

G&K SERVICES INC
Form 10-Q
February 01, 2013
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 29, 2012

Commission file number 0-4063

G&K SERVICES, INC.

(Exact name of registrant as specified in its charter)

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

MINNESOTA
(State or other jurisdiction of
incorporation or organization)

41-0449530
(I.R.S. Employer
Identification No.)

5995 OPUS PARKWAY

MINNETONKA, MINNESOTA 55343

(Address of principal executive offices and zip code)

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

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer (do not check if a smaller reporting company) Smaller reporting company

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

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

Common Stock, par value \$0.50 per share, outstanding

January 28, 2013 was 19,224,634 shares

Table of Contents

G&K Services, Inc.

Form 10-Q

Table of Contents

	PAGE
<u>PART I</u>	
<u>Item 1. Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets as of December 29, 2012 and June 30, 2012</u>	3
<u>Condensed Consolidated Statements of Operations for the three and six months ended December 29, 2012 and December 31, 2011</u>	4
<u>Condensed Consolidated Statements of Comprehensive Income for the three and six months ended December 29, 2012 and December 31, 2011</u>	5
<u>Condensed Consolidated Statements of Cash Flows for the six months ended December 29, 2012 and December 31, 2011</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
<u>Item 3. Quantitative and Qualitative Disclosure About Market Risk</u>	24
<u>Item 4. Controls and Procedures</u>	25
<u>PART II</u>	
<u>Item 1. Legal Proceedings</u>	25
<u>Item 1A. Risk Factors</u>	26
<u>Item 4. Mine Safety Disclosures</u>	26
<u>Item 6. Exhibits</u>	26
<u>Signatures</u>	27

Table of Contents**PART I****FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CONDENSED CONSOLIDATED BALANCE SHEETS***G&K Services, Inc. and Subsidiaries*

(In thousands)	December 29, 2012 (Unaudited)	June 30, 2012
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 23,715	\$ 19,604
Accounts receivable, less allowance for doubtful accounts of \$3,473 and \$2,666	98,636	93,064
Inventories, net	174,441	178,226
Other current assets	11,621	12,239
Total current assets	308,413	303,133
Property, Plant and Equipment, net	195,387	187,840
Goodwill	336,746	325,336
Other Assets	61,516	57,422
Total assets	\$ 902,062	\$ 873,731
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	\$ 37,565	\$ 41,358
Accrued expenses	65,232	69,902
Deferred income taxes	8,735	8,439
Current maturities of long-term debt	23,815	206
Total current liabilities	135,347	119,905
Long-Term Debt, net of Current Maturities	196,500	218,018
Deferred Income Taxes	14,321	5,473
Accrued Income Taxes	11,478	11,339
Pension Withdrawal Liability	23,550	23,562
Other Noncurrent Liabilities	91,385	92,375
Total liabilities	472,581	470,672
Stockholders Equity		
Common stock, \$0.50 par value	9,592	9,450
Additional paid-in capital	27,921	20,447
Retained earnings	388,934	371,267
Accumulated other comprehensive income	3,034	1,895
Total stockholders equity	429,481	403,059

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

Total liabilities and stockholders' equity	\$ 902,062	\$ 873,731
--	------------	------------

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

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

(Unaudited)

(In thousands, except per share data)	For the Three Months Ended		For the Six Months Ended	
	December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011
Revenues				
Rental operations	\$ 207,852	\$ 196,832	\$ 411,311	\$ 390,833
Direct sales	21,322	20,232	40,291	35,954
Total revenues	229,174	217,064	451,602	426,787
Operating Expenses				
Cost of rental operations	141,768	136,350	280,440	269,937
Cost of direct sales	15,554	16,252	29,887	28,167
Selling and administrative	48,996	47,508	98,871	96,254
Total operating expenses	206,318	200,110	409,198	394,358
Income from Operations	22,856	16,954	42,404	32,429
Interest expense	1,111	1,607	2,147	3,260
Income before Income Taxes	21,745	15,347	40,257	29,169
Provision for income taxes	8,524	5,881	15,142	11,410
Net Income	\$ 13,221	\$ 9,466	\$ 25,115	\$ 17,759
Basic Earnings per Common Share	\$ 0.69	\$ 0.51	\$ 1.32	\$ 0.96
Diluted Earnings per Common Share	\$ 0.68	\$ 0.51	\$ 1.30	\$ 0.95
Weighted average number of shares outstanding, basic	18,841	18,493	18,761	18,462
Weighted average number of shares outstanding, diluted	19,099	18,660	19,024	18,635
Dividends declared per share	\$ 0.195	\$ 0.130	\$ 0.390	\$ 0.260

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

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

(Unaudited)

(In thousands)	For the Three Months Ended		For the Six Months Ended	
	December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011
Net income	\$ 13,221	\$ 9,466	\$ 25,115	\$ 17,759
Other comprehensive income (loss), net of tax				
Foreign currency translation adjustments	(1,489)	2,708	(306)	(6,617)
Pension benefit liabilities	581		1,162	
Derivative financial instruments gain (loss) recognized	403	(71)	130	(71)
Derivative financial instruments loss reclassified	73	231	153	596
Total other comprehensive income (loss), net of tax	(432)	2,868	1,139	(6,092)
Total comprehensive income	\$ 12,789	\$ 12,334	\$ 26,254	\$ 11,667

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

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

(Unaudited)

(In thousands)	For the Six Months Ended	
	December 29, 2012	December 31, 2011
Operating Activities:		
Net income	\$ 25,115	\$ 17,759
Adjustments to reconcile net income to net cash provided by operating activities -		
Depreciation and amortization	16,066	17,153
Deferred income taxes	5,588	5,257
Share-based compensation	2,673	2,128
Changes in current operating items, exclusive of acquisitions		
Accounts receivable and prepaid expenses	(3,512)	(3,679)
Inventories	6,038	(13,312)
Accounts payable and other accrued expenses	(9,341)	(1,011)
Other	(1,786)	(6,516)
Net cash provided by operating activities	40,841	17,779
Investing Activities:		
Property, plant and equipment additions, net	(17,952)	(18,025)
Acquisition of business, net of cash	(18,663)	
Net cash used for investing activities	(36,615)	(18,025)
Financing Activities:		
Payments of long-term debt	(184)	(402)
Proceeds from (Payments on) revolving credit facilities, net	2,275	(3,900)
Cash dividends paid	(7,447)	(4,891)
Net issuance of common stock, under stock option plans	5,677	799
Purchase of common stock	(734)	(614)
Net cash used for financing activities	(413)	(9,008)
Increase (Decrease) in Cash and Cash Equivalents	3,813	(9,254)
Effect of Exchange Rates on Cash	298	(123)
Cash and Cash Equivalents:		
Beginning of period	19,604	22,974
End of period	\$ 23,715	\$ 13,597

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

Table of Contents

G&K SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in millions, except per share data)

(Unaudited)

1. Basis of Presentation for Interim Financial Statements

The Condensed Consolidated Financial Statements of G&K Services, Inc. (the Company or G&K) as set forth in this quarterly report have been prepared pursuant to the rules and regulations of the U. S. Securities and Exchange Commission for interim reporting. As permitted under those rules, certain footnotes and other financial information that are normally required by accounting principles generally accepted in the United States can be condensed or omitted. Our accounting policies are described in the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2012 (fiscal 2012). Management is responsible for the unaudited Condensed Consolidated Financial Statements included in this document. The Condensed Consolidated Financial Statements included in this document are unaudited but, in the opinion of management, include all adjustments (consisting of only normal recurring adjustments) necessary for a fair presentation of our financial position as of December 29, 2012, and the results of our operations for the three and six months ended December 29, 2012 and December 31, 2011 and our cash flows for the six months ended December 29, 2012 and December 31, 2011.

