

Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Description of the Business. Sonic operates and franchises the largest chain of drive-ins in the United States. As of August 31, 2005, the Sonic system was comprised of 3,039 drive-ins, of which 19% or 574 were Partner Drive-Ins and 81% or 2,465 were Franchise Drive-Ins. Sonic Drive-Ins feature Sonic signature items, such as specialty soft drinks including Cherry Limeades and slushes, frozen desserts, made-when-you-order sandwiches and hamburgers, Extra-Long Cheese Cones, hand-battered Onion Rings, Tater Tots, salads, and wraps. We derive our revenues primarily from Partner Drive-In sales and royalties from franchisees. We also receive revenues from initial franchise fees. To a lesser extent, we also receive income from the selling and leasing of signs and real estate, as well as from minority ownership interests in a few Franchise Drive-Ins.

Costs of Partner Drive-In sales, including minority interest in earnings of drive-ins, relate directly to Partner Drive-In sales. Other expenses, such as depreciation, amortization, and general and administrative expenses, relate to the Company's franchising operations, as well as Partner Drive-In operations. Our revenues and expenses are directly affected by the number and sales volumes of Partner Drive-Ins. Our revenues and, to a lesser extent, expenses also are affected by the number and sales volumes of Franchise Drive-Ins. Initial franchise fees and franchise royalties are directly affected by the number of Franchise Drive-In openings.

Overview of Business Performance. Business performance was strong during fiscal year 2005 as net income increased 19.6% and earnings per share increased 18.6% to \$1.21 per diluted share.

The Sonic brand achieved several milestones during fiscal year 2005, including:

- Surpassing the \$1.0 million mark in system-wide average unit volumes;
- Opening of the 3,000th Sonic Drive-In; and
- Our 19th consecutive year of higher system-wide same-store sales.

We continue to experience considerable momentum in our business fueled by strong growth in same-store sales that, despite some pressure on store-level operating costs during the year, led to a significant increase in system-wide average profit per store. The rise in store-level profits, in turn, helped produce a solid number of new drive-in openings by franchisees. We believe these results reflect our multi-layered growth strategy that features the following components:

- Solid same-store sales growth;
- Increased franchising income stemming from solid same-store sales growth and our unique ascending royalty rate;
- Expansion of the Sonic brand through new-unit growth, particularly by franchisees;
- Operating leverage at both the drive-in level and the corporate level; and
- The use of excess operating cash flow for franchise acquisitions and share repurchases.

Looking forward, these strategies are expected to continue to positively impact our business. We expect revenue growth of between 13% and 15% for fiscal year 2006, based upon same-store sales growth in the target range of 2% to 4%. This increase in revenues includes the expected benefit from 15 Franchise Drive-Ins which were acquired by the Company effective September 1, 2005.

The following table provides information regarding the number of Partner Drive-Ins and Franchise Drive-Ins in operation as of the end of the periods indicated as well as the system-wide growth in sales and average unit volume. System-wide information includes both Partner Drive-In and Franchise Drive-In information, which we believe is useful in analyzing the growth of the brand as well as the Company's revenues since franchisees pay royalties based on a percentage of sales.

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	System-Wide Performance		
	Year Ended August 31,		
	2005	2004	2003
	(\$ in thousands)		
Percentage increase in sales	12.4%	13.1%	7.0%
System-wide drive-ins in operation:			
Total at beginning of period	2,885	2,706	2,533
Opened	175	188	194
Closed (net of re-openings)	(21)	(9)	(21)
Total at end of period	3,039	2,885	2,706
Core markets	2,165	2,059	1,977
Developing markets	874	826	729
All markets	3,039	2,885	2,706
Average sales per drive-in:			
Core markets	\$ 1,059	\$ 1,004	\$ 947
Developing markets	934	861	802
All markets	1,023	964	907
Change in same-store sales ⁽¹⁾ :			
Core markets	5.6%	6.4%	0.5%
Developing markets	7.4	6.8	(1.2)
All markets	6.0	6.5	0.3

⁽¹⁾ Represents percentage change for drive-ins open for a minimum of 15 months.

System-wide same-store sales increased 6.0% during fiscal year 2005, largely as a result of traffic growth (an increase in the number of transactions) across all day parts (e.g. morning, lunch, afternoon, dinner, and evening). Additionally, a lesser portion of the growth came from an increase in the average check (the average amount spent per transaction). This marked our 19th consecutive year of positive same-store sales. We believe our strong sales performance is a direct consequence of our specific sales-driving initiatives including, but not limited to:

- Growth in brand awareness through increased media spending and greater use of network cable advertising;
- Strong promotions and new product news focused on quality and expanded choices for our customers;
- Continued growth of our business in non-traditional day parts including the morning, afternoon, and evening day parts, which saw solid increases in sales; and
- Use of technology to reach customers and improve the customer experience.

During fiscal year 2005, our total system-wide media expenditures were approximately \$125 million as compared to \$110 million in fiscal year 2004, which we believe continues to increase overall brand awareness and strengthen our share of voice relative to our competitors. We have also shifted more of our marketing dollars to our system-wide marketing fund efforts, which are largely used for network cable television advertising, growing this area of our advertising from approximately \$32 million in fiscal year 2004 to approximately \$60 million in fiscal year 2005. We believe increased network cable advertising provides several benefits including the ability to more effectively target and better reach the cable audience, which has now surpassed broadcast networks in terms of viewership. In addition, national cable advertising also allows us to bring additional depth to our media and expand our message beyond our traditional emphasis on a single monthly promotion. Looking forward, we expect system-wide media expenditures to be approximately \$140 million in fiscal 2006. The system-wide marketing fund portion will again represent approximately one-half of total media expenditures for fiscal 2006.

