

G&K SERVICES INC
Form 10-Q
May 06, 2011

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 2, 2011
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)

Registrant's telephone number, including area code (952) 912-5500

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(do not check if a smaller
reporting company)

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 2, 2011 was 18,711,022 shares

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

	PAGE
<u>PART I</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Condensed Balance Sheets as of April 2, 2011 and July 3, 2010</u>	3
<u>Consolidated Condensed Statements of Operations for the three and nine months ended April 2, 2011 and March 27, 2010</u>	4
<u>Consolidated Condensed Statements of Cash Flows for the nine months ended April 2, 2011 and March 27, 2010</u>	5
<u>Notes to Consolidated Condensed Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
<u>Item 3. Quantitative and Qualitative Disclosure About Market Risk</u>	24
<u>Item 4. Controls and Procedures</u>	24
<u>PART II</u>	
<u>Item 1. Legal Proceedings</u>	25
<u>Item 1A. Risk Factors</u>	25
<u>Item 6. Exhibits</u>	26
<u>Signatures</u>	27
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

Table of Contents

PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
CONSOLIDATED CONDENSED BALANCE SHEETS

G&K Services, Inc. and Subsidiaries

	April 2, 2011 (Unaudited)	July 3, 2010
(In thousands)		
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 21,838	\$ 8,774
Accounts receivable, less allowance for doubtful accounts of \$3,193 and \$3,118	91,301	82,754
Inventories, net	145,797	126,325
Other current assets	15,702	21,279
Total current assets	274,638	239,132
Property, Plant and Equipment, net	188,576	194,988
Goodwill	329,475	323,055
Other Assets	61,305	56,693
Total assets	\$ 853,994	\$ 813,868
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	\$ 34,779	\$ 25,944
Accrued expenses	71,506	71,478
Deferred income taxes	3,978	3,557
Current maturities of long-term debt	812	1,023
Total current liabilities	111,075	102,002
Long-Term Debt, net of Current Maturities	145,346	160,398
Deferred Income Taxes	1,524	1,242
Accrued Income Taxes Long Term	13,144	10,113
Other Noncurrent Liabilities	77,797	73,217
Stockholders Equity		
Common stock, \$0.50 par value	9,356	9,292
Additional paid-in capital	11,138	8,009
Retained earnings	465,266	444,986
Accumulated other comprehensive income	19,348	4,609
Total stockholders equity	505,108	466,896

Total liabilities and stockholders' equity	\$ 853,994	\$ 813,868
--	------------	------------

The accompanying notes are an integral part of these Consolidated Condensed Financial Statements.

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

(Unaudited)

(In thousands, except per share data)	For the Three Months Ended		For the Nine Months Ended	
	April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Revenues				
Rental operations	\$ 192,828	\$ 185,606	\$ 566,287	\$ 572,585
Direct sales	17,515	13,339	48,537	40,851
Total revenues	210,343	198,945	614,824	613,436
Operating Expenses				
Cost of rental operations	130,857	130,038	383,316	402,906
Cost of direct sales	13,169	9,664	36,592	30,255
Selling and administrative	50,364	45,289	144,264	142,197
Total operating expenses	194,390	184,991	564,172	575,358
Income from Operations	15,953	13,954	50,652	38,078
Interest expense	2,958	3,275	8,011	10,675
Income before Income Taxes	12,995	10,679	42,641	27,403
Provision for income taxes	5,029	3,642	17,032	9,932
Net Income	\$ 7,966	\$ 7,037	\$ 25,609	\$ 17,471
Basic weighted average number of shares outstanding	18,364	18,305	18,343	18,300
Basic Earnings per Common Share	\$ 0.43	\$ 0.38	\$ 1.40	\$ 0.95
Diluted weighted average number of shares outstanding	18,448	18,361	18,446	18,339
Diluted Earnings per Common Share	\$ 0.43	\$ 0.38	\$ 1.39	\$ 0.95
Dividends per share	\$ 0.095	\$ 0.075	\$ 0.285	\$ 0.225

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)

(In thousands)	For the Nine Months Ended	
	April 2, 2011	March 27, 2010
Operating Activities:		
Net income	\$ 25,609	\$ 17,471
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	28,232	30,014
Other adjustments	3,919	(3,350)
Changes in current operating items	(4,791)	9,319
Other assets and liabilities	(3,952)	754
Net cash provided by operating activities	49,017	54,208
Investing Activities:		
Property, plant and equipment additions, net	(15,465)	(12,249)
Divestitures of business assets, net		21,670
Net cash (used for)/provided by investing activities	(15,465)	9,421
Financing Activities:		
Payments of long-term debt	(763)	(7,434)
Payments of revolving credit facilities, net	(14,500)	(54,210)
Cash dividends paid	(5,327)	(4,185)
Net issuance of common stock, primarily under stock option plans	259	7
Purchase of common stock	(342)	(388)
Net cash used for financing activities	(20,673)	(66,210)
Increase/(Decrease) in Cash and Cash Equivalents	12,879	(2,581)
Effect of Exchange Rates on Cash	185	(94)
Cash and Cash Equivalents:		
Beginning of period	8,774	13,136
End of period	\$ 21,838	\$ 10,461

The accompanying notes are an integral part of these Consolidated Condensed Financial Statements.

Table of Contents

G&K SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Amounts in millions, except per share data)
(Unaudited)

1. Basis of Presentation for Interim Financial Statements

The Consolidated Condensed Financial Statements included herein, except for the July 3, 2010 balance sheet, which was derived from the audited Consolidated Financial Statements for the fiscal year ended July 3, 2010, have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In our opinion, the accompanying unaudited Consolidated Condensed Financial Statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly our financial position as of April 2, 2011, and the results of our operations for the three and nine months ended and our cash flows for the nine months ended April 2, 2011 and March 27, 2010. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to such rules and regulations, although we believe 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 our latest report on Form 10-K.

The results of operations for the three and nine month periods ended April 2, 2011 and March 27, 2010 are not necessarily indicative of the results to be expected for the full year. We have evaluated subsequent events through the date of filing this form 10-Q and have found none that require recognition or disclosure.

Critical accounting policies are defined as the most important and pervasive accounting policies used, areas most sensitive to material changes from external factors and those that are reflective of significant judgments and uncertainties. See Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended July 3, 2010 for additional discussion of the application of these and other accounting policies.

Inventories

Inventories consist of new goods and rental merchandise in service. New goods are stated at the lower of first-in, first-out (FIFO) cost or market, net of any reserve for obsolete or excess inventory. Merchandise placed in service to support our 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 six months to three years. In establishing estimated lives for merchandise in service, management considers historical experience and the intended use of the merchandise.

We review the estimated useful lives of our in-service merchandise on a periodic basis. During the fourth quarter of 2010, we completed an analysis of certain in-service merchandise which resulted in the estimated useful lives for the merchandise being modified to better reflect the estimated periods in which the merchandise will remain in service. The effect of the change in estimate in fiscal year 2010 and the first three quarters of fiscal year 2011 was not material.

We estimate our reserves for inventory obsolescence by periodically examining our inventory to determine if there are indicators that carrying values exceed the net realizable value. Experience has shown that significant indicators that could require the need for additional inventory write-downs include the age of the inventory, anticipated demand for our products, historical inventory usage, revenue trends and current economic conditions. We believe that adequate reserves for inventory obsolescence have been made in the Consolidated Financial Statements; however, in the future, product lines and customer requirements may change, which could result in additional inventory write-downs.

Table of Contents**Revenue Recognition**

Our rental operations business is largely based on written service agreements whereby we agree to pick-up soiled merchandise, launder and return it to our customers. The service agreements generally 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 damaged uniforms and replacement fees for non-personalized merchandise that is lost or damaged. Direct sale revenue is recognized in the period in which the product is shipped. Total revenues do not include sales tax as we consider ourselves a pass-through conduit for collecting and remitting sales taxes. During the fourth quarter of fiscal year 2010, we changed our business practices regarding the replacement of certain in-service towel and linen inventory and accordingly, we modified our revenue recognition policy related to the associated replacement fees. This revenue, which had historically been deferred and recognized over the estimated useful life of the associated in-service inventory, is now recognized upon billing. For the nine months ended April 2, 2011, the effect of this change increased revenue and income from operations by \$5.9 million, net income by \$3.7 million and basic and diluted earnings per common share by \$0.20. The change did not have a material impact on revenues, income from operations or net income for the three months ended April 2, 2011.

