Anika Therapeutics, Inc.
Form 10-Q
November 03, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2015

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

For the transition period from to

Commission File Number 000-21326

Anika Therapeutics, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Massachusetts	**04-3145961**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
32 Wiggins Avenue, Bedford, Massachusetts	**01730**
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code: **(781) 457-9000**

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report: **N/A**

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes o No x

As of October 29, 2015 there were 14,637,666 outstanding shares of Common Stock, par value $.01 per share.

ANIKA THERAPEUTICS, INC.

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References in this Quarterly Report on Form 10-Q to "we," "us," "our," "our company," and other similar references refer to Anika Therapeutics, Inc. and its subsidiaries unless the context otherwise indicates.

ANIKA, ANIKA THERAPEUTICS, CINGAL, HYAFF, HYVISC, MONOVISC, and ORTHOVISC are our registered trademarks. This Quarterly Report on Form 10-Q also contains registered marks, trademarks, and trade names that are the property of other companies.

PART I: FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Anika Therapeutics, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(unaudited)

ASSETS	September 30, 2015	December 31, 2014
Current assets:		
Cash and cash equivalents	$108,469,021	$100,155,864
Investments	22,007,370	6,750,000
Accounts receivable, net of reserves of $135,618 and $146,618 at September 30, 2015 and December 31, 2014, respectively	23,375,657	17,152,028
Inventories	12,075,157	12,406,776
Prepaid income taxes	-	412,301
Current portion deferred income taxes	1,409,328	1,188,768
Prepaid expenses and other	947,119	959,305
Total current assets	168,283,652	139,025,042
Property and equipment, at cost	57,667,111	53,619,589
Less: accumulated depreciation	(23,869,798)	(21,950,706)
	33,797,313	31,668,883
Long-term deposits and other	69,020	69,042
Intangible assets, net	12,987,683	14,894,710
Goodwill	7,713,039	8,338,699
Total assets	$222,850,707	$193,996,376
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$2,220,734	$1,201,226
Accrued expenses	6,547,775	4,747,526
Deferred revenue	33,948	24,510
Income taxes payable	4,442,342	-
Total current liabilities	13,244,799	5,973,262
Other long-term liabilities	803,571	893,935
Long-term deferred revenue	73,964	102,192
Deferred tax liability	8,974,122	8,929,890
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Preferred stock, $.01 par value; 1,250,000 shares authorized, no shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively	-	-
	150,115	148,517

Common stock, $.01 par value; 30,000,000 shares authorized, 15,011,512 and 14,851,703 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively		
Additional paid-in-capital	81,052,103	77,539,699
Accumulated other comprehensive loss	(6,066,627)	(4,494,800)
Retained earnings	124,618,660	104,903,681
Total stockholders' equity	199,754,251	178,097,097
Total Liabilities and Stockholders' Equity	$222,850,707	$193,996,376

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

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Anika Therapeutics, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations and Comprehensive Income

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Product revenue	$23,675,696	$21,975,312	$62,088,410	$57,593,873
Licensing, milestone and contract revenue	5,561	80,111	16,732	24,746,497
Total revenue	23,681,257	22,055,423	62,105,142	82,340,370
Operating expenses:				
Cost of product revenue	5,175,723	5,724,800	14,763,222	15,418,732
Research & development	2,061,689	1,999,867	5,971,771	6,160,740
Selling, general & administrative	3,308,731	4,044,538	10,301,886	11,401,399
Total operating expenses	10,546,143	11,769,205	31,036,879	32,980,871
Income from operations	13,135,114	10,286,218	31,068,263	49,359,499
Interest income, net	33,667	9,937	81,297	16,339
Income before income taxes	13,168,781	10,296,155	31,149,560	49,375,838
Provision for income taxes	4,788,916	4,125,355	11,434,581	18,872,435
Net income	$8,379,865	$6,170,800	$19,714,979	$30,503,403
Basic net income per share:				
Net income	$0.56	$0.42	$1.32	$2.09
Basic weighted average common shares outstanding	14,967,322	14,758,781	14,944,921	14,626,933
Diluted net income per share:				
Net income	$0.55	$0.40	$1.29	$1.97
Diluted weighted average common shares outstanding	15,315,808	15,434,875	15,310,758	15,469,237
Net income	$8,379,865	$6,170,800	$19,714,979	$30,503,403
Other comprehensive income (loss):				
Unrealized gain (loss) on securities, net of tax	2,294	431	(904)	431
Foreign currency translation adjustment	257,521	(1,679,968)	(1,570,923)	(1,896,823)
Total other comprehensive income (loss)	259,815	(1,679,537)	(1,571,827)	(1,896,392)
Comprehensive income	$8,639,680	$4,491,263	$18,143,152	$28,607,011

