

PFSWEB INC
Form 10-K
March 30, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2011

or

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from **to**

Commission file number 000-28275

PFSWEB, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

75-2837058
(I.R.S. Employer

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(incorporation or organization)

(Identification Number)

500 North Central Expressway, Plano, Texas
(Address of principal executive offices)

75074
(Zip code)

Registrant's telephone number, including area code:

972-881-2900

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$.001 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.

Yes No

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 No

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a Smaller reporting company)

Smaller reporting company

Indicated by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2011 (based on the closing price as reported by the National Association of Securities Dealers Automated Quotation System) was \$57,121,109.

At March 28, 2012, there were 12,782,907 shares of the registrant's Common Stock issued, \$.001 par value.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this Annual Report, to the extent not set forth herein, is incorporated herein by reference from the registrant's definitive proxy statement relating to the annual meeting of shareholders, which definitive proxy statement shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Annual Report relates.

Table of Contents**INDEX**

	Page
<u>PART I</u>	
Item 1. <u>Business</u>	1
Item 1A. <u>Risk Factors</u>	14
Item 1B. <u>Unresolved Staff Comments</u>	23
Item 2. <u>Properties</u>	23
Item 3. <u>Legal Proceedings</u>	24
Item 4. <u>Mine Safety Disclosure</u>	24
<u>PART II</u>	
Item 5. <u>Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities</u>	25
Item 6. <u>Selected Consolidated Financial Data</u>	25
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	26
Item 8. <u>Financial Statements and Supplementary Data</u>	38
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	62
Item 9A. <u>Controls and Procedures</u>	62
Item 9B. <u>Other Information</u>	63
<u>PART III</u>	
Item 10. <u>Directors and Executive Officers of the Registrant</u>	63
Item 11. <u>Executive Compensation</u>	63
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters</u>	63
Item 13. <u>Certain Relationships and Related Transactions</u>	63
Item 14. <u>Principal Accountant Fees and Services</u>	63
<u>PART IV</u>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	64
<u>Signatures</u>	74
<i>Unless otherwise indicated, all references to PFSweb, the Company, we, us and our refer to PFSweb, Inc., a Delaware corporation, and its subsidiaries; references to PFS refer to our wholly-owned subsidiaries, Priority Fulfillment Services, Inc., PFS Canada and PFS Europe; references to Supplies Distributors refer to our wholly-owned subsidiary Supplies Distributors, Inc. and its subsidiaries; and references to Retail Connect refers to our wholly-owned subsidiary PFSweb Retail Connect, Inc.</i>	

Table of Contents

PART I

Item 1. Business
General

PFSweb is an international business process outsourcing provider of end-to-end eCommerce solutions. PFSweb provides these solutions to major brand name companies seeking to optimize their supply chain and to enhance their traditional and online business channels and initiatives. We derive our revenues from a broad range of services as we process individual business transactions on our clients' behalf. Marketed as *PFSweb's End2End eCommerce*[®] solution, the services we offer are organized into the following categories:

Digital Marketing

eCommerce Technology

Order Management

Customer Care

Logistics and Fulfillment

Financial Management

Professional Consulting

Our solutions support both direct-to-consumer (DTC) and business-to-business (B2B) sales channels. The majority of our clients are the merchants of record for the orders we process through our infrastructure on their behalf. For these clients, we do not own the inventory or the resulting accounts receivable, but provide management services for these client-owned assets.

For some of our clients, we are the merchant of record for the orders we process through our infrastructure on their behalf. Under these arrangements, we either record product revenue or a net sale, own the accounts receivable and inventory and we may be paid for all or a portion of our services through the resulting profit margin. In some cases, we purchase the inventory as the product is delivered to our facility. In other situations, the client retains ownership of inventory in our facility and we purchase the inventory immediately prior to each individual customer sales transaction. In all cases, we seek inventory financing from our clients in the form of extended terms, working capital programs or marketing funds to help offset the working capital requirements that follow accounts receivable and inventory ownership.

We are headquartered in Plano, Texas where our executive and administrative offices and our primary technology operations and hosting facilities are located. We operate state-of-the-art call centers from our U.S. facilities located in Plano, Texas, and Memphis, Tennessee, and from our international facilities located in Richmond Hill, Ontario, Canada, Liège, Belgium and Manila, Philippines. We lease or manage warehouse facilities of approximately 1.4 million square feet, many containing highly automated and state of the art material handling and communications equipment, in Memphis, Tennessee, Southaven, Mississippi, Grapevine, Texas, Richmond Hill, Ontario, Canada and Liège, Belgium, allowing us to provide global distribution solutions.

Recent Events

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In March 2012, we announced the relocation of our corporate headquarters to Allen, Texas and our North Texas customer care center to downtown Dallas, Texas. We believe the relocation of both operations, which will be completed in April 2012, will afford greater flexibility to support our organic and new business growth, seasonal staffing fluctuations and provide an improved working environment for our employees

PFSWEB'S END2END ECOMMERCE SOLUTIONS

PFSweb serves as the brand behind the brand for companies seeking to increase efficiencies, enter new markets or launch optimized sales channels. As an eCommerce and business process outsourcer, we offer scalable and cost-effective solutions for brand manufacturers, online retailers, and distributors across a wide range of industry segments. We provide our clients with seamless and transparent solutions to support their business strategies, allowing them to focus on their core competencies. Leveraging PFSweb's technology, expertise and

Table of Contents

proven methodologies, we enable client organizations to develop and deploy new products and implement new business strategies or address new distribution channels rapidly and efficiently through our optimized solutions. Our clients engage us both as a consulting partner to assist them in the design of a business solution as well as a virtual and physical infrastructure partner providing the mission critical operations required to build and manage their business solution. Together, we not only help our clients define new ways of doing business, but also provide them the technology, physical infrastructure and professional resources necessary to quickly implement this business model. We allow our clients to quickly and dramatically change how they go-to-market.

Each client has a unique business model and unique strategic objectives that often require highly customized solutions. PFSweb supports clients in a wide array of industries including fashion apparel and accessories, fragrance and beauty products, consumer packaged goods, home furnishings and housewares, consumer electronics, office technology and network connectivity products and aviation spare parts. These clients turn to PFSweb for help in addressing a variety of business issues that include eCommerce, customer satisfaction and retention, time-definite logistics, vendor managed inventory and integration, supply chain compression, cost model realignments, transportation management and international expansion, among others. We also act as a constructive agent of change, providing clients the ability to alter their current distribution model, establish direct relationships with end-customers, and reduce the overall time and costs associated with existing distribution channel strategies. Our clients are seeking solutions that will provide them with dynamic supply chain and multi-channel marketing efficiencies, while ultimately delivering a world-class customer service experience.

Our value proposition is to become a seamless, well integrated extension of our clients' enterprises by delivering superior solutions that drive optimal customer experiences. On behalf of the brands we serve, we wish to increase and enhance sales and market growth, bolster customer satisfaction and customer retention, and drive costs out of the business through operations and technology related efficiencies. As both a virtual and a physical infrastructure for our clients' businesses, we embrace their brand values and strategic objectives. By utilizing our services, our clients are able to:

Quickly Capitalize on Market Opportunities. Our solutions empower clients to rapidly implement their supply chain and eCommerce strategies and to take advantage of opportunities without lengthy integration and implementation efforts. We have readily available advanced technology and physical infrastructure that is flexible in its design, which facilitates quick integration and implementation. The PFSweb solution is designed to allow our clients to deliver consistent quality service as transaction volumes grow and also to handle daily and seasonal peak periods. Through our international locations, our clients can sell their products throughout the world.

Improve the Customer Experience. We enable our clients to provide their customers with a high-touch, positive buying experience thereby maintaining and promoting brand loyalty. Through our use of advanced technology, we can respond directly to customer inquiries by e-mail, voice or data communication and assist them with online ordering and product information. We believe we offer our clients a world-class level of service, including 24-hour, seven-days-a-week, Web-enabled customer care service centers, detailed Customer Relationship Management (CRM) reporting and exceptional order accuracy. We have significant experience in the development of eCommerce storefronts that allows us to recommend features and functions easily navigated and understood by our clients' customers. Our technology platform is designed to ensure high levels of reliability and fast response times for our clients' customers. Because of our technology, our clients benefit from being able to offer the latest in customer communication and response conveniences to their customers.

Minimize Investment and Improve Operating Efficiencies. One of the most significant benefits outsourcing provides is the ability to transform fixed costs into variable costs. By eliminating the need to invest in a fixed capital infrastructure, our clients' costs typically become more directly correlated with volume increases or declines. Further, as volume increases drive the demand for greater infrastructure or capacity, we are able to quickly deploy additional resources. We provide services to multiple clients, which enables us to offer our clients economies of scale, and resulting cost efficiency, that they may not have been able to obtain on their own. Additionally, because of the large number of daily transactions we process, we have been able to justify investments in levels of automation, security surveillance, quality control processes and transportation carrier interfaces that are typically outside the scale of investment that our clients might be able to cost justify on their own. These additional capabilities can provide our clients the benefits of enhanced operating performance and efficiency, reduced inventory shrinkage, and expanded customer service options.

Table of Contents

Access a Sophisticated Technology Infrastructure. We provide our clients with ready access to a sophisticated technology infrastructure that is designed to interface seamlessly with their systems. We provide our clients with vital product and customer information that can be immediately available to them on their own systems or through web based graphic user interfaces for use in data mining, analyzing sales and marketing trends, monitoring inventory levels and performing other management functions.

We believe our highest value proposition is achieved when our clients engage our full suite of services from all of the categories included in *PFSweb's End2End eCommerce®* solutions. However, we provide our clients with the opportunity to customize their solution by selecting only certain services from our offering in à la carte fashion. We believe this flexibility and willingness to create a customized solution for each client differentiates us from our competition.

Digital Marketing Services

Our team has extensive experience partnering with our clients to help grow their business. We have expertise in developing strategies to attract new customers, converting website visitors into actual buyers, and nurturing the relationships with current customers to increase their lifetime value. We achieve this through the following services:

Search Engine Optimization (SEO). We combine knowledge of SEO best practices with a detailed knowledge of the technology platform to maximize the programs' performance. Our subject matter experts achieve measurable results by using best-of-breed on-site page optimization tactics, internal-linking strategies, back-linking strategies, and back-link building. We provide both the strategies and the implementation to achieve top rankings in the search engines, increase visibility of the brand and drive sales results.

Pay-Per-Click. We go beyond buying keywords. In addition to bid management, we provide effective copywriting as well as landing page recommendations, optimization, and creation to increase conversion. Our strategic search engine marketing approach is designed to drive incremental traffic, increase conversion, and lower ad spend.

Affiliate Marketing. We seek the best affiliate partners that fit the brands, implement the program, and manage the ongoing relationships. We develop strategies for the programs and nurture the affiliate partnerships to ensure relevant traffic is driven to the website to convert into sales.

Comparison Shopping Engines. We have experience creating and managing comparison shopping feeds that will increase brand visibility in a competitive landscape while driving sales. We use the comparison shopping engine channel to enhance the search engine marketing initiatives and power mobile applications.

Merchandising. We combine industry expertise with best-in-breed technology to increase conversion and increase average order size. Our team of experts offers services in on-site merchandising, recommendations, personalization, on-site search, and promotion management and support.

Web Analytics. All of our interactive marketing services are data driven; we look at how the various channels are performing and determine where investments need to be made. We turn data into knowledge and offer insight into the customers' behavior and create strategies to provide actionable results.

Customer Experience. We determine how to optimize the website to engage the customers with the brand, drive sales conversion, and offer an ideal customer shopping experience. Our team makes it their focus to understand the customer's needs and offer site usability assessments that will improve the customer experience, enhance the brand and support revenue goals.

Email Marketing. We provide a world class email platform to create and send dynamic 1-to-1 emails designed to achieve exceptional business results. We provide email delivery services to ensure email is reaching the inbox and have established methodologies to test content, design, and subject lines, as well as drive email strategy to engage customers and increase revenue.

Table of Contents

Social Media. Our customer-centric approach focuses on customer service first. We have the tools to disposition customer comments, posts, replies, hash tags, etc. We also have the staff to support the strategy and ongoing management of our clients' social initiatives. We provide strategies to drive traffic and sales to client websites or on Facebook.

eCommerce Technology Services

Direct-to-Consumer eCommerce (DTC). PFSweb's End2End eCommerce® solution for the DTC online channel features Demandware eCommerce, a leading third party Software-as-a-Service (SaaS) eCommerce platform. We have fully integrated Demandware with the rest of our world-class technology platform including other best-of-breed technology partners to create a PFSweb reference application that provides our clients with a very high-function DTC online store out-of-the-box. We are able to use the PFSweb reference application as a starting point to very quickly create a completely customized online store for our DTC clients. Designed specifically for DTC brands, our comprehensive offering redefines end-to-end eCommerce by enabling retailers and branded consumer goods manufacturers with the ability to employ a total outsourcing solution customized to their particular eCommerce strategy, without the loss of site or brand control associated with earlier end-to-end outsourcing solutions.

Business-to-Business eCommerce (B2B). PFSweb's End2End eCommerce® solution for the B2B online channel features our GlobalMerchant Commerceware® service that provides a complete eCommerce website solution for our B2B clients. We engage collaboratively with our clients to design, build, host, and manage fully branded, fully customized and fully integrated eCommerce web applications for B2B channels. We offer a broad range of hosting and support plans that can be tailored to fit the needs of each client. Utilizing Microsoft's .NET Technologies and our proprietary GlobalMerchant Commerceware platform, we maintain a robust hosting environment for our hosted client B2B web sites.

Order Management Services

Order Management Interfaces. Our order management technology solutions provide us and our clients with interfaces that allow for real-time information retrieval, including information on inventory, sales orders, shipments, delivery, purchase orders, warehouse receipts, customer history, accounts receivable and credit lines. These solutions are seamlessly integrated with our web-enabled customer contact centers, allowing for the processing of orders through shopping cart, phone, fax, mail, email, web chat, and other order receipt methods. As the information backbone for our total supply chain solution, order management services can be used on a stand-alone basis or in conjunction with our other business infrastructure offerings, including customer contact, financial or distribution services. In addition, for the B2B market, our technology platform provides a variety of order receipt methods that facilitate commerce within various stages of the supply chain. Our systems provide the ability for both our clients and their customers to track the status of orders at any time. Our services are transparent to our clients' customers and are seamlessly integrated with our clients' internal system platforms and web sites. By synchronizing these activities, we can capture and provide critical customer information, including:

Statistical measurements critical to creating a quality customer experience, containing real-time order status, order exceptions, back order tracking, allocation of product based on timing of online purchase and business rules, the ratio of customer inquiries to purchases, average order sizes and order response time;

B2B supply chain management information critical to evaluating inventory positioning, for the purpose of improving inventory turns, and assessing product flow-through and end-consumer demand;

Reverse logistics information, including customer response and reason for the return or rotation of product and desired customer action;

Detailed marketing information about what was sold and to whom it was sold, by location and preference; and

Web traffic reporting showing the number of visits (hits) received, areas visited, and products and information requested.

Table of Contents

Technology Collaboration. We have created a suite of technology services that enable buyers and suppliers to fully automate their business transactions within their supply chain using the order management interfaces. Our collaboration technologies operate in an open systems environment and feature the use of industry-standard XML and SOA web services, enabling customized eCommerce solutions with minimal changes to a client's systems or our Enterprise Resource Planning (ERP) systems. The result is a faster implementation process. We also support information exchange methods such as FTP, EDI, MQ Series, ALE, HTTP, and HTTPS.

Information Management. We have the ability to communicate with and transfer information to and from our clients through a wide variety of technology services, including real-time web service enabled data interfaces, file transfer methods and electronic data interchange. Our systems are designed to capture, store and electronically forward to our clients critical information regarding customer inquiries and orders, product shipments, inventory status (for example, levels of inventory on hand, on backorder, on purchase order and inventory due dates to our warehouse), product returns and other information. Our systems are capable of providing our clients with customer inventory and order information for use in analyzing sales and marketing trends and introducing new products. We also offer customized reports and data analyses based upon specific client needs to assist them in their budgeting and business decision process.

Customer Care Services

Customer Relationship Management. We offer a completely customized CRM solution for clients. Our CRM solution encompasses a full-scale customer contact management service offering, as well as a fully integrated customer analysis program. All customer contacts are captured and customer purchases are documented. Full-scale reporting on all customer transactions is available for evaluation purposes. Through each of our customer touch-points, information can be analyzed and processed for current or future use in business evaluation, product effectiveness and positioning, and supply chain planning.

Customer Order Assistance. An important feature of evolving commerce is the ability for the customer to speak with a live customer service representative. Our experience has been that a majority of consumers tell us they visited the web location for information, but not all of those consumers chose to place their order online. Our customer care services utilize features that integrate voice, e-mail, standard mail, fax, data and Internet chat communications to respond to and handle customer inquiries. Our customer care representatives answer various questions, acting as virtual representatives of our clients' organization, regarding order status, shipping, billing, returns and product information and availability as well as a variety of other questions. For certain clients, we handle Level I and Level II technical support. Level I technical support involves assisting clients' customers with basic technical issues, i.e. computer application issues. Level II support may involve a more in-depth question and answer session with the customer. Our web-enabled customer care technology identifies each customer contact automatically and routes it to the appropriate customer care representative who is individually trained in the clients' business and products.

Our web-enabled customer care centers are flexibly designed so that our customer care representatives can handle either several different clients and products in a shared agent environment, thereby creating economy of scale benefits for our clients, or through a highly customized dedicated agent support model that provides the ultimate customer experience and brand reinforcement. Our advanced technology also enables our representatives to up-sell, cross-sell and inform customers of other products and sales opportunities. The web-enabled customer care center is fully integrated into the data management and order processing system, allowing full visibility into customer history and customer trends. Through this fully integrated system, we are able to provide a complete customer care solution.