2. Contingent Liabilities**Environmental Matters**

We are currently involved in several environmental-related proceedings by certain governmental agencies, which relate primarily to allegedly operating certain facilities in noncompliance with required permits. In addition to these proceedings, in the normal course of our business, we are subject to, among other things, periodic inspections by regulatory agencies. We continue to dedicate substantial operational and financial resources to environmental compliance, and we remain fully committed to operating in compliance with all environmental laws and regulations. As of April 2, 2011 and July 3, 2010, we had reserves of approximately \$1.7 million and \$3.2 million, respectively, related to various environmental-related matters. Expense for these matters for the three and nine months ended April 2, 2011 and March 27, 2010 was not material.

We cannot predict the ultimate outcome of any of these matters with certainty and it is possible that we may incur additional losses in excess of established reserves. However, we believe the possibility of a material adverse effect on our results of operations or financial position is remote.

3. Fair Value Measurements

GAAP defines fair value, establishes a framework for measuring fair value and establishes disclosure requirements about fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. We considered non-performance risk when determining fair value of our derivative financial instruments. The fair value hierarchy prescribed under GAAP contains the following three levels:

Level 1 unadjusted quoted prices that are available in active markets for the identical assets or liabilities at the measurement date.

Level 2 other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

quoted prices for similar assets or liabilities in active markets;

quoted prices for identical or similar assets in non-active markets;

inputs other than quoted prices that are observable for the asset or liability; and

inputs that are derived principally from or corroborated by other observable market data.

Table of Contents

Level 3 unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

We have not transferred any items between fair value levels during fiscal year 2011. In addition, we valued our level 2 assets and liabilities by reference to information provided by independent third parties for similar assets and liabilities in active markets.

The following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis as of April 2, 2011 and July 3, 2010:

	As of April 2, 2011		
	Fair Value Measurements Using Inputs Considered		
	Level 1	Level 2	Total
Other assets:			
Non-qualified, non-contributory retirement plan assets	\$	\$ 10.3	\$ 10.3
Non-qualified deferred compensation plan assets	21.4		21.4
Total assets	\$ 21.4	\$ 10.3	\$ 31.7
Accrued expenses:			
Derivative financial instruments	\$	\$ 2.4	\$ 2.4
Total liabilities	\$	\$ 2.4	\$ 2.4
	As of July 3, 2010		
	Fair Value Measurements Using Inputs Considered		
	Level 1	Level 2	Total
Other assets:			
Non-qualified, non-contributory retirement plan assets	\$	\$ 9.6	\$ 9.6
Non-qualified deferred compensation plan assets	16.9		16.9
Total assets	\$ 16.9	\$ 9.6	\$ 26.5
Accrued expenses:			
Derivative financial instruments	\$	\$ 5.2	\$ 5.2
Total liabilities	\$	\$ 5.2	\$ 5.2

We do not have any level 3 assets or liabilities, and the fair value of cash, trade receivables and borrowings under the various credit agreements approximates the amounts recorded.

4. Derivative Financial Instruments

All derivative financial instruments are recognized at fair value and are recorded in the Other current assets or Accrued expenses line items in the Consolidated Condensed Balance Sheets. The accounting for changes in the fair value of a derivative financial instrument depends on whether it has been designated and qualifies as a hedging relationship and on the type of the hedging relationship. For those derivative financial instruments that

are designated and qualify as hedging instruments, we designate the hedging instrument (based on the exposure being hedged) as cash flow hedges. We do not have any derivative financial instruments that have been designated as either a fair value hedge or a hedge of a net investment in a foreign operation. Cash flows associated with derivative financial instruments are classified in the same category as the cash flows hedged in the Consolidated Condensed Statements of Cash Flows.

Table of Contents

In the ordinary course of business, we are exposed to market risks. We utilize derivative financial instruments to manage interest rate risk, and periodically energy cost price risk and foreign exchange risk. Interest rate swap contracts are entered into to manage interest rate risk associated with our fixed and variable rate debt. Futures contracts on energy commodities are periodically entered into to manage the price risk associated with forecasted purchases of gasoline and diesel fuel used in our rental operations. We designate interest rate swap contracts as cash flow hedges of the interest expense related to variable rate debt and futures contracts on energy commodities as cash flow hedges of forecasted purchases of gasoline and diesel fuel.

For derivative financial instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative financial instrument is reported as a component of Accumulated other comprehensive income and reclassified into the Consolidated Condensed Statements of Operations in the same line item associated with the forecasted transaction and in the same period as the expenses from the cash flows of the hedged items are recognized. We perform an assessment at the inception of the hedge and on a quarterly basis thereafter, to determine whether our derivatives are highly effective in offsetting changes in the value of the hedged items. Any change in the fair value resulting from hedge ineffectiveness is immediately recognized as income or expense.

We use interest rate swap contracts to limit exposure to changes in interest rates and to manage the total debt that is subject to variable and fixed interest rates. The interest rate swap contracts we utilize modify our exposure to interest rate risk by converting variable rate debt to a fixed rate without an exchange of the underlying principal amount. Approximately 72% of our outstanding variable rate debt had its interest payments modified using interest rate swap contracts as of April 2, 2011.

As of April 2, 2011, none of our anticipated gasoline and diesel fuel purchases are hedged.

We do not engage in speculative transactions or fair value hedging nor do we hold or issue financial instruments for trading purposes.

We do not have any material assets related to derivatives as of April 2, 2011 and July 3, 2010.

We do have liabilities associated with derivatives, and the following table summarizes the classification and fair value of the interest rate swap agreements and fuel commodity futures contracts, which have been designated as cash flow hedging instruments:

Relationship:	Balance Sheet Classification:	Liability Derivatives Fair Value	
		April 2, 2011	July 3, 2010
Interest rate swap contracts	Accrued expenses	\$ 2.4	\$ 5.0
Fuel commodity futures contracts	Accrued expenses		0.2
Total derivatives designated as cash flow hedging instruments		\$ 2.4	\$ 5.2

As of April 2, 2011 and July 3, 2010, all derivative financial instruments were designated as hedging instruments. For our interest rate swap contracts that qualify for cash flow hedge designation, the related gains or losses on the contracts are deferred as a component of accumulated other comprehensive income or loss (net of related income taxes) until the interest expense on the related debt is recognized. As the interest expense on the hedged debt is recognized, the other comprehensive income or loss is reclassified to Interest expense. Of the \$1.8 million net loss deferred in accumulated other comprehensive income as of April 2, 2011, a \$1.5 million loss is expected to be reclassified to interest expense in the next twelve months.

As of April 2, 2011, we had interest rate swap contracts to pay fixed rates of interest and to receive variable rates of interest based on the three-month London Interbank Offered Rate (LIBOR) on \$85.0 million notional amount, none of which are forward starting interest rate swap contracts. Of the \$85.0 million notional amount, \$45.0 million matures in 12 months, \$25.0 million matures in 13-24 months and \$15.0 million matures in

25-36 months. The average rate on the \$85.0 million of interest rate swap contracts was 4.0% as of April 2, 2011. These interest rate swap contracts are highly effective cash flow hedges and accordingly, gains or losses on any ineffectiveness was not material to any period.

