UST INC
Form 10-K
February 23, 2007

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FORM 10-K

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

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 0-17506
UST Inc.
(Exact name of registrant as specified in its charter)

Delaware **06-1193986** (State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.) **100 West Putnam Avenue Greenwich, Connecticut 06830** (Address of principal executive offices) (Zip Code)

(203) 661-1100
(Registrant s telephone number, including area code)
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock $.50 par value	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act:
None
(Title of Class)

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

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

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 accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ]

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

As of June 30, 2006, the aggregate market value of Registrant s Common Stock, $.50 par value, held by non-affiliates of Registrant (which for this purpose does not include directors or officers) was $7,192,463,311.

As of February 14, 2007, there were 160,623,408 shares of Registrant s Common Stock, $.50 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Certain pages of the Registrant s 2007 Notice of Annual Meeting and Proxy Statement

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PART I

Item 1 Business

General

UST Inc. was formed on December 23, 1986 as a Delaware corporation to serve as a new publicly-held holding company for United States Tobacco Company (USTC), which was formed in 1911. Pursuant to a reorganization approved by stockholders at the 1987 Annual Meeting, USTC became a wholly-owned subsidiary of UST Inc. on May 5, 1987, and UST Inc. continued in existence as a holding company. Effective January 1, 2001, USTC changed its name to U.S. Smokeless Tobacco Company (USSTC). UST Inc., through its direct and indirect subsidiaries (collectively Registrant or the Company unless the context otherwise requires), is engaged in the manufacturing and marketing of consumer products in the following business segments:

Smokeless Tobacco Products: The Company s primary activities are the manufacturing and marketing of smokeless tobacco products.

Wine: The Company produces and markets premium varietal and blended wines, and imports and distributes wines from Italy.

All Other Operations: The Company s international operations, which market moist smokeless tobacco, are included in all other operations.

Available Information

The Company s website address is www.ustinc.com. The Company makes available free of charge through its website its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (SEC). A free copy of these materials can also be requested via correspondence addressed to the Secretary at UST Inc., 100 West Putnam Avenue, Greenwich, Connecticut 06830. The public may read and copy any materials the Company has filed with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may also obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site (www.sec.gov) that contains reports, proxy and information statements, and other information regarding issuers, including the Company, that file electronically with the SEC.

Operating Segment Data

The Company hereby incorporates by reference the consolidated Segment Information pertaining to the years 2004 through 2006 set forth herein in Part II, Item 8, Notes to Consolidated Financial Statements Note 16, Segment Information.

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SMOKELESS TOBACCO PRODUCTS

Principal Products

The Company s principal smokeless tobacco products and brand names are as follows:

Moist:

COPENHAGEN, SKOAL, RED SEAL, HUSKY, ROOSTER

Dry:

BRUTON, CC, RED SEAL

Reports with respect to the health risks of tobacco products have been publicized for many years, and the sale, promotion and use of tobacco continue to be subject to increasing governmental regulation. In 1986, a Surgeon General s Report reached the judgment that smokeless tobacco use can cause cancer and can lead to nicotine dependence or addiction. Also in 1986, Congress passed the Comprehensive Smokeless Tobacco Health Education Act of 1986, which requires the following warnings on smokeless tobacco packages and advertising: WARNING: THIS PRODUCT MAY CAUSE MOUTH CANCER, WARNING: THIS PRODUCT MAY CAUSE GUM DISEASE AND TOOTH LOSS, WARNING: THIS PRODUCT IS NOT A SAFE ALTERNATIVE TO CIGARETTES. In light of the scientific research taken as a whole, the Company does not believe that smokeless tobacco has been shown to be a cause of any human disease, but the Company does not take the position that smokeless tobacco is safe.

Over the last several years, smokeless tobacco has been the subject of discussion in the scientific and public health community in connection with the issue of tobacco harm reduction. Tobacco harm reduction is generally described as a public health strategy aimed at reducing the health risks to cigarette smokers who have not quit and is frequently discussed in the context of proposals for an overall tobacco regulatory regime. It is reported that approximately 45 million adult Americans continue to smoke, and many have made repeated attempts to quit, including with the use of medicinal nicotine products. There has been an ongoing debate in the scientific and public health community as to what to do for these smokers. One idea that has been raised is to suggest that they switch completely to smokeless tobacco. Many believe that certain smokeless tobacco products pose significantly less risk than cigarettes and therefore could be a potential reduced risk alternative to cigarette smoking. There are others, however, who believe that there is insufficient scientific basis to encourage switching to smokeless tobacco and that such a strategy may result in unintended public health consequences.

Data from some surveys indicate that at least 80 percent of smokers believe smokeless tobacco is as dangerous as cigarette smoking. The Company believes that adult cigarette smokers should be provided accurate and relevant information on these issues so that they may make informed decisions about tobacco products. This is especially so in light of data from some surveys that indicate that at least half of the approximately 45 million adult smokers are looking for an alternative. The Company believes that there is an opportunity for smokeless tobacco products to have a significant role in a tobacco harm reduction strategy.

As indicated above, in 1986, federal legislation was enacted regulating smokeless tobacco products by, *inter alia,* requiring health warning notices on smokeless tobacco packages and advertising and prohibiting the advertising of smokeless tobacco products on any medium of electronic communications subject to the jurisdiction of the Federal Communications Commission. A federal excise tax was imposed in 1986, which was increased in 1991, 1993, 1997, 2000 and 2002. Also, in recent years, proposals have been made at the federal level for additional regulation of tobacco products including, among other things, the requirement of additional warning notices, the disallowance of advertising and promotion expenses as deductions under federal tax law, a ban or further restriction of all advertising and promotion, regulation of environmental tobacco smoke and increased regulation of the manufacturing and marketing of tobacco products by new or existing federal agencies. Similar proposals will likely be considered in the future.

On August 28, 1996, the U.S. Food and Drug Administration (the FDA) published regulations asserting unprecedented jurisdiction over nicotine in tobacco as a drug and purporting to regulate smokeless tobacco products as a medical device. The Company and other smokeless tobacco manufacturers filed suit against the FDA seeking a judicial declaration that the FDA has no authority to regulate smokeless tobacco products. On March 21, 2000, the United States Supreme Court ruled that the FDA lacks jurisdiction to regulate tobacco products. Following this ruling, proposals for federal legislation for comprehensive regulation of tobacco products continue to be considered.

