

ANGELICA CORP /NEW/  
Form 10-Q  
December 07, 2006

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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  
October 28, 2006

Commission File  
Number 1-5674

**ANGELICA CORPORATION**  
(Exact name of Registrant as specified in its charter)

MISSOURI  
(State or other jurisdiction of incorporation or  
organization)

43-0905260  
(I.R.S. Employer Identification No.)

424 South Woods Mill Road  
CHESTERFIELD, MISSOURI  
(Address of principal executive offices)

63017  
(Zip Code)

(314) 854-3800  
(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.

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

The number of shares outstanding of Registrant's Common Stock, par value \$1.00 per share, at December 1, 2006 was 9,493,073 shares.



ANGELICA CORPORATION AND SUBSIDIARIES

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**CONSOLIDATED STATEMENTS OF INCOME***Angelica Corporation and Subsidiaries**Unaudited (Dollars in thousands, except per share amounts)*

|  | Third Quarter Ended |                     | Nine Months Ended   |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | October 28,<br>2006 | October 29,<br>2005 | October 28,<br>2006 | October 29,<br>2005 |
| <b>Continuing Operations:</b>  |                     |                     |                     |                     |
| Revenues   | \$ 107,768          | \$ 107,582          | \$ 320,060          | \$ 313,281          |
| Cost of services   | (90,467)            | (93,830)            | (272,893)           | (270,335)           |
| Gross profit   | 17,301              | 13,752              | 47,167              | 42,946              |
| Selling, general and administrative expenses   | (13,392)            | (10,764)            | (41,237)            | (36,105)            |
| Amortization of other acquired assets  | (1,061)             | (1,111)             | (3,221)             | (2,952)             |
| Other operating income, net  | 2,415               | 210                 | 2,912               | 840                 |
| Income from operations   | 5,263               | 2,087               | 5,621               | 4,729               |
| Interest expense   | (2,486)             | (2,045)             | (7,055)             | (4,951)             |
| Non-operating income, net  | 185                 | 382                 | 567                 | 1,179               |
| Income (loss) from continuing operations before income taxes                                 | 2,962               | 424                 | (867)               | 957                 |
| Income tax (provision) benefit   | (387)               | 387                 | 1,228               | 270                 |
| Income from continuing operations  | 2,575               | 811                 | 361                 | 1,227               |
| <b>Discontinued Operations:</b>  |                     |                     |                     |                     |
| Loss from discontinued operations, net of tax benefit of \$0, \$708, \$0 and \$800           | -                   | (838)               | -                   | (1,168)             |
| Loss on disposal of discontinued operations, net of tax benefit of \$0, \$243, \$0 and \$243 | -                   | (354)               | -                   | (354)               |
| Loss from discontinued operations  | -                   | (1,192)             | -                   | (1,522)             |
| Net income (loss)  | \$ 2,575            | \$ (381)            | \$ 361              | \$ (295)            |
| <b>Basic earnings (loss) per share:</b>  |                     |                     |                     |                     |
| Income from continuing operations  | \$ 0.28             | \$ 0.09             | \$ 0.04             | \$ 0.14             |
| Loss from discontinued operations  | -                   | (0.13)              | -                   | (0.17)              |
| Net income (loss)  | \$ 0.28             | \$ (0.04)           | \$ 0.04             | \$ (0.03)           |
| <b>Diluted earnings (loss) per share:</b>  |                     |                     |                     |                     |
| Income from continuing operations  | \$ 0.28             | \$ 0.09             | \$ 0.04             | \$ 0.13             |
| Loss from discontinued operations  | -                   | (0.13)              | -                   | (0.16)              |
| Net income (loss)  | \$ 0.28             | \$ (0.04)           | \$ 0.04             | \$ (0.03)           |

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

**CONSOLIDATED BALANCE SHEETS***Angelica Corporation and Subsidiaries**Unaudited (Dollars in thousands)*

|  | October 28,<br>2006 | January 28,<br>2006 |
|--|---------------------|---------------------|
| <b><u>ASSETS</u></b>   |                     |                     |
| Current Assets:  |                     |                     |
| Cash   | \$ 5,463            | \$ 4,377            |
| Receivables, less reserves of \$2,089 and \$994  | 57,569              | 58,151              |
| Linens in service  | 49,223              | 43,785              |
| Prepaid expenses and other current assets  | 2,958               | 3,602               |
| Total Current Assets   | 115,213             | 109,915             |
| Property and Equipment   | 201,397             | 202,927             |
| Less -- accumulated depreciation   | 103,623             | 96,634              |
| Total Property and Equipment   | 97,774              | 106,293             |
| Other:   |                     |                     |
| Goodwill   | 49,259              | 49,259              |
| Other acquired assets  | 38,879              | 42,470              |
| Deferred income taxes  | 17,356              | 15,389              |
| Cash surrender value of life insurance   | 1,650               | 1,941               |
| Miscellaneous  | 5,938               | 6,161               |
| Total Other Assets   | 113,082             | 115,220             |
| Total Assets   | \$ 326,069          | \$ 331,428          |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>   |                     |                     |
| Current Liabilities:   |                     |                     |
| Current maturities of long-term debt   | \$ 171              | \$ 319              |
| Accounts payable   | 33,572              | 37,229              |
| Accrued wages and other compensation   | 8,515               | 7,037               |
| Deferred compensation and pension liabilities  | 3,894               | 2,977               |
| Deferred income taxes  | 2,506               | 3,321               |
| Other accrued liabilities  | 34,322              | 30,535              |
| Total Current Liabilities  | 82,980              | 81,418              |
| Long-Term Debt, less current maturities  | 82,600              | 85,096              |
| Other Long-Term Liabilities  | 15,158              | 15,366              |
| Shareholders' Equity:  |                     |                     |
| Common Stock, \$1 par value, authorized 20,000,000 shares, issued:<br>9,610,859 and 9,471,538 shares | 9,611               | 9,472               |
| Capital surplus  | 9,799               | 7,189               |
| Retained earnings  | 138,050             | 140,805             |
| Accumulated other comprehensive loss   | (5,076)             | (2,553)             |
| Unamortized restricted stock   | (4,630)             | (2,841)             |
| Common Stock in treasury, at cost: 117,386 and 169,415 shares  | (2,423)             | (2,524)             |
| Total Shareholders' Equity   | 145,331             | 149,548             |
| Total Liabilities and Shareholders' Equity   | \$ 326,069          | \$ 331,428          |

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

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**CONSOLIDATED STATEMENTS OF CASH FLOWS***Angelica Corporation and Subsidiaries**Unaudited (Dollars in thousands)*

|  | Nine Months Ended |                  |
|--|-------------------|------------------|
|  | October 28, 2006  | October 29, 2005 |
| <b>Cash Flows from Operating Activities:</b>   |                   |                  |
| Income from continuing operations  | \$ 361            | \$ 1,227         |
| Non-cash items included in income from continuing operations:                                      |                   |                  |
| Depreciation   | 11,371            | 11,187           |
| Amortization   | 4,024             | 3,260            |
| Deferred income taxes  | (1,228)           | (2,355)          |
| Cash surrender value of life insurance   | (1,029)           | (885)            |
| Gain on sale of assets   | (1,473)           | (737)            |
| Change in working capital components of continuing operations, net of businesses acquired/disposed | (4,744)           | (611)            |
| Other, net   | (1,768)           | 1,340            |
| Net cash provided by operating activities of continuing operations                                 | 5,514             | 12,426           |
| <b>Cash Flows from Investing Activities:</b>   |                   |                  |
| Expenditures for property and equipment, net   | (5,631)           | (16,100)         |
| Cost of businesses and assets acquired   | -                 | (52,284)         |
| Disposals of assets  | 5,765             | 969              |
| Life insurance premiums paid, net of death benefits received                                       | 158               | (370)            |
| Net cash provided by (used in) investing activities of continuing operations                       | 292               | (67,785)         |
| <b>Cash Flows from Financing Activities:</b>   |                   |                  |
| Repayments of long-term debt   | (80,144)          | (144,115)        |
| Borrowings of long-term debt   | 77,500            | 170,000          |
| Repayments of life insurance policy loans  | -                 | (22,988)         |
| Borrowings from life insurance policy loans  | 1,101             | 53,216           |
| Debt issuance costs  | (48)              | (323)            |
| Dividends paid   | (3,116)           | (3,041)          |
| Exercise of stock options  | 270               | 1,449            |
| Net cash (used in) provided by financing activities of continuing operations                       | (4,437)           | 54,198           |
| <b>Cash Flows from Discontinued Operations:</b>  |                   |                  |
| (Restated - See Note 1)  |                   |                  |
| Operating cash flows   | (283)             | 995              |
| Investing cash flows   | -                 | 1,035            |
| Net increase in cash   | 1,086             | 869              |
| Balance at beginning of year   | 4,377             | 926              |
| Balance at end of period   | \$ 5,463          | \$ 1,795         |
| <b>Supplemental cash flow information:</b>   |                   |                  |

|   |    |     |    |   |
|---|----|-----|----|---|
| Life insurance death benefit proceeds used to repay life insurance policy loans | \$ | 306 | \$ | - |
|---|----|-----|----|---|

