NATIONAL SERVICE INDUSTRIES INC
Form 10-Q
January 14, 2003

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 30, 2002

OR

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

For the transition period from to

Commission file number 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 x No o

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 11,179,169 shares as of December 31, 2002.

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NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES

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CONSOLIDATED BALANCE SHEETS (UNAUDITED)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES
(In thousands, except share data)

	November 30, 2002	August 31, 2002
Assets		
Current Assets:		
Cash and cash equivalents	$ 16,602	$ 20,969
Receivables, less reserves for doubtful accounts of $1,210 at November 30, 2002, and $1,173 at August 31, 2002	49,653	52,198
Inventories, at the lower of cost (on a first-in, first-out basis) or market	16,902	16,037
Linens in service, net of amortization	49,901	51,806
Prepayments	4,737	5,086
Insurance receivable (Note 8)	48,347	42,024
Other current assets	1,997	693
Total Current Assets	188,139	188,813
Property, Plant and Equipment, at cost:		
Land	5,715	5,715
Buildings and leasehold improvements	50,105	49,867
Machinery and equipment	259,227	259,730
Total Property, Plant and Equipment	315,047	315,312
Less: Accumulated depreciation and amortization	170,982	167,356
	144,065	147,956
Other Assets:		
Intangibles	8,118	8,357
Insurance receivable (Note 8)	128,940	140,831
Prepaid benefit cost	31,483	30,644
Other assets	2,405	2,497
Total Other Assets	170,946	182,329
Total Assets	$503,150	$519,098
Liabilities and Stockholders Equity		
Current Liabilities:		
Current maturities of long-term debt (Note 7)	$ 1,116	$ 1,093
Accounts payable	16,535	16,569
Accrued salaries, commissions, and bonuses	5,357	7,007
Current portion of self-insurance reserves	3,706	5,785
Environmental reserve (Note 9)	5,751	5,777
Current portion of litigation reserve (Note 8)	47,857	41,288
Deferred income taxes	5,170	8,811
Other accrued liabilities	19,144	19,506
Total Current Liabilities	104,636	105,836
Long-Term Debt, less current maturities (Note 7)	696	984
Deferred Income Taxes	10,064	7,853

Self-Insurance Reserves, less current portion	8,875	9,258
Litigation Reserve, less current portion (Note 8)	152,600	166,844
Other Long-Term Liabilities	7,559	7,690
Commitments and Contingencies (Notes 8 and 9)		
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 (Note 11)	14,479	14,479
Paid-in capital		11,570
Retained earnings	542,827	552,302
Unearned compensation on restricted stock	(4,768)	(4,092)
Accumulated other comprehensive income	(2,350)	(2,350)
	550,188	571,909
Less: Treasury stock, at cost (3,312,784 shares at November 30, 2002 and 3,510,515 shares at August 31, 2002)	331,468	351,276
Total Stockholders Equity	218,720	220,633
Total Liabilities and Stockholders Equity	$503,150	$519,098

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

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CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES
(In thousands, except per-share data)

	THREE MONTHS ENDED	
	November 30, 2002	**November 30, 2001**
Sales and Service Revenues:		
Service revenues	$ 76,092	$ 78,836
Net sales of products	43,971	55,553
Total Revenues	120,063	134,389
Costs and Expenses:		
Cost of services	47,318	47,764
Cost of products sold	34,093	42,016
Selling and administrative expenses	44,124	44,758
Restructuring expense and other charges (Note 10)		5,820
Gain on sale of business	(2,161)	
Amortization expense	465	481
Interest expense	1	111
Other income, net	(682)	(481)
Total Costs and Expenses	123,158	140,469
Loss from continuing operations before income taxes and cumulative effect of a change in accounting principle	(3,095)	(6,080)
Income tax benefit	(1,171)	(2,432)
Loss from continuing operations before cumulative effect of a change in accounting principle	(1,924)	(3,648)
Discontinued Operations (Note 5):		
Income from discontinued operations, net of tax of $7,066 in 2001		11,534
Costs associated with effecting the spin-off, net of tax benefit of $717		(19,069)
Total Discontinued Operations		(7,535)
Cumulative effect of a change in accounting principle, net of tax benefit of $10,830		(17,602)
Net Loss	$ (1,924)	$ (28,785)
Basic and diluted earnings per share (split adjusted):		
Earnings per share from continuing operations before cumulative effect of a change in accounting principle	$ (0.19)	$ (0.35)
Discontinued operations:		
Income from discontinued operations, net of tax		1.12
Costs associated with effecting the spin-off, net of tax benefit		(1.85)
Total Discontinued Operations		(0.73)
Cumulative effect of a change in accounting principle, net of tax benefit		(1.71)

