G&K SERVICES INC
Form 10-Q
February 03, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2011
Commission file number 0-4063
G&K SERVICES, INC.
(Exact name of registrant as specified in its charter)

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

5995 OPUS PARKWAY
MINNETONKA, MINNESOTA 55343
(Address of principal executive offices and zip code)
Registrant s telephone number, including area code (952) 912-5500

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o
		(do not check if a smaller reporting company)	

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

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

Common Stock, par value $0.50 per share, outstanding
January 30, 2012 was 18,835,551 shares

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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED CONDENSED BALANCE SHEETS

G&K Services, Inc. and Subsidiaries

(In thousands)	December 31, 2011 (Unaudited)	July 2, 2011
ASSETS		
Current Assets		
Cash and cash equivalents	$ 13,597	$ 22,974
Accounts receivable, less allowance for doubtful accounts of $3,101 and $3,066	94,632	90,522
Inventories, net	176,279	163,050
Other current assets	13,715	21,614
Total current assets	298,223	298,160
Property, Plant and Equipment, net	186,806	185,521
Goodwill	324,819	328,219
Other Assets	50,388	54,020
Total assets	$ 860,236	$ 865,920
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 36,908	$ 38,067
Accrued expenses	65,704	72,395
Deferred income taxes	7,577	7,626
Current maturities of long-term debt	36,611	40,710
Total current liabilities	146,800	158,798
Long-Term Debt, net of Current Maturities	95,040	95,188
Deferred Income Taxes	14,488	9,189
Accrued Income Taxes Long Term	14,238	13,199
Other Noncurrent Liabilities	65,678	74,640
Stockholders Equity		
Common stock, $0.50 par value	9,406	9,364
Additional paid-in capital	14,725	12,455
Retained earnings	483,907	471,041
Accumulated other comprehensive income	15,954	22,046
Total stockholders equity	523,992	514,906

Total liabilities and stockholders equity	$	860,236	$	865,920

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

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

(In thousands, except per share data)	For the Three Months Ended December 31, 2011	For the Three Months Ended January 1, 2011	For the Six Months Ended December 31, 2011	For the Six Months Ended January 1, 2011
Revenues				
Rental operations	$ 196,832	$ 187,089	$ 390,833	$ 373,459
Direct sales	20,232	17,003	35,954	31,022
Total revenues	217,064	204,092	426,787	404,481
Operating Expenses				
Cost of rental operations	136,350	127,456	269,937	252,459
Cost of direct sales	16,252	12,852	28,167	23,423
Selling and administrative	47,508	47,176	96,254	93,900
Total operating expenses	200,110	187,484	394,358	369,782
Income from Operations	16,954	16,608	32,429	34,699
Interest expense	1,607	2,406	3,260	5,053
Income before Income Taxes	15,347	14,202	29,169	29,646
Provision for income taxes	5,881	5,538	11,410	12,003
Net Income	$ 9,466	$ 8,664	$ 17,759	$ 17,643
Basic weighted average number of shares outstanding	18,493	18,375	18,462	18,332
Basic Earnings per Common Share	$ 0.51	$ 0.47	$ 0.96	$ 0.96
Diluted weighted average number of shares outstanding	18,660	18,478	18,635	18,416
Diluted Earnings per Common Share	$ 0.51	$ 0.47	$ 0.95	$ 0.96
Dividends per share	$ 0.130	$ 0.095	$ 0.260	$ 0.190

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)

	For the Six Months Ended	
(In thousands)	December 31, 2011	January 1, 2011
Operating Activities:		
Net income	$ 17,759	$ 17,643
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	17,153	18,811
Other adjustments	7,468	2,838
Changes in current operating items and other, net	(24,601)	(15,041)
Net cash provided by operating activities	17,779	24,251
Investing Activities:		
Property, plant and equipment additions, net	(18,025)	(10,776)
Net cash used for investing activities	(18,025)	(10,776)
Financing Activities:		
Payments of long-term debt	(402)	(505)
Payments on revolving credit facilities, net	(3,900)	(4,500)
Cash dividends paid	(4,891)	(3,551)
Net issuance of common stock, under stock option plans	799	96
Purchase of common stock	(614)	(335)
Net cash used for financing activities	(9,008)	(8,795)
(Decrease)/Increase in Cash and Cash Equivalents	(9,254)	4,680
Effect of Exchange Rates on Cash	(123)	106
Cash and Cash Equivalents:		
Beginning of period	22,974	8,774
End of period	$ 13,597	$ 13,560