The results of operations for the three and six month periods ended December 29, 2012 and December 31, 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.

This Quarterly Report on Form 10-Q should be read in conjunction with our Consolidated Financial Statements and notes included in our fiscal 2012 Annual Report on Form 10-K.

2. Contingent Liabilities

Environmental Matters

We are currently involved in several environmental-related proceedings by certain governmental agencies, which relate primarily to allegedly operating certain facilities in noncompliance with required permits. In addition to these proceedings, in the normal course of our business, we are subject to, among other things, periodic inspections by regulatory agencies, and we are involved in the remediation of various properties which we own. 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 29, 2012 and June 30, 2012, we had reserves of approximately \$1.5 million and \$1.2 million, respectively, related to various pending environmental-related matters. There was approximately \$0.5 million of expense for these matters for the three and six months ended December 29, 2012, respectively. There was no expense for these matters for the three and six month periods ended December 31, 2011.

Legal Matters

Recently, the United States Office of Federal Contract Compliance Programs, or OFCCP, has, as part of routine audits, commenced a review of certain of our employment practices. The OFCCP has issued a Notice of Violation to one of our facilities and audits of four other facilities, where the OFCCP claims there are similar alleged violations, are ongoing. We have been engaged in conversations with the OFCCP and believe that our practices are lawful and without bias. Currently, no proceeding with respect to this matter has been commenced, and, in any event, we do not believe that any resolution of this matter will have a material adverse effect on our results of operations or financial position.

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.

Table of Contents**3. New Accounting Pronouncements**

In June 2011, the Financial Accounting Standards Board 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. We adopted this guidance in the first quarter of fiscal 2013. Refer to the Condensed Consolidated Statements of Comprehensive Income.

4. Fair Value Measurements

Generally accepted accounting principles (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 do not have any level 3 assets or liabilities and we have not transferred any items between fair value levels during the first two quarters of fiscal years 2012 or 2013.

The following tables summarize the assets and liabilities measured at fair value on a recurring basis as of December 29, 2012 and June 30, 2012:

	As of December 29, 2012		
	Level 1	Level 2	Total
Other assets:			
Money market mutual funds	\$ 3.1	\$	\$ 3.1
Equity and fixed income mutual funds	21.6		21.6
Cash surrender value of life insurance policies		13.3	13.3
Derivative financial instruments		0.6	0.6
Total assets	\$ 24.7	\$ 13.9	\$ 38.6
Accrued expenses:			
Derivative financial instruments	\$	\$ 1.6	\$ 1.6
Total liabilities	\$	\$ 1.6	\$ 1.6

Table of Contents

	As of June 30, 2012		
	Fair Value Level 1	Measurements Using Level 2	Inputs Considered as Total
Other assets:			
Money market mutual funds	\$ 3.2	\$	\$ 3.2
Equity and fixed income mutual funds	18.9		18.9
Cash surrender value of life insurance policies		13.0	13.0
Derivative financial instruments			
Total assets	\$ 22.1	\$ 13.0	\$ 35.1
Accrued expenses:			
Derivative financial instruments	\$	\$ 1.4	\$ 1.4
Total liabilities	\$	\$ 1.4	\$ 1.4

The cash surrender value of life insurance policies are primarily investments established to fund the obligations of the company's non-qualified, non-contributory retirement plan. The money market, equity and fixed income mutual funds are investments established to fund the obligations of the company's non-qualified deferred compensation plan.

The following tables summarize the fair values of assets and liabilities that are recorded at historical cost as of December 29, 2012 and June 30, 2012:

	As of December 29, 2012		
	Fair Value Level 1	Measurements Using Level 2	Inputs Considered as Total
Cash and cash equivalents	\$ 23.7	\$	\$ 23.7
Total assets	\$ 23.7	\$	\$ 23.7
Current maturities of long-term debt	\$	\$ 23.8	\$ 23.8
Long-term debt, net of current maturities		196.5	196.5
Total liabilities	\$	\$ 220.3	\$ 220.3

	As of June 30, 2012		
	Fair Value Level 1	Measurements Using Level 2	Inputs Considered as Total
Cash and cash equivalents	\$ 19.6	\$	\$ 19.6
Total assets	\$ 19.6	\$	\$ 19.6
Current maturities of long-term debt	\$	\$ 0.2	\$ 0.2
Long-term debt, net of current maturities		218.0	218.0
Total liabilities	\$	\$ 218.2	\$ 218.2

The fair value of our long-term debt approximates its book value and is based on the amount that would be paid to transfer the liability to a credit-equivalent market participant at the measurement date.

5. Derivative Financial Instruments

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

In the ordinary course of business, we are exposed to market risks. We utilize derivative financial instruments to manage interest rate risk and 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 or by locking in the benchmark interest rate on forecasted issuances of fixed rate debt without an exchange of the underlying principal amount. We designate interest rate swap contracts as cash flow hedges of the interest expense related to variable and fixed rate debt.

Table of Contents

All derivative financial instruments are recognized at fair value and are recorded in the Other current assets or Accrued expenses line items in the Condensed Consolidated Balance Sheets.

For derivative financial instruments that are designated and qualify as cash flow hedges, the effective portion of the change in fair value on the derivative financial instrument is reported as a component of Accumulated other comprehensive income and reclassified into the Interest expense line item in the Condensed Consolidated Statements of Operations 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 do not have any derivative financial instruments that have been designated as either a fair value hedge, a hedge of a net investment in a foreign operation, or that are held for trading or speculative purposes. Cash flows associated with derivative financial instruments are classified in the same category as the cash flows hedged in the Condensed Consolidated Statements of Cash Flows.

Approximately 6.8% of our outstanding variable rate debt had its interest payments modified using interest rate swap contracts at December 29, 2012.

As of December 29, 2012 and June 30, 2012, we had \$1.6 million and \$1.4 million, respectively, of liabilities on interest rate swap contracts that are classified as Accrued expenses in the Condensed Consolidated Balance Sheets and \$0.6 million and \$0.0 million, respectively, of assets on interest rate swaps that are classified as Other assets in the Condensed Consolidated Balance Sheets. Of the \$0.6 million net loss deferred in accumulated other comprehensive income as of December 29, 2012, a \$0.4 million net loss is expected to be reclassified to interest expense in the next twelve months.

As of December 29, 2012 and June 30, 2012, all derivative financial instruments were designated as hedging instruments.