Net Loss	$ (0.19)	$ (2.79)
Basic Weighted Average Number of Shares Outstanding	10,357	10,305
Diluted Weighted Average Number of Shares Outstanding	10,357	10,305

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES
(In thousands)

	THREE MONTHS ENDED	
	November 30, 2002	November 30, 2001
Cash Provided by (Used for) Operating Activities:		
Net loss from continuing operations	$ (1,924)	$ (3,648)
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Depreciation and amortization	6,491	6,534
Provision for losses on accounts receivable	275	495
Gain on the sale of property, plant and equipment	(73)	(78)
Restructuring expense and other charges		5,820
Gain on the sale of business	(2,161)	
Change in assets and liabilities, net of effect of acquisitions and divestitures:		
Receivables	1,925	(2,291)
Inventories and linens in service, net	(147)	2,975
Deferred income taxes	(1,430)	(2,437)
Prepayments and other assets	(1,060)	(3,379)
Accounts payable	(258)	(4,186)
Accrued liabilities	(2,190)	5,001
Self-insurance reserves and other long-term liabilities	(4,451)	(1,015)
Net Cash (Used for) Provided by Continuing Operations	(5,003)	3,791
Net Cash Provided by Discontinued Operations		6,935
Net Cash (Used for) Provided by Operating Activities	(5,003)	10,726
Cash Provided by (Used for) Investing Activities:		
Purchases of property, plant and equipment	(2,848)	(4,996)
Sale of property, plant and equipment	271	354
Acquisitions	(240)	
Divestitures	4,075	
Change in other assets		(149)
Net Cash Provided by (Used for) Investing Activities	1,258	(4,791)
Cash Provided by (Used for) Financing Activities:		
Repayments of notes payable, net		241
Repayments of long-term debt	(265)	(245)
Treasury stock transactions, net	82	679
Cash dividends paid	(439)	(6,610)
Net Cash Used for Financing Activities	(622)	(5,935)
Net Change in Cash and Cash Equivalents	(4,367)	
Cash and Cash Equivalents at Beginning of Period	20,969	
Cash and Cash Equivalents at End of Period	$ 16,602	$

Supplemental Cash Flow Information:		
Income taxes paid during the period	$ 124	$ 3,443
Interest paid during the period	43	12,888
Noncash Activities:		
Treasury shares issued under long-term incentive plan	$	$ 1,109
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

(Dollar amounts in thousands, except per-share data and information contained in Note 8)

1. BASIS OF PRESENTATION

On November 7, 2001, management of National Service Industries, Inc. (NSI or the Company) 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 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 November 30, 2002, the consolidated results of operations for the three months ended November 30, 2002 and 2001, and the consolidated cash flows for the three months ended November 30, 2002 and 2001. 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 months ended November 30, 2002 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

Newly Adopted Accounting Standards

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 143 (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.

In August 2001, the FASB issued Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of , and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions for a disposal of a segment of a business. The Company adopted SFAS 144 effective September 1, 2002. The adoption of SFAS 144 did not have a material impact on the Company s financial statements.

