

G&K SERVICES INC  
Form 10-Q  
May 06, 2005

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**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 Quarter Ended April 2, 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  NO

Indicate by check mark whether the registrant is an accelerated filer (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.

CLASS A  
Common Stock, par value \$0.50 per share

Outstanding May 3, 2005  
19,611,249

CLASS B  
Common Stock, par value \$0.50 per share

Outstanding May 3, 2005  
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)   | April 2,<br>2005<br>(Unaudited) | July 3,<br>2004 |
|--|---------------------------------|-----------------|
| <b>ASSETS</b>  |                                 |                 |
| <b>Current Assets</b>  |                                 |                 |
| Cash and cash equivalents  | \$ 10,864                       | \$ 26,931       |
| Accounts receivable, less allowance for doubtful accounts of \$3,045 and \$2,603 | 84,458                          | 71,058          |
| Inventories  | 115,745                         | 94,476          |
| Prepaid expenses   | 12,127                          | 14,902          |
| Total current assets   | 223,194                         | 207,367         |
| <b>Property, Plant and Equipment, net</b>  | 242,228                         | 240,609         |
| <b>Goodwill</b>  | 337,751                         | 285,892         |
| <b>Other Assets</b>  | 87,643                          | 68,879          |
|  | \$ 890,816                      | \$ 802,747      |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                                       |                                 |                 |
| <b>Current Liabilities</b>   |                                 |                 |
| Accounts payable   | \$ 21,720                       | \$ 20,511       |
| Accrued expenses   | 80,610                          | 76,470          |
| Deferred income taxes  | 7,836                           | 7,395           |
| Current maturities of long-term debt   | 25,183                          | 24,018          |
| Total current liabilities  | 135,349                         | 128,394         |
| <b>Long-Term Debt, net of Current Maturities</b>                                 | 215,794                         | 184,305         |
| <b>Deferred Income Taxes</b>   | 40,244                          | 38,256          |
| <b>Other Noncurrent Liabilities</b>  | 29,413                          | 26,369          |
| <b>Stockholders Equity</b>   | 470,016                         | 425,423         |
|  | \$ 890,816                      | \$ 802,747      |

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



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

(Unaudited)

| (In thousands, except per share data)                 | For the Three Months |                   | For the Nine Months |                   |
|---|----------------------|-------------------|---------------------|-------------------|
|   | Ended                |                   | Ended               |                   |
|   | April 2,<br>2005     | March 27,<br>2004 | April 2,<br>2005    | March 27,<br>2004 |
| <b>Revenues</b>                                       |                      |                   |                     |                   |
| Rental operations                                     | \$ 188,064           | \$ 173,531        | \$ 547,465          | \$ 521,431        |
| Direct sales  | 15,746               | 5,494             | 33,912              | 18,736            |
| Total revenues  | 203,810              | 179,025           | 581,377             | 540,167           |
| <b>Operating Expenses</b>                             |                      |                   |                     |                   |
| Cost of rental operations                             | 119,139              | 110,382           | 346,563             | 331,289           |
| Cost of direct sales                                  | 12,011               | 4,061             | 25,348              | 14,145            |
| Selling and administrative                            | 42,518               | 37,353            | 122,363             | 114,677           |
| Depreciation and amortization                         | 10,407               | 9,865             | 30,726              | 29,328            |
| Total operating expenses                              | 184,075              | 161,661           | 525,000             | 489,439           |
| <b>Income from Operations</b>                         | 19,735               | 17,364            | 56,377              | 50,728            |
| Interest expense                                      | 2,891                | 2,826             | 8,080               | 8,914             |
| <b>Income before Income Taxes</b>                     | 16,844               | 14,538            | 48,297              | 41,814            |
| Provision for income taxes                            | 6,418                | 5,524             | 18,174              | 15,889            |
| <b>Net Income</b>                                     | \$ 10,426            | \$ 9,014          | \$ 30,123           | \$ 25,925         |
| Basic weighted average number of shares outstanding   | 20,994               | 20,767            | 20,910              | 20,681            |
| <b>Basic Earnings per Common Share</b>                | \$ 0.50              | \$ 0.43           | \$ 1.44             | \$ 1.25           |
| Diluted weighted average number of shares outstanding | 21,290               | 20,974            | 21,186              | 20,851            |
| <b>Diluted Earnings per Common Share</b>              | \$ 0.49              | \$ 0.43           | \$ 1.42             | \$ 1.24           |
| <b>Dividends per share</b>                            | \$ 0.0175            | \$ 0.0175         | \$ 0.0525           | \$ 0.0525         |