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

Anika Therapeutics, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(unaudited)

	Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net income	$19,714,979	$30,503,403
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,800,158	3,576,441
Stock-based compensation expense	1,562,391	1,196,361
Deferred income taxes	(15,873)	-
Provision for inventory	147,560	220,207
Tax benefit from equity awards	(876,797)	(9,236,708)
Changes in operating assets and liabilities:		
Accounts receivable	(6,549,905)	(1,840,407)
Inventories	82,360	(2,923,628)
Prepaid expenses, other current and long-term assets	403,211	183,481
Accounts payable	970,373	(992,822)
Accrued expenses	(120,334)	(989,291)
Deferred revenue	(9,135)	(2,078,543)
Income taxes payable	5,756,972	7,771,001
Other long-term liabilities	(75,777)	(167,123)
Net cash provided by operating activities	23,790,183	25,222,372
Cash flows from investing activities:		
Proceeds from maturity of investments	14,750,000	-
Purchase of investments	(30,008,761)	(19,999,169)
Purchase of property and equipment	(2,028,093)	(920,132)
Net cash used in investing activities	(17,286,854)	(20,919,301)
Cash flows from financing activities:		
Proceeds from exercise of equity awards	1,074,814	1,379,294
Tax benefit from equity awards	876,797	9,236,708
Minimum tax withholdings on share-based awards	-	(6,348,900)
Net cash provided by financing activities	1,951,611	4,267,102
Exchange rate impact on cash	(141,783)	(131,139)
Increase in cash and cash equivalents	8,313,157	8,439,034
Cash and cash equivalents at beginning of period	100,155,864	63,333,160
Cash and cash equivalents at end of period	$108,469,021	$71,772,194
Noncash Investing Activities:		
Purchases of property and equipment included in accounts payable and accrued expenses	$2,197,088	$215,783

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

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ANIKA THERAPEUTICS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(**unaudited**)

1. Nature of Business

Anika Therapeutics, Inc. develops, manufactures, and commercializes therapeutic products for tissue protection, healing, and repair. These products are based on hyaluronic acid (“HA”), a naturally occurring, biocompatible polymer found throughout the body. Due to its unique biophysical and biochemical properties, HA plays an important role in a number of physiological functions such as the protection and lubrication of soft tissues and joints, the maintenance of the structural integrity of tissues, and the transport of molecules to and within cells.

The Company is subject to risks common to companies in the biotechnology and medical device industries including, but not limited to, development by the Company or its competitors of new technological innovations, dependence on key personnel, protection of proprietary technology, commercialization of existing and new products, and compliance with U.S. Food and Drug Administration (“FDA”) and foreign regulations and approval requirements, as well as the ability to grow the Company’s business.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements and related notes have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) and in accordance with accounting principles generally accepted in the United States (“US GAAP”). The financial statements include the accounts of Anika Therapeutics, Inc. and its subsidiaries. Inter-company transactions and balances have been eliminated. The year-end consolidated balance sheet is derived from the Company’s audited financial statements, but does not include all disclosures required by US GAAP. In the opinion of management, these unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) necessary to fairly state the condensed consolidated financial position of the Company as of September 30, 2015, the results of its operations for the three- and nine-month periods ended September 30, 2015 and 2014, and cash flows for the nine-month periods ended September 30, 2015 and 2014.