We continue to use our monthly promotions to highlight our distinctive food offerings and to feature new products. We also use our promotions and product news to create a strong emotional link with consumers and to align closely with consumer trends for fresh ingredients, customization, menu variety and choice. During the past year, our new product offerings showcased the breadth of our menu and emphasized the opportunity for choice at Sonic. We will continue to have new product news in the coming months, all designed to meet customers' evolving taste preferences including the growing desire for fresh, quality product offerings and healthier alternatives.

We continue to promote the expansion of our business in non-traditional day parts (morning, afternoon, and evening). The momentum in our evening business, which rose significantly with the return of our Sonic Nights

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initiative in the summer of fiscal year 2004, continued through fiscal year 2005. Every day part, including lunch and dinner, showed positive growth during fiscal year 2005 compared to fiscal year 2004, and we believe we have continuing opportunity to grow our non-traditional day parts like afternoon and evening throughout fiscal year 2006.

Implementation of the PAYS program, which began in the fall of 2003, was completed in the remainder of our Partner Drive-Ins during the second quarter of fiscal year 2005. Under the PAYS program, a credit card terminal is added to each drive-in stall to facilitate credit and debit card transactions. Rollout to Franchise Drive-Ins began in February 2005 and is expected to be completed system-wide by the end of calendar year 2006. The average investment to install PAYS in a typical Sonic Drive-In is approximately \$25 thousand. In evaluating this initiative, we have targeted an "increased sales to investment ratio" of 1 to 1, and it has been our experience that the installation of the PAYS program has generally met and often exceeds this target.

A highlight of fiscal year 2005 was reaching the \$1.0 million mark for system-wide average unit volumes. Another positive trend that has continued for seven consecutive quarters is the performance of developing markets relative to core markets. System-wide same-store sales in developing markets outpaced same-store sales in core markets, increasing 7.4% during fiscal year 2005 on top of a 6.8% increase in fiscal year 2004. We believe this increase was primarily due to additional spending on national cable, which has benefited all of our markets, and particularly our developing markets. From an average unit volume standpoint, developing markets, which represent roughly 29% of the store base, increased 8.5% continuing the positive trend of the last year and well ahead of the average unit volume increase in core markets which increased 5.5%.

Another milestone reached during fiscal year 2005 was the opening of Sonic's 3,000th drive-in. We opened 175 new drive-ins during fiscal year 2005, consisting of 37 Partner Drive-Ins and 138 Franchise Drive-Ins, down slightly from 188 drive-in openings during fiscal year 2004 (21 Partner Drive-Ins and 167 Franchise Drive-Ins). Looking forward, the Company expects to open 180 to 190 new drive-ins during fiscal year 2006, including 150 to 160 by franchisees.

Results of Operations

Revenues. Total revenues increased 16.1% to \$623.1 million in fiscal year 2005 from \$536.4 million during fiscal year 2004. The increase in revenues primarily relates to strong sales growth for Partner Drive-Ins and, to a lesser extent, a rise in franchising income.

	Revenues			Percent Increase/ (Decrease)
	Year Ended August 31, 2005	2004	Increase/ (Decrease)	
	(In thousands)			
Revenues:				
Partner Drive-In sales	\$ 525,988	\$ 449,585	\$ 76,403	17.0%
Franchise revenues:				
Franchise royalties	88,027	77,518	10,509	13.6
Franchise fees	4,311	4,958	(647)	(13.0)
Other	4,740	4,385	355	8.1
Total revenues	<u>\$ 623,066</u>	<u>\$ 536,446</u>	<u>\$ 86,620</u>	16.1
	Year Ended August 31, 2004	2003	Increase/ (Decrease)	Percent Increase/ (Decrease)
	(In thousands)			
Revenues:				
Partner Drive-In sales	\$ 449,585	\$ 371,518	\$ 78,067	21.0%
Franchise revenues:				
Franchise royalties	77,518	66,431	11,087	16.7
Franchise fees	4,958	4,674	284	6.1
Other	4,385	4,017	368	9.2
Total revenues	<u>\$ 536,446</u>	<u>\$ 446,640</u>	<u>\$ 89,806</u>	20.1

The following table reflects the growth in Partner Drive-In sales and changes in comparable drive-in sales for Partner Drive-Ins. It also presents information about average unit volumes and the number of Partner Drive-Ins, which is useful in analyzing the growth of Partner Drive-In sales.

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	Partner Drive-In Sales		
	Year Ended August 31,		
	2005	2004	2003
	(\$ in thousands)		
Partner Drive-In sales	\$525,988	\$ 449,585	\$ 371,518
Percentage increase	17.0%	21.0%	12.3%
Partner Drive-Ins in operation:			
Total at beginning of period	539	497	452
Opened	37	21	35
Acquired from (sold to) franchisees, net	(1)	21	11
Closed	(1)	–	(1)
Total at end of period	574	539	497
Average sales per Partner Drive-In	\$ 957	\$ 886	\$ 799
Percentage increase	8.0%	10.9%	1.0%
Change in same-store sales ⁽¹⁾	7.4%	7.8%	(0.3)%

⁽¹⁾ Represents percentage change for drive-ins open for a minimum of 15 months.

