

NATIONAL SERVICE INDUSTRIES INC

Form 10-Q

April 10, 2003

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended February 28, 2003

OR

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 1-3208

NATIONAL SERVICE INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

Delaware

58-0364900

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification Number)

1420 Peachtree Street, N.E., Suite 200, Atlanta, Georgia

30309 3002

(Address of principal executive offices)

(Zip Code)

(404) 853-1000

(Registrant's telephone number, including area code)

None

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Yes No

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

Yes No

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

Common Stock \$1.00 Par Value 11,195,973 shares as of March 31, 2003.

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| | February 28, 2003 | August 31, 2002 |
|--|------------------------------|----------------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 9,478 | \$ 20,969 |
| Receivables, less allowance for doubtful accounts of \$1,150 at February 28, 2003 and \$1,173 at August 31, 2002 | 50,100 | 52,198 |
| Inventories, at the lower of cost (on a first-in, first-out basis) or market | 16,738 | 16,037 |
| Linens in service, net of amortization | 49,998 | 51,806 |
| Prepayments | 4,864 | 5,086 |
| Insurance receivable (Note 9) | 95,483 | 42,024 |
| Other current assets | 7,170 | 693 |
| | <hr/> | <hr/> |
| Total Current Assets | 233,831 | 188,813 |
| Property, Plant and Equipment, at cost: | | |
| Land | 5,715 | 5,715 |
| Buildings and leasehold improvements | 50,199 | 49,867 |
| Equipment under capital leases | 1,196 | |
| Machinery and equipment | 259,652 | 259,730 |
| | <hr/> | <hr/> |
| Total Property, Plant and Equipment | 316,762 | 315,312 |
| Less: Accumulated depreciation and amortization | 175,612 | 167,356 |
| | <hr/> | <hr/> |
| Property, Plant and Equipment, net | 141,150 | 147,956 |
| Other Assets: | | |
| Intangibles | 7,624 | 8,357 |
| Insurance receivable (Note 9) | 216,886 | 140,831 |
| Prepaid benefit cost | 31,435 | 30,644 |
| Other assets | 2,188 | 2,497 |
| | <hr/> | <hr/> |
| Total Other Assets | 258,133 | 182,329 |
| | <hr/> | <hr/> |
| Total Assets | \$633,114 | \$519,098 |
| | <hr/> | <hr/> |
| Liabilities and Stockholders Equity | | |
| Current Liabilities: | | |
| Current maturities of long-term debt (Note 8) | \$ | \$ 1,093 |
| Capital lease obligations (Note 8) | 464 | |
| Accounts payable | 14,710 | 16,569 |
| Accrued salaries, commissions, and bonuses | 5,793 | 7,007 |
| Current portion of self-insurance accrual | 3,987 | 5,785 |
| Environmental accrual (Note 10) | 5,699 | 5,777 |
| Current portion of litigation accrual (Note 9) | 82,849 | 41,288 |
| Deferred income taxes | 7,941 | 8,811 |
| Other accrued liabilities | 18,902 | 19,506 |
| | <hr/> | <hr/> |

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| | | |
|---|-------------------|-------------------|
| Total Current Liabilities | 140,345 | 105,836 |
| Long-Term Debt, less current maturities (Note 8) | | 984 |
| | <u> </u> | <u> </u> |
| Long-Term Capital Lease Obligations (Note 8) | 885 | |
| | <u> </u> | <u> </u> |
| Deferred Income Taxes | 11,770 | 7,853 |
| | <u> </u> | <u> </u> |
| Self-Insurance Accrual, less current portion | 9,219 | 9,258 |
| | <u> </u> | <u> </u> |
| Litigation Accrual, less current portion (Note 9) | 249,414 | 166,844 |
| | <u> </u> | <u> </u> |
| Other Long-Term Liabilities | 8,078 | 7,690 |
| | <u> </u> | <u> </u> |
| Commitments and Contingencies (Notes 9 and 10) | | |
| Stockholders' Equity: | | |
| Series A participating preferred stock, \$.05 stated value, 500,000 shares authorized, none issued | | |
| Preferred stock, no par value, 500,000 shares authorized, none issued | | |
| Common stock, \$1 par value, 120,000,000 shares authorized, 14,478,500 shares issued | 14,479 | 14,479 |
| Paid-in capital | | 11,570 |
| Retained earnings | 532,280 | 552,302 |
| Unearned compensation on restricted stock | (4,574) | (4,092) |
| Accumulated other comprehensive income items | (2,350) | (2,350) |
| | <u> </u> | <u> </u> |
| | 539,835 | 571,909 |
| Less: Treasury stock, at cost (3,292,868 shares at February 28, 2003 and 3,510,515 shares at August 31, 2002) | 326,432 | 351,276 |
| | <u> </u> | <u> </u> |
| Total Stockholders' Equity | 213,403 | 220,633 |
| | <u> </u> | <u> </u> |
| Total Liabilities and Stockholders' Equity | \$633,114 | \$519,098 |
| | <u> </u> | <u> </u> |

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

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CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES***(In thousands, except per-share data)*

| | THREE MONTHS ENDED | | SIX MONTHS ENDED | |
|--|----------------------|----------------------|----------------------|----------------------|
| | February 28, 2003 | February 28, 2002 | February 28, 2003 | February 28, 2002 |
| Sales and Service Revenues: | | | | |
| Service revenues | \$ 76,142 | \$ 77,335 | \$ 152,234 | \$ 156,171 |
| Net sales of products | 45,307 | 54,703 | 89,278 | 110,256 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total Revenues | 121,449 | 132,038 | 241,512 | 266,427 |
| Costs and Expenses: | | | | |
| Cost of services | 46,581 | 46,398 | 93,899 | 94,162 |
| Cost of products sold | 37,038 | 42,012 | 71,131 | 84,028 |
| Selling and administrative expenses | 45,593 | 44,033 | 89,717 | 88,791 |
| Restructuring expense and other charges (Note 11) | | (381) | | 5,439 |
| Gain on sale of business | | (379) | | (379) |
| Amortization expense | 460 | 432 | 925 | 913 |
| Interest expense, net | 47 | 168 | 48 | 279 |
| Other income, net | (680) | (176) | (1,362) | (657) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total Costs and Expenses | 129,039 | 132,107 | 254,358 | 272,576 |
| Loss from continuing operations before income taxes and cumulative effect of a change in accounting principle | | | | |
| | (7,590) | (69) | (12,846) | (6,149) |
| Income tax benefit | (2,431) | (28) | (4,418) | (2,460) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Loss from continuing operations before cumulative effect of a change in accounting principle | (5,159) | (41) | (8,428) | (3,689) |
| Discontinued Operations (Note 6): | | | | |
| Income from discontinued operations, net of tax of \$7,066 in 2002 | | | | 11,534 |
| Gain (loss) on disposal of discontinued operations, net of tax of \$816 in 2003 and tax benefit of \$717 in 2002 | | | 1,345 | (19,069) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total Discontinued Operations | | | 1,345 | (7,535) |
| Cumulative effect of a change in accounting principle, net of tax benefit of \$10,830 | | | | (17,602) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net Loss | \$ (5,159) | \$ (41) | \$ (7,083) | \$ (28,826) |
| Basic and diluted earnings per share (split adjusted): | | | | |
| Loss per share from continuing operations before cumulative effect of a change in accounting principle | \$ (0.49) | \$ | \$ (0.81) | \$ (0.36) |
| Discontinued operations: | | | | |
| Income from discontinued operations, net of tax | | | | 1.12 |
| Gain (loss) on disposal of discontinued operations, net of tax | | | 0.13 | (1.85) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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| | | | | |
|---|-----------|--------|-----------|-----------|
| Total Discontinued Operations | | | 0.13 | (0.73) |
| | _____ | _____ | _____ | _____ |
| Cumulative effect of a change in accounting principle, net of tax benefit | | | | (1.71) |
| | _____ | _____ | _____ | _____ |
| Net Loss | \$ (0.49) | \$ | \$ (0.68) | \$ (2.80) |
| | _____ | _____ | _____ | _____ |
| Basic Weighted Average Number of Shares Outstanding | 10,436 | 10,317 | 10,402 | 10,310 |
| | _____ | _____ | _____ | _____ |
| Diluted Weighted Average Number of Shares Outstanding | 10,436 | 10,317 | 10,402 | 10,310 |
| | _____ | _____ | _____ | _____ |

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

Table of Contents**CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)****NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES***(In thousands)*

| | SIX MONTHS ENDED | |
|--|------------------------------|------------------------------|
| | February 28, 2003 | February 28, 2002 |
| Cash Provided by (Used for) Operating Activities: | | |
| Net loss from continuing operations | \$ (8,428) | \$ (3,689) |
| Adjustments to reconcile net income to net cash provided by (used for) operating activities: | | |
| Depreciation and amortization | 12,902 | 12,530 |
| Provision for losses on accounts receivable | 611 | 643 |
| Gain on the sale of property, plant and equipment | (143) | (81) |
| Restructuring expense and other charges | | 5,439 |
| Gain on the sale of business | | (379) |
| Change in assets and liabilities, net of effect of acquisitions and divestitures: | | |
| Receivables | 1,142 | (354) |
| Inventories and linens in service, net | (456) | 6,011 |
| Deferred income taxes | 3,047 | 842 |
| Prepayments and other assets | (6,450) | (1,657) |
| Accounts payable | (1,914) | (9,749) |
| Accrued liabilities | (2,216) | 2,877 |
| Self-insurance accruals and other long-term liabilities | (6,256) | (12,540) |
| | <u> </u> | <u> </u> |
| Net Cash Used for Continuing Operations | (8,161) | (107) |
| Net Cash Provided by Discontinued Operations | 3,968 | 6,935 |
| | <u> </u> | <u> </u> |
| Net Cash (Used for) Provided by Operating Activities | (4,193) | 6,828 |
| | <u> </u> | <u> </u> |
| Cash Provided by (Used for) Investing Activities: | | |
| Purchases of property, plant and equipment | (4,478) | (10,607) |
| Sale of property, plant and equipment | 441 | 705 |
| Acquisitions | (356) | (60) |
| Divestitures | | 1,062 |
| Change in other assets | | (149) |
| | <u> </u> | <u> </u> |
| Net Cash Used for Investing Activities | (4,393) | (9,049) |
| | <u> </u> | <u> </u> |
| Cash Provided by (Used for) Financing Activities: | | |
| Repayments of notes payable, net | | 9,001 |
| Repayments of long-term debt | (2,077) | (411) |
| Repayments of capital lease obligations | (91) | |
| Treasury stock transactions, net | 156 | 679 |
| Cash dividends paid | (893) | (7,048) |
| | <u> </u> | <u> </u> |
| Net Cash (Used for) Provided by Financing Activities | (2,905) | 2,221 |
| | <u> </u> | <u> </u> |
| Net Change in Cash and Cash Equivalents | (11,491) | |
| Cash and Cash Equivalents at Beginning of Period | 20,969 | |

