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

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

F O R M 10 - Q

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

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

G&K SERVICES, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

YES þ NO o

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

YES þ NO o

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

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

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

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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED CONDENSED BALANCE SHEETS

G&K Services, Inc. and Subsidiaries

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

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

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

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

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

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

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

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

G&K SERVICES, INC. AND SUBSIDIARIES

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

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

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

1. Summary of Significant Accounting Policies

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

Nature of Business

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

Principles of Consolidation

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

Revenue Recognition

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

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Derivative Financial Instruments

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

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

Per Share Data

Basic earnings per common share was computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share was computed similar to the computation of basic earnings per share, except that the denominator is increased for the assumed exercise of dilutive options and other dilutive securities, including nonvested restricted stock, using the treasury stock method.

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

Stock-Based Compensation

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

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

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

Recent Accounting Pronouncements

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

2. Comprehensive Income

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

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

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

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3. Acquisitions

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

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

4. Goodwill and Intangible Assets

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

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

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

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

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

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

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

5. Long-Term Debt

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

6. Employee Benefit Plans

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

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

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

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

7. Segment Information

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

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

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

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For the Six Months Ended	United States	Canada	Total
Fiscal Year 2005:			
Revenues	$ 319,044	$ 58,523	$ 377,567
Income from operations	25,201	11,441	36,642
Property, plant and equipment additions, net	2,235	1,860	4,095
Depreciation and amortization expense	17,707	2,612	20,319
Fiscal Year 2004:			
Revenues	$ 312,967	$ 48,175	$ 361,142
Income from operations	24,382	8,982	33,364
Property, plant and equipment additions, net	7,471	901	8,372
Depreciation and amortization expense	17,298	2,165	19,463

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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 six months of fiscal 2005. All acquisitions were accounted for using the purchase method. 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 $47.1 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 $22.4 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 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 considers changes in the operating environment, competitive information, market trends, operating performance and cash flow modeling. Management completes its annual impairment test in the fourth quarter of each fiscal year and there have been no impairments of goodwill or definite-lived intangible assets in fiscal 2004 or through the first six months of fiscal 2005. 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 generate revenue. 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 six 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 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

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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.

Results of Operations

The percentage relationships to net sales of certain income and expense items for the three and six month periods ended January 1, 2005 and December 27, 2003, and the percentage changes in these income and expense items between periods are presented in the following table:

	Three Months Ended		**Six Months Ended**		**Percentage Change**	
	January 1, 2005	December 27, 2003	January 1, 2005	December 27, 2003	Three Months FY 2005 vs. FY 2004	Six Months FY 2005 vs. FY 2004
Revenues:						
Rental	93.8%	95.7%	95.2%	96.3%	4.9%	3.3%
Direct	6.2	4.3	4.8	3.7	51.9	37.2
Total revenues	100.0	100.0	100.0	100.0	6.9	4.5
Expenses:						
Cost of rental sales	63.6	63.6	63.3	63.5	4.8	3.0
Cost of direct sales	70.2	73.0	73.4	76.2	46.0	32.3
Total cost of sales	64.0	64.0	63.8	64.0	6.9	4.2
Selling and administrative	21.1	21.3	21.1	21.4	6.3	3.3
Depreciation and amortization	5.2	5.3	5.4	5.4	4.0	4.4
Income from operations	9.7	9.4	9.7	9.2	10.3	9.8
Interest expense	1.4	1.6	1.4	1.6	(10.0)	(14.8)
Income before income taxes	8.3	7.8	8.3	7.6	14.5	15.3
Provision for income taxes	3.1	3.0	3.1	2.9	12.2	13.4
Net income	5.2%	4.8%	5.2%	4.7%	15.8%	16.5%

Three months ended January 1, 2005 compared to three months ended December 27, 2003

Revenues. Total revenues in the second quarter of fiscal 2005 increased 6.9% to $195.1 million from $182.5 million in the second quarter of fiscal 2004. Rental revenue increased $8.5 million in the second quarter, or 4.9%. The organic industrial rental growth rate was approximately negative 1.0%, an improvement from negative 2.0% in the same period of fiscal 2004. Organic industrial rental revenue has improved due to improved economic conditions related to more stable employment levels, a better pricing environment and improvements in customer retention.