Table of Contents

The following tables summarize the amount of gain or loss recognized in accumulated other comprehensive income or loss and the classification and amount of gains or losses reclassified from accumulated other comprehensive income or loss into the Consolidated Condensed Statements of Operations for the three and nine months ended April 2, 2011 and March 27, 2010 related to derivative financial instruments used in cash flow hedging relationships:

Relationship:	Amount of Gain or (Loss) Recognized in Accumulated Other Comprehensive Income (Loss)			
	Three Months Ended		Nine Months Ended	
	April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Interest rate swap contracts	\$	\$ (0.6)	\$ (0.5)	\$ (1.8)
Fuel commodity futures contracts				(0.1)
Total derivatives designated as cash flow hedging instruments	\$	\$ (0.6)	\$ (0.5)	\$ (1.9)

Relationship:	Statement of Operations Classification:	Amount of Gain or (Loss) Reclassified From Accumulated Other Comprehensive Income (Loss) to Consolidated Statements of Operations			
		Three Months Ended		Nine Months Ended	
		April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Interest rate swap contracts	Interest expense	\$ (1.0)	\$ (0.9)	\$ (2.4)	\$ (2.7)
Interest rate swap contracts	Selling and Administrative		(0.1)		(0.1)
Fuel commodity futures contracts	Cost of rental operations			(0.1)	
Total derivatives designated as cash flow hedging instruments		\$ (1.0)	\$ (1.0)	\$ (2.5)	\$ (2.8)

The following table summarizes the amount of gain or loss recognized in the consolidated statement of operations for the three and nine months ended April 2, 2011 and March 27, 2010 related to derivative financial instruments not designated as hedging instruments.

Relationship:	Statement of Operations Classification:	Amount of Gain or (Loss) Recognized in Consolidated Statement of Operations			
		Three Months Ended		Nine Months Ended	
		April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Interest rate swap contracts	Selling and Administrative	\$	\$ (0.3)	\$	\$ (0.3)

5. Exit, Disposal and Related Activities

We continuously monitor our operations and related cost structure to ensure that our resource levels are appropriate and from time to time take various actions to ensure that these resources are utilized in the most efficient manner. These actions may consist of facility closures, divestitures, expansions and increases or

decreases in staffing levels.

During the first quarter of fiscal year 2010, we aligned our workforce and cost structure to better match our revenue levels. As a result, we reduced selected administrative, regional and corporate headcount, divested an unprofitable operation and recorded approximately \$1.4 million in associated severance costs in the Selling and administrative line item in the financial statements of our United States operating segment.

In the second quarter of fiscal year 2010, we sold all of the customer lists and certain assets related to our U.S. Cleanroom operations. In addition, we disposed of a non-core linen operation at one of our production facilities. As a result of these transactions, including the associated asset impairment charges, we recognized a net gain of \$1.2 million in the Selling and administrative line in the Consolidated Condensed Statements of Operations.

Table of Contents

In the third quarter of fiscal year 2010, we sold a portion of the customer list and certain assets related to a non-core linen operation and refined our estimates related to the disposition of our Cleanroom operations. As a result of these transactions, including the associated impairment charges, we recognized a net gain of \$2.5 million in the Selling and administrative line in the Consolidated Condensed Statements of Operations.

There was no exit, disposal or related activities in fiscal year 2011.

6. Income Taxes

Our effective tax rate increased to 39.9% in the first three quarters of fiscal 2011 from 36.2% in the same period of fiscal 2010. The current year tax rate is higher than our statutory tax rate primarily due to the write-off of deferred tax assets associated with equity compensation, adjustments resulting from the final calculation and filing of our annual income tax return, offset by the decrease in tax reserves for uncertain tax positions due to the expiration of certain tax statutes. The prior year tax rate was lower than our statutory rate due to the adjustment of deferred tax liabilities related to Canada, the enactment of a provincial tax rate reduction and the favorable tax treatment on the sale of certain assets, offset by the write-off of deferred tax assets associated with equity based compensation.

7. Per Share Data

Basic earnings per common share was 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 using the treasury stock method and non-vested restricted stock.

	Three Months Ended		Nine Months Ended	
	April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Weighted average number of common shares outstanding used in computation of basic earnings per share	18.4	18.3	18.3	18.3
Weighted average effect of non-vested restricted stock grants and assumed exercise of options		0.1	0.1	
Shares used in computation of diluted earnings per share	18.4	18.4	18.4	18.3

We excluded potential common shares related to our outstanding equity compensation grants of 1.4 million and 1.5 million for the three months ended April 2, 2011 and March 27, 2010, respectively, and 1.3 million and 1.8 million for the nine months ended April 2, 2011 and March 27, 2010, respectively, from the computation of diluted earnings per share. Inclusion of these shares would have been anti-dilutive.

8. Comprehensive Income

For the three and nine month periods ended April 2, 2011 and March 27, 2010, the components of comprehensive income were as follows:

	Three Months Ended		Nine Months Ended	
	April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Net income	\$ 8.0	\$ 7.0	\$ 25.6	\$ 17.5
Other comprehensive income:				
Foreign currency translation adjustments, net of tax	4.2	1.7 (0.6)	12.7 (0.5)	13.4 (1.9)

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

Derivative financial instruments (loss) recognized, net of tax					
Derivative financial instruments loss reclassified, net of tax	1.0		1.0	2.5	2.8
Total comprehensive income	\$ 13.2	\$	9.1	\$ 40.3	\$ 31.8

Table of Contents**9. Inventories**

The components of inventory as of April 2, 2011 and July 3, 2010 are as follows:

	April 2, 2011	July 3, 2010
Raw materials	\$ 10.8	\$ 7.5
Work in process	1.0	0.5
Finished goods	49.5	49.0
 New goods	 \$ 61.3	 \$ 57.0
Merchandise in service	\$ 84.5	\$ 69.3
 Total inventories	 \$ 145.8	 \$ 126.3

10. Goodwill and Intangible Assets

Goodwill by segment is as follows:

	United States	Canada	Total
Balance as of July 3, 2010	\$ 259.7	\$ 63.4	\$ 323.1
Foreign currency translation and other	0.2	6.2	6.4
 Balance as of April 2, 2011	 \$ 259.9	 \$ 69.6	 \$ 329.5

Other intangible assets, which are included in Other assets on the Consolidated Condensed Balance Sheet, are as follows:

	April 2, 2011	July 3, 2010
Customer contracts	\$ 115.6	\$ 114.0
Accumulated amortization	(97.0)	(91.7)
 Net customer contracts	 \$ 18.6	 \$ 22.3
 Non-competition agreements	 \$ 11.2	 \$ 11.1
Accumulated amortization	(11.1)	(10.8)
 Net non-competition agreements	 \$ 0.1	 \$ 0.3

The customer contracts include the combined value of the written service agreements and the related customer relationship. Other intangible assets are amortized over a weighted average life of approximately 11 years. Amortization expense was \$4.2 million and \$4.6 million for the nine months ended April 2, 2011 and March 27, 2010, respectively. Estimated amortization expense for each of the next five fiscal years based on the intangible assets as of April 2, 2011 is as follows:

2011 remaining	\$ 1.3
2012	5.0
2013	3.9
2014	2.7

2015
2016

1.9
1.4

Table of Contents**11. Long-Term Debt**

We have a \$300.0 million, unsecured revolving credit facility with a syndicate of banks, which expires on July 1, 2012. Borrowings in U.S. dollars under this credit facility will, at our election, bear interest at (a) the adjusted London Interbank Offered Rate (LIBOR) for specified interest periods plus a margin, which can range from 2.25% to 3.25%, determined with reference to our consolidated leverage ratio or (b) a floating rate equal to the greatest of (i) JPMorgan's prime rate, (ii) the federal funds rate plus 0.50% and (iii) the adjusted LIBOR for a one month interest period plus 1.00%, plus, in each case, a margin determined with reference to our consolidated leverage ratio. Base rate loans will, at our election, bear interest at (i) the rate described in clause (b) above or (ii) a rate to be agreed upon by us and JPMorgan. Borrowings in Canadian dollars under the credit facility will bear interest at the greater of (a) the Canadian Prime Rate and (b) the LIBOR for a one month interest period on such day (or if such day is not a business day, the immediately preceding business day) plus 1.00%.