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| | | |
|---|----------|----------|
| Cash and Cash Equivalents at End of Period | \$ 9,478 | \$ |
| Supplemental Cash Flow Information: | | |
| Income taxes paid during the period | \$ 105 | \$ 3,501 |
| Interest paid during the period | 125 | 12,987 |
| Noncash Activities: | | |
| Capital lease obligations incurred during the period | \$ 1,440 | \$ |
| Non cash aspects of sale of business: | | |
| Reduction of liabilities recorded in conjunction with the 1997 sale of business | | 379 |
| Cumulative effect of a change in accounting principle | | 28,432 |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES

Recent Developments

On April 1, 2003, National Service Industries, Inc. (NSI or the Company) and NS Acquisition Corp. (Buyer), an affiliate of California Investment Fund, LLC, entered into an Agreement and Plan of Merger, pursuant to which each outstanding share of the Company's common stock will be converted into the right to receive \$10.00 in cash (the Merger). The closing of the Merger is subject to the approval of the Company's stockholders, the receipt of certain financing, and other customary conditions. Commitment letters have been obtained with respect to all necessary financing in connection with the Merger. The Merger is expected to close around midyear in calendar year 2003. Upon completion of the Merger, the Company will no longer be a reporting company with the Securities and Exchange Commission and its shares will cease to trade on the New York Stock Exchange.

1. BASIS OF PRESENTATION

On November 7, 2001, management of NSI approved the spin-off, subject to certain conditions, of its lighting equipment and chemicals businesses into a separate publicly-traded company with its own management and board of directors. The spin-off conditions were met November 29, 2001 and the spin-off was effected on November 30, 2001 through a tax-free distribution (Distribution) of 100% of the outstanding shares of common stock of Acuity Brands, Inc. (Acuity), a wholly-owned subsidiary of NSI owning and operating the lighting equipment and chemicals businesses. Each NSI stockholder of record as of November 16, 2001, the record date for the distribution, received one share of Acuity common stock for each share of NSI common stock held at that date.

Certain NSI corporate assets, liabilities, and expenses have been allocated to Acuity based on an estimate of the proportion of corporate amounts allocable to Acuity, utilizing such factors as revenues, number of employees, and other relevant factors. As a result of the spin-off, the Company's financial statements for the six months ended February 28, 2002 have been prepared with Acuity's net assets, results of operations, and cash flows presented as discontinued operations. All historical statements have been restated to conform with this presentation. In the opinion of management, the allocations have been made on a reasonable basis.

The interim consolidated financial statements included herein have been prepared by the Company without audit and the consolidated balance sheet as of August 31, 2002 has been derived from audited statements. These statements reflect all adjustments, all of which are of a normal, recurring nature, which are, in the opinion of management, necessary to present fairly the consolidated financial position as of February 28, 2003, the consolidated results of operations for the three and six months ended February 28, 2003 and 2002, and the consolidated cash flows for the six months ended February 28, 2003 and 2002. Certain reclassifications have been made to the prior year's financial statements to conform to the current year's presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. The Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended August 31, 2002.

The results of operations for the three and six months ended February 28, 2003 are not necessarily indicative of the results to be expected for the full fiscal year because the Company's revenues and income are generally higher in the second half of its fiscal year and because of the uncertainty of general business conditions.

2. RECENT ACCOUNTING STANDARDS

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) 143, Accounting for Asset Retirement Obligations. SFAS 143 addresses financial accounting and reporting obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes the cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement. The Company adopted SFAS 143 effective September 1, 2002. The adoption of SFAS 143 did not have a material impact on the Company's financial statements.

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In June 2002, the FASB issued SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities . SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3,

Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) . The principal difference between SFAS 146 and EITF Issue 94-3 relates to its requirements for recognition of a liability for a cost associated with an exit or disposal activity. SFAS 146 requires that a liability for a cost associated with an exit or disposal activity to be recognized when the liability is incurred. Under EITF Issue 94-3, a liability for an exit cost as defined in EITF Issue 94-3 was recognized at the date of an entity's commitment to an exit plan. A fundamental conclusion reached by the Board in this Statement is that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, SFAS 146 eliminates the definition and requirements for recognition of exit costs in EITF Issue 94-3. This Statement also establishes that fair value is the objective for initial measurement of the liability. SFAS 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS 146 did not have a material impact on the Company's financial statements.

In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN No. 45 clarifies the requirements of SFAS No. 5, Accounting for Contingencies, relating to the guarantor's accounting for and disclosures of certain guarantees issued. The initial recognition and measurement provisions of the interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements of the interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company's disclosures related to guarantees can be found in Note 13.

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In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 148 allows for three methods of transition for those companies that adopt SFAS No. 123's provisions for fair value recognition. SFAS No. 148's transition guidance and provisions for annual disclosures are effective for fiscal years ending after December 15, 2002. SFAS 148's amendment of the disclosure provisions of Opinion 28 is effective for financial reports containing condensed consolidated financial statements for interim periods beginning after December 31, 2002. The Company will not adopt fair value accounting for employee stock options under SFAS No. 123 and SFAS No. 148, but will continue to disclose the required pro-forma information in the notes to the consolidated financial statements.

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51. FIN 46 addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The application of this Interpretation is not expected to have a material effect on the Company's consolidated financial statements.

3. INTANGIBLE ASSETS

The Company adopted SFAS 142 as of September 1, 2001. Summarized information for the Company's acquired intangible assets is as follows:

| (in thousands) | February 28, 2003 | | August 31, 2002 | |
|------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortized intangible assets: | | | | |
| Customer contracts | \$ 11,745 | \$(4,591) | \$ 11,589 | \$(3,851) |
| Other | 1,643 | (1,173) | 1,635 | (1,016) |
| Total | \$ 13,388 | \$(5,764) | \$ 13,224 | \$(4,867) |

The Company amortizes customer contracts over estimated useful lives of seven years. Other acquired intangible assets, consisting primarily of restrictive covenant agreements, are amortized over the lives of the agreements, which average approximately four years. The Company recorded amortization expense of \$460,000 and \$925,000 related to intangible assets for the three and six months ended February 28, 2003 and \$432,000 and \$913,000 for the three and six months ended February 28, 2002, respectively.

The textile rental and envelope segments each tested goodwill for impairment during the first quarter of fiscal 2002 as required by SFAS 142 upon adoption, utilizing a combination of valuation techniques including the expected present value of future cash flows, a market multiple approach and a comparable transaction approach. As a result of this valuation process as well as the application of the remaining provisions of SFAS 142, the Company recorded a pre-tax transitional impairment loss of \$28.4 million, representing the write-off of all of the Company's existing goodwill. This write-off was reported as a cumulative effect of a change in accounting principle, on a net of tax basis, in the Company's Consolidated Statement of Operations for the six months ended February 28, 2002.

4. BUSINESS SEGMENT INFORMATION

The following tables summarize the Company's business segment information from continuing operations:

| (in thousands) | Sales and Service Revenues | Operating Profit (Loss) | Depreciation and Amortization Expense | Capital Expenditures Including Acquisitions |
|----------------|----------------------------|-------------------------|---------------------------------------|---|
|----------------|----------------------------|-------------------------|---------------------------------------|---|

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| Three Months Ended February 28, 2003 | | | | |
|---|-------------------|------------------|----------------|----------------|
| Textile Rental | \$ 76,142 | \$(1,454) | \$4,224 | \$1,386 |
| Envelope | 45,307 | (2,139) | 2,074 | 360 |
| | <u>121,449</u> | <u>(3,593)</u> | <u>6,298</u> | <u>1,746</u> |
| Corporate | | (3,950) | 113 | |
| Interest expense | | (47) | | |
| | <u>121,449</u> | <u>(7,590)</u> | <u>6,411</u> | <u>1,746</u> |
| Total | \$ 121,449 | \$(7,590) | \$6,411 | \$1,746 |

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| (in thousands) | Sales and Service Revenues | Operating Profit (Loss) | Depreciation and Amortization Expense | Capital Expenditures Including Acquisitions |
|---|----------------------------------|-------------------------------|--|--|
| Three Months Ended February 28, 2002 | | | | |
| Textile Rental | \$ 77,335 | \$ 1,342 | \$ 4,071 | \$ 3,155 |
| Envelope | 54,703 | 649 | 1,800 | 2,381 |
| | <u>132,038</u> | <u>1,991</u> | <u>5,871</u> | <u>5,536</u> |
| Corporate | | (1,892) | 125 | 135 |
| Interest expense | | (168) | | |
| Total | <u>\$ 132,038</u> | <u>\$ (69)</u> | <u>\$ 5,996</u> | <u>\$ 5,671</u> |
| Six Months Ended February 28, 2003 | | | | |
| Textile Rental | \$ 152,234 | \$ (5,721) | \$ 8,480 | \$ 3,268 |
| Envelope | 89,278 | (3,078) | 4,188 | 1,402 |
| | <u>241,512</u> | <u>(8,799)</u> | <u>12,668</u> | <u>4,670</u> |
| Corporate | | (3,999) | 234 | 164 |
| Interest expense | | (48) | | |
| Total | <u>\$ 241,512</u> | <u>\$ (12,846)</u> | <u>\$ 12,902</u> | <u>\$ 4,834</u> |
| Six Months Ended February 28, 2002 | | | | |
| Textile Rental | \$ 156,171 | \$ (4,037) | \$ 8,188 | \$ 7,260 |
| Envelope | 110,256 | 2,803 | 4,004 | 3,219 |
| | <u>266,427</u> | <u>(1,234)</u> | <u>12,192</u> | <u>10,479</u> |
| Corporate | | (4,636) | 338 | 188 |
| Interest expense | | (279) | | |
| Total | <u>\$ 266,427</u> | <u>\$ (6,149)</u> | <u>\$ 12,530</u> | <u>\$ 10,667</u> |

Total Assets

| (in thousands) | February 28, 2003 | August 31, 2002 |
|----------------|----------------------|--------------------|
| Textile Rental | \$ 203,644 | \$ 207,886 |
| Envelope | 93,810 | 99,391 |
| Subtotal | <u>297,454</u> | <u>307,277</u> |
| Corporate | 335,660 | 211,821 |
| Total | <u>\$ 633,114</u> | <u>\$ 519,098</u> |

5. INVENTORIES

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Major classes of inventory as of February 28, 2003 and August 31, 2002 were as follows:

| (in thousands) | February 28, 2003 | August 31, 2002 |
|----------------------------|----------------------|--------------------|
| Raw Materials and Supplies | \$ 6,073 | \$ 5,716 |
| Work-in-Process | 3,375 | 2,493 |
| Finished Goods | 7,290 | 7,828 |
| Total | \$ 16,738 | \$ 16,037 |

6. DISCONTINUED OPERATIONS

In October 2002, the Company sold its linen business in San Diego, California for \$4,784,000 of cash. The net gain on the transaction of \$1,345,000, net of tax of \$816,000, is included in discontinued operations. The results of operations for this business were not material and, accordingly, are not presented in discontinued operations.