Direct sale revenue increased 51.9% to $12.0 million in the second quarter of fiscal 2005 compared to $7.9 million in the same period of fiscal 2004. The organic direct sale growth rate was approximately 17.0%. The increase in organic direct sale revenue was due primarily to the success of our annual outerwear promotion.

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.

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Cost of Rental and Direct Sale. Cost of rental operations increased 4.8% to $116.4 million in the second quarter of fiscal 2005 from $111.1 million in the same period of fiscal 2004. Gross margin from rental sales was 36.4% in the second quarter of both fiscal 2005 and fiscal 2004. Rental gross margins continue to be impacted by operational initiatives that resulted in lower merchandise costs, which were largely offset by higher energy costs.

Cost of direct sales increased 46.0% to $8.4 million in the second quarter of fiscal 2005 from $5.8 million in the same period of fiscal 2004. Gross margin from direct sales increased to 29.8% in the second quarter of fiscal 2005 from 27.0% in the second quarter of fiscal 2004. The increase in gross margin was primarily due to additional volume and margin associated with a recently acquired business.

Selling and Administrative. Selling and administrative expenses increased to $41.2 million in the second quarter of fiscal 2005 from $38.8 million in the same period of fiscal 2004. As a percentage of total revenues, selling and administrative expenses decreased to 21.1% in the second quarter of fiscal 2005 from 21.3% in the second quarter of fiscal 2004. The decrease as a percent of revenue is largely attributed to leverage on incremental revenue growth.

Depreciation and Amortization. Depreciation and amortization expense increased 4.0% to $10.2 million in the second quarter of fiscal 2005 from $9.8 million in the same period of fiscal 2004. As a percentage of total revenues, depreciation and amortization expense decreased to 5.2% in the second quarter of fiscal 2005 from 5.3% in the second quarter of fiscal 2004. Capital expenditures, excluding acquisition of businesses, were $4.7 million in the second quarter of fiscal 2005 compared to $4.8 million in the prior year s quarter.

Interest Expense. Interest expense was $2.6 million in the second quarter of fiscal 2005, down from $2.9 million in the same period of fiscal 2004. The decrease was due to lower debt levels associated with significant levels of cash flows and slightly lower interest rates.

Provision for Income Taxes. Our effective tax rate decreased to 37.3% in the second quarter of fiscal 2005 from 38.0% in the same period of fiscal 2004 largely due to decreases in Canadian statutory income tax rates.

Six months ended January 1, 2005 compared to six months ended December 27, 2003

Revenues. Total revenues for the first six months of fiscal 2005 increased 4.5% to $377.6 million from $361.1 million for the same period of fiscal 2004. Rental revenue increased $11.5 million in the first six months, or 3.3%. The organic industrial rental growth rate was approximately negative 1.5%. Organic industrial rental revenue continues to be negatively impacted by lost uniform wearers due to reduced employment levels within our existing customer base and more competitive pricing on both new accounts and account renewals.

Direct sale revenue increased 37.2% to $18.2 million in the first six months of fiscal 2005 compared to $13.2 million in the same period of fiscal 2004. The organic direct sale growth rate was approximately 16.0%. The increase is largely due to garment sales through our rental operations including our annual outerwear promotion.

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 3.0% to $227.4 million in the first six months of fiscal 2005 from $220.9 million in the same period of fiscal 2004. Gross margin from rental sales increased to 36.7% in the first six months of fiscal 2005 from 36.5% in the same period of fiscal 2004. The benefit of numerous operational initiatives that resulted in lower merchandise and processing costs were partially offset by higher energy costs.

Cost of direct sales increased 32.3% to $13.3 million in the first six months of fiscal 2005 from $10.1 million in the same period of fiscal 2004. Gross margin from direct sales increased to 26.6% in the first six months of fiscal 2005 from 23.8% in the same period of fiscal 2004. The increase in margins was primarily due to the increase in sales volume.

Selling and Administrative. Selling and administrative expenses increased 3.3% to $79.8 million in the first six months of fiscal 2005 from $77.3 million in the same period of fiscal 2004. As a percentage of total revenues, selling and administrative expenses decreased to 21.1% in the first six months of fiscal 2005 from 21.4% in the same period of fiscal 2004. The decrease as a percent of revenue was due to leverage on incremental revenue growth and a $0.3 million gain on sale of property, partially offset by increased costs in connection with the expansion of our new account sales team.