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THIRD QUARTER AND NINE MONTHS ENDED  
OCTOBER 28, 2006 AND OCTOBER 29, 2005

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

*Basis of Presentation*

The accompanying condensed consolidated financial statements are unaudited, and these consolidated statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the fiscal year ended January 28, 2006 (fiscal 2005). It is management's opinion that all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results during the interim period have been included. All significant intercompany accounts and transactions have been eliminated. The results of operations and cash flows for the third quarter and nine months ended October 28, 2006 are not necessarily indicative of the results that will be achieved for the full fiscal year 2006.

*Restated Consolidated Statements of Cash Flows*

Subsequent to the issuance of its unaudited consolidated financial statements for the quarter and nine months ended October 29, 2005, management of the Company determined that the cash flows associated with discontinued operations should not have been presented as a single line item within the Consolidated Statements of Cash Flows. As a result, in the fourth quarter of fiscal 2005, the Company changed the presentation of cash flows from discontinued operations to present separate disclosure of the cash flows from operating, investing, and financing activities.

*Linens in Service*

The Company reviews the amortization period of its linens in service on an ongoing basis. In order to satisfy its initiative to provide customers with 100% order fill rates the Company has purchased a significant amount of additional linens, which results in linens being washed less often and therefore lasting longer. As a result, the Company determined that the actual useful life of its linens was longer than the estimated useful life previously used for amortization purposes in its financial statements. Effective April 30, 2006, the first day of its 2006 second fiscal quarter, the Company changed its estimate of the average useful life from 60 weeks to 63 weeks to reflect the estimated periods during which these linens will remain in service. The effect of this change was to reduce 2006 third quarter and year to date linen amortization expense by \$505,000 and \$804,000, respectively; increase 2006 third quarter and year to date net income by \$312,000 and \$497,000, respectively; and increase 2006 third quarter and year to date income per share (both basic and diluted) by \$0.03 and \$0.05, respectively.

## NOTE 2. SHARE-BASED PAYMENTS

The Company has various stock option and stock bonus plans that provide for the granting of incentive stock options, non-qualified stock options, restricted stock and performance awards to certain employees and directors. A total of 1,975,000 shares have been authorized to be issued under all such plans. In addition, on October 31, 2006, shareholders approved an amendment to one of these performance plans that increased the authorized number of shares to be issued by 250,000 shares. Options and awards have been granted at or above the fair market value at the date of grant, although certain plans allow for awards to be granted at a price below fair market value. Options vest over four years except for those granted in fiscal 2004 and 2005 which vest in six months, and are exercisable not less than six months or more than 10 years after the date of grant. Restricted shares granted to non-employee directors generally vest over one to three years. Restricted shares granted to employees generally represent performance-contingent awards that vest at the end of three years upon the attainment of certain earnings performance goals, with the exception of certain retainer awards granted in the third quarter of fiscal 2006 that vest over a ten year period upon the attainment of certain earnings performance goals.

Effective January 29, 2006, the first day of fiscal 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) "Share-Based Payment" (SFAS 123(R)) using the modified prospective method of adoption, which does not require restatement of prior periods. Under the modified prospective method, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption, net of an estimate of expected forfeitures. Under SFAS 123(R), compensation expense is based on the estimated fair values of stock options and restricted stock determined on the date of grant and is recognized over the related vesting period. For performance-contingent restricted stock, if it is determined that the performance contingency will not be satisfied, any previously recognized compensation expense is reversed in the period such determination is made. As of January 17, 2006, the Board of Directors approved the accelerated vesting of 64,334 unvested stock options. The exercise price of these options was greater than the market price of the underlying stock on the date of modification. By accelerating the vesting of these options, approximately \$173,000 and \$43,000 of compensation expense will not be incurred in fiscal years 2006 and 2007, respectively. The adoption of SFAS No. 123(R) did not have a material impact on the consolidated financial statements.

The Company determines the fair value of its restricted stock awards based on the market price of its common stock on the date of grant. Restricted stock activity for the nine months ended October 28, 2006 was as follows:

|                               | Shares   | Weighted<br>Average Grant<br>Date Fair Value |
|-------------------------------|----------|--|
| Nonvested at January 29, 2006 | 141,972  | \$ 25.64                                     |
| Granted                       | 227,238  | 16.80  |
| Vested                        | (13,878) | 21.22  |
| Forfeited                     | (55,802) | 22.69  |
| Nonvested at October 28, 2006 | 299,530  | \$ 19.69                                     |

The Company estimates the fair value of its option awards on the date of grant using the Black-Scholes option pricing model. No options were granted in the third quarter or nine months ended October 28, 2006. For the nine months ended October 29, 2005, the Company granted 106,500 options with a weighted average fair value of \$6.94, using the Black-Scholes model and the following assumptions: risk-free interest rate of 4.04%; expected dividend yield of 3.8%; volatility of 31.4% and expected lives of nine to ten years. The risk-free interest rate was based on external data while all other assumptions were determined based on the Company's historical experience with stock options. Activity in the Company's stock option plans for the nine months ended October 28, 2006 was as follows:

|   | Shares    | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (Years) | Aggregate<br>Intrinsic Value |
|---|-----------|---------------------------------------|---|------------------------------|
| Options outstanding at January 29, 2006 | 813,675   | \$ 21.77                              | 6.1   |                              |
| Granted                                 | -         | -                                     |   |                              |
| Exercised                               | (21,325)  | 13.46                                 |   |                              |
| Forfeited                               | (30,975)  | 29.19                                 |   |                              |
| Expired                                 | (127,000) | 20.38                                 |   |                              |
| Options outstanding at October 28, 2006 | 634,375   | \$ 21.96                              | 6.4   | \$ 1,415,000                 |
| Options exercisable at October 28, 2006 | 632,875   | \$ 21.97                              | 6.4   | \$ 1,410,000                 |

Cash proceeds, tax benefits and intrinsic value related to total stock options exercised during the third quarter and first nine months of 2006 and 2005 were as follows:

|   | Third Quarter Ended |                     | Nine Months Ended   |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | October 28,<br>2006 | October 29,<br>2005 | October 28,<br>2006 | October 29,<br>2005 |
| Proceeds from stock options exercised           | \$ 34,000           | \$ 207,000          | \$ 287,000          | \$ 1,621,000        |
| Tax benefits related to stock options exercised | \$ -                | \$ 98,000           | \$ -                | \$ 763,000          |
| Intrinsic value of stock options exercised      | \$ 21,000           | \$ 255,000          | \$ 130,000          | \$ 1,983,000        |

The Company did not realize a tax benefit related to the exercise of stock options in the third quarter or first nine months of fiscal 2006 as there was no taxable income for the benefit to offset due to net operating loss and tax credit carryovers.

Prior to March 24, 2006, the Company generally issued shares from treasury stock to satisfy restricted stock awards and stock option exercises. Effective on that date, the Company began issuing new shares to satisfy such awards and exercises.

