

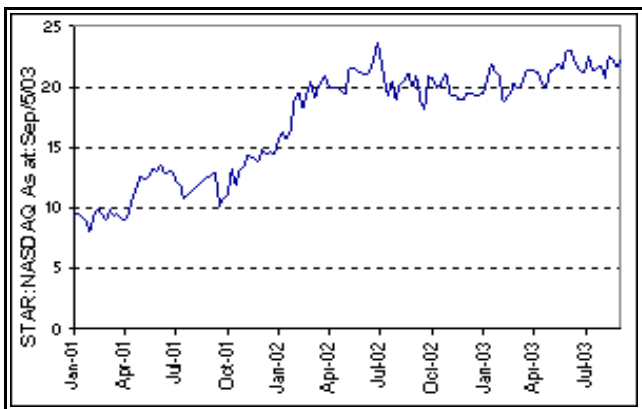
## THE COMPANY

Lone Star Steakhouse owns and operates over 243 mid-priced, casual dining restaurants. Its "Texas-style" menu can be found under three different banners throughout the United States, as well as, 26 restaurants in Australia and Canada. Lone Star Steakhouse & Saloon provides a roadhouse type atmosphere, Del Frisco's Double Eagle Steak House caters to a more high-end business clientele and Sullivan's Steakhouse provides entertainment with jazz and swing music featured regularly.

## FINANCIAL DATA

	2000	2001	2002e
Earnings per Share (\$)	0.62	0.55	0.75
Price to Earnings (times)	29.0	32.7	24.0
Dividend (\$)	0.38	0.50	0.60
Dividend Yield (%)	2.11	2.78	3.33
Book Value (\$)	16.71	18.89	19.00
Price to Book Value (times)	1.08	0.95	0.94

## HISTORICAL SHARE PRICES



## WHY ABC FUNDS BOUGHT LONE STAR

While we are bottom-up investors at ABC Funds, the overall economic environment always plays a key role in stock picking. The current stock market volatility and economic uncertainty leave many investors wondering whether consumer driven sectors will perform despite a faltering economy. We believe that fundamental analysis is key, particularly now. Sticking to companies with strong balance sheets and solid operations will provide investors with added protection during uncertain times. With this in mind, we feel that Lone Star Steakhouse is a fundamentally undervalued company with a number of significant features.

Lone Star presently trades at \$12.50 and carries a 4% dividend yield. But at one point, only five years ago in 1996, the stock was trading above \$40. A tough 1998 precipitated a substantial share price decline which has left the stock languishing between \$8 to \$12 for the past two and half years. Currently Lone Star trades below its tangible book value of \$16.81, which is significantly lower than its industry peers which trade at about 3.85 times book value. The company provides excellent cash flow, is debt free and has considerable financial flexibility for expansion and acquisitions.

We do not feel that Lone Star's low valuations are warranted. While the last few years have proven to be challenging for Lone Star, we feel that management is on the right track. The first quarter of 2001 has been a reflection of this. Net income was up 16% over the comparable quarter and same store sales increased for all three of its banners. Management has recognized that slow and steady wins the race and has moderated expansion plans. The company has also re-evaluated its geographic stance resulting in the closure and sale of a number of non-profitable locations. It is also worth noting that as of March 2001, Lone Star owns approximately 65% of its locations which might provide added value to the company in the event of a sale.

In the meantime Lone Star remains fundamentally sound. It generates free cash flow and has no debt on the balance sheet. Its favourable financial position which includes \$39.5 million (\$1.64 per share) in cash allows for the continuation of its \$0.50 per year dividend, which was implemented in the second quarter of 2000 and a significant share repurchase program. Over the past three years Lone Star's share repurchase program has been very aggressive. Its shares outstanding have decreased from about 41 million in 1997 to 24 million today, having repurchased shares at an average price of \$9.61. These shares were acquired well below book value, were anti-dilutive and have significantly increased Lone Star's book value without incurring any debt. Incidentally, management owns approximately 23% of the company stock, with the CEO, Jamie Coulter owning about 10% or 2.4 million shares. With the share buyback continuing, this "creeping privatization" increases management's interest, control and motivation.

Although the restaurant industry can be extremely difficult and is out of favour in the current economic environment, we believe Lone Star's low valuations and fundamental financial strength reduce downside risk and provide excellent future upside potential.