The accompanying unaudited condensed consolidated financial statements and related notes should be read in conjunction with the Company’s annual financial statements filed with its Annual Report on Form 10-K for the year ended December 31, 2014. The results of operations for the three- and nine-month periods ended September 30, 2015 are not necessarily indicative of the results to be expected for the year ending December 31, 2015. Certain prior period amounts have been reclassified to conform to the current period presentation. There was no impact on operating

income.

A revision was made to the condensed consolidated statement of cash flows for the six months ended June 30, 2014 to correctly reflect the tax benefit from the exercise of certain equity awards. This revision had an impact on the statement of cash flows as a reduction of cash provided by operating activities of approximately $2.5 million with a corresponding increase to cash provided by financing activities related to the tax benefit from exercise of stock options for the six months ended June 30, 2014 of the same amount. This revision had no impact on the statement of operations or cash position. The revision to the condensed consolidated statement of cash flows noted above represents amounts that are not deemed to be material, individually or in the aggregate, to the prior period condensed consolidated financial statements.

3. Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers." ASU 2014-09 supersedes the revenue recognition requirements in "Topic 605, Revenue Recognition" and requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In July 2015, the FASB issued a deferral of ASU 2014-09 of one year making it effective for annual reporting periods beginning on or after December 15, 2017 while also providing for early adoption not to occur before the original effective date. The Company is assessing the appropriate method for implementing ASU 2014-09, as well as the impact the adoption of ASU 2014-09 will have on its consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, Inventory (Topic 330) "Simplifying the Measurement of Inventory." ASU 2015-11 more closely aligns the measurement of inventory in US GAAP with the measurement of inventory in International Financial Reporting Standards by requiring companies using the first-in, first-out and average costs methods to measure inventory using the lower of cost and net realizable value, where net realizable value is the estimated selling prices in the ordinary course of business less reasonably predictable costs of completion, disposal, and transportation. The provisions of ASU 2015-11 are effective for annual and interim periods beginning after December 15, 2016. ASU 2015-11 should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The adoption of this amendment is not expected to have a material impact on the Company's financial position or results of operations.

4. Investments

All of the Company's investments are classified as available-for-sale and are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income, net of related income taxes. The Company's investments at September 30, 2015 and December 31, 2014 are as follows:

	September 30, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	$3,008,761	$ -	$ (1,391)	$3,007,370
Bank certificates of deposit	19,000,000	-	-	19,000,000
	$22,008,761	$ -	$ (1,391)	$22,007,370

	December 31, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Bank certificates of deposit	$6,750,000	$ -	$ -	$6,750,000

5. Fair Value Measurements

Goodwill, Intangibles and Other Long-Lived Assets

As required under Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142), goodwill is separately disclosed from other intangible assets on the balance sheet and no longer amortized. SFAS 142 also requires that companies test goodwill for impairment on an annual basis and when events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit to which goodwill is assigned below its carrying amount. Our evaluation follows the two step impairment test prescribed by SFAS 142. First we assess whether the fair value of the reporting units exceeds the carrying amount of the unit including goodwill. Our evaluation considers changes in the operating environment, competitive position, market trends, operating performance, quoted market prices for our equity securities and fair value models and research prepared by independent analysts. If the carrying amount of a reporting unit exceeded its fair value, we would perform a second test to measure the amount of impairment loss, if any. Management completes its annual impairment tests in the fourth quarter of each fiscal year. There have been no impairments of goodwill or definite-lived intangible assets in fiscal 2005 and there have been no events or circumstances through the first three months of fiscal 2006 that would indicate that there may have been any impairment of goodwill or definite-lived assets. Future events could cause management to conclude that impairment indicators exist and that goodwill and other intangibles associated with acquired businesses are impaired. Any resulting impairment loss could have a material impact on our financial condition and results of operations.

Property, plant and equipment and definite-lived intangible assets are depreciated or amortized over their useful lives. Useful lives are based on management estimates of the period that the assets will add value. Long-lived assets and definite-lived intangible 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 or definite-lived intangible assets in fiscal 2005 or through the first three months of fiscal 2006.