On November 7, 2001, the Company's Board of Directors approved the spin-off of its lighting equipment and chemicals businesses into a separate publicly-traded company with its own management and board of directors. The spin-off was effected on November 30, 2001 through a tax-free distribution of 100% of the outstanding shares of common stock of Acuity, a wholly-owned subsidiary of the Company owning and operating the lighting equipment and chemicals businesses. Each NSI stockholder of record as of November 16, 2001, the record date for the Distribution, received one share of the Acuity common stock for each share of NSI common stock held at that date.

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As a result of the November 2001 spin-off, the Company's financial statements have been prepared with these businesses' net assets, results of operations, and cash flows presented as discontinued operations through the effective date of the Distribution, November 30, 2001. All historical statements have been restated to conform with this presentation.

In conjunction with the spin-off, the Company and Acuity entered into various agreements that addressed the allocation of assets and liabilities between them and that defined their relationship after the separation, including a distribution agreement, a tax disaffiliation agreement, an employee benefits agreement, a transition services agreement and a lease agreement. Management believes the amounts paid or received associated with these services are representative of the fair value of the services provided.

In addition, Acuity and NSI entered into a put option agreement, whereby NSI had the option to require Acuity to purchase the property where NSI's corporate headquarters are located for a purchase price equal to 85 percent of the agreed-upon fair market value of the property. On May 23, 2002 the Company completed the cash sale of the property to an unrelated third party. Subsequent to the sale, NSI executed a release of the put option agreement, thereby extinguishing any rights that NSI had under the agreement.

7. EARNINGS PER SHARE

The Company accounts for earnings per share using Statement of Financial Accounting Standards No. 128, Earnings per Share. Under this statement, basic earnings per share is computed by dividing net earnings available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed similarly but reflects the dilutive effect of potential common shares, including options and restricted stock.

The following table calculates basic earnings per common share and diluted earnings per common share at February 28, 2003 and 2002:

| (in thousands except per share data) | Three Months Ended February 28, | | Six Months Ended February 28, | |
|--|------------------------------------|---------|----------------------------------|------------|
| | 2003 | 2002 | 2003 | 2002 |
| <i>Basic and diluted earnings per common share:</i> | | | | |
| Loss from continuing operations before cumulative effect of a change in accounting principle | \$ (5,159) | \$ (41) | \$ (8,428) | \$ (3,689) |
| Basic and diluted weighted average shares outstanding | 10,436 | 10,317 | 10,402 | 10,310 |
| Loss from continuing operations before cumulative effect of a change in accounting principle per share | \$ (0.49) | \$ | \$ (0.81) | \$ (0.36) |

Stock options to purchase 1,213,000 and 1,225,000 shares of common stock for the three and six months ended February 28, 2003, respectively, and 1,275,000 and 1,175,000 shares of common stock for the three and six months ended February 28, 2002, respectively, and unvested restricted shares of 736,000 and 713,000 for the three and six months ended February 28, 2003, respectively, and 322,000 and 189,000 for the three and six months ended February 28, 2002, respectively, were not included in the computation of diluted earnings per share because their effect would have been antidilutive.

8. LONG-TERM DEBT AND CAPITAL LEASES

In January 2003, the Company incurred capital lease obligations for equipment of \$1,440,000. At February 28, 2003, the capital lease obligations were \$1,349,000.

In October 2001, the Company negotiated a \$40 million, three-year committed credit facility with a single major US bank that became effective at the time of the spin-off. The facility contains financial covenants including a leverage ratio, a ratio of income available for fixed charges to fixed charges, and a minimum amount of stockholders' equity. Interest rates under the facility are based on the LIBOR rate or other rates, at the Company's option. The Company pays an annual fee on the commitment based on the Company's leverage ratio. At February 28, 2003, the Company failed to comply with two financial covenants in the credit facility, which resulted in an event of default under the credit agreement.

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The covenants in question require the Company, as of the end of each fiscal quarter, to maintain a minimum ratio of income available for fixed charges to fixed charges for the preceding four consecutive fiscal quarters and a minimum amount of stockholders' equity (as such terms are defined in the credit agreement). On March 28, 2003, the lender agreed to waive the event of default pursuant to an agreement that will require the Company to obtain the lender's approval of any additional borrowings under the credit facility. The credit facility is expected to be terminated upon consummation of the Merger. At February 28, 2003, no amounts were outstanding, standby letters of credit of approximately \$11.4 million were outstanding and \$28.6 million was available under the facility.

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9. LEGAL PROCEEDINGS

The Company is subject to various legal claims arising in the normal course of business out of the conduct of its current and prior businesses, including product liability claims. Based on information currently available, it is the opinion of management that the ultimate resolution of pending and threatened legal proceedings will not have a material adverse effect on the Company's financial condition or results of operations beyond its current estimates. However, in the event of unexpected future developments, it is possible that the ultimate resolution of such matters, if unfavorable, could have a material adverse effect on the Company's financial condition and results of operations in a particular future period. The Company accrues for legal claims when payments associated with the claims become probable and can be reasonably estimated for financial statement purposes. While management believes that its accruals are appropriate based on information currently available, the actual costs of resolving pending and future legal claims against the Company may differ substantially from the amounts accrued.

Among the product liability claims to which the Company is subject are claims for personal injury or wrongful death arising from the installation and distribution of asbestos-containing insulation, primarily in the southeastern United States, by a previously divested business of the Company. Most claims against the Company seek both substantial compensatory damages and punitive damages. The Company believes that many of the claims against it are without merit. The Company believes its conduct with respect to asbestos-containing insulation was consistent with recognized safety standards at the relevant times, and the Company believes there is no basis for imposing punitive damages against it in connection with asbestos claims. In addition, the Company believes that it has substantial legal defenses against many of these claims, including that the Company did not manufacture any asbestos-containing building products, that the Company did not distribute or install products at certain sites where exposure is alleged, and that statutes of repose in some states bar the claims. However, there is no assurance that the Company will be successful in asserting defenses to these claims.

Prior to February 1, 2001, the Center for Claims Resolution (the "CCR"), a membership organization for asbestos defendants, handled the processing and settlement of claims on behalf of the Company and retained local counsel for the defense of claims. Pursuant to a written agreement among CCR members, the Company was responsible for varying percentages of defense and liability payments on a claim-by-claim basis for each claim in which it was named in accordance with predetermined sharing formulae. Substantially all of the Company's portion of those payments was paid directly by the Company's insurers. Since February 1, 2001, the Company has retained trial counsel directly, rather than through the CCR, to defend asbestos-related claims against the Company and has engaged another outside consultant to provide claims processing and administration services for asbestos-related claims. The Company is more vigorously defending asbestos-related claims and will seek to dismiss without any settlement payment claims arising in jurisdictions or involving worksites where the Company did not distribute or install asbestos-containing products.

During the past two years, certain former members of the CCR have failed to make payments to the CCR, by reason of bankruptcy or otherwise, for their shares of certain settlement agreements the CCR had reached on behalf of its members with plaintiffs. Consequently, with respect to some settlement agreements, the CCR has been unable to make the full payments contemplated by those agreements. In some circumstances, the Company and other members and former members of the CCR have contributed additional funds to the CCR to permit it to make certain payments contemplated by the settlement agreements, though the Company does not believe it is liable for such additional funds. As of February 28, 2003, the Company has contributed approximately \$6.3 million to the CCR for this purpose, and it may make further such payments in the future. Some plaintiffs who are parties to settlement agreements with the CCR that contemplate payments that the CCR has been unable to make have commenced litigation against the CCR, the Company, and other members and former members to recover amounts due under these settlement agreements. The Company believes that it should not be liable for settlement payments attributable to other members or former members of the CCR, and the Company has joined a joint defense group with other CCR members to defend these claims.

The Company believes that any amount it pays, including the \$6.3 million it has already contributed to the CCR, on account of payments contemplated by settlement agreements entered into by the CCR on behalf of its members, should be covered either by the Company's insurance or by surety bonds and collateral provided by those former members who failed to meet their obligations. There can be no assurance, however, that the Company can actually recover any of these amounts. Accordingly, no insurance or other recovery with respect to these amounts has been recorded as an asset in the Company's financial statements.

The amount of the Company's liability on account of payments contemplated by settlement agreements entered into by the CCR is uncertain. The Company has included in its accruals its estimate of the Company's potential liability in this respect, but the Company's ultimate liability for these matters could be greater than estimated if more CCR members or former members fail to meet their obligations or if the courts determine that the Company could be liable for settlement payments that were attributable to other CCR members.

Several significant companies that are traditional co-defendants in asbestos claims, both former members of the CCR and non-members, have sought protection under Chapter 11 of the federal bankruptcy code during the past three years. Litigation against such co-defendants generally is stayed or restricted as a result of their bankruptcy filings. The absence of these traditional defendants may increase the number of claims filed

against other defendants, including the Company, and may increase the cost of resolving such claims. Due to the uncertainties surrounding the ultimate effect of these bankruptcies on remaining asbestos defendants, the effect on the amount of the Company's liabilities cannot be determined.