Total compensation expense charged to income for all stock option and stock bonus plans during the third quarter and nine months ended October 28, 2006 was \$130,000 and \$500,000, respectively (net of \$81,000 and \$309,000 related income taxes). During the third quarter and nine months ended October 29, 2005, the Company recognized (income) expense of \$(384,000) and \$152,000 for restricted stock and performance-based awards, respectively (net of \$27,000 and \$178,000 related income taxes). The total compensation expense related to nonvested stock options and awards not yet recognized is currently expected to be a combined total of approximately \$2,906,000. This cost is expected to be recognized over a weighted average period of 4.9 years. Substantially all of the Company's current quarter and

expected future stock-based compensation expense is related to restricted stock awards.

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Prior to the adoption of SFAS 123(R), the Company measured compensation expense for stock-based compensation plans using the intrinsic value-based method of accounting prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), and followed the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." Accordingly, no compensation expense was recognized for stock-based compensation plans other than for restricted stock and performance-based awards. Had compensation expense for stock-based compensation plans for the third quarter and nine months ended October 29, 2005 been determined consistent with SFAS No. 123, the Company's net income and earnings per share would approximate the following pro forma amounts:

| (Dollars in thousands, except per share amounts)   | Third<br>Quarter Ended<br>October 29,<br>2005 | Nine Months<br>Ended<br>October 29,<br>2005 |
|--|---|---|
| Net loss:  |   |   |
| As reported  | \$ (381)                                      | \$ (295)                                    |
| Add: stock-based employee compensation (credit) expense included in net loss, net of tax                                       | (384)   | 152   |
| Deduct: stock-based employee compensation credit (expense) determined under fair-value based method for all awards, net of tax | 543   | (788)                                       |
| Pro forma net loss   | \$ (222)                                      | \$ (931)                                    |
| Basic loss per share:  |   |   |
| As reported  | \$ (0.04)                                     | \$ (0.03)                                   |
| Pro forma  | (0.02)  | (0.10)                                      |
| Diluted loss per share:  |   |   |
| As reported  | \$ (0.04)                                     | \$ (0.03)                                   |
| Pro forma  | (0.02)  | (0.10)                                      |

### NOTE 3. ACQUISITIONS

On March 21, 2005, the Company acquired one hundred percent of the issued and outstanding shares of common stock and warrants of Royal Institutional Services, Inc. and its affiliate, The Surgi-Pack Corporation (together "Royal"). The total purchase price of \$45,179,000, plus an additional \$713,000 of related acquisition costs, was paid in cash and was funded through long-term borrowings. The net assets acquired consisted primarily of working capital, leasehold interests in two operating facilities and the related equipment, customer contracts and goodwill.

The results of operations of Royal are included in the Company's Consolidated Statements of Income since the date of acquisition on March 21, 2005. Unaudited pro forma consolidated revenues for the nine months ended October 29, 2005, assuming the Royal acquisition had been completed as of the beginning of the period, totaled \$320,072,000, and unaudited pro forma consolidated income from continuing operations amounted to \$1,076,000 or \$0.12 per diluted share. These pro forma amounts are not necessarily indicative of the consolidated results of operations that would have occurred had this acquisition been made at the beginning of fiscal 2005.

#### NOTE 4. NON-OPERATING INCOME, NET

In the first nine months of fiscal 2006, the Company recorded non-operating income of \$567,000 which included a \$281,000 loss related to a natural gas derivative (see Note 11) offset by interest income and a gain of \$184,000 from the death benefit of a Company-owned life insurance policy.

In the first nine months of fiscal 2005, the Company recorded non-operating income of \$1,179,000 which included \$158,000 income related to a natural gas derivative and \$360,000 from the second cash distribution received in connection with the liquidation of the parent company of an issuer of life insurance policies owned by the Company following its demutualization in 2000. These distributions did not affect the life insurance policies or their cash surrender value. The Company does not anticipate any further significant distributions from this liquidation.

Non-operating income, net, also includes interest earned on invested cash balances and notes receivable.

#### NOTE 5. INCOME TAXES

The Company recorded a tax benefit of \$1,228,000 from continuing operations for the nine months ended October 28, 2006. This benefit consisted of \$249,000 based upon the Company's estimated effective tax rate of 28.8% for the year, \$479,000 from federal and state credits, and \$500,000 from the release of certain tax contingency reserves and other discrete adjustments including the impact of state tax law changes and true-ups following the filing of the fiscal 2005 tax return. The effective tax rate of 28.8% on income from continuing operations for the nine months ended October 28, 2006, reflects the statutory tax rate adjusted for permanent items and state tax benefits, as applicable.

Management has established accruals for tax contingencies for exposures associated with tax deductions and return filing positions which may be challenged. The ultimate disposition of any of these items is not expected to have a material impact on the Company's financial condition, but may be material to the period of resolution. The tax contingency accruals are reviewed quarterly and adjusted as necessary in light of changing circumstances. During the third quarter of fiscal 2006, tax contingency reserves of \$308,000 were released as a discrete item following this review due to the expiration of the tax statute.

The Company has a federal net operating loss carryover of \$26,370,000 which will expire beginning in 2025; \$3,734,000 of federal tax credit carryover which expires at various dates beginning in 2022 or have no expiration date; \$8,659,000 of state tax credit carryover which expires at various dates beginning in 2012 or have no expiration date; and various other charitable contribution carryovers, tax credits and state net operating loss carryovers.

In assessing the adequacy of the deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company considers projected future taxable income and tax planning strategies in making this assessment.

#### NOTE 6. COMMITMENTS AND CONTINGENCIES

Prior to its sale of the Life Uniform retail business segment to Healthcare Uniform Company, Inc. in fiscal 2004, the Company was a guarantor under certain Life Uniform store lease agreements. These guarantees obligated the Company to make all payments due under the leases until their expiration in the event of default of Life Uniform. In connection with the sale of Life Uniform, the Company requested consents, as required, from landlords to assign the store leases to Healthcare Uniform Company. As a condition to such consents, certain landlords required that the Company continue as a guarantor of the leases. Under the Company's agreement with Healthcare Uniform Company, these guarantees will only extend until the end of each lease's then current term. As of October 28, 2006, the Company is secondarily obligated as a guarantor for 54 store lease agreements and the estimated maximum potential amount of future payments the Company could be required to make under these guarantees is \$9,079,000. Although these guarantees expire at various dates through fiscal year 2014, approximately 62% of the estimated maximum potential future payments expire by the end of fiscal year 2008.

The Company has provided certain indemnities to the buyer in connection with the sale of Life Uniform. Although indemnification claims are generally subject to an aggregate limit of \$6,000,000, the Company believes the likelihood of making any payments for indemnification claims is remote and has reserved accordingly.

In connection with the March 2005 Royal acquisition (see Note 3), a portion of the purchase price was placed into escrow, with payment to the sellers contingent upon the occurrence of certain events as specified in the purchase agreement. As of October 28, 2006, \$2,000,000 remained in escrow. Of this amount, \$1,000,000 is due the sellers in March 2015 upon compliance with the restrictive covenants. The sellers are also scheduled to receive \$1,000,000 in March 2007 absent indemnification claims.

The Company faces a possible exposure to outstanding workers' compensation claims incurred prior to fiscal 1999 that were sold to a former insurance carrier, in addition to exposure for deposits with that carrier for claims incurred in fiscal years 1999, 2000 and 2001 that have not yet been resolved and for claims in excess of the deductible for fiscal years 1999, 2000, 2001 and 2002. This carrier is experiencing financial difficulties and may be unable to fulfill its obligation to pay these claims, which could have a material unfavorable impact on the Company's results of operations and financial condition if it is forced to assume these liabilities. The Company estimates its possible exposure from these outstanding claims and deposits to be approximately \$940,000 as of October 28, 2006.