The increases in Partner Drive-In sales result from newly constructed and acquired drive-ins and same-store sales increases in existing drive-ins, offset by the loss of sales for sold and closed drive-ins.

	Change in	
	Partner Drive-In Sales	
	Year Ended August 31,	
	2005	2004
	(\$ in thousands)	
Increase from addition of newly constructed drive-ins ⁽¹⁾	\$ 28,184	\$ 23,099
Increase from acquisition of drive-ins ⁽²⁾	19,831	38,378
Increase from same-store sales	31,109	28,561
Decrease from drive-ins sold or closed ⁽³⁾	(2,721)	(11,971)
Net increase in Partner Drive-In sales	\$ 76,403	\$ 78,067

⁽¹⁾ Represents the increase for 58 and 55 drive-ins opened since the beginning of the prior fiscal year as of August 31, 2005 and 2004, respectively.

⁽²⁾ Represents the increase for 28 and 77 drive-ins acquired since the beginning of the prior fiscal year as of August 31, 2005 and 2004, respectively.

⁽³⁾ Represents the decrease for 9 and 45 drive-ins sold or closed since the beginning of the prior fiscal year as of August 31, 2005 and 2004, respectively.

During fiscal year 2005, same-store sales at Partner Drive-Ins again exceeded the same-store sales performance of our franchisees. The increase in average unit volume was also strong – growing 8.0% during the year as a result of the acquisition of higher volume drive-ins in Colorado in July 2004 as well as strong performance from new stores. Effective July 1, 2005, we rolled over the acquisition of the Colorado drive-ins which accounted for approximately three percentage points of the growth in Partner Drive-In sales during fiscal year 2005.

Beginning in fiscal year 2004, we implemented initiatives designed to close the approximately \$130 thousand sales gap in annual average unit volumes between Partner Drive-Ins and Franchise Drive-Ins. To a large degree, this effort is modeled on the best practices of our top-volume Partner and Franchise Drive-Ins. Our intent is to complement the strong profit motive created through our partnership program with strong incentives focused on top-line growth. During fiscal year 2004, this gap narrowed by 25% or approximately \$30 thousand per drive-in. During fiscal year 2005, the trend continued as same-store sales growth at Partner Drive-Ins outpaced same-store sales of Franchise Drive-Ins, closing the gap by another \$15 thousand.

Over the past several years, we have completed the acquisition of several Franchise Drive-Ins in various markets including the acquisition of 51 drive-ins located in the San Antonio, Texas market in May 2003 and the acquisition of

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22 drive-ins located in the Denver and Colorado Springs, Colorado markets in July 2004. Effective September 1, 2005, we acquired 15 franchise drive-ins located in the Tennessee and Kentucky markets. These acquisitions have added and are expected to continue to add to revenue growth and are expected to continue to be accretive to earnings over time. Our acquisitions are focused on higher volume stores with strong store-level management already in place. In addition, the selling franchisee usually retains a significant drive-in base and continues growing with us in other areas. We view these types of acquisitions of drive-ins with proven track records as a very good, lower-risk use of our capital and they remain a very viable potential use of our excess cash flow in future years.

The following table reflects the growth in franchise revenues (franchise royalties and franchise fees) as well as franchise sales, average unit volumes and the number of Franchise Drive-Ins. While we do not record Franchise Drive-In sales as revenues, we believe this information is important in understanding our financial performance since these sales are the basis on which we calculate and record franchise royalties. This information is also indicative of the financial performance of our Franchise Drive-Ins.

	Franchise Information		
	Year Ended August 31,		
	2005	2004	2003
	(\$ in thousands)		
Franchise fees and royalties ⁽¹⁾	\$ 92,338	\$ 82,476	\$ 71,105
Percentage increase	12.0%	16.0%	8.7%
Franchise Drive-Ins in operation:			
Total at beginning of period	2,346	2,209	2,081
Opened	138	167	159
Acquired from (sold to) Company, net	1	(21)	(11)
Closed	(20)	(9)	(20)
Total at end of period	2,465	2,346	2,209
Franchise Drive-In sales	\$ 2,474,133	\$ 2,219,340	\$ 1,988,842
Percentage increase	11.5%	11.6%	6.1%
Effective royalty rate	3.56%	3.49%	3.34%
Average sales per Franchise Drive-In	\$ 1,039	\$ 983	\$ 929
Change in same-store sales ⁽²⁾	5.8%	6.2%	0.4%

⁽¹⁾ See Revenue Recognition Related to Franchise Fees and Royalties in the Critical Accounting Policies and Estimates section of MD&A.

⁽²⁾ Represents percentage change for drive-ins open for a minimum of 15 months.

Franchise income, which consists of franchise royalties and franchise fees, increased 12.0% to \$92.3 million in fiscal year 2005.