As of December 29, 2012, 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 \$160.0 million notional amount, \$145.0 million of which are forward starting interest rate swap contracts. Of the \$160.0 million notional amount, \$15.0 million matures in the next 12 months, \$75.0 million matures in 25-36 months and \$70.0 million matures after 60 months. The average rate on the \$160.0 million of interest rate swap contracts was 1.73% as of December 29, 2012. 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 Condensed Consolidated Statements of Operations for the three and six months ended December 29, 2012 and December 31, 2011 related to derivative financial instruments used in cash flow hedging relationships:

Relationship:	Amount of Gain (Loss) Recognized in Accumulated Other Comprehensive Income (Loss)			
	Three Months Ended		Six Months Ended	
	December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011
Interest rate swap contracts	\$ 0.4	\$ (0.1)	\$ 0.1	\$ (0.1)
Total derivatives designated as cash flow hedging instruments	\$ 0.4	\$ (0.1)	\$ 0.1	\$ (0.1)

Table of Contents

Relationship:	Statement of Operations Classification:	Amount of Loss Reclassified From Accumulated Other Comprehensive Income (Loss) to Consolidated Statements of Operations			
		Three Months Ended		Six Months Ended	
		December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011
Interest rate swap contracts	Interest expense	\$ (0.1)	\$ (0.2)	\$ (0.2)	\$ (0.6)
Total derivatives designated as cash flow hedging instruments		\$ (0.1)	\$ (0.2)	\$ (0.2)	\$ (0.6)

6. Income Taxes

Our effective tax rate decreased to 37.6% in the six months ended December 29, 2012 from 39.1% in the six months ended December 31, 2011. The tax rate for the prior period was higher than the current period primarily due to the write-off of deferred tax assets associated with equity compensation in the prior period and a decrease in reserves for uncertain tax positions due to resolution of a tax contingency during the current period.

7. Earnings Per Share

Accounting Standards Codification (ASC) 260-10-45, Participating Securities and the Two-Class Method (ASC 260-10-45), addresses whether awards granted in invested share-based payment transactions that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and therefore are included in computing earnings per share under the two-class method. Participating securities are securities that may participate in dividends with common stock and the two-class method is an earnings allocation formula that treats a participating security as having rights to earnings that would otherwise have been available to common shareholders. Under the two-class method, earnings for the period are allocated between common shareholders and other shareholders, based on their respective rights to receive dividends. Certain restricted stock awards granted under our Equity Plans are considered participating securities as these awards receive non-forfeitable dividends at the same rate as common stock.

The computations of our basic and diluted earnings per share are set forth below:

	Three Months Ended		Six Months Ended	
	December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011
Basic earnings per share:				
Net income	\$ 13.2	\$ 9.5	\$ 25.1	\$ 17.8
Less: Income allocable to participating securities	(0.2)		(0.4)	
Earnings available to common stockholders	\$ 13.0	\$ 9.5	\$ 24.7	\$ 17.8
Weighted average shares outstanding, basic	18.8	18.5	18.8	18.5
Earnings per share, basic	\$ 0.69	\$ 0.51	\$ 1.32	\$ 0.96
Diluted earnings per share:				
Earnings available to common stockholders	\$ 13.0	\$ 9.5	\$ 24.7	\$ 17.8
Weighted average shares outstanding, basic	18.8	18.5	18.8	18.5
Weighted average effect of non-vested restricted stock grants and assumed exercise of stock options	0.3	0.2	0.2	0.1
Weighted average shares outstanding, diluted	19.1	18.7	19.0	18.6
Earnings per share, diluted	\$ 0.68	\$ 0.51	\$ 1.30	\$ 0.95

Table of Contents

We excluded potential common shares related to our outstanding equity compensation grants of 0.6 million and 1.3 million for the three months ended December 29, 2012 and December 31, 2011, respectively, and 0.5 million and 1.3 million for the six months ended December 29, 2012 and December 31, 2011, respectively, from the computation of diluted earnings per share. Inclusion of these shares would have been anti-dilutive.

8. Inventories

The components of inventory as of December 29, 2012 and June 30, 2012 are as follows:

	December 29, 2012	June 30, 2012
Raw Materials	\$ 12.4	\$ 14.8
Work in Process	1.7	1.6
Finished Goods	56.4	57.9
New Goods	70.5	74.3
Merchandise in Service	103.9	103.9
Total Inventories	\$ 174.4	\$ 178.2

9. Goodwill and Intangible Assets

Goodwill by segment is as follows:

	United States	Canada	Total
Balance as of June 30, 2012	\$ 259.3	\$ 66.0	\$ 325.3
Acquisitions	10.0		10.0
Foreign currency translation and other	(0.1)	1.5	1.4
Balance as of December 29, 2012	\$ 269.2	\$ 67.5	\$ 336.7

The goodwill within the United States segment has been reduced by \$107.0 million of accumulated impairment losses. There were no impairment losses recorded in the three and six month periods ended December 29, 2012 and December 31, 2011.

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

	December 29, 2012	June 30, 2012
Customer contracts	\$ 118.1	\$ 114.9
Accumulated amortization	(105.0)	(102.5)
Net Customer Contracts	\$ 13.1	\$ 12.4

The customer contracts include the combined value of the written service agreements and the related customer relationship. Customer contracts are amortized over a weighted average life of approximately 12 years.

Amortization expense was \$2.2 million and \$2.5 million for the six months ended December 29, 2012 and December 31, 2011, respectively. Estimated amortization expense for each of the next five fiscal years based on the intangible assets as of December 29, 2012 is as follows:

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

2013 remaining	\$ 1.8
2014	2.9
2015	2.2
2016	1.6
2017	1.4
2018	0.6

Table of Contents**10. Long-Term Debt**

Debt as of December 29, 2012 and June 30, 2012 includes the following:

	December 29, 2012	June 30, 2012
Borrowings under unsecured revolving credit facility	\$ 121.5	\$ 114.4
Borrowings under unsecured variable rate notes	75.0	75.0
Borrowings under secured variable rate loans	23.8	28.6
Other debt arrangements including capital leases		0.2
	220.3	218.2
Less current maturities	(23.8)	(0.2)
Total long-term debt	\$ 196.5	\$ 218.0

We have a \$250.0 million, five-year unsecured revolving credit facility with a syndicate of banks, which expires on March 7, 2017. Borrowings in U.S. dollars under this credit facility, at our election, bear interest at (a) adjusted LIBOR for specified interest periods plus a margin, which can range from 1.00% to 2.00%, determined with reference to our consolidated leverage ratio or (b) a floating rate equal to the greatest of (i) JPMorgan's prime rate, (ii) the federal funds rate plus 0.50% and (iii) the adjusted LIBOR for a one month interest period plus 1.00%, plus, in each case, a margin determined with reference to our consolidated leverage ratio. Base rate loans will, at our election, bear interest at (i) the rate described in clause (b) above or (ii) a rate to be agreed upon by us and JPMorgan. Borrowings in Canadian dollars under the credit facility will bear interest at (a) the Canadian deposit offered rate plus 0.10% for specified interest periods plus a margin determined with reference to our consolidated leverage ratio or (b) a floating rate equal to the greater of (i) the Canadian prime rate and (ii) the Canadian deposit offered rate for a one month interest period plus 1.00%, plus, in each case, a margin determined with reference to our consolidated leverage ratio.

As of December 29, 2012, borrowings outstanding under the revolving credit facility were \$121.5 million. The unused portion of the revolver may be used for general corporate purposes, acquisitions, share repurchases, dividends, working capital needs and to provide up to \$50.0 million in letters of credit. As of December 29, 2012, letters of credit outstanding against the revolver totaled \$0.6 million and primarily related to our property and casualty insurance programs. No amounts have been drawn upon these letters of credit. Availability of credit under this facility requires that we maintain compliance with certain covenants.