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The claims activity for each of the six month periods ended February 28 was as follows:

| | <u>2003</u> | <u>2002</u> |
|---|-----------------|---------------|
| Open claims, beginning of period | 35,300 | 35,000 |
| Served | 19,700 | 4,900 |
| Dismissed | (3,500) | (11,300) |
| Settled | (12,300) | (2,800) |
| | <u>39,200</u> | <u>25,800</u> |
| Settled in principle after February 1, 2001 but not finalized | (9,700) | (2,800) |
| | <u>29,500</u> | <u>23,000</u> |
| Average resolution indemnity cost per claim for the six months ended February 28* | \$ 2,262 | \$ 880 |
| Total claims resolved since February 1, 2001 | <u>46,800</u> | |
| Average resolution indemnity cost per claim for claims resolved since February 1, 2001* | <u>\$ 1,261</u> | |

*Average resolution indemnity cost is based on indemnity costs for 15,800 and 14,100 claims dismissed and settled during the six months ended February 28, 2003 and 2002, respectively. During the six months ended February 28, 2003, a significant number of claims reflected as pending as of August 31, 2002 were settled in principle but have not been finalized for an average indemnity cost substantially higher than the Company's historical averages. If these claims were included in the average resolution indemnity cost per claim for the six months ended February 28, 2003, the cost would increase from \$2,262 to \$4,933 per claim. If these claims were included in the average resolution indemnity cost per claim for claims resolved since February 1, 2001, the cost would increase from \$1,261 to \$2,354 per claim. These cases were pending against the Company in Jefferson County (Beaumont) and Orange County, Texas, and the Company elected to settle these claims for amounts significantly greater than its historical averages in order to avoid the risk of potentially higher jury awards in these unfavorable jurisdictions.

As of February 28, 2003 and 2002, there were approximately 7,000 and 7,900 additional claims, respectively, that were, as part of CCR settlements, settled in principle prior to February 1, 2001 but not finalized.

As of February 28, 2003 and August 31, 2002, an estimated accrual of \$332.3 million and \$208.1 million, respectively, for asbestos-related liabilities, before consideration of insurance recoveries, has been reflected in the accompanying financial statements, primarily in long-term liabilities. During the year ended August 31, 2002, as part of its ongoing estimating process, consultation with outside experts, the nature of pending claims, the jurisdiction in which claims have been filed, and in light of its gained experience in administration of its defense strategy and recent settlement activity, the Company reviewed its asbestos claims liabilities and adjusted the balances in these accounts from its prior three year outlook to an estimate of the total probable liabilities from pending and expected future asbestos claims over an approximate fifty year period, which takes into consideration the life expectancy of individuals potentially exposed. As a result of such review, the Company increased its liabilities for asbestos-related costs by approximately \$94 million and recorded an additional insurance recovery amount of \$77 million.

During the quarter ended February 28, 2003, the Company engaged external consulting economists to review the expected asbestos claims liabilities. Based on information supplied by this study and management's knowledge of and experience with its asbestos liabilities and insurance recoveries, the Company concluded that an additional increase in its liabilities was necessary. This increase is attributed to higher average resolution indemnity costs per claim than previously estimated. The increase in the liabilities resulting from this review process was a range of \$138 million to \$209 million. Management does not believe that any amount in the range is more accurate than any other. Therefore, as of February 28, 2003, the Company increased its liabilities for asbestos-related costs by approximately \$138 million, the low end of the range. Additionally, the Company believes it has adequate insurance coverage available to cover this increase in liabilities and therefore recorded an additional insurance recovery amount of \$138 million.

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The Company's estimates of indemnity payments and defense costs associated with pending and future asbestos claims are based on the Company's estimate of the number of future asbestos-related claims and the type of disease, if any, alleged or expected to be alleged in such claims, assumptions regarding the timing and amounts of settlement payments, the status of ongoing litigation and settlement initiatives, and the advice of outside counsel with respect to the current state of the law related to asbestos claims. The ultimate liability for all pending and future claims cannot be determined with certainty due to the difficulty of forecasting the numerous variables that can affect the amount of liability. There are inherent uncertainties involved in estimating these amounts, and the Company's actual costs in future periods could differ materially from the Company's estimates due to changes in facts and circumstances after the date of each estimate.

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The Company believes that it has insurance coverage available to recover most of its asbestos-related costs. With the exception of the Company's payments on account of settlement obligations of defaulting CCR members as discussed above, the Company has reached settlement agreements with substantially all of its relevant insurers providing for payment of substantially all asbestos-related claims (subject to retentions) up to the various policy limits. The timing and amount of future recoveries from insurance carriers will depend on the pace of claims review and processing by such carriers and on the resolution of any remaining disputes regarding coverage under such policies. In the event the Company's insurers dispute amounts billed to them or pay on an untimely basis, the Company takes all practicable steps to secure payment, including alternative dispute resolution procedures and litigation to resolve the issues. The Company currently is involved in an alternative dispute resolution proceeding with one insurer to resolve outstanding insurance policy interpretation issues. The Company has resolved an alternative dispute resolution proceeding with another insurer, and, as part of that resolution, has received payment of past due amounts at issue in the proceeding, has reached an agreement to ensure timely payments of future obligations, and has reached a consensus with the insurer concerning policy interpretation issues.

The Company believes its recorded receivables, which includes both billed amounts and estimates of future recoveries, from insurance carriers are collectible. The Company reached this conclusion after considering various factors including its prior insurance-related recoveries in respect of asbestos-related claims, existing insurance policies, settlement agreements with insurers, the apparent viability of its insurers, the advice of outside counsel with respect to the applicable insurance coverage law relating to terms and conditions of those policies, and a general assessment by the Company and its advisors of the financial condition of the relevant insurers. Accordingly, an estimated aggregate insurance recovery of \$312.4 million and \$182.9 million has been reflected in the accompanying financial statements as of February 28, 2003 and August 31, 2002, respectively, with respect to previously paid claims, pending and future claims and the other items included in the accrual of asbestos-related liabilities. Approximately \$95.5 million and \$42.0 million of the aggregate insurance recovery and \$82.8 million and \$41.3 million of the asbestos-related accrual have been classified as current assets and liabilities in the accompanying balance sheet as of February 28, 2003 and August 31, 2002, respectively.

Management continues to monitor claims activity, the status of lawsuits (including settlement initiatives), legislative developments, and costs incurred in order to ascertain whether an adjustment to the existing accruals should be made to the extent that historical experience may differ significantly from the Company's underlying assumptions. As additional information becomes available, the Company will reassess its liability and revise its estimates as appropriate. Management currently believes that, based on the factors discussed in the preceding paragraphs and taking into account the accruals reflected as of February 28, 2003, the resolution of asbestos-related uncertainties and the incurrence of asbestos-related costs net of related insurance recoveries should not have a material adverse effect on the Company's long-term consolidated financial position or results of operations. However, as the Company's estimates are periodically re-evaluated, additional accruals to the liabilities reflected in the Company's financial statements may be necessary, and such accruals could be material to the results of the period in which they are recorded. Given the number and complexity of factors that affect the Company's liability and its available insurance, the actual liability and insurance recovery may differ substantially from the Company's estimates. No assurance can be given that the Company will not be subject to significant additional asbestos litigation and material additional liabilities. If actual liabilities significantly exceed the Company's estimates or if expected insurance recoveries become unavailable, due to additional insolvencies among the Company's primary or excess insurance carriers, disputes with carriers or otherwise, the Company's results of operations, liquidity and financial condition could be materially adversely affected.

The Company has been sued in four putative class actions, including a case brought on behalf of the general public in California, relating to the collection by National Linen Service of energy surcharges, environmental charges and, in two of the cases, sales taxes. One of these cases, which had been pending in federal court in South Carolina, has been dismissed. The other three cases are pending. The first case was filed in the Circuit Court of Barbour County, Alabama in May 2001 and was removed to the United States District Court for the Middle District of Alabama. The federal court denied the plaintiff's motion to remand the case to state court. Another case was filed in Superior Court of Napa County, California in May 2002. This case alleges that National Linen Service and numerous other linen and uniform suppliers have violated Sections 17200 and 17500 of the California Business and Professions Code. The third remaining case was filed in the United States District Court in the Southern District of Illinois in June 2002. This case alleges that National Linen Service and numerous other linen and uniform suppliers and the Textile Rental Services Association violated federal antitrust laws and state statutes in setting and charging the fees described above. As of April 7, 2003, no substantive discovery had occurred in any case. Based on information currently available, it is the opinion of management that the claims in these cases are without merit and that the ultimate resolution of these legal proceedings will not have a material adverse effect on the Company's financial condition or results of operations.

Table of Contents**10. ENVIRONMENTAL MATTERS**

The Company's operations are subject to comprehensive laws and regulations relating to the generation, storage, handling, transportation, and disposal of hazardous substances and solid and hazardous wastes and to the remediation of contaminated sites. Permits and environmental controls are required for certain of the Company's operations to limit air and water pollution, and these permits are subject to modification, renewal and revocation by issuing authorities. The Company believes that it is in substantial compliance with all material environmental laws, regulations and permits. On an ongoing basis, the Company incurs capital and operating costs relating to environmental compliance. Environmental laws and regulations have generally become stricter in recent years, and the cost of responding to future changes may be substantial.

The Company's environmental accruals, which are included in current liabilities, totaled \$5,699,000 and \$5,777,000 at February 28, 2003 and August 31, 2002, respectively. The actual cost of environmental issues may be lower or higher than that accrued due to the difficulty in estimating such costs and potential changes in the status of government regulations.

Certain environmental laws can impose liability regardless of fault. The federal Superfund law is an example of such an environmental law. However, liability under Superfund is mitigated by the presence of other parties who will share in the costs associated with clean-up of sites. The extent of liability is determined on a case-by-case basis taking into account many factors, including the number of other parties whose status or activities also subjects them to liability regardless of fault.

The Company is currently a party to, or otherwise involved in, legal proceedings in connection with state and federal Superfund sites, one of which is located on property owned by the Company. Except for the Blydenburgh Landfill matter in New York (which is discussed below), the Company believes its liability is *de minimis* at each of the currently active sites which it does not own where it has been named as a potentially responsible party (PRP) due to its limited involvement at the site and/or the number of viable PRPs. For property which the Company owns on East Paris Street in Tampa, Florida, the Company was requested by the State of Florida to clean up chlorinated solvent contamination in the groundwater beneath the property and beneath surrounding property known as Seminole Heights Solvent Site and to reimburse approximately \$430,000 of costs already incurred by the State of Florida in connection with such contamination. The Company presented expert evidence to the State of Florida in 1998 that the Company is not the source of the contamination, and the State has referred this matter to the Environmental Protection Agency for review. At this point in time, it is not possible to quantify the extent, if any, of the Company's exposure.

In connection with the sale of certain assets, including 29 of the Company's textile rental plants in 1997, the Company has retained environmental liabilities arising from events occurring prior to the closing, subject to certain exceptions. The Company has received notice from the buyer of the textile rental plants of the alleged presence of perchloroethylene contamination on two of the properties in Texas involved in the sale. Because the Company is not the source of contamination, the Company asserted indemnification claims against the company from which it bought the properties. The prior owner is currently addressing the contamination at its expense at the properties, subject to a reservation of rights. At this time, it is too early to quantify the Company's potential exposure in these matters, the likelihood of an adverse result, or the outcome of the Company's indemnification claims against the prior owner.