Quality Monitoring. Quality is essential in our client solutions. As representatives of our clients, our customer care representatives must adhere to the unique quality standards of each client. We continually monitor the quality of our customer care representatives against each client quality standard and use the results to provide agent-level feedback to continually improve the customer care experience. Clients may participate in the quality process by remotely listening to calls, assisting in the grading of recorded calls, and providing ongoing direction to improve quality standards.

Customer Self-Help. With the need for efficiency and cost optimization for many of our clients, we have integrated interactive voice response (IVR) as another option for customer contacts. IVR creates an "electronic workforce" with virtual agents that can assist customers with vital information at any time of the day or night. IVR

Table of Contents

allows for our clients' customers to deal interactively with our system to handle basic customer inquiries, such as account balance, order status, shipment status, catalog requests, product and price inquiries, and routine order entry for established customers. The inclusion of IVR in our service offering allows us to offer a cost effective way to handle high volume, low complexity calls.

Logistics and Fulfillment Services

Advanced Distribution Facilities and Infrastructure. An integral part of our solution is the warehousing and distribution of inventory either owned by our clients or owned by us. We currently have approximately 1.3 million square feet of leased or managed warehouse space domestically and internationally to store and process our own and our clients' inventory. We receive inventory in our distribution centers, verify shipment accuracy, unpack and audit packages (a process that includes spot-checking a percentage of the inventory to validate piece counts and check for damages that may have occurred during shipping, loading and unloading). Upon request, we inspect for other damages or defects, which may include checking fabric, stitching and zippers for soft goods, or testing power-up capabilities for electronic items as well as product specifications. We generally stock for sale within one business day of unloading. On behalf of our clients, we pick, pack and ship their customer orders and can provide customized packaging, customized monogramming, capabilities of high volume shrink packaging, inserts and promotional literature for distribution with customer orders. For many clients, we provide gift-wrapping services including line level gifting, customized gift-wrapping paper, ribbon, gift-box and gift-messaging.

Our distribution facilities contain computerized sortation equipment, highly mobile pick-to-light carts, powered material handling equipment, scanning and bar-coding systems and automated conveyors and in-line scales. Our distribution complexes include several advanced technology enhancements, such as radio frequency technology in product receiving processing to ensure accuracy, as well as an automated package routing and a pick-to-light paperless order fulfillment system. Our advanced distribution systems provide us with the capability to warehouse an extensive number of stock keeping units (SKUs), ranging from large high-end laser printers to small cosmetic compacts. Our facilities are flexibly configured to process B2B and single pick DTC orders from the same central location.

In addition to our advanced distribution systems, our pick-to-light carts, stationary pick-to-light areas and conveyor system controls provide real time productivity reporting, thereby providing our management team with the tools to implement productivity standards. This combination of computer-controlled equipment provides the seamless integration of our pick-to-light systems and mass sortation capabilities. This unique combination of technologies ensures high order accuracy for each and every customer order.

We are able to take advantage of a variety of shipping and delivery options, which range from next day service to zone skipping to optimize transportation costs. Our facilities and systems are equipped with multi-carrier functionality, allowing us to integrate with all leading package carriers and provide a comprehensive freight and transportation management offering. In addition, an increasingly important service we provide is reverse logistics management. We offer a wide array of product return services, including issuing return authorizations, return carrier shipping labels, receipt of product, crediting customer accounts and disposition of returned product.

Our domestic clients enjoy the benefits of having their inventory assets secured by trained law enforcement professionals from our security headquarters in Memphis, Tennessee and Southaven, Mississippi. Continual validation ensures that we employ the latest in security processes and procedures to further enhance our surveillance and detection capabilities. Our security program continues to gain trust and confidence from our clients as we protect their products and assets.

Facility Operations and Management. Our facilities management service offering includes distribution facility design and optimization, business process reengineering and ongoing staffing and management. Along with our operations in Mississippi and Tennessee, we also manage an aircraft parts distribution center in Grapevine, Texas on behalf of one of our clients. Our expertise in supply chain management, logistics and customer-centric fulfillment operations extends through our management of client-owned facilities, resulting in cost reductions, process improvements and technology-driven efficiencies.

Table of Contents

Kitting and Assembly Services. Our expanded kitting and assembly services enable our clients to reduce the time and costs associated with managing multiple suppliers, warehousing hubs, and light manufacturing partners. As a single source provider, we provide the advantage of convenience, accountability and speed. Our comprehensive kitting and assembly services provide a quality one-stop resource for any international channel. Our kitting and assembly services include light assembly, specialized kitting and supplier-consigned inventory hub either in our distribution facilities or co-located elsewhere. We also offer customized light manufacturing and supplier relationship management (SRM).

We will work with clients to re-sequence certain supply chain activities to aid in an inventory postponement strategy. We can provide kitting and assembly services and build-to-stock thousands of units daily to stock in a Just-in-Time (JIT) environment. This service, for example, can entail the procurement of packaging materials including retail boxes, foam inserts and anti-static bags. These raw material components may be shipped to us from domestic or overseas manufacturers, and we will build the finished SKUs to stock for the client. Also included is the custom configuration of high-end printers and servers. This strategy allows manufacturers to make a smaller investment in base unit inventory while meeting changing customer demand for highly customizable products.

Combining our assembly services with our supplier-owned inventory hub services allows our clients to reduce cycle times, to compress their supply chains and to consolidate their operations and supplier management functions. We have supplier inventory management, assembly and fulfillment services all in one place, providing greater flexibility in product line utilization, as well as rapid response to change orders or packaging development. Our standard capabilities include: build-to-order, build-to-stock, expedited orders, passive and active electrostatic discharge (ESD) controls, product labeling, serial number generation, marking and/or capture, lot number generation, asset tagging, bill of materials (BOM) or computer automated design (CAD) engineering change processing, SKU-level pricing and billing, manufacturing and metrics reporting, first article approval processes, and comprehensive quality controls.

Our kitting and assembly services also include procurement. We work directly with client suppliers to make JIT inventory orders for each component in client packages, thereby ensuring we receive the appropriate inventory quantities at just the right time and we then turn them around JIT to customers.

Kitting and inventory hub services enable clients to collapse supply chains into the minimal steps necessary to prepare product for distribution to any channel, including wholesale, mass merchant retail, or direct to consumer. Clients no longer have to employ multiple providers or require suppliers to consign multiple inventory caches for each channel. We offer our clients the opportunity to consolidate operations from a channel standpoint, as well as from a geographic perspective. Our integrated, global information systems and international locations support business needs worldwide.

Product Management and Inspection Services. We also operate a coupon management system and product management program. Coupons are managed and activated by a unique serial number, thus significantly reducing fraudulent activity. Our capabilities also extend into salvage operations, allowing our clients to reclaim valuable raw materials and components from discontinued or obsolete inventory.

We operate a test and repair center where we visually inspect items for cosmetic defects. These items are put through rigorous testing that includes: functionality, durability, accessory inspection and packaging. Items that pass the testing are repackaged and resold with a noted exception of open-box merchandise. Items that fail the inspection are disassembled and working spare parts are saved for future use in repairs.

Financial Management Services

Our financial services are divided into two major areas: 1) billing, credit, collection and cash application services for B2B clients and 2) fraud review, chargeback management and processing and settlement credit card services for DTC clients.

Business-to-Business Financial Management. For B2B clients, we offer full-service accounts receivable management and collection capabilities, including the ability to generate customized computer-generated invoices in our clients' names. We assist clients in reducing accounts receivable and days sales outstanding, while minimizing costs associated with maintaining an in-house collections staff. We offer electronic credit services in the format of EDI and XML communications direct from our clients to their vendors, suppliers and retailers.

Table of Contents

Direct-to-Consumer Financial Management. For DTC clients, we offer secure credit card processing related services for orders made via a client web site or through our customer contact center. We offer manual credit card order review as an additional level of fraud protection. We also calculate sales taxes, goods and services taxes or value added taxes, if applicable, for numerous taxing authorities and on a variety of products. Using third-party leading-edge fraud protection services and risk management systems, we can offer high levels of security and reduce the level of risk for client transactions.

Professional Consulting Services

As part of the tailored solution for our clients, we offer a full team of experts specifically designated to focus on our clients' businesses. Team members play a consultative role, providing constructive evaluation, analysis and recommendations for the client's business. This team creates customized solutions and devises plans that will increase efficiencies and produce benefits for the client when implemented.

Comprised of industry experts from top-tier consulting firms and industry market leaders, our team of professional consultants provides client service focus and eCommerce, customer care, logistics and distribution expertise. They have built solutions for Fortune 1000 and Global 2000 market leaders in a wide range of industries, including multi-channel retailers, apparel, technology, telecommunications, cosmetics, aviation, housewares, high-value collectibles, sporting goods, pharmaceuticals and several more. Focusing on the evolving infrastructure needs of major corporations and their business initiatives, our team has a solid track record providing consulting services in the areas of interactive marketing eCommerce, supply chain management, distribution and fulfillment, technology interfacing, logistics and customer support.

SELLER SERVICES FINANCIAL MODELS

Enablement Financial Model

We refer to the standard PFS seller services financial model as the Enablement model. In this model, our clients own the inventory and are the merchants of record and engage us to provide various business outsourcing services in support of their business operations. We provide eCommerce website services, inventory and order management, customer service, payment processing, and operations reports such as product sales, sales tax, and inventory management reports. In this model, we provide infrastructure and services and the clients are responsible for all financial operations and reporting related to the sales transactions.

The Enablement model should generate margins for our clients consistent with other retailers in our clients' product category and the bottom line financial results for our clients should be similar to other retailers in their space. Service fee revenues in this model are reported in our traditional PFSweb service fee segment.

Agent (Flash) Financial Model

As an additional service, we offer an Agent model, or Flash model, in which our clients maintain ownership of the product inventory stored at our locations, as in the Enablement model. When a customer orders the product from our clients, a flash sale transaction passes product ownership of each order to us and we in turn immediately re-sell the product to the customer. The flash ownership exchange establishes us as the merchant of record. This enables us to use our existing credit card merchant infrastructure to process sales to end customers, removing the need for clients to establish these business processes internally, but permitting clients to control the sales process to end customers. In this model, based on the terms of our current client arrangements, we record product revenue on a net basis.

Retail Financial Model

In addition to the Enablement and the Agent models, we also offer a Retail model. Under the Retail model, a PFSweb subsidiary purchases inventory from the client just as any other client reseller partner. In the Retail model, we place the initial and replenishment purchase orders with the client and take ownership of the product upon delivery to our facility.

Table of Contents

Because we are the product owner as well as the merchant of record, we work closely with the client to plan sales and promotional activities. Under the Retail model, depending upon the product category and sales characteristics, we may require the client to provide product price protection as well as product purchase payment terms, right of return, and obsolescence protection appropriate to the product sales profile. Since we purchase and own the inventory and accounts receivable, this business model generally requires significant working capital requirements for which we have credit available either through credit terms provided by our clients or under senior credit facilities.

The costs of all standard PFSweb services normally billed on a transaction basis under the Enablement model, as well as certain credit risks, may be covered by the selling margin under the Retail model arrangement. The bottom line financial results for our client should be similar to the financial benefits from the retail channel, although unlike the traditional retail channel, our clients generally control the presentation and branding of the web site and owns all the customer data from the eCommerce activities.

We currently provide the Retail model for a portion of our Procter & Gamble engagement for DTC sales through the P&G eStore. In addition, we use our Retail model to enable our Supplies Distributors subsidiary to serve as a global master distributor of printer supplies for Ricoh Infoprint Solutions Company (IPS) a wholly-owned subsidiary of Ricoh Company Ltd. (Ricoh). In this model, the product revenues are reported in our Business and Retail Connect segment.

INDUSTRY INFORMATION AND COMPETITIVE LANDSCAPE

Industry Overview

Business activities in the public and private sectors continue to operate in an environment of rapid technological advancement, increasing competition and continuous pressure to improve operating and supply chain efficiency while decreasing costs. We currently see the following trends within the industry:

Manufacturers strive to restructure their supply chains to maximize efficiency and reduce costs in both B2B and DTC markets, and to create a variable-cost supply chain able to support the multiple, unique needs of each of their initiatives, including traditional and electronic commerce.

Companies in a variety of industries seek outsourcing as a method to address one or more business functions that are not within their core business competencies, to reduce operating costs or to improve the speed or cost of implementation.

Supply Chain Management Trend

As companies maintain focus on improving their businesses and balance sheet financial ratios, significant efforts and investments continue to be made identifying ways to maximize supply chain efficiency and extend supply chain processes. Working capital financing, vendor managed inventory, supply chain visibility software solutions, distribution channel skipping, direct to consumer eCommerce sales initiatives, and complex upstream supply chain collaborative technology are products that manufacturers seek to help them achieve greater supply chain efficiency.

A key business challenge facing many manufacturers and retailers as they evaluate their supply chain efficiency is in determining how the trend toward increased direct-to-customer business activity will impact their traditional B2B and DTC commerce business models. Order management and small package fulfillment and distribution capabilities are becoming increasingly important processes as this trend evolves. We believe manufacturers will look to outsource their non-core competency functions to support this modified business model. We believe companies will continue to strategically plan for the impact that eCommerce and other new technology advancements will have on their traditional commerce business models and their existing technology and infrastructure capabilities.

Table of Contents

Manufacturers, as buyers of materials, are also imposing new business practices and policies on their supplier partners to shift the normal supply chain costs and risks associated with inventory ownership away from their own balance sheets. Through techniques like Vendor Managed Inventory or Consigned Inventory Programs (CIP), manufacturers are asking their suppliers, as a part of the supplier selection process, to provide capabilities where the manufacturer need not own, or even possess, inventory prior to the exact moment that unit of inventory is required as a raw material component or for shipping to a customer. To be successful for all parties, business models such as these often require a sophisticated collection of technological capabilities that allow for complete integration and collaboration of the information technology environments of both the buyer and supplier. For example, for an inventory unit to arrive at the precise required moment in the manufacturing facility, it is necessary for the Manufacturing Resource Planning systems of the manufacturer to integrate with the CRM systems of the supplier. When hundreds of supplier partners are involved, this process can become quite complex and technologically challenging. Buyers and suppliers are seeking solutions that utilize XML based protocols and traditional EDI standards to ensure an open systems platform that promote easier technology integration in these collaborative solutions.

Outsourcing Trend

In response to growing competitive pressures and technological innovations, we believe many companies, both large and small, are focusing their critical resources on the core competencies of their business and utilizing eCommerce and business process outsourcing to accelerate their business plans in a cost-effective manner and perform non-core business functions. Outsourcing can provide many key benefits, including the ability to:

Enter new business markets or geographic areas rapidly;

Increase flexibility to meet changing business conditions and demand for products and services;

Enhance customer satisfaction and gain competitive advantage;

Reduce capital and personnel investments and convert fixed investments to variable costs;

Improve operating performance and efficiency; and

Capitalize on skills, expertise and technology infrastructure that would otherwise be unavailable or expensive given the scale of the business.

Typically, many outsourcing service providers are focused on a single function, such as information technology, call center management, credit card processing, warehousing or package delivery. This focus creates several challenges for companies looking to outsource more than one of these functions, including the need to manage multiple outsourcing service providers, to share information with service providers and to integrate that information into their internal systems. Additionally, the delivery of these multiple services must be transparent to the customer and enable the client to maintain brand recognition and customer loyalty. Furthermore, traditional commerce outsourcers are frequently providers of domestic-only services versus international solutions. As a result, companies requiring global solutions must establish additional relationships with other outsourcing parties.

Another vital point for major brand name companies seeking to outsource is the protection of their brand. When looking for an outsourcing partner to provide infrastructure solutions, brand name companies must find a company that can ensure the same quality performance and superior experience their customers expect from their brands. Working with an outsourcing partner requires finding a partner that can maintain the consistency of their brand image, which is one of the most valuable intangible assets that recognized brand name companies possess.

Competition

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We face competition from many different sources depending upon the type and range of services requested by a potential client. Many other companies offer one or more of the same services we provide on an individual basis. Our competitors include vertical outsourcers, which are companies that offer a single function solution, such as call centers, public warehouses or credit card processors. We occasionally compete with transportation logistics providers, known in the industry as 3PL s and 4PL s (third or fourth party logistics providers), who offer product management functions as an ancillary service to their primary transportation services. We also compete against other eCommerce and business process outsourcing providers, who perform various services similar to our solution offerings.

In many instances, we compete with the in-house operations of our potential clients themselves. Occasionally, the operations departments of potential clients believe they can perform the same services we do, at similar quality levels and costs, while others are reluctant to outsource business functions that involve direct customer contact. We cannot be certain we will be able to compete successfully against these or other competitors in the future.

Table of Contents

Although many of our competitors offer one or more of our services, we believe our primary competitive advantage is our ability to offer a full array of customized services marketed as *PFSweb's End2End eCommerce*[®] solutions, thereby eliminating any need for our clients to coordinate these services from many different providers. We believe we can differentiate ourselves by offering our clients a very broad range of eCommerce and business process services that address, in many cases, the entire value chain, from demand to delivery.

We also compete on the basis of many other important additional factors, including:

operating performance and reliability;

ease of implementation and integration;

experience of the people required to successfully and efficiently design and implement solutions;

experience operating similar solutions dynamically;

leading edge technology capabilities;

global reach; and

price.

We believe we can compete favorably with respect to many of these factors. However, the market for our services is competitive and continually evolving, and we may not be able to compete successfully against current and future competitors.

COMPANY INFORMATION

Clients and Marketing

Our target clients include online retailers as well as leading technology and consumer goods brands looking to quickly and efficiently implement or enhance business initiatives, adapt their go-to-market strategies, or introduce new products or programs, without the burden of modifying or expanding their technology, customer care, supply chain and logistics infrastructure. Our solutions are applicable to a multitude of industries and company types and we have provided solutions for such companies as:

IPS (printer supplies in several geographic areas), Xerox (printers and printer supplies), Roots Canada Ltd. (apparel), Hawker Beechcraft Corp. (facilities management and time-definite logistics supporting parts distribution), Riverbed Technologies (technology products), LEGO Brand Retail (toys), Fifth and Pacific Cos, Inc (fashion apparel and accessories), Procter & Gamble (consumer packaged goods), AAFES (military exchange service), L'Oréal (health & beauty), Sorel (active outdoor apparel) among many others.