The Company faces some significant risk and uncertainty to its business operations related to the status of labor relations at its service centers. Approximately 75% of the Company's workforce is represented by one of several unions. In May 2006, the Company and UNITE HERE reached agreement on and renewed collective bargaining agreements covering service centers in Colton and San Diego, California, and covering several service centers in the Los Angeles, California area. In addition, the Company and UNITE HERE reached agreement on collective bargaining agreements at seven service centers that were organized in the last half of fiscal 2005; these agreements were ratified by the membership and finalized as of the end of the second quarter of fiscal 2006. Late in the second quarter of fiscal 2006, the Company and UNITE HERE negotiated a renewal agreement for the Company's service center in Rockmart, Georgia that has been ratified and finalized. Collectively, these new and renewal agreements apply to approximately 34% of the Company's workforce. At four other service centers, collective bargaining agreements covering production employees are scheduled to expire in late fiscal 2006; the process of renegotiating these agreements has been initiated. These contracts apply to approximately 20% of the Company's workforce. Any work interruptions or stoppages that may result from the inability to reach ratified agreements at any, some or all of these locations could have a material adverse impact on the Company's results of operations and financial condition.

The Company is a party to various claims and legal proceedings which arose in the ordinary course of its business. Although the ultimate disposition of these proceedings is not presently determinable, management does not believe that an adverse determination in any or all of such proceedings will have a material adverse effect upon the consolidated financial condition or operating results of the Company.

#### NOTE 7. DISCONTINUED OPERATIONS

During the third quarter of fiscal 2005, the Company made the decision to close its Columbia, Illinois service center and exit the St. Louis market. The service center's customer contracts, personal property and real estate were sold prior to the end of fiscal 2005. The results of operations and cash flows for the service center are segregated and reported as discontinued operations for all periods presented in this report.

#### NOTE 8. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of Common Stock outstanding during the period. Diluted earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of Common and Common equivalent shares outstanding.

The following table reconciles weighted average shares outstanding to amounts used to calculate basic and diluted earnings (loss) per share for the third quarter and nine months ended October 28, 2006 and October 29, 2005 (shares in thousands):



|  | Third Quarter Ended |                     | Nine Months Ended   |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | October 28,<br>2006 | October 29,<br>2005 | October 28,<br>2006 | October 29,<br>2005 |
| Weighted Average Shares:                                     |                     |                     |                     |                     |
| Average shares outstanding                                   | 9,191               | 9,132               | 9,179               | 9,079               |
| Effect of dilutive securities                                | 31                  | 217                 | 38                  | 268                 |
| Average shares outstanding, adjusted<br>for dilutive effects | 9,222               | 9,349               | 9,217               | 9,347               |

NOTE 9. GOODWILL AND OTHER ACQUIRED ASSETS

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," the Company performed its annual goodwill impairment test at the end of the third quarter of fiscal 2006 which resulted in no indication of impairment.

Other acquired assets consisted of the following (dollars in thousands):

|                       | October 28, 2006            |                             |                                  | January 28, 2006            |                             |                                  |
|-----------------------|-----------------------------|-----------------------------|----------------------------------|-----------------------------|-----------------------------|----------------------------------|
|                       | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Other<br>Acquired<br>Assets, net | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Other<br>Acquired<br>Assets, net |
| Customer contracts    | \$ 41,724                   | \$ (10,471)                 | \$ 31,253                        | \$ 42,094                   | \$ (8,290)                  | \$ 33,804                        |
| Non-compete covenants | 11,089                      | (3,463)                     | 7,626                            | 11,089                      | (2,423)                     | 8,666                            |
| Other acquired assets | \$ 52,813                   | \$ (13,934)                 | \$ 38,879                        | \$ 53,183                   | \$ (10,713)                 | \$ 42,470                        |

Aggregate amortization expense for the nine months ended October 28, 2006 and October 29, 2005 amounted to \$3,221,000 and \$2,952,000, respectively. Other acquired assets are scheduled to be fully amortized by fiscal year 2020 with corresponding annual amortization expense estimated for each of the next five fiscal years as follows (dollars in thousands):

|      |          |
|------|----------|
| 2006 | \$ 4,281 |
| 2007 | 4,166    |
| 2008 | 3,813    |
| 2009 | 3,504    |
| 2010 | 3,038    |

NOTE 10. LONG TERM DEBT

The Company's long-term bank borrowings are financed through a \$150,000,000 revolving credit facility under a loan agreement that matures on November 30, 2010. Amounts borrowed under the credit facility bear interest at a floating rate equal to either (i) LIBOR plus a margin, or (ii) a Base Rate, defined as the higher of either (a) the Federal Funds Rate plus 0.50% or (b) the Prime Rate. The margin for the LIBOR rate option is based on the Company's ratio of "Funded Indebtedness" to "EBITDA," as each is defined in the loan agreement, and may range from 2.0% to 2.75%. The LIBOR interest rate option may be selected for periods of 1 to 3 months, 6 months or 12 months. The Company has fixed the interest rate on \$10,000,000 of the credit facility borrowings with an interest rate swap agreement that extends through May 2007.



As of October 28, 2006, there was \$82,600,000 of outstanding debt under the credit facility, secured by a first lien on all equipment, inventory, and accounts receivable, and certain real estate. Of this amount, \$10,000,000 bore interest at a fixed rate of 3.58% pursuant to the interest rate swap agreement plus the LIBOR margin under the credit facility, which was 2.75% as of October 28, 2006. Of the remaining debt, \$72,500,000 bore interest at rates ranging from 5.32% to 5.56% under LIBOR contracts, plus a margin (2.75% as of October 28, 2006), and \$100,000 bore interest at 8.25%, the Prime Rate, as of October 28, 2006. Furthermore, the Company had \$13,702,000 outstanding in irrevocable letters of credit as of October 28, 2006, which reduced the amount available to borrow under the line of credit to \$23,382,000. As of October 28, 2006, the fee on the outstanding letters of credit and unused funds was 2.75% and 0.375%, respectively.

The Company is subject to certain financial covenants under its loan agreement. One of these covenants requires that the Company maintain a minimum consolidated net worth of \$120,920,000 plus an aggregate amount equal to 50% of quarterly net income beginning with the fourth quarter of fiscal 2005 (with no reduction for net losses), and an asset coverage ratio of no less than 1 to 1. Other covenants require the Company to maintain a minimum ratio of "EBITDA" to "Fixed Charges" of no less than 1.05 to 1, increasing to 1.15 to 1 effective October 31, 2006, and a maximum ratio of "Funded Indebtedness" to "EBITDA" of no more than 4.0 to 1, decreasing to 3.5 to 1 effective January 31, 2010. An amendment to the loan agreement was executed on July 28, 2006 that modified certain definitions related to the financial covenants. The Company was in compliance with these loan covenants as of October 28, 2006.

As of October 28, 2006, there were \$29,972,000 of life insurance policy loans outstanding. The loans bear interest at a fixed rate of 8.0% or variable rates ranging from 5.4% to 6.3%. The proceeds upon surrender of the policies will be reduced by the amount of any loans outstanding, unless repaid by the Company prior to that time. The total amount borrowed is netted against cash surrender value of life insurance in the Consolidated Balance Sheets as of October 28, 2006 and January 28, 2006.

#### NOTE 11. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company entered into an interest rate swap agreement with one of its lenders effective September 9, 2002. The swap agreement fixes the variable portion of the interest rate (excluding a margin) at 3.58% on \$10,000,000 of the outstanding debt under the Company's revolving credit facility until the swap's termination on May 30, 2007. The Company has elected to apply cash flow hedge accounting for the interest rate swap agreement in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." Accordingly, the derivative is recorded as an asset or liability at its fair value and the effective portion of changes in the fair value of the derivative, as measured quarterly, is reported in accumulated other comprehensive income. The (loss) gain on the derivative included in accumulated other comprehensive loss in the third quarter ended October 28, 2006 and October 29, 2005 amounted to \$(31,000) and \$32,000, respectively, net of tax; and \$(33,000) and \$121,000 for the nine months ended October 28, 2006 and October 29, 2005, respectively, net of tax. The Company has recorded a long-term asset of \$110,000 and \$165,000 for the fair value of the derivative as of October 28, 2006 and January 28, 2006, respectively.