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 millions, except per share data)
(Unaudited)

1. Basis of Presentation for Interim Financial Statements

The Consolidated Condensed Financial Statements included herein, except for the July 2, 2011 balance sheet, which was derived from the audited Consolidated Financial Statements for the fiscal year ended July 2, 2011, have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In our opinion, the accompanying unaudited Consolidated Condensed Financial Statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly our financial position as of December 31, 2011, and the results of our operations for the three and six months ended and our cash flows for the six months ended December 31, 2011 and January 1, 2011. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to such rules and regulations, although we believe that the disclosures herein are adequate to make the information presented not misleading. It is suggested that these Consolidated Condensed Financial Statements be read in conjunction with the Consolidated Financial Statements and the notes thereto included in our latest report on Form 10-K.

The results of operations for the three and six month periods ended December 31, 2011 and January 1, 2011 are not necessarily indicative of the results to be expected for the full year. We have evaluated subsequent events and have found none that require recognition or disclosure, except as discussed in Note 13, Employee Benefit Plans of the Notes to the Consolidated Condensed Financial Statements.

Critical accounting policies are defined as the most important and pervasive accounting policies used, areas most sensitive to material changes from external factors and those that are reflective of significant judgments and uncertainties. See Note 1, Summary of Significant Accounting Policies of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended July 2, 2011 for additional discussion of the application of these and other accounting policies.

Inventories

Inventories consist of new goods and rental merchandise in service. New goods are stated at the lower of first-in, first-out (FIFO) cost or market, net of any reserve for obsolete or excess inventory. Merchandise placed in service to support our rental operations is amortized into cost of rental operations over the estimated useful lives of the underlying inventory items, primarily on a straight-line basis, which results in a matching of the cost of the merchandise with the weekly rental revenue generated by the merchandise. Estimated lives of rental merchandise in service range from six months to three years. In establishing estimated lives for merchandise in service, management considers historical experience and the intended use of the merchandise.

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

Revenue Recognition

Our rental operations business is largely based on written service agreements whereby we agree to pick-up soiled merchandise, launder and then deliver clean uniforms and other related products. The service agreements generally provide for weekly billing upon completion of the laundering process and delivery to the customer. Accordingly, we recognize revenue from rental operations in the period in which the services are provided. Revenue from rental operations also includes billings to customers for lost or damaged uniforms and replacement fees for non-personalized merchandise that is lost or damaged. Direct sale revenue is recognized in the period in which the product is shipped. Total revenues do not include sales tax as we consider ourselves a pass-through conduit for collecting and remitting sales taxes.

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During the fourth quarter of fiscal year 2010, we changed our business practices regarding the replacement of certain in-service towel and linen inventory and accordingly, we modified our revenue recognition policy related to the associated replacement fees. This revenue, which had historically been deferred and amortized over the estimated useful life of the associated in-service inventory, is now recognized upon billing. For the three months ended January 1, 2011, the effect of this change increased revenue and income from operations by $1.9 million, net income by $1.1 million and basic and diluted earnings per common share by $0.06. For the six months ended January 1, 2011, the effect of this change increased revenue and income from operations by $5.9 million, net income by $3.7 million and basic and diluted earnings per common share by $0.20. There were no comparable amounts recognized in the three and six month periods ended December 31, 2011.

2. Contingent Liabilities

Environmental Matters

We are currently involved in several environmental-related proceedings by certain governmental agencies, which relate primarily to allegedly operating certain of our facilities in noncompliance with required permits. In addition to these proceedings, in the normal course of our business, we are subject to, among other things, periodic inspections by regulatory agencies. We continue to dedicate substantial operational and financial resources to environmental compliance, and we remain fully committed to operating in compliance with all environmental laws and regulations. As of December 31, 2011 and July 2, 2011, we had reserves of approximately $1.3 million and $1.4 million, respectively, related to various pending environmental-related matters. There was no expense for these matters for the three and six months ended December 31, 2011 and January 1, 2011.