We target potential clients through an extensive integrated marketing program comprised of a variety of direct marketing techniques, email marketing initiatives, trade event participation, search engine marketing, public relations and a sophisticated outbound tele-sales lead generation model. We have also developed an intricate messaging matrix that defines our various eCommerce and business process outsourcing solutions and products, the vehicles we utilize to deliver marketing communication on these solutions/products and the target audience segments that display a demand for these solutions/products. This messaging matrix allows us to deploy highly targeted solution messages to selected key vertical industry segments where we feel we are able to provide significant service differentiation and value. We also pursue strategic marketing alliances with consulting firms, software manufacturers and other logistics providers to increase market awareness and generate referrals and customer leads.

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Because of the highly complex nature of the solutions we provide, our clients demand significant competence and experience from a variety of different business disciplines during the sales cycle. As such, we utilize a selected member of our senior executive team to lead the design and proposal development of each potential new client we choose to pursue. The senior executive is supported by a select group of highly experienced individuals from our professional services group with specific industry knowledge of, or experience with, the solutions development process. We employ a team of highly trained implementation managers whose responsibilities include the oversight and supervision of client projects and maintaining high levels of client satisfaction during the transition process between the various stages of the sales cycle and steady state operations.

Table of Contents

Technology

We maintain advanced management information systems and have automated key business functions using online, real-time or batch systems. These systems enable us to provide information concerning sales, inventory status, customer payments and other operations essential for us and our clients to efficiently manage electronic commerce and supply chain business programs. Our systems are designed to scale rapidly to handle the transaction processing demands of our clients and our growth.

We employ technology from a select group of vendors. For example, we deploy IBM e-servers and network printers in appropriate models to run web site functions as well as order management and distribution functions. Our network backbone is powered by Cisco, who provides network connectivity and network security solutions for our worldwide locations. We utilize Avaya Communication for telephone switch and call center management functions, and to interact with customers via voice, e-mail or chat. Avaya Communication technology also allows us to share web pages between customers and our service representatives. We have the ability to transmit and receive voice, data and video simultaneously on a single network connection to a customer to more effectively serve that customer for our client. Clients' interest in using this technology stems from its ability to allow shoppers to consult with known experts in a way the customer chooses prior to purchasing. Our sophisticated computer-telephony integration has been accomplished by combining systems software from IBM and Avaya Communication together with our own application development. We use Verizon Business for our private enterprise network and AT&T as our long distance carrier. We use Oracle's J.D. Edwards as the software provider for the primary ERP applications used in our operational areas and financial areas. We use Dematic/Rapistan Materials Handling Automation for our automated order selection, automated conveyor and pick-to-light (inventory retrieval) systems, and Symbol Technologies/Telxon for our warehouse radio frequency applications. Our Warehouse Management System (WMS) and Distribution Requirements Planning (DRP) system have been developed in-house to meet the varied unique requirements of our vertical markets. Both the WMS and DRP are tightly integrated to both the North American and European deployments of our J.D. Edwards' system.

Many internal infrastructures are not sufficient to support the explosive growth in e-business, e-marketplaces, supply chain compression, distribution channel realignment and the corresponding demand for real-time information necessary for strategic decision-making and product fulfillment. To address this need, we have created *PFSweb's End2End eCommerce*[®] platform to enable companies with little or no eCommerce infrastructure to speed their time to market and minimize resource investment and risk, and to allow all companies involved to improve the efficiency of their supply chain.

Using the various components of our collaboration technology suite, we can assist our clients in easily integrating their web sites or ERP systems to our systems for real-time web service enabled transaction processing without regard for their hardware platform or operating system. This high-level of systems integration allows our clients to automatically process orders, customer data and other eCommerce information. We also can track information sent to us by the client as it moves through our systems in the same manner a carrier would track a package throughout the delivery process. Our systems enable us to track, at a detailed level, information received, transmission timing, any errors or special processing required and information sent back to the client.

We provide technology interfaces to our back-office applications including our customized Oracle J.D. Edwards order management and fulfillment application. We utilize Gentrans Integration Suite (GIS) as our technology platform for Enterprise Application Integration with our clients and clients' trading partners. With GIS, we have greatly increased our ability to quickly design and deploy customized B2B and DTC eCommerce solutions for our clients by utilizing a robust business process modeling tool and a highly scalable operating infrastructure. This platform facilitates the efficient and secure exchange of electronic business transactions/documents in a wide variety of formats (i.e. XML, X.12 EDI, delimited text, IDOCS) and communication protocols (i.e. FTP/SFTP, AS2/HTTP/HTTPS, AS1 SMTP, MQ Series and SOA Web Services).

We have invested in advanced telecommunications, computer telephony, electronic mail and messaging, automated fax technology, IVR technology, barcode scanning, wireless technology, fiber optic network communications and automated inventory management systems. We have also developed and utilize telecommunications technology that provides for automatic customer call recognition and customer profile recall for inbound customer service representatives.

Table of Contents

The primary responsibility of our systems development team of IT professionals is directed at implementing custom solutions for new clients and maintaining existing client relationships. Our development team can also produce proprietary systems infrastructure to expand our capabilities in circumstances where we cannot purchase standard solutions from commercial providers. We also utilize temporary and/or contract resources when needed for additional capacity.

Our information technology operations and infrastructure are built on the premise of reliability and scalability. We maintain diesel generators and un-interruptible power supply equipment to provide constant availability to computer rooms, call centers and warehouses. Multiple internet service providers and redundant web servers provide for a high degree of availability to web sites that interface with our systems. Capacity planning and upgrading is performed regularly to allow for quick implementation of new clients and avoid time-consuming infrastructure upgrades that could slow growth rates. In the event of a disastrous situation, we also have a disaster recovery plan that provides geographically separated and comparably equipped data centers that are able to recover stored data in a reasonable and effective manner.

Strategy

We continue to maintain our simple but effective strategy statement to drive our actions, QGP. This acronym stands for Quality, Growth and Profit. We believe if we can achieve outstanding performance on these three basic elements, they will provide for a stable foundation for our future. As the evolution of our business model continues, we will remain focused on these three fundamentals:

Quality: To exceed our clients service level requirements and enhance the value of their brand while providing their customers a positive, memorable and efficient experience.

Growth: To increase our revenue and gross profit from its current levels. To aggressively market simplified product messages to drive new clients and revenue and profit growth. To become a larger company and create career and additional employment opportunities. To embrace strategic partnering to accentuate strengths and minimize weaknesses.

Profit: To generate positive cash flow and continue to strive for consistent profitable results. To increase the value of our company for all of its stakeholders while rewarding our team members with challenging, fun and memorable life experiences.

The successful balance of the execution of these fundamental strategies is targeted to result in the formation of a solid strategic and financial foundation and provide us a sustainable and profitable business model for the future.

See **Risk Factors** for a complete discussion of risk factors related to our ability to achieve our objectives and fulfill our business strategies.

Employees

As of December 31, 2011, we had approximately 1,400 employees, of which approximately 1,100 were located in the United States. We have never suffered an interruption of business as a result of a labor dispute. We consider our relationship with our employees to be good. In the U.S., Canada and Philippines, we are not a party to any collective bargaining agreements and while our European subsidiaries are not a party to a collective-bargaining agreement, they are required to comply with certain rules mentioned in collective bargaining agreements, agreed upon by representatives of their industry (logistics) and unions.

Our success in recruiting, hiring and training large numbers of skilled employees and obtaining large numbers of hourly employees during peak periods for distribution and call center operations is critical to our ability to provide high quality distribution and support services. Call center representatives and distribution personnel receive feedback on their performance on a regular basis and, as appropriate, are recognized for superior performance or

Table of Contents

given additional training. Generally, our clients provide specific product training for our customer service representatives and, in certain instances, on-site client personnel to provide specific technical support. To maintain good employee relations and to minimize employee turnover, we strive to offer competitive pay, hire primarily full-time employees who are eligible to receive a full range of employee benefits, and provide employees with clear, visible career paths.

Internet Access to Reports

We maintain an Internet website, www.pfsweb.com. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K (and amendments, if any, to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934) are made available, free of charge, through the investor relations section of this website as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. The information on this website is not incorporated in this report.

Government Regulation

We are subject to federal, state, local and foreign consumer protection laws, including laws protecting the privacy of our customers' personally identifiable information and other non-public information and regulations prohibiting unfair and deceptive trade practices. Furthermore, the growth and demand for online commerce has and may continue to result in more stringent consumer protection laws that impose additional compliance burdens and greater penalties on online companies. Moreover, there is a trend toward regulations requiring companies to provide consumers with greater information regarding, and greater control over, how their personal data is used, and requiring notification when unauthorized access to such data occurs. For example, many states currently require us to notify each of our customers who are affected by any data security breach in which an unauthorized person, such as a computer hacker, obtains such customer's name and one or more of the customer's social security number, driver's license number, credit or debit card number or other similar personal information. In addition, several jurisdictions, including foreign countries, have adopted privacy-related laws that restrict or prohibit unsolicited email promotions, commonly known as "spam," and that impose significant monetary and other penalties for violations. One such law, the CAN-SPAM Act of 2003 imposes complex, burdensome and often ambiguous requirements in connection with our sending commercial email to our customers and potential customers. Moreover, in an effort to comply with these laws, Internet service providers may increasingly block legitimate marketing emails. These consumer protection laws may become more stringent in the future and could result in substantial compliance costs and could interfere with the conduct of our business.

We collect sales or other similar taxes for shipments of goods in certain states. One or more local, state or foreign jurisdictions may seek to impose sales tax; (12,340) (7,166) (25,785) (14,727)

Interest, net

(8,555) (10,793) (18,130) (22,263)

Earnings before income taxes

\$219,043 \$214,791 \$387,296 \$399,694

- (1) Operating profit for each reportable segment and corporate expenses for both 2007 periods reflect the impact of restructuring charges, as

applicable. See
Note 13,
Restructuring,
for additional
information.

- (2) Smokeless
Tobacco
segment
operating profit
for the six
months ending
June 30, 2007
and 2006
includes
antitrust
litigation
charges of
\$122.1 million
and
\$1.4 million,
respectively.
See Note 14,
Contingencies,
for additional
information.

The Company's identifiable assets by reportable segment as of June 30, 2007 did not change significantly from amounts appearing in the December 31, 2006 Consolidated Segment Information (See the 2006 Form 10-K), with the exception of corporate assets which reflect an increase in cash and cash equivalents primarily related to the sale of the corporate headquarters building (See Note 8, Assets Held For Sale for further information).

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****8 ASSETS HELD FOR SALE**

The Company had \$1.8 million classified as assets held for sale at June 30, 2007, which consisted of the Company's corporate conference center located in Watch Hill, Rhode Island. As noted in the 2006 Form 10-K, this property initially met the criteria to be considered held for sale under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, at December 31, 2006. There have been no impairment charges recorded with respect to this property, as its net carrying value is lower than its estimated fair value less costs to sell. The Company currently anticipates that the sale of the Watch Hill conference center will occur later in 2007.

In January 2007, the Company sold a winery property located in the State of Washington for net proceeds of \$3.1 million, resulting in a pre-tax gain of \$2 million, which was recorded as a reduction to selling, advertising and administrative (SA&A) expenses in the Condensed Consolidated Statement of Operations. Prior to this transaction, the property was included within assets held for sale on the December 31, 2006 Consolidated Statement of Financial Position.

In March 2007, the Company finalized the sale of its corporate headquarters for cash proceeds of \$130 million, as well as a below-market, short-term lease with an imputed fair market value of approximately \$6.7 million. This sale resulted in a pre-tax gain of approximately \$105 million, which is reported on the gain on sale of corporate headquarters building line in the Condensed Consolidated Statement of Operations. Prior to this transaction, the property was included within assets held for sale on the December 31, 2006 Consolidated Statement of Financial Position.

In March 2006, the Company sold a winery property located in California with a carrying value of \$3.4 million for net proceeds of \$5.9 million, resulting in a pre-tax gain of \$2.5 million, which was recorded as a reduction to SA&A expenses in the Condensed Consolidated Statement of Operations.

9 NET EARNINGS PER SHARE

Basic earnings per share is computed by dividing net earnings by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share is computed by dividing net earnings by the weighted-average number of shares of common stock outstanding during the period, increased to include the number of shares of common stock that would have been outstanding had all potentially dilutive shares of common stock been issued. The dilutive effect of outstanding options, restricted stock and restricted stock units is reflected in diluted earnings per share by applying the treasury stock method under SFAS No. 128, *Earnings per Share*. Under the treasury stock method, an increase in the fair value of the Company's common stock can result in a greater dilutive effect from outstanding options, restricted stock and restricted stock units. Furthermore, the exercise of options and the vesting of restricted stock and restricted stock units can result in a greater dilutive effect on earnings per share than that recognized under the treasury stock method.

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

The following table presents the computation of basic and diluted net earnings per share:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Numerator:				
Net earnings	\$ 139,971	\$ 134,655	\$ 247,484	\$ 250,568
Denominator:				
Denominator for basic earnings per share				
weighted-average shares	159,557	160,791	159,762	161,194
Dilative effect of share-based awards	1,547	1,449	1,578	1,248
Denominator for diluted earnings per share	161,104	162,240	161,340	162,442
Basic earnings per share	\$ 0.88	\$ 0.84	\$ 1.55	\$ 1.55
Diluted earnings per share	\$ 0.87	\$ 0.83	\$ 1.53	\$ 1.54

Options to purchase approximately ten thousand and nine thousand shares of common stock outstanding as of June 30, 2007 and 2006, respectively, were not included in the computation of diluted earnings per share because their exercise prices were greater than the average market price of the Company's common stock and, therefore, were antidilutive.

10 COMPREHENSIVE INCOME

The components of comprehensive income for the Company are net earnings, foreign currency translation adjustments, the change in the fair value of derivatives designated as effective cash flow hedges and changes in deferred components of net periodic pension and other postretirement benefit costs. For the second quarter of 2007 and 2006, total comprehensive income, net of taxes, amounted to \$143.5 million and \$136.4 million, respectively. For the first six months of 2007 and 2006, total comprehensive income, net of taxes, amounted to \$250.9 million and \$252.8 million, respectively.

11 - PURCHASE COMMITMENTS

As of June 30, 2007, the Company had entered into unconditional purchase obligations in the form of contractual commitments. Unconditional purchase obligations are commitments that are either noncancelable or cancelable only under certain predefined conditions.

As of June 30, 2007, the Company has contractual obligations of approximately \$59.5 million for the purchase of leaf tobacco to be used in the production of moist smokeless tobacco products. In the first quarter of 2007, the Company completed \$15.3 million in leaf tobacco purchases related to all contracts outstanding at December 31, 2006. There are no contractual obligations to purchase leaf tobacco with terms beyond one year.

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Purchase commitments under contracts to purchase grapes for the periods beyond one year are subject to variability resulting from potential changes in market price indices. The following table presents a summary of the net change in the Company's future payment obligations since January 1, 2007, and the balance of such commitments at June 30, 2007, for the purchases and processing of grapes for use in the production of wine, based upon estimated yields and market conditions:

	2007	2008	2009	2010	2011	Thereafter	Total
Grape commitments							
January 1, 2007	\$ 66,805	\$ 65,605	\$ 65,776	\$ 63,193	\$ 59,047	\$ 125,011	\$ 445,437
Net increase	1,130	1,857	2,068	1,929	1,421	4,135	12,540
Grape commitments							
June 30, 2007	\$ 67,935	\$ 67,462	\$ 67,844	\$ 65,122	\$ 60,468	\$ 129,146	\$ 457,977

12 - DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company has hedged against the variability of forecasted interest payments attributable to changes in interest rates through the date of an anticipated debt issuance in 2009 via a forward starting interest rate swap. The forward starting interest rate swap has a notional amount of \$100 million and the terms call for the Company to receive interest quarterly at a variable rate equal to the London InterBank Offered Rate (LIBOR) and to pay interest semi-annually at a fixed rate of 5.715 percent. The fair value of the forward starting interest rate swap at June 30, 2007 was a net asset of \$0.6 million, based on a dealer quote, considering current market rates, and was included in other assets on the Condensed Consolidated Statement of Financial Position. Accumulated other comprehensive income at June 30, 2007 included the accumulated gain on the cash flow hedge (net of taxes) of \$0.4 million, which reflects the \$2.2 million and \$2.4 million of other comprehensive income recognized for the three and six months ended June 30, 2007, respectively, in connection with the change in fair value of the swap.

The Company has hedged the interest rate risk on its \$40 million aggregate principal amount of floating rate senior notes with a ten-year interest rate swap having a notional amount of \$40 million and quarterly settlement dates over the term of the contract. The Company pays a fixed rate of 7.25 percent and receives a floating rate of three-month LIBOR plus 90 basis points on the notional amount. The fair value of the swap at June 30, 2007 was a net liability of \$0.7 million, based on a dealer quote, considering current market conditions, and was included in other liabilities on the Condensed Consolidated Statement of Financial Position. Accumulated other comprehensive loss at June 30, 2007 included the accumulated loss on the cash flow hedge (net of taxes) of \$0.5 million, which reflects the \$0.7 million and \$0.2 million of other comprehensive income recognized for the three and six months ended June 30, 2007, respectively, in connection with the change in fair value of the swap.

13 - RESTRUCTURING

During the third quarter of 2006, the Company announced and commenced implementation of a cost-reduction initiative called Project Momentum, with targeted savings of at least \$100 million over its first three years. This initiative is designed to create additional resources for growth via operational productivity and efficiency enhancements. The Company believes that such an effort is prudent as it will provide additional financial flexibility in the increasingly competitive smokeless tobacco category. The Company has recently finalized plans on various other initiatives, primarily related to manufacturing operations and

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

procurement functions, expected to generate \$50 million in additional savings beyond the initial \$100 million of targeted savings. The incremental \$50 million of savings are expected to be realized in 2008 and 2009.