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Over the years, various state and local governments have continued to regulate tobacco products, including, among other things, the imposition of significantly higher taxes, increases in the minimum age to purchase tobacco products, adult sampling and advertising bans or restrictions, ingredient and constituent disclosure requirements, regulation of environmental tobacco smoke and significant tobacco control media campaigns. Additional state and local legislative and regulatory actions will likely be considered in the future, including, among other things, restrictions on the use of flavorings. The Company is unable to assess the future effects these various actions may have on its smokeless tobacco business. The Company believes that any proposals for additional regulation at the federal, state or local level should recognize the distinct differences between smokeless tobacco products and cigarettes.

On November 23, 1998, the Company entered into the Smokeless Tobacco Master Settlement Agreement (the STMSA) with attorneys general of various states and U.S. territories to resolve the remaining health care cost reimbursement cases initiated by various attorneys general against the Company. The STMSA required the Company to adopt various marketing and advertising restrictions and make payments potentially totaling $100 million, subject to a minimum 3 percent inflationary adjustment per annum, over a minimum of ten years for programs to reduce youth usage of tobacco and combat youth substance abuse and for enforcement purposes. The period over which the payments are to be made is subject to various indefinite deferral provisions based upon the Company s share of the smokeless tobacco segment of the overall tobacco market (as defined in the STMSA).

On October 22, 2004, the Fair and Equitable Tobacco Reform Act of 2004 (the Tobacco Reform Act or the FETRA) was enacted in connection with a comprehensive federal corporate reform and jobs creation bill. The Tobacco Reform Act effectively repeals all aspects of the U.S. federal government s tobacco farmer support program, including marketing quotas and nonrecourse loans. As a result of the Tobacco Reform Act, the Secretary of Agriculture will impose quarterly assessments on tobacco manufacturers and importers, not to exceed a total of $10.1 billion over a ten-year period from the date of enactment. Amounts assessed by the Secretary will be impacted by a number of allocation factors, as defined in the Tobacco Reform Act. These quarterly assessments will be used to fund a trust to compensate, or buy out, tobacco quota farmers, in lieu of the repealed federal support program. The Company does not believe that the assessments imposed under the Tobacco Reform Act will have a material adverse impact on its consolidated financial position, results of operations or cash flows in any reporting period.

Raw Materials

Except as noted below, raw materials essential to the Company s smokeless tobacco business are generally purchased in domestic markets under competitive conditions.

The Company purchased all of its leaf tobacco from domestic suppliers in 2006, as it has for the last several years. Various factors, including the level of domestic tobacco production, can affect the amount of tobacco purchased by the Company from domestic sources. Tobaccos used in the manufacture of smokeless tobacco products are processed and aged by the Company for a period of two to three years prior to their use.

The Company or its suppliers purchase certain flavoring components from foreign sources, which are used in the Company s smokeless tobacco products.

At the present time, the Company has no reason to believe that future raw material requirements for its tobacco products will not be satisfied. However, the continuing availability and the cost of tobacco is dependent upon a variety of factors which cannot be predicted, including, but not limited to, weather, growing conditions, local planting decisions, overall market demands and other factors.

In addition, with the enactment of the Tobacco Reform Act and its repeal of federal tobacco price support and quota programs, tobacco can be grown anywhere in the United States with no volume limitations or price protection or guarantees. As a result, the Tobacco Reform Act has favorably impacted the Company s cost of leaf tobacco purchases since its enactment. Grower contracting for the 2007 tobacco buying season is not yet complete; however, the Company believes that costs incurred for leaf tobacco purchases will approximate those incurred in 2006.

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Working Capital

The principal portion of the Company s operating cash requirements relates to its need to maintain significant inventories of leaf tobacco, primarily for the manufacturing of smokeless tobacco products, to ensure an aging process of two to three years prior to use.

Customers

The Company markets its moist smokeless tobacco products throughout the United States principally to wholesalers and retail chain stores. Approximately 34 percent of the Company s gross sales of tobacco products are made to four customers, one of which, McLane Co. Inc., a national distributor, accounts for approximately 17 percent of the Company s consolidated revenue. The Company has maintained satisfactory relationships with its customers over the years and expects that such relationships will continue.

Competitive Conditions

The tobacco manufacturing industry in the United States is composed of at least four domestic companies larger than the Company and many smaller ones. The larger companies primarily concentrate on the manufacture and marketing of cigarettes; however, in 2006, a major cigarette company entered the smokeless tobacco category through its acquisition of one of the Company s competitors. In addition, certain cigarette companies have begun test marketing smokeless tobacco products and have indicated the intent to continue to expand this activity. The Company is a well established and major factor in the smokeless tobacco sector of the overall tobacco market. Consequently, the Company competes actively with both larger and smaller companies in the marketing of its tobacco products. Competition also includes both domestic and international companies marketing and selling price-value and sub-price-value smokeless tobacco products. The Company s principal methods of competition in the marketing of its tobacco products include quality, advertising, promotion, sampling, price, product recognition, product innovation and distribution.

WINE

The Company is an established producer of premium varietal and blended wines. CHATEAU STE. MICHELLE and COLUMBIA CREST varietal table wines and DOMAINE STE. MICHELLE sparkling wine are produced by the Company in the State of Washington and marketed and distributed throughout the United States. In addition, the Company produces and markets two California premium wines under the labels of VILLA MT. EDEN and CONN CREEK and Oregon premium wines under the ERATH label. The Company is also 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. Approximately 50 percent of the Company s wine segment gross sales are made to two distributors, with one of these distributors accounting for approximately 36 percent of total wine segment gross sales. Substantially all wines are sold through state-licensed distributors with whom the Company maintains satisfactory relationships.

It has been claimed that the use of alcohol beverages may be harmful to health. In 1988, federal legislation was enacted regulating alcohol beverages by requiring health warning notices on such beverages. Still wines containing not more than 14 percent alcohol by volume, such as the majority of the Company s wines, are subject to a federal excise tax of $1.07 per gallon for manufacturers, such as the Company, that produce more than 250,000 gallons a year. In recent years, proposals have been made at the federal level for additional regulation of alcohol beverages, including, but not limited to, increases in excise tax rates, modification of the required health warning notices and further regulation of advertising, labeling and packaging. Substantially similar proposals will likely be considered in 2007. Also in recent years, increased regulation of alcohol beverages by various states included, but was not limited to, the imposition of higher excise taxes and advertising restrictions. Additional state and local legislative and regulatory actions affecting the marketing of alcohol beverages will likely be considered during 2007. The Company is unable to assess the future effects these regulatory and other actions may have on the sale of its wines.