As of April 2, 2011, borrowings outstanding under the revolving credit facility were \$50.0 million. The unused portion of the revolver may be used for general corporate purposes, acquisitions, share repurchases, dividends, working capital needs and to provide up to \$50.0 million in letters of credit. As of April 2, 2011, letters of credit outstanding against the revolver totaled \$8.6 million and primarily relate to our property and casualty insurance programs. No amounts have been drawn upon these letters of credit. Availability of credit under this facility requires that we maintain compliance with certain covenants. In addition, there are certain restricted payment limitations on dividends or other distributions, including share repurchases. The covenants under this agreement are the most restrictive when compared to our other credit facilities. The following table illustrates compliance with regard to the material covenants required by the terms of this facility as of April 2, 2011:

	Required	Actual
Maximum Leverage Ratio (Debt/EBITDA)	3.50	1.48
Minimum Interest Coverage Ratio (EBITDA/Interest Expense)	3.00	10.27
Minimum Net Worth	\$ 314.8	\$ 505.1

Our maximum leverage ratio and minimum interest coverage ratio covenants are calculated by adding back non-cash charges, as defined in our debt agreement.

Advances outstanding as of April 2, 2011 bear interest at a weighted average all-in rate of 2.56% (LIBOR plus 2.25%) for the Eurocurrency rate loans and an all-in rate of 3.25% (Lender Prime Rate) for overnight base rate loans. We also pay a fee on the unused daily balance of the revolving credit facility based on a leverage ratio calculated on a quarterly basis. At April 2, 2011 this fee was 0.25% of the unused daily balance.

We have \$75.0 million of variable rate unsecured private placement notes. The notes bear interest at 0.60% over LIBOR and are scheduled to mature on June 30, 2015. The notes do not require principal payments until maturity. Interest payments are reset and paid on a quarterly basis. As of April 2, 2011, the outstanding balance of the notes was \$75.0 million at an all-in rate of 0.91% (LIBOR plus 0.60%).

We maintain an accounts receivable securitization facility whereby the lender will make loans to us on a revolving basis. On September 29, 2010, we completed the Second Amended and Restated Loan Agreement. The primary purpose of entering into the Loan Agreement and replacing the prior loan agreement was to (i) make conforming changes in connection with the previously disclosed reduction of the facility limit to \$40.0 million effective July 1, 2010; (ii) make available an amount not exceeding \$15.0 million under the facility for the issuance of letters of credit (subject to the aggregate \$40.0 million facility limit); and (iii) add three of our subsidiaries as parties to the related intercompany receivables sale agreement to increase the borrowing base. Under the above stated amendment, we will now pay interest at a rate per annum equal to a margin of 0.85%, plus the average annual interest rate for such commercial paper. In addition, this facility is subject to customary fees for the issuance of letters of credit and any unused portion of the facility. Under this facility, and customary with transactions of this nature, our eligible accounts receivable are sold to a consolidated subsidiary.

As of April 2, 2011, there was \$20.0 million outstanding under this loan agreement at an all-in interest rate of 1.14%. Additionally, \$15.0 million of letters of credit were outstanding under this facility on this date, primarily

related to our property and casualty insurance programs. The facility expires on September 26, 2012. See Note 4 to the Consolidated Condensed Financial Statements for details of our interest rate swap and hedging activities related to our outstanding debt.

Table of Contents**12. Share-Based Compensation**

We grant share-based awards, including restricted stock and options to purchase our common stock. Stock options are granted to employees and directors for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant. Share-based compensation is recognized in the Consolidated Condensed Statements of Operations on a straight-line basis over the requisite service period. The amortization of share-based compensation reflects estimated forfeitures adjusted for actual forfeiture experiences. We review our estimated forfeiture rates on an annual basis. As share-based compensation expense is recognized, a deferred tax asset is recorded that represents an estimate of the future tax deduction from the exercise of stock options or release of restrictions on the restricted stock. At the time share-based awards are exercised, cancelled, expire or restrictions lapse, we recognize adjustments to income tax expense. Total compensation expense related to share-based awards was \$0.9 million and \$1.2 million for the three months ended April 2, 2011 and March 27, 2010, respectively, and \$3.3 million and \$3.5 million for the nine months ended April 2, 2011 and March 27, 2010, respectively. The number of options exercised and restricted stock vested since July 3, 2010 was 0.1 million shares.

13. Employee Benefit Plans

On December 31, 2006, we froze our pension and supplemental executive retirement plans.

The components of net periodic pension cost for these plans for the three months ended April 2, 2011 and March 27, 2010 are as follows:

	Pension Plan		Supplemental Executive Retirement Plan	
	Three Months Ended		Three Months Ended	
	April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Interest cost	\$ 0.9	\$ 0.9	\$ 0.2	\$ 0.2
Expected return on assets	(0.7)	(0.7)		
Amortization of net loss	0.5	0.2		
Net periodic pension cost	\$ 0.7	\$ 0.4	\$ 0.2	\$ 0.2

The components of net periodic pension cost for these plans for the nine months ended April 2, 2011 and March 27, 2010 are as follows:

	Pension Plan		Supplemental Executive Retirement Plan	
	Nine Months Ended		Nine Months Ended	
	April 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010
Interest cost	\$ 2.8	\$ 2.7	\$ 0.5	\$ 0.5
Expected return on assets	(2.3)	(2.3)		
Amortization of net loss	1.5	0.8		
Net periodic pension cost	\$ 2.0	\$ 1.2	\$ 0.5	\$ 0.5

14. Segment Information

We have two operating segments, United States (includes the Dominican Republic and Ireland operations) and Canada, which have been identified as components of our organization that are reviewed by our Chief Executive Officer to determine resource allocation and evaluate performance.

Each operating segment derives revenues from the branded work apparel and facility services industry.

During the three and nine months ended April 2, 2011, and for the same periods of the prior fiscal year, no single customer accounted for more than 2.0% of our total revenues. Substantially all of our customers are in the United States, Canada and Ireland.

Table of Contents

Income from operations includes the impact of an intercompany management fee charged to Canada, which is self-eliminated in the total income from operations below. This intercompany management fee was approximately \$2.1 million and \$2.4 million for the three months ended April 2, 2011 and March 27, 2010, respectively and \$6.5 million and \$7.3 million for the nine months ended April 2, 2011 and March 27, 2010, respectively.

We evaluate performance based on income from operations. Financial information by segment for the three and nine month periods ended April 2, 2011 and March 27, 2010 is as follows:

For the Three Months Ended	United States	Canada	Elimination	Total
Third Quarter Fiscal Year 2011:				
Revenues	\$ 172.7	\$ 37.6	\$	\$ 210.3
Income from operations	12.3	3.7		16.0
Total assets	784.4	147.6	(78.0)	854.0
Depreciation and amortization expense	8.0	1.4		9.4
Third Quarter Fiscal Year 2010:				
Revenues	\$ 163.0	\$ 35.9	\$	\$ 198.9
Income from operations	7.9	6.1		14.0
Total assets	759.5	138.8	(78.8)	819.5
Depreciation and amortization expense	8.3	1.4		9.7

For the Nine Months Ended	United States	Canada	Elimination	Total
Fiscal Year 2011:				
Revenues	\$ 508.2	\$ 106.6	\$	\$ 614.8
Income from operations	40.6	10.1		50.7
Total assets	784.4	147.6	(78.0)	854.0
Depreciation and amortization expense	24.3	3.9		28.2
Fiscal Year 2010:				
Revenues	\$ 505.5	\$ 107.9	\$	\$ 613.4
Income from operations	26.4	11.7		38.1
Total assets	759.5	138.8	(78.8)	819.5
Depreciation and amortization expense	25.7	4.3		30.0

15. Stock Repurchase

As of April 2, 2011, we have a \$175.0 million share repurchase program which was originally authorized by our Board of Directors in May 2007 for \$100.0 million and increased to \$175.0 million in May 2008. We did not repurchase any shares under this program in fiscal year 2010, nor have we made any repurchases this fiscal year. We have approximately \$57.9 million remaining under this authorization.

