

G&K SERVICES INC  
Form 10-Q  
May 05, 2006

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 10-Q**  
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**  
**OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended April 1, 2006**  
**Commission file number 0-4063**  
**G&K SERVICES, INC.**  
(Exact name of registrant as specified in its charter)

MINNESOTA

41-0449530

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

5995 OPUS PARKWAY  
MINNETONKA, MINNESOTA 55343

(Address of principal executive offices and zip code)  
(952) 912-5500

(Registrant's telephone number, including area code)

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

YES

NO

Indicate by 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  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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

Common Stock, par value \$0.50 per share, outstanding  
May 1, 2006 was 21,271,489 shares.

---

**Table of Contents**

**G&K Services, Inc.  
Form 10-Q  
Table of Contents**

	<b>PAGE</b>
<b><u>PART I</u></b>	
<b><u>Item 1.</u></b> <b><u>Financial Statements</u></b>	
<u>Consolidated Condensed Balance Sheets as of April 1, 2006 and July 2, 2005</u>	3
<u>Consolidated Statements of Operations for the three and nine months ended April 1, 2006 and April 2, 2005</u>	4
<u>Consolidated Condensed Statements of Cash Flows for the nine months ended April 1, 2006 and April 2, 2005</u>	5
<u>Notes to Consolidated Condensed Financial Statements</u>	6
<b><u>Item 2.</u></b> <b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	14
<b><u>Item 3.</u></b> <b><u>Quantitative and Qualitative Disclosure About Market Risk</u></b>	23
<b><u>Item 4.</u></b> <b><u>Controls and Procedures</u></b>	23
<b><u>PART II</u></b>	
<b><u>Item 2.</u></b> <b><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	24
<b><u>Item 6.</u></b> <b><u>Exhibits</u></b>	24
<b><u>Signatures</u></b>	25
<u>Chief Executive Officer to Sec. 302 Certification</u>	
<u>Chief Financial Officer to Sec. 302 Certification</u>	
<u>Chief Executive Officer to Sec. 906 Certification</u>	
<u>Chief Financial Officer to Sec. 906 Certification</u>	

**Table of Contents**

**PART I**  
**FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS****CONSOLIDATED CONDENSED BALANCE SHEETS***G&K Services, Inc. and Subsidiaries*

(In thousands)	April 1, 2006 (Unaudited)	July 2, 2005 (Restated)
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 21,960	\$ 15,345
Accounts receivable, less allowance for doubtful accounts of \$3,146 and \$2,890	95,426	83,459
Inventories	137,290	121,120
Prepaid expenses	14,630	16,587
Total current assets	269,306	236,511
<b>Property, Plant and Equipment, net</b>	249,896	243,307
<b>Goodwill</b>	344,642	338,701
<b>Other Assets</b>	84,336	84,650
	\$ 948,180	\$ 903,169
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 32,874	\$ 25,695
Accrued expenses	66,877	71,483
Deferred income taxes	9,201	8,971
Current maturities of long-term debt	17,925	26,537
Total current liabilities	126,877	132,686
<b>Long-Term Debt, net of Current Maturities</b>	212,066	210,462
<b>Deferred Income Taxes</b>	30,756	30,887
<b>Other Noncurrent Liabilities</b>	54,427	47,691
<b>Stockholders Equity</b>	524,054	481,443
	\$ 948,180	\$ 903,169

The accompanying notes are an integral part of these consolidated condensed financial statements.

**Table of Contents****CONSOLIDATED STATEMENTS OF OPERATIONS***G&K Services, Inc. and Subsidiaries*

(Unaudited)

	For the Three Months Ended		For the Nine Months Ended	
	April 1, 2006	April 2, 2005 (Restated)	April 1, 2006	April 2, 2005 (Restated)
(In thousands, except per share data)				
<b>Revenues</b>				
Rental operations	\$ 201,562	\$ 188,064	\$ 594,985	\$ 547,465
Direct sales	24,579	15,746	58,452	33,912
Total revenues	226,141	203,810	653,437	581,377
<b>Operating Expenses</b>				
Cost of rental operations	131,387	119,139	383,565	346,563
Cost of direct sales	17,659	12,011	42,015	25,348
Selling and administrative	49,619	43,283	141,219	124,577
Depreciation and amortization	10,883	10,407	32,126	30,726
Total operating expenses	209,548	184,840	598,925	527,214
<b>Income from Operations</b>	16,593	18,970	54,512	54,163
Interest expense	3,395	2,891	9,712	8,080
<b>Income before Income Taxes</b>	13,198	16,079	44,800	46,083
Provision for income taxes	2,840	6,129	13,837	17,338
<b>Net Income</b>	\$ 10,358	\$ 9,950	\$ 30,963	\$ 28,745
Basic weighted average number of shares outstanding	21,132	20,994	21,069	20,910
<b>Basic Earnings per Common Share</b>	\$ 0.49	\$ 0.47	\$ 1.47	\$ 1.37
Diluted weighted average number of shares outstanding	21,311	21,322	21,228	21,362
<b>Diluted Earnings per Common Share</b>	\$ 0.49	\$ 0.47	\$ 1.46	\$ 1.35
<b>Dividends per share</b>	\$ 0.0175	\$ 0.0175	\$ 0.0525	\$ 0.0525

The accompanying notes are an integral part of these consolidated condensed financial statements.

**Table of Contents****CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS***G&K Services, Inc. and Subsidiaries*

(Unaudited)

	For the Nine Months Ended	
	April 1,	April 2,
(In thousands)	2006	2005 (Restated)
<b>Operating Activities:</b>		
Net income	\$ 30,963	\$ 28,745
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	32,126	30,726
Stock-based compensation	3,060	2,891
Deferred income taxes	354	1,095
Changes in current operating items, exclusive of acquisitions	(17,320)	(20,253)
Other assets and liabilities	829	1,159
Net cash provided by operating activities	50,012	44,363
<b>Investing Activities:</b>		
Property, plant and equipment additions, net	(26,414)	(10,194)
Acquisitions of business assets and other	(13,020)	(74,895)
Net cash used for investing activities	(39,434)	(85,089)
<b>Financing Activities:</b>		
Repayments of long-term debt	(7,661)	(21,317)
Proceeds from short-term borrowings, net	2,050	41,200
Cash dividends paid	(1,112)	(1,100)
Sale of common stock	2,395	4,268
Net cash (used for) provided by financing activities	(4,328)	23,051
<b>Increase (Decrease) in Cash and Cash Equivalents</b>	<b>6,250</b>	<b>(17,675)</b>
<b>Effect of Exchange Rates on Cash</b>	<b>365</b>	<b>1,608</b>
<b>Cash and Cash Equivalents:</b>		
Beginning of period	15,345	26,931
End of period	\$ 21,960	\$ 10,864
<b>Supplemental Cash Flow Information:</b>		
Non-Cash Transactions		
Debt issued in connection with business acquisitions	\$ (1,419)	\$ 11,890

The accompanying notes are an integral part of these consolidated condensed financial statements.