Depreciation and Amortization. Depreciation and amortization expense increased 4.4% to $20.3 million in the first six months of fiscal 2005 from $19.5 million in the same period of fiscal 2004. As a percentage of total revenues, depreciation and amortization expense remained constant at 5.4% in the first six months of both fiscal 2005 and fiscal 2004. Capital expenditures, excluding acquisition of businesses, were $4.1 million in the first six months of fiscal 2005 compared to $8.4 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 during the first quarter of fiscal 2005.

Interest Expense. Interest expense was $5.2 million in the first six months of fiscal 2005, down from $6.1 million in the same period of fiscal 2004. The decrease was due to lower debt levels associated with significant levels of cash flows and slightly lower interest rates.

Provision for Income Taxes. Our effective tax rate decreased to 37.4% in the first six 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 $29.4 million in the first six months of fiscal 2005 and $52.9 million in the same period of fiscal 2004. Operating cash flow was down from the prior year primarily due to the timing of cash payments for income taxes, an increase in new inventory in connection with our expansion of our manufacturing operation and one-time improvements in the prior year related to a focus on timely collection of accounts receivable.

Working capital at January 1, 2005 was $83.7 million, up 5.9% 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 $40.1 million in the first six months of fiscal 2005 and $15.5 million in the same period of fiscal 2004. In fiscal 2005, cash was largely used for acquisitions of business assets with capital expenditures being largely 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 property, plant and equipment additions.

Financing Activities. Cash used for financing activities was $6.8 million in the first six months of fiscal 2005 and $31.8 million in the same period of fiscal 2004. Cash used in both fiscal 2005 and 2004 was primarily related to the repayment of long-term debt. The Company paid dividends of $0.7 million during the first six 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 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 January 1, 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.

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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 January 1, 2005 for the fiscal years ending June (in thousands):

	2005 Remaining	2006	2007	2008	2009	2010 and There-after	Total
Variable rate term loan and revolving credit facility	$ 7,500	$ 18,750	$ 22,500	$ 107,000	$	$	$ 155,750
Fixed rate term loan		7,143	7,143	7,143	7,143	14,285	42,857
Other debt arrangements, including capital leases	680	530	11,958				13,168
Operating leases	7,501	10,814	9,537	7,284	4,612	5,282	45,030
Total contractual cash obligations	$ 15,681	$ 37,237	$ 51,138	$ 121,427	$ 11,755	$ 19,567	$ 256,805

Also, at January 1, 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 January 1, 2005, we had available cash on hand of $11.0 million and over $164.4 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 $1.0 million in the second 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. 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

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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 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.

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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 second quarter of fiscal 2005 by approximately $0.2 million. This estimated exposure considers the mitigating effects of interest rate swap agreements outstanding at January 1, 2005 on the change in the cost of variable rate debt.

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.

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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 January 1, 2005.

Period	Total Number of Shares (or Units) Purchased (1)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet be Purchased Under the Plans or Programs
Month #1 (Fiscal month ending November 6, 2004)	324	$ 0.50		
Month #2 (Fiscal month ending December 4, 2004)				
Month #3 (Fiscal month ending January 1, 2005)	2,574	$ 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

a. The Company held its Annual Meeting of Shareholders on November 11, 2004.

b. The following two persons were elected as Class III directors: John S. Bronson and Wayne M. Fortun. The following six persons comprise the other directors whose terms of office continued after the Annual Meeting of Shareholders: Michael G. Allen, Paul Baszucki, Richard M. Fink, Richard L. Marcantonio, M. Lenny Pippin and Alice M. Richter.

c. 1. Each director nominee received the following votes:

	Shares	
	In Favor	Withhold Authority
Mr. Bronson	31,861,254	300,390
Mr. Fortun	30,865,637	1,296,007

2. Shareholders ratified the appointment of Ernst & Young LLP, Independent Registered Public Accounting Firm, as independent auditors of the Company for 2005: 30,739,115 shares in favor, 1,412,985 shares voting against and 9,544 shares abstaining.

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

10.1 Loan Agreement dated November 17, 2004 among G&K Services, Inc., and its subsidiaries, Three Pillars Funding LLC and SunTrust Capital Markets, Inc.

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 November 12, 2004.

A Form 8-K, Item 1.01 Entry Into a Material Definitive Agreement and Item 2.03 Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant was filed on November 19, 2004.

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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: February 8, 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)