In connection with the continued implementation of Project Momentum, restructuring charges of \$3.9 million and \$7.4 million, related to the aforementioned \$100 million in savings, were recognized for the three and six months ended June 30, 2007, respectively, and are reported on the restructuring charges line in the Condensed Consolidated Statement of Operations. These charges were incurred in connection with the formal plans undertaken by management and are accounted for in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The recognition of restructuring charges involves the use of judgments and estimates regarding the nature, timing and amount of costs to be incurred under Project Momentum. While the Company believes that its estimates are appropriate and reasonable based upon the information available, actual results could differ from such estimates. The following table provides a summary of restructuring charges incurred for the three and six months ended June 30, 2007, as well as cumulative charges incurred to date and the total amount of charges expected to be incurred, in connection with Project Momentum, for each major type of cost associated with the initiative:

	Restructuring Charges Incurred for the Three Months Ended June 30, 2007	Restructuring Charges Incurred for the Six Months Ended June 30, 2007	Cumulative Charges Incurred as of June 30, 2007	Total Charges Expected to be Incurred ⁽¹⁾
One-time termination benefits	\$ 596	\$ 644	\$ 16,269	\$ 19,700-\$21,200
Contract termination costs	4	21	411	400 - 500
Other restructuring costs	3,308	6,763	12,745	13,400 - 13,800
Total	\$ 3,908	\$ 7,428	\$ 29,425	\$ 33,500-\$35,500

(1) The total cost of one-time termination benefits expected to be incurred under Project Momentum reflects the initiative's overall anticipated elimination of approximately 10 percent of the Company's salaried,

full-time positions across various functions and operations, primarily at the Company's corporate headquarters, as well as a reduction in the number of hourly positions within the manufacturing operations. The majority of the total restructuring costs expected to be incurred, related to the initial savings target of \$100 million, were recognized in 2006, with the remainder anticipated to be recognized in 2007, while the charges to be recognized in connection with the incremental \$50 million in savings are expected to be recognized through 2008, with the majority anticipated to be recorded in 2007. Total restructuring charges expected to be incurred related to the aforementioned

\$150 million in aggregate savings currently represent the Company's best estimates of the ranges of such charges, although there may be additional charges recognized as additional actions are identified and finalized.

One-time termination benefits relate to severance-related costs and outplacement services for employees terminated in connection with Project Momentum, as well as enhanced retirement benefits for qualified individuals. Contract termination costs relate to the termination of operating leases in conjunction with the consolidation and relocation of facilities. Other restructuring costs are mainly comprised of other costs directly related to the implementation of Project Momentum, primarily professional fees, as well as asset impairment charges.

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

The following table provides a summary of restructuring charges incurred for the three and six months ended June 30, 2007, as well as cumulative charges incurred to date and the total amount of charges expected to be incurred, in connection with Project Momentum, by reportable segment:

	Restructuring Charges Incurred for the Three Months Ended June 30, 2007	Restructuring Charges Incurred for the Six Months Ended June 30, 2007	Cumulative Charges Incurred as of June 30, 2007	Total Charges Expected to be Incurred
Smokeless Tobacco	\$ 3,253	\$ 6,486	\$ 26,028	\$ 29,000-\$30,700
Wine			322	400 - 500
All Other Operations			151	1,100 - 1,200
Total reportable segments	3,253	6,486	26,501	\$ 30,500-\$32,400
Corporate (unallocated)	655	942	2,924	3,000 - 3,100
Total	\$ 3,908	\$ 7,428	\$ 29,425	\$ 33,500-\$35,500

Accrued restructuring charges are included in the accounts payable and accrued expenses line on the Condensed Consolidated Statement of Financial Position. A reconciliation of the changes in the liability balance since December 31, 2006 is presented below.

	One-Time Termination Benefits	Contract Termination Costs	Other Costs	Total
Balance as of December 31, 2006	\$ 4,349	\$ 192	\$ 52	\$ 4,593
Add: restructuring charges incurred	644	21	6,763	7,428
Less: payments	(3,429)	(94)	(6,175)	(9,698)
Less: reclassified liabilities ⁽¹⁾	(11)		(588)	(599)
Balance as of June 30, 2007	\$ 1,553	\$ 119	\$ 52	\$ 1,724

⁽¹⁾ Represents liabilities associated with restructuring charges that have been recorded within other line items on the

Condensed
Consolidated
Statement of
Financial
Position at
June 30, 2007.
The \$11
thousand relates
to share-based
compensation,
which is
reflected in
additional
paid-in capital.
The \$0.6 million
relates to asset
impairment
charges which
were
reclassified as
reductions to the
respective asset
categories.

14 CONTINGENCIES

The Company has been named in certain health care cost reimbursement/third party recoupment/class action litigation against the major domestic cigarette companies and others seeking damages and other relief. The complaints in these cases on their face predominantly relate to the usage of cigarettes; within that context, certain complaints contain a few allegations relating specifically to smokeless tobacco products. These actions are in varying stages of pretrial activities. The Company believes these pending litigation matters will not result in any material liability for a number of reasons, including the fact that the Company has had only limited involvement with cigarettes and the Company's current percentage of total tobacco industry sales is relatively small. Prior to 1986, the Company manufactured some cigarette products which had a de minimis market share. From May 1, 1982 to August 1, 1994, the Company distributed a small volume of imported cigarettes and is indemnified against claims relating to those products.

Table of Contents

UST Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

Smokeless Tobacco Litigation

The Company is named in certain actions in West Virginia brought on behalf of individual plaintiffs against cigarette manufacturers, smokeless tobacco manufacturers, and other organizations seeking damages and other relief in connection with injuries allegedly sustained as a result of tobacco usage, including smokeless tobacco products. Included among the plaintiffs are three individuals alleging use of the Company's smokeless tobacco products and alleging the types of injuries claimed to be associated with the use of smokeless tobacco products. These individuals also allege the use of other tobacco products.

The Company is named in an action in Florida by an individual plaintiff against various smokeless tobacco manufacturers including the Company for personal injuries, including cancer, oral lesions, leukoplakia, gum loss and other injuries allegedly resulting from the use of the Company's smokeless tobacco products. The plaintiff also claims nicotine addiction and seeks unspecified compensatory damages and certain equitable and other relief, including, but not limited to, medical monitoring.

The Company has been named in an action in Connecticut brought by a plaintiff individually, as executrix and fiduciary of her deceased husband's estate and on behalf of their minor children for injuries, including squamous cell carcinoma of the tongue, allegedly sustained by decedent as a result of his use of the Company's smokeless tobacco products. The Complaint also alleges addiction to smokeless tobacco. The Complaint seeks compensatory and punitive damages in excess of \$15 thousand and other relief.

The Company believes, and has been so advised by counsel handling these cases, that it has a number of meritorious defenses to all such pending litigation. Except as to the Company's willingness to consider alternative solutions for resolving litigation issues, all such cases are, and will continue to be, vigorously defended. The Company believes that the ultimate outcome of such pending litigation will not have a material adverse effect on its consolidated financial results or its consolidated financial position, although if plaintiffs were to prevail, the effect of any judgment or settlement could have a material adverse impact on its consolidated financial results in the particular reporting period in which resolved and, depending on the size of any such judgment or settlement, a material adverse effect on its consolidated financial position. Notwithstanding the Company's assessment of the potential financial impact of these cases, the Company is not able to estimate with any certainty the amount of loss, if any, which would be associated with an adverse resolution.

Antitrust Litigation

Following a previous antitrust action brought against the Company by a competitor, Conwood Company L.P, the Company was named as a defendant in certain actions brought by indirect purchasers (consumers and retailers) in a number of jurisdictions. As indirect purchasers of the Company's smokeless tobacco products during various periods of time ranging from January 1990 to the date of certification or potential certification of the proposed class, plaintiffs in those actions allege, individually and on behalf of putative class members in a particular state or individually and on behalf of class members in the applicable states, that the Company has violated the antitrust laws, unfair and deceptive trade practices statutes and/or common law of those states. In connection with these actions, plaintiffs sought to recover compensatory and statutory damages in an amount not to exceed \$75 thousand per purported class member or per class member, and certain other relief. The indirect purchaser actions, as filed, were similar in all material respects.

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Prior to 2007, actions in all but four of the jurisdictions were resolved, either through court-approved settlements or dismissals, including a dismissal in the New Hampshire action that is currently on appeal by the plaintiffs. Pursuant to the settlements, adult consumers received coupons redeemable on future purchases of the Company's moist smokeless tobacco products, and the Company agreed to pay all related administrative costs and plaintiffs' attorneys' fees. In May 2007, the Company entered into a Memorandum of Understanding to resolve the California class action and a Settlement Agreement to resolve the Wisconsin class action. The Wisconsin Settlement Agreement has been preliminarily approved by the court. For additional details on the resolution of the Wisconsin class action, see Item 1. Legal Proceedings in Part II. In connection with the resolution of the Wisconsin and California class actions, the Company recorded a \$122.1 million pre-tax charge in the first quarter of 2007 related to the estimated costs to resolve these actions, subject to respective court approval. Approximately \$28.5 million of this charge relates to settlement of the Wisconsin action resulting from court-ordered mediation in April 2007. The charge reflects costs attributable to coupons that will be distributed to consumers, which will be redeemable on future purchases of the Company's moist smokeless tobacco products. Also reflected in the Wisconsin charge are plaintiffs' attorneys' fees and other administrative costs of the settlement. The remaining \$93.6 million of the first quarter 2007 charge relates to settlement of the California action in May 2007, as a result of court-ordered mediation. This charge brings the total recognized liability for the California action to \$96 million, which reflects the cost of cash payments to be made to the benefit of class members, as well as plaintiffs' attorneys' fees and other administrative costs of the settlement. The liability associated with the Company's estimated costs to resolve all indirect purchaser actions increased to approximately \$130.9 million at June 30, 2007, from \$12.9 million at December 31, 2006, primarily as a result of the charge recognized for the Wisconsin and California settlements, partially offset by actual coupon redemption and payments of administrative costs related to previous settlements.

To date, indirect purchaser actions in almost all of the jurisdictions have been resolved, including those subject to court approval, leaving two unresolved actions in the States of Pennsylvania and Massachusetts. In the Pennsylvania action, which is before a federal court in Pennsylvania, the Third Circuit Court of Appeals has accepted the Company's appeal of the trial court's denial of the Company's motion to dismiss the complaint. The Company continues to believe there is insufficient basis for plaintiffs' complaint. The Company also believes the facts and circumstances in the Massachusetts class action will continue to support its defenses. The Company believes, and has been so advised by counsel handling these actions, that it has meritorious defenses in this regard, and they are and will continue to be vigorously defended. The Company believes that the ultimate outcome of these actions will not have a material adverse effect on its consolidated financial results or its consolidated financial position, although if plaintiffs were to prevail, beyond the amounts accrued, the effect of any judgment or settlement could have a material adverse impact on its consolidated financial results in the particular reporting period in which resolved and, depending on the size of any such judgment or settlement, a material adverse effect on its consolidated financial position. Notwithstanding the Company's assessment of the financial impact of these actions, management is not able to estimate the amount of loss, if any, beyond the amounts accrued, which could be associated with an adverse resolution.

Also, two additional matters remain outstanding in connection with indirect purchaser actions.

Counsel for plaintiffs in the settlement of the Kansas and New York actions filed a motion for an additional amount of approximately \$8.5 million in attorneys' fees, expenses and costs, plus interest, beyond the

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

previously agreed-upon amounts already paid by the Company. An evidentiary hearing on plaintiffs' motion was held in April 2006. To date, the court has not ruled on the motion. The Company believes, and has been so advised by counsel handling this case, that it has meritorious defenses in this regard, and will continue to vigorously defend against this motion. As such, the Company has not recognized a liability for the additional amounts sought in this motion.

The Company has been served with a purported class action complaint filed in federal court in West Virginia, attempting to challenge certain aspects of a prior settlement approved by the Tennessee state court and seeking additional amounts purportedly consistent with subsequent settlements of similar actions, estimated by plaintiffs to be between \$8.9 million and \$214.2 million, as well as punitive damages and attorneys' fees. The Company believes, and has been so advised by counsel handling this case, that it has meritorious defenses in this regard, and will continue to vigorously defend against this complaint. As such, the Company has not recognized a liability for the additional amounts sought in this complaint.

The Company believes that the ultimate outcome of these two matters will not have a material adverse effect on its consolidated financial results or its consolidated financial position, although if plaintiffs were to prevail, the effect of an adverse resolution could have a material adverse impact on its consolidated financial results in the particular reporting period in which resolved and, depending on the size of any such resolution, a material adverse effect on its consolidated financial position. Notwithstanding the Company's assessment of the financial impact of these actions, management is not able to estimate the amount of loss, if any, which could be associated with an adverse resolution.

Other Litigation

The Company has been named in an action in California brought by the People of the State of California, in the name of the Attorney General of the State of California, alleging that the Company's sponsorship relating to the National Hot Rod Association violates various provisions of the Smokeless Tobacco Master Settlement Agreement (STMSA) and the related Consent Decree entered in connection with the STMSA (see Note 15, Other Matters for additional information regarding the STMSA). The complaint seeks declaratory and injunctive relief, unspecified monetary sanctions, attorneys' fees and costs, and a finding of civil contempt. In July 2007, the parties reached a non-binding agreement in principle to resolve this matter. In connection with such agreement, a charge was recognized during the second quarter of 2007. The proceedings have been stayed pending the parties' drafting and negotiation of a stipulation and final judgment. For additional details see Item 1. Legal Proceedings in Part II.

In the event the parties do not reach an agreement as to the terms of the stipulation and judgment referenced above, the foregoing case will continue to be vigorously defended. In this regard, the Company believes, and has been so advised by counsel handling the foregoing case, that it has a number of meritorious defenses.

15 - OTHER MATTERS

On October 22, 2004, the Fair and Equitable Tobacco Reform Act of 2004 (the Tobacco Reform Act) was enacted in connection with a comprehensive federal corporate reform and jobs creation bill. Under the Tobacco Reform Act, the Secretary of Agriculture imposes quarterly assessments on tobacco manufacturers and importers used to fund a trust to compensate tobacco quota farmers. The Company does not believe that the assessments imposed under the Tobacco Reform Act will have a material adverse impact on its

Table of Contents**UST Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

consolidated financial position, results of operations or cash flows in any reporting period. The Company recognized charges of approximately \$0.9 million and \$1.9 million for the three and six months ended June 30, 2007, respectively, and \$0.9 million and \$1.5 million for the three and six months ended June 30, 2006, respectively, associated with the assessments required by the Tobacco Reform Act.

In November 1998, the Company entered into the STMSA with the attorneys general of various states and U.S. territories to resolve the remaining health care cost reimbursement cases initiated against the Company. The STMSA required the Company to adopt various marketing and advertising restrictions and make payments potentially totaling \$100 million over a minimum of 10 years for programs to reduce youth usage of tobacco and combat youth substance abuse and for enforcement purposes. For the second quarter and six months ended June 30, 2007, total charges recorded by the Company in connection with the STMSA were \$4.6 million and \$9.2 million, respectively. Total charges recorded by the Company in connection with the STMSA for the second quarter and six months ended June 30, 2006 were \$4.2 million and \$8.4 million, respectively.

For further information on both items, refer to Part II, Item 8 Financial Statements and Supplementary Data Notes to the Consolidated Financial Statements Note 22, Other Matters, in the 2006 Form 10-K.

16 BORROWING ARRANGEMENTS

On June 29, 2007, the Company entered into a \$300 million, five-year revolving credit facility (the Credit Facility) which will primarily be used for general corporate purposes, including the support of commercial paper borrowings. The Company may elect to increase its borrowing capacity under the Credit Facility to \$500 million subject to certain terms. The Credit Facility replaces the Company's previous \$300 million, three-year revolving credit facility which was terminated on June 29, 2007, shortly before its July 9, 2007 contractual expiration. The Company did not have any borrowings under the Credit Facility at June 30, 2007.

Costs of approximately \$0.3 million associated with the establishment of the Credit Facility were capitalized and will be amortized over the applicable term. The Credit Facility requires the maintenance of a fixed charge coverage ratio, the payment of commitment and administrative fees and includes affirmative and negative covenants customary for facilities of this type. The commitment fee payable on the unused portion of the Credit Facility is determined based on an interest rate, within a range of rates, dependent upon the Company's senior unsecured debt rating. The commitment fee currently payable is 0.05 percent per annum.

17 SUBSEQUENT EVENTS

In July 2007, the Company executed an agreement to purchase Stag's Leap Wine Cellars (Stag's Leap) and its signature Napa Valley, CA vineyards for approximately \$185 million, subject to certain closing conditions. The purchase will be completed through one of the Company's consolidated subsidiaries, with a 15 percent minority interest to be held by Marchesi Antinori S.r.l.(Antinori), and is expected to close in September 2007.

Table of Contents

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of the Company's consolidated results of operations and financial condition should be read in conjunction with the condensed consolidated financial statements and notes to the condensed consolidated financial statements within this Form 10-Q, as well as the consolidated financial statements and notes thereto included in the 2006 Form 10-K. Herein, the Company makes forward-looking statements that involve risks, uncertainties and assumptions. Actual results may differ materially from those anticipated in those forward-looking statements as a result of various factors, including, but not limited to, those presented under "Cautionary Statement Regarding Forward-Looking Information" within Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). In addition, the Company has presented certain risk factors relevant to the Company's business included in Item 1A in Part I of the 2006 Form 10-K.

INTRODUCTION

MD&A is provided as a supplement to the accompanying consolidated financial statements and notes thereto, to assist individuals in their review of such statements. MD&A has been organized as follows:

OVERVIEW This section provides context for the remainder of MD&A, including a general description of the Company's overall business, its business segments and a high-level summary of Company-specific and industry-wide factors impacting its operations.