5



**Table of Contents**

G&K SERVICES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
(Amounts in thousands, except per share data)  
Three and nine month periods ended April 1, 2006 and April 2, 2005  
(Unaudited)

The consolidated condensed financial statements included herein, except for the July 2, 2005 balance sheet which was derived from the audited consolidated financial statements for the fiscal year ended July 2, 2005, have been prepared by G&K Services, Inc. (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of the Company, the accompanying unaudited consolidated condensed financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of the Company as of April 1, 2006, and the results of its operations for the three and nine months ended and its cash flows for the nine months ended April 1, 2006 and April 2, 2005. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures herein are adequate to make the information presented not misleading. It is suggested that these consolidated condensed financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's latest report on Form 10-K.

The results of operations for the three and nine month periods ended April 1, 2006 and April 2, 2005 are not necessarily indicative of the results to be expected for the full year.

**1. Summary of Significant Accounting Policies**

Accounting policies followed by the Company are set forth in Note 1 in the Company's Annual Report on Form 10-K for the fiscal year ended July 2, 2005.

**Nature of Business**

G&K Services, Inc. (the Company) is a market leader in providing branded identity apparel and facility services programs that enhance image and safety in the workplace. The Company serves a wide variety of industrial, service and high-technology companies providing them with rented uniforms or purchase options as well as facility services products such as floor mats, dust mops, wiping towels, selected linen items and several restroom products. The Company also manufactures certain uniform garments that it uses to support its garment rental programs. The Company has two operating segments, United States and Canada, which have been identified as components of the Company that are reviewed by the Company's Chief Executive Officer to determine resource allocation and evaluate performance.

**Principles of Consolidation**

The accompanying consolidated condensed financial statements include the accounts of the Company and its subsidiaries, all of which are wholly owned. Significant intercompany balances and transactions have been eliminated in consolidation.

**Revenue Recognition**

The Company's rental operations business is largely based on written service agreements whereby it agrees to collect, launder and deliver uniforms and other related products. The service agreements provide for weekly billing upon completion of the laundering process and delivery to the customer. Accordingly, the Company recognizes revenue from rental operations in the period in which the services are provided. Revenue from rental operations also includes billings to customers for lost or abused merchandise. Direct sale revenue is recognized in



the period in which the product is shipped.

**Table of Contents****Derivative Financial Instruments**

The Company uses derivative financial instruments to manage the risk that changes in interest rates will affect the amount of its future interest payments. Interest rate swap contracts are used to balance the proportion of total debt that is subject to variable and fixed interest rates. The interest rate swap contracts are reflected at fair value in the consolidated condensed balance sheets and the related gains or losses on these contracts are recorded in other comprehensive income, which is a component of stockholders' equity. Amounts to be paid or received under the contracts are accrued as interest rates change and are recognized over the life of the contracts as an adjustment to interest expense. The net effect of this accounting is that interest expense on the portion of variable rate debt being hedged is generally recorded based on fixed interest rates.

The Company also uses derivative financial instruments to manage the risk that changes in gasoline cost will affect the future financial results of the Company. The Company purchases futures contracts to effectively hedge a portion of anticipated actual gasoline purchases. The futures contracts are reflected at fair value in the consolidated condensed balance sheet and the related gains or losses on these contracts are recorded in other comprehensive income, which is a component of stockholders' equity or in the statements of operations depending on the effectiveness of the hedge. Upon settlement of each contract, the actual gain or loss is reflected in gasoline expense.

The Company may periodically hedge firm commitments with its foreign subsidiary, generally with foreign currency contracts. These agreements are recorded at current market values and the gains and losses are included in earnings. Gains and losses on such transactions were not significant in the third quarter of fiscal 2006 or 2005.

**Per Share Data**

Basic earnings per common share were computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share was computed similarly to the computation of basic earnings per share, except that the denominator is increased for the assumed exercise of dilutive options and other dilutive securities, including nonvested restricted stock, using the treasury stock method.

	Three Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
Weighted average number of common shares outstanding used in computation of basic earnings per share	21,132	20,994	21,069	20,910
Weighted average effect of nonvested restricted stock grants and assumed exercise of options	179	328	159	452
Shares used in computation of diluted earnings per share	21,311	21,322	21,228	21,362

Potential common shares related to the Company's outstanding stock options and restricted stock grants of 492,000 and 84,000 for the three month periods, and 487,000 and 210,000 for the nine month periods ended April 1, 2006 and April 2, 2005, respectively, were excluded from the computation of diluted earnings per share. Inclusion of these shares would have been anti-dilutive as the exercise price of these shares exceeded market

value.

**Table of Contents****Reclassifications**

Certain prior period amounts have been reclassified to conform with current year presentation. These reclassifications did not impact current or historical net income or stockholders' equity.

**2. Comprehensive Income**

For the three and nine month periods ended April 1, 2006 and April 2, 2005, the components of comprehensive income were as follows:

	Three Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
Net income	\$ 10,358	\$ 9,950	\$ 30,963	\$ 28,745
Other comprehensive income				
Foreign currency translation adjustments, net of tax	(405)	(1,205)	6,331	9,233
Net unrealized holding gain on derivative financial instruments, net of tax	457	575	975	804
Comprehensive income	\$ 10,410	\$ 9,320	\$ 38,269	\$ 38,782

**3. Goodwill and Intangible Assets**

The changes in the carrying amount of goodwill for the nine months ended April 1, 2006, by operating segment, are as follows:

	United States	Canada	Total
Balance as of July 2, 2005	\$ 286,313	\$ 52,388	\$ 338,701
Goodwill acquired during the period, net of purchase price adjustments	(229)	3,388	3,159
Other, primarily foreign currency translation		2,782	2,782
Balance as of April 1, 2006	\$ 286,084	\$ 58,558	\$ 344,642

**Table of Contents**

Information regarding the Company's other intangible assets, which are included in other assets on the consolidated condensed balance sheet, are as follows:

	Carrying Amount	As of April 1, 2006 Accumulated Amortization	Net
Customer contracts	\$105,683	\$55,344	\$50,339
Non-competition agreements	10,879	8,142	2,737
Total	\$116,562	\$63,486	\$53,076

	Carrying Amount	As of July 2, 2005 Accumulated Amortization	Net
Customer contracts	\$102,021	\$47,821	\$54,200
Non-competition agreements	10,829	7,239	3,590
Total	\$112,850	\$55,060	\$57,790

The customer contracts include the combined value of the written service agreements and the related customer relationship. It has been determined that there is no significant separate value in any customer relationships.

Amortization expense was \$8,056 and \$6,803 for the nine months ended April 1, 2006 and April 2, 2005, respectively. Estimated amortization expense for each of the five succeeding fiscal years based on the intangible assets as of April 1, 2006 is as follows:

2006 remaining	\$ 2,770
2007	10,610
2008	10,048
2009	6,329
2010	6,152
2011	5,482

**4. Long-Term Debt**

On August 31, 2005, the Company amended and restated its revolving credit facility. The amended and restated revolving credit facility of \$325,000 expires on August 31, 2010. As of April 1, 2006, borrowings outstanding under the revolving credit facility were \$58,300. The unused portion of the revolver may be used for general corporate purposes, acquisitions, working capital needs and to provide up to \$50,000 in letters of credit. As of April 1, 2006, letters of credit outstanding against the revolver were \$33,140.