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The Company uses grapes harvested from its own vineyards, as well as grapes purchased from independent growers located in Washington, California and Oregon and purchases bulk wine from other sources. Total grape tonnage harvested and purchased in 2006 is adequate to meet expected demand. The Company s principal competition comes from many larger, well-established national and international companies, as well as many smaller wine producers. The Company s principal methods of competition include quality, price, consumer and trade wine tastings, competitive wine judging and advertising.

ALL OTHER OPERATIONS

All Other Operations consists of the Company s international operations, which market moist smokeless tobacco products in select markets. Prior to June 18, 2004, All Other Operations also included a cigar operation which manufactured and marketed the premium cigar brands of DON TOMÁS, ASTRAL and HELIX. The cigar operation was transferred to a smokeless tobacco competitor on June 18, 2004, in connection with an agreement to resolve an antitrust action. Neither of the above, singly, constituted a material portion of the Company s operations in any of the years presented.

ADDITIONAL BUSINESS INFORMATION

Environmental Regulations

Compliance with federal, state and local provisions regulating the discharge of materials into the environment or otherwise relating to the protection of the environment has not had a material effect upon the capital expenditures, earnings or competitive position of the Company.

Number of Employees

The Company s average number of employees during 2006 was 5,008.

Trademarks and Patents

The Company markets its consumer products under a number of trademarks and patents. All of the Company s trademarks and patents either have been registered or applications therefore are pending with the United States Patent and Trademark Office.

Seasonal Business

No material portion of the business of any operating segment of the Company is seasonal.

Backlog of Orders

Backlog of orders is not a material factor in any operating segment of the Company.

Item 1A Risk Factors

Set forth below is a description of certain risk factors which the Company believes may be relevant to an understanding of the Company and its businesses. Stockholders are cautioned that these and other factors may affect future performance and cause actual results to differ from those which may, from time to time, be anticipated. See Cautionary Statement Regarding Forward-Looking Information included in Part II, Item 7 of this Form 10-K.

The Company s product sales and results of operations are subject to economic conditions and other factors beyond the Company s control. In addition, such conditions and other factors could affect the timing or amount of anticipated cost savings related to Project Momentum.

The Company s future results will be affected by the growth in the smokeless tobacco and wine marketplaces and the demand for the Company s smokeless tobacco and wine products. Factors affecting demand for the Company s products include, among other things, general economic conditions and actions by competitors, as well as the cost of the products to consumers which, in turn, is affected, in part, by the Company s costs in

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manufacturing such products and the excise taxes payable. Sales volumes of the Company s smokeless tobacco products, particularly premium products, may be impacted by fluctuations in gasoline prices, which have a direct impact on adult consumer disposable income. The impact of fluctuations in gasoline prices on smokeless tobacco product sales volume may be exacerbated due to the fact that a significant amount of the Company s products are sold at locations which also sell gasoline. The Company s quarterly results may also be affected by wholesaler order patterns. Many of these factors are beyond the control of the Company which makes results of operations difficult to predict.

In addition, the Company s ability to achieve its results of operations target is tied in part to successful implementation of its cost reduction initiative, called Project Momentum, which is designed to create additional resources for growth via operational, productivity and efficiency enhancements. Project Momentum, which commenced during the third quarter of 2006, is expected to result in targeted savings of at least $100 million over its first three years. While the Company believes its targeted cost reductions will be achieved, the Company cannot guarantee the success of the initiative. If Project Momentum is not successful, the Company s results of operations could be adversely affected.

Fire, violent weather conditions and other disasters may adversely affect the Company s operations.

A major fire, violent weather conditions or other disasters that affect the Company s manufacturing facilities, or its suppliers or vendors, could have a material adverse effect on the Company s operations. Although the Company believes it has adequate amounts of available insurance coverage and sound contingency plans for these events, a prolonged interruption in the Company s manufacturing operations could have a material adverse effect on its ability to effectively operate its business.

Company product sales are subject to customer concentration risk.

Over the past three years, sales to one customer in the Smokeless Tobacco segment have averaged approximately 16.6 percent of annual Smokeless Tobacco segment sales, while sales to two customers in the Wine segment have averaged 46.9 percent of annual Wine segment sales. No other customer accounted for 10 percent or more of Smokeless Tobacco segment or Wine segment sales over the three-year period. The loss of any of these customers, or a significant decline in sales orders from any of these customers, could have an adverse affect on the Company s results of operations or financial condition.

Ingredient or product adulteration could harm the integrity and quality of the Company s products, which could negatively impact consumer perception of the Company s brands and have an adverse effect on the sale of the Company s products.

The success of the Company s brands is dependent upon the quality of those brands and the positive perception that consumers have of such brands. Adulteration, whether arising accidentally or through deliberate third party action, could harm the quality of the Company s products and may result in reduced sales of the affected products, or have an adverse ancillary effect on the Company s other products, which could have an adverse affect on the Company s results of operations or financial condition.

The smokeless tobacco category is highly competitive and the Company s volumes and profitability may be adversely affected by continued consumer down-trading from premium brands to price-value brands or by new entrants into the marketplace.

The Company faces significant competition in the smokeless tobacco category, both from existing category competitors and new entrants, which may reduce its market share and put pressure on its gross margins. The Company s premium unit volume trends have recently improved, with a shift from declining premium net unit volume to modest growth; however, its premium net unit volume growth rate still lags the growth rate of the overall smokeless tobacco category. The Company recognizes the need to continue to expand the smokeless category, strengthen brand loyalty and develop innovative products to ensure continued growth in its results of operations.

The Company has been implementing plans which focus on the growth of the smokeless tobacco category by building awareness and social acceptability of smokeless tobacco products among adults and by promoting the convenience of smokeless tobacco relative to cigarettes to attract new adult consumers to the category.

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In light of the growth of price-value products, the Company has also been implementing plans to increase sales volume of its premium brands by building and strengthening premium brand loyalty through various promotional programs, including implementation of price-based programs to provide improved value in price sensitive areas of the United States, and through the introductions of new, differentiated premium products. However, while the Company believes that it is pursuing the right course of action, the Company cannot guarantee the success of these action plans. If the Company s strategy is not successful, total premium unit volume may decline and results of operations could be adversely affected.