In May 1999, the State of New York filed a lawsuit against the Company alleging that the Company is responsible under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) as a successor to Serv-All Uniform Rental Corp. (Serv-All), for past and future response costs in connection with the disposal of perchloroethylene at the Blydenburgh Landfill in Islip, New York. The Company believes that it is not a successor to Serv-All and therefore has no liability with respect to the Blydenburgh Landfill.

In February 2001, the federal district court in the Eastern District of New York issued a declaratory judgment that the Company is a successor to Serv-All. On December 12, 2001, the Court granted summary judgment for the State finding the Company jointly and severally liable for all CERCLA response costs at the Blydenburgh Landfill. Final judgment was entered on September 17, 2002, in the amount of \$12,499,000. A notice of appeal was filed on October 10, 2002. Briefing has been completed and oral argument has not been scheduled.

In its appeal, the Company asserted that the trial court erred in declaring that the Company is a successor to Serv-All, in finding that the State's claims were not barred by the statute of limitations, and in holding that the Company is jointly and severally liable for response costs. Even if the Company were unsuccessful in its appeal to the Second Circuit Court of Appeals, the Company would have a right to seek recovery of response costs from the many other parties whose wastes were disposed of at the Blydenburgh Landfill. In fact, the Company has initiated the process of seeking recovery in a related case filed by the State of New York against Hickey's Carting Co. (Hickey's) in the Eastern District of New York (the Hickey's Case).

In the Hickey's Case, the State of New York sued Hickey's, the company Serv-All retained to transport its waste, for past and future response costs in connection with the release of hazardous substances at the Blydenburgh Landfill in Islip, New York. On September 3, 2002, Hickey's

sued the Company, along with several other parties, for contribution to any judgment ultimately awarded against Hickey s.

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The Company has all of the same defenses in the Hickey's Case as in the case brought against the Company by the State of New York. The Company has also counterclaimed against Hickey's and cross-claimed against the other named parties, seeking contribution toward the judgment entered in the case brought against the Company by the State of New York.

If the Company prevails in the Second Circuit with its argument that it is not a successor to Serv-All, the Company will then file a motion to dismiss it from the Hickey's Case. Even if the Company does not prevail, any liability to the State of New York will be reduced by the contributions the Company will receive from the many other parties, including Hickey's, whose wastes were disposed of at the Blydenburgh Landfill, and the Company will have no additional liability to Hickey's or any other party in the Hickey's Case.

The Company also believes it is entitled to indemnification for all costs associated with the Blydenburgh Landfill by the parent (Initial Parent) of Initial Services Investments, Inc., which the Company acquired in 1992 and which had previously purchased and sold certain assets of Serv-All. On May 22, 2002, the Company filed a lawsuit against Initial Parent, seeking to enforce an indemnification provided by Initial Parent to the Company. The lawsuit seeks full indemnification by Initial Parent for all costs and expenses of litigating the Blydenburgh Landfill action, as well as a declaration that Initial Parent is obligated to indemnify the Company for any judgment which ultimately is assessed against the Company. On July 15, 2002, Initial Parent filed a motion to dismiss the lawsuit, followed by a motion for summary judgment on July 25, 2002. On January 31, 2003, the court denied both motions. Discovery in the indemnity lawsuit is progressing, but is not complete.

At this point, it is too early to quantify the Company's potential exposure, the likelihood of an adverse result, or the outcome of the Company's indemnification claim, and thus, no accrual has been recorded related to any of the above-described matters relating to the Blydenburgh Landfill.

11. RESTRUCTURING EXPENSE AND OTHER CHARGES

During the first quarter of fiscal 2002, the Company closed two under-performing facilities in the textile rental segment and recorded a related charge of \$5,820,000. The charge included severance costs of \$11,000 for four employees, all of whom were terminated prior to the end of the first quarter, and \$1,396,000 in exit expenses to close and consolidate facilities. Exit expenses primarily include costs of lease terminations and costs to dispose of facilities. Additionally, as a further result of the closure of the two textile rental facilities, the Company recognized long-lived asset impairments totaling \$4,413,000. Textile rental assets to be disposed of were reduced to state them at their estimated fair value less costs to sell. Assets to be disposed of primarily related to equipment located in the facilities included in the restructuring program noted above. After the charge, the remaining net book value of these assets was immaterial. Estimated fair market values were established based on an analysis of expected future cash flows. During the second quarter of fiscal 2002, the severance and exit cost accruals were adjusted as necessary based upon further review and analysis by management. The net change was a reduction of \$159,000 to the severance accrual and an increase of \$191,000 to the exit cost accrual.

The major components of the fiscal 2003 and 2002 restructuring charges and related activity are as follows:

| (in thousands) | Reserve, Beginning of Year | Cash Payments | Expense | Reserve, February 28 |
|-----------------|----------------------------------|------------------|---------|-------------------------|
| 2003 | | | | |
| Severance costs | \$ 527 | \$ (195) | \$ | \$ 332 |
| Exit costs | 557 | (264) | | 293 |
| 2002 | | | | |
| Severance costs | 2,969 | (2,187) | (148) | 634 |
| Exit costs | 1,582 | (1,951) | 1,587 | 1,218 |

The losses resulting from the restructuring activities and asset impairments are included in Restructuring expense and other charges in the Consolidated Statements of Operations.

Table of Contents**12. RESTRICTED STOCK**

In October 2002, the Company awarded 183,927 shares of restricted stock to officers and other key employees. In January 2003, the Company awarded 39,494 shares of restricted stock to its non-employee directors. The shares vest ratably in three equal annual installments beginning one year from the date of the grant. During the vesting period, the participants have voting rights and receive dividends, but the shares may not be sold, assigned, transferred, pledged or otherwise encumbered. For officers and other key employees, granted but unvested shares are forfeited upon termination of employment. For non-employee directors, except for death, disability or retirement, if a director resigns or is terminated, shares granted but unvested are forfeited.

The fair value of the restricted shares on the date of the grant is amortized ratably over the vesting period. Unearned compensation on the October 2002 and the January 2003 grants of restricted stock of \$1,044,000 and \$262,000, respectively, was recorded based on the market value of the shares on the date of grant and is generally being amortized over three years. The unamortized balance of unearned compensation on restricted stock is included as a separate component of stockholders' equity. Additionally, as a result of the grants, the cost of the treasury stock in excess of the unearned compensation reduced additional paid-in capital to zero; the remaining amount reduced retained earnings.

13. GUARANTEES*Guarantees*

NSI guaranteed the payment of up to \$712,500 as of February 28, 2003 for debt of Royal Airline Linen of Atlanta, LLC (RALA), an equity investment of the Company. The Company may be obligated to pay the principal amount of the debt and any related interest in the event of default by RALA. The guarantee expires when the underlying debt is paid in full, which was scheduled for July 2005. On March 21, 2003, RALA paid the debt in full, thereby releasing the Company from its guarantee.

Indemnifications

NSI enters into contracts that include indemnification provisions as a routine part of its business activities. In general, these provisions indemnify the counterparty for matters such as breaches of representations and warranties and any personal injury or property damage arising from NSI's actions or omissions, and in the context of a sale of portions of the business, any liabilities resulting from the conduct of the business prior to closing. In addition, in many sales agreements involving real property, NSI specifically indemnifies the counterparty for certain environmental obligations. For most contracts, there are no limitations on the maximum potential future payments for the environmental indemnification provisions. In most cases, the maximum potential amount is not estimable given that the magnitude of claims under those indemnifications would be a function of the extent of damages actually incurred, which is not practicable to estimate unless and until the event occurs. However, where damages have been incurred by the counterparty and indemnification payments are probable, the Company has recorded an estimate of the liability. As of February 28, 2003, the Company has approximately \$2,320,000 accrued for potential payments to be made for indemnifications included in sales agreements. No indemnification provisions have been entered into since December 31, 2002.

Standby Letters of Credit

In connection with the Company's casualty insurance program and certain asbestos-related litigation, the Company has provided standby letters of credit. As of February 28, 2003, standby letters of credit of approximately \$11.4 million were outstanding. These letters of credit expire at various dates in fiscal 2003 and fiscal 2004, and the Company anticipates that they will be renewed upon expiration. Additionally, as provided in the transition services agreement entered into in conjunction with the spin-off, Acuity will, for a fee, provide collateral associated with the casualty insurance program. At February 28, 2003 standby letters of credit of \$7.8 million were provided by Acuity for the benefit of the Company. The Company expenses the fees associated with obtaining the letters of credit as they are incurred.

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

The following discussion should be read in conjunction with the consolidated financial statements and related notes.

Recent Developments

On April 1, 2003, National Service Industries, Inc. (NSI or the Company) and NS Acquisition Corp. (Buyer), an affiliate of California Investment Fund, LLC, entered into an Agreement and Plan of Merger, pursuant to which each outstanding share of the Company's common stock will be converted into the right to receive \$10.00 in cash (the Merger). The closing of the Merger is subject to the approval of the Company's stockholders, the receipt of certain financing, and other customary conditions. Commitment letters have been obtained with respect to all necessary financing in connection with the Merger. The Merger is expected to close around midyear in calendar year 2003. Upon completion of the Merger, the Company will no longer be a reporting company with the Securities and Exchange Commission and its shares will cease to trade on the New York Stock Exchange.

National Service Industries, Inc. (the Company or NSI) operates in two business segments textile rental and envelope manufacturing. NSI is headquartered in Atlanta, Georgia, and provides products and services throughout the United States. Net working capital was \$93.5 million at February 28, 2003, up from \$83.0 million at August 31, 2002, and the current ratio decreased from 1.8 at August 31, 2002 to 1.7 at February 28, 2003.

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 142 (SFAS 142), Goodwill and Other Intangible Assets. SFAS 142 requires companies to cease amortizing goodwill that existed at June 30, 2001 and establishes a new method for testing goodwill for impairment on an annual basis (or an interim basis if an event occurs that might reduce the fair value of a reporting unit below its carrying value). Any goodwill resulting from acquisitions completed after June 30, 2001 will not be amortized. SFAS 142 also requires that an identifiable intangible asset that is determined to have an indefinite useful economic life not be amortized, but separately tested for impairment using a fair value based approach.

The textile rental and envelope segments each tested goodwill for impairment during the first quarter of fiscal 2002 as required by SFAS 142 upon adoption, utilizing a combination of valuation techniques including the expected present value of future cash flows, a market multiple approach and a comparable transaction approach. As a result of this valuation process, as well as the application of the remaining provisions of SFAS 142, the Company recorded a pre-tax transitional impairment loss of \$28.4 million, representing the write-off of all of the Company's existing goodwill. This write-off was reported as a cumulative effect of a change in accounting principle, on a net of tax basis, in the Company's Consolidated Statement of Operations for the six months ended February 28, 2002 (see Note 3 to the financial statements included in this filing).

