G&K SERVICES INC
Form 10-Q
February 08, 2005

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

F O R M 10 - Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended January 1, 2005 Commission file number 0-4063

G&K SERVICES, INC.

(Exact name of registrant as specified in its charter)

MINNESOTA	41-0449530
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

5995 OPUS PARKWAY
MINNETONKA, MINNESOTA 55343
(Address of principal executive offices and zip code)

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

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

YES þ NO o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES þ NO o

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

CLASS A	Outstanding January 31, 2005
Common Stock, par value $0.50 per share	19,581,724

CLASS B	Outstanding January 31, 2005
Common Stock, par value $0.50 per share	1,474,996

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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED CONDENSED BALANCE SHEETS

G&K Services, Inc. and Subsidiaries

(In thousands)	January 1, 2005 (Unaudited)	July 3, 2004
ASSETS		
Current Assets		
Cash and cash equivalents	$ 10,958	$ 26,931
Accounts receivable, less allowance for doubtful accounts of $3,255 and $2,603	83,776	71,058
Inventories	112,513	94,476
Prepaid expenses	10,726	14,902
Total current assets	217,973	207,367
Property, Plant and Equipment, net	238,593	240,609
Goodwill	311,633	285,892
Other Assets	80,056	68,879
	$ 848,255	$ 802,747
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 26,706	$ 20,511
Accrued expenses	74,744	76,470
Deferred income taxes	7,871	7,395
Current maturities of long-term debt	24,935	24,018
Total current liabilities	134,256	128,394
Long-Term Debt, net of Current Maturities	186,840	184,305
Deferred Income Taxes	39,874	38,256
Other Noncurrent Liabilities	28,074	26,369
Stockholders Equity	459,211	425,423
	$ 848,255	$ 802,747

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

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CONSOLIDATED STATEMENTS OF OPERATIONS
G&K Services, Inc. and Subsidiaries
(Unaudited)

(In thousands, except per share data)	For the Three Months Ended January 1, 2005	For the Three Months Ended December 27, 2003	For the Six Months Ended January 1, 2005	For the Six Months Ended December 27, 2003
Revenues				
Rental operations	$ 183,110	$ 174,620	$ 359,401	$ 347,900
Direct sales	12,025	7,919	18,166	13,242
Total revenues	195,135	182,539	377,567	361,142
Operating Expenses				
Cost of rental operations	116,415	111,062	227,424	220,907
Cost of direct sales	8,441	5,783	13,337	10,084
Selling and administrative	41,226	38,791	79,845	77,324
Depreciation and amortization	10,161	9,773	20,319	19,463
Total operating expenses	176,243	165,409	340,925	327,778
Income from Operations	18,892	17,130	36,642	33,364
Interest expense	2,641	2,933	5,189	6,088
Income before Income Taxes	16,251	14,197	31,453	27,276
Provision for income taxes	6,054	5,395	11,756	10,365
Net Income	$ 10,197	$ 8,802	$ 19,697	$ 16,911
Basic weighted average number of shares outstanding	20,911	20,666	20,868	20,638
Basic Earnings per Common Share	$ 0.49	$ 0.43	$ 0.94	$ 0.82
Diluted weighted average number of shares outstanding	21,200	20,850	21,133	20,789
Diluted Earnings per Common Share	$ 0.48	$ 0.42	$ 0.93	$ 0.81
Dividends per share	$ 0.0175	$ 0.0175	$ 0.0350	$ 0.0350

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

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
G&K Services, Inc. and Subsidiaries
(Unaudited)

(In thousands)	For the Six Months Ended January 1, 2005	December 27, 2003
Operating Activities:		
Net income	$ 19,697	$ 16,911
Adjustments to reconcile net income to net cash provided by operating activities -		
Depreciation and amortization	20,319	19,463
Deferred income taxes	540	562
Amortization of deferred compensation restricted stock	523	467
Changes in current operating items, exclusive of acquisitions	(12,564)	15,314
Other assets and liabilities	838	197
Net cash provided by operating activities	29,353	52,914
Investing Activities:		
Property, plant and equipment additions, net	(4,095)	(8,372)
Acquisitions of business assets and other	(36,038)	(7,137)
Net cash used for investing activities	(40,133)	(15,509)
Financing Activities:		
Proceeds from issuance of long-term debt		1,345
Repayments of long-term debt	(17,114)	(6,427)
Proceeds from (repayments of) short-term borrowings, net	7,400	(28,700)
Cash dividends paid	(732)	(726)
Sale of common stock	3,633	2,703
Net cash used for financing activities	(6,813)	(31,805)
(Decrease) Increase in Cash and Cash Equivalents	(17,593)	5,600
Effect of Exchange Rates on Cash	1,620	375
Cash and Cash Equivalents:		
Beginning of period	26,931	11,504
End of period	$ 10,958	$ 17,479
Supplemental Cash Flow Information:		
Non-Cash Transactions -		
Debt issued in connection with business acquisitions	$ 11,890	$

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

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G&K SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Amounts in thousands, except per share data)
Three and six month periods ended January 1, 2005 and December 27, 2003
(Unaudited)

The consolidated condensed financial statements included herein, except for the July 3, 2004 balance sheet which was derived from the audited consolidated financial statements for the fiscal year ended July 3, 2004, have been prepared by G&K Services, Inc. (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of the Company, the accompanying unaudited consolidated condensed financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of the Company as of January 1, 2005, and the results of its operations for the three and six months ended and its cash flows for the six months ended January 1, 2005 and December 27, 2003. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures herein are adequate to make the information presented not misleading. It is suggested that these consolidated condensed financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s latest report on Form 10-K.