Borrowings under the revolving credit facility bear interest at 0.55% to 1.50% over the London Interbank Offered Rate ( LIBOR ), or the Canadian prime rate for Canadian borrowings, based on a leverage ratio calculated on a quarterly basis. Advances outstanding as of April 1, 2006 bear interest at LIBOR plus 0.875%. The Company also pays a fee on the unused daily balance of the revolver based on a leverage ratio calculated each quarter.



**Table of Contents**

**5. Stock-Based Compensation**

The Company maintains Stock Option and Compensation Plans (the Employee Plans ) to grant certain stock awards, including stock options at fair market value and restricted shares, to key employees of the Company. Exercise periods for stock options are limited to a maximum of 10 years and a minimum of one year. A maximum of 3,000,000 stock awards can be granted under the Employee Plans and 1,039,194 awards were available for grant as of April 1, 2006.

The Company also maintains the 1996 Director Stock Option Plan (the Directors Plan ). The Directors Plan provides for automatic grant of 3,000 nonqualified stock options (initial grants) to nonemployee directors of the Company as of the later of August 1996 or the date such individuals became directors of the Company and 1,500 nonqualified stock options on each subsequent annual shareholder meeting date and 500 stock grants on the first business day of each calendar year that each nonemployee director is serving. The Company has reserved 100,000 shares of Class A common stock for issuance under the Directors Plan. These options expire within 10 years of grant and are exercisable one year from the date of grant, except for the initial grants, of which, one-third of the total options are exercisable each year beginning with the first anniversary of the date of grant. The option price will be the average market price of the Class A common stock during the 10 business days preceding the date of grant.

The Company has adopted the provisions of the Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment ( SFAS 123(r) ) in the first quarter of fiscal 2006 under the modified retrospective transition method. SFAS 123(r) eliminates accounting for share-based compensation transactions using the intrinsic value method prescribed in APB Opinion No. 25, Accounting for Stock Issued to Employees, and requires instead that the fair value of all share-based transactions, including grants of employee stock options, be recognized in the income statement. Under the modified retrospective transition method, all prior period financial statements were restated to recognize compensation cost in the amounts previously reported in the Notes to Consolidated Financial Statements.

As a result of adopting SFAS 123(r) on July 3, 2005, income before income taxes and net income have been restated by \$765 and \$476 for the three month period, and \$2,214 and \$1,378 for the nine month period ended April 2, 2005, respectively. Basic and diluted earnings per share have been restated by \$0.03 and \$0.02 per share for the three month period, and \$0.07 and \$0.07 per share for the nine month period ended April 2, 2005, respectively. The beginning balances of deferred taxes, paid in capital and retained earnings have been restated by \$6,013, \$18,496 and \$12,483, respectively, to recognize compensation cost for fiscal years 1996 through 2005 in the amounts previously reported in the Notes to Consolidated Financial Statements under provisions of SFAS No.123, Accounting for Stock-Based Compensation.

**Table of Contents**

The following schedule summarizes activity in the plans for the three and nine month periods ended April 1, 2006:

	Stock Options				Weighted Average Exercise Price
	Employee Plans	Directors Plan	Grant Price		
Three months:					
Outstanding at December 31, 2005	1,358,744	60,500	\$ 25.00	53.34	\$ 35.81
Granted	2,350	1,500	38.09	38.34	38.25
Exercised	(32,349)		27.95	36.41	31.55
Canceled	(5,662)		27.95	46.00	39.33
Outstanding at April 1, 2006	1,323,083	62,000	\$ 25.00	53.34	\$ 35.87
Nine months:					
Outstanding at July 2, 2005	1,161,547	55,000	\$ 25.00	53.34	\$ 34.21
Granted	260,015	15,000	38.09	42.97	42.08
Exercised	(66,026)	(8,000)	25.00	41.56	31.38
Canceled	(32,453)		27.95	46.00	38.28
Outstanding at April 1, 2006	1,323,083	62,000	\$ 25.00	53.34	\$ 35.87
Exercisable at April 1, 2006	849,555	43,000	\$ 25.00	53.34	\$ 34.12

The following schedule summarizes the information related to stock options outstanding at April 1, 2006:

Range of Exercise Price	Number Outstanding	Options Outstanding		Options Exercisable	
		Average Remaining Option Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$16.50 - 25.00	42,300	4.2	\$ 25.00	42,300	\$ 25.00
25.01 - 37.00	860,794	7.0	32.57	647,682	31.76
37.01 - 53.34	481,989	5.9	42.71	202,573	43.58
	1,385,083	6.5	\$ 35.87	892,555	\$ 34.12

The weighted average fair value of options granted was \$11.47 and \$12.76 for the three month periods, and \$10.90 and \$10.96 for the nine month periods ended April 1, 2006 and April 2, 2005, respectively. The weighted



average exercise price was \$31.55 and \$30.26 for the three month periods, and \$31.38 and \$29.37 for the nine month periods ended April 1, 2006 and April 2, 2005, respectively.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used: risk-free interest rates of 4.40% and 3.88% for the three month periods, and 3.91% and 3.37% for the nine month periods ended April 1, 2006 and April 2, 2005, respectively; expected annual dividends of \$0.07 per share; expected lives of 4 years and 5 years for the three and nine months ended April 1, 2006 and April 2, 2005, respectively; and expected volatility of 24.52% and 25.85% for the three month periods, and 24.46% and 26.41% for the nine month periods ended April 1, 2006 and April 2, 2005, respectively.

**Table of Contents**

Compensation cost for stock options is recognized on a straight-line basis over the requisite service period of the award (or to an employee's eligible retirement date, if earlier). Total compensation expense related to stock options was \$600 and \$765 for the three month periods, and \$2,205 and \$2,214 for the nine month periods ended April 1, 2006 and April 2, 2005, respectively.

Under the Employee Plans, the Company grants restricted stock to key employees for nominal consideration. The restrictions lapse over periods up to seven years. The Company granted 450 shares of restricted stock in the three month period ended April 1, 2006 and 80,185 and 12,250 shares of restricted stock in the nine month periods ended April 1, 2006 and April 2, 2005, respectively. The weighted average grant date fair value per share of restricted stock granted during the three month period ended April 1, 2006 was \$39.09, and for the nine month periods ended April 1, 2006 and April 2, 2005 was \$42.57 and \$36.41, respectively. Compensation expense is recognized as the restrictions are removed from the stock for the difference between the par value and fair market value as of the grant date. Total compensation expense related to restricted stock was \$342 and \$154 for the three month periods, and \$855 and \$677 for the nine month periods ended April 1, 2006 and April 2, 2005, respectively.