On November 7, 2001, the Board of Directors of NSI approved the spin-off, subject to certain conditions, of its lighting equipment and chemicals businesses into a separate publicly-traded company with its own management and board of directors. The spin-off conditions were met November 29, 2001 and the spin-off was effected on November 30, 2001 through a tax-free distribution (Distribution) of 100% of the outstanding shares of common stock of Acuity Brands, Inc. (Acuity), a wholly-owned subsidiary of NSI owning and operating the lighting equipment and chemicals businesses. Each NSI stockholder of record as of November 16, 2001, the record date for the Distribution, received one share of Acuity common stock for each share of NSI common stock held on that date. The historical financial statements of NSI have been restated to reflect Acuity as a discontinued operation (see Note 6 to the financial statements included in this filing).

In conjunction with the Distribution, the Company and Acuity entered into various agreements that address the allocation of assets and liabilities between them and that define their relationship after the separation, including a distribution agreement, a tax disaffiliation agreement, an employee benefits agreement, a transition services agreement and a lease agreement. Under the tax disaffiliation agreement, Acuity will indemnify NSI for certain taxes and liabilities that may arise related to the Distribution. The agreement also sets out each party's rights and obligations with respect to deficiencies and refunds, if any, of federal, state, local, or foreign taxes for periods before and after the Distribution. The transition services agreement provides that NSI and Acuity will provide each other services in such areas as information management and technology, employee benefits administration, payroll, financial accounting and reporting, claims administration and reporting, legal, and other areas where NSI and Acuity may need transitional assistance and support. In addition to other services described in the agreement, the transition services agreement provides that Acuity will, for a fee, provide collateral associated with various property and casualty insurance programs of NSI as follows:

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| Period | | |
|-------------------|------------------|--------------------------|
| Beginning | Ending | Letters of Credit |
| September 1, 2002 | October 31, 2002 | \$10.4 million |
| November 1, 2002 | October 31, 2003 | \$ 8.0 million |
| November 1, 2003 | October 31, 2004 | \$ 5.0 million |
| November 1, 2004 | October 31, 2005 | \$ 2.0 million |

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Management believes the amounts paid or received associated with these services are representative of the fair value of the services provided. At February 28, 2003, standby letters of credit of \$7.8 million were provided by Acuity for the benefit of the Company.

In addition, Acuity and NSI entered into a put option agreement, whereby NSI had the option to require Acuity to purchase the property where NSI's corporate headquarters are located for a purchase price equal to 85 percent of the agreed-upon fair market value of the property. On May 23, 2002 the Company completed the cash sale of the property to an unrelated third party. Subsequent to the sale, NSI executed a release of the put option agreement, thereby extinguishing any rights that NSI had under the agreement.

As a result of the spin-off, the net assets and results of operations of the lighting equipment and chemicals businesses have been reflected as discontinued operations for all periods presented herein. The Company's continuing operations consist of its textile rental and envelope segments.

Critical Accounting Policies

NSI's financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of the financial statements requires the Company to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. The Company reviews its estimates on a regular basis including those related to litigation, insurance receivable and environmental matters. The Company's estimates are based on historical experience and other assumptions management believes are reasonable under current circumstances. Actual results may differ from these estimates under different assumptions or circumstances.

In December 2001, the Securities and Exchange Commission (SEC) requested that all registrants include their critical accounting policies in Management's Discussion and Analysis. The SEC indicated that a critical accounting policy is one which is both important to the portrayal of the company's financial condition and results of operations and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. NSI believes the following represent its critical accounting policies:

Litigation

The Company is subject to various legal claims arising in the normal course of business out of the conduct of its current and prior businesses, including product liability claims. The Company accrues for legal claims when payments associated with the claims become probable and can be reasonably estimated for financial statement purposes. While management believes that its accruals are appropriate based on information currently available, the actual costs of resolving legal claims may be substantially different from the amounts accrued.

Among the product liability claims to which the Company is subject are claims for personal injury or wrongful death arising from the installation and distribution of asbestos-containing insulation, primarily in the southeastern United States, by a previously divested business of the Company. Most claims against the Company seek both substantial compensatory damages and punitive damages. The Company believes that many of the claims against it are without merit. The Company believes its conduct with respect to asbestos-containing insulation was consistent with recognized safety standards at the relevant times, and the Company believes there is no basis for imposing punitive damages against it in connection with asbestos claims. In addition, the Company believes that it has substantial legal defenses against many of these claims, including that the Company did not manufacture any asbestos-containing building products, that the Company did not distribute or install products at certain sites where exposure is alleged, and that statutes of repose in some states bar the claims. However, there is no assurance that the Company will be successful in asserting defenses to these claims.

Prior to February 1, 2001, the Center for Claims Resolution (the CCR), a membership organization for asbestos defendants, handled the processing and settlement of claims on behalf of the Company and retained local counsel for the defense of claims. Pursuant to a written agreement among CCR members, the Company was responsible for varying percentages of defense and liability payments on a claim-by-claim basis for each claim in which it was named in accordance with predetermined sharing formulae. Substantially all of the Company's portion of those payments was paid directly by the Company's insurers. Since February 1, 2001, the Company has retained trial counsel directly, rather than through the CCR, to defend asbestos-related claims against the Company and has engaged another outside consultant to provide claims processing and administration services for asbestos-related claims. The Company is more vigorously defending asbestos-related claims and will seek to dismiss without any settlement payment claims arising in jurisdictions or involving worksites where the Company did not distribute or install asbestos-containing products.

At August 31, 2001, the accrual for asbestos-related liabilities, before consideration of insurance recoveries, was based on the following: the Company's estimate of indemnity payments and defense costs associated with pending and future asbestos-related claims; settlements agreed to

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but not paid; the Company's expected payment on account of settlement obligations of defaulting CCR members; interest on settlement payments that are subject to ongoing dispute resolution with certain insurance providers; and

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other legal fees and expenses. During 2002, as part of its ongoing estimating process, consultation with outside experts, the nature of pending claims, the jurisdictions in which claims have been filed, and in light of its gained experience in administration of its defense strategy and recent settlement activity, the Company reviewed its asbestos claims liabilities and adjusted the balances in these accounts from its prior three year outlook to its estimate of the total probable liabilities from pending and expected future asbestos claims over an approximate fifty year period, which takes into consideration the life expectancy of individuals potentially exposed. As a result of such review, the Company increased its liabilities for asbestos-related costs by \$94 million and recorded an additional insurance recovery of \$77 million.

During the quarter ended February 28, 2003, the Company engaged external consulting economists to review the expected asbestos claims liabilities. Based on information supplied by this study and management's knowledge of and experience with its asbestos liabilities and insurance recoveries, the Company concluded that an additional increase in its liabilities was necessary. This increase is attributed to higher average resolution indemnity costs per claim than previously estimated. The increase in the liabilities resulting from this review process was a range of \$138 million to \$209 million. Management does not believe that any amount in the range is more accurate than any other. Therefore, as of February 28, 2003, the Company increased its liabilities for asbestos-related costs by approximately \$138 million, the low end of the range. Additionally, the Company believes it has adequate insurance coverage available to cover this increase in liabilities and therefore recorded an additional insurance recovery amount of \$138 million.

The Company's estimates of indemnity payments and defense costs associated with pending and future asbestos claims are based on the Company's estimate of the number of future asbestos-related claims and the type of disease, if any, alleged or expected to be alleged in such claims, assumptions regarding the timing and amounts of settlement payments, the status of ongoing litigation and settlement initiatives, and the advice of outside counsel with respect to the current state of the law related to asbestos claims. The ultimate liability for all pending and future claims cannot be determined with certainty due to the difficulty of forecasting the numerous variables that can affect the amount of liability. There are inherent uncertainties involved in estimating these amounts, and the Company's actual costs in future periods could differ materially from the Company's estimates due to changes in facts and circumstances after the date of each estimate. For additional information, see Note 9, Legal Proceedings, in the Notes to the Consolidated Financial Statements included in this filing.

Insurance Receivable

The Company believes that it has insurance coverage available to recover most of its asbestos-related costs. With the exception of the Company's payments on account of settlement obligations of defaulting CCR members, the Company has reached settlement agreements with substantially all of its relevant insurers providing for payment of substantially all asbestos-related claims (subject to retentions) up to the various policy limits, as discussed in Note 9, Legal Proceedings, in the Notes to the Consolidated Financial Statements included in this filing. The timing and amount of future recoveries from insurance carriers will depend on the pace of claims review and processing by such carriers and on the resolution of any remaining disputes regarding coverage under such policies. In the event the Company's insurers dispute amounts billed to them or pay on an untimely basis, the Company takes all practicable steps to secure payment, including alternative dispute resolution procedures and litigation to resolve the issues. The Company currently is involved in an alternative dispute resolution proceeding with one insurer to resolve outstanding insurance policy interpretation issues. The Company has resolved an alternative dispute resolution proceeding with another insurer, and, as part of that resolution, has received payment of past due amounts at issue in the proceeding, has reached an agreement to ensure timely payments of future obligations, and has reached a consensus with the insurer concerning policy interpretation issues.

The Company believes its recorded receivables, which includes both billed amounts and estimates of future recoveries, from insurance carriers are collectible. The Company reached this conclusion after considering various factors including its prior insurance-related recoveries in respect of asbestos-related claims, existing insurance policies, settlement agreements with insurers, the apparent viability of its insurers, the advice of outside counsel with respect to the applicable insurance coverage law relating to terms and conditions of those policies, and a general assessment by the Company and its advisors of the financial condition of the relevant insurers. Although the Company believes these assumptions are reasonable, other assumptions could have been used that would result in substantially lower recoveries. If expected insurance recoveries become unavailable, due to insolvencies among the Company's primary or excess insurance carriers, disputes with carriers or otherwise, the Company's results of operations, liquidity and financial condition could be materially adversely affected.

Environmental Matters

The Company's operations, as well as similar operations of other companies, are subject to comprehensive laws and regulations relating to the generation, storage, handling, transportation, and disposal of hazardous substances and solid and hazardous wastes and to the remediation of contaminated sites. Permits and environmental controls are required for certain of the Company's operations to limit air and water pollution, and these permits are subject to modification, renewal and revocation by issuing authorities. The Company believes that it is in substantial compliance with all material environmental laws, regulations and permits. On an ongoing basis, the Company incurs capital and operating costs relating to environmental compliance. Environmental laws and regulations have generally become stricter in recent years, and the cost of

responding to future changes may be substantial.