The results of operations for the three and six month periods ended January 1, 2005 and December 27, 2003 are not necessarily indicative of the results to be expected for the full year.

1. Summary of Significant Accounting Policies

Accounting policies followed by the Company are set forth in Note 1 in the Company s Annual Report on Form 10-K for the fiscal year ended July 3, 2004.

Nature of Business

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

Principles of Consolidation

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

Revenue Recognition

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

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Derivative Financial Instruments

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

The Company may periodically hedge firm cash flow commitments with its foreign subsidiary, generally with foreign currency contracts. These agreements are recorded at current market values and the gains and losses are included in earnings. Gains and losses on such transactions were not significant in the second quarter of fiscal 2005 or fiscal 2004.

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 similar to the computation of basic earnings per share, except that the denominator is increased for the assumed exercise of dilutive options and other dilutive securities, including nonvested restricted stock, using the treasury stock method.

	Three Months Ended		Six Months Ended	
	January 1, 2005	December 27, 2003	January 1, 2005	December 27, 2003
Weighted average number of common shares outstanding used in computation of basic earnings per share	20,911	20,666	20,868	20,638
Weighted average effect of nonvested restricted stock grants and assumed exercise of options	289	184	265	151
Shares used in computation of diluted earnings per share	21,200	20,850	21,133	20,789

Stock-Based Compensation

The Company maintains Stock Option and Compensation Plans (the Employee Plans), which are more fully described in Note 6 in the Company s Annual Report on Form 10-K for the fiscal year ended July 3, 2004. The Company applies Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for its stock option plans. Accordingly, only compensation cost related to restricted stock issued under the Employee Plans has been recognized in the accompanying consolidated statements of operations. Compensation cost related to the restricted shares was $246 and $235 for the three month periods and $523 and $467 for the six month periods ended January 1, 2005 and December 27, 2003, respectively. Had compensation cost been recognized based on the fair values of options at the grant dates consistent with the provisions of Statement of Financial Accounting

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Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), the Company s net income and net income per common share would have been adjusted as follows:

	Three Months Ended		Six Months Ended	
	January 1, 2005	December 27, 2003	January 1, 2005	December 27, 2003
Net income, as reported	$ 10,197	$ 8,802	$ 19,697	$ 16,911
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(469)	(506)	(902)	(950)
Pro forma net income	$ 9,728	$ 8,296	$ 18,795	$ 15,961
Basic net income per share:				
As reported	$ 0.49	$ 0.43	$ 0.94	$ 0.82
Pro forma	0.46	0.40	0.90	0.77
Diluted net income per share:				
As reported	$ 0.48	$ 0.42	$ 0.93	$ 0.81
Pro forma	0.45	0.40	0.88	0.77

Recent Accounting Pronouncements

In December, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment (SFAS 123(R)), which is a revision of SFAS 123, Accounting for Stock-Based Compensation. Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123 for determining the fair value of a share-based payment. However, SFAS 123(R) requires the fair value of all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement. Pro forma disclosure is no longer an alternative. The new standard will be effective for public entities (excluding small business issuers) in the first interim or annual reporting period beginning after June 15, 2005. G&K plans to adopt this Statement in the first quarter of fiscal 2006. The Company is currently evaluating the impact of this standard on its consolidated financial statements.

2. Comprehensive Income

For the three and six month periods ended January 1, 2005 and December 27, 2003, the components of comprehensive income were as follows:

	Three Months Ended		Six Months Ended	
	January 1, 2005	December 27, 2003	January 1, 2005	December 27, 2003
Net income	$ 10,197	$ 8,802	$ 19,697	$ 16,911
Other comprehensive income				
Foreign currency translation adjustments, net of tax	5,480	2,845	10,438	2,502

Net unrealized holding gain (loss) on derivative financial instruments, net of tax	227	(45)	229	326
Comprehensive income	$ 15,904	$ 11,602	$ 30,364	$ 19,739

3. Acquisitions

During the first six months of fiscal 2005 the Company made several small acquisitions. All acquisitions were accounted for using the purchase method. The total purchase consideration, including related acquisition costs of these transactions was $47,081, which includes $11,890 of debt issued. The total purchase price exceeded the estimated fair values of assets acquired and liabilities assumed by $22,393. The Company may be required to pay up to $12,000 of additional cash consideration for these acquisitions contingent on specific future events.

The pro forma effects of these acquisitions, had they been acquired at the beginning of the fiscal year, were not material, either individually or in the aggregate, to the Company.