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In July 2001, the FASB issued Statement No. 141 (SFAS 141) Business Combinations, and Statement No. 142 (SFAS 142), Goodwill and Other Intangible Assets. SFAS 141 prospectively prohibits the pooling of interests method of accounting for business combinations initiated after June 30, 2001. 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 Company adopted SFAS 142 as of September 1, 2001. Summarized information for the Company s acquired intangible assets is as follows:

Acquired Intangible Assets

	November 30, 2002		August 31, 2002	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Customer contracts	$11,783	$(4,214)	$11,589	$(3,851)
Other	1,639	(1,090)	1,635	(1,016)
Total	$13,422	$(5,304)	$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 $465 and $481 related to intangible assets for the three months ended November 30, 2002 and 2001, 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 $28,432, 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 Income for the three months ended November 30, 2001.

3. BUSINESS SEGMENT INFORMATION

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

Three Months Ended November 30, 2002	Sales and Service Revenues	Operating Profit (Loss)	Depreciation and Amortization Expense	Capital Expenditures Including Acquisitions
Textile Rental	$ 76,092	$(2,106)	$4,256	$1,882
Envelope	43,971	(939)	2,114	1,042
	120,063	(3,045)	6,370	2,924
Corporate		(49)	121	164
Interest expense		(1)		
Total	$120,063	$(3,095)	$6,491	$3,088

Three Months Ended November 30, 2001	Sales and Service Revenues	Operating Profit (Loss)	Depreciation and Amortization Expense	Capital Expenditures Including Acquisitions
Textile Rental	$ 78,836	$ (5,379)	$ 4,117	$ 4,105
Envelope	55,553	2,154	2,204	838
	134,389	(3,225)	6,321	4,943
Corporate		(2,744)	213	53
Interest expense		(111)		
Total	$ 134,389	$ (6,080)	$ 6,534	$ 4,996

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	Total Assets	
	November 30, 2002	August 31, 2002
Textile Rental	$205,143	$207,886
Envelope	96,601	99,391
Subtotal	301,744	307,277
Corporate	201,406	211,821
Total	$503,150	$519,098

4. INVENTORIES

Major classes of inventory as of November 30, 2002 and August 31, 2002 were as follows:

	November 30, 2002	August 31, 2002
Raw Materials and Supplies	$ 5,940	$ 5,716
Work-in-Process	3,324	2,493
Finished Goods	7,638	7,828
Total	$16,902	$16,037

5. 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.

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.

6. 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 November 30, and reflects the January 7, 2002 one-for-four reverse stock split further described in note 11:

	Three Months Ended November 30,	
	2002	**2001**
Basic and diluted earnings per common share:		
Income from continuing operations before cumulative effect of a change in accounting principle	$ (1,924)	$ (3,648)
Basic and diluted weighted average shares outstanding	10,357	10,305
Basic earnings from continuing operations before cumulative effect of a change in accounting principle per share	$ (0.19)	$ (0.35)

Stock options to purchase 1,237 and 1,074 shares of common stock for the three months ended November 30, 2002 and 2001, respectively, and unvested restricted shares of 805 and 12 for the three months ended November 30, 2002 and 2001, respectively, were not included in the computation of diluted earnings per share because their effect would have been antidilutive.

7. LONG-TERM DEBT

Outstanding borrowings at November 30, 2002 included $1,812 in notes payable at an interest rate of 8.5%.

In October 2001, the Company negotiated a $40,000, 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 net worth. 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. No amounts were outstanding under this facility at November 30, 2002.

8. 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 November 30, 2002, the Company has contributed approximately $5.8 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 $5.8 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.