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The Company accrues for known environmental claims when payments associated with the claims become probable and the costs can be reasonably estimated. The actual cost of environmental issues may be higher than that accrued due to difficulty in estimating such costs and potential changes in the status of government regulations.

Results of Operations

NSI generated revenue of \$121.4 million and \$241.5 million for the three and six months ended February 28, 2003, respectively, compared to revenue of \$132.0 million and \$266.4 million, respectively, in the previous year. The decrease was primarily related to the overall softer economy, which has resulted in pricing pressures and lower volumes in the textile rental segment, and lower direct mail and credit card solicitation envelope volumes in the envelope segment.

Losses from continuing operations were \$5.2 million, or \$0.49 per diluted share, for the three months ended February 28, 2003, compared to losses from continuing operations of \$41 thousand, or \$0.00 per diluted share, for the three months ended February 28, 2002. On a year-to-date basis, net losses from continuing operations for the first six months of the current fiscal year were \$8.4 million, or \$0.81 per diluted share, compared to the prior year's net losses from continuing operations of \$3.7 million, or \$0.36 per diluted share. Additionally, offsetting the net losses from continuing operations for the first six months of the current year is a gain from the first quarter of \$2.5 million. During the first quarter of fiscal 2003, the Company reached a settlement in principle with one of its asbestos-related insurance carriers regarding several coverage issues, including an agreement as to the amount of compensation (i.e. interest charge), owed by the Company to the carrier for covering prior period asbestos-related settlements in place of other nonpaying carriers. As a result, the Company recognized a gain of \$2.5 million, which was reflected as a reduction in corporate expense. The increase in net losses from continuing operations is attributed to lower revenues, several under-performing textile rental plants and increased corporate costs.

Textile rental segment second quarter revenues of \$76.1 million decreased 1.5 percent compared to last year's \$77.3 million. On a year-to-date basis, revenues decreased \$3.9 million, or 2.5 percent compared to the same prior year period. The decrease in revenue is primarily attributed to the sale of the San Diego business in the first quarter and the discontinuance of a significant healthcare customer at the end of the fourth quarter of fiscal 2002. Additionally, overall volumes per customer continue to be negatively impacted by soft economic conditions, particularly in those segments dependent on corporate travel and entertainment such as lodging and fine dining. Operating losses for the quarter were \$1.5 million compared to last year's operating profit of \$1.3 million. On a year-to-date basis, the textile rental segment had an operating loss of \$5.7 million for the first six months of fiscal 2003 versus an operating loss of \$4.0 million for the first six months of fiscal 2002. The operating loss for the first six months of fiscal 2002 included \$5.4 million relating to the closure of two facilities and \$304 thousand of gains related to previously divested businesses. Revenue shortfalls, increased costs related to employee benefits and unfavorable results from several under-performing plants resulted in the reduction in profitability.

The fiscal 2002 restructuring charge included severance costs of \$11 thousand for four employees, and \$1.4 million in exit expenses to close and consolidate facilities. Exit expenses primarily include costs of lease terminations and costs to dispose of closed facilities. Additionally, as a further result of the closure of the two textile rental facilities, the Company recognized long-lived asset impairments totaling \$4.4 million. Textile rental assets to be disposed of were reduced to state them at their estimated fair value less costs to sell. Assets to be disposed of primarily related to equipment located in the facilities included in the restructuring program noted above. After the charge, the remaining net book value of these assets was immaterial. Estimated fair market values were established based on an analysis of expected future cash flows.

The envelope segment second quarter revenues of \$45.3 million decreased 17.2 percent from last year's results of \$54.7 million. Although courier volumes increased, lower direct mail and increased competitive pricing pressures in both the direct mail and transactional segments resulted in the revenue decline. Operating losses of \$2.1 million compared to operating profit in the prior year of \$649 thousand are primarily the result of lower revenues. On a year-to-date basis, the envelope segment revenues of \$89.3 million decreased 19.0 percent from fiscal 2002's results of \$110.3 million. Operating losses for the current year of \$3.1 million declined from operating profit for the six months ended February 28, 2002 of \$2.8 million.

Corporate expenses for the second quarter were \$4.0 million compared to last year's \$1.9 million. This increase is primarily attributable to costs associated with the previously announced retirement of the Company's chairman. Corporate expenses on a year-to-date basis were approximately \$4.0 million compared to last year's expense of \$4.6 million. In addition to the increased costs associated with the retirement of the Company's chairman, the year-to-date expenses included the \$2.5 million benefit of the insurance settlement.

Net interest expense of \$47 thousand and \$48 thousand for the three and six months ended February 28, 2003, respectively, decreased from last year's expense of \$168 thousand and \$279 thousand for the same prior year periods due to lower interest bearing obligations and interest earned on cash and cash equivalents. During the second quarter of fiscal 2003, the Company

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retired long-term debt of approximately \$1.8 million and incurred capital lease obligations of approximately \$1.4 million for equipment in the textile rental segment. Additionally, the income tax benefit for the current year decreased to approximately 34 percent of income from continuing operations compared to 40 percent in the prior year as a result of the anticipated impact in the current year of two federal income tax credits as well as management's decision to provide a valuation allowance for certain state tax net operating loss carryforwards which have been generated in fiscal 2003.

In October 2002, the Company sold its linen business in San Diego, California for \$4.8 million of cash. The net gain on the transaction of \$1.3 million, net of tax of \$816 thousand, is included in discontinued operations. The results of operations for this business were not material and, accordingly, are not presented in discontinued operations.

Liquidity and Capital Resources

Operating Activities

Continuing operations used cash of \$8.2 million during the six months ended February 28, 2003 compared with cash used of \$107 thousand during the respective period of the prior year. Fiscal 2003 cash used by continuing operations was impacted by a larger net loss than in the prior year. Additionally, during the prior year there were significant non-cash restructuring expenses included in the net loss from continuing operations, which contributed to the lower cash used by operations.

Investing Activities

Investing activities used cash of \$4.4 million during the six months ended February 28, 2003 versus cash used of \$9.0 million for the same period in the prior year. The decrease in cash used was primarily due to reductions in purchases of property, plant and equipment.

Capital expenditures totaled \$4.5 million for the six month period compared to \$10.6 million for the same period in the prior year. During the six months ended February 28, 2003, the textile rental segment invested primarily in equipment replacements. Additionally, the textile rental segment incurred \$1.4 million in capital lease obligations for information systems. Capital expenditures in the envelope segment were primarily related to manufacturing equipment purchases and replacements. Equipment purchases in the envelope segment provided newer technology that produces a higher quality product more efficiently and at a lower cost. During the six months ended February 28, 2002, capital expenditures in the envelope segment related primarily to manufacturing equipment purchases and information systems. The textile rental segment's expenditures were primarily attributable to replacement of old equipment, and delivery truck purchases and refurbishments.

Financing Activities

Cash used for financing activities totaled \$2.9 million during the six months ended February 28, 2003 compared to cash provided of \$2.2 million in the same period in fiscal 2002. The decrease in cash provided is primarily due to net borrowing activity and lower dividends. During the first six months of fiscal 2003, the Company had repayments of approximately \$2.2 million compared to \$8.6 million borrowed, on a net basis, for the same period in the prior year. Dividend payments totaled \$0.9 million, or \$0.08 per share, compared with \$7.0 million, or \$0.68 per share, for the prior-year period.

In October 2001, the Company negotiated a \$40 million, three-year committed credit facility with a single major US bank that became effective at the time of the spin-off. The facility contains financial covenants including a leverage ratio, a ratio of income available for fixed charges to fixed charges, and a minimum amount of stockholders' equity. Interest rates under the facility are based on the LIBOR rate or other rates, at the Company's option. The Company will pay an annual fee on the commitment based on the Company's leverage ratio. At February 28, 2003, the Company failed to comply with two financial covenants in the credit facility, which resulted in an event of default under the credit agreement. The covenants in question require the Company, as of the end of each fiscal quarter, to maintain a minimum ratio of income available for fixed charges to fixed charges for the preceding four consecutive fiscal quarters and a minimum amount of stockholders' equity (as such terms are defined in the credit agreement). On March 28, 2003, the lender agreed to waive the event of default pursuant to an agreement that will require the Company to obtain the lender's approval of any additional borrowings under the credit facility. The credit facility is expected to be terminated upon consummation of the Merger. At February 28, 2003, no amounts were outstanding, standby letters of credit of approximately \$11.4 million were outstanding and \$28.6 million was available under the facility.

In connection with the Company's casualty insurance program and certain asbestos-related litigation, the Company has provided standby letters of credit. As of February 28, 2003, standby letters of credit of approximately \$11.4 million were outstanding. These letters of credit expire at various dates in fiscal 2003 and fiscal 2004, and the Company anticipates that they will be renewed upon expiration. Additionally, as provided in

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the transition services agreement entered into in conjunction with the spin-off, Acuity will, for a fee, provide collateral associated with the casualty insurance program. At February 28, 2003, standby letters of credit of \$7.8 million were provided by Acuity for the benefit of the Company. The Company expenses the fees associated with obtaining the letters of credit as they are incurred.

NSI guaranteed the payment of up to \$712,500 as of February 28, 2003 for debt of Royal Airline Linen of Atlanta, LLC (RALA), an equity investment of the Company. The Company may be obligated to pay the principal amount of the debt and any related interest in the event of default by RALA. The guarantee expires when the underlying debt is paid in full, which was scheduled for July 2005. On March 21, 2003, RALA paid the debt in full, thereby releasing the Company from its guarantee.

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NSI enters into contracts that include indemnification provisions as a routine part of its business activities. In general, these provisions indemnify the counterparty for matters such as breaches of representations and warranties and any personal injury or property damage arising from NSI's actions or omissions, and in the context of a sale of portions of the business, any liabilities resulting from the conduct of the business prior to closing. In addition, in many sales agreements involving real property, NSI specifically indemnifies the counterparty for certain environmental obligations. For most contracts, there are no limitations on the maximum potential future payments for the environmental indemnification provisions. In most cases, the maximum potential amount is not estimable given that the magnitude of claims under those indemnifications would be a function of the extent of damages actually incurred, which is not practicable to estimate unless and until the event occurs. However, where damages have been incurred by the counterparty and indemnification payments are probable, the Company has recorded an estimate of the liability. As of February 28, 2003, the Company has approximately \$2,320,000 accrued for potential payments to be made for indemnifications included in sales agreements. No indemnification provisions have been entered into since December 31, 2002.