## UPDATES

Since our original write-up of Lone Star on May 18 the company has become a bit of a news item. Firstly, it has been announced that a dissident shareholder, Guy Adams, whom by the way only owns 1,100 shares is attempting to get voted onto the Board and oust Jamie Coulter. The current Board of directors and management team owns 26% of the company. We view this action as negative in the short term but potentially positive in the longer term. Lone Star remains fundamentally cheap and this activity may prompt management to review its options in order to create additional shareholder value. In our view, we see this as a catalyst for a possible takeover, an aggressive share buyback program or privatization. More importantly we feel that this publicity will bring deserved attention to the stock and may attract more interest.

The second piece of data that has put some pressure on Lone Star's share price is its removal from the S&P Midcap 400 Index and its placement in the S&P Smallcap 600 Index. In essence, Lone Star has demoted itself to this level through its assertive share buyback program. With Lone Star trading at a significant discount to its book value, we view its anti-dilutive share repurchase program as very positive.

While we believe that in the long run these events will create a catalytic spin for Lone Star, we will have to ride out the short-term effects on its share price. We have taken advantage of this downward pressure in order to add to our position.

ABC Funds  
June 29, 2001

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The fear of economic and stock market uncertainty continues to plague investors. But in light of the recessionary environment Lone Star reported solid third quarter results with 4.2% revenue growth and an increase in adjusted net income to \$0.20 versus \$0.11 in the comparable quarter. While a softer fourth quarter is looming we feel that the company's fundamental strength will help to endure a slowdown in the economy.

Moreover, Lone Star continues to be an extremely compelling value play. Lone Star still trades significantly below its tangible book value of almost \$17 and at a dividend yield of 4%. It has a healthy balance sheet with no debt, bolstered by \$2.39 per share of cash. Of particular interest is the fact that Lone Star has retained UBS Warburg to explore strategic alternatives for the company. The company has an aggressive share buyback program in place; we feel that privatization is a possibility. Also, its low valuations earmark the company as a viable takeover candidate. In the meantime, as patient investors we will anxiously await a catalytic event that will result in significant share price appreciation.

ABC Funds  
October 19, 2001

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Over the last few months Lone Star's shareholders have become very aggressive in pushing management towards creating shareholder value. As a result several new corporate governance initiatives have been implemented:

- The Board has decided to increase the number of directors on the Board to eight from five. This has led to the addition of three new qualified and accomplished members: Tommy LaSorda, Michael Ledeen, and Mark Saltzgaber.
- It has been decided to terminate Lone Star's poison pill by redeeming its stock purchase rights. Consequently, shareholders will receive a one-time payment of \$0.01 per common share, which will be paid on December 10.
- It is going to be put forth at the next annual meeting to remove the staggered terms of directors. The proposal suggests that directors should be reelected annually commencing in 2003.

We view these proposed changes as positive for Lone Star. The company continues to review all aspects of the company in order to realize value for its shareholders. We feel that in time Lone Star's efforts will increase its share price.

ABC Funds  
November 23, 2001

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At \$18.00 we have seen Lonestar's share price appreciate significantly since we originally earmarked it as a value favourite. This has, in part, been fuelled by stronger consumer confidence levels and better than expected earnings.

Earnings per share for the fourth quarter 2001, before unusual items were \$0.14 compared to \$0.03 in 2000. The company was able to boost its fourth quarter results through the improvement of operating controls, higher average unit sales and lower beef prices. For the year the company reported earnings per share of \$0.55 versus \$0.62 in 2000. We are pleased with these results as they come in spite of a tough economic period.

Although Lonestar's stock price has significantly appreciated over the last few months, we feel that there is more value yet to be realized. Its fundamentals remain firm with a book value of \$18.90, no debt on the balance sheet and \$3.45 per share in cash. Also, on January 9, Lonestar announced a 20% increase in its quarterly cash dividend from \$0.125 to \$0.15 per share. Additionally,

## UPDATES (cont'd)

Lonestar continues to buy back stock under its share repurchase plan. It is also important to keep in mind that Lonestar has been exploring strategic alternatives for the company. This could result in an opportunistic acquisition or takeover bid. In the meantime, we continue to monitor the stock carefully as its fundamentals strengthen its share price.