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

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

(Unaudited)

|  | For the Nine Months Ended |                   |
|--|---------------------------|-------------------|
|  | April 2,<br>2005          | March 27,<br>2004 |
| (In thousands)   |                           |                   |
| <b>Operating Activities:</b>   |                           |                   |
| Net income   | \$ 30,123                 | \$ 25,925         |
| Adjustments to reconcile net income to net cash provided by operating activities - |                           |                   |
| Depreciation and amortization  | 30,726                    | 29,328            |
| Deferred income taxes  | 509                       | 671               |
| Amortization of deferred compensation - restricted stock                           | 677                       | 659               |
| Changes in current operating items, exclusive of acquisitions                      | (19,418)                  | 24,758            |
| Other assets and liabilities   | 1,159                     | 308               |
| Net cash provided by operating activities  | 43,776                    | 81,649            |
| <b>Investing Activities:</b>   |                           |                   |
| Property, plant and equipment additions, net                                       | (10,194)                  | (12,790)          |
| Acquisitions of business assets and other  | (74,895)                  | (26,082)          |
| Net cash used for investing activities   | (85,089)                  | (38,872)          |
| <b>Financing Activities:</b>   |                           |                   |
| Proceeds from issuance of long-term debt   |                           | 1,345             |
| Repayments of long-term debt   | (21,317)                  | (9,647)           |
| Proceeds from (repayments of) short-term borrowings, net                           | 41,200                    | (24,100)          |
| Cash dividends paid  | (1,100)                   | (1,090)           |
| Sale of common stock   | 4,855                     | 3,714             |
| Net cash provided by (used for) financing activities                               | 23,638                    | (29,778)          |
| <b>(Decrease) Increase in Cash and Cash Equivalents</b>                            | <b>(17,675)</b>           | <b>12,999</b>     |
| <b>Effect of Exchange Rates on Cash</b>  | <b>1,608</b>              | <b>254</b>        |
| <b>Cash and Cash Equivalents:</b>  |                           |                   |
| Beginning of period  | 26,931                    | 11,504            |
| End of period  | \$ 10,864                 | \$ 24,757         |
| <b>Supplemental Cash Flow Information:</b>   |                           |                   |
| 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 nine month periods ended April 2, 2005 and March 27, 2004

(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 April 2, 2005, and the results of its operations for the three and nine months ended and its cash flows for the nine months ended April 2, 2005 and March 27, 2004. 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 nine month periods ended April 2, 2005 and March 27, 2004 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.

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

The Company uses derivative financial instruments to manage the risk that changes in interest rates will affect the amount of its future interest payments. Interest rate swap contracts are used to 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 also uses derivative financial instruments to manage the risk that changes in gasoline cost will affect the future financial results of the Company. The Company purchases gasoline futures contracts to effectively hedge a portion of anticipated actual gasoline purchases. The gasoline futures contracts are reflected at fair value in the consolidated condensed balance sheet and the related gains or losses on these contracts are deferred in stockholders equity (as a component of other comprehensive income). Upon settlement of each contract, the actual gain or loss is reflected in gasoline expense.

The Company may also 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, if any, on all such transactions were not significant in the third 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 |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | April 2,<br>2005   | March 27,<br>2004 | April 2,<br>2005  | March 27,<br>2004 |
| Weighted average number of common shares outstanding used in computation of basic earnings per share | 20,994             | 20,767            | 20,910            | 20,681            |
| Weighted average effect of nonvested restricted stock grants and assumed exercise of options         | 296                | 207               | 276               | 170               |
| Shares used in computation of diluted earnings per share   | 21,290             | 20,974            | 21,186            | 20,851            |

**Table of Contents****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 \$154 and \$192 for the three month periods and \$677 and \$659 for the nine month periods ended April 2, 2005 and March 27, 2004, 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 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 |          | Nine Months Ended |           |
|---|--------------------|----------|-------------------|-----------|
|   | April 2,           | March    | April 2,          | March 27, |
|   | 2005               | 2004     | 2005              | 2004      |
| Net income, as reported   | \$ 10,426          | \$ 9,014 | \$ 30,123         | \$ 25,925 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (475)              | (398)    | (1,378)           | (1,348)   |
| Pro forma net income  | \$ 9,951           | \$ 8,616 | \$ 28,745         | \$ 24,577 |
| Basic net income per share:   |                    |          |                   |           |
| As reported   | \$ 0.50            | \$ 0.43  | \$ 1.44           | \$ 1.25   |
| Pro forma   | 0.47               | 0.42     | 1.37              | 1.19      |
| Diluted net income per share:   |                    |          |                   |           |
| As reported   | \$ 0.49            | \$ 0.43  | \$ 1.42           | \$ 1.24   |
| Pro forma   | 0.47               | 0.41     | 1.35              | 1.18      |

**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.

**Table of Contents****2. Comprehensive Income**

For the three and nine month periods ended April 2, 2005 and March 27, 2004, the components of comprehensive income were as follows:

|   | Three Months Ended |                      | Nine Months Ended |                   |
|---|--------------------|----------------------|-------------------|-------------------|
|   | April 2,<br>2005   | March<br>27,<br>2004 | April 2,<br>2005  | March 27,<br>2004 |
| Net income  | \$ 10,426          | \$ 9,014             | \$ 30,123         | \$ 25,925         |
| Other comprehensive income  |                    |                      |                   |                   |
| Foreign currency translation adjustments, net of tax                        | (1,205)            | (635)                | 9,233             | 1,867             |
| Net unrealized holding gain on derivative financial instruments, net of tax | 575                | 9                    | 804               | 335               |
| Comprehensive income  | \$ 9,796           | \$ 8,388             | \$ 40,160         | \$ 28,127         |

