



**K-BRO LINEN INCOME FUND**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**AND**

**CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED**

**JUNE 30, 2009 and 2008**

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## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

August 5, 2009

*The following Management's Discussion and Analysis ("MD&A") is supplemental to, and should be read in conjunction with, the unaudited consolidated financial statements of K-Bro Linen Income Fund ("the Fund") for the six months ended*

*June 30, 2009 and the audited consolidated financial statements and MD&A for the year ended December 31, 2008. These financial statements and other documents filed with regulatory authorities can be found on SEDAR at [www.sedar.com](http://www.sedar.com). The Fund's financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The Fund's reporting currency is the Canadian dollar. The Fund and its subsidiary K-Bro Linen Systems Inc. will collectively be referred to as "K-Bro" in this MD&A.*

*Management is responsible for the information contained in this MD&A and its consistency with information presented to the Audit Committee and Board of Trustees. All information in this document has been reviewed and approved by the Audit Committee and Board of Trustees. This review was performed by management with information available as of August 5, 2009.*

*In the interest of providing unitholders and potential investors of K-Bro with information regarding future plans and operations, this MD&A contains forward-looking information that represents internal expectations, estimates or beliefs concerning, among other things, future activities or future operating results and various components thereof. The use of any of the words "anticipate", "continue", "expect", "may", "will", "project", "should", "believe", and similar expressions suggesting future outcomes or events are intended to identify forward-looking information. Statements regarding such forward-looking information reflect management's current beliefs and are based on information currently available to management.*

*These statements are not guarantees of future performance and are based on management's estimates and assumptions that are subject to risks and uncertainties, which could cause K-Bro's actual performance and financial results in future periods to differ materially from the forward-looking information contained in this MD&A. These risks and uncertainties include, among other things, (i) risks associated with acquisitions, including the possibility of undisclosed material liabilities; (ii) K-Bro's competitive environment; (iii) utility and labour costs; (iv) K-Bro's dependence on long-term contracts, (v) increased capital expenditure requirements; (vi) reliance on key personnel; and (vii) the availability of future financing. Material factors or assumptions that were applied in drawing a conclusion or making an estimate set out in the forward-looking information include: (i) volumes and pricing assumptions; (ii) utility costs; (iii) expected impact of labour cost initiatives; and (iv) the level of capital expenditures. Although the forward-looking information contained in this MD&A is based upon what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward-looking statements. Certain statements regarding forward-looking information included in this MD&A may be considered "financial outlook" for purposes of applicable securities laws, and such financial outlook may not be appropriate for purposes other than this MD&A.*

*All forward-looking information in this MD&A is qualified by these cautionary statements. Forward-looking information in this MD&A is presented only as of the date made. Except as required by law, K-Bro does not undertake any obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances.*

*This MD&A also makes reference to certain non-GAAP measures to assist in assessing the Fund's financial performance. Non-GAAP measures do not have any standard meaning prescribed by GAAP and are therefore unlikely to be comparable to similar measures presented by other issuers. Please see "Non-GAAP Measures" for further discussion.*

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## INTRODUCTION

### Core Business

The Fund is a limited purpose trust established under the laws of Alberta pursuant to the Amended and Restated Fund Declaration of Trust dated February 3, 2005. The Fund was created for the purpose of acquiring, directly or indirectly, all of the issued and outstanding securities of K-Bro Linen Systems Inc.

K-Bro is the largest owner and operator of laundry and linen processing facilities in Canada. K-Bro provides a comprehensive range of general linen and operating room linen processing, management and distribution services to healthcare institutions, hotels and other commercial accounts. K-Bro currently has processing facilities in six Canadian cities: Toronto, Edmonton, Calgary, Vancouver, Victoria and Quebec City.

### Industry and Market

K-Bro provides laundry and linen services to Canadian healthcare, hospitality and other commercial customers. Typical services offered by K-Bro include the processing, management and distribution of general and operating room linens, including sheets, blankets, towels, surgical gowns and drapes and other linen. Other types of processors in K-Bro's industry in Canada include independent privately-owned facilities (i.e. typically small, single facility companies), public sector central laundries and public and private sector on-premise laundries (known as "OPLs"). Participants in other sectors of the laundry and linen services industry, such as uniform rental companies (which own and launder uniforms worn by their customers' employees) and facilities management companies (which manage public sector central laundries and OPLs), typically do not offer services that significantly overlap with those offered by K-Bro.

Management believes that the healthcare and hospitality sectors of the laundry and linen services industry represent a stable base of annual recurring business with opportunities for growth as additional healthcare beds and funds are made available to meet the needs of an aging demographic.

### Industry Characteristics and Trends

Management believes that the industry exhibits the following characteristics and trends:

*Stable Industry with Moderate Cyclicity* – As evidenced by the stability in the number of approved hospital beds in the healthcare system and hotel rooms in the hospitality industry. Service relationships are typically formalized through contracts in the healthcare sector that are typically long term (from seven to ten years), while contracts in the hospitality sector typically range from two to five years.

*Significant Barriers to Entry* – Establishing new laundry facilities involves significant up-front investment in equipment, linen, facilities and labour. In addition, customer contracts are typically long-term, making it more difficult for new entrants to access new accounts other than upon the expiry of a contract's term.

*Outsourcing and Privatization* – There are often advantages to healthcare institutions in outsourcing the processing of healthcare linen to private sector laundry companies such as K-Bro because of the economies of scale and significant management expertise that can be provided on a more comprehensive and cost-effective basis than customers can achieve in operating their own laundry facilities.

*Fragmentation* – Most Canadian cities have at least one and sometimes several private sector competitors operating in the healthcare and hospitality sectors of the laundry and linen services industry. Management believes that the presence of these operators provides acquisition and consolidation opportunities for larger industry participants with the financial means to complete acquisitions.