ABC Funds  
February 1, 2002

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On April 2, Lone Star announced that it received a buyout offer from Bruckmann, Rosser, Sherrill & Co., a New York investment firm. A non-binding letter of intent was signed by Lone Star, which expires on April 27. It is expected that the transaction will close in the third quarter. Bruckmann, Rosser, Sherrill has investments in other restaurant ventures such as California Pizza Kitchen and McCormick and Schmick Restaurant Corp.

The offer of \$20.50 for Lone Star's common stock, is essentially what we would define as a "take-under", as it was below the previous days closing price of \$20.66 and only one times its book value. We feel that Lone Star warrants a higher price and since it is a non-binding letter of agreement, we believe that there remains a possibility that another offer could be put forth.

ABC Funds  
April 12, 2002

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We have sold all of our Lone Star Steakhouse & Saloon Inc. shares through Lone Star's 4 million share modified Dutch auction tender / buyback at \$21 3/8 net. While we believe that the share price can go higher, we tendered our holdings as the stock price had reached our primary price target.

We netted a 71% capital gain over a ten month period and collected several income dividends. The proceeds of this disposition will provide us with the necessary cash to purchase new undervalued securities which we are now uncovering during the present market weakness.

ABC Funds  
July 5, 2002

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We have recently repurchased our holding of Lone Star Steakhouse which we previously liquidated at \$21.40 during the company's 4 million share Dutch auction buyback in June. Since that time, Lone Star has fallen to \$18 - 18 1/2 which, we believe, represents excellent long term value.

As of its September 19, 2002 reporting date for its third quarter ending September 3, 2002, Lone Star earned a fully-diluted 32¢ vs. 20¢ per share for the same period last year. The company remains debt-free, with good free cash flow, is on track to earn \$1.60 / \$1.70 for 2002, pays a 60¢ dividend which provides for a 3.3% yield and trades below an estimated third quarter book value of approximately \$19.14. On a comparative basis, Lone Star continues to trade at a significant discount to its casual-dining competitors with regard to PE multiples, book value, etc.

ABC Funds  
September 26, 2002

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As we briefly discussed last week, we have repurchased an old familiar Value Favourite, Lone Star Steakhouse. Although we had tendered our stock in Lone Star through the modified Dutch auction, we still believed in the Company's fundamentals. In the months since the tender offer, Lone Star fell below \$19 and we took advantage of the market turbulence to rebuild a position in the stock. We would like to elaborate on our rationale and provide some more details on the story.

One of the most important attributes of a value investor is discipline. Discipline to buy cheap stocks and discipline to sell them when they become fairly valued or even overvalued. Our investment discipline forced us to liquidate our position in Lone Star once the stock reached our primary target. We simply felt that it was time to "ring the till" based on Lone Star's valuation after a period of solid share price performance.

In the market turmoil of recent months, Lone Star's share price pulled back below \$19. Because we had been patiently waiting for attractive investment opportunities, we again purchased the stock. At these levels, Lone Star was trading below book value, was debt free, was generating free cash flow, was buying back shares and was yielding just over 3%. Given the trend of improving quarterly financial results and the emphasis on building shareholder value, we believe that Lone Star could easily return to levels reached in late June/early July of 2002.

The Lone Star story should be a familiar one. Basically, the Company owns and operates a chain of Texas-style casual dining restaurants as well as two more-upscale chains. But the real story is much more intriguing. Lone Star Steakhouse, after a tremendous

## UPDATES (cont'd)

run in the mid 1990's, traded at a discount to its peers for various reasons. However, 2001 turned out to be a very eventful year and was a turning point for the stock's performance. A dissident shareholder was elected to the Board of Directors and, perhaps not coincidentally, corporate governance and shareholder value became top priorities.

Lone Star's management responded well by separating the positions of Chairman and Chief Executive Officer, increasing the number of Board members from 5 to 8, redeeming the "poison pill" or share purchase rights and retaining UBS Warburg to review strategic options and alternatives to enhance shareholder value. Next, Lone Star signed a letter of intent with Bruckmann, Rosser & Sherrill for the sale of the Company. However, the two parties could not agree on specific terms and the letter of intent was allowed to expire. After further review, the Company announced a modified Dutch Auction Tender Offer for up to 4 million shares. The tender offer was over subscribed, so the Company purchased approximately 85.5% of the shares tendered at \$21.375. Shareholders were then free to hold or sell their remaining 14.5% in the open market.