The covenants under this agreement are the most restrictive when compared to our other credit facilities. The following table illustrates compliance with regard to the material covenants required by the terms of this facility as of December 29, 2012:

	Required	Actual
Maximum Leverage Ratio (Debt/EBITDA)	3.50	2.14
Minimum Interest Coverage Ratio (EBITDA/Interest Expense)	3.00	23.23
Minimum Net Worth	\$ 379.6	\$ 429.5

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

Advances outstanding as of December 29, 2012 bear interest at a weighted average all-in rate of 1.74%. We also pay a fee on the unused daily balance of the revolving credit facility based on a leverage ratio calculated on a quarterly basis. At December 29, 2012 this fee was 0.25% of the unused daily balance.

We have \$75.0 million of variable rate unsecured private placement notes. The notes bear interest at 0.60% over LIBOR and are scheduled to mature on June 30, 2015. The notes do not require principal payments until maturity. Interest payments are reset and paid on a quarterly basis. As of December 29, 2012, the outstanding balance of the notes was \$75.0 million at an all-in rate of 0.96%.

Table of Contents

We maintain a \$50.0 million accounts receivable securitization facility, which expires on September 27, 2013. Under the terms of the facility, we pay interest at a rate per annum equal to a margin of 0.76%, plus LIBOR. The facility is subject to customary fees for the issuance of letters of credit and any unused portion of the facility. As is customary with transactions of this nature, our eligible accounts receivable are sold to a consolidated subsidiary. As of December 29, 2012, there was \$23.8 million outstanding under this loan agreement at an all-in interest rate of 0.97% and \$26.2 million of letters of credit were outstanding, primarily related to our property and casualty insurance programs.

See Note 5, *Derivative Financial Instruments* of the Notes to the Condensed Consolidated Financial Statements for details of our interest rate swap and hedging activities related to our outstanding debt.

11. Share-Based Compensation

We grant share-based awards, including restricted stock and options to purchase our common stock. Stock options are granted to employees and directors for a fixed number of shares with an exercise price equal to the fair value of the shares at the date of grant. Share-based compensation is recognized in the Condensed Consolidated Statements of Operations on a straight-line basis over the requisite service period. The amortization of share-based compensation reflects estimated forfeitures adjusted for actual forfeiture experience. Forfeiture rates are reviewed on an annual basis. As share-based compensation expense is recognized, a deferred tax asset is recorded that represents an estimate of the future tax deduction from the exercise of stock options or release of restrictions on the restricted stock. At the time share-based awards are exercised, cancelled, expire or restrictions lapse, we recognize adjustments to income tax expense. Total compensation expense related to share-based awards was \$1.1 million and \$0.9 million for the three months ended December 29, 2012 and December 31, 2011 and \$2.7 million and \$2.1 million for the six months ended December 29, 2012 and December 31, 2011, respectively. The number of options exercised and restricted stock vested since June 30, 2012, was 0.3 million shares.

On August 23, 2012, our Chief Executive Officer was granted a performance based restricted stock award (the *Performance Award*). The Performance Award has both a financial performance component and a service component. The Performance Award has a target level of 100,000 restricted shares, a maximum award of 150,000 restricted shares and a minimum award of 50,000 restricted shares, subject to attainment of financial performance goals and service conditions. Since the company has not yet achieved the threshold performance amount, none of these shares are considered outstanding in the diluted earnings per share calculation as of December 29, 2012.

12. Employee Benefit Plans**Defined Benefit Pension Plan**

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

The components of net periodic pension cost for these plans for the three months ended December 29, 2012 and December 31, 2011 are as follows:

	Pension Plan Three Months Ended		Supplemental Executive Retirement Plan Three Months Ended	
	December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011
Interest cost	\$ 0.9	\$ 0.9	\$ 0.1	\$ 0.2
Expected return on assets	(1.1)	(1.0)		
Amortization of net loss	0.9	0.4	0.1	
Net periodic pension cost	\$ 0.7	\$ 0.3	\$ 0.2	\$ 0.2

Table of Contents

The components of net periodic pension cost for these plans for the six months ended December 29, 2012 and December 31, 2011 are as follows:

	Pension Plan		Supplemental Executive Retirement Plan	
	Six Months Ended		Six Months Ended	
	December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011
Interest cost	\$ 1.8	\$ 1.9	\$ 0.3	\$ 0.4
Expected return on assets	(2.1)	(2.0)		
Amortization of net loss	1.7	0.8	0.2	
Net periodic pension cost	\$ 1.4	\$ 0.7	\$ 0.5	\$ 0.4

During fiscal year 2013, we contributed approximately \$3.5 million to the pension plan.

Multi-Employer Pension Plans

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

Central States MEPP

In the third quarter of fiscal year 2012, we concluded negotiations with a union to discontinue our participation in the Central States Southeast and Southwest Areas Pension Fund (Central States MEPP) for two of our locations. In addition, we also closed two redundant branch facilities that participated in the Central States MEPP. In the first quarter of fiscal 2013, we successfully concluded negotiations to discontinue participation at two additional locations. We continue to participate in the Central States MEPP at one remaining location, although, subject to our good faith bargaining obligations, we believe it is probable that we will also withdraw from the Central States MEPP at this location, thus completely discontinuing our participation in the Central States MEPP.

Employer s accounting for MEPPs (ASC 715-80) provides that a withdrawal liability should be recorded if circumstances that give rise to an obligation become probable and estimable. As a result of the actions noted above, in the third quarter of fiscal year 2012, we recorded a pre-tax charge of \$24.0 million. This charge included the estimated discounted actuarial value of the total withdrawal liability, incentives for union participants and other related costs that had been incurred. We expect to pay the withdrawal liability over a period of 20 years. The amount of the withdrawal liability recorded is based on the best information available and is subject to change based on revised MEPP information received periodically from the union sponsors, the discount rate used to calculate the liability, and other factors. These potential changes could have a material impact on our results of operations and financial condition.

Other MEPPs

A partial or full withdrawal from a MEPP may be triggered by circumstances beyond our control. As evidenced by the negotiations above, we could also trigger the liability by successfully negotiating with a union to discontinue participation in the MEPP. If a future withdrawal from a plan occurs, we will record our proportional share of any unfunded vested benefits in the period in which the withdrawal occurs.

The ultimate amount of the withdrawal liability assessed by the MEPPs is impacted by a number of factors, including, among other things, investment returns, benefit levels, interest rates, financial difficulty of other participating employers in the plan and our continued participation with other employers in the MEPPs, each of which could impact the ultimate withdrawal liability.

We continue to actively participate in several other MEPPs, for which we have not recorded a withdrawal liability. Based upon the most recent plan data available from the trustees managing these MEPPs, our share of the undiscounted, unfunded vested benefits for these MEPPs is estimated to be \$3.0 million to \$4.0 million as of December 29, 2012.

Table of Contents**13. Segment Information**

We have two operating segments, United States (includes the Dominican Republic and Ireland operations) and Canada, which have been identified as components of our organization that are reviewed by our Chief Executive Officer to determine resource allocation and evaluate performance. Each operating segment derives revenues from the branded uniform and facility services programs. During the three and six months ended December 29, 2012, and for the same periods of the prior fiscal year, no single customer's transactions accounted for more than 2.0% of our total revenues. Substantially all of our customers are in the United States and Canada.

The income from operations for each segment includes the impact of an intercompany management fee assessed by the United States segment to the Canada segment and is self-eliminated in the total income from operations below. This intercompany management fee was approximately \$1.9 million and \$2.0 million for the three months ended December 29, 2012 and December 31, 2011, respectively and \$3.8 million and \$4.0 million for the six months ended December 29, 2012 and December 31, 2011, respectively.