Since October 2005, the Company has entered into natural gas futures contracts to fix the price for a portion of its future purchases of natural gas and reduce its exposure to volatility in the cost of natural gas consumed by its service centers due to fluctuations in the price on the New York Mercantile Exchange (NYMEX). These futures contracts combined are expected to hedge approximately 62% of the Company's total requirements for natural gas (measured at current usage rates) for 2006 and 2007 fiscal years, and approximately 40% and 15% of the Company's natural gas requirements, respectively, in 2008 and 2009. As of October 28, 2006, the weighted-average cost of natural gas under these contracts for the remainder of their term is \$9.55 per decatherm. The Company has elected to apply cash flow hedge accounting for these derivatives in accordance with SFAS No. 133. Accordingly, the net (loss) gain on the derivatives included in accumulated other comprehensive loss for the third quarter and nine months ended October 28, 2006, amounted to \$(1,587,000) and \$(2,489,000), respectively, net of tax, and \$302,000, net of tax, for the third quarter and nine months ended October 29, 2005. Prior to the second quarter of fiscal 2006, a portion of the Company's natural gas derivatives were not considered a cash flow hedge for accounting purposes. The change in fair market value for these derivatives was included in non-operating income, net for the nine months ended October 28, 2006, and amounted to a loss of \$281,000. The Company has recorded a current liability of \$2,887,000 and \$914,000 as of October 28, 2006 and January 28, 2006, respectively, and a long-term liability of \$2,140,000 and \$340,000 as of October 28, 2006 and January 28, 2006, respectively, for the fair value of the derivatives. The Company estimates that \$2,894,000 of unrealized losses included in accumulated other comprehensive loss before taxes as of October 28, 2006 will be reclassified to cost of services within the next 12 months as natural gas is purchased for consumption in the service centers.

In addition to the futures contracts, the Company has existing contracts as of October 28, 2006 for the physical delivery of natural gas that fix the NYMEX cost of gas for approximately 3% of its estimated natural gas purchase requirements in the next 12 months, and that fix the basis cost of gas for approximately 81% of its estimated natural gas purchase requirements in the next 12 months. Although these contracts are considered derivative instruments, they meet the normal purchases exclusion contained in SFAS No. 133, as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," and SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," and are therefore exempted from the related accounting requirements.

#### NOTE 12. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss), consisting primarily of net income (loss) and changes in the fair value of derivatives (see Note 11), net of taxes, totaled \$956,000 and \$(47,000) for the third quarter ended October 28, 2006 and October 29, 2005, respectively; and \$(2,162,000) and \$128,000 for the nine months ended October 28, 2006 and October 29, 2005, respectively.

## NOTE 13. RETIREMENT BENEFITS

The Company has a non-contributory defined benefit pension plan covering primarily all salaried and hourly administrative non-union personnel who had met participation requirements prior to September 1, 2004. The benefit formula is based on years of service and compensation during employment. The funding policy of the pension plan is in accordance with the requirements of the Employee Retirement Income Security Act of 1974. The Company amended the pension plan, effective September 1, 2004, to freeze participation in the plan. No employee shall become a participant in the pension plan on or after that date.

The net periodic pension expense recognized in the third quarter and nine months ended October 28, 2006 and October 29, 2005 was as follows:

| (Dollars in thousands)             | Third Quarter Ended |                     | Nine Months Ended   |                     |
|------------------------------------|---------------------|---------------------|---------------------|---------------------|
|                                    | October 28,<br>2006 | October 29,<br>2005 | October 28,<br>2006 | October 29,<br>2005 |
| Pension expense:                   |                     |                     |                     |                     |
| Service cost                       | \$ (3)              | \$ 105              | \$ 223              | \$ 315              |
| Interest cost                      | 308                 | 316                 | 932                 | 950                 |
| Expected return on plan assets     | (322)               | (333)               | (966)               | (999)               |
| Amortization of prior service cost | -                   | 5                   | -                   | 15                  |
| Recognized actuarial loss          | 17                  | -                   | 51                  | -                   |
| Net periodic pension expense       | \$ -                | \$ 93               | \$ 240              | \$ 281              |

An adjustment was made in the third quarter of fiscal 2006 to reflect final actuarial calculations for the pension plan's 2006 plan year. The decrease in expense is reflective of the reduced number of active plan participants as of January 1, 2006. Total expense for fiscal 2006 is expected to be approximately \$320,000. In addition, the Company currently expects to contribute \$1,988,000 to the pension plan in fiscal 2006.

## NOTE 14. NEW ACCOUNTING PRONOUNCEMENTS

In May 2005, the Financial Accounting Standards Board ("FASB") issued SFAS No. 154, "Accounting Changes and Error Corrections." SFAS No. 154 replaces APB Opinion No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for the accounting for and reporting of a voluntary change in accounting principle. This statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change, instead of including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 is effective for the Company's fiscal year ending January 27, 2007.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments" which amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities." SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for the Company's fiscal year ending January 26, 2008. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. The Company does not expect the adoption of SFAS No. 155 to have a material impact on its consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. FIN 48 is effective for the Company's fiscal year ending January 26, 2008. The Company is currently evaluating the impact of this standard on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which establishes a framework for measuring the fair value of assets and liabilities. This framework is intended to provide increased consistency in how fair value determinations are made under various existing accounting standards which permit, or in some cases require, estimates of fair market value. SFAS No. 157 also expands financial statement disclosure requirements about a company's use of fair value measurements, including the effect of such measures on earnings. SFAS No. 157 is effective for the Company's fiscal year ending January 31, 2009. The Company does not expect the adoption of SFAS No. 157 to have a material impact on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," which amends SFAS No. 87, "Employers' Accounting for Pensions," SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions" and SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits." SFAS No. 158 requires that employers recognize on a prospective basis the funded status of their defined benefit pension and other postretirement plans on their consolidated balance sheet and recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost. Based on the funded status of the Company's defined benefit postretirement plan as of January 1, 2006, the Company would be required to recognize an additional pension obligation of approximately \$1,200,000, resulting in a charge to accumulated other comprehensive loss. This aspect of SFAS No. 158 is effective for the Company's current fiscal year ending January 27, 2007. The statement also requires that employers measure plan assets and obligations as of the date of their year-end financial statements beginning with the Company's fiscal year ending January 31, 2009. The Company has not yet determined the impact that this portion of SFAS No. 158 will have on its consolidated balance sheets.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides interpretive guidance on how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in the current year financial statements. SAB 108 requires registrants to quantify misstatements using both an income statement ("rollover") and balance sheet ("iron curtain") approach and evaluate whether either approach results in a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. If prior year errors that had been previously considered immaterial now are considered material based on either approach, no restatement is required so long as management properly applied its previous approach and all relevant facts and circumstances were considered. If prior years are not restated, the cumulative effect adjustment is recorded in opening retained earnings as of the beginning of the fiscal year of adoption. SAB 108 is effective for the Company's fiscal year ending January 27, 2007, with earlier adoption encouraged. The Company does not expect the adoption of SAB 108 to have a material impact on its consolidated financial statements.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

THIRD QUARTER AND NINE MONTHS ENDED OCTOBER 28, 2006  
COMPARED WITH  
THIRD QUARTER AND NINE MONTHS ENDED OCTOBER 29, 2005

General

Angelica Corporation is a leading provider of outsourced linen management services to the healthcare industry in the United States. We offer comprehensive linen management services to the U.S. healthcare industry, including hospitals, long-term care facilities, surgery centers, medical clinics, dental offices, and other medical providers. Among the items that we clean and provide, on either a rental or customer-owned basis, are bed linens, towels, gowns, scrubs, surgical linens and surgical packs, as well as mops, mats and other dust control products. To a more limited extent, we also provide linen management services to customers in the hospitality business. Currently, we operate 30 laundry service centers and serve customers in 23 states.