The claims activity for each of the three month periods ended November 30 was as follows:

	2002	2001
Open claims, beginning of period	35,300	35,000
Served	16,000	2,300
Dismissed	(100)	(11,300)
Settled	(1,200)	(2,300)
	50,000	23,700
Settled in principle after February 1, 2001 but not finalized	(13,700)	(2,900)
Open claims pending, end of period	36,300	20,800
Average resolution indemnity cost per claim for the three months ended November 30*	$ 916	$ 785
Total claims resolved since February 1, 2001	32,300	
Average resolution indemnity cost per claim for claims resolved since February 1, 2001*	$ 815	

* Average resolution indemnity cost is based on indemnity costs for 1,300 and 13,600 claims dismissed and settled during the three months ended November 30, 2002 and 2001, respectively. During the three months ended November 30, 2002, 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 three months ended November 30, 2002, the cost would increase from $916 to $14,192 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 $815 to $2,657 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 November 30, 2002 and 2001, there were approximately 7,800 and 11,200 additional claims, respectively, that were, as part of CCR settlements, settled in principle prior to February 1, 2001 but not finalized.

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As of November 30, 2002 and August 31, 2002, an estimated accrual of $200.4 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 concluded that a reasonable estimate of its expected future claims for approximately fifty years would require an increase in its liabilities ranging from approximately $94 million to $139 million over the amounts recorded as of August 31, 2001. Additionally, the Company believes it has insurance coverage available to recover most of its asbestos-related costs; however, out-of-pocket costs associated with the range of additional liabilities could be from $17 million to $31 million, representing the costs that would be paid by the Company due primarily to the insolvency of certain foreign insurance carriers. Management does not believe that any amount in the range is more accurate than any other. Therefore, as of August 31, 2002, the Company increased its liabilities for asbestos related costs by approximately $94 million, the low end of the range and recorded an additional insurance recovery amount of $77 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.

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 has initiated alternative dispute resolution proceedings with two insurers to resolve outstanding insurance policy interpretation issues, and, with respect to one of the insurers, to secure payment of past due amounts and to ensure that the insurer s future obligations will be met in a timely fashion. 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 $177.3 million and $182.9 million has been reflected in the accompanying financial statements as of November 30, 2002 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 $48.3 million and $42.0 million of the aggregate insurance recovery and $47.9 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 November 30, 2002 and August 31, 2002, respectively. Approximately $5.7 million of insurance recovery was under alternative dispute resolution proceedings at November 30, 2002.

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 November 30, 2002, 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. 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. The second case was filed in the Court of Common Pleas, Fifteenth Judicial Circuit, County of Horry, South Carolina in October 2001. That case was removed to the United States District Court for South Carolina, Florence Division. The South Carolina federal court also denied plaintiff s motion to remand. The third 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 fourth 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 January 1, 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.

9. 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 $5,751 and $5,777 at November 30, 2002 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 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 as a successor to Serv-All Uniform Rental Corp. (Serv-All) for past and future response costs in connection with the release or potential release of hazardous substances at and from 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 denied the Company s motion for summary judgment on the issue of successor liability and granted the State of New York s motion for partial summary judgment, issuing a declaratory judgment that the

Company is a successor to Serv-All. Subsequently, the Company and the State of New York each filed a cross-motion for summary judgment on the Company s liability under the Comprehensive Environmental Response, Compensation, and Liability Act.

On December 12, 2001, the Court granted summary judgment for the State. At a January 9, 2002 status conference, the Court verbally denied the Company s motion for summary judgment and explicitly noted that the issues presented by this case were appropriate for judicial review. The Court reiterated its denial of the Company s motion in a written order on January 10, 2002. Final judgment in the amount of $12,477 was entered against the Company on February 1, 2002. Execution of the judgment was stayed pending appeal to the Second Circuit Court of Appeals.

The Company filed a notice of appeal to the Second Circuit Court of Appeals on March 1, 2002. As a result of a technical error made by the District Court in the language of the final judgment, the judgment was remanded to the Eastern District of New York to be corrected. This correction was made, and the final judgment was re-entered on September 17, 2002, in the amount of $12,499. A second notice of appeal was filed on October 10, 2002. Briefing will be completed by March 28, 2003, and oral argument will be scheduled no earlier than April 15, 2003.