In 2006, a major cigarette company entered the smokeless tobacco category through its acquisition of one of the Company s competitors. In addition, certain cigarette companies have begun test marketing smokeless tobacco products and have indicated the intent to continue to expand this activity. If smokers continue to switch from cigarettes to smokeless tobacco products, these competitors may strengthen their presence in the smokeless tobacco category, or other competitors with substantial resources may test or enter the smokeless tobacco category and introduce new products that are designed to compete directly with the Company s products. While there is the possibility that such actions may have the effect of expanding the smokeless tobacco category, which could be beneficial to the Company, it is also possible that such actions could be detrimental since it may require the Company to expend significant resources to maintain its premium unit volume. The Company cannot, at this time, predict with any certainty what effect, if any, such actions may have on the Company and its results of operations.

Fluctuations in the price and availability of tobacco leaf could adversely affect the Company s results of operations.

Tobacco is the most important raw material in the manufacture of the Company s smokeless tobacco products. The Company is not directly involved in the cultivation of tobacco leaf and is dependent on third parties to produce tobacco and other raw materials that it requires to manufacture its smokeless tobacco products. As with other agricultural commodities, the price of tobacco leaf tends to depend upon variations in weather conditions, growing conditions, local planting decisions, overall market demands or other factors. The Company s inability to purchase tobacco leaf of the desired quality from U.S. suppliers on commercially reasonable terms, or an interruption in the supply of these materials, in the absence of readily available alternative sources, could have a negative impact on the Company s business and its results of operations.

The Company s continuing ability to hire and retain qualified employees is important to the future success of the Company.

The environment in which the Company operates, as a smokeless tobacco company, presents challenges not faced by other consumer products companies. Accordingly, the continuing ability to hire and retain qualified employees who are capable of working in this challenging environment is critical to the Company s success.

The tobacco industry is subject to governmental regulation and other restrictions. In particular, restrictions on tobacco marketing and advertising limit the options available to the Company to market smokeless tobacco products.

Advertising, promotion and brand building continue to play a key role in the Company s business, with significant expenditure on programs to support key brands and to develop new products. As described above, in 1986, federal legislation was enacted regulating smokeless tobacco products by, among other things, requiring health warning notices on smokeless tobacco packages and advertising and prohibiting the advertising of smokeless tobacco products on any medium of electronic communications subject to the jurisdiction of the Federal Communications Commission. Since 1986, other proposals have been made at both the federal and state level for additional regulation of smokeless tobacco products. These proposals have included, among other things, increased regulation of the manufacturing and marketing of tobacco products by federal and state agencies (including, without limitation, the FDA), the requirement of additional warning notices, a ban or further restriction on advertising and promotion, ingredients and constituent disclosure requirements, restrictions on the use of flavorings, adult sampling bans or restrictions, tax stamping, increasing the minimum purchase age and the disallowance of advertising and promotion expenses as deductions under federal tax law. The regulatory environment in which the Company operates can also be affected by general social and political factors.

Proposals for comprehensive federal regulation of tobacco products will continue to be considered. The Company is not opposed to FDA regulation that addresses public health concerns and takes into account the distinct differences between smokeless tobacco and cigarettes while permitting the Company to continue to communicate responsibly with tobacco-interested adults and responsibly manufacture, market and sell quality smokeless tobacco products to adult consumers.

In addition to increased regulatory restrictions, the Company is subject to various marketing and advertising restrictions under the STMSA, which the Company entered into in 1998 with the attorneys general of various states and U.S. territories to resolve the remaining health care cost reimbursement cases initiated by various attorneys general. The Company is the only smokeless tobacco manufacturer to sign the STMSA. See Item 1 Business Smokeless Tobacco Products Principal Products. The Company also receives from time to time inquiries from various attorneys general relating to the STMSA and other state regulations in connection with various aspects of the Company s business.

Present regulations and any further regulations, depending on the nature of the regulations and their applicability to the Company and its future plans, could have an adverse effect on the Company s ability to advertise, promote and build its brands and/or to promote and introduce new brands and products and, as such, have an adverse effect on its results of operations.

The excise taxes on smokeless tobacco products could affect consumer preferences and have an adverse effect on the sale of the Company s products.

Smokeless tobacco products are subject to significant federal and state excise taxes, which may continue to increase over time. Any increase in the level of federal excise taxes or the enactment of new or increased state or local excise taxes would have the effect of increasing the cost of smokeless tobacco products to consumers and, as such, could affect the demand for, and consumption levels of, smokeless tobacco products in general and premium brands in particular. Furthermore, the current *ad valorem* method of taxation, which is utilized by most states, bases the amount of taxes payable on a fixed percentage of the wholesale price, as opposed to some states which tax premium and price-value brands equitably based on weight. Therefore, the *ad valorem* method of taxation has the inequitable effect of increasing the taxes payable on premium brands to a greater degree than the taxes payable on price-value brands, which further exacerbates the price gap between premium and price-value brands. To the extent that any such actions adversely affect the sale of the Company s products, such actions could have an adverse effect on the Company s results of operations and cash flows.

The Company has ongoing payment obligations under the Fair and Equitable Tobacco Reform Act, the STMSA and other state settlement agreements.

In 2006, the Company incurred expenses of approximately $3.2 million, $16.7 million and $4.3 million under the FETRA, the STMSA and other state settlement agreements, respectively. The Company presently expects to continue to incur expenses under the FETRA, the STMSA and other related settlement agreements. Based on information presently available to the Company, the Company does not anticipate that any increases in such expenses to be incurred in the future will have a material adverse effect on the Company. However, the amounts payable in the future cannot be predicted with certainty and may increase based upon, among other things, the relative share of the overall tobacco market held by smokeless tobacco and the Company s share of the moist smokeless tobacco marketplace. It is also possible that the amounts payable under the FETRA may be offset, in part, through reductions in the cost of tobacco, which may result from the competitive setting of prices expected to occur as a result of the FETRA.

The Company is subject, from time to time, to smokeless tobacco and health litigation, which, if adversely determined, could subject the Company to substantial charges and liabilities.

The Company is currently subject to various legal actions, proceedings and claims arising out of the sale, use, distribution, manufacture, development, advertising, marketing and claimed health effects of its smokeless tobacco products. See Item 3 Legal Proceedings. The Company believes, and has been so advised by counsel handling the respective 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 certain 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. However, if plaintiffs in these actions were to prevail, the effect of any judgment or settlement could have a material adverse impact on the Company s consolidated financial results in the particular reporting period in which any such litigation is resolved and, depending on the size of any such judgment or settlement, a material adverse effect on the Company s consolidated financial position. In addition, similar litigation and claims relating to the Company s smokeless tobacco products may continue to be filed against the Company in the future. An increase in the number of pending claims, in addition to the risks posed as to outcome, could increase the Company s costs of litigating and administering product liability claims.