Critical Accounting Policy - Linens in Service

We review our policy for amortizing linens in service on an ongoing basis. In order to satisfy our initiative to provide customers with 100% order fill rates we have purchased a significant amount of additional linens, which results in linens being washed less often and therefore lasting longer. As a result, we determined that the actual useful life of our linens was longer than the estimated useful life previously used for amortization purposes in our financial statements and, effective April 30, 2006, the first day of our 2006 second fiscal quarter, changed the estimate of the average useful life from 60 weeks to 63 weeks to reflect the estimated periods during which these linens will remain in service. The effect of this change was to reduce 2006 third quarter and year to date linen amortization expense by \$0.5 million and \$0.8 million, respectively; increase 2006 third quarter and year to date net income by \$0.3 million and \$0.5 million, respectively; and increase 2006 third quarter and year to date income per share (both basic and diluted) by \$0.03 and \$0.05, respectively.

Results of Operations

*Third Quarter Ended October 28, 2006 Compared to Third Quarter Ended October 29, 2005*

Third quarter fiscal 2006 revenues were \$107.8 million, a slight increase of \$0.2 million, or 0.2%, compared with the same period in fiscal 2005. Organic growth from net new business additions and price increases contributed \$3.8 million of the third quarter increase, representing an organic growth rate of 4.2%, while fiscal 2005 acquisitions contributed \$1.1 million of the increase. These increases were substantially offset by the loss of \$4.7 million of revenues due to the sale of non-healthcare customer accounts in fiscal 2005 and 2006.



Cost of services of \$90.5 million in the third quarter of fiscal 2006 decreased \$3.4 million, or 3.6%, from the same year ago period. As a result of this \$3.4 million decrease and revenue pricing improvements, cost of services decreased to 83.9% of revenues in the third quarter of fiscal 2006 from 87.2% in the prior year period. The current quarter decline consisted primarily of the following:

- Merchandise cost decreased from 17.7% of revenues in the third quarter of fiscal 2005 to 16.2% in the third quarter of fiscal 2006, or \$1.5 million. Amortization expense related to higher targeted inventory ratios and increased linen purchases was more than offset by the revised useful life of new linens discussed above and higher revenue per pound, decreasing total merchandise costs as a percent of revenues. We also recognized in the third quarter fiscal 2006 a \$0.2 million cumulative benefit of a vendor rebate program, as it became probable that current year purchases would exceed the threshold for earning the rebate.
- Production labor and fringe benefit costs decreased \$0.6 million to 34.0% of revenues in the third quarter fiscal 2006 versus 34.6% in the prior year quarter.
- Utility expenses decreased \$0.6 million to 9.2% of revenues in the third quarter fiscal 2006 versus 9.9% in the prior year quarter.
- Delivery expenses decreased \$0.6 million from the third quarter of fiscal 2005 to the third quarter of fiscal 2006. The transfer of certain customer contracts between service centers also helped reduce delivery expenses.

Gross margin has increased sequentially to 16.1% in the third quarter fiscal 2006 from 14.4%, 13.8% and 10.6% in the second quarter fiscal 2006, first quarter fiscal 2006 and the fourth quarter fiscal 2005, respectively. The current quarter gross margin of 16.1% is up from 12.8% in the 2005 third quarter, reflecting our revenue pricing improvements combined with the favorable expense variances discussed above.

In the third quarter fiscal 2006, selling, general and administrative expenses increased by \$2.6 million over third quarter fiscal 2005 to \$13.4 million, or 12.4% of revenues, compared to 10.0% of revenues a year ago. The increase in SG&A expenses resulted primarily from higher incentive compensation, bad debt and sales tax accruals of \$0.9 million, a \$0.7 million reversal of amortization expense related to our long-term incentive plan during the third quarter fiscal 2005, consulting fees of \$0.4 million related to our operations process improvement (“OPI”) implementation, higher travel costs of \$0.3 million related to the OPI implementation and increased sales initiatives, and legal and shareholder relation expenses of \$0.2 million associated with the Board of Directors’ Special Committee. On August 30, 2006, we entered into settlement agreements with certain major shareholders with respect to the issues for which the Special Committee was organized. As part of the settlements, the Special Committee was disbanded.

In the third quarter of fiscal 2006, we reported other operating income of \$2.4 million related primarily to the sale of certain real estate and the settlement received from the lawsuit that was initiated in connection with the Vallejo eminent domain proceedings in fiscal 2005, compared with income of \$0.2 million in the third quarter fiscal 2005 primarily from a gain on the divestiture of non-healthcare business.

Interest expense in third quarter fiscal 2006 increased by \$0.4 million to \$2.5 million. The increase resulted primarily from higher interest rates, which increased from an average 6.2% per annum in the third quarter fiscal 2005 to an average 7.7% per annum in the third quarter fiscal 2006.

We recorded \$0.2 million non-operating income in the third quarter of fiscal 2006, consisting primarily of interest income. During the third quarter of fiscal 2005, we recorded \$0.4 million non-operating income, which included \$0.2 million income related to a natural gas derivative.

For the third quarter of fiscal 2006, we recorded an income tax provision of \$0.4 million compared to a benefit of \$0.4 million in the third quarter of fiscal 2005. The provision in the current fiscal quarter as compared to the benefit in prior fiscal quarter is due primarily to higher pretax income for the third quarter of fiscal 2006.

Income from continuing operations was \$2.6 million in the third quarter of fiscal 2006, up from \$0.8 million in the prior year quarter. The increase was due primarily to the gross margin improvement and other operating income items explained above, partially offset by higher SG&A and interest costs.

Net loss for the third quarter of fiscal 2005 included a loss from discontinued operations of \$1.2 million related to our Columbia, Illinois service center which was sold in the prior year.

*Nine Months Ended October 28, 2006 Compared to Nine Months Ended October 29, 2005*

Revenues for the first nine months of fiscal 2006 of \$320.1 million represented an increase of 2.2%, or \$6.8 million, from \$313.3 million in the first nine months fiscal 2005. Organic growth from net new business additions and price increases contributed \$10.1 million of the increase, representing an organic growth rate of 3.7%, while fiscal 2005 acquisitions contributed \$10.6 million of the increase. These increases were offset by the loss of \$13.9 million of revenues due to the sale of non-healthcare customer accounts in fiscal 2005 and 2006.

In the first nine months of fiscal 2006, cost of services increased from the same period in fiscal 2005 by \$2.6 million, or 0.9%, to \$272.9 million. The increase primarily reflected the year over year increase in operating volumes and higher energy prices for natural gas and delivery fuel. Because of revenue pricing improvements, cost of services declined to 85.3% of revenues from 86.3% in fiscal 2005, allowing gross margin to increase to 14.7% for the first nine months of fiscal 2006 from 13.7% in the prior year period.

For the first nine months of fiscal 2006, selling, general and administrative expenses increased \$5.1 million to 12.9% of revenues from 11.5% of revenues in the same period a year ago. The increase in SG&A expenses resulted primarily from an increase in incentive compensation and bad debt accruals of \$2.5 million, professional fees of \$2.1 million related to our operations process improvement implementation and financial consulting projects, and legal and shareholder relation expenses of \$0.8 million associated with the Board of Directors' Special Committee. The first nine months fiscal 2005 also included \$0.8 million associated with our evaluation of alternatives to our then existing debt structure and changes in our senior management, offset by a \$0.7 million reversal of amortization expense related to our long-term incentive plan. On August 30, 2006, we entered into settlement agreements with certain major shareholders with respect to the issues for which the Special Committee was organized. As part of the settlements, the Special Committee was disbanded.

Amortization expense increased by \$0.3 million to \$3.2 million in the first nine months of fiscal 2006, reflecting the impact of intangible assets acquired during fiscal 2005.

In the first nine months fiscal 2006, we reported other operating income of \$2.9 million, reflecting gains from the sale of three parcels of real estate and a settlement received from the lawsuit that was initiated in connection with the Vallejo eminent domain proceedings in fiscal 2005, compared to other operating income of \$0.8 million in the first nine months of fiscal 2005, primarily from the divestiture of non-healthcare business.

Interest expense for the first nine months of fiscal 2006 increased \$2.1 million to \$7.1 million. The increase resulted from a combination of higher interest rates and higher average borrowings. Interest rates increased from an average 5.4% per annum in the first nine months of fiscal 2005 to an average 7.4% per annum in the first nine months of fiscal 2006. Higher average debt levels for the first nine months of fiscal 2006 reflected the impact of March 2005 acquisition borrowings.