RESULTS OF OPERATIONS This section provides an analysis of the Company's results of operations for the three and six months ended June 30, 2007 and 2006. This section is organized using a layered approach, beginning with a discussion of consolidated results at a summary level, followed by more detailed discussions of business segment results and unallocated corporate items, including interest and income taxes.

OUTLOOK This section provides information regarding the Company's current expectations, mainly with regard to the remainder of the current fiscal year, and is organized to provide information by business segment and on a consolidated basis.

LIQUIDITY AND CAPITAL RESOURCES This section provides an analysis of the Company's financial condition, including cash flows for the three and six months ended June 30, 2007 and 2006 and any material updates to the Company's aggregate contractual obligations as of June 30, 2007.

NEW ACCOUNTING STANDARDS This section provides information regarding any newly issued accounting standards which have not yet been adopted by the Company.

OVERVIEW

BUSINESS

UST Inc. is a holding company for its wholly-owned subsidiaries: U.S. Smokeless Tobacco Company and International Wine & Spirits Ltd. Through its largest subsidiary, U.S. Smokeless Tobacco Company, the Company is a leading manufacturer and marketer of moist smokeless tobacco products including brands such as Copenhagen, Skoal, Red Seal, Husky and Rooster. Through International Wine & Spirits Ltd., the Company produces and markets premium wines sold nationally, via its Ste. Michelle Wine Estates subsidiary, under labels such as Chateau Ste. Michelle, Columbia Crest, Conn Creek, Villa Mt. Eden, Red Diamond, Distant Bay, 14 Hands and Erath. The Company also produces and markets sparkling wine under

Table of Contents

the Domaine Ste. Michelle label. In addition, the Company is the exclusive United States importer and distributor of the portfolio of wines produced by the Italian winemaker Antinori, which includes such labels as Tignanello, Solaia, Tormaresca, Montenisa and Haras de Pirque.

The Company conducts its business principally in the United States. The Company's operations are divided primarily into two reportable segments: Smokeless Tobacco and Wine. The Company's international smokeless tobacco operations, which are not significant, are reported as All Other Operations.

In the third quarter of 2006, the Company commenced implementation of a cost-reduction initiative called Project Momentum, with targeted savings of at least \$100 million over its first three years. The Company believes that such an effort is prudent from a long-term growth perspective, as it is designed to provide resources for additional financial flexibility, whether to address potential competitive challenges in the smokeless tobacco category, make further investments behind its brands or possibly increase net earnings. Operating income results in both the second quarter and six-month periods of 2007 include the positive contribution realized from this initiative, and the Company is confident that it is on track to realize the targeted savings, as planned. In addition, the Company has recently finalized plans on various other initiatives under Project Momentum, primarily related to manufacturing operations and the procurement function, which are expected to generate at least \$50 million in additional savings beyond the original target, resulting in a new savings target of at least \$150 million over the original three-year period. The majority of the incremental \$50 million in savings are expected to be realized in 2008 and 2009. See *Consolidated Results Restructuring Charges* within the *Results of Operations* section below for further information.

SMOKELESS TOBACCO SEGMENT**Category Growth**

The Company's primary objective in the Smokeless Tobacco segment is to continue to grow the moist smokeless tobacco category by building awareness and social acceptability of smokeless tobacco products among adults, primarily smokers, with a secondary objective of being competitive in every segment of the moist smokeless tobacco category. Over the past several years, industry trends have shown that some adult consumers in this category have migrated from premium brands to brands in the price-value and sub-price-value segments. As such, a key to the Company's future growth and profitability is attracting growing numbers of adult consumers, primarily smokers, to the moist smokeless tobacco category, as approximately every one percent of adult smokers who convert to moist smokeless tobacco represents a 7 percent to 8 percent increase in the category's adult consumer base, and consumer research indicates that the majority of new adult consumers enter the category in the premium segment.

In addition to advertising initiatives focused on category growth, the Company has utilized its direct mail marketing program to promote the discreetness and convenience of smokeless tobacco relative to cigarettes to over four million adult smokers. The direct mail program, which the Company believes has been successful over the past two years, continues in 2007. Also crucial to the success of the Smokeless Tobacco segment's category growth initiatives is product innovation, as evidenced by the contribution that new products have made to the Smokeless Tobacco segment's results over the past several years. The Company believes that its category growth efforts have contributed to the moist smokeless tobacco category's strong growth rates since their implementation.

Table of Contents**Premium Brand Loyalty**

While category growth remains the Company's priority, it has significantly increased its focus on efforts to increase adult consumer loyalty for its premium moist smokeless tobacco products. In connection with these efforts, during 2006 the Company implemented a plan under which it incurred significant incremental spending to stabilize premium net unit volume by strengthening premium brand loyalty. The premium brand loyalty plan is designed to deliver value to adult consumers through promotional spending and other price-focused initiatives implemented on a state-by-state basis. Based on sequential trend improvements in net unit volume for premium products throughout 2006 (with year-over-year growth in the second half of 2006), and with continued year-over-year growth in 2007, the Company believes the premium brand loyalty efforts have proven successful. As a result of this success and as a means to accelerate profitable net unit volume growth, during 2007 the Company is increasing spending above 2006 levels on such initiatives, and is now expecting year-over-year premium net unit volume growth of approximately 1.5 percent in 2007, as compared to the original target of 1 percent, excluding the impact of an extra billing day in the fourth quarter.

WINE SEGMENT

The Company's focus in the Wine segment is to become one of the premier fine wine companies in the world, to elevate Washington state wines to the quality and prestige of the top regions of the world, and to be known for superior products, innovation and customer focus. In order to achieve these goals, attention is directed towards traditional style wines in the super premium to luxury-priced categories. Recent achievements have been well aligned with these goals. According to ACNielsen, Ste. Michelle Wine Estates was the fastest growing top-10 winery in the U.S. during the first half of 2007, and in 2006 the Company's wines comprised 6.2 percent of total domestic 750ml units as compared to 5.9 percent in 2005. The alliance with Antinori, to become its exclusive United States importer and distributor, and the purchase of the Erath label and winery, both of which occurred in 2006, have broadened the Wine segment's position with respect to the two key wine regions represented by Antinori and Erath. The addition of the Italian wines positions the Wine segment as a leader in U.S. distribution of Tuscan wines, while the addition of Erath establishes the Company's Wine segment as one of the largest producers of Oregon Pinot Noir. The Company continued to be the category leader for Riesling in 2006; comprising 30 percent of the market based on ACNielsen data. Overall, the Wine segment maintained its strong leadership position in Washington State.

The Company remains focused on the continued expansion of its sales force and category management staff to further broaden the distribution of its wines in the domestic market, especially in certain account categories such as restaurants, wholesale chains and mass merchandisers. Sustained growth in the Wine segment will also be dependent on third party acclaim and ongoing category growth.

Consistent with the Company's focus on becoming one of the premier fine wine companies in the world, it has recently executed an agreement to purchase Stag's Leap Wine Cellars and its signature Napa Valley, CA vineyards for approximately \$185 million, subject to certain closing conditions. The purchase will be completed through one of the Company's consolidated subsidiaries, with a 15 percent minority interest to be held by Antinori. This acquisition, which is expected to close in September 2007, will provide additional prestige to the Wine segment's acclaimed portfolio and is expected to contribute to the segment's operating profit growth over the long-term, with a return that is expected to be more than double the Company's cost of capital.

Table of Contents**RESULTS OF OPERATIONS**

(In thousands, except per share amounts or where otherwise noted)

CONSOLIDATED RESULTS**Second Quarter of 2007 compared with the Second Quarter of 2006**

	Three Months Ended		Increase/	
	June 30,		(Decrease)	
	2007	2006	Amount	%
Net sales	\$ 491,254	\$ 472,900	\$ 18,354	3.9
Net earnings	139,971	134,655	5,316	3.9
Basic earnings per share	0.88	0.84	0.04	4.8
Diluted earnings per share	0.87	0.83	0.04	4.8
Restructuring charges	3,908		3,908	

Net Earnings

Consolidated net earnings increased in the second quarter of 2007, as compared to the second quarter of 2006, as a result of increased operating income, the impact of lower net interest expense and a lower effective tax rate. The Company reported operating income of \$227.6 million in the second quarter of 2007, representing 46.3 percent of consolidated net sales, compared to operating income of \$225.6 million, or 47.7 percent of consolidated net sales, in the second quarter of 2006. The increase in operating income was primarily due to the following:

Increased net sales in the Wine segment; and

Lower selling, advertising and administrative (SA&A) expenses in the Smokeless Tobacco segment, which can be attributed to Project Momentum.

These factors were partially offset by:

The impact of \$3.9 million in restructuring charges incurred in connection with Project Momentum (see *Restructuring Charges* section below), which adversely impacted the 2007 operating margin percentage by approximately 0.8 percentage points; and

Increased unallocated corporate expenses, primarily due to the amortization of imputed rent related to a below-market short-term lease the Company executed in connection with the sale of its corporate headquarters building and costs associated with a change in executive management, the aggregate amount of which adversely impacted the 2007 operating margin by 1 percentage point.

Basic and diluted earnings per share were \$0.88 and \$0.87, respectively, for the second quarter of 2007, representing a 4.8 percent increase from each of the corresponding comparative measures in 2006. Average basic shares outstanding were lower in the second quarter of 2007 than in the comparable prior year period, primarily as a result of share repurchases, partially offset by the exercise of stock options. Average diluted shares outstanding in the second quarter of 2007 were lower than those in the second quarter of 2006 due to the impact of share repurchases and a lower level of dilutive outstanding options, partially offset by the impact of a comparatively higher average stock price in 2007, which has the effect of increasing diluted shares outstanding.

Table of Contents**Net Sales**

	Three Months Ended June 30,		Increase/ (Decrease)	
	2007	2006	Amount	%
Net Sales by Segment:				
Smokeless Tobacco	\$ 399,018	\$ 399,110	\$ (92)	
Wine	79,519	62,000	17,519	28.3
All Other Operations	12,717	11,790	927	7.9
Consolidated Net Sales	\$ 491,254	\$ 472,900	\$ 18,354	3.9

The increase in consolidated net sales for the second quarter of 2007, as compared to the second quarter of 2006, was primarily due to the following:

Improved case volume for premium wine;

An increase in both premium and overall net unit volume for moist smokeless tobacco products; and,

Improved international results.

These factors were partially offset by:

Lower net revenue realization per unit in the Smokeless Tobacco segment, reflecting the impact of the premium brand loyalty plan.

Segment Net Sales as a Percentage of Consolidated Net Sales

Q2 2007

Q2 2006

* Smokeless
Tobacco

Table of Contents**Gross Margin**

	Three Months Ended		Increase/	
	June 30,		(Decrease)	
	2007	2006	Amount	%
Gross Margin by Segment:				
Smokeless Tobacco	\$ 329,487	\$ 330,384	\$ (897)	(0.3)
Wine	26,850	22,567	4,283	19.0
All Other Operations	8,068	7,535	533	7.1
Consolidated Gross Margin	\$ 364,405	\$ 360,486	\$ 3,919	1.1

The consolidated gross margin increase in the second quarter of 2007, as compared to the second quarter of 2006, was primarily due to higher net sales, partially offset by higher cost of products sold, in the Wine segment.

	June 30,		Increase/	
	2007	2006	(Decrease)	
Gross Margin as a % of Net Sales by Segment:				
Smokeless Tobacco	82.6%	82.8%	(0.2)	
Wine	33.8%	36.4%	(2.6)	
All Other Operations	63.4%	63.9%	(0.5)	
Consolidated	74.2%	76.2%	(2.0)	

The decline in the consolidated gross margin, as a percentage of net sales, was mainly due to the following:

Higher case volume for wine, which sells at lower margins than moist smokeless tobacco products;

Increased unit costs in the Wine segment; and,

Lower net revenue realization per unit in the Smokeless Tobacco segment.

Restructuring Charges

The Company recognized \$3.9 million in restructuring charges in the second quarter of 2007 in connection with the continued implementation of Project Momentum, the Company's previously announced cost-reduction initiative. This initiative is designed to create additional financial resources for growth via operational productivity and efficiency enhancements. The Company believes that such an effort is prudent as it is designed to provide additional flexibility in the increasingly competitive smokeless tobacco category. Refer to the *Restructuring Charges* section within the First Six Months of 2007 compared with the First Six Months of 2006 discussion below for additional information, including cumulative charges incurred to date and the total amount of charges expected to be incurred in connection with Project Momentum for each major type of cost associated with the initiative.

Table of Contents**First Six Months of 2007 compared with the First Six Months of 2006**

	Six Months Ended		Increase/ (Decrease)	
	June 30,		Amount	%
	2007	2006		
Net sales	\$938,272	\$906,541	\$ 31,731	3.5
Net earnings	247,484	250,568	(3,084)	(1.2)
Basic earnings per share	1.55	1.55		
Diluted earnings per share	1.53	1.54	(0.01)	(0.6)
Gain on sale of corp. HQ bldg	105,143		105,143	
Antitrust litigation	122,100	1,350	120,750	
Restructuring charges	7,428		7,428	

Net Earnings

Consolidated net earnings decreased in the first six months of 2007, as compared to the first six months of 2006, as a result of lower operating income, partially offset by the impact of a lower effective tax rate and lower net interest expense. The Company reported operating income of \$405.4 million in the first half of 2007, representing 43.2 percent of consolidated net sales, compared to operating income of \$422 million, or 46.5 percent of consolidated net sales, in the first half of 2006. The decrease in operating income was primarily due to the following:

An antitrust litigation charge of \$122.1 million representing the estimated costs associated with the resolution of indirect purchaser class actions in the States of Wisconsin and California, which adversely impacted the operating margin percentage by approximately 13 percentage points;

The impact of \$7.4 million in restructuring charges incurred in connection with Project Momentum (see *Restructuring Charges* section below), which adversely impacted the operating margin percentage by approximately 0.8 percentage points; and

Increased unallocated corporate expenses, primarily due to amortization charges for the below-market short-term lease on its current corporate headquarters building and costs associated with a change in executive management, the aggregate amount of which adversely impacted the operating margin by 1 percentage point.

These factors were partially offset by:

The impact of a \$105 million pre-tax gain recognized in connection with the sale of the Company's corporate headquarters building, which favorably impacted the operating margin percentage by 11.2 percentage points;

Increased net sales in both the Wine and Smokeless Tobacco segments; and,

Lower SA&A expenses in the Smokeless Tobacco segment, which can be traced to the impact of Project Momentum.

Basic earnings per share of \$1.55 for the first six months of 2007 was level with basic earnings per share reported for the first six months of 2006, while diluted earnings per share of \$1.53 for the first half of 2007 reflected a decrease of 0.6 percent from the corresponding comparative measure in 2006. Average basic shares outstanding were lower in the first six months of 2007 than in the comparable prior year period,

Table of Contents

primarily as a result of share repurchases, partially offset by the exercise of stock options. Average diluted shares outstanding in the first six months of 2007 were lower than those in the first six months of 2006 due to the impact of share repurchases and a lower level of dilutive outstanding options, partially offset by the impact of a comparatively higher average stock price in 2007, which effectively increases diluted shares outstanding.

Net Sales

	Six Months Ended June 30,		Increase/ (Decrease)	
	2007	2006	Amount	%
Net Sales by Segment:				
Smokeless Tobacco	\$ 766,451	\$ 765,388	\$ 1,063	0.1
Wine	148,295	118,309	29,986	25.3
All Other Operations	23,526	22,844	682	3.0
Consolidated Net Sales	\$ 938,272	\$ 906,541	\$ 31,731	3.5

The increase in consolidated net sales for the first half of 2007, as compared to the first half of 2006, was primarily due to the following:

Improved case volume for premium wine;

Net sales growth in the Smokeless Tobacco segment, reflecting an increase in both premium and overall net unit volume for moist smokeless tobacco products ; and,

Improved international results.

These factors were partially offset by:

Lower net revenue realization per unit in the Smokeless Tobacco segment.

Segment Net Sales as a Percentage of Consolidated Net Sales

Six Months Ended June 30, 2007

Six Months Ended June 30, 2006

* Smokeless
Tobacco

Table of Contents**Gross Margin**

	Six Months Ended		Increase/	
	June 30,		(Decrease)	
	2007	2006	Amount	%
Gross Margin by Segment:				
Smokeless Tobacco	\$ 629,939	\$ 632,019	\$ (2,080)	(0.3)
Wine	50,949	43,261	7,688	17.8
All Other Operations	14,882	14,637	245	1.7
Consolidated Gross Margin	\$ 695,770	\$ 689,917	\$ 5,853	0.8

The consolidated gross margin increase in the first six months of 2007, as compared to the first six months of 2006, was primarily due to higher net sales in the Wine and Smokeless Tobacco segments, partially offset by higher cost of products sold in both of these segments.

	Six Months Ended		Increase/
	June 30,		
	2007	2006	
Gross Margin as a % of Net Sales by Segment:			
Smokeless Tobacco	82.2%	82.6%	(0.4)
Wine	34.4%	36.6%	(2.2)
All Other Operations	63.3%	64.1%	(0.8)
Consolidated	74.2%	76.1%	(1.9)

The decline in the consolidated gross margin, as a percentage of net sales, was mainly due to the following:

Higher case volume for wine, which sells at lower margins than moist smokeless tobacco products;

Lower net revenue realization per unit in the Smokeless Tobacco segment; and,

Increased costs of products sold in the Smokeless Tobacco and Wine segments.