16. Restricted Stock Unit Withholdings

We issue restricted stock units as part of our equity incentive plans. Upon vesting, the participant may elect to have shares withheld to pay the minimum statutory tax withholding requirements. Although shares withheld are not issued, they are treated as common stock repurchases in our financial statements as they reduce the number of shares that would have been issued upon vesting.

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 work 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 work apparel and facility services products, such as floor mats, dust mops, wiping towels, restroom supplies and selected linen items.

We believe that the existing North American rental market is approximately \$7.0 billion, while the existing portion of the direct sale market targeted by us is approximately \$5.0 billion.

We have participated in the industry consolidation from family owned and small local providers to several large providers. Our acquisition strategy is focused on acquisitions that expand our geographic presence and/or expand our local market share and further leverage our existing production facilities.

A decrease in customer employment levels associated with the recent recession has impacted our revenue. As a result, we periodically adjust our operations to serve our customers in the most efficient and cost effective manner. As part of these adjustments, we may realign our workforce, close production or branch facilities or divest operations. We are continuously assessing our business and making adjustments as necessary.

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 GAAP. 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.

Critical accounting policies are defined as the most important and pervasive accounting policies used, areas most sensitive to material changes from external factors and those that are reflective of significant judgments and uncertainties. See Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended July 3, 2010 for additional discussion of the application of these and other accounting policies.

Inventories

Inventories consist of new goods and rental merchandise in service. New goods are stated at the lower of first-in, first-out (FIFO) cost or market, net of any reserve for obsolete or excess inventory. Merchandise placed in service to support our 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 six months to three years. In establishing estimated lives for merchandise in service, management considers historical experience and the intended use of the merchandise.

We review the estimated useful lives of our in-service merchandise on a periodic basis. During the fourth quarter of 2010, we completed an analysis of certain in-service merchandise which resulted in the estimated useful lives for the merchandise being modified to better reflect the estimated periods in which the merchandise will remain in service. The effect of the change in estimate in fiscal year 2010 and the first three quarters of fiscal year 2011 was not material.

We estimate our reserves for inventory obsolescence by periodically examining our inventory to determine if there are indicators that carrying values exceed the net realizable value. Experience has shown that significant indicators that could require the need for additional inventory write-downs include the age of the inventory, anticipated demand for our products, historical inventory usage, revenue trends and current economic conditions. We believe that adequate reserves for inventory obsolescence have been made in the Consolidated Financial Statements; however, in the future, product lines and customer requirements may change, which could result in additional inventory write-downs.

Table of Contents**Revenue Recognition**

Our rental operations business is largely based on written service agreements whereby we agree to pick-up soiled merchandise, launder and then deliver clean uniforms and other related products. The service agreements generally 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 damaged uniforms and replacement fees for non-personalized merchandise that is lost or damaged. Direct sale revenue is recognized in the period in which the product is shipped. Total revenues do not include sales tax as we consider ourselves a pass-through conduit for collecting and remitting sales taxes.

During the fourth quarter of fiscal year 2010, we changed our business practices regarding the replacement of certain in-service towel and linen inventory and accordingly, we modified our revenue recognition policy related to the associated replacement fees. This revenue, which had historically been deferred and recognized over the estimated useful life of the associated in-service inventory, is now recognized upon billing. For the nine months ended April 2, 2011, the effect of this change increased revenue and income from operations by \$5.9 million, net income by \$3.7 million and basic and diluted earnings per common share by \$0.20. The change did not have a material impact on revenues, income from operations or net income for the three months ended April 2, 2011.

Results of Operations

The percentage relationships to revenues of certain income and expense items for the three and nine month periods ended April 2, 2011 and March 27, 2010, 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 2, 2011	March 27, 2010	April 2, 2011	March 27, 2010	Three Months FY 2011 vs. FY 2010	Nine Months FY 2011 vs. FY 2010
Revenues:						
Rental operations	91.7%	93.3%	92.1%	93.3%	3.9%	(1.1)%
Direct sales	8.3	6.7	7.9	6.7	31.3	18.8
Total revenues	100.0	100.0	100.0	100.0	5.7	0.2
Expenses:						
Cost of rental operations	67.9	70.1	67.7	70.4	0.6	(4.9)
Cost of direct sales	75.2	72.4	75.4	74.1	36.3	20.9
Total cost of sales	68.5	70.2	68.3	70.6	3.1	(3.1)
Selling and administrative	23.9	22.8	23.5	23.2	11.2	1.5
Income from operations	7.6	7.0	8.2	6.2	14.3	33.0
Interest expense	1.4	1.6	1.3	1.7	(9.7)	(25.0)
Income before income taxes	6.2	5.4	6.9	4.5	21.7	55.6
Provision for income taxes	2.4	1.8	2.8	1.6	38.1	71.5

Net income	3.8%	3.5%	4.2%	2.8%	13.2%	46.6%
------------	------	------	------	------	-------	-------

Table of Contents***Three months ended April 2, 2011 compared to three months ended March 27, 2010***

Revenues. Total revenue in the third quarter of fiscal 2011 increased 5.7% to \$210.3 million from \$198.9 million in the third quarter of fiscal 2010.

Rental revenue increased \$7.2 million, or 3.9% in the third quarter of fiscal 2011 compared to the same period of the prior fiscal year. The improvement in the rental organic growth rate was driven by virtually all components of organic growth, including customer retention, new account sales, price and customer employment levels. In addition, revenue was positively impacted by \$2.0 million due to a favorable foreign currency translation rate. Our organic rental growth rate for the third quarter of fiscal 2011 was 3.0% compared to negative 10.5% in the same period of the prior fiscal year. Our organic rental growth rate reflects a continuing improvement in business execution. Our organic rental growth rate is calculated using rental revenue, adjusted to exclude the impact of foreign currency exchange rate changes, divestitures and acquisitions compared to prior-period results. We believe that the organic rental growth rate better reflects changes in our existing rental business and is therefore useful in analyzing our financial condition and results of operations.

Direct sale revenue increased 31.3% to \$17.5 million in the third quarter of fiscal 2011 compared to \$13.3 million in the same period of fiscal 2010. This increase resulted from several new large account sales and improved catalog sales during the current quarter.

Cost of Rental. Cost of rental operations increased 0.6% to \$130.9 million in the third quarter of fiscal 2011 from \$130.0 million in the same period of fiscal 2010. As a percentage of rental revenue, our gross margin from rental operations increased 220 basis points to 32.1% in the third quarter of fiscal 2011 from 29.9% in the same period of fiscal 2010. The improvement in rental gross margin is the result of the leverage provided by a higher revenue base, lower merchandise costs, and improved productivity across our core rental operations and continued specific location profit improvement actions, partially offset by increased energy and health costs.

Cost of Direct Sales. Cost of direct sales increased to \$13.2 million in the third quarter of fiscal 2011 from \$9.7 million in the same period of fiscal 2010. Gross margin from direct sales decreased to 24.8% in the third quarter of fiscal 2011 from 27.6% in the same quarter of fiscal 2010. The decrease in direct sale margin was due to increased merchandise costs and to a lesser extent a lower proportion of higher margin business in the current quarter.

Selling and Administrative. Selling and administrative expenses increased 11.2% to \$50.4 million in the third quarter of fiscal 2011 from \$45.3 million in the same period of fiscal 2010. As a percentage of total revenues, selling and administrative expenses increased to 23.9% in the third quarter of fiscal 2011 from 22.8% in the third quarter of fiscal 2010. The increase in selling and administrative expenses is primarily the result of the net gain of \$2.5 million associated with the divestiture and asset write downs that occurred in the prior year that did not reoccur in the current quarter. In addition, the current quarter includes increased incentive and sales based compensation as well as expenses associated with the impairment of certain direct sale inventory.

Interest Expense. Interest expense was \$3.0 million in the third quarter of fiscal 2011, a decrease from the \$3.3 million reported in the same period of fiscal 2010. The decreased interest expense was primarily due to lower average debt balances and interest rates in the current quarter compared to the same period in the prior year. These items were partially offset by the early termination of an interest rate swap arrangement in the current quarter that resulted in an additional \$0.6 million of expense.