We recorded \$0.6 million non-operating income in the first nine months of fiscal 2006, which included interest income and a \$0.2 million gain from the death benefit of a Company-owned life insurance policy, partially offset by a \$0.3 million loss related to a natural gas derivative. During the first nine months of fiscal 2005, we recorded non-operating income of \$1.2 million, which included a \$0.4 million distribution from the liquidation of the parent company of the issuer of life insurance policies we own, \$0.2 million income related to a natural gas derivative, and interest income.

For the first nine months of fiscal 2006, we recorded a tax benefit of \$1.2 million compared to a benefit of \$0.3 million in the first nine months of fiscal 2005. The higher tax benefit is due primarily to a pretax loss in the first nine months of fiscal 2006 as compared to pretax income in the same period a year ago.

We reported income from continuing operations of \$0.4 million in the first nine months of fiscal 2006, compared to income of \$1.2 million in the first nine months of fiscal 2005. The decrease resulted primarily from higher professional fees and higher interest expense, as discussed above. These increases were partially offset by the increase in revenues resulting from prior year acquisitions and current year organic growth.

Net loss for the first nine months of fiscal 2005 included a loss from discontinued operations of \$1.5 million related to our Columbia, Illinois service center which was sold in the prior year.

### Financial Condition

As of October 28, 2006, working capital totaled \$32.2 million and the current ratio (*i.e.*, the ratio of current assets to current liabilities) was 1.4 to 1, compared with \$28.5 million and 1.4 to 1, respectively, at January 28, 2006. The increase in working capital reflects primarily a higher balance of linens in service as discussed below.

Accounts receivable decreased by \$0.6 million in the first nine months fiscal 2006, due primarily to the collection of a miscellaneous receivable in the first quarter of fiscal 2006. Linens in service increased by \$5.4 million as a result of a significant injection of linens into the system to increase our customer order fill rates and the related change in estimated useful life from 60 to 63 weeks, as explained above under “Critical Accounting Policy - Linens in Service”.

Accounts payable decreased by \$3.7 million as higher payable balances at the beginning of the year were paid down to more normal levels. The higher balances at January 28, 2006 were attributable to higher in-transit payments and the timing of certain invoices. The decline in accounts payable was offset by a \$3.8 million increase in other accrued liabilities reflecting changes in the fair value of our natural gas derivatives as well as higher accrued interest and insurance reserves. Long-term debt of \$82.6 million as of October 28, 2006 was \$2.5 million less than at January 28, 2006. Cash received near the end of the quarter related to a real estate sale and a lawsuit settlement provided funds to reduce our outstanding debt. Our ratio of total debt to total capitalization as of October 28, 2006 was 36.3% compared to 36.4% as of January 28, 2006. Book value per share at the end of third quarter fiscal 2006 was \$15.31, a decline from \$16.08 as of January 28, 2006.

### Liquidity and Capital Resources

Cash flow provided by operating activities of continuing operations decreased \$6.9 million for the first nine months ended October 28, 2006 compared with the same period a year ago. The current year decline resulted primarily from an unfavorable change in working capital components of \$4.7 million, reflecting our increased linen purchases and paying down beginning of year accounts payable balances to more normal levels.

Cash flows from investing activities for the first nine months ended October 28, 2006, included capital expenditures of \$5.6 million, down from \$16.1 million in the prior year period as we implement best practices systemwide before incurring discretionary capital expenditures. In the first nine months of fiscal 2006, we received net proceeds of \$5.8 million from the disposal of assets and \$0.5 million from the death benefit of a Company-owned life insurance policy, the gain on which was recognized in the fourth quarter of fiscal 2005. Cash flows from investing activities for the first nine months ended October 29, 2005 included \$52.3 million of cost of businesses acquired, including cash paid for Royal Institutional Services, Inc. (“Royal”) and the final payment of \$3.6 million for the fiscal year 2004 acquisition of the Duke University Health System laundry.

Cash used in financing activities was \$4.4 million in the first nine months of fiscal 2006 reflecting net debt repayments of \$2.6 million under our loan agreement and dividend payments of \$3.1 million, offset partially by borrowings of \$1.1 million from life insurance policy loans. In the first nine months of fiscal 2005, cash provided by financing activities of \$54.2 million reflected the net proceeds of \$56.1 million from bank debt and life insurance policy loans, used primarily to fund the prior year acquisition of Royal and capital expenditures. In addition, proceeds from stock option exercises decreased from \$1.4 million in the first nine months of fiscal 2005 to \$0.3 million in the first nine months of fiscal 2006.

As of October 28, 2006, there was \$82.6 million of debt outstanding under our credit facility. Of this amount, \$10.0 million bore interest at a fixed rate of 3.58% pursuant to an interest rate swap agreement plus a margin under the credit facility (2.75% as of October 28, 2006). Of the remaining debt, \$72.5 million bore interest at rates ranging from 5.32% to 5.56% under LIBOR contracts, plus a margin (2.75% at October 28, 2006), and \$0.1 million bore interest at 8.25%, the Prime Rate, as of October 28, 2006.

In addition to amounts due under our loan agreement, at the end of the third quarter fiscal 2006 there were \$30.0 million of life insurance policy loans outstanding. The proceeds of these loans, bearing interest at a fixed rate of 8.0% or variable rates ranging from 5.4% to 6.3%, were used to pay down our revolving line of credit in fiscal 2005 and 2006. On October 28, 2006, we also had \$13.7 million in irrevocable letters of credit outstanding, which reduced the amount available to borrow under the loan agreement to \$23.4 million.

We are subject to certain financial covenants under our loan agreement. The covenants require us to maintain a minimum consolidated net worth of \$120.9 million plus an aggregate amount equal to 50% of quarterly net income beginning with the fourth quarter of fiscal 2005 (with no reductions for net losses), and an asset coverage ratio of no less than 1 to 1. We are also required to maintain a minimum ratio of "EBITDA" to "Fixed Charges" of no less than 1.05 to 1, increasing to 1.15 to 1 effective October 31, 2006, and a maximum ratio of "Funded Indebtedness" to "EBITDA" of no more than 4.0 to 1, decreasing to 3.5 to 1 effective January 31, 2010. An amendment to the loan agreement was executed on July 28, 2006 that modified certain definitions related to the financial covenants. We were in compliance with these loan covenants as of October 28, 2006.

Management believes that our financial condition, operating cash flow and available sources of external funds are sufficient to satisfy our requirements for debt service, capital expenditures, dividends and working capital over the course of the next 12 months. However, if we pursue a large acquisition or are unable to achieve our forecasted operating results during the next twelve months, our forecasted cash flows could be negatively impacted requiring that we consider alternative funding sources in order to avoid violations of our loan covenants.

#### Recent Accounting Pronouncements

Effective January 29, 2006, the first day of fiscal 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004) "Share-Based Payment" (SFAS 123(R)) using the modified prospective method of adoption, which does not require restatement of prior periods. Under the modified prospective method, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption, net of an estimate of expected forfeitures. Under SFAS 123(R), compensation expense is based on the estimated fair values of stock options and restricted stock determined on the date of grant and is recognized over the related vesting period. For performance-contingent restricted stock, if it is determined that the performance contingency will not be satisfied, any previously recognized compensation expense is reversed in the period such determination is made. As of January 17, 2006, the Board of Directors approved the accelerated vesting of 64,334 unvested stock options. The exercise price of these options was greater than the market price of the underlying stock on the date of modification. By accelerating the vesting of these options, approximately \$0.2 million and \$0.1 million of compensation expense will not be incurred in fiscal years 2006 and 2007, respectively. Substantially all of our current quarter and expected future stock-based compensation expense is related to restricted stock awards. The total compensation expense related to nonvested stock options and awards not yet recognized is currently expected to be a combined total of approximately \$2.9 million. This cost is expected to be recognized over a weighted average period of 4.9 years. The adoption of SFAS No. 123(R) did not have a material impact on our consolidated financial statements.