The Company could be subject to additional charges and liabilities as it seeks to resolve the remaining antitrust related lawsuits.

In March of 2000, in an action brought by one of the Company s competitors, Conwood Company L.P. (Conwood Litigation), alleging violations of the antitrust laws, a significant verdict was rendered against the Company. See Item 3 Legal Proceedings. Following the commencement of this lawsuit, actions were also brought on behalf of direct and indirect purchasers of the Company s products. While the Company has paid the verdict and settled the actions brought on behalf of direct purchasers and many of the actions brought on behalf of indirect purchasers, a number of actions on behalf of indirect purchasers brought in a limited number of states are still ongoing. Further, the Company has been served in a purported class action attempting to challenge certain aspects of a settlement agreement reached with indirect purchasers in multiple states 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 intends to continue to pursue settlement of the remaining indirect purchaser actions on terms substantially similar to the settlements previously entered into by the Company in connection with other indirect purchaser actions, with the exception of a purported class action in the State of Pennsylvania, for which the Company believes there is insufficient basis for such a claim. As discussed in Item 3 Legal Proceedings, 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. However, if plaintiffs were to prevail, beyond the amounts previously accrued, the effect of any judgment or settlement could have a material adverse impact on the Company s consolidated financial results in the particular reporting period in which such action is resolved and, depending on the size of any such judgment or settlement, a material adverse effect on the Company s consolidated financial position.

The Company s wine business is subject to significant competition, including from many large, well-established national and international organizations.

While the Company believes that it is well positioned to compete based on the quality of its wines and the dedication of its workforce, its overall success may be subject to the actions of competitors in the wine category. Many of these competitors are large, well-established national and international companies with significant resources to support distribution and retail sales. In addition, sales of the Company s wines can be affected by the quality and quantity of imports.

The Company s wine business may be adversely affected by its ability to grow and/or acquire enough high quality grapes for its wines, which could result in a supply shortage. Conversely, the Company s wine business may also be adversely impacted by grape and bulk wine oversupply.

The adequacy of the Company s grape supply is influenced by consumer demand for wine in relation to industry-wide production levels. While the Company believes that it can grow and/or otherwise secure, through contracts with independent growers, sufficient regular supplies of high quality grapes, it cannot be certain that grape supply shortages will not occur. As grapes grown in the State of Washington account for approximately 95 percent of the Company s harvested and contracted grapes, if eastern Washington state experiences adverse weather conditions, widespread vine disease or other crop damage, fruit availability may be compromised, quality may be negatively impacted and production costs may increase. An increase in production cost could lead to an increase in the Company s wine prices, which may ultimately have a negative impact on its sales.

In cases of significant grape and bulk wine oversupply in the marketplace, the Company s ability to increase or even sustain existing sales prices may be limited.

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The Company s wine business may be negatively impacted by an increase in excise taxes or governmental regulations related to the alcohol beverages.

Significant increases in excise or other taxes on alcohol beverages could adversely affect sales of the Company s wine products. Federal, state and local governmental agencies regulate the alcohol beverage industry through various means, including licensing requirements, pricing, labeling and advertising restrictions, and distribution and production policies. New regulations, or revisions to existing regulations, resulting in further restrictions or taxes on the manufacture and sale of alcohol beverages may have an adverse affect on the Company s wine business.

Item 1B Unresolved Staff Comments

Not applicable.

Item 2 Properties

All of the principal properties in the Company s operations were utilized only in connection with the Company s business operations. The Company believes that the properties described below at December 31, 2006 were suitable and adequate for the purposes for which they were used, and were operated at satisfactory levels of capacity. All principal properties are owned by the Company.

Smokeless Tobacco Products

The Company owns and operates three principal smokeless tobacco manufacturing and processing facilities located in Franklin Park, Illinois; Hopkinsville, Kentucky; and Nashville, Tennessee.

Wine

The Company owns and operates nine wine-making facilities seven in Washington state, one in California and one in Oregon. In addition, it owns and operates vineyards in Washington state and California.

Item 3 Legal Proceedings

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 that 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.

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 six 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. The actions for three of these individuals have been dismissed; one in September 2006 which was dismissed without prejudice and two in October 2006 which were dismissed with prejudice. All three remaining individuals also allege the use of other tobacco products.

In *Matthew Vassallo v. United States Tobacco Company, et al.*, Circuit Court of the 11th Judicial District, Miami-Dade County, Florida (Case No. 02-28397 CA-20), this action by an individual plaintiff against various smokeless tobacco manufacturers including the Company and certain other organizations alleges personal injuries, including cancer, oral lesions, leukoplakia, gum loss and other injuries allegedly resulting from the use of defendants smokeless tobacco products. Plaintiff also claims nicotine addiction and seeks unspecified compensatory damages and certain equitable and other relief, including, but not limited to, medical monitoring.

In *Susan Smith, as Guardian for William Cole Cooper, a Minor v. UST Inc., et al.*, United States District Court for the District of Idaho (Civ.04-170-E-BLW), this action was brought against the Company on behalf of a minor child alleging that his father died of cancer of the throat as a result of his use of the Company s smokeless tobacco product. Plaintiff also alleges addiction to nicotine and seeks unspecified compensatory damages and other relief.

In *Kelly June Hill, Executrix and Fiduciary of the Estate of Bobby Dean Hill, et al. v. U.S. Smokeless Tobacco Company,* Connecticut Superior Court, Judicial District of Stamford (Docket No. FST-X05-CV-05-4003788-S) this action was brought by a plaintiff individually, as Executrix and Fiduciary of the Estate of Bobby Dean Hill, 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 $15,000 and other relief.

The Company believes, and has been so advised by counsel handling the foregoing 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 certain litigation issues, all such cases are, and will continue to be, vigorously defended.