**6. Employee Benefit Plans**

The components of net periodic pension cost are as follows for the three months ended April 1, 2006 and April 2, 2005:

	Pension Plan		Supplemental Executive Retirement Plan	
	Three Months Ended		Three Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
Service cost	\$ 1,190	\$ 948	\$ 234	\$ 198
Interest cost	809	681	188	171
Expected return on assets	(617)	(545)		
Prior service cost	13	14	11	11
Loss	341	129	76	47
Net periodic pension cost	\$ 1,736	\$ 1,227	\$ 509	\$ 427

The components of net periodic pension cost are as follows for the nine months ended April 1, 2006 and April 2, 2005:

	Pension Plan		Supplemental Executive Retirement Plan	
	Nine Months Ended		Nine Months Ended	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005
Service cost	\$ 3,571	\$ 2,843	\$ 702	\$ 588
Interest cost	2,427	2,042	565	509

Edgar Filing: G&K SERVICES INC - Form 10-Q

Expected return on assets	(1,850)	(1,634)		
Prior service cost	39	42	32	32
Loss	1,021	387	228	151
Net periodic pension cost	\$ 5,208	\$ 3,680	\$ 1,527	\$ 1,280

12

---

**Table of Contents****7. Segment Information**

The Company has two operating segments, United States and Canada, which have been identified as components of the Company that are reviewed by the Company's Chief Executive Officer to determine resource allocation and evaluate performance. Each operating segment derives revenues from the branded identity apparel and facility services industry, which includes garment rental and non-apparel items such as floor mats, dust mops, wiping towels, selected linen items and several restroom products. No one customer's transactions account for 1.0% or more of the Company's revenues.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies (see Note 1). Corporate expenses are allocated to the segments based on segment revenue. Income from operations for the three and nine months ended April 1, 2006, for United States operating segment, includes a provision of \$2,050 related to the pending resolution of two specific legal matters. The Company evaluates performance based on income from operations. Financial information by geographic location for the three and nine month periods ended April 1, 2006 and April 2, 2005 is as follows:

For the Three Months Ended	United States	Canada	Total
Third Quarter Fiscal Year 2006:			
Revenues	\$ 186,965	\$ 39,176	\$ 226,141
Income from operations	10,254	6,339	16,593
Property, plant and equipment additions, net	9,144	788	9,932
Depreciation and amortization expense	9,389	1,494	10,883
Third Quarter Fiscal Year 2005:			
Revenues	\$ 170,069	\$ 33,741	\$ 203,810
Income from operations	12,510	6,460	18,970
Property, plant and equipment additions, net	4,884	1,215	6,099
Depreciation and amortization expense	8,976	1,431	10,407
For the Nine Months Ended	United States	Canada	Total
Fiscal Year 2006:			
Revenues	\$ 541,459	\$ 111,978	\$ 653,437
Income from operations	35,419	19,093	54,512
Property, plant and equipment additions, net	24,320	2,094	26,414
Depreciation and amortization expense	27,653	4,473	32,126
Fiscal Year 2005:			
Revenues	\$ 489,113	\$ 92,264	\$ 581,377
Income from operations	36,263	17,900	54,163
Property, plant and equipment additions, net	7,119	3,075	10,194
Depreciation and amortization expense	26,683	4,043	30,726

**Table of Contents**

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

(Unaudited)

**Overview**

G&K Services, Inc., founded in 1902 and headquartered in Minnetonka, Minnesota, is a market leader in providing branded identity apparel and facility services programs that enhance image and safety in the workplace. We serve a wide variety of North American industrial, service and high-technology companies providing them with rented uniforms and facility services products such as floor mats, dust mops, wiping towels, restroom supplies and selected linen items. We also sell uniforms and other apparel items to customers in our direct sale programs. Industry-wide North American rental market revenues are approximately \$6.5-\$7.0 billion annually, while the portion of the industry-wide revenues targeted by us is approximately \$4.5-\$5.0 billion in size.

In the third quarter of fiscal year 2006 our rental business increased to \$201.6 million, up 7.2 percent over the prior-year quarter. Direct sale revenue increased to \$24.6 million, up 56.1 percent over the prior-year quarter, driven almost entirely by organic growth. The growth of direct sale revenue for the quarter was driven primarily by revenue from Lion Uniform Group. Earnings per diluted share totaled \$0.49 for the quarter, up 4.3 percent from \$0.47 during the prior-year quarter. The increase in earnings were due to higher sales and a lower effective tax rate, partially offset by the impact of higher costs, continued investment in strategic initiatives, costs associated with the accelerated new account growth, reserves established for the pending resolution of two specific legal matters and increased employee benefit costs which includes healthcare and worker's compensation costs.

Our industry is consolidating from many family owned and small local providers to several large providers. We are participating in this industry consolidation. Our goal is to build a national footprint and, we accordingly, place strategic value on acquisitions which expand our geographic presence.

We made two small acquisitions during the first nine months of fiscal 2006. In October, 2005, we acquired certain assets from an organization in Ontario, Canada, a uniform and textile service company serving customers in Sarnia, Ontario, Detroit, Michigan and St. Louis, Missouri. This purchase expands and enhances our uniform and textile rental business in North America. Also in October, 2005, we acquired certain customer contracts from an organization, serving customers in the southeast United States. This purchase enhances our geographic coverage in North America.

The pro forma effect of these acquisitions, had they been acquired at the beginning of each fiscal year, were not material, either individually or in aggregate. The total purchase price consideration, including related acquisition costs of the transaction was \$11.3 million. The total purchase price exceeded the estimated fair values of assets acquired and liabilities assumed by \$3.2 million.

**Critical Accounting Policies**

The discussion of the financial condition and results of operations are based upon the consolidated condensed financial statements, which have been prepared in conformity with U.S. generally accepted accounting principles. As such, management is required to make certain estimates, judgments and assumptions that are believed to be reasonable based on the information available. These estimates and assumptions affect the reported amount of assets and liabilities, revenues and expenses, and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and estimates, the most important and pervasive accounting policies used and the areas most sensitive to material changes from external factors. See Note 1 to the consolidated condensed financial statements for additional discussion of the application of these and other accounting policies.

**Table of Contents*****Revenue Recognition and Allowance for Doubtful Accounts***

Our rental operations business is largely based on written service agreements whereby we agree to collect, launder and deliver uniforms and other related products. The service agreements provide for weekly billing upon completion of the laundering process and delivery to the customer. Accordingly, we recognize revenue from rental operations in the period in which the services are provided. Revenue from rental operations also includes billings to customers for lost or abused merchandise. Direct sale revenue is recognized in the period in which the product is shipped. Estimates are used in determining the collectibility of billed accounts receivable. Management analyzes specific accounts receivable and historical bad debt experience, customer credit worthiness, current economic trends and the age of outstanding balances when evaluating the adequacy of the allowance for doubtful accounts. Significant management judgments and estimates are used in connection with establishing the allowance in any accounting period. While we have been consistent in applying our judgments and in making our estimates over relevant periods, material differences may result in the amount and timing of bad debt expense recognition for any given period if management makes different judgments or utilizes different estimates.

