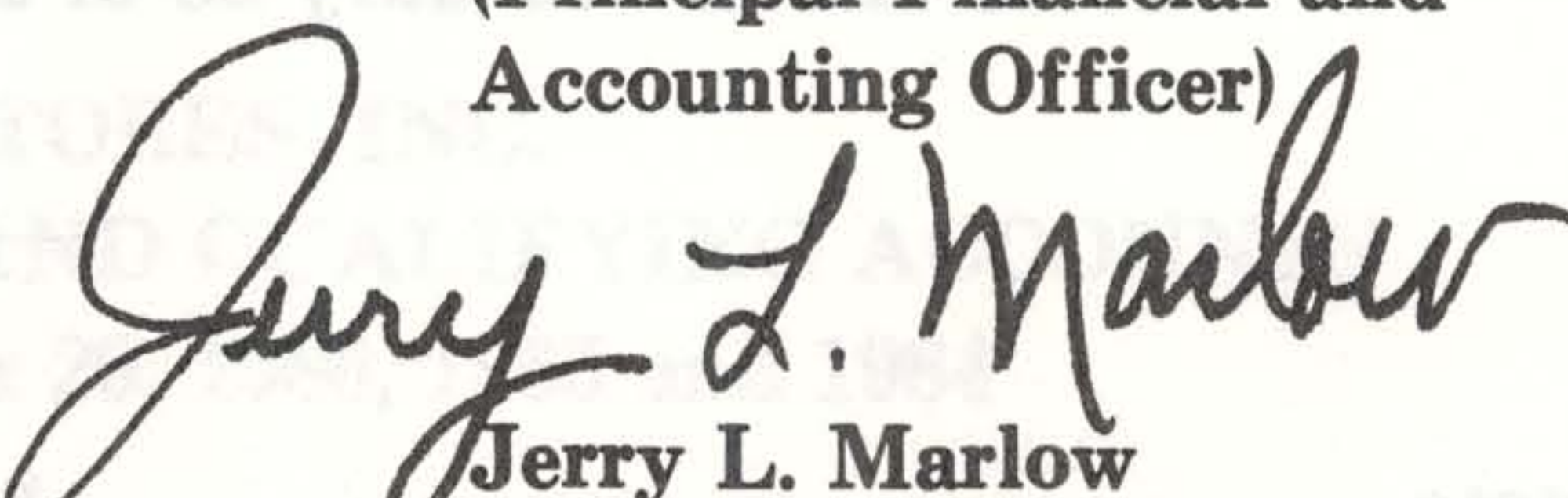
PAY 'N PAK STORES, INC. (Registrant)

By 
David J. Heerensperger
Director and Chairman
of the Board
(Principal Executive Officer)

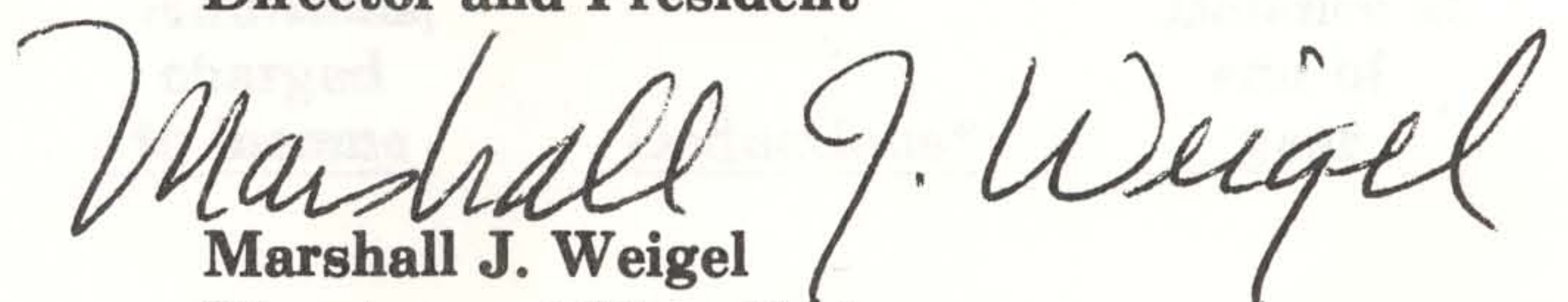
Dated: April 30, 1986

By 
Douglas G. Southern
Vice President-Finance and
Secretary-Treasurer
(Principal Financial and
Accounting Officer)

Dated: April 30, 1986

By 
Jerry L. Marlow
Director and President

Dated: April 30, 1986

By 
Marshall J. Weigel
Director and Vice-Chairman

Dated: April 30, 1986

Majority of Board of Directors

EXHIBIT INDEX

- (3) Bylaws as Amended. Restated Articles of Incorporation as amended are incorporated by reference from the Registrants Form 10-K filed for the fiscal year ended February 29, 1984.
- (4) Note Agreement with The Prudential Insurance Company of American dated August 15, 1979, as amended.
- (5) Credit Agreement with PruFunding, inc. dated November 1, 1983 as amended. Note Agreement with National Life Insurance Company, the Franklin Life Insurance Company, Southland Life Insurance Company and Columbia Mutual Life Insurance Company dated as of October 15, 1985. Credit Agreement with Bankers Trust Company dated as of December 23, 1985.
- (22) Subsidiaries of the Registrant are incorporated by reference from the Registrant's Form 10-K filed for the fiscal year ended February 28, 1981.

Copies of the above exhibits may be obtained from the Securities and Exchange Commission or the Registrant by written request.

P.O. Box 8808

Kent, Washington 98031-0480
(206) 854-5450

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