Restructuring Charges

The Company recognized \$7.4 million in restructuring charges in the first six months of 2007 related to actions undertaken in connection with Project Momentum. Under this initiative, the Company has now targeted at least \$150 million in savings to be realized within the three years following its implementation. The following table provides a summary of restructuring charges incurred during the second quarter and first six months of 2007, the cumulative charges incurred to date and the total amount of charges expected to be incurred in connection with this initiative for each major cost, by category:

Table of Contents

	Restructuring Charges Incurred for the Three Months Ended June 30, 2007	Restructuring Charges Incurred for the Six Months Ended June 30, 2007	Cumulative Charges Incurred as of June 30, 2007	Total Charges Expected to be Incurred ⁽¹⁾
One-time termination benefits	\$ 596	\$ 644	\$ 16,269	\$ 19,700 - \$21,200
Contract termination costs	4	21	411	400 - 500
Other restructuring costs	3,308	6,763	12,745	13,400 - 13,800
Total	\$ 3,908	\$ 7,428	\$ 29,425	\$ 33,500 - \$35,500

(1) The total cost of one-time termination benefits expected to be incurred under Project Momentum reflects the initiatives overall anticipated elimination of approximately 10 percent of the Company's salaried, full-time positions across various functions and operations, primarily at the Company's corporate headquarters, as well as a reduction in the number of hourly positions within the manufacturing

operations. The majority of the total one-time termination benefit costs expected to be incurred in connection with the initial savings target of \$100 million were recognized in 2006, with the remainder anticipated to be recognized in 2007, while the charges to be recognized in connection with the incremental \$50 million in savings are expected to be recognized through 2008, with the majority anticipated to be recorded in 2007. The majority of total contract termination costs expected to be incurred was recognized in 2006, with the remainder anticipated to be recognized in 2007. Approximately half of the total other restructuring charges expected to be incurred were recognized in 2006, with the

remainder expected to be recognized in 2007 and 2008. While the Company believes that its estimates of total restructuring charges expected to be incurred related to the aforementioned \$150 million in savings are appropriate and reasonable based upon the information available, actual results could differ from such estimates. Total restructuring charges expected to be incurred currently represent the Company's best estimates of the ranges of such charges; although there may be additional charges recognized as additional actions are identified and finalized. As any additional actions are approved and finalized and costs or charges are determined, the Company

will file a Form
8-K under
Item 2.05 or
report such
costs or charges
in its periodic
reports, as
appropriate.

One-time termination benefits relate to severance-related costs and outplacement services for employees terminated in connection with Project Momentum, as well as enhanced retirement benefits for qualified individuals. Contract termination costs relate to charges for the termination of operating leases incurred in conjunction with the consolidation and relocation of facilities. Other restructuring costs are mainly comprised of other costs directly related to the implementation of Project Momentum, primarily professional fees, along with asset impairment charges. Primarily all of the restructuring charges expected to be incurred will result in cash expenditures, although approximately \$4 million of such charges relate to pension enhancements offered to applicable employees, all of which will be paid directly from the respective pension plan's assets. As of June 30, 2007, the liability balance associated with restructuring charges amounted to \$1.7 million. Refer to Item 1, Financial Statements Notes to Condensed Consolidated Financial Statements Note 13, Restructuring, for further information regarding accrued restructuring charges.

Table of Contents**SMOKELESS TOBACCO SEGMENT****Second Quarter of 2007 compared with the Second Quarter of 2006**

	Three Months Ended June 30,		Increase/ (Decrease)	
	2007	2006	Amount	%
Net sales	\$399,018	\$399,110	\$ (92)	
Restructuring charges	3,253		3,253	
Operating profit	223,758	219,452	4,306	2.0

Net Sales

Smokeless Tobacco segment net sales in the second quarter of 2007 were flat as compared to the second quarter of 2006, as the favorable impact of an increase in both premium and overall net unit volume for moist smokeless tobacco products was offset by the following impact of the Company's price-focused initiatives:

An unfavorable shift in premium product mix, with lower net unit volume for straight stock premium products more than offset by an increase in net unit volume for value pack and promotional premium products;

An unfavorable shift in price-value product mix, with the increase in price-value net unit volume largely due to sales of value packs, which were introduced in the first quarter of 2007; and,

Increased sales incentives, primarily retail buydowns.

The Company believes that its price-focused initiatives, which relate primarily to its premium brand loyalty initiative, along with the impact of its continued category growth efforts aimed at converting adult smokers, continue to be successful in driving net unit volume growth for its moist smokeless tobacco products, particularly premium products.

Percentage of Smokeless Tobacco Segment Net Sales by Product Category**Q2 2007****Q2 2006**

* Moist smokeless tobacco products

** Includes dry snuff products and tobacco seeds

Table of Contents

Net sales results for both premium and price-value products include net can sales for standard products, which consist of straight stock, pre-pack promotional products, and beginning in the first quarter of 2007, value pack products. Prior to 2007, only premium standard products included value packs. Straight stock refers to single cans sold at wholesale list prices. Value packs, which were introduced to more effectively compete for and retain value-conscious adult consumers, are two-can packages sold year-round reflecting lower per-can wholesale list prices than wholesale list prices for straight stock single-can products. Pre-pack promotions refer to those products that are bundled and packaged in connection with a specific promotional pricing initiative for a limited period of time.

MSTP Net Unit Volume

	Three Months Ended June		Increase/(Decrease)	
	2007	30, 2006	Cans	%
Net Unit Volume (thousands of cans):				
Premium	144,065	141,978	2,087	1.5
Price Value	25,792	23,755	2,037	8.6
Total	169,857	165,733	4,124	2.5

Percentage of Total MSTP Net Unit Volume by Category Segment**Q2 2007****Q2 2006**

Overall net unit volume for moist smokeless tobacco products increased 2.5 percent in the second quarter of 2007, as compared to the similar 2006 period, reflecting the sixth consecutive quarter of overall year-over-year growth and the third consecutive quarter of growth in excess of 2 percent. The increases for premium and price-value products each accounted for roughly half of the overall volume increase, on an absolute can basis. The premium net unit volume growth of 1.5 percent in the second quarter of 2007 represents the fourth consecutive quarter of year-over-year premium net unit volume growth and was ahead of the Company's expectations.

Table of Contents

The Company continues to be encouraged by the recent trend improvement in net unit volume for premium products, specifically in the year-over-year comparisons seen in the past several quarters. The Company believes this improvement in premium net unit volume performance is attributable to the following factors:

Continued implementation of the Company's premium brand loyalty plan, which has narrowed the price gaps between premium and price-value products on a state-by-state basis, in varying degrees; and,

Continued spending on category growth initiatives.

Net unit volume for price-value products includes Red Seal, the Company's price-value product, and Husky, the Company's sub-price-value product. Net unit volume for Red Seal increased moderately in the second quarter of 2007, as compared to the second quarter of 2006. The Company has implemented price-focused initiatives related to Red Seal, which have returned the brand to net unit volume growth during 2007 after a disappointing performance in the latter half of 2006. Net unit volume for Husky increased significantly in the second quarter of 2007, as compared to the corresponding prior year period, which benefited from the 2007 introduction of value packs.

The Company remains committed to the development of new products and packaging that cover both core product launches and other possible innovations. During the first quarter of 2007, the Company launched Skoal Citrus Blend in two forms, Long Cut and Pouches. In the second quarter of 2007 the Company announced that it will be introducing an all-new-line of premium moist smokeless tobacco products known as Cope, which will be available in three long cut varieties. Cope is designed to make the Company's core brand, Copenhagen, more approachable for adult smokers and will be available at retail in mid-September 2007. Net can sales for the second quarter and first six months of 2007 included approximately 23.4 million cans and 44.4 million cans, respectively, of new products that were launched nationally within the last three years, representing 13.8 percent and 13.6 percent, respectively, of the Company's total moist smokeless tobacco net unit volume for the respective periods. These new products included:

Three varieties of Skoal Long Cut*

Three varieties of Skoal Pouches*

Skoal Bandits (new and improved)**

Copenhagen Long Cut Straight**

Two varieties of Husky Fine Cut

Various varieties of Husky Long Cut

* Includes Citrus Blend variety, which was introduced during 2007.

** Product introduced during 2006.

In connection with the Company's objective to grow the moist smokeless tobacco category by building awareness and improving the social acceptability of smokeless tobacco products among adult consumers, primarily smokers, the Company's premium portion pack products have demonstrated continued growth. Net unit volume for these portion pack products, which include Copenhagen and Skoal Pouches, as well as new and improved Skoal Bandits, increased significantly in the second quarter of 2007, as compared to the corresponding prior year period, and represented 9.4 percent of the Company's premium net unit volume.

The Company began limited marketing of a new product, Skoal Dry, in two lead markets in July 2006. In keeping with the objective to improve smokeless tobacco's social acceptability, this product, also aimed at converting adult smokers, is designed to be spit-free. The Company continues to evaluate the results of this initiative.

Table of Contents**Cost of Products Sold**

Costs of products sold for the second quarter of 2007 increased as compared to the corresponding period of 2006, as the favorable impact of reduced manufacturing costs resulting from Project Momentum initiatives were more than offset by the overall increased net unit volume of moist smokeless tobacco products, increased material costs and a charge related to the write-off of certain packaging material.

Gross Margin

	Three Months Ended		Increase/(Decrease)	
	June 30,		Amount	%
	2007	2006		
Gross Margin	\$329,487	\$330,384	\$(897)	(0.3)
Gross Margin as % of Net Sales	82.6%	82.8%		

Gross margin decreased slightly in the second quarter of 2007, compared to the second quarter of 2006, primarily as a result of the aforementioned increased material costs and packaging material inventory write-off. The gross margin, as a percentage of net sales, declined by 0.2 percentage points in the second quarter of 2007, as compared to the corresponding period of 2006, as a result of these factors and a shift in product mix, which reflected higher net unit volume for both premium and price-value value pack products and increased premium promotional net unit volume along with lower net unit volume for straight stock premium products.

SA&A Expenses

SA&A expenses decreased 7.6 percent in the second quarter of 2007 to \$102.5 million, compared to \$110.9 million in the second quarter of 2006, reflecting overall improvements in cost management as a result of Project Momentum and other favorable spending, specifically:

Lower salaries and related costs associated with certain positions eliminated in the restructuring;

Lower costs associated with fringe benefits;

Lower consulting fees;

Decreased print advertising costs;

Lower costs associated with retail shelving systems used to promote the moist smokeless tobacco category's products; and,

A decrease in other administrative expenses.

These decreases were partially offset by:

Higher direct marketing spending, primarily related to the Company's premium brand-building and category growth initiatives;

Higher legal-related costs; and,

Increased one-on-one marketing costs.

The Company's SA&A expenses include legal expenses, which incorporate, among other things, costs of administering and litigating product liability claims. For the quarters ended June 30, 2007 and 2006, outside legal fees and other internal and external costs incurred in connection with administering and litigating

Table of Contents

product liability claims were \$3.7 million and \$4.3 million, respectively. These costs reflect a number of factors, including the number of claims, and the legal and regulatory environments affecting the Company's products. The Company expects these factors to be the primary influence on its future costs of administering and litigating product liability claims. The Company does not expect these costs to increase significantly in the future; however, it is possible that adverse changes in the aforementioned factors could have a material adverse effect on such costs, as well as on results of operations and cash flows in the periods such costs are incurred.

Restructuring Charges

Smokeless Tobacco segment results for the three months ended, June 30, 2007, reflect \$3.2 million of the restructuring charges discussed in the Consolidated Results section above.

First Six Months of 2007 compared with the First Six Months of 2006

	Six Months Ended		Increase/ (Decrease)	%
	June 30,			
	2007	2006	Amount	
Net sales	\$766,451	\$765,388	\$ 1,063	0.1
Restructuring charges	6,486		6,486	
Antitrust litigation	122,100	1,350	120,750	
Operating profit	294,748	411,142	(116,394)	(28.3)

Net Sales

The increase in Smokeless Tobacco segment net sales in the first six months of 2007, as compared to the first six months of 2006, reflects the favorable impact of an increase in both premium and overall net unit volume for moist smokeless tobacco products, partially offset by the following impact of the Company's price-focused initiatives:

An unfavorable shift in premium product mix, with lower net unit volume for straight stock premium products more than offset by an increase in net unit volume for value pack and promotional premium products;

An unfavorable shift in price-value product mix, with the increase in price-value net unit volume largely due to volume for price-value value pack products; and,

Increased sales incentives, primarily retail buydowns.

As noted in the discussion of quarterly results above, the Company believes that its price-focused initiatives continue to be successful in driving net unit volume growth for its moist smokeless tobacco products, particularly premium products. The Company also believes that the success is further illustrated by the achievement of net sales growth despite escalating gasoline prices during the first half of 2007 and the comparative impact of the initial implementation of the premium loyalty initiative in the first half of 2006. The Company believes that can sales of its smokeless tobacco products, primarily premium products, can be affected by fluctuations in gasoline prices. The impact of such fluctuations may be exacerbated due to the fact that a significant portion of the Company's net unit volume is sold at outlets that also sell gasoline.

Table of Contents**Percentage of Smokeless Tobacco Segment Net Sales by Product Category****Six Months Ended June 30, 2007****Six Months Ended June 30, 2006**

* Moist smokeless tobacco products

** Includes dry snuff products and tobacco seeds

MSTP Net Unit Volume

	Six Months Ended June,		Increase/(Decrease)	
	2007	2006	Cans	%
Net Unit Volume (thousands of cans):				
Premium	275,909	271,962	3,947	1.5
Price Value	49,141	45,460	3,681	8.1
Total	325,050	317,422	7,628	2.4

Percentage of Total MSTP Net Unit Volume by Category Segment**Six Months Ended June 30, 2007****Six Months Ended June 30, 2006**

The increases in overall and premium net unit volume for moist smokeless tobacco products of 2.4 percent and 1.5 percent, respectively, in the first six months of 2007, as compared to the similar 2006 period, reflect the positive impact of the continued implementation of the Company's premium brand loyalty initiative, as well as continued spending on category growth initiatives. The net unit volume increase of 8.1 percent for price-value products in the first six months of 2007, as compared to the first six months of 2006, was mainly driven by substantially higher net unit volume for Husky, with a moderate increase for Red Seal.

Table of Contents

The following provides information from the Company's Retail Account Data Share & Volume Tracking System (RAD-SVT) for the 26-week period ending June 16, 2007, as provided by Management Science Associates, Inc., which measures shipments from wholesale to retail.

	Can-Volume % Change from Prior Year Period	% Share		Percentage Point Increase/(Decrease) from Prior Year Period
Total Category Data:				
Total Moist Smokeless Category	7.2%	N/A		N/A
Total Premium Segment	1.4%	56.5%	*	(3.2)
Total Value Segments	15.8%	43.4%	*	3.2
Company Data:				
Total Moist Smokeless Category	3.2%	61.2%		(2.4)
Total Premium Segment	2.1%	91.0%		0.6
Total Value Segments	9.6%	22.6%		(1.3)

* Amounts reported do not add to 100 percent, as this table does not reflect the herbal segment of the total moist smokeless category.

The Company believes that a useful measurement of the Company's premium brand loyalty initiative is the number of states for which premium net unit volume is growing. According to RAD-SVT data utilized during the planning stages in late 2005, premium net unit volume was growing in 20 states, representing approximately 25 percent of the Company's overall premium net unit volume. During the most recent 26-week period ended June 16, 2007, these statistics improved to 36 states for which premium net unit volume was growing, representing approximately 74 percent of the Company's overall premium net unit volume.

In addition, there has been a favorable ancillary benefit from the Company's premium brand loyalty initiative on category share trends. As reflected in the table above, the Company's share of the moist smokeless tobacco category during the most recent 26-week RAD-SVT period was 61.2 percent, which was effectively flat versus the 61.3 percent share for the 26-week period ended February 24, 2007, reported in the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2007. Furthermore, the Company's share of the category has been essentially stable on a sequential 4-week period basis since October 2006. While some additional category share loss is expected going forward, the Company is encouraged by this recent trend improvement.

RAD-SVT information is provided as an indication of current domestic moist smokeless tobacco trends from wholesale to retail and is not intended as a basis for measuring the Company's financial performance. This information can vary significantly from the Company's actual results due to the fact that the Company reports net shipments to wholesale, while RAD-SVT measures shipments from wholesale to retail. In addition, differences in the time periods

measured, as well as differences as a result of new product introductions and promotions, affect comparisons of the Company's actual results to those from RAD-SVT. The Company believes the difference in trend between RAD-SVT and its own net shipments is due to such factors. Furthermore, Management Science Associates, Inc. periodically reviews and adjusts RAD-SVT information, in order to improve the overall accuracy of the information for comparative and analytical purposes, by incorporating refinements to the extrapolation methodology used to project data from a statistically

Table of Contents

representative sample. Adjustments are typically made for static store counts and new reporting customers.

Cost of Products Sold

Costs of products sold for the first six months of 2007 increased as compared to the first six months of 2006, as the impact of increased net unit volume for moist smokeless tobacco products, higher material costs and a charge related to the write-off of packaging material, were partially offset by the favorable impact of reduced manufacturing costs resulting from Project Momentum initiatives.

Gross Margin

	Six Months Ended		Increase/(Decrease)	
	June 30,		Amount	%
	2007	2006		
Gross Margin	\$629,939	\$632,019	\$(2,080)	(0.3)
Gross Margin as % of Net Sales	82.2%	82.6%		

Gross margin decreased slightly in the first six months of 2007, compared to the first six months of 2006, primarily as a result of the aforementioned cost of products sold variance, partially offset by higher net sales. The gross margin, as a percentage of net sales, declined by 0.4 percentage points in the first six months of 2007, as compared to the corresponding period of 2006, as a result of these factors and a shift in product mix, which included higher net unit volume for both premium and price-value value pack products and increased premium promotional net unit volume, along with lower net unit volume for straight stock premium products.

SA&A Expenses

SA&A expenses decreased 5.9 percent in the first six months of 2007 to \$206.6 million, compared to \$219.5 million in the first six months of 2006, reflecting overall improvements in cost management as a result of Project Momentum and other favorable spending, specifically:

Lower salaries and related costs associated with certain positions eliminated in the restructuring;

Lower costs associated with fringe benefits;

Lower consulting fees;

Lower costs associated with retail shelving systems used to promote the moist smokeless tobacco category's products;

A decrease in costs associated with samples, due to a decline in sample shipments; and,

A decrease in other administrative expenses.