We evaluate performance based on income from operations. Financial information by segment for the three and six month periods ended December 29, 2012 and December 31, 2011 is as follows:

For the Three Months Ended	United States	Canada	Elimination	Total
Second Quarter Fiscal Year 2013:				
Revenues	\$ 189.0	\$ 40.2	\$	\$ 229.2
Income from operations	18.1	4.8		22.9
Total assets	830.4	159.6	(87.9)	902.1
Depreciation and amortization expense	6.7	1.3		8.0
Second Quarter Fiscal Year 2012:				
Revenues	\$ 179.5	\$ 37.6	\$	\$ 217.1
Income from operations	12.9	4.1		17.0
Total assets	796.4	143.9	(80.1)	860.2
Depreciation and amortization expense	7.1	1.3		8.4

For the Six Months Ended	United States	Canada	Elimination	Total
Fiscal Year 2013:				
Revenues	\$ 374.4	\$ 77.2	\$	\$ 451.6
Income from operations	34.3	8.1		42.4
Total assets	830.4	159.6	(87.9)	902.1
Depreciation and amortization expense	13.5	2.6		16.1
Fiscal Year 2012:				
Revenues	\$ 353.0	\$ 73.8	\$	\$ 426.8
Income from operations	25.4	7.0		32.4
Total assets	796.4	143.9	(80.1)	860.2
Depreciation and amortization expense	14.6	2.6		17.2

14. Share Repurchase

As of December 29, 2012, we have a \$175.0 million share repurchase program which was originally authorized by our Board of Directors in May 2007 for \$100.0 million and increased to \$175.0 million in May 2008. We had no repurchases for the three and six months ended December 29, 2012 and December 31, 2011. As of December 29, 2012, we had approximately \$57.9 million remaining under this authorization.

Table of Contents**15. Acquisitions**

In the second quarter of fiscal 2013, we completed an acquisition in our rental operations business. The results of the acquired business have been included in our Condensed Consolidated Financial Statements since the date of acquisition. The acquisition extends our rental operations footprint into five of the top 100 North American markets which we did not previously serve. The acquisition-date fair value of the consideration transferred totaled \$18.6 million, which consisted entirely of cash.

The following table summarizes the estimated fair values of the assets acquired at the acquisition date. We are in the process of obtaining third-party valuations of certain intangible and tangible assets; thus, the provisional measurements of intangible assets, goodwill and certain tangible assets are subject to change.

Accounts receivable and inventory	\$ 2.3
Property, plant and equipment	3.5
Customer lists	2.8
Goodwill	10.0
Net assets acquired	\$ 18.6

The \$2.8 million that was assigned to customer lists is subject to a weighted-average useful life of approximately 8 years. The \$10.0 million of goodwill has been assigned to the U.S. Rental operations reporting unit within the United States operating segment. The goodwill recognized is attributable primarily to expected synergies and the assembled workforce of the acquired business. All of the goodwill is expected to be deductible for income tax purposes.

The pro forma effects of this acquisition, had it been acquired at the beginning of the fiscal year, was not material. The amount of revenue related to the acquired business that has been included in our Condensed Consolidated Statements of Operations for the three and six months ended December 29, 2012 was approximately \$1.0 million. The amount of earnings, after deducting integration costs and the related interest on the additional borrowings, was not material during the period.

Table of Contents

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

(Unaudited)

Overview

G&K Services, Inc., founded in 1902 and headquartered in Minnetonka, Minnesota, is a service-focused market leader of branded uniform and facility services programs. We deliver value to our customers by enhancing their image and brand, and by promoting workplace safety, security and cleanliness. We accomplish this by providing high quality branded work apparel programs, and a variety of facility products and services including floor mats, towels, mops and restroom hygiene products.

Over the past three years we have made broad-based improvements to our business, by pursuing a strategy which included four key elements: focusing on customer satisfaction; improving day-to-day execution; increasing our focus on cost management; and addressing underperforming locations and assets. Executing this strategy has led to significant improvements in our financial results. We have delivered solid organic revenue growth, expanded operating margins and produced strong cash flows.

We believe it is healthy for a company to regularly evaluate and adjust, as appropriate, its strategy. In fiscal 2013, we modified our strategy, building on the improvements made over the past three years to drive further performance gains. Our approach has four parts:

1. Keep our customer promise
2. Improve how we target customers
3. Drive operational excellence
4. Strengthen our high performing team

To measure the progress of our strategy we have established two primary financial objectives, which include achieving operating income margin of 10% and return on invested capital (ROIC) of 10%. We define ROIC as adjusted net operating income after tax, divided by the sum of total debt less cash plus stockholders' equity. Our goal is to achieve these two financial targets by the end of our fiscal year 2014. In the second quarter, we achieved the first of these two targets by achieving a 10% operating income margin. We are also focused on maximizing free cash flow, which we define as net cash provided by operating activities less investments in property, plant and equipment.

Our industry continues to consolidate as many family-owned, local operators and regional companies have been acquired by larger providers. Historically, we have participated in this consolidation with an acquisition strategy focused on expanding our geographic presence and/or expanding our local market share in order to further leverage our existing production facilities. We remain active in evaluating quality acquisitions that would strengthen our business. During the three months ended December 29, 2012 we made one small acquisition. The pro forma effect of this acquisition, had it been acquired at the beginning of each fiscal year, was not material. The total purchase consideration was \$18.6 million. The total purchase price exceeded the estimated fair value of assets acquired and liabilities assumed by \$10.0 million.

Over the past year our results have been adversely impacted by rising prices for commodities, especially cotton, polyester and crude oil. This has contributed to the significant increase in merchandise costs. We expect merchandise costs as a percentage of rental revenue to gradually moderate throughout fiscal year 2013.

Critical Accounting Policies

Our significant accounting policies are described in 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 June 30, 2012. The accounting policies used in preparing our interim fiscal year 2013 Condensed Consolidated Financial Statements are the same as those described in our Annual Report.

The discussion of the financial condition and results of operations are based upon the Condensed Consolidated Financial Statements, which have been prepared in conformity with United States generally accepted accounting principles (GAAP). As such, management is required to make certain estimates, judgments and assumptions that are believed to be reasonable based on the information available. These estimates and assumptions affect the reported amount of assets and liabilities, revenues and expenses, and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Table of Contents

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 estimates. We believe our critical accounting policies are those related to:

Revenue recognition

Employee benefit plans

Income taxes

Share based payments

Derivative financial instruments

Inventories

Goodwill and intangible assets

Results of Operations

The percentage relationships to revenues of certain income and expense items for the three and six month periods ended December 29, 2012 and December 31, 2011, 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	
	December 29, 2012	December 31, 2011	December 29, 2012	December 31, 2011	Three Months FY 2013 vs. FY 2012	Six Months FY 2013 vs. FY 2012
Revenues:						
Rental operations	90.7%	90.7%	91.1%	91.6%	5.6%	5.2%
Direct sales	9.3	9.3	8.9	8.4	5.4	12.1
Total revenues	100.0	100.0	100.0	100.0	5.6	5.8
Expenses:						
Cost of rental operations	68.2	69.3	68.2	69.1	4.0	3.9
Cost of direct sales	72.9	80.3	74.2	78.3	(4.3)	6.1
Total cost of sales	68.6	70.3	68.7	69.8	3.1	4.1
Selling and administrative	21.4	21.9	21.9	22.6	3.1	2.7
Income from operations	10.0	7.8	9.4	7.6	34.8	30.8

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

Interest expense	0.5	0.7	0.5	0.8	(30.9)	(34.1)
Income before income taxes	9.5	7.1	8.9	6.8	41.7	38.0
Provision for income taxes	3.7	2.7	3.4	2.7	44.9	32.7
Net income	5.8%	4.4%	5.6%	4.2%	39.7%	41.4%

Three months ended December 29, 2012 compared to three months ended December 31, 2011

Revenues. Total revenue in the second quarter of fiscal 2013 increased 5.6% to \$229.2 million from \$217.1 million in the second quarter of fiscal 2012.