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

3. New Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued updated accounting guidance to amend existing requirements for fair value measurements and disclosures. The guidance expands the disclosure requirements around fair value measurements categorized in Level 3 of the fair value hierarchy and requires disclosure of the level in the fair value hierarchy of items that are not measured at fair value but whose fair value must be disclosed. It also clarifies and expands upon existing requirements for fair value measurements of financial assets and liabilities as well as instruments classified in shareholders equity. The guidance is effective for our third quarter of fiscal 2012. We do not expect the adoption of this guidance to have a material impact on our Consolidated Financial Statements.

In June 2011, the FASB issued new guidance on the presentation of other comprehensive income. The new guidance eliminates the option to present components of other comprehensive income as part of the statement of changes in shareholders equity and requires an entity to present either one continuous statement of net income and other comprehensive income or in two separate, but consecutive, statements. This new guidance is effective for our first quarter of fiscal 2013, and is to be applied retrospectively. We do not expect the adoption of this guidance to have a material impact on our Consolidated Financial Statements.

In September 2011, the FASB issued new guidance with respect to the annual goodwill impairment test which adds a qualitative assessment that allows companies to determine whether they need to perform the two-step impairment test. The objective of the guidance is to simplify how companies test goodwill for impairment, and more specifically, to reduce the cost and complexity of performing the goodwill impairment test. The guidance may change how the goodwill impairment test is performed, but will not change the timing or measurement of goodwill impairments. The qualitative screen will be effective starting with our fiscal year 2013 with early adoption permitted.

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In September 2011, the FASB issued new guidance on disclosures surrounding multiemployer pension plans. The new guidance requires that employers provide additional separate disclosures for multiemployer pension plans and multiemployer other postretirement benefit plans. The additional quantitative and qualitative disclosures will provide users with more detailed information about an employer s involvement in multiemployer plans. This guidance will be effective for us starting June 30, 2012, with early adoption permitted and retrospective application required. We do not expect the adoption of this guidance to have a material impact on our Consolidated Financial Statements.

4. Fair Value Measurements

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

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

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

-quoted prices for similar assets or liabilities in active markets;
-quoted prices for identical or similar assets in non-active markets;
-inputs other than quoted prices that are observable for the asset or liability; and
-inputs that are derived principally from or corroborated by other observable market data.

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

We have not transferred any items between fair value levels during the first two quarters of fiscal years 2012 or 2011. In addition, we valued our level 2 assets and liabilities by reference to information provided by independent third parties for similar assets and liabilities in active markets.

The following tables summarize the assets and liabilities measured at fair value on a recurring basis as of December 31, 2011 and July 2, 2011:

	As of December 31, 2011 Fair Value Measurements Using Inputs Considered as		
	Level 1	Level 2	Total
Other assets:			
Non-qualified, non-contributory retirement plan assets	$	$ 10.2	$ 10.2
Non-qualified deferred compensation plan assets	21.5		21.5
Total assets	$ 21.5	$ 10.2	$ 31.7
Accrued expenses:			
Derivative financial instruments	$	$ 1.4	$ 1.4
Total liabilities	$	$ 1.4	$ 1.4

	As of July 2, 2011 Fair Value Measurements Using Inputs Considered as		
	Level 1	Level 2	Total
Other assets:			
Non-qualified, non-contributory retirement plan assets	$	$ 10.3	$ 10.3
Non-qualified deferred compensation plan assets	21.8		21.8
Total assets	$ 21.8	$ 10.3	$ 32.1
Accrued expenses:			
Derivative financial instruments	$	$ 2.1	$ 2.1
Total liabilities	$	$ 2.1	$ 2.1

The non-qualified, non-contributory retirement plan assets above consist primarily of the cash surrender value of life insurance policies and the non-qualified deferred compensation plan assets above consist primarily of various equity, fixed income and money market mutual funds.