Franchise royalties increased 13.6% to \$88.0 million in fiscal year 2005, compared to \$77.5 million in fiscal year 2004. Of the \$10.5 million increase, approximately \$6.3 million resulted from Franchise Drive-Ins' same-store sales growth of 5.8% in fiscal year 2005, combined with an increase in the effective royalty rate to 3.56% during fiscal year 2005 compared to 3.49% during fiscal year 2004. Each of our license agreements contains an ascending royalty rate whereby royalties, as a percentage of sales, increase as sales increase. The balance of the increase was attributable to growth in the number of Franchise Drive-Ins over the prior period.

Franchise royalties increased 16.7% to \$77.5 million in fiscal year 2004, compared to \$66.4 million in fiscal year 2003. Of the \$11.1 million increase, approximately \$6.7 million resulted from Franchise Drive-Ins' same-store sales growth of 6.2% in fiscal year 2004, combined with an increase in the effective royalty rate to 3.49% during fiscal year 2004 compared to 3.34% during fiscal year 2003. The balance of the increase was attributable to growth in the number of Franchise Drive-Ins over the prior period.

Franchise fees decreased 13.0% to \$4.3 million as franchisees opened 138 new drive-ins in fiscal year 2005 as compared to 167 openings in fiscal year 2004. Franchise fees increased 6.1% to \$5.0 million during fiscal 2004 as 167 Franchise Drive-Ins opened compared to 159 during the previous year.

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During fiscal year 2005, development on the franchise side was negatively impacted by a number of factors. We had numerous projects affected by various delays caused by zoning and permitting difficulties as well as site specific location and construction issues. We believe this is a direct by-product of a more challenging development environment as much of our development is occurring in harder-to-develop markets, including Florida and California. In addition, since the development cycle tends to be 18 to 24 months long, we are, to some degree, feeling the impact of a slowdown in store profitability during 2003 that tends to create a more cautious approach to development from franchisees.

Looking forward, there has been a strong rise in per store profits over the last 24 months that has positively impacted the pipeline for future franchise development. This is evidenced by 163 area development agreements at the end of fiscal year 2005 representing approximately 635 planned Franchise Drive-In openings over the next few years, compared to 157 such agreements at August 31, 2004 which represented approximately 570 planned Franchise Drive-In openings. Another step that has contributed to growth in the franchise pipeline is the recent planned expansion into a number of new markets, primarily located along the east and west coasts. In the past, our market expansion has been limited to a fewer number of markets at one time; we believe the brand awareness provided by our national cable advertising efforts will support this planned expansion to a greater number of markets.

Twenty Franchise Drive-Ins were closed during fiscal year 2005, which was an increase from the nine Franchise Drive-Ins closed during fiscal year 2004. Fifteen of the closings occurred during the second quarter and related primarily to two weaker franchise operators in two different markets. We do not believe that these drive-in closings are indicative of the Sonic brand's success. We have taken steps to require stronger financial qualifications of new franchisees, which we believe will significantly mitigate this type of risk. In addition, we expect that some of these drive-ins may re-open under new franchisee ownership.

We anticipate 150 to 160 store openings by franchisees during fiscal year 2006. Substantially all of these new drive-ins will open under our newest form of license agreement, which contains a higher average royalty rate and initial opening fee. As a result of these new Franchise Drive-In openings and the continued benefit of the ascending royalty rate, we expect approximately \$10 million in incremental franchise fees and royalties in fiscal year 2006.

Operating Expenses. Overall, drive-in cost of operations, as a percentage of Partner Drive-In sales, increased to 80.2% in fiscal year 2005 from 79.8% in fiscal year 2004. Minority interest in earnings of drive-ins is included as a part of cost of sales, in the table below, since it is directly related to Partner Drive-In operations.

	Operating Margins		
	Year Ended August 31,		
	2005	2004	2003
Costs and Expenses ⁽¹⁾ :			
Partner Drive-Ins:			
Food and packaging	26.2%	26.3%	26.0%
Payroll and other employee benefits	30.3	30.2	29.6
Minority interest in earnings of			
Partner Drive-Ins	4.1	4.4	3.9
Other operating expenses	19.6	18.9	19.0
Total Partner Drive-In cost of operations	80.2%	79.8%	78.5%

⁽¹⁾ As a percentage of Partner Drive-In sales.

Food and packaging costs decreased by 0.1 percentage points during fiscal year 2005 compared to fiscal year 2004 following an increase of 0.3 percentage points during fiscal year 2004 compared to fiscal year 2003. In the early part of the year, we experienced significant, year-over-year increases in several commodities including beef, dairy, and tomatoes. They were offset by menu price increases of approximately 1% in December 2004 and 1.5% in May 2005, as well as abatement of price pressures for these items, particularly dairy, in the latter part of the year. Looking forward, we anticipate that slightly lower year-over-year costs for beef, as well as lower costs for other items will result in lower food and packaging costs, as a percentage of sales, on a year-over-year basis in fiscal year 2006. This favorable outlook may be negatively impacted if energy prices remain high throughout the year.

Labor costs increased by 0.1 percentage points during fiscal year 2005 compared to fiscal year 2004 after an increase of 0.6 percentage points during fiscal year 2004 compared to fiscal year 2003. The slight increase for fiscal year 2005 resulted from staffing increases at the assistant manager level, as well as higher labor costs related to opening newly constructed stores as higher staffing levels were required for pre-opening training and through the initial opening period. The 2004 increase was primarily a result of significant payments made under the sales-based

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incentive program for drive-in management as well as higher staffing levels reflecting successful ongoing efforts to reduce turnover at Partner Drive-Ins.