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 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. 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-month periods ended October 1, 2005 and October 2, 2004, and the percentage changes in these income and expense items between periods are presented in the following table:

	Three Months Ended		Percentage Change Three Months
	Oct 1, 2005	Oct 2, 2004	FY 2006 vs. FY 2005
Revenues:			
Rental	93.3%	96.6%	10.1%
Direct	6.7	3.4	126.0
Total revenues	100.0	100.0	14.0
Expenses:			
Cost of rental sales	64.2	63.0	12.2
Cost of direct sales	73.5	79.7	108.4
Total cost of sales	64.8	63.5	16.2
Selling and administrative	21.0	21.6	11.3
Depreciation and amortization	5.1	5.6	4.3
Income from operations	9.1	9.3	10.8
Interest expense	1.5	1.3	18.3
Income before income taxes	7.6	8.0	9.5
Provision for income taxes	2.6	3.0	1.3
Net income	5.0%	5.0%	14.4%

Three months ended October 1, 2005 compared to three months ended October 2, 2004

Revenues. Total revenues in the first quarter of fiscal 2006 increased 14.0% to $207.9 million from $182.4 million in the first quarter of fiscal 2005. Rental revenue increased $17.8 million in the first quarter, or 10.1%. The organic industrial rental growth rate was approximately 3%, an improvement from negative 2% in the same period of

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fiscal 2005. Organic industrial rental revenue has improved due to growth initiatives and improving economic conditions, slightly offset by the impact of Hurricanes Katrina and Rita by approximately 0.4%.

Direct sale revenue increased 126.0% to $13.9 million in the first quarter of fiscal 2006 compared to $6.1 million in the same period of fiscal 2005. The organic direct sale growth rate was approximately 11%. The increase in organic direct sale revenue was due primarily to large shipments throughout the quarter to one customer at our direct sale unit. Organic growth rates are calculated using industrial rental and direct sale revenue, respectively, adjusted for foreign currency exchange rate differences and revenue from newly acquired business compared to prior-period results. We believe that the organic growth rates better reflect the growth of our existing industrial rental and direct sale business and are therefore useful in analyzing our financial condition and results of operations.

Cost of Rental and Direct Sale. Cost of rental operations increased 12.2% to $124.5 million in the first quarter of fiscal 2006 from $111.0 million in the same period of fiscal 2005. Gross margin from rental sales decreased to 35.8% in the first quarter of fiscal 2006 from 37.0% in the first quarter of fiscal 2005. Rental gross margins declined due to higher energy costs, costs associated with new customer growth and the impact on our operations of hurricanes.

Cost of direct sales increased 108.4% to $10.2 million in the first quarter of fiscal 2006 from $4.9 million in the same period of fiscal 2005. Gross margin from direct sales increased to 26.5% in the first quarter of fiscal 2006 from 20.3% in the first quarter of fiscal 2005. The increase in gross margin was primarily due to changes in product mix and volume related efficiencies.

Selling and Administrative. Selling and administrative expenses increased 11.3% to $43.7 million in the first quarter of fiscal 2006 from $39.3 million in the same period of fiscal 2005. As a percentage of total revenues, selling and administrative expenses were 21.0% in the first quarter of fiscal 2006 down from 21.6% in the first quarter of fiscal 2005. In dollar terms, total selling and administrative expenses increased with continued investment in growth oriented initiatives, additional expense related to acquired businesses and costs associated with hurricanes. These increases were partially offset by a $1.5 million gain on sale of property.

Depreciation and Amortization. Depreciation and amortization expense increased 4.3% to $10.6 million in the first quarter of fiscal 2006 from $10.2 million in the same period of fiscal 2005. As a percentage of total revenues, depreciation and amortization expense decreased to 5.1% in the first quarter of fiscal 2006 from 5.6% in the first quarter of fiscal 2005. Net capital expenditures, excluding acquisition of businesses, were $8.5 million in the first quarter of fiscal 2006 compared to $(0.6) million in the prior year s quarter.

Income from Operations. Hurricanes in the first quarter of fiscal 2006 had a negative impact on net operating margins of approximately 0.8%.

Interest Expense. Interest expense was $3.0 million in the first quarter of fiscal 2006, up from $2.5 million in the same period of fiscal 2005. The increase was due to higher debt levels in conjunction with the acquisition of business assets in the previous twelve months and an increase in interest rates.