The Company has settlement agreements for certain asbestos-related liabilities. The timing of some of these payments is contingent on several factors, including the Company's receipt of legal documentation from claimants and plaintiff attorneys. The Company estimates that its asbestos-related obligations due over the next twelve months are \$82.8 million. However, the Company anticipates that substantially all of the settled asbestos liabilities will be reimbursed by insurance. Management believes its current cash balances, anticipated cash flows from operations and insurance reimbursements, and the committed credit facilities are sufficient to meet the Company's planned level of capital spending and general operating cash requirements, including but not limited to cash requirements related to litigation as discussed above and as further described in Note 9 to the financial statements, for the next twelve months. However, if the anticipated insurance reimbursements are not received timely, the Company will not have sufficient liquidity to meet the planned level of capital spending and general operating cash requirements, including but not limited to cash requirements related to litigation as discussed above.

At February 28, 2003 and August 31, 2002, the Company did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Legal Proceedings

For information concerning legal proceedings, including trends and developments involving legal proceedings, see Note 9 to the financial statements included in this filing.

Environmental Matters

For information concerning environmental matters, see Note 10 to the financial statements included in this filing.

Item 3. Quantitative and Qualitative Disclosures About Market Risk*Disclosures about Market Risk*

The Company believes that its exposure to market risks that may impact the Consolidated Balance Sheets, Consolidated Statements of Operations, and Consolidated Statements of Cash Flows primarily relate to changing interest rates and commodity prices. The Company does not enter into derivative arrangements for trading or speculative purposes.

Interest Rates

The Company's credit line is subject to interest rate fluctuations. These fluctuations expose the Company to changes in interest expense and cash flows. The Company did not have any variable-rate debt outstanding at February 28, 2003.

Commodity Price Risk

From time to time, the Company's textile rental segment enters into arrangements locking in for specified periods the prices the Company will pay for the volume of natural gas to which the contract relates. The contracts are structured to reduce the segment's exposure to changes in the price of natural gas. However, these contracts also limit the benefit the segment might have otherwise received from decreases in the price of natural gas. The Company does not believe a 10 percent adverse change in market rates of natural gas would have a material impact on its Consolidated Balance Sheets or Consolidated Statements of Operations. At February 28, 2003, there were no outstanding contracts for natural

gas.

The Company's envelope segment uses paper as its primary raw material. Generally, the Company passes fluctuations in the price of paper through to its customers. The Company does not believe that a 10 percent change in market rates of paper would have a material impact on its Consolidated Balance Sheets or Consolidated Statements of Operations.

Item 4. Controls and Procedures

Within 90 days of the filing of this report, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, management, including the Chief Executive Officer and the Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of February 28, 2003. No significant changes in the Company's internal controls or in other factors have occurred that could significantly affect controls subsequent to February 28, 2003.

Disclosure controls and procedures are designed to ensure that information required to be disclosed in the Company's periodic filings with the Commission is (i) recorded, processed, summarized and reported within the time periods specified by the Commission's rules and forms, and (ii) accumulated and communicated to the Company's management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

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Internal controls are part of the Company's disclosure controls and procedures and, in accordance with Exchange Act rules, are designed to provide reasonable assurances that (i) transactions are executed in accordance with management's general or specific authorization, (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with accounting principles generally accepted in the United States and to maintain accountability for assets, (iii) access to assets is permitted only in accordance with management's general or specific authorization, and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Cautionary Statement Regarding Forward-Looking Information

This report contains forward-looking statements within the meaning of the federal securities laws. Statements that are not historical facts, including statements about management's and the Company's beliefs and expectations, are forward-looking statements. Forward-looking statements include statements preceded by, followed by or that include the words believes, expects, anticipates, plans, estimates or similar expressions. These statements include, among others, statements regarding our expected business outlook, pricing levels, raw materials costs, anticipated financial and operating results, strategies, contingencies, financing and working capital requirements, sources of liquidity, capital expenditures, amounts and timing of expenditures with respect to asbestos litigation and environmental matters, amounts and timing of insurance recoveries covering those expenses, the resolution of allocation and coverage issues with the Company's insurers, the solvency of the Company's insurers, competitive conditions, general economic conditions and the expected timing of the closing of the Merger.

Forward-looking statements are only predictions and are not guarantees of performance. These statements are based on management's beliefs and assumptions, which in turn are based on currently available information. These assumptions could prove inaccurate. Forward-looking statements also involve risks and uncertainties, which could cause actual results to differ materially from those contained in any forward-looking statement. Many of these factors are beyond the Company's ability to control or predict. Such factors include, but are not limited to:

changes in general business and economic conditions;

fluctuations in raw material prices;

unexpected developments or outcomes in the Company's legal or environmental proceedings;

the risk of additional insolvencies among the Company's insurance carriers;

the risk of an increase or acceleration in the number of asbestos-related claims filed against the Company;

the risk of adverse judgments and damage awards against the Company in pending or future litigation;

the risk that the number of future asbestos claims or the settlement costs of such claims will exceed the Company's forecasts;

changes in competitive conditions in the Company's markets;

foreign currency fluctuations relative to the U.S. dollar;

increases in labor and other significant operating expenses; and

the timely satisfaction of the conditions set forth in the definitive agreement relating to the Merger, including the receipt of all necessary financing to complete the Merger.

Investors should not place undue reliance on any forward-looking statements, which are based on current expectations. Further, forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update publicly any of them in light of new information or future events.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

For information concerning legal proceedings, including trends and developments involving legal proceedings, see Note 9 to the financial statements included in this filing.

Item 4. Submission of Matters to a Vote of Security Holders

At the annual meeting of stockholders held December 19, 2002, all nominees for director were elected to the board without opposition. The vote on the election of directors was as follows:

| | <u>For</u> | <u>Against</u> |
|---------------------------|------------|----------------|
| Brock A. Hattox, Chairman | 8,330,977 | 125,340 |
| Dennis R. Beresford | 8,272,044 | 184,273 |
| John E. Cay, III | 8,281,380 | 174,937 |
| Don L. Chapman | 8,325,427 | 130,890 |
| Joia M. Johnson | 8,289,607 | 166,710 |
| Michael Z. Kay | 8,326,061 | 130,256 |
| Betty L. Seigel | 8,327,992 | 128,325 |
| John T. Sweetwood | 8,290,055 | 166,262 |

At the annual meeting of stockholders, the stockholders also approved a proposal to ratify the appointment of PricewaterhouseCoopers LLP as the Company's independent auditors for the fiscal year ended August 31, 2003. The vote on this proposal was:

| <u>For</u> | <u>Against</u> | <u>Abstain</u> |
|------------|----------------|----------------|
| 8,307,784 | 126,075 | 22,458 |

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits are listed on the Index to Exhibits (page 27)

(b) No reports on Form 8-K were filed during the quarter for which this report is filed.

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SIGNATURES

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

NATIONAL SERVICE INDUSTRIES, INC.

REGISTRANT

DATE April 10, 2003

/s/ BROCK A. HATTOX

BROCK A. HATTOX
CHAIRMAN, CHIEF EXECUTIVE
OFFICER AND PRESIDENT

DATE April 10, 2003

/s/ CHESTER J. POPKOWSKI

CHESTER J. POPKOWSKI
SENIOR VICE PRESIDENT,
CHIEF FINANCIAL OFFICER AND
TREASURER

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CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER

I, Brock A. Hattox, President and Chief Executive Officer of National Service Industries, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Service Industries, Inc. (the registrant);
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and
6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ Brock A. Hattox

Brock A. Hattox
President and Chief Executive Officer

Date: April 10, 2003

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CERTIFICATION OF THE CHIEF FINANCIAL OFFICER

I, Chester J. Popkowski, Senior Vice President, Chief Financial Officer and Secretary of National Service Industries, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of National Service Industries, Inc. (the registrant);
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and
6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ Chester J. Popkowski

Chester J. Popkowski
*Senior Vice President, Chief Financial Officer
and Treasurer*

Date: April 10, 2003

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INDEX TO EXHIBITS

| | | |
|--------------------|---|--|
| Exhibit 2 | Agreement and Plan of Merger, dated as of April 1, 2003, by and between NS Acquisition Corp. and National Service Industries, Inc. | Reference is made to Exhibit 2.1 of registrant's Form 8-K filed with the Commission on April 2, 2003, which is incorporated herein by reference. |
| Exhibit 3 | (a) Restated Certificate of Incorporation (b) By-Laws as Amended and Restated October 16, 2001 | Reference is made to Exhibit 3 (a) of registrant's Form 10-K for the fiscal year ended August 31, 2001, which is incorporated herein by reference. Reference is made to Exhibit 3 (b) of registrant's Form 10-K for the fiscal year ended August 31, 2001, which is incorporated herein by reference. |
| Exhibit 4 | (a) Amended and Restated Rights Agreement dated as of December 17, 1997 between National Service Industries, Inc. and Wachovia Bank, N.A. (replacing Wachovia Bank, N.A. with First Chicago Trust Company) (b) First Amendment dated as of April 30, 1998 between National Service Industries, Inc. and First Chicago Trust Company of New York, to the Amended and Restated Rights Agreement, dated as of December 17, 1997 between National Service Industries, Inc. and Wachovia Bank, N.A. (c) Second Amendment dated as of January 6, 1999 between National Service Industries, Inc. and First Chicago Trust Company of New York, to the Amended and Restated Rights Agreement, dated as of December 17, 1997 between National Service Industries, Inc. and First Chicago Trust Company of New York, as Rights Agent, as amended | Reference is made to Exhibit 4.1 of registrant's Form 8-A/A as filed with the Commission on December 17, 1997, which is incorporated herein by reference. Reference is made to Exhibit 1 of registrant's Form 8-A/A-3 as filed with the Commission on June 22, 1998, which is incorporated herein by reference. Reference is made to Exhibit 1 of registrant's Form 8-A/A-4 as filed with the Commission on January 12, 1999, which is incorporated herein by reference. |
| Exhibit 10(iii)(A) | (1) Amendment No. 2 to Employment Agreement dated December 19, 2002, by and between National Service Industries, Inc. and Brock A. Hattox (2) Indemnification Agreement dated March 31, 2003 between National Service Industries, Inc. and directors, officers, employees or agents (3) Third Amendment to the Amended and Restated Rights Agreement dated April 1, 2003 | Filed with the Securities and Exchange Commission as part of the Form 10-Q. Filed with the Securities and Exchange Commission as part of the Form 10-Q. Filed with the Securities and Exchange Commission as part of the Form 10-Q. |
| Exhibit 99.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | Filed with the Securities and Exchange Commission as part of the Form 10-Q. |
| Exhibit 99.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | Filed with the Securities and Exchange Commission as part of the Form 10-Q. |