Table of Contents

Rental revenue increased \$11.0 million, or 5.6% in the second quarter of fiscal 2013 compared to the same period of the prior fiscal year. Our organic rental growth rate was 4.5% compared to 6.0% in the same period of the prior fiscal year. The decline in the organic growth rate from the prior year was primarily due to a decrease in new account sales and a slight deterioration in the number of uniform wearers at existing customers, offset by continued improved execution related to merchandise recovery billings, uniform preparation services, and increased customer usage of non-garment products and pricing. Our organic rental growth rate is calculated using rental revenue, adjusted to exclude the impact of foreign currency exchange rate changes, divestitures and acquisitions compared to prior-period results. We believe that the organic rental revenue reflects the growth of our existing rental business and is, therefore, useful in analyzing our financial condition and results of operations. The impact of foreign currency exchange rates added approximately 0.6% to our rental operations growth rate, while acquisitions added approximately 0.5%.

Direct sale revenue increased 5.4% to \$21.3 million in the second quarter of fiscal 2013 compared to \$20.2 million in the same period of fiscal 2012. The increase in direct sales was primarily driven by additional uniform purchases by existing customers.

Cost of Rental. Cost of rental operations, which includes merchandise, production and delivery expenses, increased 4.0% to \$141.8 million in the second quarter of fiscal 2013 from \$136.4 million in the same period of fiscal 2012. As a percentage of rental revenue, our gross margin from rental operations increased to 31.8% in the second quarter of fiscal 2013 from 30.7% in the same period of fiscal 2012. The improvement in rental gross margin was primarily due to the favorable impact of fixed costs absorbed over a higher revenue base, continued improvements in production and delivery productivity, lower depreciation expense and lower natural gas and health insurance costs. These favorable variances were partially offset by a continued and expected increase in merchandise costs and higher workers' compensation costs. The increase in merchandise costs was driven by increased raw material costs, increased merchandise requirements to support new account growth and new customer additions, and a mix shift to higher cost specialty garments.

Cost of Direct Sales. Cost of direct sales decreased to \$15.6 million in the second quarter of fiscal 2013 from \$16.3 million in the same period of fiscal 2012. Gross margin from direct sales increased to 27.1% in the second quarter of fiscal 2013 from 19.7% in the same quarter of fiscal 2012. The lower margin in the prior year period was due to higher product costs, increased mix of lower margin business and program launch costs associated with several new accounts. The current period included improvements resulting from increased sales of higher margin products and lower distribution costs due to improved productivity.

Selling and Administrative. Selling and administrative expenses increased 3.1% to \$49.0 million in the second quarter of fiscal 2013 from \$47.5 million in the same period of fiscal 2012. As a percentage of total revenues, selling and administrative expenses decreased to 21.4% in the second quarter of fiscal 2013 from 21.9% in the second quarter of fiscal 2012. The decrease was due to effective cost control as we leveraged fixed costs over a higher revenue base, a decrease in depreciation and amortization expense and lower sales commissions. These improvements were partially offset by higher incentive compensation expense, additional environmental remediation costs and higher bad debt expense.

Interest Expense. Interest expense was \$1.1 million in the second quarter of fiscal 2013, a decrease from the \$1.6 million reported in the same period of fiscal 2012. The decreased interest expense was due to lower average interest rates and a reduction in the amortization of debt closing costs resulting from the renewal of our unsecured revolving credit facility and the maturity of certain interest rate swap agreements. These decreases were partially offset by higher average debt balances.

Provision for Income Taxes. Our effective tax rate increased to 39.2% in the second quarter of fiscal 2013 from 38.3% in the same period of fiscal 2012. The current period tax rate was higher than the prior period tax rate primarily due to higher tax expense on foreign earnings in the current period.

Six months ended December 29, 2012 compared to six months ended December 31, 2011

Revenues. Total revenue for the first six months of fiscal 2013 increased 5.8% to \$451.6 million compared to \$426.8 million for the same period in the prior fiscal year.

Rental revenue increased \$20.5 million, or 5.2% in the first six months of fiscal 2013 compared to the same period of the prior fiscal year. Our organic rental growth rate was 5.0% compared to 5.5% in the same period of the prior fiscal year. The decline in the organic growth rate from the prior year was primarily due to a decrease in new account sales and a slight deterioration in the number of uniform wearers at existing customers, offset by continued improved execution related to merchandise recovery billings, uniform preparation services, and increased customer usage of non-garment products and pricing. The impact of foreign currency exchange rates added approximately 0.2% to our rental operations growth rate, while acquisitions added approximately 0.3%.

Table of Contents

Direct sale revenue increased 12.1% to \$40.3 million in the first six months of fiscal 2013 compared to \$36.0 million in the same period of fiscal 2012. This increase was primarily driven by several large new accounts and additional uniform purchases by existing customers.

Cost of Rental. Cost of rental operations, which includes merchandise, production and delivery expenses, increased 3.9% to \$280.4 million in the first six months of fiscal 2013 from \$269.9 million in the same period of fiscal 2012. As a percentage of rental revenue, our gross margin from rental sales increased to 31.8% in the first six months of fiscal 2013 from 30.9% in the same period of fiscal 2012. The improvement in rental gross margin was primarily due to the favorable impact of fixed costs absorbed over a higher revenue base, continued improvements in production and delivery productivity, lower depreciation expense and lower natural gas and health insurance costs. These favorable variances were partially offset by a continued and expected increase in merchandise costs and higher workers' compensation costs. The increase in merchandise costs was driven by increased raw material costs, increased merchandise requirements to support new account growth and new customer additions, and a mix shift to higher cost specialty garments.

Cost of Direct Sales. Cost of direct sales increased to \$29.9 million in the first six months of fiscal 2013 from \$28.2 million in the same period of fiscal 2012. Gross margin from direct sales increased to 25.8% in the first six months of fiscal 2013 from 21.7% reported in the same period of fiscal 2012. The lower margin in the prior year period was due to higher product costs, increased mix of lower margin business and program launch costs associated with several new accounts. The current period benefited from increased sales of higher margin products and lower distribution costs due to improved productivity.

Selling and Administrative. Selling and administrative expenses increased 2.7% to \$98.9 million in the first six months of fiscal 2013 from \$96.3 million in the same period of fiscal 2012. As a percentage of total revenues, selling and administrative expenses decreased to 21.9% in the first six months of fiscal 2013 from 22.6% in the same period of fiscal 2012. The decrease was due to effective cost control as we leveraged fixed costs over a higher revenue base, a decrease in depreciation and amortization expense, lower sales commissions and lower group health insurance costs. These improvements were partially offset by higher incentive compensation expense and higher bad debt expense.