Provision for Income Taxes. Our effective tax rate decreased to 34.7% in the first quarter of fiscal 2006 from 37.5% in the same period of fiscal 2005 due to reductions of taxes previously provided and a favorable mix of income earned in various taxing jurisdictions, including foreign operations, with different tax rates.

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 interest payments on indebtedness, capital expenditures, acquisitions and general corporate purposes.

Operating Activities. Net cash provided by operating activities was $7.3 million in the first three months of fiscal 2006 and $14.7 million in the same period of fiscal 2005. In the first quarter of fiscal 2006, cash provided by operations was negatively impacted due to working capital needed to support organic growth and incentive compensation payments in connection with fiscal 2005 performance. In the first quarter of fiscal 2005 cash provided

by operations was positively impacted by one-time improvements related to a focus on timely collection of accounts receivable.

Working capital at October 1, 2005 was $134.4 million, up 43.3% from $93.8 million at July 2, 2005. The increase in working capital is largely due to the reduction of current portions of long term debt as a result of our renewed credit facility.

Investing Activities. Net cash used in investing activities was $9.3 million in the first three months of fiscal 2006 and $19.3 million in the same period of fiscal 2005. In fiscal 2006, cash was primarily used for property, plant and equipment additions. In fiscal 2005, cash was largely used for acquisitions of business assets and investments made in information technology and revenue growth initiatives, partially offset by proceeds from the sale of selected plant assets. Proceeds on these sales totaled $5.6 million.

Financing Activities. Cash provided by financing activities was $4.6 million in the first three months of fiscal 2006 and cash used for financing activities was $11.1 million in the same period of fiscal 2005. Cash provided in fiscal 2006 was from debt proceeds used primarily for property, plant and equipment additions. Cash used in fiscal 2005 was primarily related to the repayment of long-term debt.

On August 31, 2005, we amended and restated our revolving credit facility. The amended and restated revolving credit facility of $325.0 million expires on August 31, 2010. As of October 1, 2005, borrowings outstanding under the revolving credit facility were $67.9 million. The unused portion of the revolver may be used for general corporate purposes, acquisitions, working capital needs and to provide up to $50 million in letters of credit. As of October 1, 2005, letters of credit outstanding against the revolver were $28.2 million.

Borrowings under the revolving credit facility bear interest at 0.55% to 1.50% over the London Interbank Offered Rate (LIBOR), or the Canadian prime rate for Canadian borrowings, based on a leverage ratio calculated on a quarterly basis. Advances outstanding as of October 1, 2005 bear interest at LIBOR plus 0.75%. We also pay a fee on the unused daily balance of the revolver based on a leverage ratio calculated each quarter.

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

	2006 Remaining	2007	2008	2009	2010	2011 and There-after	Total
Variable rate term loan and revolving credit facility	$	$	$	$	$ 67,850	$	$ 67,850
Variable rate notes						75,000	75,000
Variable rate loan			50,000				50,000
Fixed rate notes		7,143	7,143	7,143	7,143	7,142	35,714
Other debt arrangements, including capital leases	484	12,101	121	42			12,748
Operating leases	12,481	14,458	11,237	7,366	5,087	3,750	54,379
Total contractual cash obligations	$ 12,965	$ 33,702	$ 68,501	$ 14,551	$ 80,080	$ 85,892	$ 295,691

Also, at October 1, 2005, we had stand-by letters of credit totaling $28.2 million issued and 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.

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At October 1, 2005, we had available cash on hand of $18.3 million and approximately $229 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 2006 and to reduce the amounts outstanding under the revolving credit facility; however, we may utilize borrowings under the revolving credit facility to supplement our cash requirements from time to time. We estimate that capital expenditures in fiscal 2006 will be approximately $25 million to $30 million.

The amount of cash flow generated from operations is subject to a number of risks and uncertainties. In fiscal 2006, 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 our earnings and cash flow from operations, existing credit facilities and our ability to obtain additional debt or equity capital, if necessary, will be adequate to finance acquisition opportunities.