Provision for Income Taxes. Our effective tax rate increased to 38.7% in the third quarter of fiscal 2011 from 34.1% in the same period of fiscal 2010. The current year tax rate is higher than our statutory tax rate primarily due to adjustments resulting from the final calculation and filing of our annual income tax return, offset by the decrease in tax reserves for uncertain tax positions due to the expiration of certain tax statutes. The prior year tax rate was lower due to the decrease in tax reserves for uncertain tax positions due to the expiration of certain tax statutes and the favorable tax treatment on the sale of certain assets, offset by the write-off of deferred tax assets associated with equity based compensation.

Table of Contents***Nine months ended April 2, 2011 compared to nine months ended March 27, 2010***

Revenues. Total revenue for the first nine months of fiscal 2011 increased 0.2% to \$614.8 million compared to \$613.4 million for the same period in the prior fiscal year.

Rental revenue decreased \$6.3 million, or 1.1% in the first nine months of fiscal 2011 compared to the same period of the prior fiscal year. The decrease in rental revenue is due to the divestiture of certain non-core rental operations in fiscal 2010 that resulted in lower rental revenue of \$14.3 million or 2.5% in fiscal year 2011. These items were partially offset by \$5.6 million associated with the favorable impact of foreign currency translation rates during fiscal year 2011 and \$5.9 million related to the modification of our revenue recognition policy as a result of changes to our business practices regarding certain in-service towel and linen inventory as previously discussed. Our organic rental growth rate was negative 0.5% compared to negative 12.75% in the same period of the prior fiscal year. The improvement in the rental organic growth rate was driven by virtually all components of organic growth, including customer retention, new account sales, price and customer employment levels.

Direct sale revenue increased 18.8% to \$48.5 million in the first nine months of fiscal 2011 compared to \$40.9 million in the same period of fiscal 2010. This increase resulted from several new large account sales and a strong outerwear promotion.

Cost of Rental. Cost of rental operations decreased 4.9% to \$383.3 million in the first nine months of fiscal 2011 from \$402.9 million in the same period of fiscal 2010. As a percentage of rental revenue, our gross margin from rental sales increased to 32.3% in the first nine months of fiscal 2011 from 29.6% in the same period of fiscal 2010. The 270 basis point improvement from the prior year includes 70 basis points associated with the change in our revenue recognition policy previously discussed. The remaining 200 basis point improvement is the result lower merchandise costs, improved productivity across our core rental operations and continued specific location profit improvement actions. These lower costs were partially offset by higher energy costs in the current year. In addition, the prior-year period expenses also included \$1.5 million associated with a union decertification at one location.

Cost of Direct Sales. Cost of direct sales increased to \$36.6 million in the first nine months of fiscal 2011 from \$30.3 million in the same period of fiscal 2010. Gross margin from direct sales decreased to 24.6% in the third quarter of fiscal 2011 from 25.9% reported in the same period of fiscal 2010. The decrease in direct sale margin was due primarily to changes in product mix and higher merchandise costs.

Selling and Administrative. Selling and administrative expenses increased 1.5% to \$144.3 million in the first nine months of fiscal 2011 from \$142.2 million in the same period of fiscal 2010. As a percentage of total revenues, selling and administrative expenses increased to 23.5% in the first nine months of fiscal 2011 from 23.2% in the same period of fiscal 2010. The increase is primarily due to a net gain in the prior year related to the divestiture and impairment of certain business assets recorded which totaled \$3.4 million. In addition, the current year includes increased incentive and sales based compensation and expenses associated with the impairment of certain direct sale inventory.

Interest Expense. Interest expense was \$8.0 million in the first nine months of fiscal 2011, a decrease from the \$10.7 million in the same period of fiscal year 2010. The decreased interest expense was due to lower average interest rates and lower average debt balances. These items were partially offset by the early termination of an interest rate swap arrangement in the third quarter of fiscal year 2011 that resulted in an additional \$0.6 million of expense.

Provision for Income Taxes. Our effective tax rate increased to 39.9% in the first nine months of fiscal 2011 from 36.2% in the same period of fiscal 2010. The current year tax rate is higher than our statutory tax rate primarily due to the write-off of deferred tax assets associated with equity compensation and adjustments resulting from the final calculation and filing of our annual income tax return, offset by the decrease in tax reserves for uncertain tax positions due to the expiration of certain tax statutes. The prior year tax rate was lower than our statutory rate due to the adjustment of deferred tax liabilities related to Canada, the enactment of a provincial tax rate reduction and the favorable tax treatment on the sale of certain assets, offset by the write-off of deferred tax assets associated with equity based compensation.

Table of Contents***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 payments on indebtedness, capital expenditures, acquisitions, dividends and general corporate purposes.

Operating Activities. Net cash provided by operating activities was \$49.0 million in the first nine months of fiscal 2011 and \$54.2 million in the same period of fiscal 2010. The decrease is primarily due to lower collections on accounts receivable and increased expenditures related to inventory, partially offset by higher net income.

Investing Activities. Net cash used for investing activities was \$15.5 million in the first nine months of fiscal 2011 and net cash provided by investing activities was \$9.4 million in the same period of fiscal 2010. In fiscal year 2011, cash was used for purchases of property, plant and equipment. In fiscal year 2010, cash was provided by divestitures of business assets partially offset by capital expenditures.

Financing Activities. Cash used for financing activities was \$20.7 million in the first nine months of fiscal 2011 compared to \$66.2 million in fiscal year 2010. The decrease is primarily due to debt reduction payments that occurred in fiscal year 2010 that did not reoccur in the current fiscal year. During the first nine months of fiscal 2011 and 2010, we paid dividends of \$5.3 million and \$4.2 million, respectively.

We have a \$300.0 million, unsecured revolving credit facility with a syndicate of banks, which expires on July 1, 2012. Borrowings in U.S. dollars under this credit facility will, at our election, bear interest at (a) the adjusted London Interbank Offered Rate (LIBOR) for specified interest periods plus a margin, which can range from 2.25% to 3.25%, determined with reference to our consolidated leverage ratio or (b) a floating rate equal to the greatest of (i) JPMorgan's prime rate, (ii) the federal funds rate plus 0.50% and (iii) the adjusted LIBOR for a one month interest period plus 1.00%, plus, in each case, a margin determined with reference to our consolidated leverage ratio. Base rate loans will, at our election, bear interest at (i) the rate described in clause (b) above or (ii) a rate to be agreed upon by us and JPMorgan. Borrowings in Canadian dollars under the credit facility will bear interest at the greater of (a) the Canadian Prime Rate and (b) the LIBOR for a one month interest period on such day (or if such day is not a business day, the immediately preceding business day) plus 1.00%.

As of April 2, 2011, borrowings outstanding under the revolving credit facility were \$50.0 million. The unused portion of the revolver may be used for general corporate purposes, acquisitions, share repurchases, dividends, working capital needs and to provide up to \$50.0 million in letters of credit. As of April 2, 2011, letters of credit outstanding against the revolver totaled \$8.6 million and primarily relate to our property and casualty insurance programs. No amounts have been drawn upon these letters of credit. Availability of credit under this facility requires that we maintain compliance with certain covenants. In addition, there are certain restricted payment limitations on dividends or other distributions, including share repurchases. The covenants under this agreement are the most restrictive when compared to our other credit facilities. The following table illustrates compliance with regard to the material covenants required by the terms of this facility as of April 2, 2011:

	Required	Actual
Maximum Leverage Ratio (Debt/EBITDA)	3.50	1.48
Minimum Interest Coverage Ratio (EBITDA/Interest Expense)	3.00	10.27
Minimum Net Worth	\$ 314.8	\$ 505.1

Our maximum leverage ratio and minimum interest coverage ratio covenants are calculated by adding back non-cash charges, as defined in our debt agreement.