**3. Acquisitions**

During the first nine months of fiscal 2005 the Company made several small acquisitions. The total purchase consideration, including related acquisition costs of these transactions was \$85,832, which includes \$11,890 of debt issued. The total purchase price exceeded the estimated fair values of assets acquired and liabilities assumed by \$48,938. 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 nine months ended April 2, 2005, by operating segment, are as follows:

|   | United<br>States | Canada    | Total      |
|---|------------------|-----------|------------|
| Balance as of July 3, 2004                    | \$ 254,998       | \$ 30,894 | \$ 285,892 |
| Goodwill acquired during the period           | 31,481           | 17,457    | 48,938     |
| Other, primarily foreign currency translation |                  | 2,921     | 2,921      |
| Balance as of April 2, 2005                   | \$ 286,479       | \$ 51,272 | \$ 337,751 |

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

|                            | As of April 2, 2005 |                             |           |
|----------------------------|---------------------|-----------------------------|-----------|
|                            | Carrying<br>Amount  | Accumulated<br>Amortization | Net       |
| Customer contracts         | \$ 102,516          | \$ 45,528                   | \$ 56,988 |
| Non-competition agreements | 10,834              | 6,833                       | 4,001     |
| Total                      | \$ 113,350          | \$ 52,361                   | \$ 60,989 |

|                            | As of July 3, 2004 |                             |           |
|----------------------------|--------------------|-----------------------------|-----------|
|                            | Carrying<br>Amount | Accumulated<br>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 |

Amortization expense was \$6,803 and \$5,891 for the nine months ended April 2, 2005 and March 27, 2004, respectively. Estimated amortization expense for each of the five succeeding fiscal years based on the intangible assets as of April 2, 2005 is as follows:

|                |          |
|----------------|----------|
| 2005 remaining | \$ 2,699 |
| 2006           | 10,778   |
| 2007           | 10,576   |
| 2008           | 10,000   |
| 2009           | 6,292    |
| 2010           | 6,045    |

**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 April 2, 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.

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**Table of Contents****6. Employee Benefit Plans**

The components of net periodic pension cost are as follows for the three months ended April 2, 2005 and March 27, 2004:

|                           | Pension Plan       |                | Supplemental Executive Retirement Plan |                |
|---------------------------|--------------------|----------------|--|----------------|
|                           | Three Months Ended |                | Three Months Ended                     |                |
|                           | April 2, 2005      | March 27, 2004 | April 2, 2005                          | March 27, 2004 |
| Service cost              | \$ 948             | \$ 987         | \$ 198                                 | \$ 183         |
| Interest cost             | 681                | 629            | 171                                    | 142            |
| Expected return on assets | (545)              | (379)          |  |                |
| Prior service cost        | 14                 | 14             | 11                                     | 9              |
| Loss                      | 129                | 263            | 47                                     | 78             |
| Net periodic pension cost | \$ 1,227           | \$ 1,514       | \$ 427                                 | \$ 412         |

The components of net periodic pension cost are as follows for the nine months ended April 2, 2005 and March 27, 2004:

|                           | Pension Plan      |                | Supplemental Executive Retirement Plan |                |
|---------------------------|-------------------|----------------|--|----------------|
|                           | Nine Months Ended |                | Nine Months Ended                      |                |
|                           | April 2, 2005     | March 27, 2004 | April 2, 2005                          | March 27, 2004 |
| Service cost              | \$ 2,843          | \$ 2,969       | \$ 588                                 | \$ 547         |
| Interest cost             | 2,042             | 1,890          | 509                                    | 428            |
| Expected return on assets | (1,634)           | (1,139)        |  |                |
| Prior service cost        | 42                | 42             | 32                                     | 27             |
| Loss                      | 387               | 791            | 151                                    | 235            |
| Net periodic pension cost | \$ 3,680          | \$ 4,553       | \$ 1,280                               | \$ 1,237       |

**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. Annually, 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 nine month periods ended April 2, 2005 and March 27, 2004 is as follows:

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| For the Three Months Ended                   | United<br>States | Canada    | Total      |
|--|------------------|-----------|------------|
| Third Quarter Fiscal Year 2005:              |                  |           |            |
| Revenues                                     | \$ 170,069       | \$ 33,741 | \$ 203,810 |
| Income from operations                       | 13,276           | 6,459     | 19,735     |
| Property, plant and equipment additions, net | 4,884            | 1,215     | 6,099      |
| Depreciation and amortization expense        | 8,976            | 1,431     | 10,407     |
| Third Quarter Fiscal Year 2004:              |                  |           |            |
| Revenues                                     | \$ 153,696       | \$ 25,329 | \$ 179,025 |
| Income from operations                       | 12,442           | 4,922     | 17,364     |
| Property, plant and equipment additions, net | 3,807            | 611       | 4,418      |
| Depreciation and amortization expense        | 8,771            | 1,094     | 9,865      |
|  |                  |           |            |
| For the Nine Months Ended                    | United<br>States | Canada    | Total      |
| Fiscal Year 2005:                            |                  |           |            |
| Revenues                                     | \$ 489,113       | \$ 92,264 | \$ 581,377 |
| Income from operations                       | 38,477           | 17,900    | 56,377     |
| Property, plant and equipment additions, net | 7,119            | 3,075     | 10,194     |
| Depreciation and amortization expense        | 26,683           | 4,043     | 30,726     |
| Fiscal Year 2004:                            |                  |           |            |
| Revenues                                     | \$ 466,662       | \$ 73,505 | \$ 540,167 |
| Income from operations                       | 36,824           | 13,904    | 50,728     |
| Property, plant and equipment additions, net | 11,278           | 1,512     | 12,790     |
| Depreciation and amortization expense        | 26,069           | 3,259     | 29,328     |