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 $1.7 million in the first quarter of fiscal 2006 and $1.5 million in the same period of fiscal 2005. At July 2, 2005, the fair value of our pension plan assets totaled $29.1 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 2, 2005, 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 2, 2005 is based on an allocation of U.S. equities and U.S. fixed income securities. Decreasing the expected long-term rate of return by 0.5% (from 8.0% to 7.5%) would increase our estimated fiscal 2006 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 5.50% at July 2, 2005. 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 5.50% to 5.00%) would have increased our accumulated benefit obligation at July 2, 2005 by approximately $4.1 million and increased the estimated fiscal 2006 pension expense by approximately $1.1 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 4-5% of our total revenue.

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. These legal actions include lawsuits that challenge the practice of

charging for certain environmental services on invoices. None of these legal actions are expected to have a material adverse effect on our results of operations or financial position.

Stock-Based Compensation

We have adopted the provisions of the Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment (SFAS 123(r)) in the first quarter of fiscal 2006 under the modified retrospective transition method. SFAS 123(r) eliminates accounting for share-based compensation transactions using the intrinsic value method prescribed in APB Opinion No. 25, Accounting for Stock Issued to Employees, and requires instead that the fair value of all share-based transactions, including grants of employee stock options, be recognized in the income statement. Under the modified retrospective transition method, all prior period financial statements were restated to recognize compensation cost in the amounts previously reported in the Notes to Consolidated Financial Statements. Income before income taxes and net income for the quarter ended October 2, 2004 have been restated by $.7 million and $.4 million, respectively. Basic and diluted earnings per share have each been restated by $0.02 per share. The beginning balances of deferred taxes, paid in capital and retained earnings have been restated by $6.0 million, $18.5 million and $12.5 million, respectively, to recognize compensation cost for fiscal years 1996 through 2005 in the amounts previously reported in the Notes to Consolidated Financial Statements under provisions of SFAS No. 123.

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.

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 and employment levels; 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 branded identity apparel and facility services industry; unplanned litigation or regulatory proceedings; 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 2, 2005.

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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 first quarter of fiscal 2006 by approximately $0.3 million. This estimated exposure considers the mitigating effects of interest rate swap agreements outstanding at October 1, 2005 on the change in the cost of variable rate debt.

Energy Cost Risk

We use derivative financial instruments to manage the risk that changes in gasoline cost will affect the future financial results of the Company. We purchase gasoline futures contracts to effectively hedge a portion of anticipated actual gasoline purchases. The gasoline futures contracts are reflected at fair value in the consolidated balance sheet and the related gains or losses on these contracts are deferred in stockholders equity (as a component of other comprehensive income) or in the statements of operations depending on the effectiveness of the hedge. Upon settlement of each contract, the actual gain or loss is reflected in gasoline expense. The current fair market value of all outstanding contracts at October 1, 2005 is $0.6 million.

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 October 1, 2005.

Period	Total Number of Shares (or Units) Purchased	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 August 6, 2005)				
Month #2 (Fiscal month ending September 3, 2005)				
Month #3 (Fiscal month ending October 1, 2005)				

The Company has two classes of voting securities outstanding: Class A common stock, $0.50 par value per share, and Class B common stock, $0.50 par value per share. Each share of Class A common stock is entitled to one vote, and each share of Class B common stock is entitled to 10 votes, on each matter submitted to a vote of shareholders. Class A common stock may be acquired by holders of Class B Common Stock upon conversion of their shares of Class B common stock, at any time, on the basis of one share of Class A common stock for each share of Class B common stock converted. On September 2, 2005, the Company issued 199,167 shares of Class A common stock to one of its shareholders upon the conversion by such shareholder of a like number of shares of Class B common stock. The Company received no proceeds from such issuance. Because such issuance of Class A common stock upon the conversion of Class B common stock did not involve a public offering of securities, we relied on the exemption from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended, in connection with such issuance.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

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

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

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

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

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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 August 26, 2005.

A Form 8-K, Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers as filed on August 29, 2005.

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SIGNATURES

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

G&K SERVICES, INC.
(Registrant)

Date: November 4, 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)