Antitrust Litigation

The Company is named as a defendant in a number of purported class actions, as well as class actions in the states of California, Massachusetts and Wisconsin. On February 27, 2006, the Company was served with a Summons and Class Action Complaint in an action entitled *Gregory Hunt, et al. v. United States Tobacco Company, et al.*, United States District Court for the Eastern District of Pennsylvania (Case No. 06-CV-1099). Each of these actions are brought by indirect purchasers (consumers and retailers) 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 that, individually and on behalf of putative class members in a particular state or individually and on behalf of class members in the states of California, Massachusetts and Wisconsin, the Company violated the antitrust laws, unfair and deceptive trade practices statutes and/or common law of those states. Plaintiffs seek to recover compensatory and statutory damages in an amount not to exceed $75,000 per class member, or per putative class member, and certain other relief. The indirect purchaser actions are similar in all material respects.

The Company has entered into a settlement with indirect purchasers, which has been approved by the court, in the states of Arizona, Florida, Hawaii, Iowa, Maine, Michigan, Minnesota, Mississippi, Nevada, New Mexico, North Carolina, North Dakota, South Dakota, Tennessee, Vermont and West Virginia and in the District of Columbia (Settlement). Pursuant to the approved Settlement, adult consumers receive coupons redeemable on future purchases of the Company s moist smokeless tobacco products. The Company will pay all administrative costs of the Settlement and plaintiffs attorneys fees. The Company also intends to pursue settlement of other indirect purchaser actions not covered by the Settlement on substantially similar terms, with the exception of Pennsylvania, for which the Company believes there is insufficient basis for such a claim.

On March 8, 2006, the court entered final approval of the settlement of the Kansas class action and New York action. An evidentiary hearing on plaintiffs motion for an additional amount of approximately $8.5 million in attorneys fees, expenses and costs, plus interest, beyond the previously agreed-upon amounts already paid by the Company was held April 4-5, 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. (See Form 10-Q for the period ended September 30, 2005 for additional information.)

In *Robert A. Martin, et al. v. Gordon Ball, et al.*, United States District Court for the Northern District of West Virginia (No. 5:06-CV-85), the Company deemed service of the complaint to have been effective as of July 17, 2006 and filed an Answer. This action was brought by fifteen individual plaintiffs on behalf of themselves and a purported class of persons who filed claims for coupons as part of the Company s settlement of the action

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entitled *Philip Edward Davis, et al. v. United States Tobacco Company, et al.*, Circuit Court of Jefferson County, Tennessee. The *Martin* plaintiffs allege that the Company breached the Settlement Agreement in the *Davis* action, and has been unjustly enriched, because it failed to distribute to each of the purported class members a denomination of coupons with an aggregate value equal to the aggregate value of the coupons distributed as part of the settlement in another indirect purchaser action. Plaintiffs also allege claims for breach of fiduciary duty, unjust enrichment, and conversion against the counsel who represented the class members in the *Davis* action. Plaintiffs seek 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.

Each of the foregoing actions is derived directly from the previous antitrust action brought against the Company by a competitor, Conwood Company L.P. For the plaintiffs in the putative class actions to prevail, they will have to obtain class certification. The plaintiffs in the above actions also will have to obtain favorable determinations on issues relating to liability, causation and damages. The Company believes, and has been so advised by counsel handling these cases, that it has meritorious defenses in this regard, and they are, and will continue to be, vigorously defended.

Other Litigation

In *People of the State of California, ex rel. Bill Lockyer, Attorney General of the State of California v. U.S. Smokeless Tobacco Company,* Superior Court of California, County of San Diego (Case No. G1C851376), this action alleges that the Company s sponsorship relating to the National Hot Rod Association violates various provisions of the STMSA and the related Consent Decree entered in connection with the STMSA. The complaint seeks declaratory and injunctive relief, unspecified monetary sanctions, attorneys fees and costs, and a finding of civil contempt.

The Company believes, and has been so advised by counsel handling the foregoing case, that it has a number of meritorious defenses. Except as to the Company s willingness to consider alternative solutions for resolving certain litigation issues, the foregoing case is, and will continue to be, vigorously defended.

Item 4 Submission of Matters to a Vote of Security Holders

Not applicable.

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PART II

Item 5 Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market for Registrant s Common Equity

The Company s common stock is listed on the New York Stock Exchange (NYSE) under the symbol **UST.** As of January 31, 2007, there were approximately 7,065 stockholders of record of the Company s common stock. The table below sets forth the high and low sales prices per share of the Company s common stock, as reported by the NYSE Composite Tape, and the cash dividends per share declared and paid in each quarter during fiscal years 2006 and 2005. The Company has paid cash dividends without interruption since 1912. While the Company expects to continue its policy of paying cash dividends in the future, such policy is subject to annual review and approval by the Company s Board of Directors. Factors that are taken into consideration with regard to the level of dividend payments include the Company s net earnings, capital requirements and financial condition.

	2006			**2005**		
	High	**Low**	**Dividends**	**High**	**Low**	**Dividen**
First Quarter	**$43.14**	**$37.96**	**$0.57**	$56.90	$47.71	$0.55
Second Quarter	**45.78**	**41.10**	**0.57**	54.85	42.90	0.55
Third Quarter	**55.06**	**44.61**	**0.57**	47.62	39.81	0.55
Fourth Quarter	**59.49**	**52.34**	**0.57**	42.50	37.59	0.55
Year	**$59.49**	**$37.96**	**$2.28**	$56.90	$37.59	$2.20

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Performance Graph

The following graph compares the total returns for an investment in the Company s common stock over the last five years to the Standard and Poor s (S&P) 500 Stock Index and the S&P Tobacco Index assuming a $100 investment made on December 31, 2001. Each of the three measures of cumulative total return assumes reinvestment of dividends. The stock performance shown on the graph below is not necessarily indicative of future price performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN
Among UST Inc., The S&P 500 Index
And The S&P Tobacco Index

	December 31,					
	2001	2002	2003	2004	2005	2006
ST Inc.	$100.00	$101.02	$114.47	$162.74	$145.16	$217.06
& P 500	100.00	77.90	100.24	111.15	116.61	135.03
& P Tobacco	100.00	93.20	131.67	157.78	197.52	241.30

Issuer Purchases of Equity Securities

The following table presents the monthly share repurchases by the Company during the fourth quarter of the fiscal year ended December 31, 2006:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of the Repurchase Programs(1)	Maximum Number of Shares that May Yet Be Purchased Under the Repurchase Programs(1)
October 1 31, 2006	305,500	$55.07	305,500	13,534,052
November 1 30, 2006	309,400	$54.95	309,400	13,224,652
December 1 31, 2006	281,600	$57.33	281,600	12,943,052
Total	896,500	$55.74	896,500	

(1) 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.