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

(Unaudited)

**Overview**

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

We made several small acquisitions during the first nine months of fiscal 2005. In August 2004, we acquired Keefer Laundry Ltd., a textile laundry company serving the Vancouver and Whistler areas of British Columbia. The acquisition extends our uniform and textile rental service area to Western Canada. Nettoyeur Shefford Inc., a uniform and textile service company serving Granby and Montreal, Quebec was purchased in October 2004. This acquisition enhances our market position serving customers in the province of Quebec. Also in October 2004, we purchased certain industrial rental assets and customers of Marathon Linen, Inc., a uniform and textile service company serving the Detroit metro area. This acquisition expands our geographic coverage to a major North American market. In December 2004, we acquired the direct sale uniform group and related assets from Lion Apparel, Inc., a Dayton Ohio based designer, marketer and distributor of customized uniform programs. This acquisition expands our direct sale business and positions us to pursue greater direct sale growth. Custom Linen Systems, Ltd. was acquired in February 2005. Custom Linen Systems is a textile laundry company serving Calgary and Edmonton, Alberta. This acquisition expands our uniform and textile rental service presence in western Canada. In March 2005, we acquired certain assets from Coyne Textile Services. We acquired two processing facilities serving customers in Connecticut, New York, Pennsylvania and New Jersey, and also acquired certain customer assets in Maryland and Florida. This purchase expands and enhances our uniform and textile rental business in North America.

The pro forma effect of these acquisitions, had they been acquired at the beginning of the fiscal year, were not material, either individually or in the aggregate. The total purchase consideration, including related acquisition costs of these transactions was \$85.8 million, which includes \$11.9 million of debt issued. The total purchase price exceeded the estimated fair values of assets acquired and liabilities assumed by \$48.9 million. The Company may be required to pay up to \$12.0 million of additional cash consideration for these acquisitions contingent on specific future events.

**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 accounting principles generally accepted in the United States. As such, management is required to make certain estimates, judgments and assumptions that are believed to be reasonable based on the information available. These estimates and assumptions affect the reported amount of assets and liabilities, revenues and expenses, and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. See Note 1 to the consolidated condensed financial statements for additional discussion of the application of these and other accounting

policies.

***Revenue Recognition and Allowance for Doubtful Accounts***

Our rental operations business is largely based on written service agreements whereby we agree to collect, launder and deliver uniforms and other related products. The service agreements provide for weekly billing upon completion

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of the laundering process and delivery to the customer. Accordingly, we recognize revenue from rental operations in the period in which the services are provided. Revenue from rental operations also includes billings to customers for lost or abused merchandise. Direct sale revenue is recognized in the period in which the product is shipped.

Estimates are used in determining the collectibility of billed accounts receivable. Management analyzes specific accounts receivable and historical bad debt experience, customer credit worthiness, current economic trends and the age of outstanding balances when evaluating the adequacy of the allowance for doubtful accounts. Significant management judgments and estimates are used in connection with establishing the allowance in any accounting period. Material differences may result in the amount and timing of bad debt expense recognition for any given period if management makes different judgments or utilizes different estimates.

### ***Inventories***

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

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

We adopted Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ) at the beginning of fiscal 2002 and as a result no longer amortize goodwill. SFAS 142 also requires that companies test goodwill for impairment on an annual basis and when events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit to which goodwill is assigned below its carrying amount. Our evaluation follows the two step impairment test prescribed by SFAS 142. First we assess whether the fair value of the reporting units exceeds the carrying amount of the unit including goodwill. Our evaluation considers changes in the operating environment, competitive position, market trends, operating performance, quoted market prices for our equity securities and fair value models and research prepared by independent analysts. If the carrying amount of a reporting unit exceeded its fair value, we would perform a second test to measure the amount of impairment loss, if any. Management completes its annual impairment tests in the fourth quarter of each fiscal year. There have been no impairments of goodwill or definite-lived intangible assets in fiscal 2004 and there have been no events or circumstances through the first nine months of fiscal 2005 that would more likely than not indicate that there has been any impairment of goodwill or definite-lived assets. Future events could cause management to conclude that impairment indicators exist and that goodwill and other intangibles associated with acquired businesses are impaired. Any resulting impairment loss could have a material impact on our financial condition and results of operations.

Property, plant and equipment and definite-lived intangible assets are depreciated or amortized over their useful lives. Useful lives are based on management estimates of the period that the assets will add value. Long-lived assets are evaluated for impairment whenever events and circumstances indicate an asset may be impaired. There have been no write-downs of any long-lived assets in fiscal 2004 or through the first nine months of fiscal 2005.