These decreases were partially offset by:

Higher legal-related costs;

Increased direct marketing spending, primarily related to the Company's premium brand-building and category growth initiatives; and,

Increased one-on-one marketing costs.

For the six months ended June 30, 2007 and 2006, outside legal fees and other internal and external costs incurred in connection with administering and litigating product liability claims, which are reflected within

Table of Contents

the segment's SA&A expenses, were \$7 million and \$7.1 million, respectively.

Antitrust Litigation

The first six months of 2007 reflect the impact of a \$122.1 million pre-tax charge the Company recognized in the first quarter, representing the estimated costs in connection with the resolution of the Company's two significant remaining indirect purchaser class actions. This charge is comprised of the following:

A \$93.6 million pre-tax charge related to a May 2007 settlement, subject to court approval, reached in the State of California action as a result of court-ordered mediation. This charge brings the total recognized liability for the California action to \$96 million, which reflects the cost of cash payments to be made to the benefit of class members, as well as plaintiffs' attorneys' fees and other administrative costs of the settlement.

A \$28.5 million charge related to a settlement, subject to court approval, reached in the State of Wisconsin action during a court-ordered mediation session that was held in April 2007. This charge reflects costs attributable to coupons, which will be distributed to consumers, and will be redeemable, over the next several years, on future purchases of the Company's moist smokeless tobacco products. Also reflected in this charge are plaintiffs' attorneys' fees and other administrative costs of the settlement.

In the first six months of 2006, the Company recorded a \$1.4 million pre-tax charge reflecting a change in the estimated redemption rate for coupons in conjunction with the resolution of certain states' indirect purchaser antitrust actions (see Item 1, Notes to Condensed Consolidated Financial Statements Note 14, Contingencies, for additional details regarding the Company's antitrust litigation).

Restructuring Charges

Smokeless Tobacco segment results for the six months ended, June 30, 2007, reflect \$6.5 million of the restructuring charges discussed in the Consolidated Results section above.

Table of Contents**WINE SEGMENT****Second Quarter of 2007 compared with the Second Quarter of 2006**

	Three Months Ended		Increase/ (Decrease)	
	June 30,		Amount	%
	2007	2006		
Net sales	\$79,519	\$62,000	17,519	28.3
Operating profit	11,235	9,387	1,848	19.7

Net Sales

The increase in Wine segment net sales for the second quarter of 2007, as compared to the corresponding 2006 period, was primarily due to a 19.5 percent increase in premium case volume. These favorable net sales results reflect the following factors:

The incremental revenue contributed by the Antinori and Erath labels, which were added to the Company's portfolio in the second half of 2006;

The broadening of the distribution of the Company's wines as a direct result of the Company's continued efforts to increase distribution through the expansion of its sales force; and,

The impact of favorable third party acclaim and product ratings.

Case Volume**Percentage of Total Case Volume by Brand****Q2 2007****Q2 2006**

Chateau Ste. Michelle and Columbia Crest, the Company's two leading wine brands, accounted for 71 percent of total premium case volume in the second quarter of 2007, as compared to 75.9 percent in the corresponding 2006 period. The decline from 2006 to 2007 reflects a percentage increase in all other wine case volume, which was driven by the addition of the Antinori and Erath brands in the 2007 period. Case volume for Chateau Ste. Michelle continued to be strong in the second quarter of 2007, increasing 14.1 percent as compared to the second quarter of 2006, with the increase primarily due to higher case volume for white varietals. Case volume for Columbia Crest increased 9.7 percent in the second quarter of 2007, as

Table of Contents

compared to the corresponding 2006 period, primarily due to increased case volume for Grand Estates Merlot and the Two Vines red varietals. Overall case volume for 2007 was also favorably impacted by the addition of Antinori and Erath, with volume from these brands accounting for approximately 8.9 percentage points of the overall 19.5 percent case volume increase. Case volume for Red Diamond and 14 Hands, two of the Company's newer labels, also contributed to the increase in case volume for the second quarter of 2007, while sales of Domaine Ste. Michelle were lower.

Cost of Products Sold

Segment cost of products sold in the second quarter of 2007 increased 33.6 percent from the same prior year period, which was primarily attributable to the costs associated with Antinori products, as well as overall increased case volume and the impact of higher costs per case.

Gross Margin

	Three Months Ended		Increase/(Decrease)	
	June 30,		Amount	%
	2007	2006		
Gross Margin	\$26,850	\$22,567	\$4,283	19.0
Gross Margin as % of Net Sales	33.8%	36.4%		

The increase in gross margin in the second quarter of 2007, versus the second quarter of 2006, was due to the increase in net sales, partially offset by the increased cost per case in the second quarter of 2007. The decrease in gross margin, as a percentage of net sales, was mainly due to the increased case costs and case sales associated with the distribution of Antinori brands, which generate a lower gross margin than varietals produced by the Company.

SA&A Expenses

SA&A expenses of \$15.6 million in the second quarter of 2007 were 18.5 percent higher than the \$13.2 million of such expenses recognized in the corresponding prior year period, reflecting the following:

Higher salaries and related costs, due to the sales force expansion associated with broadening the distribution of the Company's wines throughout the domestic market; and,

Higher advertising and promotional expenses, as the prior year reflected the favorable impact of a cooperative arrangement for advertising and promotional expenses related to the distribution of Antinori wines.

These increases were partially offset by:

Lower advertising production costs for Chateau Ste. Michelle; and,

Lower legal costs and consulting fees.

Table of Contents**First Six Months of 2007 compared with the First Six Months of 2006**

	Six Months Ended		Increase/ (Decrease)	
	June 30,			
	2007	2006	Amount	%
Net sales	\$ 148,295	\$ 118,309	29,986	25.3
Operating profit	22,379	17,923	4,456	24.9

Net Sales

The increase in Wine segment net sales for the first six months of 2007, as compared to the first six months of 2006, was primarily due to a 17 percent increase in premium case volume. These favorable net sales results reflect the following factors:

The incremental impact of the Antinori and Erath labels;

Expanded distribution of the Company's wines; and,

Favorable third party acclaim and product ratings.

Case Volume**Percentage of Total Case Volume by Brand****Six Months Ended June 30, 2007****Six Months Ended June 30, 2006**

Chateau Ste. Michelle and Columbia Crest accounted for 70.8 percent of total premium case volume in the first six months of 2007, as compared to 75.5 percent for the corresponding 2006 period. As seen in the second quarter, this shift is primarily due to the impact of case volume for the Antinori and Erath labels. Case volume for Chateau Ste. Michelle increased 12.9 percent in the first half of 2007, as compared to the corresponding 2006 period, with the increase primarily due to higher case volume for white varietals, particularly Riesling and Chardonnay, and to a lesser extent, the Cabernet Sauvignon red varietal. Case volume for Columbia Crest increased 7 percent in the first half of 2007, versus the first half of 2006, primarily due to increased case volume for the Two Vines and Grand Estates red varietals. Case volume for the Antinori and Erath brands accounted for approximately 7.3 percentage points of the Wine segment's overall 17 percent case volume increase. Case volume for Red Diamond and 14 Hands also contributed to the increase in case volume in the first half of 2007.

Table of Contents**Cost of Products Sold**

Segment cost of products sold in the first six months of 2007 increased 29.7 percent from the same prior year period, which was primarily attributable to the costs associated with Antinori products, as well as overall increased case volume and the impact of higher costs per case.

Gross Margin

	Six Months Ended		Increase/(Decrease)	
	June 30,		Amount	%
	2007	2006		
Gross Margin	\$ 50,949	\$ 43,261	\$ 7,688	17.8
Gross Margin as % of Net Sales	34.4%	36.6%		

The increase in gross margin in the first six months of 2007, versus the first six months of 2006, was due to the increase in net sales, partially offset by the increased cost per case. The decrease in gross margin, as a percentage of net sales, was mainly due to the additional case costs and case sales associated with the distribution of Antinori brands, which generate a lower gross margin than varietals produced by the Company.

SA&A Expenses

SA&A expenses of \$28.6 million in the first six months of 2007 were 12.8 percent higher than the \$25.3 million of such expenses recognized in the corresponding prior year period, reflecting the following:

Higher salaries and related costs, due to the continued expansion of the sales force;

Higher advertising and promotional expenses, as the prior year reflected the favorable impact of the cooperative advertising and promotional arrangement for Antinori wines;

Increased print advertising expenses; and,

A lower pre-tax gain associated with the sale of non-strategic winery properties, as the current year reflects a \$2 million pre-tax gain related to the sale of a property located in Washington, as compared to a \$2.5 million pre-tax gain reflected in the prior year related to the sale of a property located in California.

These increases were partially offset by:

Lower point-of-sale advertising expenses, primarily due to timing; and,

Lower legal costs and consulting fees.

Table of Contents**ALL OTHER OPERATIONS****Second Quarter of 2007 compared with the Second Quarter of 2006**

	Three Months Ended		Increase/	
	June 30,		(Decrease)	
	2007	2006	Amount	%
Net sales	\$12,717	\$11,790	\$ 927	7.9
Operating profit	4,945	3,911	1,034	26.4

Net sales for All Other Operations increased in the second quarter of 2007, as compared to the corresponding period of 2006, primarily due to higher net unit volume for moist smokeless tobacco products sold by the Company's international operations, as well as the favorable impact of foreign exchange rates. Gross margin, as a percentage of net sales, decreased in the second quarter of 2007 to 63.4 percent, from 63.9 percent in 2006, primarily due to higher unit costs. Operating profit for All Other Operations represented 38.9 percent of net sales in the second quarter of 2007, as compared to 33.2 percent in the second quarter of 2006. The increase in operating profit and operating margin was primarily due to the aforementioned increase in net sales, as well as lower SA&A expenses.

First Six Months of 2007 compared with the First Six Months of 2006

	Six Months Ended		Increase/	
	June 30,		(Decrease)	
	2007	2006	Amount	%
Net sales	\$23,526	\$22,844	\$ 682	3.0
Operating profit	8,941	7,619	1,322	17.4

In the first six months of 2007, net sales for All Other Operations increased, as compared to the first six months of 2006, as higher net sales attributable to higher net unit volume for moist smokeless tobacco products sold by the Company's international operations in Canada was partially offset by the impact of a decline in net unit volume in the Company's other international markets. Net sales for the first six months of 2007 also benefited from a favorable exchange rate. The gross margin percentage decreased in the first six months of 2007 to 63.3 percent, from 64.1 percent in the similar 2006 period, primarily due to higher unit costs. Operating profit for All Other Operations represented 38 percent of net sales in the first six months of 2007, as compared to 33.4 percent in the first six months of 2006. Lower SA&A expenses were the main driver of the increases in both operating profit and operating margin during the period.

Table of Contents

UNALLOCATED CORPORATE

Second Quarter of 2007 compared with the Second Quarter of 2006

Administrative Expenses

Unallocated corporate administrative expenses increased 63.1 percent to \$11.7 million in the second quarter of 2007, as compared to \$7.2 million in the second quarter of 2006, reflecting the following:

An unfavorable variance due to a share-based compensation charge associated with a change in executive management, which accounted for 18.9 percentage points of the overall increase; and,

The amortization of imputed rent related to the below-market short-term lease associated with the Company's relocation of its corporate headquarters, which accounted for 40.3 percentage points of the overall increase.

Restructuring Charges

Unallocated restructuring charges incurred in connection with Project Momentum amounted to \$0.7 million in the second quarter of 2007. The unallocated restructuring charges consisted of one-time termination benefit charges, as well as professional fees directly related to the implementation of Project Momentum.

Interest Expense

Net interest expense decreased \$2.2 million, or 20.7 percent, in the second quarter of 2007, as compared to the second quarter of 2006, primarily due to higher income from cash equivalent and short-term investments, which resulted from higher average levels of investments and higher interest rates in the current year.

Income Tax Expense

The Company recorded income tax expense of \$79.1 million in the second quarter of 2007 compared to \$80.1 million in the second quarter of 2006. The Company's effective tax rate was 36.1 percent in the second quarter of 2007, compared to 37.3 percent in the corresponding 2006 period. The decrease in the effective tax rate for the second quarter of 2007 was primarily due to the scheduled statutory increase in 2007 for the deduction available for qualified domestic production activities.

First Six Months of 2007 compared with the First Six Months of 2006

Administrative Expenses

Unallocated corporate administrative expenses increased 68.7 percent to \$24.8 million in the first six months of 2007, as compared to \$14.7 million in the first six months of 2006, reflecting the following:

Charges of \$6 million associated with a change in executive management, which accounted for more than half of the overall increase;

The amortization of imputed rent for the below-market short-term headquarters lease, which accounted for 26.1 percentage points of the overall increase; and,

Higher legal expenses.

Table of Contents

Restructuring Charges

Unallocated restructuring charges incurred in connection with Project Momentum amounted to approximately \$1 million in the first six months of 2007. The unallocated restructuring charges consisted of one-time termination benefit charges, as well as professional fees directly related to the implementation of Project Momentum.

Interest Expense

Net interest expense decreased \$4.1 million, or 18.6 percent, in the first six months of 2007, as compared to the first six months of 2006, primarily due to higher income from cash equivalent and short-term investments, which resulted from higher average levels of investments and higher interest rates.

Income Tax Expense

The Company recorded income tax expense of \$139.8 million in the first six months of 2007 compared to \$149.1 million in the first six months of 2006. Income tax expense in the first half of 2007 reflects the impact of antitrust litigation charges, as well as the gain recognized in connection with the sale of the Company's corporate headquarters building. The Company's effective tax rate was 36.1 percent in the first half of 2007, compared to 37.3 percent in the first half of 2006. The decrease in the effective tax rate for the first six months of 2007, as compared to the corresponding period of 2006, was primarily due to the scheduled statutory increase in 2007 for the deduction available for qualified domestic production activities.

OUTLOOK

SMOKELESS TOBACCO SEGMENT

Category Growth

The Company remains committed to its category growth initiatives, which continue to be successful, demonstrated by a continued strong growth rate through the first half of 2007, according to RAD-SVT data. According to data from ACNielsen, moist smokeless tobacco is one of the fastest growing consumer packaged goods categories at retail. In addition, consumer research indicates in 2006, the number of new adult consumers entering the moist smokeless tobacco category continued to increase, bringing the total adult consumer base to over 6 million from 4.7 million in 2001, a majority of which entered in the premium segment. In light of the success of the Company's category growth initiatives achieved to date, as well as the favorable impact to the category from the Company's premium brand loyalty initiative (discussed further below), going forward the Company expects that these initiatives will continue to expand the adult consumer base and attract new adult consumers, primarily smokers, to the category and to premium brands. The Company will continue to utilize its direct mail marketing program to promote the discreetness and convenience of smokeless tobacco relative to cigarettes to adult smokers, as well as product innovation, which the Company believes have both contributed to category growth in the last few years. The Company expects category growth to remain strong; however, the Company believes that it is likely to moderate somewhat from the 7.2 percent increase seen in the most recent 26-week RAD-SVT period as 2007 comparisons begin to lap the accelerated growth that was experienced in the second half of 2006. As such, the Company continues to expect category growth in the range of 5 percent to 6 percent in 2007.

Table of Contents**Premium Brand Loyalty**

As the Company has previously communicated, it is expanding upon its premium brand loyalty initiative during 2007, with a focus on growth of underlying premium net unit volume, and, as demonstrated by the results for the first six months of 2007, both volume trends and category share performance have improved. The Company expects to see moderated category share loss over the remainder of 2007, which, when coupled with the aforementioned slight decline in anticipated category growth rates, should enable it to deliver solid premium volume growth for the year. With respect to premium net unit volume, the Company expects to benefit from the presence of an extra billing day in the fourth quarter of 2007. Given the Company's strong first half 2007 premium net unit volume trends, its shipment and share trends and continued strong moist smokeless tobacco category growth, the Company is now anticipating premium net unit volume growth of approximately 1.5 percent for the year, as compared to the original target of 1 percent, excluding the impact of the extra billing day.

State Excise Taxes

The Company intends to continue its efforts to promote tax equity in the 38 states that currently impose excise taxes on smokeless tobacco products expressed as a percentage of the wholesale price (ad valorem) rather than on the basis of weight. During the second quarter of 2007 one additional state, Delaware, passed legislation to convert to a tax based on weight, bringing the total number of tax equity states to 12, along with the federal government. This marks the second state to convert to a weight-based tax during 2007 and the fifth state to convert during the last year. The Company believes that ad valorem excise taxes on smokeless tobacco products artificially drive consumer behavior and create market distortions by providing a tax preference for lower priced products. Weight-based excise taxes or specific taxes on smokeless tobacco products would, in the Company's opinion, allow products to compete fairly in the marketplace on the basis of price and product attributes, not the relative tax burden. The Company believes its support of weight-based state excise taxes on smokeless tobacco products is in the best interest of the Company, its wholesaler customers, retailers, adult consumers of the Company's moist smokeless tobacco products and the state governments.

Project Momentum Cost Savings Initiative

During 2007, the first full year of Project Momentum's implementation, operating results reflect the positive contribution realized from this initiative. Given the progress achieved to date, and the continued focus on identifying operational efficiencies and cost reductions, the Company is confident that it will realize its first \$100 million in targeted savings over the planned three-year period. As noted in the Overview section of MD&A, the Company has recently finalized plans on various initiatives, primarily related to manufacturing operations and procurement functions, expected to generate \$50 million in additional savings beyond the original \$100 million of targeted savings. The incremental \$50 million of savings are expected to be realized in 2008 and 2009, bringing the total expected savings within the first three years of Project Momentum's implementation to \$150 million. These cost savings are expected to create additional resources for the Company's growth, as well as additional flexibility in the increasingly competitive smokeless tobacco category. The total targeted savings of at least \$150 million does not include the impact of the sale of the Company's corporate headquarters building in the first quarter of 2007, which generated a pre-tax gain of approximately \$105 million, and net cash proceeds of approximately \$85 million.