Looking forward, the average wage rate has increased slightly in the last two quarters of fiscal year 2005, although the increase has not been significant to date. We plan to continue making significant payments under our sales incentive program, as we believe it has been a major driver of strong sales performance at Partner Drive-Ins. These increases, however, should be leveraged by higher volumes. As a result, we expect labor costs to be flat to slightly favorable, as a percentage of sales, on a year-over-year basis, in fiscal year 2006.

Minority interest, which reflects our store-level partners' pro-rata share of earnings from our partnership program, increased by \$1.6 million during fiscal year 2005, reflecting the increase in average profit per store. During fiscal year 2004, minority interest increased \$5.5 million, also reflecting the increase in average profit per store. Overall, we continue to view the partnership program as an integral part of our culture at Sonic and a large factor in the success of our business, and we are pleased that profit distributions to our partners increased during fiscal year 2005. Since we expect our average store level profits to continue to grow in fiscal year 2006, we would expect minority interest to increase in dollar terms but stay relatively flat as a percentage of sales.

Other operating expenses increased by 0.7 percentage points during fiscal year 2005. Costs increased primarily as a result of credit card charges associated with the increase in credit card transactions stemming from the success of the PAYS program, as well as increased repairs and maintenance expenses resulting from a greater focus on the physical appearance of our drive-ins, both inside and outside. Utility costs also increased toward the end of fiscal year 2005 as a result of increased energy prices. During fiscal year 2004, other operating expenses decreased by 0.1 percentage points as the leverage of operating at higher unit volumes more than offset increased costs. Looking forward, we expect cost increases in many of the items listed above, particularly utility costs, to carry over into fiscal year 2006. Our expectations for other operating costs will continue to depend upon future swings in energy costs, but we generally expect that the cost increases will result in other operating expenses increasing 0.25 to 0.50 percentage points, in fiscal year 2006.

To summarize, we are expecting overall restaurant-level margins to be relatively flat during fiscal year 2006 on a year-over-year basis, depending upon the variability in energy costs.

Selling, General and Administrative. Selling, general and administrative expenses increased 6.5% to \$40.7 million during fiscal year 2005 and 8.0% to \$38.3 million during fiscal year 2004. We continue to see leverage as the growth in these expenses was considerably less than the growth in revenues. As a percentage of total revenues, selling, general and administrative expenses decreased to 6.5% in fiscal year 2005, compared with 7.1% in fiscal year 2004 and 7.9% in fiscal year 2003. Beginning in the first quarter of fiscal year 2006, the Company will adopt FAS 123R which requires the fair value of stock options be charged to expense. The projected impact of adopting this standard is estimated to be additional expense of approximately \$8 to \$9 million during fiscal year 2006. This expense is expected to be incurred pro-rata over the fiscal year, with the amount increasing slightly in the third and fourth quarters due to the annual grant of options that typically occurs at Sonic's spring board meeting. Excluding the impact of FAS 123R, we anticipate that these costs will increase in the range of 10% to 12% in fiscal year 2006 and to decline as a percentage of sales. This rate of increase is higher than prior years primarily because of increased headcount additions which management believes is necessary to support continued growth in our business.

Depreciation and Amortization. Depreciation and amortization expense increased 10.1% to \$35.8 million in fiscal year 2005 due, in part, to additional depreciation stemming from the Colorado acquisition in July 2004. Similarly, depreciation and amortization expense increased 11.3% to \$32.5 million in fiscal year 2004 as a result of the San Antonio and Colorado acquisitions, as well as the capital lease on our corporate office space. Capital expenditures, excluding acquisitions, were \$85.9 million in fiscal year 2005. Looking forward, with approximately \$75 to \$80 million in capital expenditures planned for the year, normal depreciation and amortization is expected to increase by approximately 9% to 11% for the year. However, the Company re-evaluated the remaining asset life of certain assets related to the retrofit of Partner Drive-Ins in the late 1990s and has determined that the remaining useful life should be reduced. This reduction will cause an incremental increase in depreciation and amortization over the next four quarters of approximately 7% over the prior year, resulting in an overall expectation that depreciation and amortization will increase in the range of 16% to 18% for the year.

Provision for Impairment of Long-lived Assets. One Partner Drive-In and one property held for disposal became impaired during fiscal year 2005 under the guidelines of FAS 144 – "Accounting for the Impairment or Disposal of Long-Lived Assets." As a result, a total provision for impairment of long-lived assets of \$0.4 million was recorded for the carrying costs of these assets in excess of their estimated fair values. One Partner Drive-In became impaired during fiscal year 2004 which resulted in a provision for impairment of \$0.7 million to reduce the drive-in's carrying cost to its estimated fair value. During fiscal year 2003, two Partner Drive-Ins became impaired which resulted in a provision for impairment totaling \$0.7 million to reduce the drive-ins' carrying cost to their estimated fair value. We continue to perform quarterly analyses of certain underperforming drive-ins. It is reasonably possible that the

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estimate of future cash flows associated with these drive-ins may change in the near future resulting in the need to write-down assets associated with one or more of these drive-ins to fair value. While it is impossible to predict if future write-downs will occur, we do not believe that future write-downs will impede our ability to continue growing earnings at a solid rate.