Advances outstanding as of April 2, 2011 bear interest at a weighted average all-in rate of 2.56% (LIBOR plus 2.25%) for the Eurocurrency rate loans and an all-in rate of 3.25% (Lender Prime Rate) for overnight base rate loans. We also pay a fee on the unused daily balance of the revolving credit facility based on a leverage ratio calculated on a quarterly basis. At April 2, 2011 this fee was 0.25% of the unused daily balance.

We have \$75.0 million of variable rate unsecured private placement notes. The notes bear interest at 0.60% over LIBOR and are scheduled to mature on June 30, 2015. The notes do not require principal payments until maturity.

Interest payments are reset and paid on a quarterly basis. As of April 2, 2011, the outstanding balance of the notes was

\$75.0 million at an all-in rate of 0.91% (LIBOR plus 0.60%).

Table of Contents

We maintain an accounts receivable securitization facility whereby the lender will make loans to us on a revolving basis. On September 29, 2010, we completed the Second Amended and Restated Loan Agreement. The primary purpose of entering into the Loan Agreement and replacing the prior loan agreement was to (i) make conforming changes in connection with the previously disclosed reduction of the facility limit to \$40.0 million effective July 1, 2010; (ii) make available an amount not exceeding \$15.0 million under the facility for the issuance of letters of credit (subject to the aggregate \$40.0 million facility limit); and (iii) add three of our subsidiaries as parties to the related intercompany receivables sale agreement to increase the borrowing base. Under the above stated amendment, we will now pay interest at a rate per annum equal to a margin of 0.85%, plus the average annual interest rate for such commercial paper. In addition, this facility is subject to customary fees for the issuance of letters of credit and any unused portion of the facility. Under this facility, and customary with transactions of this nature, our eligible accounts receivable are sold to a consolidated subsidiary.

As of April 2, 2011, there was \$20.0 million outstanding under this loan agreement at an all-in interest rate of 1.14%. Additionally, \$15.0 million of letters of credit were outstanding under this facility on this date, primarily related to our property and casualty insurance programs. The facility expires on September 26, 2012.

See Note 4 to the Consolidated Condensed Financial Statements for details of our interest rate swap and hedging activities related to our outstanding debt.

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

At April 2, 2011, we had approximately \$246.4 million of available capacity under our revolving and accounts receivable credit facilities. However, borrowings would be limited to \$232.4 million due to debt covenants. Our revolving credit facility contributes \$227.4 million of liquidity while our accounts receivable securitization facility contributes \$5.0 million. We anticipate that we will generate sufficient cash flows from operations to satisfy our cash commitments and capital requirements for fiscal 2011 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 2011 will be approximately \$20 to \$25 million.

Off Balance Sheet Arrangements

At April 2, 2011, we had \$23.6 million of stand-by letters of credit that were issued and outstanding, primarily in connection with our property and casualty insurance programs. No amounts have been drawn upon these letters of credit.

Pension Obligations

Pension expense is recognized on an accrual basis over an employee's approximate service periods. Pension expense is generally independent of funding decisions or requirements. We recognized expense for our defined benefit pension plan of \$0.7 million and \$0.4 million in the third quarter of fiscal 2011 and 2010, respectively. At July 3, 2010, the fair value of our pension plan assets totaled \$39.8 million.

Effective January 1, 2007, we froze our defined benefit pension plan and related supplemental executive retirement plan. Future growth in benefits has not occurred beyond December 31, 2006.

The calculation of pension expense and the corresponding liability requires the use of a number of critical 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 may differ from these assumptions. Pension expense increases as the expected rate of return on pension plan assets decreases. At July 3, 2010, we estimated that the pension plan assets will generate a long-term rate of return of 7.75%. This rate was developed by evaluating input from our outside actuary as well as long-term inflation assumptions. The expected long-term rate of return on plan assets at July 3, 2010 is based on an allocation of equity and fixed income securities. Decreasing the expected long-term rate of return by 0.5% (from 7.75% to 7.25%) would increase our estimated 2011 pension expense by approximately \$0.2 million. Pension liability and future pension expense increase as the discount rate is reduced. We discounted future pension obligations using a rate of 5.60% at July 3, 2010. The discount rate is determined in consultation with our outside actuary based upon reference to a yield curve based on high quality bonds.

Decreasing the discount rate by 0.5% (from 5.60% to 5.10%) would increase our accumulated benefit obligation at July 3, 2010 by approximately \$6.2 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. As part of our assessment of the expected return on plan assets, we considered several factors, including our historical asset performance, which included the recent decline in the global equity markets, and concluded that a 7.75% long-term rate was appropriate.

Table of Contents***Multi-Employer Pension Plans***

We participate in a number of union sponsored, collectively bargained multi-employer pension plans (MEPPs). The company records the required cash contributions to the MEPPs as an expense in the period incurred and a liability is recognized for any contributions due and unpaid, consistent with the accounting for defined contribution plans. In addition, we are responsible for our proportional share of any unfunded vested benefits related to the MEPPs. However, under the applicable accounting rules, we are not required to record a liability for our portion of any withdrawal liability until we exit from the plan.

In the first quarter of fiscal year 2011, two locations voted to decertify their respective unions. The decertification resulted in a partial withdrawal from the related MEPPs and triggered a charge of \$1.0 million that was recorded in the first quarter of fiscal year 2011. In the second quarter of fiscal year 2010, local union members at another facility voted to decertify their union. As a result, we recorded a net charge of approximately \$0.8 million during fiscal year 2010.

As evidenced by the three previous decertifications noted above, a partial or full withdrawal from a MEPP may be triggered by circumstances beyond our control, such as union members voting to decertify their union. If a future withdrawal from a plan occurs we will record our proportional share of any unfunded vested benefits in the period in which the withdrawal occurs. The ultimate amount of the withdrawal liability assessed by the MEPPs is impacted by a number of factors, including investment returns, benefit levels, interest rates and continued participation by the company and other employers in the MEPPs. Based upon the most recent information available from the trustees managing the MEPPs, our share of the unfunded vested benefits for the remaining plans is estimated to be approximately \$23.0 to \$29.0 million. Though the most recent plan data available from the MEPPs was used in computing this estimate, it is subject to change based on, among other things, future market conditions, employer contributions and benefit levels, each of which could impact the ultimate withdrawal liability.

Exit, Disposal and Related Activities

We continuously monitor our operations and related cost structure to ensure that our resource levels are appropriate and from time to time take various actions to ensure that these resources are utilized in the most efficient manner. These actions may consist of facility closures, divestitures, expansions and increases or decreases in staffing levels. During the first quarter of fiscal year 2010, we aligned our workforce and cost structure to better match our revenue levels. As a result, we reduced selected administrative, regional and corporate headcount, divested an unprofitable operation and recorded approximately \$1.4 million in associated severance costs in the Selling and administrative line item in the financial statements of our United States operating segment.

In the second quarter of fiscal year 2010, we sold all of the customer lists and certain assets related to our U.S. cleanroom operations. In addition, we disposed of a non-core linen operation at one of our production facilities. As a result of these transactions, including the associated asset impairment charges, we recognized a net gain of \$1.2 million in the Selling and administrative line in the Consolidated Statements of Operations.

In the third quarter of fiscal year 2010, we sold a portion of the customer list and certain assets related to a non-core linen operation and refined our estimates related to the disposition of our Cleanroom operations. As a result of these transactions, including the associated impairment charges, we recognized a net gain of \$2.5 million in the Selling and administrative line in the Consolidated Condensed Statements of Operations.

There was no exit, disposal or related activities in fiscal year 2011.

Table of Contents

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. In addition, we are party to certain legal matters described in Part II Item 1. Legal Proceedings of this report.

Environmental Matters

We are currently involved in several environmental-related proceedings by certain governmental agencies, which relate primarily to allegedly operating certain facilities in noncompliance with required permits. In addition to these proceedings, in the normal course of our business, we are subject to, among other things, periodic inspections by regulatory agencies. We continue to dedicate substantial operational and financial resources to environmental compliance, and we remain fully committed to operating in compliance with all environmental laws and regulations. As of April 2, 2011 and July 3, 2010, we had reserves of approximately \$1.7 million and \$3.2 million, respectively, related to various environmental-related matters. Expense for these matters for the three and nine months ended April 2, 2011 and March 27, 2010 was not material.