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Item 6 Selected Financial Data

CONSOLIDATED SELECTED FINANCIAL DATA FIVE YEARS

(Dollars in thousands, except per share amounts)

	2006	2005	2004	2003	2002
Summary of Operations For the Year Ended December 31					
Net sales	**$1,850,911**	$1,851,885	$1,838,238	$1,731,862	$1,674,403
Cost of products sold (includes excise taxes)	**466,088**	443,131	412,641	384,487	358,931
Selling, advertising and administrative expenses	**525,990**	518,797	513,570	470,740	447,709
Restructuring charges	**21,997**				
Antitrust litigation	**2,025**	11,762	(582)	280,000	1,260,510
Operating income (loss)	**834,811**	878,195	912,609	596,635	(392,747)
Interest, net	**41,785**	50,578	75,019	76,905	46,146
Earnings (loss) from continuing operations before income taxes	**793,026**	827,617	837,590	519,730	(438,893)
Income tax expense (benefit)	**291,060**	293,349	299,538	197,681	(170,980)
Earnings (loss) from continuing operations	**501,966**	534,268	538,052	322,049	(267,913)
Income (loss) from discontinued operations (including income tax effect)	**3,890**		(7,215)	(3,260)	(3,556)
Net earnings (loss)	**$505,856**	$534,268	$530,837	$318,789	$(271,469)
Per Share Data					
Net earnings (loss) per basic share:					
Earnings (loss) from continuing operations	**$3.13**	$3.26	$3.26	$1.93	$(1.59)
Income (loss) from discontinued operations	**0.02**		(0.05)	(0.02)	(0.02)
Net earnings (loss) per basic share	**3.15**	3.26	3.21	1.91	(1.61)
Net earnings (loss) per diluted share:					
Earnings (loss) from continuing operations	**3.10**	3.23	3.23	1.92	(1.59)
Income (loss) from discontinued operations	**0.02**	-	(0.04)	(0.02)	(0.02)

Net earnings (loss) per diluted share	**$3.12**	$3.23	$3.19	$1.90	$(1.61)
Dividends per share	**$2.28**	$2.20	$2.08	$2.00	$1.92
Market price per share:					
High	**$59.49**	$56.90	$48.97	$37.79	$41.35
Low	**37.96**	37.59	34.00	26.73	25.30
Financial Condition at December 31					
Cash and cash equivalents	**$254,393**	$202,025	$450,202	$433,040	$382,003
Current assets	**998,110**	889,554	1,173,133	1,247,966	2,291,267
Current liabilities	**300,077**	258,778	618,873	521,093	1,462,442
Working capital	**698,033**	630,776	554,260	726,873	828,825
Ratio of current assets to current liabilities	**3.3:1**	3.4:1	1.9:1	2.4:1	1.6:1
Total assets	**1,440,348**	1,366,983	1,659,483	1,726,494	2,765,275
Long-term debt	**840,000**	840,000	840,000	1,140,000	1,140,000
Total debt	**840,000**	840,000	1,140,000	1,140,000	1,140,000
Stockholders equity (deficit)	**65,826**	75,098	9,565	(115,187)	(46,990)
Other Data					
Stock repurchased	**$200,003**	$200,038	$200,031	$150,095	$50,262
Dividends paid	**$367,499**	$361,208	$344,128	$322,986	$324,233
Dividends paid as a percentage of net earnings	**72.6%**	67.6%	64.8%	104.5%	N/M
Return on net sales	**27.3%**	28.8%	28.9%	18.4%	N/M
Return on average assets	**36.0%**	35.3%	31.4%	14.2%	N/M
Average number of shares (in thousands) basic	**160,772**	163,949	165,164	166,572	168,786
Average number of shares (in thousands) diluted	**162,280**	165,497	166,622	167,376	168,786

N/ M: Not meaningful due to net loss.

See Management s Discussion and Analysis and Notes to Consolidated Financial Statements.

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Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations

UST INC.

MANAGEMENT S DISCUSSION AND ANALYSIS (MD&A)

The following discussion and analysis of the Company s consolidated results of operations and financial condition should be read in conjunction with the consolidated financial statements and notes thereto, included in Part II, Item 8 of this Form 10-K. In MD&A, the Company makes forward-looking statements that involve risks, uncertainties, and assumptions. Actual results may differ materially from those anticipated in these forward-looking statements as a result of various factors, including, but not limited to, those presented under the Cautionary Statement Regarding Forward-Looking Information section presented at the end of MD&A. In addition, the Company has presented certain risk factors relevant to the Company s business in Item 1A in Part I of this 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 a general description of the Company s overall business, a description of the Company s business segments and a high-level summary of the Company s consolidated financial results for the most recently completed fiscal year.

RESULTS OF OPERATIONS This section provides an analysis of the Company s results of operations for the three years ended December 31, 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 next fiscal year. This section 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 years ended December 31, 2006, the Company s sources of liquidity, capital expenditures, debt outstanding, share repurchase programs and dividends paid on the Company s common stock and the Company s aggregate contractual obligations as of December 31, 2006.

OFF-BALANCE SHEET ARRANGEMENTS This section provides information regarding any off-balance sheet arrangements that are material to the Company s results of operations or financial condition.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES This section discusses accounting policies that are considered by the Company to be significant to the Company s financial condition and results of operations, require significant judgment and require estimates on the part of management in application.

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. U.S. Smokeless Tobacco Company is a leading manufacturer and marketer of moist smokeless tobacco products including brands such as Copenhagen, Skoal, Red Seal and Husky. International Wine & Spirits Ltd., through its Ste. Michelle Wine Estates subsidiary, produces and markets premium wines sold nationally under labels such as Chateau Ste. Michelle, Columbia Crest, Red Diamond, 14 Hands and Snoqualmie. In the third quarter of 2006, through an acquisition, the Company added the Erath label to its portfolio of premium wines. The Company also produces and markets sparkling wine under the

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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, and its operations are divided primarily into two segments: Smokeless Tobacco and Wine. The Company s international smokeless tobacco operations, which are not significant, are reported as All Other Operations.

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, 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 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 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, continued during 2006 and the Company intends to continue the program 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.

Premium Brand Loyalty

While category growth remains the Company s priority, it has significantly increased its focus on efforts to increase adult consumer loyalty within the premium segment of the moist smokeless tobacco category. 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, the Company believes the premium brand loyalty efforts have proven successful and, therefore, intends to build upon this success by increasing spending above 2006 levels on such initiatives during 2007, with the goal of growing underlying premium net unit volume approximately one percent in 2007.