We tendered our stock and sold the balance in the market because we felt the price was fair. But the subsequent share price decline and several new developments caused us to look at the stock again. On September 10, 2002, Lone Star released preliminary operating results for its third quarter. The Company stated that earnings would be in the range of \$0.30 to \$0.32 per share on a diluted basis. Importantly, the Company raised guidance for full year fiscal 2002 sales of \$605 to \$615 million and earnings per share of \$1.63 to \$1.70, after adjusting for unusual items.

When the third quarter results were released on September 19, 2002, adjusted net income came in at \$0.32 per fully diluted share, at the upper end of the forecasted range, compared to \$0.20 reported the previous year. With the combination of an active share buyback program, the Dutch auction and earnings growth, book value has grown to \$19.15 per share.

On the third quarter conference call, management discussed the Company's strategic outlook. After opening 11 Lone Star restaurants in 2001, there were no plans for expansion in 2002. However, management suggested that between 8 and 12 Lone Star restaurants and 2 to 4 new high-end restaurants would be opened in 2003. Most of the locations will be leased and the capital expenditure is expected to total approximately \$25 million. This expansion can be easily financed using internally generated cash flow and the Company's strong balance sheet.

We believe that management has shown good progress in terms of improving corporate governance and building shareholder value. Lone Star's discount to its peers should contract as the Company opens new locations and demonstrates revenue and earnings growth. Our discipline will again force us to act decisively should Lone Star approach fair value under our updated set of assumptions and projections.

ABC Funds

October 4, 2002

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On February 5th 2003 Lone Star Steakhouse and Saloon reported financial results for the fourth quarter and year ending 2002. Income from continuing operations before restaurant-closing costs increased 3.1% to \$12.5 million or \$0.59 per share for the fourth quarter and 49.2% to \$42.3 million or \$1.91 per share for the year. Revenue from continuing operations increased 8% to \$195 million for the fourth quarter and increased 3.9% to \$616 million for the year.

During the fourth quarter, management repurchased 1.1 million shares bringing the total to 5.1 million shares for the full year. Since 1997, Lone Star management has reduced the total outstanding number of Lone Star shares from 41 million to 21 million. The measurable benefit to shareholders of buying back stock cannot be ignored, as the earning power of each share has nearly doubled in five years as a result.

Lone Star has also announced that it will increase the size of its quarterly dividend by 10% from \$0.15 per share to \$0.165 per share. On an annualized basis, the dividend will increase from \$0.60 per share to \$0.66 per share. This is the second consecutive year that Lone Star has increased its dividend reflecting the company's strong balance sheet and cash flow as well as management's commitment to creating shareholder value.

On the company's conference call, management gave earnings per share guidance in the range of \$1.80 to \$1.90 per basic share for 2003. While slightly below 2002 levels, management explained that the lower guidance is due to the fact that fiscal 2002 enjoyed a 53rd week of operations including two New Year's Eve sales days in 2002. As a result, 2003 will not have a New Year's Eve sales day. Management estimated that the extra week during the holidays in fiscal 2002 added \$12.9 million to revenues and \$2 million or \$0.09 per share to net income for the fourth quarter.

The company plans to open 6-8 more restaurants in 2003 and well as continue its program of remodeling its existing restaurants. The remodeling is to consist of "contemporarizing" the steakhouses by improving the lighting, staff uniforms, and music and by eliminating line-dancing night. Restaurants that have been remodeled have so far experienced an 8%-10% improvement in sales.

Lone Star continues to trade at a discount to its book value of \$20 per share, a ten times multiple to expected 2003 earnings and a

## UPDATES (cont'd)

yield of 3.5%. On a comparative basis, Lone Star trades at a discount to its casual dining peers on a P/E and book value basis. Any dissipation in homeland security fears or signs of economic improvement should compel U.S. consumers to return to dining out more frequently. When this does occur, we believe Lone Star will benefit accordingly.

ABC Funds  
February 14, 2003

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On April 11th Lone Star Steakhouse and Saloon reported operating results for the first quarter of 2003. Net income from continuing operations was \$8.7 million or \$0.41 per share down from \$12.2 million or \$0.53 per share in the first quarter last year. Revenue from continuing operations declined 2.3% to \$144.5 million in the quarter from \$147.8 million last year. It is important to note that last year's first quarter included New Year's eve sales and profits that were not included in this quarter's numbers. Additionally, sales during the first quarter were impacted by severe snowstorms, the war with Iraq, and a challenging U.S. economy.