We cannot predict the ultimate outcome of any of these matters with certainty and it is possible that we may incur additional losses in excess of established reserves. However, we believe the possibility of a material adverse effect on our results of operations or financial position is remote.

Share-Based Compensation

We grant share-based awards, including restricted stock and options to purchase our common stock. Stock options are granted to employees and directors for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant. Share-based compensation is recognized in the Consolidated Condensed Statements of Operations on a straight-line basis over the requisite service period. The amortization of share-based compensation reflects estimated forfeitures adjusted for actual forfeiture experiences. We review our estimated forfeiture rates on an annual basis. As share-based compensation expense is recognized, a deferred tax asset is recorded that represents an estimate of the future tax deduction from the exercise of stock options or release of restrictions on the restricted stock. At the time share-based awards are exercised, cancelled, expire or restrictions lapse, we recognize adjustments to income tax expense. Total compensation expense related to share-based awards was \$0.9 million and \$1.2 million for the three months ended April 2, 2011 and March 27, 2010, respectively, and \$3.3 million and \$3.5 million for the nine months ended April 2, 2011 and March 27, 2010, respectively. The number of options exercised and restricted stock vested since July 3, 2010 was 0.1 million shares.

Cautionary Statements Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a safe harbor from civil litigation for forward-looking statements. Forward-looking statements may be identified by words such as estimates, anticipates, projects, plans, expects, intends, believes, seeks, could, should, may and will or the negative versions thereof and similar and by the context in which they are used. Such statements are based upon our current expectations and speak only as of the date made. These statements are subject to various risks, uncertainties and other factors that could cause actual results to differ from those set forth in or implied by this Quarterly Report on Form 10-Q. Factors that might cause such a difference include, but are not limited to, the possibility of greater than anticipated operating costs, lower sales volumes, the performance and costs of integration of acquisitions or assumption of unknown liabilities in connection with acquisitions, fluctuations in costs of materials and labor, costs and possible effects of union organizing activities, loss of key management, uncertainties regarding any existing or newly-discovered expenses and liabilities related to environmental compliance and remediation, failure to achieve and maintain effective internal controls for financial reporting required by the Sarbanes-Oxley Act of 2002, the initiation or outcome of litigation or government investigations, higher than assumed sourcing or distribution costs of products, the disruption of operations from catastrophic events, disruptions in capital markets, the liquidity of counterparties in financial transactions, changes in federal and state tax laws, economic uncertainties and the reactions of competitors in terms of price and service. We undertake no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made except as required by law. 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 3, 2010.

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, such as interest rate swap agreements, to manage interest rate risk on our fixed and variable rate debt. Under these arrangements, we agree to exchange, at specified intervals, the difference between fixed and floating interest amounts, calculated by reference to an agreed upon notional principal amount. Interest rate swap agreements are entered into for periods consistent with related underlying exposures and do not constitute positions independent of those exposures. The estimated exposure considers the mitigating effects of interest rate swap agreements outstanding at April 2, 2011 on the change in the cost of variable rate debt. The current fair market value of all outstanding contracts at April 2, 2011 was an unrealized loss of \$2.4 million.

A sensitivity analysis was performed to measure our interest rate risk over a one-year period to changes in market interest rates for forecasted debt levels and interest rate swaps. The base rate used for the sensitivity analysis for variable rate debt and interest rate swaps is the three month LIBOR market interest rates at April 2, 2011. The credit spread is included in the base rate used in the analysis. The two scenarios include measuring the sensitivity to interest expense with an immediate 50 basis point change in market interest rates and the impact of a 50 basis point change distributed evenly throughout the year. Based on the forecasted average debt level, outstanding interest rate swaps and current market interest rates, the forecasted interest expense is \$7.2 million. The scenario with an immediate 50 basis point change would increase or decrease forecasted interest by \$0.4 million or 5.4%. The scenario that distributes the 50 basis point change evenly would increase or decrease forecasted interest expense by \$0.2 million or 3.4%.

Energy Cost Risk

We are subject to market risk exposure related to changes in energy costs. To manage this risk we have historically utilized derivative financial instruments to mitigate the impact of gasoline and diesel cost volatility on our future financial results. As of April 2, 2011, we have no outstanding derivative financial instruments. Periodically, we may utilize derivative financial instruments to manage gasoline and diesel fuel cost volatility.

A sensitivity analysis was performed to measure our energy cost risk over a one-year period for forecasted levels of unleaded and diesel fuel purchases. The sensitivity analysis that was performed assumed gasoline and diesel prices at April 2, 2011 and forecasted gasoline and diesel purchases over a one-year period. For each one percentage point increase or decrease in gasoline and diesel prices under these forecasted levels, our forecasted gasoline and diesel costs would change by approximately \$0.2 million.

Production costs at our plants are also subject to fluctuations in natural gas costs. To reduce our exposure to changes in natural gas prices, we utilize natural gas supply contracts in the normal course of business. These contracts meet the definition of normal purchase and, therefore, are not considered derivative instruments for accounting purposes.

Foreign Currency Exchange Risk

Our material foreign subsidiaries are located in Canada. The assets and liabilities of these subsidiaries 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

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) or Rule 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this Form 10-Q. Based on their evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective.

There have been no changes in our internal controls over financial reporting that occurred during the period covered by this Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

**PART II
OTHER INFORMATION**

ITEM 1. LEGAL PROCEEDINGS

The U.S. Environmental Protection Agency (U.S. EPA) previously identified certain alleged deficiencies with respect to the operations at our facility located in South Chicago, Illinois. We have responded to the U.S. EPA and will continue to work cooperatively to resolve this matter.

The U.S. EPA has likewise previously identified certain alleged deficiencies with respect to the operations at our Manchester, New Hampshire facility, and it issued a related testing order. We have completed the requested testing and submitted a test report to the U.S. EPA and the New Hampshire Department of Environmental Services (NHDES). Subsequently, the U.S. EPA issued a Notice of Violation alleging noncompliance with state and federal laws concerning air emissions and permitting. We continue to work cooperatively with the U.S. EPA to resolve this matter.

We cannot predict the ultimate outcome of any of these matters with certainty and it is possible that we may incur additional losses in excess of established reserves. However, we believe the possibility of a material adverse effect on our results of operations or financial position is remote.

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended July 3, 2010, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently believe are immaterial could have a material adverse affect on our business, financial condition and/or operating results.

Risks associated with the suppliers from whom our products are sourced, and the cost of those products, could adversely affect our operating results.

The products we sell are sourced from a variety of domestic and international suppliers. Global sourcing of many of these products is an important factor in our financial performance. We endeavor that all of our suppliers comply with applicable laws, including, without limitation, labor and environmental laws. Our ability to secure and maintain qualified suppliers who meet our standards and to access products in a timely and efficient manner can be a significant challenge, especially with respect to suppliers located and goods sourced outside the United States. Political and economic stability in the countries in which foreign suppliers are located, the financial stability of suppliers, failure to meet our supplier standards, labor problems experienced by our suppliers, the availability and cost of raw materials to suppliers, currency exchange rates, transport availability and cost, inflation and other factors relating to the suppliers and the countries in which they are located are beyond our control. In addition, United States and Canadian foreign trade policies, tariffs and other impositions on imported goods, trade sanctions imposed on certain countries, the limitation on the importation of certain types of goods or of goods containing certain materials from other countries and other factors relating to foreign trade are beyond our control. These and other factors affecting our suppliers and our access to products could adversely affect our operating results.

Table of Contents

ITEM 6. EXHIBITS

a. Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a) 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-14(a)/15d-14(a) 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 6, 2011

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

By: /s/ Thomas J. Dietz
Thomas J. Dietz
Vice President and Controller
(Principal Accounting Officer)