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

5. Derivative Financial Instruments

All derivative financial instruments are recognized at fair value and are recorded in the Other current assets or Accrued expenses line items in the Consolidated Condensed Balance Sheets. The accounting for changes in the fair value of a derivative financial instrument depends on whether it has been designated and qualifies as a hedging relationship and on the type of the hedging relationship. For those derivative financial instruments that are designated and qualify as hedging instruments, we designate the hedging instrument (based on the exposure being hedged) as cash flow hedges. We do not have any derivative financial instruments that have been designated as either a fair value hedge or a hedge of a net investment in a foreign operation. Cash flows associated with derivative financial instruments are classified in the same category as the cash flows hedged in the Consolidated Condensed Statements of Cash Flows.

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

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

We use interest rate swap contracts to limit exposure to changes in interest rates and to manage the total debt that is subject to variable and fixed interest rates. The interest rate swap contracts we utilize modify our exposure to interest rate risk by converting variable rate debt to a fixed rate without an exchange of the underlying principal amount. Approximately 46% of our outstanding variable rate debt had its interest payments modified using interest rate swap contracts as of December 31, 2011.

As of December 31, 2011, none of our anticipated gasoline and diesel fuel purchases were hedged.

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

The following table summarizes the classification and fair value of the interest rate swap agreements, which have been designated as cash flow hedging instruments:

		Liability Derivatives Fair Value	
Relationship:	Balance Sheet Classification:	December 31, 2011	July 2, 2011
Interest rate swap contracts	Accrued expenses	$ 1.4	$ 2.1
Total derivatives designated as cash flow hedging instruments		$ 1.4	$ 2.1

As of December 31, 2011 and July 2, 2011, all derivative financial instruments were designated as hedging instruments.

For our interest rate swap contracts that qualify for cash flow hedge designation, the related gains or losses on the contracts are deferred as a component of accumulated other comprehensive income or loss (net of related income taxes) until the interest expense on the related debt is recognized. As the interest expense on the hedged debt is recognized, the other comprehensive income or loss is reclassified to the Interest expense line item in our Consolidated Condensed Statements of Operations. Of the $1.0 million net loss deferred in accumulated other comprehensive income as of December 31, 2011, a $0.6 million loss is expected to be reclassified to interest expense in the next twelve months.

As of December 31, 2011, we had interest rate swap contracts to pay fixed rates of interest and to receive variable rates of interest based on the three-month London Interbank Offered Rate (LIBOR) on $115.0 million notional amount, $75.0 million of which are forward starting interest rate swap contracts. Of the $115.0 million notional amount, $25.0 million matures in 12 months, $15.0 million matures in 13-24 months and $75.0 million matures in 37-48 months. The average rate on the $115.0 million of interest rate swap contracts was 2.2% as of December 31, 2011. These interest rate swap contracts are highly effective cash flow hedges and accordingly, gains or losses on any ineffectiveness were not material to any period.

The following tables summarize the amount of gain or loss recognized in accumulated other comprehensive income or loss and the classification and amount of gains or losses reclassified from accumulated other comprehensive income or loss into the Consolidated Condensed Statements of Operations for the three and six months ended December 31, 2011 and January 1, 2011 related to derivative financial instruments used in cash flow hedging relationships:

	Amount of Loss Recognized in Accumulated Other Comprehensive Income/(Loss)			
	Three Months Ended		Six Months Ended	
Relationship:	December 31, 2011	January 1, 2011	December 31, 2011	January 1, 2011
Interest rate swap contracts	$ (0.1)	$	$ (0.1)	$ (0.5)
Total derivatives designated as cash flow hedging instruments	$ (0.1)	$	$ (0.1)	$ (0.5)

Amount of Loss Reclassified From Accumulated Other Comprehensive Income/(Loss) to Consolidated

		Statements of Operations			
		Three Months Ended		Six Months Ended	
Relationship:	Statements of Operations Classification:	December 31, 2011	January 1, 2011	December 31, 2011	January 1, 2011
Interest rate swap contracts	Interest expense	$ (0.2)	$ (0.7)	$ (0.6)	$ (1.4)
Fuel commodity futures contracts	Cost of rental operations				(0.1)
Total derivatives designated as cash flow hedging instruments		$ (0.2)	$ (0.7)	$ (0.6)	$ (1.5)