***Inventories***

Our inventories consist of new goods and rental merchandise in service. Estimates are used in determining the likelihood that new goods on hand can be sold to customers or used in rental operations. Historical inventory usage and current revenue trends are considered in estimating both obsolete and excess inventories. New goods are stated at lower of cost or market, net of any reserve for obsolete or excess inventory. Merchandise placed in service to support rental operations is amortized into cost of rental operations over the estimated useful lives of the underlying inventory items, primarily on a straight-line basis, which results in a matching of the cost of the merchandise with the weekly rental revenue generated by the merchandise. Estimated lives of rental merchandise in service range from nine months to three years. In establishing estimated lives for merchandise in service, management considers historical experience and the intended use of the merchandise. Material differences may result in the amount and timing of operating profit for any period if management makes different judgments or utilizes different estimates.

***Goodwill, Intangibles and Other Long-Lived Assets***

As required under Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ), goodwill is separately disclosed from other intangible assets on the balance sheet and no longer amortized. SFAS 142 also requires that companies test goodwill for impairment on an annual basis and when events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit to which goodwill is assigned below its carrying amount. Our evaluation follows the two step impairment test prescribed by SFAS 142. First we assess whether the fair value of the reporting units exceeds the carrying amount of the unit including goodwill. Our evaluation considers changes in the operating environment, competitive position, market trends, operating performance, quoted market prices for our equity securities and fair value models and research prepared by independent analysts. If the carrying amount of a reporting unit exceeded its fair value, we would perform a second test to measure the amount of impairment loss, if any. Management completes its annual impairment tests in the fourth quarter of each fiscal year. There have been no impairments of goodwill or definite-lived intangible assets in fiscal 2005 and we believe there have been no events or circumstances through the first nine months of fiscal 2006 that would indicate that there may have been any impairment of goodwill or definite-lived assets. Future events could cause management to conclude that impairment indicators exist and that goodwill and other intangibles associated with acquired businesses are impaired. Any resulting impairment loss could have a material impact on our financial condition and results of operations.

Property, plant and equipment and definite-lived intangible assets are depreciated or amortized over their useful lives. Useful lives are based on management estimates of the period that the assets will add value. Long-lived assets and definite-lived intangible assets are evaluated for impairment whenever events and circumstances indicate an asset may be impaired. There have been no material write-downs of long-lived assets or definite-lived intangible assets in fiscal 2005 or through the first nine months of fiscal 2006.

**Table of Contents****Insurance**

We self-insure for certain obligations related to health, workers' compensation and auto and general liability programs. We purchase stop-loss insurance policies to protect us from catastrophic losses. Estimates are used in determining the potential liability associated with reported claims and for losses that have occurred, but have not been reported. Management estimates consider historical claims experience, escalating medical cost trends, expected timing of claim payments and an actuarial analysis provided by a third party. Changes in the cost of medical care, our ability to settle claims and the estimates and judgments used by management could have a material impact on the amount and timing of expense for any period.

**Income Taxes**

In the normal course of business, we are subject to audits from federal, state, Canadian provincial and other tax authorities regarding various tax liabilities. These audits may alter the timing or amount of taxable income or deductions, or the allocation of income among tax jurisdictions. The amount ultimately paid upon resolution of issues raised may differ from the amount accrued. We believe that taxes accrued on our consolidated balance sheets fairly represent the amount of future tax liability due.

We utilize income tax planning to reduce our overall cost of income taxes. Upon audit, it is possible that certain strategies might be disallowed resulting in an increased liability for income taxes. We believe that the provision for liabilities resulting from the implementation of income tax planning is appropriate. To date, we have not experienced an examination by governmental revenue authorities that would lead management to believe that our past provisions for exposures related to income tax planning are not appropriate.

Deferred income taxes are determined in accordance with SFAS No. 109, Accounting for Income Taxes. Deferred tax assets and liabilities are recorded for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements, using statutory rates in effect for the year in which the differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. We record valuation allowances to reduce deferred tax assets when it is more likely than not that some portion of the asset may not be realized. We evaluate our deferred tax assets and liabilities on a periodic basis. We believe that we have adequately provided for our future tax consequences based upon current facts and circumstances.

**Results of Operations**

The percentage relationships to net sales of certain income and expense items for the three and nine month periods ended April 1, 2006 and April 2, 2005, and the percentage changes in these income and expense items between periods are presented in the following table:

	Three Months Ended		Nine Months Ended		Percentage Change	
	April 1, 2006	April 2, 2005	April 1, 2006	April 2, 2005	Three Months FY 2006 vs. FY 2005	Nine Months FY 2006 vs. FY 2005
Revenues:						
Rental	89.1%	92.3%	91.1%	94.2%	7.2%	8.7%
Direct	10.9	7.7	8.9	5.8	56.1	72.4
Total revenues	100.0	100.0	100.0	100.0	11.0	12.4
Expenses:						
Cost of rental sales	65.2	63.4	64.5	63.3	10.3	10.7
Cost of direct sales	71.8	76.3	71.9	74.7	47.0	65.8

Edgar Filing: G&K SERVICES INC - Form 10-Q

Total cost of sales	65.9	64.3	65.1	64.0	13.6	14.4
Selling and administrative	22.0	21.3	21.7	21.4	14.6	13.4
Depreciation and amortization	4.8	5.1	4.9	5.3	4.6	4.6
Income from operations	7.3	9.3	8.3	9.3	(12.5)	0.6
Interest expense	1.5	1.4	1.4	1.4	17.4	20.2
Income before income taxes	5.8	7.9	6.9	7.9	(17.9)	(2.8)
Provision for income taxes	1.2	3.0	2.2	3.0	(53.7)	(20.2)
Net income	4.6%	4.9%	4.7%	4.9%	4.1%	7.7%

16

---



**Table of Contents*****Three months ended April 1, 2006 compared to three months ended April 2, 2005***

**Revenues.** Total revenues in the third quarter of fiscal 2006 increased 11.0% to \$226.1 million from \$203.8 million in the third quarter of fiscal 2005. Rental revenue increased \$13.5 million in the third quarter, or 7.2%. The organic industrial rental growth rate was approximately 3.5%, an improvement from 1.5% in the same period of fiscal 2005. Organic industrial rental revenue has improved due to growth initiatives and in particular, accelerated new account growth. These improvements were slightly offset by lost revenues related to hurricanes.

Direct sale revenue increased 56.1% to \$24.6 million in the third quarter of fiscal 2006 compared to \$15.7 million in the same period of fiscal 2005. The organic direct sale growth rate during the same period was approximately 54.0%.

The increase in organic direct sale revenue was due primarily to the installation of a new uniform program with a major customer in our Lion Uniform Group, along with increased revenue from a number of other customers.

Organic growth rates are calculated using industrial rental and direct sale revenue, respectively, adjusted for foreign currency exchange rate differences and revenue from newly acquired business compared to prior-period results with comparable adjustments. We believe that the organic growth rates better reflect the growth of our existing industrial rental and direct sale business and are therefore useful in analyzing our financial condition and results of operations.

**Cost of Rental and Direct Sale.** Cost of rental operations increased 10.3% to \$131.4 million in the third quarter of fiscal 2006 from \$119.1 million in the same period of fiscal 2005. Gross margin from rental sales decreased to 34.8% in the third quarter of fiscal 2006 from 36.6% in the same period of fiscal 2005. Rental gross margins declined due to higher energy costs and costs associated with new customer growth. These costs were partially offset by operational initiatives focused on lower merchandise and production costs as well as the impact of higher pricing.