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 or potential release of hazardous substances at and from the Blydenburgh Landfill in Islip, New York. On September 3, 2002, Hickey s then sued the Company, along with several other parties, for contribution to any judgment ultimately awarded against Hickey s.

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 believes that it is not a successor to Serv-All and therefore has no liability with respect to the Blydenburgh Landfill (either to the State of New York or to Hickey s) and has responded to the lawsuit accordingly. 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. The Company has filed briefs in opposition to these 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.

10. RESTRUCTURING EXPENSE AND OTHER CHARGES

During 2001, management conducted reviews of its continuing operations as part of a strategic initiative to examine under-performing operations and to position the Company for an economic slowdown. As a result of these reviews, the Company approved a significant restructuring program and recorded a related charge of $5,014 during the fourth quarter of fiscal 2001. The accrual included severance costs of $3,087 for 367 employees of the textile rental and envelope segments, all of whom were terminated prior to the end of the fiscal year, $1,582 in exit expenses to close and consolidate facilities in the envelope segment, and $345 in losses related to the sale of two textile rental businesses. As of August 31, 2001, approximately $118 of the severance accrual had been paid to employees.

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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. The charge included severance costs of $11 for four employees, all of whom were terminated prior to the end of the first quarter, and $1,396 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. 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 major components of the fiscal 2003 and 2002 restructuring charges and related activity are as follows:

	Reserve, Beginning of Year	Cash Payments	Expense	Reserve, November 30
2003				
Severance costs	$ 527	$	$	$ 527
Exit costs	557	(181)		376
2002				
Severance costs	2,969	(1,479)	11	1,501
Exit costs	1,582	(776)	1,396	2,202

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

11. REVERSE STOCK SPLIT

On January 3, 2002, the Company s stockholders approved a one-for-four reverse stock split of NSI common stock, which began trading on a reverse split basis on January 7, 2002. As a result of the stock split, every four shares of NSI common stock were replaced with one share of NSI common stock. The reverse split did not change the number of authorized shares of NSI common stock or the par value per share of NSI common stock. All references to common stock, common shares outstanding, average numbers of common stock shares outstanding and per share amounts in these Consolidated Financial Statements and Notes to Consolidated Financial Statements prior to the effective date of the reverse stock split have been restated to reflect the one-for-four common stock reverse split on a retroactive basis.

12. RESTRICTED STOCK

In October 2002, the Company awarded 183,927 shares of restricted stock to officers and other key employees. 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. Additionally, granted but unvested shares are forfeited upon termination of employment.

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 grant of restricted stock of $1,044 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 grant, 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.

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.

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. The Company remained in solid financial condition at November 30, 2002. Net working capital was $83.5 million, up from $83.0 million at August 31, 2002, and the current ratio remained constant at 1.8.

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 Income for the three months ended November 30, 2001 (see Note 2 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 5 to the financial statements included in this filing).

In conjunction with the spin-off, 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:

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

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.

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.

On January 3, 2002, the Company s stockholders approved a one-for-four reverse stock split of NSI common stock, which began trading on a reverse split basis on January 7, 2002. As a result of the stock split, every four shares of NSI common stock were replaced with one share of NSI common stock. The reverse split did not change the number of authorized shares of NSI common stock or the par value per share of NSI common stock. All references to common stock, common shares outstanding, average numbers of common stock shares outstanding and per share amounts in these Consolidated Financial Statements, Notes to Consolidated Financial Statements and Management s Discussion and Analysis of Financial Condition and Results of Operations prior to the effective date of the reverse stock split have been restated to reflect the one-for-four common stock reverse split on a retroactive basis.