### ***Insurance***

We self-insure for certain obligations related to health, workers compensation and auto and general liability programs. We purchase stop-loss insurance policies to protect us from catastrophic losses. Estimates are used in determining the potential liability associated with reported claims and for losses that have occurred, but have not been reported. Management estimates consider historical claims experience, escalating medical cost trends, expected



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timing of claim payments and an actuarial analysis provided by a third party. Changes in the cost of medical care, our ability to settle claims and the estimates and judgments used by management could have a material impact on the amount and timing of expense for any period.

***Income Taxes***

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

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

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

**Table of Contents****Results of Operations**

The percentage relationships to net sales of certain income and expense items for the three and nine month periods ended April 2, 2005 and March 27, 2004, and the percentage changes in these income and expense items between periods are presented in the following table:

|                               | <b>Three Months</b>  |                       | <b>Nine Months</b>   |                       | <b>Percentage Change</b>   |                            |
|-------------------------------|----------------------|-----------------------|----------------------|-----------------------|----------------------------|----------------------------|
|                               | <b>Ended</b>         |                       | <b>Ended</b>         |                       | <b>Three Months</b>        | <b>Nine Months</b>         |
|                               | <b>April 2, 2005</b> | <b>March 27, 2004</b> | <b>April 2, 2005</b> | <b>March 27, 2004</b> | <b>FY 2005 vs. FY 2004</b> | <b>FY 2005 vs. FY 2004</b> |
| Revenues:                     |                      |                       |                      |                       |                            |                            |
| Rental                        | 92.3%                | 96.9%                 | 94.2%                | 96.5%                 | 8.4%                       | 5.0%                       |
| Direct                        | 7.7                  | 3.1                   | 5.8                  | 3.5                   | 186.6                      | 81.0                       |
| Total revenues                | 100.0                | 100.0                 | 100.0                | 100.0                 | 13.8                       | 7.6                        |
| Expenses:                     |                      |                       |                      |                       |                            |                            |
| Cost of rental sales          | 63.4                 | 63.6                  | 63.3                 | 63.5                  | 7.9                        | 4.6                        |
| Cost of direct sales          | 76.3                 | 73.9                  | 74.7                 | 75.5                  | 195.8                      | 79.2                       |
| Total cost of sales           | 64.3                 | 63.9                  | 64.0                 | 63.9                  | 14.6                       | 7.7                        |
| Selling and administrative    | 20.9                 | 20.9                  | 21.0                 | 21.2                  | 13.8                       | 6.7                        |
| Depreciation and amortization | 5.1                  | 5.5                   | 5.3                  | 5.5                   | 5.5                        | 4.8                        |
| Income from operations        | 9.7                  | 9.7                   | 9.7                  | 9.4                   | 13.7                       | 11.1                       |
| Interest expense              | 1.4                  | 1.6                   | 1.4                  | 1.7                   | 2.3                        | (9.4)                      |
| Income before income taxes    | 8.3                  | 8.1                   | 8.3                  | 7.7                   | 15.9                       | 15.5                       |
| Provision for income taxes    | 3.2                  | 3.1                   | 3.1                  | 2.9                   | 16.2                       | 14.4                       |
| Net income                    | 5.1%                 | 5.0%                  | 5.2%                 | 4.8%                  | 15.7%                      | 16.2%                      |

***Three months ended April 2, 2005 compared to three months ended March 27, 2004***

**Revenues.** Total revenues in the third quarter of fiscal 2005 increased 13.8% to \$203.8 million from \$179.0 million in the third quarter of fiscal 2004. Rental revenue increased \$14.5 million in the third quarter, or 8.4%. The organic industrial rental growth rate was approximately 1.5%, an improvement from negative 2.0% in the same period of fiscal 2004. Organic industrial rental revenue has improved due to growth initiatives and improving economic conditions.

Direct sale revenue increased 186.6% to \$15.7 million in the third quarter of fiscal 2005 compared to \$5.5 million in the same period of fiscal 2004. The organic direct sale growth rate was approximately 65.0%. The increase in organic direct sale revenue was due primarily to large shipments at our direct sale unit to one customer.

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

*Cost of Rental and Direct Sale.* Cost of rental operations increased 7.9% to \$119.1 million in the third quarter of fiscal 2005 from \$110.4 million in the same period of fiscal 2004. Gross margin from rental sales increased to 36.6% in the third quarter of fiscal 2005 from 36.4% in the same period of fiscal 2004. Rental gross margins continue to be impacted by operational initiatives focused on lower merchandise and production costs. Results from these initiatives were partially offset by higher energy costs.

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Cost of direct sales increased 195.8% to \$12.0 million in the third quarter of fiscal 2005 from \$4.1 million in the same period of fiscal 2004. Gross margin from direct sales decreased to 23.7% in the third quarter of fiscal 2005 from 26.1% in the third quarter of fiscal 2004. The decrease in gross margin was primarily due to changes in product mix and lower gross margin in the Lion Uniform Group. Historically, Lion's revenues are seasonally lower in the first calendar quarter and their fixed distribution and warehousing costs are spread over a smaller revenue base.