On May 20th, Canada's Federal Agricultural Minister announced that the remains of a cow slaughtered in late January tested positive for bovine spongiform encephalopathy, better known as BSE or mad-cow disease. Although meat from the cow did not enter the food chain, news of the finding sent restaurant stocks with beef-dominant menus sharply lower. Many investors feared that Americans would boycott hamburger chains and steakhouses in much the same way the British and Japanese did in 2000 and 2001 after similar outbreaks occurred.

We believe that business at Lone Star's restaurants will not be significantly impacted by this isolated case of BSE in Canada. First of all, Lone Star does not operate any steakhouses in Canada, nor does it import any beef from Canada. Second, interest in the story by the U.S. media seems to be dissipating. The perceived risk of contracting mad cow disease usually has a greater impact on business than the actual risk of contracting it. Currently, the perceived risk of the disease will depend to a large degree upon how much play it continues to receive in the American press. While the story still dominates the newspaper headlines in Canada at this time, it is receiving far less attention south of the border. With mad cow disease out of the headlines in the U.S for the moment, we believe that business will remain as usual at Lone Star's steakhouses and saloons.

ABC Funds  
May 23, 2003

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Sales were higher at Lone Star restaurants in the second quarter of 2003 compared to the same period last year. This reverses the sales trend reported in the first quarter, which was negatively impacted by the Iraq war, unfavourable weather and concerns about the U.S. economy. Net income for the quarter rose 26% to \$7.1 million or \$.37 per share compared with \$6.1 million or \$.24 for the second quarter of last year. It should be noted that this year's quarter benefited from a favourable tax rate and the exclusion of a one-time merger cost which lowered earnings in last year's quarter. Adjusting for these one-time exceptions, Lone Star's earnings would have been lower on a year over year basis.

Perhaps the most significant impact on this quarter's earnings was food costs, which increased to 34.9% of sales from 32.9% a year ago. As we reported in May, a single cow in Alberta was found to have bovine spongiform encephalopathy, or mad cow disease. This event became the basis for a U.S. import ban on all Canadian beef and while Lone Star does not purchase any of its beef from Canada, this supply disruption has caused the price of U.S. beef to soar. In the last three weeks of June, food costs were running at 37% of sales at Lone Star.

Earnings for the second half of 2003 at Lone Star will likely be less than earnings in the second half of last year. Fourth quarter results this year will not include sales from New Year's Eve due to the timing of Lone Star's fiscal year end. Also, beef costs will likely remain at current levels due to the import ban on Canadian beef. With that, we now expect Lone Star's full year earnings to be less than management's previously stated guidance of between \$1.80 and \$1.90 per share.

Despite a cautious outlook for the remainder of 2003, we continue to believe that Lone Star represents an attractive investment opportunity for those willing to look ahead to 2004 or even 2005. Lone Star's book value is now over \$20 a share and the company remains completely debt free. The question that begs to be asked is whether Lone Star is a candidate for a management-led leveraged buyout. In the meantime Lone Star's annual dividend of \$.66 per share (which was raised from \$.60/share in February) represents a yield of over 3% and the company continues to repurchase its shares on an ongoing basis. Lone Star is well positioned to benefit from a better economy and lower beef prices once the import ban on Canadian beef is lifted. In addition, Lone Star management is expected to launch a full scale remodeling program after it completes some initial tests next quarter. We believe that these factors will result in higher sales and earnings for Lone Star and eventually a higher valuation of its shares.

ABC Funds  
July 25, 2003

## **UPDATES (cont'd)**

For the second time in just over a year, we have liquidated our position in Lone Star Steakhouse and Saloon. Our primary motive for the sale was valuation, as Lone Star shares had increased nearly 10% since our last update. On August 21st Lone Star significantly lowered its earnings guidance for the year due to the continuing high cost of beef, which represents over 60% of its costs. While admittedly this is only a short term negative until the mad-cow concerns dissipate, the Company now expects to earn between \$0.12 and \$0.15 for the third quarter and between \$0.92 and \$1.08 per share for the full year. On that note, Lone Star shares now trade at over twenty times this year's earnings, and at a 22% premium to its tangible book value of \$18.43. In the event that the shares decline and reflect the poor near term profit outlook, we will review the stock for possible repurchase.

ABC Funds

September 5, 2003

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