Interest Expense. Interest expense was \$2.1 million in the first six months of fiscal 2013, a decrease from the \$3.3 million in the same period of fiscal 2012. The decreased interest expense was due to lower average interest rates and a reduction in the amortization of debt closing costs resulting from the renewal of our unsecured revolving credit facility and the maturity of certain interest rate swap agreements. These decreases were partially offset by higher average debt balances.

Provision for Income Taxes. Our effective tax rate decreased to 37.6% in the six months ended December 29, 2012 from 39.1% in the six months ended December 31, 2011. The tax rate for the prior period was higher than the current period primarily due to the write-off of deferred tax assets associated with equity compensation in the prior period and a decrease in reserves for uncertain tax positions due to resolution of a tax contingency during the current period.

Liquidity, Capital Resources and Financial Condition

Our primary sources of cash are net cash flows from operations and borrowings under our debt arrangements. Primary uses of cash are working capital needs, payments on indebtedness, capital expenditures, acquisitions, dividends and general corporate purposes.

Working capital at December 29, 2012 was \$173.1 million, a \$10.1 million decrease from \$183.2 million at June 30, 2012. The decrease in working capital is primarily due to the reclassification of the debt outstanding under our accounts receivable securitization facility to current from long-term and a decrease in new goods inventory, partially offset by an increase in accounts receivable due to increased revenue and a slight deterioration in the days sales outstanding and a decrease due to the timing of accounts payable disbursements.

Operating Activities. Net cash provided by operating activities was \$40.8 million in the first six months of fiscal 2013 and \$17.8 million in the same period of fiscal 2012. The increase was due to improvements in working capital, higher net income and lower contributions to our pension plan, partially offset by higher tax payments in the current year.

Investing Activities. Net cash used for investing activities was \$36.6 million in the first six months of fiscal 2013 and \$18.0 million in the same period of fiscal 2012. The increase was due to an acquisition in the second quarter of fiscal 2013, which totaled \$18.6 million.

Table of Contents

Financing Activities. Cash used for financing activities was \$0.4 million in the first six months of fiscal 2013 compared to \$9.0 million in fiscal 2012. The decreased use of cash was primarily due to the acquisition in the second quarter of fiscal 2013, partially offset by higher debt payments as a result of stronger cash flow. During the first six months of fiscal 2013 and 2012, we paid dividends of \$7.4 million and \$4.9 million, respectively.

We have a \$250.0 million, five-year unsecured revolving credit facility with a syndicate of banks, which expires on March 7, 2017. Borrowings in U.S. dollars under this credit facility, at our election, bear interest at (a) the adjusted London Interbank Offered Rate (LIBOR) for specified interest periods plus a margin, which can range from 1.00% to 2.00%, determined with reference to our consolidated leverage ratio or (b) a floating rate equal to the greatest of (i) JPMorgan's prime rate, (ii) the federal funds rate plus 0.50% and (iii) the adjusted LIBOR for a one month interest period plus 1.00%, plus, in each case, a margin determined with reference to our consolidated leverage ratio. Base rate loans will, at our election, bear interest at (i) the rate described in clause (b) above or (ii) a rate to be agreed upon by us and JPMorgan. Borrowings in Canadian dollars under the credit facility will bear interest at (a) the Canadian deposit offered rate plus 0.10% for specified interest periods plus a margin determined with reference to our consolidated leverage ratio or (b) a floating rate equal to the greater of (i) the Canadian prime rate and (ii) the Canadian deposit offered rate for a one month interest period plus 1.00%, plus, in each case, a margin determined with reference to our consolidated leverage ratio.

As of December 29, 2012, borrowings outstanding under the revolving credit facility were \$121.5 million. The unused portion of the revolver may be used for general corporate purposes, acquisitions, share repurchases, dividends, working capital needs and to provide up to \$50.0 million in letters of credit. As of December 29, 2012, letters of credit outstanding against the revolver totaled \$0.6 million and primarily related to our property and casualty insurance programs. No amounts have been drawn upon these letters of credit. Availability of credit under this facility requires that we maintain compliance with certain covenants.

The covenants under this agreement are the most restrictive when compared to our other credit facilities. The following table illustrates compliance with regard to the material covenants required by the terms of this facility as of December 29, 2012:

	Required	Actual
Maximum Leverage Ratio (Debt/EBITDA)	3.50	2.14
Minimum Interest Coverage Ratio (EBITDA/Interest Expense)	3.00	23.23
Minimum Net Worth	\$ 379.6	\$ 429.5

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

Advances outstanding as of December 29, 2012 bear interest at a weighted average all-in rate of 1.74%. We also pay a fee on the unused daily balance of the revolving credit facility based on a leverage ratio calculated on a quarterly basis. At December 29, 2012 this fee was 0.25% of the unused daily balance.

We have \$75.0 million of variable rate unsecured private placement notes. The notes bear interest at 0.60% over LIBOR and are scheduled to mature on June 30, 2015. The notes do not require principal payments until maturity. Interest payments are reset and paid on a quarterly basis. As of December 29, 2012, the outstanding balance of the notes was \$75.0 million at an all-in rate of 0.96%.

We maintain a \$50.0 million accounts receivable securitization facility, which expires on September 27, 2013. Under the terms of the facility, we pay interest at a rate per annum equal to a margin of 0.76%, plus LIBOR. The facility is subject to customary fees for the issuance of letters of credit and any unused portion of the facility. As is customary with transactions of this nature, our eligible accounts receivable are sold to a consolidated subsidiary. As of December 29, 2012, there was \$23.8 million outstanding under this loan agreement at an all-in interest rate of 0.97% and \$26.2 million of letters of credit were outstanding, primarily related to our property and casualty insurance programs.

See Note 5, *Derivative Financial Instruments* of the Notes to the Condensed Consolidated Financial Statements for details of our interest rate swap and hedging activities related to our outstanding debt.

Table of Contents

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

At December 29, 2012, we had approximately \$127.9 million of available capacity under our revolving and accounts receivable credit facilities. Our revolving credit facility contributes all of the liquidity as our accounts receivable securitization facility is fully utilized. We anticipate that cash flows from operations and our available capacity under our revolving credit facility will be sufficient to satisfy our cash commitments, including payment of the \$23.8 million of debt due in the next 12 months, and capital requirements for fiscal 2013. We estimate that capital expenditures in fiscal 2013 will be approximately \$35-\$40 million.

Off Balance Sheet Arrangements

At December 29, 2012, we had \$26.8 million of stand-by letters of credit that were issued and outstanding, primarily in connection with our property and casualty insurance programs. No amounts have been drawn upon these letters of credit.

Pension Obligations

Pension expense is recognized on an accrual basis over the employees' approximate service periods. Pension expense is generally independent of funding decisions or requirements. We recognized expense for our defined benefit pension plan of \$0.7 million and \$0.3 million in the second quarter of fiscal 2013 and 2012, respectively. At June 30, 2012, the fair value of our pension plan assets totaled \$53.8 million.

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

Multi-Employer Pension Plans

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

Central States MEPP

In the third quarter of fiscal year 2012, we concluded negotiations with a union to discontinue our participation in the Central States Southeast and Southwest Areas Pension Fund (Central States MEPP) for two of our locations. In addition, we also closed two redundant branch facilities that participated in the Central States MEPP. In the first quarter of fiscal 2013, we successfully concluded negotiations to discontinue participation at two additional locations. We continue to participate in the Central States MEPP at one remaining location, although, subject to our good faith bargaining obligations, we believe it is probable that we will also withdraw from the Central States MEPP at this location, thus completely discontinuing our participation in the Central States MEPP.