Cost of direct sales increased 47.0% to \$17.7 million in the third quarter of fiscal 2006 from \$12.0 million in the same period of fiscal 2005. Gross margin from direct sales increased to 28.2% in the third quarter of fiscal 2006 from 23.7% in the third quarter of fiscal 2005. The increase in gross margin was primarily due to improved efficiencies from higher volume.

**Selling and Administrative.** Selling and administrative expenses increased to \$49.6 million in the third quarter of fiscal 2006 from \$43.3 million in the same period of fiscal 2005. As a percentage of total revenues, selling and administrative expenses increased to 22.0% in the third quarter of fiscal 2006 from 21.3% in the third quarter of fiscal 2005. Total selling and administrative expenses increased due to the establishment of \$2.1 million of reserves for two specific legal matters, the continued investment in growth oriented initiatives, information technology and productivity improvements and sales expenses associated with new account growth.

**Depreciation and Amortization.** Depreciation and amortization expense increased 4.6% to \$10.9 million in the third quarter of fiscal 2006 from \$10.4 million in the same period of fiscal 2005. As a percentage of total revenues, depreciation and amortization expense decreased to 4.8% in the third quarter of fiscal 2006 from 5.1% in the third quarter of fiscal 2005. Capital expenditures, excluding acquisition of businesses, were \$9.9 million in the third quarter of fiscal 2006 compared to \$6.1 million in the prior year's quarter with similar adjustments.

**Interest Expense.** Interest expense was \$3.4 million in the third quarter of fiscal 2006, up from \$2.9 million in the same period of fiscal 2005. The increase was due to increased debt levels in conjunction with the acquisition of business assets in the previous twelve months and an increase in interest rates.

**Provision for Income Taxes.** Our effective tax rate decreased to 21.5% in the third quarter of fiscal 2006 from 38.1% in the same period of fiscal 2005 due to a reduction in taxes previously provided for as a result of the expiration of certain tax statutes and adjustments resulting from the final calculation and filing of the Company's fiscal 2005 tax returns.

**Table of Contents*****Nine months ended April 1, 2006 compared to nine months ended April 2, 2005***

**Revenues.** Total revenues for the first nine months of fiscal 2006 increased 12.4% to \$653.4 million from \$581.4 million for the same period of fiscal 2005. Rental revenue increased \$47.5 million in the first nine months, or 8.7%. The organic industrial rental growth rate was approximately 3.5%. Organic industrial rental revenue has improved due to growth initiatives and in particular, accelerated new account growth and improved customer retention. These improvements were slightly offset by lost revenues associated with hurricanes.

Direct sale revenue increased 72.4% to \$58.5 million in the first nine months of fiscal 2006 compared to \$33.9 million in the same period of fiscal 2005. The organic direct sale growth rate was approximately 29.5%. The increase in organic direct sale revenue is largely due to garment sales through our rental operations including our annual outerwear promotion and growth in our Lion Uniform Group which was due primarily to the installation of a new uniform program with a major customer.

**Cost of Rental and Direct Sale.** Cost of rental operations increased 10.7% to \$383.6 million in the first nine months of fiscal 2006 from \$346.6 million in the same period of fiscal 2005. Gross margin from rental sales decreased to 35.5% in the first nine months of fiscal 2006 from 36.7% in the same period of fiscal 2005. Higher energy costs, costs associated with new customer growth, the impact of hurricanes on the operations and costs related to acquisitions, primarily in Canada were partially offset by numerous operational initiatives as well as the impact of higher pricing. Cost of direct sales increased 65.8% to \$42.0 million in the first nine months of fiscal 2006 from \$25.3 million in the same period of fiscal 2005. Gross margin from direct sales increased to 28.1% in the first nine months of fiscal 2006 from 25.3% in the same period of fiscal 2005. The increase in margins was primarily due to improved cost leverage resulting from greater sales volume.

**Selling and Administrative.** Selling and administrative expenses increased 13.4% to \$141.2 million in the first nine months of fiscal 2006 from \$124.6 million in the same period of fiscal 2005. As a percentage of total revenues, selling and administrative expenses increased to 21.7% in the first nine months of fiscal 2006 from 21.4% in the same period of fiscal 2005. The increase as a percent of revenue was due to the establishment of a reserve of \$2.1 million for two specific legal matters, continued investment in growth initiatives and increased staffing to support long-term growth and strategic initiatives. These costs were partially offset as a percent of revenue by additional leverage provided by incremental revenue growth.

**Depreciation and Amortization.** Depreciation and amortization expense increased 4.6% to \$32.1 million in the first nine months of fiscal 2006 from \$30.7 million in the same period of fiscal 2005. As a percentage of total revenues, depreciation and amortization expense decreased to 4.9% in the first nine months of fiscal 2006 from 5.3% in the same period of fiscal 2005. Capital expenditures, excluding acquisition of businesses, were \$26.4 million in the first nine months of fiscal 2006 compared to \$10.2 million in the same period of fiscal 2005. The increase in capital expenditures was driven primarily by the addition of a new facility and improvements to existing facilities. These additions were partially offset by disposals of fixed assets.

**Income from Operations.** Hurricanes in the first nine months of fiscal 2006 had a negative impact on net operating margins of approximately 0.3%.

**Interest Expense.** Interest expense was \$9.7 million in the first nine months of fiscal 2006, up from \$8.1 million in the same period of fiscal 2005. The increase was due to increased debt levels in conjunction with the acquisition of business assets in the previous twelve months and an increase in interest rates.

**Table of Contents**

*Provision for Income Taxes.* Our effective tax rate decreased to 30.9% in the first nine months of fiscal 2006 from 37.6% in the same period of fiscal 2005 due to a reduction in taxes previously provided for as a result of the expiration of certain tax statutes and adjustments resulting from a favorable mix of income earned in various taxing jurisdictions and the final calculation and filing of the Company's fiscal 2005 tax returns.

***Liquidity, Capital Resources and Financial Condition***

Our primary sources of cash are net cash flows from operations and borrowings under our debt arrangements. Primary uses of cash are interest payments on indebtedness, capital expenditures, acquisitions and general corporate purposes.

*Operating Activities.* Net cash provided by operating activities was \$50.0 million in the first nine months of fiscal 2006 and \$44.4 million in the same period of fiscal 2005. This increase is due primarily to cash provided from net income and changes in operating items.

Working capital at April 1, 2006 was \$142.4 million, up 37.2% from \$103.8 million at July 2, 2005. The increase in working capital is largely due to the increases in our accounts receivable and inventory in connection with the overall growth of the Company.

*Investing Activities.* Net cash used in investing activities was \$39.4 million in the first nine months of fiscal 2006 and \$85.1 million in the same period of fiscal 2005. In fiscal 2006, cash was primarily used for acquisition of property plant and equipment additions and business assets. In fiscal 2005, cash was largely used for acquisition of business assets and property plant and equipment additions, partially offset by proceeds from the sale of selected plant assets. Proceeds on these sales totaled \$5.6 million.