4. Goodwill and Intangible Assets

The changes in the carrying amount of goodwill for the six months ended January 1, 2005, by operating segment, are as follows:

	United States	Canada	Total
Balance as of July 3, 2004	$ 254,998	$ 30,894	$ 285,892
Goodwill acquired during the period	9,727	12,666	22,393
Other, primarily foreign currency translation		3,348	3,348
Balance as of January 1, 2005	$ 264,725	$ 46,908	$ 311,633

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

	As of January 1, 2005		
	Carrying Amount	Accumulated Amortization	Net
Customer contracts	$ 92,393	$ 43,369	$ 49,024
Non-competition agreements	11,972	6,564	5,408
Total	$ 104,365	$ 49,933	$ 54,432

	As of July 3, 2004		
	Carrying Amount	Accumulated Amortization	Net
Customer contracts	$ 80,142	$ 38,991	$ 41,151
Non-competition agreements	9,822	6,013	3,809
Total	$ 89,964	$ 45,004	$ 44,960

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Amortization expense was $4,306 and $3,917 for the six months ended January 1, 2005 and December 27, 2003, respectively. Estimated amortization expense for each of the five succeeding fiscal years based on the intangible assets as of January 1, 2005 is as follows:

2005 remaining	$ 4,714
2006	9,324
2007	9,122
2008	8,752
2009	5,076
2010	4,816

5. Long-Term Debt

On November 17, 2004, the Company entered into a loan agreement expiring on October 23, 2007. Under the loan agreement, the lender will make loans to the Company on a revolving basis up to $50,000. The Company will be required to pay interest on outstanding loan balances at a rate per annum of one month LIBOR plus a margin or, if the lender is funding the loan through the issuance of commercial paper to third parties, at a rate per annum equal to a margin plus the average annual interest rate for such commercial paper. In connection with the loan agreement, the Company granted a first priority security interest in certain of its U.S. based receivables. The amount of funds available under the loan agreement will be based on the amount of eligible receivables and various reserves required. The loan agreement contains representations, warranties, covenants and indemnifications customary for facilities of this type. At January 1, 2005, there was $50,000 outstanding under the agreement. The Company used the net proceeds of this loan to reduce indebtedness under its unsecured credit facilities.

6. Employee Benefit Plans

The components of net periodic pension cost are as follows for the three months ended January 1, 2005 and December 27, 2003:

	Pension Plan Three Months Ended		Supplemental Executive Retirement Plan Three Months Ended	
	January 1, 2005	December 27, 2003	January 1, 2005	December 27, 2003
Service cost	$ 741	$ 991	$ 164	$ 182
Interest cost	532	631	142	143
Expected return on assets	(426)	(380)		
Prior service cost	11	14	9	9
Loss	101	264	38	79
Net periodic pension cost	$ 959	$ 1,520	$ 353	$ 413

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The components of net periodic pension cost are as follows for the six months ended January 1, 2005 and December 27, 2003:

	Pension Plan Six Months Ended		Supplemental Executive Retirement Plan Six Months Ended	
	January 1, 2005	December 27, 2003	January 1, 2005	December 27, 2003
Service cost	$ 1,895	$ 1,982	$ 390	$ 364
Interest cost	1,361	1,261	338	286
Expected return on assets	(1,089)	(760)		
Prior service cost	28	28	21	18
Loss	258	528	104	157
Net periodic pension cost	$ 2,453	$ 3,039	$ 853	$ 825

7. Segment Information

The Company has two operating segments under the guidelines of SFAS No. 131: United States and Canada, which have been identified as components of the Company that are reviewed by the Company s Chief Executive Officer to determine resource allocation and evaluate performance. Each operating segment derives revenues from the corporate identity apparel and facility services industry, which includes garment rental and facility services products such as floor mats, dust mops, wiping towels, selected linen items and several restroom products. No one customer s transactions account for 1.0% or more of the Company s revenues.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies (see Note 1). Corporate expenses are allocated to the segments based on segment revenue. The Company evaluates performance based on income from operations. Financial information by geographic location for the three and six month periods ended January 1, 2005 and December 27, 2003 is as follows:

For the Three Months Ended	United States	Canada	Total
Second Quarter Fiscal Year 2005:			
Revenues	$ 163,175	$ 31,960	$ 195,135
Income from operations	12,348	6,544	18,892
Property, plant and equipment additions, net	3,355	1,326	4,681
Depreciation and amortization expense	8,806	1,355	10,161
Second Quarter Fiscal Year 2004:			
Revenues	$ 157,209	$ 25,330	$ 182,539
Income from operations	12,085	5,045	17,130
Property, plant and equipment additions, net	3,794	957	4,751
Depreciation and amortization expense	8,671	1,102	9,773

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For the Six Months Ended	United States	Canada	Total
Fiscal Year 2005:			
Revenues	$ 319,044	$ 58,523	$ 377,567
Income from operations	25,201	11,441	36,642
Property, plant and equipment additions, net	2,235	1,860	4,095
Depreciation and amortization expense			