## **FORWARD-LOOKING STATEMENTS**

Any forward-looking statements made in this document reflect the Company's current views with respect to future events and financial performance and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties that may cause actual results to differ materially from those set forth in these statements. These potential risks and uncertainties include, but are not limited to, competitive and general economic conditions, the ability to retain current customers and to add new customers in competitive market environments, competitive pricing in the marketplace, delays in the shipment of orders, availability of labor at appropriate rates, availability and cost of energy and water supplies, the cost of workers' compensation and healthcare benefits, the ability to attract and retain key personnel, the ability of the Company to recover its seller note and avoid future lease obligations as part of its sale of its former Life Uniform division, the ability of the Company to execute its operational strategies, unusual or unexpected cash needs for operations or capital transactions, the effectiveness of the Company's initiatives to reduce key operating costs as a percent of revenues, the ability to obtain financing in required amounts and at appropriate rates and terms, the ability to identify, negotiate, fund, consummate and integrate acquisitions, and other factors which may be identified in the Company's filings with the Securities and Exchange Commission.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company is exposed to commodity price risk related to the use of natural gas in its laundry service centers. The total cost of natural gas in the third quarter and nine months ended October 28, 2006 was approximately \$5.7 million and \$18.4 million, respectively. To reduce the uncertainty of fluctuating energy prices, the Company has entered into fixed-price contracts as of October 28, 2006 for approximately 68% of its estimated natural gas purchase requirements in the next 12 months. A hypothetical 10% increase in the cost of natural gas not covered by these contracts would result in a reduction of approximately \$0.8 million in annual pretax earnings.

The Company is also exposed to commodity price risk resulting from the consumption of gasoline and diesel fuel for delivery trucks. The total cost of delivery fuel in the third quarter and nine months ended October 28, 2006 was approximately \$2.4 million and \$6.8 million, respectively. A hypothetical 10% increase in the cost of delivery fuel would result in a decrease of approximately \$0.9 million in annual pretax earnings.

The Company's exposure to interest rate risk relates primarily to its variable-rate revolving debt agreement and life insurance policy loans. As of October 28, 2006, there was \$82.6 million of outstanding debt under the credit facility, of which \$10.0 million bore interest at a fixed rate of 3.58% (plus a margin) under an interest rate swap agreement entered into by the Company with one of its lenders to moderate the exposure. Amounts borrowed under the credit facility in excess of the \$10.0 million covered by the interest rate swap agreement bore interest at a rate equal to either (i) LIBOR plus a margin, or (ii) a Base Rate, defined as the higher of (a) the Federal Funds Rate plus .50% or (b) the Prime Rate. The margin is based on the Company's ratio of "Funded Indebtedness" to "EBITDA," as each is defined in the Loan Agreement. As of October 28, 2006, the margin was 2.75%. Of the \$30.0 million in life insurance policy loans outstanding as of October 28, 2006, a total of \$24.1 million of these loans bore interest at variable rates ranging from 5.4% to 6.3%. A hypothetical increase of 100 basis points in short-term interest rates applicable to the outstanding variable-rate debt not covered by the interest rate swap agreement would result in a reduction of approximately \$1.0 million in annual pretax earnings.

### **Item 4. Controls and Procedures**

The Company maintains a system of internal controls and procedures designed to provide reasonable assurance as to the reliability of the unaudited consolidated financial statements and other disclosures included in this report. The Company's Board of Directors, operating through its Audit Committee which is composed entirely of independent Directors, provides oversight to the financial reporting process.



As of the end of the period covered by this report, the Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based upon their evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in ensuring that material information relating to the Company, including its consolidated subsidiaries, is made known to them by others within those entities in a timely manner, particularly during the period for which this quarterly report is being prepared. The Chief Executive Officer and Chief Financial Officer also concluded based upon their evaluation that the Company's disclosure controls and procedures are effective in ensuring that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

There were no changes in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 4. Submission of Matters to a Vote of Security Holders**

At the October 31, 2006 Annual Meeting of Shareholders, each of the two nominees for directors of the Company was elected based on the following votes:

| <u>Name</u>                                    | <u>Votes<br/>“For”</u> | <u>Votes<br/>“Withheld”</u> |
|--|------------------------|-----------------------------|
| For terms expiring at the 2009 Annual Meeting: |                        |                             |
| Ronald J. Kruszewski                           | 8,618,971              | 351,675                     |
| Stephen M. O’Hara                              | 8,571,264              | 399,382                     |

Don W. Hubble, John J. Quicke and Ronald N. Riner, with terms ending in 2007, and James R. Henderson, Charles W. Mueller and Kelvin R. Westbrook, with terms ending in 2008, all continue as directors of the Company.

The shareholders approved the amendment and restatement of the Angelica Corporation 1999 Performance Plan. The tabulation was as follows: 5,995,027 voting for, 1,891,178 voting against, 10,968 abstaining, and 1,073,473 broker non-votes.

The shareholders also approved the ratification of the appointment of Deloitte & Touche LLP as Angelica’s independent registered public accounting firm for the fiscal year 2006. The tabulation was as follows: 8,945,894 voting for, 5,823 voting against, and 18,929 abstaining.

**Item 6. Exhibits**

(a) See Exhibit Index on page 30.

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SIGNATURES

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

Angelica Corporation  
(Registrant)

Date: December 7, 2006

/s/ Stephen M. O'Hara  
Stephen M. O'Hara  
Chairman, President and  
Chief Executive Officer

/s/ James W. Shaffer  
James W. Shaffer  
Vice President and  
Chief Financial Officer  
(Principal Financial Officer)  
(Principal Accounting Officer)

**EXHIBIT INDEX**

| <u>Exhibit Number</u> | <u>Description</u>  |
|-----------------------|---|
|                       | *Asterisk indicates exhibits filed herewith.<br>**Incorporated by reference from the document listed.   |
| 3.1                   | Restated Articles of Incorporation of the Company, as currently in effect. Filed as Exhibit 3.1 to the Form 10-K for the fiscal year ended January 26, 1991.**  |
| 3.2                   | Amendment to Certificate of Designation, Preferences and Rights of Class B Series 2 Junior Participating Preferred Stock. Filed as Exhibit 3.1 to a current report on Form 8-K on September 5, 2006.**  |
| 3.3                   | Current By-Laws of the Company, as amended and restated. Filed as Exhibit 3.3 to the Form 10-Q for fiscal quarter ended July 29, 2006.**  |
| 4.1                   | Shareholder Rights Plan dated August 25, 1998. Filed as Exhibit 1 to Registration Statement on Form 8-A on August 28, 1998.**   |
| 4.2                   | Form of Amendment No. 1 to Rights Agreement, dated as of August 29, 2006, between Angelica Corporation and UMB Bank, N.A. Filed as Exhibit 4.1 to a current report on Form 8-K on September 5, 2006.**  |
| 4.3                   | Form of Amendment No. 2 to Rights Agreement, dated September 19, 2006, by and between Angelica Corporation and UMB Bank, N.A. Filed as Exhibit 4.1 to a current report on Form 8-K on September 22, 2006.**   |
| 10.1                  | Angelica Corporation 1999 Performance Plan, as amended and restated August 29, 2006 and approved by the shareholders of the Company on October 31, 2006. Filed as Appendix B to the Company's Proxy Statement for the Annual Meeting of Shareholders held October 31, 2006, and reported on a current report on Form 8-K filed November 13, 2006.** |
| 10.2                  | Letter agreements dated September 19, 2006 relating to cash compensation for retainer and board fees for Steel directors.*  |
| 10.3                  | Form of Special Restricted Stock Agreement under the 1999 Performance Plan.*  |
| 10.4                  | Employment Offer Letter by and between the Company and John Olbrych, dated November 22, 2006.*  |
| 31.1                  | Section 302 Certification of Chief Executive Officer.*  |
| 31.2                  | Section 302 Certification of Chief Financial Officer.*  |
| 32.1                  | Section 906 Certification of Chief Executive Officer.*  |
| 32.2                  | Section 906 Certification of Chief Financial Officer.*  |