WINE SEGMENT

The Company s focus in the Wine segment is to become one of the premier fine wine companies of 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. Achievements in 2006 were well aligned with these goals. According to ACNielsen, in 2006, the Company s wines comprised 6.2 percent of total domestic 750ml units; in 2005, such share was 5.9 percent. The alliance with Antinori, to become its exclusive United States importer and distributor, and the purchase of the Erath label and winery 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; comprising 30 percent of the

Management s Discussion and Analysis (Continued)

market based on ACNielsen data. Overall, the Wine segment maintained its strong leadership position in Washington state.

Recent ACNielsen wine industry data indicate that full-year 2006 case volume for the Company s wines grew approximately 17 percent compared to 2005, outpacing industry-wide domestic case volume growth for 750ml varietals of approximately 13 percent during the same period, reflecting expanded distribution of the Company s wines. 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.

CONSOLIDATED

The Company s results for 2006, while lower than 2005, reflected the impact of the strategic initiatives undertaken in 2006. Net sales and net earnings declined in 2006, tracing to the previously announced incremental costs incurred in the Smokeless Tobacco segment to stabilize premium net unit volume by strengthening premium brand loyalty and on additional category growth initiatives. These efforts produced the desired effect, as premium net unit volume for moist smokeless tobacco products stabilized for the full year in 2006, as compared to the prior year, and increased 1.7 percent during the fourth quarter of 2006, as compared to the comparative prior year period. In addition, during 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. Results for 2006 also reflect the impact of restructuring charges incurred in connection with Project Momentum. The Company believes that such an effort is prudent from a long-term growth perspective, as it is designed to provide additional financial flexibility in the increasingly competitive smokeless tobacco category. Results for 2006 were favorably impacted by the performance of the Wine segment, which once again had record net sales and operating profit. The results of 2006 also reflected increased net sales and operating income from All Other Operations.

Discussion of the Company s plans and initiatives in the Smokeless Tobacco and Wine segments is included in the Outlook section of MD&A.

RESULTS OF OPERATIONS

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

CONSOLIDATED RESULTS

2006 compared with 2005

	Year Ended December 31,		Increase/ (Decrease)	
	2006	**2005**	**Amount**	**%**
Net sales	**$1,850,911**	$1,851,885	$(974)	(0.1)
Net earnings	**505,856**	534,268	(28,412)	(5.3)
Basic earnings per share	**3.15**	3.26	(0.11)	(3.4)
Diluted earnings per share	**3.12**	3.23	(0.11)	(3.4)

Net Earnings

Consolidated net earnings decreased in 2006, as compared to 2005, as a result of lower operating income, partially offset by lower net interest and income tax expenses, as well as income from discontinued operations. The Company reported operating income of $834.8 million for 2006, representing 45.1 percent of consoli-

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dated net sales, compared to operating income of $878.2 million, or 47.4 percent of consolidated net sales, in 2005. The decrease in operating income was primarily due to the following:

- Lower net revenue realization per premium unit in the Smokeless Tobacco segment;
- Increased costs of products sold in the Wine segment, mainly related to increased case volume;
- The impact of $22 million in restructuring charges incurred in connection with Project Momentum (see *Restructuring Charges* section below), which adversely impacted the operating margin percentage by approximately 1.2 percentage points; and,
- Increased selling, advertising and administrative (SA&A) expenses.

These factors were partially offset by:

- Increased case and net can volume in the Wine and Smokeless Tobacco segments, respectively;
- Cost savings realized in connection with Project Momentum, along with the intended ancillary benefit derived from an enhanced focus on cost containment in other areas; and,
- Lower charges related to certain states indirect purchaser antitrust actions.

Net earnings for 2006 included after-tax income of $3.9 million from discontinued operations, which resulted from the reversal of an accrual for an income tax-related contingency originally recorded in connection with the June 2004 transfer of the Company s former cigar operations to a smokeless tobacco competitor. This reversal resulted from a change in facts and circumstances, as the income tax consequences of the Company s anticipated sale of its corporate headquarters in connection with Project Momentum have eliminated the need for the aforementioned contingency.
Basic and diluted earnings per share for 2006 were $3.15 and $3.12, respectively, a decrease of 3.4 percent for each measure as compared to the corresponding comparative measures in 2005. Average basic shares outstanding were lower in 2006 than in 2005 primarily as a result of share repurchases, partially offset by the exercise of stock options. Average diluted shares outstanding in 2006 were lower than those in 2005 due to the impact of share repurchases and a lower level of dilutive outstanding options, partially offset by the impact of a higher average stock price in 2006, as compared to 2005, which has the effect of increasing diluted shares outstanding.

Net Sales

	Year Ended December 31,		Increase/ (Decrease)	
	2006	**2005**	**Amount**	**%**
Net Sales by Segment:				
Smokeless Tobacco	**$1,522,686**	$1,561,667	$(38,981)	(2.5)
Wine	**282,403**	248,342	34,061	13.7
All Other Operations	**45,822**	41,876	3,946	9.4
Consolidated Net Sales	**$1,850,911**	$1,851,885	$(974)	(0.1)

For the year ended December 31, 2006, consolidated net sales of $1.851 billion were effectively level with those in 2005 reflecting the following:

- Lower net revenue realization per premium unit in the Smokeless Tobacco segment in connection with the implementation of the Company s premium brand loyalty initiatives;
- Increased net unit volume for moist smokeless tobacco products, including a slight increase in premium net unit volume;

Improved case volume for premium wine; and,
Increased international sales of moist smokeless tobacco products.

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Management s Discussion and Analysis (Continued)

Segment Net Sales as a Percentage of Consolidated Net Sales

2006

2005

* Smokeless Tobacco

Gross Margin

	Year Ended December 31,		Increase/ (Decrease)	
	2006	**2005**	**Amount**	**%**
Gross Margin by Segment:				
Smokeless Tobacco	**$1,256,156**	$1,289,212	$(33,056)	(2.6)
Wine	**99,418**	92,618	6,800	7.3
All Other Operations	**29,249**	26,924	2,325	8.6
Consolidated Gross Margin	**$1,384,823**	$1,408,754	$(23,931)	(1.7)

The consolidated gross margin decline, as compared to the prior year, was primarily due to lower net sales in the Smokeless Tobacco segment and higher cost of products sold for the Wine segment and All Other Operations, partially offset by higher Wine segment and All Other Operations net sales.

Year Ended December 31,