*Selling and Administrative.* Selling and administrative expenses increased to \$42.5 million in the third quarter of fiscal 2005 from \$37.4 million in the same period of fiscal 2004. As a percentage of total revenues, selling and administrative expenses were 20.9% in the third quarter of both fiscal 2005 and fiscal 2004. Total selling and administrative expenses increased with continued investment in growth oriented initiatives and additional spending related to acquired businesses.

*Depreciation and Amortization.* Depreciation and amortization expense increased 5.5% to \$10.4 million in the third quarter of fiscal 2005 from \$9.9 million in the same period of fiscal 2004. As a percentage of total revenues, depreciation and amortization expense decreased to 5.1% in the third quarter of fiscal 2005 from 5.5% in the third quarter of fiscal 2004. Capital expenditures, excluding acquisition of businesses, were \$6.1 million in the third quarter of fiscal 2005 compared to \$4.4 million in the prior year's quarter.

*Interest Expense.* Interest expense was \$2.9 million in the third quarter of fiscal 2005, up from \$2.8 million in the same period of fiscal 2004. The increase was due to increased debt levels in conjunction with the acquisition of business assets in the current fiscal year.

*Provision for Income Taxes.* Our effective tax rate increased to 38.1% in the third quarter of fiscal 2005 from 38.0% in the same period of fiscal 2004.

***Nine months ended April 2, 2005 compared to nine months ended March 27, 2004***

*Revenues.* Total revenues for the first nine months of fiscal 2005 increased 7.6% to \$581.4 million from \$540.2 million for the same period of fiscal 2004. Rental revenue increased \$26.0 million in the first nine months, or 5.0%. The organic industrial rental growth rate was approximately negative 0.5%. Organic industrial rental revenue continues to be negatively impacted by lost uniform wearers due to reduced employment levels within our existing customer base, partially offset by a better pricing environment and improved customer retention.

Direct sale revenue increased 81.0% to \$33.9 million in the first nine months of fiscal 2005 compared to \$18.7 million in the same period of fiscal 2004. The organic direct sale growth rate was approximately 30.0%. The increase in organic direct sale revenue is largely due to garment sales through our rental operations including our annual outerwear promotion and shipments to large customers at our direct sales unit.

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

*Cost of Rental and Direct Sale.* Cost of rental operations increased 4.6% to \$346.6 million in the first nine months of fiscal 2005 from \$331.3 million in the same period of fiscal 2004. Gross margin from rental sales increased to 36.7% in the first nine months of fiscal 2005 from 36.5% in the same period of fiscal 2004. The benefit of numerous operational initiatives focused on lower merchandise and production costs were partially offset by higher energy costs.

Cost of direct sales increased 79.2% to \$25.3 million in the first nine months of fiscal 2005 from \$14.1 million in the same period of fiscal 2004. Gross margin from direct sales increased to 25.3% in the first nine months of fiscal 2005 from 24.5% in the same period of fiscal 2004. The increase in margins was primarily due to improved cost leverage resulting from greater sales volume.

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*Selling and Administrative.* Selling and administrative expenses increased 6.7% to \$122.4 million in the first nine months of fiscal 2005 from \$114.7 million in the same period of fiscal 2004. As a percentage of total revenues, selling and administrative expenses decreased to 21.0% in the first nine months of fiscal 2005 from 21.2% in the same period of fiscal 2004. The improvement as a percent of revenue was largely due to additional leverage on incremental revenue growth and a \$0.3 million gain on sale of property, partially offset by continued investment in growth initiatives.

*Depreciation and Amortization.* Depreciation and amortization expense increased 4.8% to \$30.7 million in the first nine months of fiscal 2005 from \$29.3 million in the same period of fiscal 2004. As a percentage of total revenues, depreciation and amortization expense decreased to 5.3% in the first nine months of fiscal 2005 from 5.5% in the same period of fiscal 2004. Capital expenditures, excluding acquisition of businesses, were \$10.2 million in the first nine months of fiscal 2005 compared to \$12.8 million in the same period of fiscal 2004. The decreased level of spending in the current year was driven by proceeds from the sale of selected plant assets, partially offset by investments in information technology and revenue growth initiatives.

*Interest Expense.* Interest expense was \$8.1 million in the first nine months of fiscal 2005, down from \$8.9 million in the same period of fiscal 2004. The decrease was due to lower debt levels resulting from strong operating cash flows and slightly lower interest rates.

*Provision for Income Taxes.* Our effective tax rate decreased to 37.6% in the first nine months of fiscal 2005 from 38.0% in the same period of fiscal 2004 due largely to decreases in Canadian statutory income tax rates.

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

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

*Operating Activities.* Net cash provided by operating activities was \$43.8 million in the first nine months of fiscal 2005 and \$81.6 million in the same period of fiscal 2004. In fiscal 2005, cash provided by operations was negatively impacted by the timing of payments of taxes as well as growth in new inventories in connection with the expansion of our manufacturing operation. These uses of cash were partially offset by continued emphasis to control in-service inventory expenditures. Fiscal 2004 cash provided by operations was positively impacted by one-time improvements related to a focus on timely collection of accounts receivable as well as several initiatives focused on controlling the usage of in-service inventory.