Interest Expense. Net interest expense decreased 9.3% in fiscal year 2005 compared to a 2.6% increase in fiscal year 2004 as a result of strong cash flow from operations. The reduction in interest expense more than offset the decrease in interest income relating to the outsourcing of our partner notes to a third-party financial institution in August 2004. Interest expense increased in fiscal year 2004 largely due to the addition of the capital lease associated with our new office space. Our ability to generate positive operating cash flow enabled us to expend \$85.9 million in capital expenditures, \$42.3 million in share repurchases and still reduce our long-term debt by \$22.0 million. Going forward, we expect our continued repurchase of stock, as well as the acquisition of 15 drive-ins effective September 1, 2005, will produce higher interest expense in future quarters depending on the level of shares repurchased or additional franchise acquisitions.

Income taxes. The provision for income taxes reflects an effective federal and state tax rate of 36.35% for fiscal year 2005 compared with 36.82% in fiscal year 2004 and 37.25% in fiscal year 2003. The lower rate for fiscal year 2005 resulted primarily from a retroactive tax law change that reinstated expired tax credits in the first quarter of fiscal year 2005. The reduction in our effective tax rate in fiscal year 2004 was primarily a result of the benefit of higher tax credits. We expect the adoption of FAS 123R for stock options in the first quarter of fiscal year 2006 to impact the tax rate, as only the portion of stock option expense expected to result in a future tax deduction is considered deductible for tax accounting purposes. Sonic currently estimates the tax benefit for stock options to be approximately 25% of the amount expensed. Considering these variables, we anticipate that our effective tax rate will increase during fiscal year 2006 to a range of 37.5% to 38.0% and vary from quarter to quarter as circumstances on individual tax matters change.

Financial Position

During fiscal year 2005, current assets increased 1.9% to \$35.2 million compared to \$34.6 million as of the end of fiscal year 2004. Net property, equipment and capital leases increased by 12.4% as a result of capital expenditures. The increases in current assets and net property, equipment and capital leases were partially offset by decreases in notes receivable, resulting from early repayment by franchisees, to produce an 8.6% increase in total assets to \$563.3 million as of the end of fiscal year 2005.

Total current liabilities increased \$16.2 million or 33.0% during fiscal year 2005 as a result of increases in income taxes payable and trade payables. The non-current portion of long-term debt decreased \$22.7 million or 28.9% as a result of repayment of debt using cash generated from operating activities. Overall, total liabilities decreased \$5.1 million or 2.8% as a result of the items discussed above.

Stockholders' equity increased \$49.8 million or 14.9% during fiscal year 2005 primarily resulting from earnings during the period of \$75.4 million offset by treasury stock repurchases of \$42.3 million. Proceeds and the related tax benefit from the exercise of stock options accounted for the balance of the increase. At the end of fiscal year 2005, our debt-to-total capital ratio stood at 20.4%, down from 26.8% at the end of fiscal year 2004. For the twelve months ended August 31, 2005, return on average stockholders' equity was 21.0% and return on average assets was 13.9%.

Liquidity and Sources of Capital

Net cash provided by operating activities increased \$25.6 million or 24.3% to \$132.3 million in fiscal year 2005 as compared to \$106.7 million in fiscal year 2004, primarily as a result of an increase in operating profit before depreciation and amortization and an increase in operating liabilities related to the amount and timing of tax and other liability payments. We also anticipate continuing to generate increasing positive free cash flow going forward. We believe free cash flow, which we define as net income plus depreciation, amortization and stock-based compensation expense less capital expenditures, is useful in evaluating the liquidity of the Company by assessing the level of funds available for share repurchases, acquisitions of Franchise Drive-Ins, and repayment of debt. We expect free cash flow to approach \$50 million for fiscal year 2006.

We have an agreement with a group of banks that provides us with a \$150.0 million line of credit expiring in July 2010. As of August 31, 2005, our outstanding borrowings under the line of credit were \$30.2 million at an effective borrowing rate of 5.11%, as well as \$0.7 million in outstanding letters of credit. The amount available under the line of credit as of August 31, 2005, was \$119.1 million. We have long-term debt maturing in fiscal year 2006 of \$8.9 million. Of this amount, \$4.6 million relates to our senior unsecured notes that will be maturing in August 2006, and is classified as long-term because we intend to utilize amounts available under our line of credit to fund this obligation. We believe that free cash flow will be adequate for repayment of any long-term debt that does not get refinanced or extended. We plan to use the line of credit to finance the opening of newly constructed drive-ins and other planned

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capital expenditures, acquisitions of existing drive-ins, purchases of the Company's common stock and for other general corporate purposes, as needed. See Note 9 of the Notes to Consolidated Financial Statements for additional information regarding our long-term debt.

On April 7, 2005, our Board of Directors approved an increase in the amount available under our share repurchase program from \$60.0 million to \$150.0 million and extended the program through August 31, 2006. Pursuant to this program, the Company acquired 1.3 million shares at an average price of \$31.48 for a total cost of \$42.3 million during fiscal year 2005. As of August 31, 2005, we had \$107.7 million available under the program.