Employer's accounting for MEPPs (ASC 715-80) provides that a withdrawal liability should be recorded if circumstances that give rise to an obligation become probable and estimable. As a result of the actions noted above, in the third quarter of fiscal year 2012, we recorded a pre-tax charge of \$24.0 million. This charge included the estimated discounted actuarial value of the total withdrawal liability, incentives for union participants and other related costs that had been incurred. We expect to pay the withdrawal liability over a period of 20 years. The amount of the withdrawal liability recorded is based on the best information available and is subject to change based on revised MEPP information received periodically from the union sponsors, the discount rate used to calculate the liability, and other factors. These potential changes could have a material impact on our results of operations and financial condition.

Other MEPPs

A partial or full withdrawal from a MEPP may be triggered by circumstances beyond our control. As evidenced by the negotiations above, we could also trigger the liability by successfully negotiating with a union to discontinue participation in the MEPP. If a future withdrawal from a plan occurs, we will record our proportional share of any unfunded vested benefits in the period in which the withdrawal occurs.

Table of Contents

The ultimate amount of the withdrawal liability assessed by the MEPPs is impacted by a number of factors, including, among other things, investment returns, benefit levels, interest rates, financial difficulty of other participating employers in the plan and our continued participation with other employers in the MEPPs, each of which could impact the ultimate withdrawal liability.

We continue to actively participate in several other MEPPs, for which we have not recorded a withdrawal liability. Based upon the most recent plan data available from the trustees managing these MEPPs, our share of the undiscounted, unfunded vested benefits for these MEPPs is estimated to be \$3.0 million to \$4.0 million as of December 29, 2012.

Litigation

We are involved in a variety of legal actions relating to personal injury, employment, environmental and other legal matters that arise in the normal course of business. In addition, we are party to certain additional legal matters described in Part II Item 1. Legal Proceedings of this report.

Cautionary Statements Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a safe harbor from civil litigation for forward-looking statements. Forward-looking statements may be identified by words such as estimates, anticipates, projects, plans, expects, intends, believes, see, should, may and will or the negative versions thereof and similar expressions and by the context in which they are used. Such statements are based upon our current expectations and speak only as of the date made. These statements are subject to various risks, uncertainties and other factors that could cause actual results to differ from those set forth in or implied by this Quarterly Report on Form 10-Q. Factors that might cause such a difference include, but are not limited to, the possibility of greater than anticipated operating costs, lower sales volumes, the performance and costs of integration of acquisitions or assumption of unknown liabilities in connection with acquisitions, fluctuations in costs of materials and labor, costs and possible effects of union organizing or other union activities, strikes, loss of key management, uncertainties regarding any existing or newly-discovered expenses and liabilities related to environmental compliance and remediation, failure to achieve and maintain effective internal controls for financial reporting required by the Sarbanes-Oxley Act of 2002, the initiation or outcome of litigation or government investigation, higher than assumed sourcing or distribution costs of products, the disruption of operations from catastrophic events, disruptions in capital markets, the liquidity of counterparties in financial transactions, changes in federal and state tax laws, economic uncertainties and the reactions of competitors in terms of price and service. We undertake no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made except as required by law. Additional information concerning potential factors that could affect future financial results is included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2012.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Interest Rate Risk

We are subject to market risk exposure related to changes in interest rates. We use financial instruments such as interest rate swap agreements, to manage interest rate risk on our variable rate debt. Under these arrangements, we agree to exchange, at specified intervals, the difference between fixed and floating interest amounts, calculated by reference to an agreed upon notional principal amount. Interest rate swap agreements are entered into for periods consistent with related underlying exposures and do not constitute positions independent of those exposures. The estimated exposure considers the mitigating effects of interest rate swap agreements outstanding at December 29, 2012 on the change in the cost of variable rate debt. The current fair market value of all outstanding contracts at December 29, 2012 was an unrealized loss of \$1.0 million.

We performed an analysis to measure the sensitivity of our interest expense to changes in market interest rates for forecasted debt levels and interest rate swaps. The base rate used for the sensitivity analysis for variable rate debt and interest rate swaps is the three month LIBOR market interest rates at December 29, 2012. The credit spread is included in the base rate used in the analysis. The two scenarios include measuring the sensitivity to interest expense with an immediate 50 basis point change in market interest rates and the impact of a 50 basis point change distributed evenly throughout the year. Based on the forecasted average debt level, outstanding interest rate swaps and current market interest rates, the forecasted annual interest expense is \$4.5 million. The scenario with an immediate 50 basis point change would increase or decrease forecasted interest expense by \$0.7 million or 15.1%. The scenario that distributes the 50 basis point change evenly would increase or decrease forecasted interest expense by \$0.4 million or 9.5%.

Table of Contents

Energy Cost Risk

We are subject to market risk exposure related to changes in energy costs. To manage this risk, from time to time we have utilized derivative financial instruments to mitigate the impact of gasoline and diesel cost volatility on our future financial results. As of December 29, 2012, we have no outstanding derivative financial instruments related to gasoline and diesel fuel, however, we may utilize them to manage cost volatility in the future.

We performed an analysis to measure the sensitivity of our energy costs to changes in the prices of unleaded gasoline and diesel fuel. The analysis used gasoline and diesel prices at December 29, 2012 and forecasted purchases over the next twelve months. For each one percentage point increase or decrease in gasoline and diesel prices under these assumptions, our gasoline and diesel costs would change by approximately \$0.2 million.

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

Foreign Currency Exchange Risk

Our material foreign subsidiaries are located in Canada. The assets and liabilities of these subsidiaries are denominated in the Canadian dollar and, as such, are translated into U.S. dollars at the exchange rate in effect at the balance sheet date. Results of operations are translated using the average exchange rates throughout the period. The effect of exchange rate fluctuations on translation of assets and liabilities are recorded as a component of stockholders' equity and are included in the "Accumulated other comprehensive income" line item of the Condensed Consolidated Balance Sheets. Gains and losses from foreign currency transactions are included in results of operations.

ITEM 4. CONTROLS AND PROCEDURES

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

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

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

Recently, the United States Office of Federal Contract Compliance Programs, or OFCCP, has, as part of routine audits, commenced a review of certain of our employment practices. The OFCCP has issued a Notice of Violation to one of our facilities and audits of four other facilities, where the OFCCP claims there are similar alleged violations, are ongoing. We have been engaged in conversations with the OFCCP and believe that our practices are lawful and without bias. Currently, no proceeding with respect to this matter has been commenced, and, in any event, we do not believe that any resolution of this matter will have a material adverse effect on our results of operations or financial position.

We cannot predict the ultimate outcome of any of these or other similar 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 condition is remote.

Table of Contents

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended June 30, 2012, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently believe are immaterial could have a material adverse affect on our business, financial condition and/or operating results.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 6. EXHIBITS

a. Exhibits

10.1 Form of Terms of Employee Restricted Stock Grant Revised August 2012.

10.2 Form of Terms of Non-Qualified Employee Stock Option Revised August 2012.

31.1 Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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

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

101 Financial statements from the quarterly report on Form 10-Q of G&K Services, Inc. for the quarter ended December 29, 2012, formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Comprehensive Income, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

G&K SERVICES, INC.
(Registrant)

Date: February 1, 2013

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

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