Table of Contents**Antitrust Litigation**

The Company is named as a defendant in certain actions brought by indirect purchasers (consumers and retailers) in several states. As noted in the discussion of results of operations, the Company recognized a charge of \$122.1 million during the first six months of 2007 related to the estimated cost of the settlements in the California and Wisconsin class actions, which are subject to court approval. These settlements resolve what the Company believes are its two significant remaining indirect purchaser antitrust cases (see Item 1, Notes to Condensed Consolidated Financial Statements Note 14, Contingencies, for additional details regarding the Company's antitrust litigation).

WINE SEGMENT

The Wine segment forecasts continued strong growth for the full year of 2007 of 10 percent or more for both net sales and operating profit. Favorable acclaim received for products late in 2006 and the first half of 2007 are expected to continue to benefit net sales during the remainder of the year. In addition, revenues for the Wine segment are expected to continue to be favorably impacted by the strategic alliance with Antinori, although the impact to the remainder of 2007 is expected to be less significant than the impact realized in the first half of 2007. This is due to the fact that comparisons will begin to match up against the start of the Company's distribution of the Antinori brands, which began in the second half of 2006. In addition, due to planned reinvestment of incremental profits generated from the Antinori alliance for advertising and promotion during its first two years, the impact to Wine segment operating profit is expected to moderate. Revenues are also expected to continue to be favorably impacted from sales of the Erath label, primarily Pinot Noir from Oregon, which the Company began selling late in the third quarter of 2006, resulting in a favorable impact to segment net sales and operating profit in 2007. As previously indicated, the Company executed an agreement to purchase Stag's Leap, one of Napa Valley's premier luxury wine brands, and expects to close on the transaction in September 2007. While the Company does not anticipate a material impact to segment results in 2007, it does expect that the addition of Stag's Leap to its portfolio will significantly enhance its value and performance over the next five years.

CONSOLIDATED

As a result of the strength in second quarter 2007 performance, the Company is now targeting full-year 2007 diluted earnings per share of \$3.21, with a range from \$3.16 to \$3.27, which includes the net unfavorable impact of \$0.14 per diluted share related to the following:

The unfavorable impact of \$0.48 per diluted share related to antitrust litigation settlement charges recognized in the first quarter of 2007; and,

The unfavorable impact of \$.05 per diluted share related to restructuring charges expected to be recognized in 2007 related to Project Momentum.

These factors will be partially offset by:

The favorable impact of \$0.39 per diluted share related to the sale of the Company's corporate headquarters building.

As noted last quarter, as a result of the cost savings realized to date, as well as the proceeds received from the sale of the Company's headquarters building, the Company has seen a significant increase in its cash and short-term investments. Therefore, in an effort to provide enhanced value to shareholders, the Company increased the amount it expects to spend in connection with its program to repurchase outstanding shares of its common stock in 2007 from \$200 million to \$300 million. During the second quarter of 2007 the

Table of Contents

Company spent \$20 million of the incremental \$100 million, with the remainder expected to be spent throughout the second half of the year. Over the long-term, the Company's goal is to provide an average annual total shareholder return of 10 percent, including diluted earnings per share growth and a strong dividend.

LIQUIDITY AND CAPITAL RESOURCES

(In thousands, except per share amounts or where otherwise noted)

	Six Months Ended		Increase/ (Decrease)	%
	2007	2006		
			Amount	
Net cash provided by (used in):				
Operating activities	\$ 241,975	\$ 283,320	\$(41,345)	(14.6)
Investing activities	87,803	4,302	83,501	
Financing activities	(279,584)	(259,753)	(19,831)	(7.6)

Operating Activities

The primary source of cash from operating activities in the first six months of 2007 and 2006, respectively, was net earnings generated mainly by the Smokeless Tobacco segment, adjusted for the effects of non-cash items. In the first six months of 2007, the most significant uses of cash were for the payment of federal income taxes, as well as accounts payable and accrued expenses incurred in the normal course of business, including payments for purchases of leaf tobacco for use in moist smokeless tobacco products. The decrease in cash provided by operating activities during the first six months of 2007, as compared to the corresponding 2006 period, was primarily related to the timing of payments related to federal income taxes and prepaid expenses and other assets, as well as timing of collection of accounts receivable.

Investing Activities

The increase in cash provided by investing activities for the first six months of 2007, as compared to the first six months of 2006, was primarily due to \$130.2 million of net proceeds from the sale of the Company's corporate headquarters building and the sale of winery property located in the State of Washington, as compared to \$5.9 million in net proceeds from the sale of winery property located in California received in the same period of the prior year. The impact of these items was partially offset by the purchase of short-term investments of \$20 million in the first six months of 2007 compared to proceeds of \$10 million from the sale of such investments in the corresponding 2006 period. Expenditures related to property, plant and equipment of \$22.6 million in the first six months of 2007 were significantly higher than the comparable prior year period. The Company expects net spending under the 2007 capital program to approximate \$84 million.

Financing Activities

The higher level of net cash used in financing activities during the first six months of 2007, as compared to the first six months of 2006, was primarily due to an increase in funds utilized for repurchases of common stock under the Company's share repurchase program, with payments amounting to \$120.1 million in 2007 versus \$100 million in 2006. The \$20.1 million increase on share repurchases, as compared to the prior year, relates to a portion of the incremental \$100 million that the Company previously announced it plans to spend

Table of Contents

during 2007 under its repurchase program. Dividends paid during the first six months of 2007 amounted to \$192.3 million, compared to \$184 million paid during the first six months of 2006, as the impact of a 5.3 percent dividend increase was partially offset by a lower level of shares outstanding resulting from share repurchases. Proceeds received from the issuance of stock, related to stock option exercise activity, were slightly higher in the first half of 2007, as compared to the first half of 2006, with proceeds amounting to \$26.1 million in 2007 versus \$23 million in 2006. Cash flow from financing activities for the first six months of 2007 also reflects an increase of \$5.3 million, as compared to the first six months of 2006, in the tax benefit realized by the Company related to the exercise of stock options, in excess of the tax deduction that would have been recorded had the fair value method of accounting for stock options been applied to all stock option grants.

As a result of the aforementioned sources and uses of cash, the Company's cash and cash equivalents balance of \$304.6 million at June 30, 2007 increased from the \$254.4 million balance at December 31, 2006.

The Company will continue to have significant cash requirements for the remainder of 2007, primarily for the payment of dividends, the repurchase of common stock, purchases of leaf tobacco and grape inventories, capital spending, payments pursuant to antitrust litigation settlements and the recently announced agreement to purchase Stag's Leap. The Company estimates that amounts expended in 2007 for tobacco leaf purchases for moist smokeless tobacco products will be slightly lower than amounts expended in 2006, while grape and bulk wine purchases and grape harvest costs for wine products will be greater than amounts expended in 2006. As noted, the cost savings realized to date from Project Momentum, as well as the proceeds received from the sale of the Company's headquarters building, have resulted in a significant increase in the Company's cash and short-term investments. Therefore, in an effort to provide enhanced value to shareholders, the Company increased the amount it expects to spend in connection with its share repurchase program in 2007 from \$200 million to \$300 million. As discussed in the *Financing Activities* section above, the Company spent approximately \$20 million of the incremental \$100 million during the first half of 2007, with the remainder expected to be spent throughout the second half of the year. The payment of approximately \$185 million related to the Stag's Leap acquisition is expected to be made during the third quarter of 2007. Funds generated from net earnings will be the primary means of meeting cash requirements over this period.

Credit Facility

On June 29, 2007, the Company entered into a \$300 million, five-year revolving credit facility (the *Credit Facility*) which will primarily be used for general corporate purposes, including the support of commercial paper borrowings. The Company may elect to increase its borrowing capacity under the *Credit Facility* to \$500 million subject to certain terms. The *Credit Facility* replaces the Company's previous \$300 million, three-year revolving credit facility which was terminated on June 29, 2007, shortly before its July 9, 2007 contractual expiration. The *Credit Facility* requires the maintenance of a fixed charge coverage ratio, the payment of commitment and administrative fees and includes affirmative and negative covenants customary for facilities of this type. The commitment fee payable on the unused portion of the *Credit Facility* is determined based on an interest rate, within a range of rates, dependent upon the Company's senior unsecured debt rating. The commitment fee currently payable is 0.05 percent per annum. The Company did not have any borrowings under the *Credit Facility* at June 30, 2007.

Table of Contents**AGGREGATE CONTRACTUAL OBLIGATIONS**

There have been no material changes in the Company's aggregate contractual obligations since December 31, 2006, with the exception of the execution of leaf tobacco and grape purchase activity in connection with normal purchase contracts. In the first quarter of 2007, the Company completed \$15.3 million in leaf tobacco purchases related to all contracts outstanding at December 31, 2006. As of June 30, 2007, the Company has contractual obligations of approximately \$59.5 million for the purchase of leaf tobacco to be used in the production of moist smokeless tobacco products and \$458 million for the purchase and processing of grapes to be used in the production of wine products. There are no contractual obligations to purchase leaf tobacco with terms beyond one year. As of June 30, 2007, the Company did not have any liabilities for unrecognized tax benefits in accordance with FIN 48 for which payment is expected in the next 12 months. The Company cannot make a reasonably reliable estimate of the amount of liabilities for unrecognized tax benefits that may result in cash settlements for periods beyond 12 months.

NEW ACCOUNTING STANDARDS

The Company reviews new accounting standards to determine the expected financial impact, if any, that the adoption of each such standard will have. As of the filing of this Form 10-Q, there were no new accounting standards issued that were projected to have a material impact on the Company's consolidated financial position, results of operations or liquidity. Refer to Part I, Item 1, Financial Statements Notes to Condensed Consolidated Financial Statements Note 2, Recent Accounting Pronouncements, for further information regarding new accounting standards.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Reference is made to the section captioned Cautionary Statement Regarding Forward-Looking Information which was filed as part of Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of the 2006 Form 10-K, regarding important factors that could cause actual results to differ materially from those contained in any forward-looking statement made by the Company, including forward-looking statements contained in this report.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See Item 7A of the 2006 Form 10-K, which is incorporated herein by reference. There has been no material change in the information provided therein. However, in order to demonstrate the sensitivity of the Company's interest rate hedges to immediate changes in applicable market interest rates, updated sensitivity analyses are provided below. The Company has hedged against the variability of forecasted interest payments attributable to changes in interest rates through the date of an anticipated debt issuance in 2009 with a forward starting interest rate swap. The forward starting interest rate swap has a notional amount of \$100 million and the terms call for the Company to receive interest quarterly at a variable rate equal to LIBOR and to pay interest semi-annually at a fixed rate of 5.715 percent. The fair value of the forward starting interest rate swap at June 30, 2007 was a net asset of \$0.6 million, based on a dealer quote and considering current market rates. As an indication of the forward starting swap's sensitivity to changes in interest rates, based upon an immediate 100 basis point increase in the applicable interest rate at June 30, 2007, the fair value of the forward starting swap would increase by approximately \$6.3 million to a net asset of \$6.9 million. Conversely, a 100 basis point decrease in that rate would decrease the fair value of the forward starting swap by \$7.3 million to a net liability of \$6.7 million.

Table of Contents

The Company has hedged the interest rate risk on its \$40 million aggregate principal amount of floating rate senior notes with a ten-year interest rate swap having a notional amount of \$40 million and quarterly settlement dates over the term of the contract. The Company pays a fixed rate of 7.25 percent and receives a floating rate of three-month LIBOR plus 90 basis points on the notional amount. The fair value of the swap at June 30, 2007 was a net liability of \$0.7 million, based on a dealer quote and considering current market conditions. As an indication of the interest rate swap's sensitivity to changes in interest rates, based upon an immediate 100 basis point increase in the applicable interest rate at June 30, 2007, the fair value of the interest rate swap would increase by approximately \$0.6 million to a net liability of \$0.1 million. Conversely, a 100 basis point decrease in that rate would decrease the fair value of the interest rate swap by \$0.7 million to a net liability of \$1.4 million.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company, under the direction of its Chief Executive Officer (CEO) and interim Chief Financial Officer (CFO), has reviewed and evaluated the effectiveness of its disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, the Company's CEO and interim CFO believe, as of the end of such period, that the Company's disclosure controls and procedures are effective.

Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In Jason Feuerabend, et al. v. UST Inc., et al., Circuit Court, Milwaukee County, Wisconsin (Case No. 02CV007124), on May 31, 2007, the Company entered into a Settlement Agreement whereby adult consumers in Wisconsin will be eligible to register for the settlement. The Company will provide each adult consumer who registers with coupons redeemable on future purchases of the Company's moist smokeless tobacco products in exchange for a dismissal of the action and a general release. The Company has also agreed to pay all administrative costs of the settlement, plaintiffs attorneys' fees and costs, and costs related to incentives for the Company to promote the settlement and encourage adult consumers to register for the settlement. On June 14, 2007, the court granted preliminary approval of the terms of the settlement.

In People of the State of California, ex. Rel., Bill Lockyer, Attorney General of the State of California v. U.S. Smokeless Tobacco Company (Case No.GIC851376), on July 2, 2007, the parties reached a non-binding agreement in principle to resolve this matter. The agreement in principle provides that the Company would be permitted to continue its National Hot Rod Association and Don Prudhomme Racing, Inc. brand name sponsorship under the Smokeless Tobacco Master Settlement Agreement in accordance with the terms of the agreement in principle. In addition, the Company would pay attorneys' fees and costs and/or other items upon which the parties may mutually agree. The proceedings have been stayed pending the parties' drafting and negotiation of a stipulation and final judgment.

ITEM 1A. RISK FACTORS

There have been no material changes in the Company's risk factors from those disclosed in Part I, Item 1A of the 2006 Form 10-K.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table presents the monthly share repurchases during the quarter ended June 30, 2007:

Period	Total Number of Shares Purchased ⁽¹⁾	Average Price Paid Per Share ⁽²⁾	Total Number of Shares Purchased as Part of the Repurchase Programs ⁽³⁾	Maximum Number of Shares that May Yet Be Purchased Under the Repurchase Programs ⁽³⁾
April 1 30, 2007	281,002	\$59.19	278,680	11,798,032
May 1 31, 2007	309,585	\$55.41	309,585	11,488,447
June 1 30, 2007	688,650	\$52.84	688,650	10,799,797
Total	1,279,237	\$54.85	1,276,915	

(1) Amounts reported in this column include shares of restricted stock withheld upon vesting to satisfy tax withholding obligations.

(2) The reported average price paid per share relates only to shares purchased as part of the repurchase programs.

(3) In December 2004, the Company's Board of Directors authorized a program to repurchase up to 20 million shares of its outstanding common stock. Share repurchases

under this
program
commenced in
June 2005.

ITEM 5. OTHER INFORMATION

On July 27, 2007, Michelle-Antinori, LLC (Michelle-Antinori), a California limited liability company with an 85 percent ownership interest to be held by Ste. Michelle Wine Estates, an indirect wholly-owned subsidiary of the Company, and a 15 percent ownership interest to be held by Antinori, entered into an agreement with Stag s Leap Wine Cellars, Stag s Leap Vineyards, L.P. and Rainbowday, LLC (collectively Stag s Leap). Pursuant to such agreement (the Purchase Agreement), Michelle-Antinori will acquire 100 percent of Stag s Leap for total aggregate consideration of approximately \$185 million, comprised of cash and assumed debt, subject to certain closing conditions. The transaction contemplated by the Purchase Agreement is expected to close in September 2007. The Purchase Agreement contains representations, warranties, covenants, seller non-competition arrangements and indemnification obligations customary for transactions of this nature, as well as an escrow for the benefit of Michelle-Antinori, consisting of approximately 7.5 percent of the purchase price. One-half of the escrow amount is expected to be released to Stag s Leap beginning on the six-month anniversary of the closing date, with the remainder expected to be released by the one-year anniversary of the closing date, in each case subject to any claims. With respect to the \$185 million in consideration to be paid by Michelle-Antinori upon closing of the sale, the Company will be providing bridge financing to Antinori for its 15 percent share of the purchase price via a non-recourse loan in the amount of \$27.8 million. The loan will bear interest at a rate of 7 percent per annum, have a maximum term of two years and be secured by Antinori s ownership interest in Michelle-Antinori.

Table of Contents

The foregoing description of the Purchase Agreement does not purport to be complete and is qualified in its entirety by reference to the complete text of the Purchase Agreement, a copy of which, excluding exhibits and disclosure schedules, is filed as Exhibit 2.1 hereto and is incorporated into this report by reference.

ITEM 6. EXHIBITS

Exhibit 2.1 Interest Purchase Agreement by and among Stag's Leap Wine Cellars, Stag's Leap Vineyards, L.P., Rainbowday, LLC and Michelle-Antinori, LLC, dated as of July 27, 2007, excluding exhibits and disclosure schedules.

Exhibit 10.1 Form of Notice of Grant and Restricted Stock Agreement, incorporated by reference to Exhibit 10.1 to Form 8-K filed May 4, 2007.

Exhibit 10.2 \$300,000,000 Five-Year Revolving Credit Agreement, dated as of June 29, 2007, among UST Inc., certain financial institutions and other persons from time to time parties thereto (the Lenders) and Citibank, N.A., as the Administrative Agent for the Lenders, Citigroup Global Markets Inc. and The Bank of Nova Scotia, as Joint Lead Arrangers and Joint Book Runners and The Bank of Nova Scotia, Calyon New York Branch, PNC Bank, National Association, US Bank, National Association and Citizens Bank of Massachusetts, as Co-Syndication Agents, incorporated by reference to Exhibit 10.1 to Form 8-K filed July 3, 2007.

Exhibit 10.3 Agreement, dated July 20, 2007, by and between UST Inc. and Raymond P. Silcock, incorporated by reference to Exhibit 10.1 to Form 8-K filed July 23, 2007.

Exhibit 10.4 Amendment to the UST Inc. Long-Term Incentive Plan, dated August 2, 2007.

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.

Exhibit 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

UST Inc.
(Registrant)

Date August 2, 2007

/s/ JAMES D. PATRACUOLLA
James D. Patracuolla
Interim Chief Financial Officer, Vice
President and Controller
55