Working capital at April 2, 2005 was \$87.8 million, up 11.2% from \$79.0 million at July 3, 2004. The increase in working capital is largely due to the proceeds recorded from the sale of selected plant assets.

*Investing Activities.* Net cash used in investing activities was \$85.1 million in the first nine months of fiscal 2005 and \$38.9 million in the same period of fiscal 2004. In fiscal 2005, cash was largely used for acquisition of business assets and investments made in information technology and revenue growth initiatives, partially offset by proceeds from the sale of selected plant assets. The sale of these assets is the result of our continued focus on improving asset utilization. Proceeds on these sales totaled \$5.6 million. In fiscal 2004, cash was primarily used for acquisitions of business assets and property, plant and equipment additions.

*Financing Activities.* Cash provided by financing activities was \$23.6 million in the first nine months of fiscal 2005 and cash used for financing activities was \$29.8 million in the same period of fiscal 2004. Cash provided in fiscal 2005 was largely the result of short term borrowings in connection with the acquisition of business assets. Cash used in fiscal 2004 was related to the repayment of both short-term and long-term debt. The Company paid dividends of

\$1.1 million during the first nine months of fiscal 2005.

On November 17, 2004, we entered into a loan agreement expiring on October 23, 2007. Under the loan agreement, the lender will make loans to us on a revolving basis up to \$50.0 million. We 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

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annual interest rate for such commercial paper. In connection with the loan agreement, we granted a first priority security interest in certain of our 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 April 2, 2005, there was \$50.0 million outstanding under the agreement. We used the net proceeds of this loan to reduce indebtedness under our unsecured credit facilities.

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

The following table summarizes our fixed cash obligations as of April 2, 2005 for the fiscal years ending June (in thousands):

|   | 2005<br>Remaining | 2006      | 2007      | 2008       | 2009      | 2010 and<br>There-<br>after | Total      |
|---|-------------------|-----------|-----------|------------|-----------|-----------------------------|------------|
| Variable rate term loan and revolving credit facility | \$ 3,750          | \$ 18,750 | \$ 22,500 | \$ 140,800 | \$        | \$                          | \$ 185,800 |
| Fixed rate term loan                                  |                   | 7,143     | 7,143     | 7,143      | 7,143     | 14,285                      | 42,857     |
| Other debt arrangements, including capital leases     | (289)             | 641       | 11,968    |            |           |                             | 12,320     |
| Operating leases                                      | 3,895             | 14,134    | 11,574    | 8,836      | 5,705     | 6,474                       | 50,618     |
| Total contractual cash obligations                    | \$ 7,356          | \$ 40,668 | \$ 53,185 | \$ 156,779 | \$ 12,848 | \$ 20,759                   | \$ 291,595 |

Also, at April 2, 2005, we had stand-by letters of credit totaling \$28.6 million that have been issued and are outstanding, primarily in connection with our property and casualty insurance programs and to provide security in connection with a promissory note. No amounts have been drawn upon these letters of credit.

At April 2, 2005, we had available cash on hand of \$10.9 million and approximately \$130 million of available capacity under our revolving credit facility. We anticipate that we will generate sufficient cash flows from operations to satisfy our cash commitments and capital requirements for fiscal 2005; however, we may utilize borrowings under the revolving credit facility to supplement our cash requirements from time to time.

The amount of cash flow generated from operations is subject to a number of risks and uncertainties. In fiscal 2005, we may actively seek and consider acquisitions of business assets, the consummation of any acquisition could affect our liquidity profile and level of outstanding debt. We believe that available capacity under our revolving credit facility will be adequate to finance any such acquisitions and planned capital expenditures in fiscal 2005.

***Pension Obligations***

We account for our defined benefit pension plan using Statement of Financial Accounting Standards No. 87 Employer's Accounting for Pensions (SFAS 87). Under SFAS 87, pension expense is recognized on an accrual basis



over employees' approximate service periods. Pension expense calculated under SFAS 87 is generally independent of funding decisions or requirements. We recognized expense for our defined benefit pension plan of \$1.2 million in the third quarter of fiscal 2005 and \$1.5 million in the same period of fiscal 2004. At July 3, 2004, the fair value of our pension plan assets totaled \$26.7 million.

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 can differ from these assumptions. Pension expense increases as the expected rate of return on pension plan assets decreases.

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At July 3, 2004, we estimated that the pension plan assets will generate a long-term rate of return of 8.0%. This rate was developed by evaluating input from our actuary as well as long-term inflation assumptions. The expected long-term rate of return on plan assets at July 3, 2004 is based on an allocation of U.S. equities and U.S. fixed income securities. Decreasing the expected long-term rate of return by 0.5% (from 8.0% to 7.5%) would increase our estimated fiscal 2005 pension expense by approximately \$0.1 million. Pension liability and future pension expense increase as the discount rate is reduced. We discounted future pension obligations using a rate of 6.25% at July 3, 2004. The discount rate is determined based on the current rates earned on high quality long-term bonds. Decreasing the discount rate by 0.5% (from 6.25% to 5.75%) would have increased our accumulated benefit obligation at July 3, 2004 by approximately \$3.8 million and increased the estimated fiscal 2005 pension expense by approximately \$0.9 million.