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) 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 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 other legal fees and expenses. During 2002, as part of its ongoing estimating process, consultation with outside experts, the nature

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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 concluded that a reasonable estimate of its expected future claims for approximately fifty years would require an increase in its liabilities ranging from approximately $94 million to $139 million over the amounts recorded as of August 31, 2001. Management does not believe that any amount in the range is more accurate than any other. Therefore, as of August 31, 2002, the Company increased its liabilities for asbestos-related costs by $94 million, the low end of the range and recorded an additional insurance recovery of $77 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 8, 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 8, 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 has initiated alternative dispute resolution proceedings with two insurers to resolve outstanding insurance policy interpretation issues, and, with respect to one of the insurers, to secure payment of past due amounts and to ensure that the insurer s future obligations will be met in a timely fashion. Approximately $5.7 million of insurance recovery was under alternative dispute resolution proceedings at November 30, 2002. 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.

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.

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Results of Operations

NSI generated revenue of $120.1 million for the three months ended November 30, 2002, compared to revenue of $134.4 million in the previous year. The decrease was primarily related to the overall softer economy, which has resulted in lower volumes per customer in the textile rental segment and decreases in pricing in the envelope segment.

During the first quarter of fiscal 2003, the Company completed the sale of its linen business in San Diego for $4.8 million and recorded a gain of $2.2 million. In addition, 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 (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.

Losses from continuing operations were $1.9 million, or $0.19 per diluted share, for the three months ended November 30, 2002, compared to losses from continuing operations of $3.6 million, or $0.35 per diluted share, for the three months ended November 30, 2001.

Textile rental segment first quarter revenues of $76.1 million decreased 3.5 percent compared to last year s $78.8 million. 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. These conditions, combined with the revenue loss as a result of the sale of the San Diego business, account for the lower revenue. Operating losses for the quarter were $2.1 million compared to last year s operating loss of $5.4 million. Operating results in the current year include $2.2 million of pretax gains from the sale of the San Diego business. Fiscal 2002 results included charges of $5.8 million for severance and restructuring activities. The following table presents information that management believes will provide the reader more consistent, comparable trend information:

	Three Months Ended November 30,	
	2002	**2001**
	(Dollar amounts in millions)	
Loss from continuing operations	$ (2.1)	$ (5.4)
Gain on sale of business	(2.2)	
Restructuring and severance charge		5.8
Adjusted operating (loss) profit	$ (4.3)	$ 0.4

Revenue shortfalls and increased costs related to employee benefits, casualty insurance, legal defense and plant efficiency programs 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 first quarter revenues of $44.0 million decreased 20.8 percent from last year s results of $55.6 million. Lower direct mail and courier volumes, increased competitive pricing pressures in both the direct mail and transactional segments, and the closure of the segment s Los Angeles facility in fiscal 2002 account for the revenue decline. Operating losses of $0.9 million compared to operating profit in the prior year of $2.2 million are the result of lower revenues and increased benefit costs partially offset by improvements in operational efficiencies.

Corporate expenses, which included the $2.5 million benefit of the insurance settlement, were approximately $0.1 million for the quarter. Excluding the settlement, corporate costs were $2.6 million for the first quarter compared to last year s $2.7 million.

Net interest expense of $1 thousand for the three months ended November 30, 2002 decreased from last year s $111 thousand due to lower interest bearing obligations and interest earned on cash and cash equivalents. Additionally, the income tax benefit decreased to approximately 38 percent of income from continuing operations compared to 40 percent in the prior year as a result of fluctuations in two federal income tax credits.

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Liquidity and Capital Resources

Operating Activities

Continuing operations used cash of $5.0 million during the three months ended November 30, 2002 compared with cash provided of $3.8 million during the respective period of the prior year. Fiscal 2003 cash used by continuing operations was impacted by segment bonus payments, payout of a deferred compensation program and annual insurance premium payments.

Investing Activities

Investing activities provided cash of $1.3 million versus cash used of $4.8 million in the prior year. The increase in cash provided was primarily due to the sale of the linen business in San Diego as well as reductions in purchases of property, plant and equipment.

Capital expenditures totaled $2.8 million for the three month period compared to $5.0 million in the prior year. During the three months ended November 30, 2002, the textile rental segment invested primarily in equipment replacements. 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 three months ended November 30, 2001, 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 $0.6 million during the three months ended November 30, 2002 compared to cas