*Financing Activities.* Cash used for financing activities was \$4.3 million in the first nine months of fiscal 2006 and cash provided by financing activities was \$23.1 million in the same period of fiscal 2005. Cash used in fiscal 2006 was for repayments of long-term debt. Cash provided in fiscal 2005 was primarily related to the short-term borrowings in connection with the acquisition of business assets. The Company paid dividends of \$1.1 million during the first nine months of fiscal 2006.

As of April 1, 2006, borrowings outstanding under the revolving credit facility were \$58.3 million. The unused portion of the revolver may be used for general corporate purposes, acquisitions, working capital needs and to provide up to \$50 million in letters of credit. As of April 1, 2006, letters of credit outstanding against the revolver were \$33.1 million.

Borrowings under the revolving credit facility bear interest at 0.55% to 1.50% over the London Interbank Offered Rate ( LIBOR ), or the Canadian prime rate for Canadian borrowings, based on a leverage ratio calculated on a quarterly basis. Advances outstanding as of April 1, 2006 bear interest at LIBOR plus 0.875%. We also pay a fee on the unused daily balance of the revolver based on a leverage ratio calculated each quarter.

*Cash Obligations.* Under various agreements, we are obligated to make future cash payments in fixed amounts. These include payments under the variable rate term loan and revolving credit facility, the fixed rate term loan, capital lease obligations and rent payments required under non-cancelable operating leases with initial or remaining terms in excess of one year.

**Table of Contents**

The following table summarizes our fixed cash obligations as of April 1, 2006 for the fiscal years ending June (in thousands):

	2006 Remaining	2007	2008	2009	2010	2011 and There- after	Total
Variable rate revolving credit facility	\$	\$	\$	\$	\$ 58,300	\$	\$ 58,300
Variable rate senior notes						75,000	75,000
Variable rate senior loan			50,000				50,000
Fixed rate notes		7,143	7,143	7,143	7,143	7,142	35,714
Other debt arrangements, including capital leases	38	10,777	120	42			10,977
Operating leases	4,546	16,387	13,404	9,070	6,541	6,014	55,962
<b>Total contractual cash obligations</b>	<b>\$ 4,584</b>	<b>\$ 34,307</b>	<b>\$ 70,667</b>	<b>\$ 16,255</b>	<b>\$ 71,984</b>	<b>\$ 88,156</b>	<b>\$ 285,953</b>

Also, at April 1, 2006, we had stand-by letters of credit totaling \$33.1 million issued and outstanding, primarily in connection with our property and casualty insurance programs and to provide security in connection with a promissory note. No amounts have been drawn upon these letters of credit.

At April 1, 2006, we had available cash on hand of \$22.0 million and approximately \$234 million of available capacity under our revolving credit facility when considering current outstanding borrowings and letters of credit. We anticipate that we will generate sufficient cash flows from operations to satisfy our cash commitments and capital requirements for fiscal 2006 and to reduce the amounts outstanding under the revolving credit facility; however, we may utilize borrowings under the revolving credit facility to supplement our cash requirements from time to time. We estimate that capital expenditures in fiscal 2006 will be approximately \$30 million to \$35 million.

The amount of cash flow generated from operations is subject to a number of risks and uncertainties. In fiscal 2006, we may actively seek and consider acquisitions of business assets; the consummation of any acquisition could affect our liquidity profile and level of outstanding debt. We believe that our earnings and cash flow from operations, existing credit facilities and our ability to obtain additional debt or equity capital, if necessary, will be adequate to finance acquisition opportunities.

**Pension Obligations**

We account for our defined benefit pension plan using Statement of Financial Accounting Standards No. 87

Employer's Accounting for Pensions (SFAS 87). Under SFAS 87, pension expense is recognized on an accrual basis over employees' approximate service periods. Pension expense calculated under SFAS 87 is generally independent of funding decisions or requirements. We recognized expense for our defined benefit pension plan of \$1.7 million in the third quarter of fiscal 2006 and \$1.2 million in the same period of fiscal 2005. At July 2, 2005, the fair value of our pension plan assets totaled \$29.1 million.

The calculation of pension expense and the corresponding liability requires the use of a number of assumptions, including the expected long-term rate of return on plan assets and the assumed discount rate. Changes in these assumptions can result in different expense and liability amounts, and future actual experience can differ from these assumptions. Pension expense increases as the expected rate of return on pension plan assets decreases. At July 2, 2005, we estimated that the pension plan assets will generate a long-term rate of return of 8.0%. This rate was

**Table of Contents**

developed by evaluating input from our actuary as well as long-term inflation assumptions. The expected long-term rate of return on plan assets at July 2, 2005 is based on an allocation of U.S. equities and U.S. fixed income securities. Decreasing the expected long-term rate of return by 0.5% (from 8.0% to 7.5%) would increase our estimated fiscal 2006 pension expense by approximately \$0.1 million. Pension liability and future pension expense increase as the discount rate is reduced. We discounted future pension obligations using a rate of 5.50% at July 2, 2005. The discount rate is determined based on the current rates earned on high quality long-term bonds. Decreasing the discount rate by 0.5% (from 5.50% to 5.00%) would have increased our accumulated benefit obligation at July 2, 2005 by approximately \$4.1 million and increased the estimated fiscal 2006 pension expense by approximately \$1.1 million. Future changes in plan asset returns, assumed discount rates and various other factors related to the participants in our pension plan will impact our future pension expense and liabilities. We cannot predict with certainty what these factors will be in the future.

***Impact of Inflation***

In general, management believes that our results of operations are not dependent on moderate changes in the inflation rate. Historically, we have been able to manage the impact of more significant changes in inflation rates through our customer relationships, customer agreements that generally provide for price increases consistent with the rate of inflation or 5.0%, whichever is greater, and continued focus on improvements of operational productivity. Significant increases in energy costs, specifically natural gas and gasoline, can materially affect our results of operations and financial condition. Currently, energy costs represent approximately 5% of our total revenue.

***Litigation***

We are involved in a variety of legal actions relating to personal injury, employment, environmental and other legal matters that arise in the normal course of business. These legal actions include lawsuits that challenge the practice of charging for certain environmental services on invoices and certain contract disputes. During the three months ended April 1, 2006, the Company recorded a provision of \$2.1 million related to the pending resolution of two specific legal matters. None of these legal actions are expected to have a material adverse effect on our results of operations or financial position.