Future changes in plan asset returns, assumed discount rates and various other factors related to the participants in our pension plan will impact our future pension expense and liabilities. We cannot predict with certainty what these factors will be in the future.

### ***Impact of Inflation***

In general, management believes that our results of operations are not dependent on moderate changes in the inflation rate. Historically, we have been able to manage the impact of more significant changes in inflation rates through our customer relationships, customer agreements that generally provide for price increases consistent with the rate of inflation or 5.0%, whichever is greater, and continued focus on improvements of operational productivity.

Significant increases in energy costs, specifically natural gas and gasoline, can materially affect our results of operations and financial condition. Currently, energy costs represent between 3-4% of our total revenue.

### ***Litigation***

We are involved in a variety of legal actions relating to personal injury, customer contracts, employment, trade practices, environmental and other legal matters that arise in the normal course of business. These legal actions include lawsuits that challenge the practice of charging for certain environmental services on invoices, and being named, along with other defendants, as a potentially responsible party at certain waste disposal sites where ground water contamination has been detected or is suspected. None of these legal actions are expected to have a material adverse effect on our results of operations or financial position.

### ***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. We plan to adopt this Statement in the first quarter of fiscal 2006. We are currently evaluating the impact of this standard on our consolidated financial statements.

### **Cautionary Statements Regarding Forward-Looking Statements**

The Private Securities Litigation Reform Act of 1995 (the Act ) provides companies with a safe harbor when making forward-looking statements as a way of encouraging them to furnish their shareholders with information regarding expected trends in their operating results, anticipated business developments and other prospective information. Statements made in this report concerning our intentions, expectations or predictions about future results or events are forward-looking statements within the meaning of the Act. These statements reflect our current expectations or beliefs, and are subject to risks and uncertainties that could cause actual results or events to vary from stated expectations, which could be material and adverse. Given that circumstances may change, and new

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risks to the business may emerge from time to time, having the potential to negatively impact our business in ways we could not anticipate at the time of making a forward-looking statement, you are cautioned not to place undue reliance on these statements, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Some of the factors that could cause actual results or events to vary from stated expectations include, but are not limited to, the following: unforeseen operating risks; the effects of overall economic conditions; fluctuations in costs of insurance and energy; acquisition integration costs; the performance of acquired businesses; preservation of positive labor relationships; competition, including pricing, within the corporate identity apparel and facility services industry; and the availability of capital to finance planned growth. Additional information concerning potential factors that could effect future financial results is included in the Company's Annual Report on Form 10-K for the fiscal year ended July 3, 2004.

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

### **Interest Rate Risk**

We are subject to market risk exposure related to changes in interest rates. We use financial instruments, including fixed and variable rate debt, as well as interest rate swaps to manage interest rate risk. Interest rate swap agreements are entered into for periods consistent with related underlying exposures and do not constitute positions independent of those exposures. Assuming the current level of borrowings, a one percentage point increase in interest rates under these borrowings would have increased our interest expense for the third quarter of fiscal 2005 by approximately \$0.3 million. This estimated exposure considers the mitigating effects of interest rate swap agreements outstanding at April 2, 2005 on the change in the cost of variable rate debt.

### **Energy Cost Risk**

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

### **Foreign Currency Exchange Risk**

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

## **ITEM 4. CONTROLS AND PROCEDURES**

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 the Company's disclosure controls and procedures are effective.

There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced above.

Table of Contents**PART II****OTHER INFORMATION****ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The following table includes information about our share repurchases for the quarter ended April 2, 2005.

| Period   | Total<br>Number of<br>Shares (or<br>Units)<br>Purchased<br>(1) | Average<br>Price<br>Paid per<br>Share<br>(or Unit) | Total<br>Number of<br>Shares (or<br>Units)<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number<br>(or<br>Approximate<br>Dollar Value)<br>of<br>Shares (or<br>Units) that<br>May Yet be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--|--|--|--|---|
| <b>Month #1</b><br><b>(Fiscal month ending February 5, 2004)</b> |  |  |  |   |
| <b>Month #2</b><br><b>(Fiscal month ending March 5, 2004)</b>    |  |  |  |   |
| <b>Month #3</b><br><b>(Fiscal month ending April 2, 2005)</b>    | 4,000  | \$ 0.50  |  |   |

- (1) All repurchased shares were initially issued under the Employee Plans as restricted stock grants subject to forfeiture upon termination of employment. All repurchases were made upon forfeiture of shares by the recipient of such restricted stock grants. Pursuant to the Restricted Stock Agreements governing such grants, the repurchase price for all shares was \$0.50, which represents the per share amount paid by the restricted stock grant recipient on the date of grant.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

## a. Exhibits

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

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

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

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

b. Reports on Form 8-K

A Form 8-K, Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers as filed on February 25, 2005.

A Form 8-K, Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers as filed on March 22, 2005.

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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, 2005

By: /s/ Jeffrey L. Wright

Jeffrey L. Wright  
Senior Vice President and Chief  
Financial Officer  
(Principal Financial Officer)

By: /s/ Michael F. Woodard

Michael F. Woodard  
Vice President and Controller  
(Principal Accounting Officer)