We opened 37 newly constructed Partner Drive-Ins and sold a net of one drive-in to franchisees during fiscal year 2005. We funded total capital additions for fiscal year 2005 of \$85.9 million, which included the cost of newly opened drive-ins, new equipment for existing drive-ins, drive-ins under construction, the acquisition of Franchise Drive-Ins, and other capital expenditures, from cash generated by operating activities and borrowings under our line of credit. During fiscal year 2005, we purchased the real estate for 31 of the 41 newly constructed and acquired drive-ins. Sales of real estate relating to drive-ins previously sold to franchisees are a component of cash from investing activities and totaled \$1.3 million during fiscal year 2005 compared to \$8.8 million during fiscal year 2004.

Subsequent to August 31, 2005, the Company acquired 15 Franchise Drive-Ins for \$13.9 million, excluding any post-closing adjustments. The Company also continued to repurchase shares of stock under the share repurchase program, purchasing an additional 1.4 million shares for \$40.0 million. The total remaining amount authorized for repurchase as of November 10, 2005 was \$67.6 million. These cash outlays also led to additional advances under the available line of credit, with the total amount outstanding at November 10, 2005 of \$63.0 million, an increase of \$32.9 million over the balance at August 31, 2005.

We plan capital expenditures of approximately \$75 to \$80 million in fiscal year 2006, excluding potential acquisitions and share repurchases. These capital expenditures primarily relate to the development of additional Partner Drive-Ins, stall additions, relocations of older drive-ins, store equipment and point-of-sale system upgrades, and enhancements to existing financial and operating information systems. We expect to fund these capital expenditures through cash flow from operations and borrowings under our existing line of credit.

As of August 31, 2005, our total cash balance of \$6.4 million reflected the impact of the cash generated from operating activities, borrowing activity, and capital expenditures mentioned above. We believe that existing cash and funds generated from operations, as well as borrowings under the line of credit, will meet our needs for the foreseeable future.

Off-Balance Sheet Arrangements

The Company has obligations for guarantees on certain franchisee loans and lease agreements. See Note 15 of the Notes to Consolidated Financial Statements for additional information about these guarantees. The Company has no other off-balance sheet financings.

Contractual Obligations and Commitments

In the normal course of business, Sonic enters into purchase contracts, lease agreements and borrowing arrangements. Our commitments and obligations as of August 31, 2005 are summarized in the following table:

	Payments Due by Period				
	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
(In thousands)					
Contractual Obligations:					
Long-term debt	\$ 60,195	\$ 4,261	\$ 9,461	\$ 42,199	\$ 4,274
Capital leases	58,960	4,960	9,522	9,547	34,931
Operating leases	154,782	9,722	19,056	18,515	107,489
Total	<u>\$ 273,937</u>	<u>\$ 18,943</u>	<u>\$ 38,039</u>	<u>\$ 70,261</u>	<u>\$ 146,694</u>

Impact of Inflation

Though increases in labor, food or other operating costs could adversely affect our operations, we do not believe that inflation has had a material effect on income during the past several years.

Seasonality

We do not expect seasonality to affect our operations in a materially adverse manner. Our results during the second fiscal quarter (the months of December, January and February) generally are lower than other quarters because of the climate of the locations of a number of Partner and Franchise Drive-Ins.

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Critical Accounting Policies and Estimates

The Consolidated Financial Statements and Notes to Consolidated Financial Statements included in this document contain information that is pertinent to management's discussion and analysis. The preparation of financial statements in conformity with generally accepted accounting principles requires management to use its judgment to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities. These assumptions and estimates could have a material effect on our financial statements. We evaluate our assumptions and estimates on an ongoing basis using historical experience and various other factors that are believed to be relevant under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We annually review our financial reporting and disclosure practices and accounting policies to ensure that our financial reporting and disclosures provide accurate and transparent information relative to the current economic and business environment. We believe that of our significant accounting policies (see Note 1 of Notes to Consolidated Financial Statements), the following policies involve a higher degree of risk, judgment and/or complexity.

Impairment of Long-Lived Assets. We review each Partner Drive-In for impairment when events or circumstances indicate it might be impaired. We test for impairment using historical cash flows and other relevant facts and circumstances as the primary basis for our estimates of future cash flows. This process requires the use of estimates and assumptions, which are subject to a high degree of judgment. In addition, at least annually, we assess the recoverability of goodwill and other intangible assets related to our brand and drive-ins. These impairment tests require us to estimate fair values of our brand and our drive-ins by making assumptions regarding future cash flows and other factors. If these assumptions change in the future, we may be required to record impairment charges for these assets.

Ownership Program. Our drive-in philosophy stresses an ownership relationship with supervisors and drive-in managers. Most supervisors and managers of Partner Drive-Ins own an equity interest in the drive-in, which was previously financed by the Company. We outsourced the financing of partner notes to a third-party in the fourth fiscal quarter of 2004. Supervisors and managers are neither employees of Sonic nor of the drive-in in which they have an ownership interest.

The investments made by managers and supervisors in each partnership or limited liability company are accounted for as minority interests in the financial statements. The ownership agreements contain provisions, which give Sonic the right, but not the obligation, to purchase the minority interest of the supervisor or manager in a drive-in. The amount of the investment made by a partner and the amount of the buy-out are based on a number of factors, primarily upon the drive-in's financial performance for the preceding 12 months, and are intended to approximate the fair value of a minority interest in the drive-in.