***Stock-Based Compensation***

We have adopted the provisions of the Statement of Financial Accounting Standards No. 123 (revised 2004)

Share-Based Payment ( SFAS 123(r) ) in the first quarter of fiscal 2006 under the modified retrospective transition method. SFAS 123(r) eliminates accounting for share-based compensation transactions using the intrinsic value method prescribed in APB Opinion No. 25, Accounting for Stock Issued to Employees, and requires instead that the fair value of all share-based transactions, including grants of employee stock options, be recognized in the income statement. Under the modified retrospective transition method, all prior period financial statements were restated to recognize compensation cost in the amounts previously reported in the Notes to Consolidated Financial Statements. As a result of our adopting SFAS 123(r) on July 3, 2005, income before income taxes and net income have been restated by \$0.8 million and \$0.5 million for the three month period, and \$2.2 million and \$1.4 million for the nine month period ended April 2, 2005, respectively. Basic and diluted earnings per share have been restated by \$0.03 and \$0.02 per share for the three month period, and \$0.07 and \$0.07 per share for the nine month period ended April 1, 2006, respectively. The beginning balances of deferred taxes, paid in capital and retained earnings have been restated by \$6.0 million, \$18.5 million and \$12.5 million, respectively, to recognize compensation cost for fiscal years 1996 through 2005 in the amounts previously reported in the Notes to Consolidated Financial Statements under provisions of SFAS No.123, Accounting for Stock-Based Compensation.

We estimate the fair value of each option grant on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used: risk-free interest rates of 4.40% and 3.88% for the three month periods, and 3.91% and 3.37% for the nine month periods ended April 1, 2006 and April 2, 2005,

**Table of Contents**

respectively; expected annual dividends of \$0.07 per share; expected lives of 4 years and 5 years for the three and nine months ended April 2, 2006 and April 2, 2005, respectively; and expected volatility of 24.52% and 25.85% for the three month periods, and 24.46% and 26.41% for the nine month periods ended April 1, 2006 and April 2, 2005, respectively.

We recognize compensation cost for stock options on a straight-line basis over the requisite service period of the award (or to an employee's eligible retirement date, if earlier). Total compensation expense related to stock options was \$0.6 million and \$0.8 million for the three month periods, and \$2.2 million and \$2.2 million for the nine month periods ended April 1, 2006 and April 2, 2005, respectively.

Under the Employee Plans, we grant restricted stock to key employees for nominal consideration. The restrictions lapse over periods up to seven years. We granted 450 shares of restricted stock in the three month period ended April 1, 2006 and 80,185 and 12,250 shares of restricted stock in the nine month periods ended April 1, 2006 and April 2, 2005, respectively. The weighted average grant date fair value per share of restricted stock granted during the three month period ended April 1, 2006 was \$39.09, and for the nine month periods ended April 1, 2006 and April 2, 2005 was \$42.57 and \$36.41, respectively. We recognize compensation expense as the restrictions are removed from the stock for the difference between the par value and fair market value as of the grant date. Total compensation expense related to restricted stock was \$0.3 million and \$0.2 million for the three month periods, and \$0.9 million and \$0.7 million for the nine month periods ended April 1, 2006 and April 2, 2005, respectively.

**Cautionary Statements Regarding Forward-Looking Statements**

The Private Securities Litigation Reform Act of 1995 (the Act) provides companies with a safe harbor when making forward-looking statements as a way of encouraging them to furnish their shareholders with information regarding expected trends in their operating results, anticipated business developments and other prospective information.

Statements made in this report concerning our intentions, expectations or predictions about future results or events are forward-looking statements within the meaning of the Act. These statements reflect our current expectations or beliefs, and are subject to risks and uncertainties that could cause actual results or events to vary from stated expectations, which could be material and adverse. Given that circumstances may change, and new risks to the business may emerge from time to time, having the potential to negatively impact our business in ways we could not anticipate at the time of making a forward-looking statement, you are cautioned not to place undue reliance on these statements, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Some of the factors that could cause actual results or events to vary from stated expectations include, but are not limited to, the following: unforeseen operating risks; the effects of overall economic conditions and employment levels; fluctuations in costs of insurance and energy; acquisition integration costs; the performance of acquired businesses; preservation of positive labor relationships; competition, including pricing, within the branded identity apparel and facility services industry; unplanned litigation or regulatory proceedings; and the availability of capital to finance planned growth. Additional information concerning potential factors that could effect future financial results is included in the Company's Annual Report on Form 10-K for the fiscal year ended July 2, 2005.

**Table of Contents**

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

**Interest Rate Risk**

We are subject to market risk exposure related to changes in interest rates. We use financial instruments, including fixed and variable rate debt, as well as interest rate swaps to manage interest rate risk. Interest rate swap agreements are entered into for periods consistent with related underlying exposures and do not constitute positions independent of those exposures. Assuming the current level of borrowings, a one percentage point increase in interest rates under these borrowings would have increased our interest expense for the third quarter of fiscal 2006 by approximately \$0.3 million. This estimated exposure considers the mitigating effects of interest rate swap agreements outstanding at April 1, 2006 on the change in the cost of variable rate debt.

**Energy Cost Risk**

We use derivative financial instruments to manage the risk that changes in gasoline cost will affect the future financial results of the Company. We purchase gasoline futures contracts to effectively hedge a portion of anticipated actual gasoline purchases. The gasoline futures contracts are reflected at fair value in the consolidated condensed balance sheet and the related gains or losses on these contracts are deferred in stockholders' equity (as a component of other comprehensive income) or in the statements of operations depending on the effectiveness of the hedge. Upon settlement of each contract, the actual gain or loss is reflected in gasoline expense. The current fair market value of all outstanding contracts at April 1, 2006 is a negative \$0.1 million.

**Foreign Currency Exchange Risk**

We have a significant foreign subsidiary located in Canada. The assets and liabilities of this subsidiary are denominated in the Canadian dollar and as such are translated into U.S. dollars at the exchange rate in effect at the balance sheet date. Results of operations are translated using the average exchange rates throughout the period. The effect of exchange rate fluctuations on translation of assets and liabilities are recorded as a component of stockholders' equity. Gains and losses from foreign currency transactions are included in results of operations.

**ITEM 4. CONTROLS AND PROCEDURES**

Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced above. There was no change in our internal control over financial reporting during the period covered by this Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II  
OTHER INFORMATION**

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

At the beginning of the third quarter, the Company had two classes of voting securities outstanding: Class A Common Stock, \$0.50 par value per share, and Class B Common Stock, \$0.50 par value per share. Each share of Class A Common Stock is entitled to one vote, and each share of Class B Common Stock was entitled to 10 votes, in each case, on matters submitted to a vote of the Company's shareholders. Class A Common Stock may be acquired by holders of Class B Common Stock upon conversion of their shares of Class B Common Stock, at any time, on the basis of one share of Class A Common Stock for each share of Class B Common Stock converted. On February 3, 2006 and March 23, 2006 the Company issued 1,208,256 and 67,573 shares of Class A Common Stock, respectively, to three of its shareholders upon the conversion by such shareholders of a like number of shares of Class B Common Stock. The Company received no proceeds from such issuance. The Company relied on available exemptions from registration to complete this transaction.

**ITEM 6. EXHIBITS**

a. Exhibits

31.1 Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-15(e)/15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-15(e)/15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



**Table of Contents**

SIGNATURES

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

G&K SERVICES, INC.  
(Registrant)

Date: May 5, 2006

By: /s/ Jeffrey L. Wright  
Jeffrey L. Wright  
Senior Vice President  
and Chief Financial Officer  
(Principal Financial Officer)

By: /s/ Michael F. Woodard  
Michael F. Woodard  
Vice President and Controller  
(Principal Accounting Officer)