The net book value of a minority interest acquired by the Company in a Partner Drive-In is recorded as an investment in partnership, which results in a reduction in the minority interest liability on the Consolidated Balance Sheet. If the purchase price exceeds the net book value of the assets underlying the partnership interest, the excess is recorded as goodwill. The acquisition of a minority interest for less than book value results in a decrease in purchased goodwill. Any subsequent sale of the minority interest to another minority partner is recorded as a pro-rata reduction of goodwill and investment, and no gain or loss is recognized on the sale of the minority ownership interest. Goodwill created as a result of the acquisition of minority interests in Partner Drive-Ins is not amortized but is tested annually for impairment under the provisions of FAS 142, "Goodwill and Other Intangible Assets."

Revenue Recognition Related to Franchise Fees and Royalties. Initial franchise fees are nonrefundable and are recognized in income when we have substantially performed or satisfied all material services or conditions relating to the sale of the franchise. Area development fees are nonrefundable and are recognized in income on a pro-rata basis when the conditions for revenue recognition under the individual development agreements are met. Both initial franchise fees and area development fees are generally recognized upon the opening of a Franchise Drive-In or upon termination of the agreement between Sonic and the franchisee.

Our franchisees are required under the provisions of the license agreements to pay royalties to Sonic each month based on a percentage of actual net sales. However, the royalty payments and supporting financial statements are not due until the 20th of the following month. As a result, we accrue royalty revenue in the month earned based on estimates of Franchise Drive-Ins' sales. These estimates are based on actual sales at Partner Drive-Ins and projections of average unit volume growth at Franchise Drive-Ins.

Income Taxes. We estimate certain components of our provision for income taxes. These estimates include, among other items, depreciation and amortization expense allowable for tax purposes, allowable tax credits for items such as wages paid to certain employees, effective rates for state and local income taxes and the tax deductibility of certain other items.

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Our estimates are based on the best available information at the time that we prepare the provision, including legislative and judicial developments. We generally file our annual income tax returns several months after our fiscal year end. Income tax returns are subject to audit by federal, state and local governments, typically several years after the returns are filed. These returns could be subject to material adjustments or differing interpretations of the tax laws. Adjustments to these estimates or returns can result in significant variability in the tax rate from period to period.

Forward-looking Statements

This annual report contains various "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements represent our expectations or beliefs concerning future events, including the following: any statements regarding future sales or expenses, any statements regarding the continuation of historical trends, and any statements regarding the sufficiency of our working capital and cash generated from operating and financing activities for our future liquidity and capital resource needs. Without limiting the foregoing, the words "believes," "anticipates," "plans," "expects," and similar expressions are intended to identify forward-looking statements. We caution that the following important economic and competitive factors, among others, could cause the actual results to differ materially from those in the forward-looking statements made in this report and from time to time in news releases, reports, proxy statements, registration statements, and other written or electronic communication, as well as verbal forward-looking statements made from time to time by representatives of the Company. Factors that may cause actual results to differ materially from forward-looking statements include, without limitation, risks of the restaurant industry, including risks of and publicity surrounding food-borne illnesses, a highly competitive industry and the impact of changes in consumer spending patterns, consumer tastes, local, regional, and national economic conditions, weather, demographic trends, traffic patterns, employee availability, increases in utility costs, and cost increases or shortages in raw food products. In addition, the opening and success of new drive-ins will depend on various factors, including weather, strikes, the availability of suitable sites for new drive-ins, the negotiation of acceptable lease or purchase terms for new locations, local permitting and regulatory compliance, our ability to manage the anticipated expansion and hire and train personnel, the financial viability of our franchisees, particularly multi-unit operators, and general economic and business conditions. Accordingly, such forward-looking statements do not purport to be predictions of future events or circumstances and may not be realized. For these reasons, you should not place undue reliance on forward-looking statements. We undertake no obligation to publicly update or revise them.

Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from changes in interest rates on debt and notes receivable, as well as changes in commodity prices.

Our exposure to interest rate risk currently consists of our senior notes, outstanding line of credit, and notes receivable. The senior notes bear interest at fixed rates which average 6.8%. The aggregate balance outstanding under the senior notes as of August 31, 2005 was \$24.4 million. Should interest rates increase or decrease, the estimated fair value of these notes would decrease or increase, respectively. As of August 31, 2005, the estimated fair value of the senior notes exceeded the carrying amount by approximately \$0.6 million. The line of credit bears interest at a rate benchmarked to U.S. and European short-term interest rates. The balance outstanding under the line of credit was \$30.2 million as of August 31, 2005. The impact on our results of operations of a one-point interest rate change on the average outstanding balance under the line of credit during fiscal year 2005 would be approximately \$0.1 million. We have made certain loans to our franchisees totaling \$3.5 million as of August 31, 2005. The interest rates on these notes are generally between 6.0% and 10.5%. We believe the fair market value of these notes approximates their carrying amount.

The Company and its franchisees purchase certain commodities such as beef, potatoes, chicken and dairy products. These commodities are generally purchased based upon market prices established with vendors. These purchase arrangements may contain contractual features that limit the price paid by establishing price floors or caps; however, we have not made any long-term commitments to purchase any minimum quantities under these arrangements. We do not use financial instruments to hedge commodity prices because these purchase agreements help control the ultimate cost and any commodity price aberrations are generally short term in nature.

This market risk discussion contains forward-looking statements. Actual results may differ materially from this discussion based upon general market conditions and changes in financial markets.