## **Customers and Product Mix**

K-Bro's customers include some of the largest healthcare and hospitality institutions in Canada. Healthcare customers include acute care hospitals and long-term care facilities. Most of K-Bro's hospitality customers (typically 250+ rooms) generate between 500,000 and 3,000,000 pounds of linen per year. Most healthcare customers generate between 500,000 pounds of linen per year for a hospital and up to 20,000,000 pounds of linen per year for a healthcare region.

## **SUMMARY OF RESULTS AND KEY EVENTS FOR THE PERIOD**

### **Significant EBITDA Growth in 2009**

EBITDA (see *Non-GAAP Measures*) increased in the second quarter of 2009 to \$4.1 million from \$3.3 million in the second quarter of 2008. This was an increase of 24.5%. For the six months ended June 30, 2009, EBITDA increased to \$7.6 million from \$5.5 million in the same 2008 period, an increase of 38.9%. The EBITDA margin has increased to 18.9% in Q2 2009 versus 15.1% in Q2 2008. For the six months ended June 30, the EBITDA margin has increased to 17.6% in 2009 versus 13.2% in 2008.

This is primarily the result of:

- the operating efficiencies being achieved in the new Calgary plant that started up in Q2 2008 with increased volumes and price adjustments pursuant to a further 10 year contract with its major healthcare customer;
- contractual price adjustments from customers;
- the positive impact of the labour initiatives being realized; and,
- a significant decrease in the cost of natural gas on the unhedged portion of K-Bro's requirements.

### **Year to Date Revenue Growth Achieved**

Although revenue decreased in the second quarter of 2009 by 0.4% compared to the second quarter of 2008, for the six months ended June 30, 2009, revenue increased by 4.2% over the comparable 2008 period. Of this year to date growth, approximately 0.6 percentage points are the result of the acquisition of the assets of Buanderie HMR Inc. ("HMR") located in Quebec City, Quebec which took place on January 31, 2008, 2.1 percentage points are from the addition of new customers part way through 2008 and in 2009, 3.4 percentage points are from growth in existing customers as a result of growing volumes and price increases, and the loss or termination of existing customers accounted for a 1.9 percentage point reduction. Of the 3.4 percentage points of organic growth, approximately half is from price increases and half from volume increases.

The weakened economy, strong Canadian dollar and new US passport requirements had a negative impact on hospitality revenues in the second quarter of 2009. Revenue for this sector contracted by 6.8% in Q2 2009 compared to Q2 2008 and by 2.4% in the first six months of 2009 compared to the same period in 2008. The addition of new hospitality customers in Vancouver and Toronto (see *Market Activities and Opportunities*) will offset some of this decrease but there can be no assurance that this trend will end soon as the general economic conditions may continue to negatively impact K-Bro's hospitality revenues if tourism or business travel decreases further in the future.

## **Labour Cost Improvements Achieved**

Labour costs for plant staff as a percentage of plant revenue decreased in the second quarter from 46.3% in 2008 to 44.4% in 2009 (and from 48.4% for the first six months of 2008 to 44.9% for 2009).

This decrease in labour costs is the result of the new, more efficient Calgary plant and the impact of utilizing the federal government's Temporary Foreign Worker Program. Staff hired under the Temporary Foreign Worker Program have been deployed as they arrive between Edmonton, Calgary, Vancouver and Victoria to fill current vacancies, reduce overtime and night shifts, and to fill vacancies due to turnover. This federal program has been in existence since 1996 and the "temporary" nature of it applies to the workers who are granted a 24 month work permit that can be extended under certain circumstances.

## **Market Activities and Opportunities**

Activities of significance in K-Bro's markets in 2009 have included:

*British Columbia* – Processing has commenced for a total of five new hotel accounts.

*Alberta* – In Edmonton, K-Bro's operating room linen contract was extended for another 21 months to December 31, 2010. In addition, Alberta Health Services announced that the operational opening date for the Mazankowski Heart Institute will be in the summer or early fall of 2009 and some wards have now opened. In Calgary, the finalized signed contract with the health region (which commenced March 1, 2008) was received.

*Ontario* – Processing has commenced for four new hotel accounts and the contracts of three other hotel customers were extended for a further three year period. As previously announced, the Halton Healthcare contract was lost and service was ended in April. One hospital contract was extended for a further five year period to 2016 pursuant to an extension option exercised by the customer.

*Quebec* – Processing commenced for two new hotel customers.

The new hotel customers noted above will generate additional annual revenue of approximately \$2.0 million.

K-Bro currently has several proposals out and has entered into discussions with potential new healthcare and hospitality customers. In addition, discussions are at various stages with potential acquisition candidates. Neither the timing nor the degree of likelihood of success of any of these proposals or potential acquisitions can be stated with any degree of accuracy at this time. The current state of the economy and capital markets adds a significant component of uncertainty to this growth process with respect to availability and cost of capital as well as the accretiveness of opportunities.

## **Effects of Economic Volatility and Uncertainty**

K-Bro management feels that it is positioned to withstand the current market volatility and uncertainty given that:

- Approximately 78% of its revenues are from large publicly funded healthcare customers under long-term contract.
- K-Bro's \$30 million line of credit is with a major Canadian bank and has a term to February 28, 2011 with an annual option to renew for an additional year. No events of default have occurred and at June 30, 2009, K-Bro had unutilized borrowing capacity under this line of \$23.0 million or 77% of the line available.
- K-Bro's payout ratio for the quarter was 56.2% and 57.7% for the six months ended June 30, 2009. The undistributed portion of cashflow provides K-Bro with cashflow from operations to fund growth or cushion it against business downturns.
- K-Bro has fixed a portion of certain potentially volatile components of its cost structure such as natural gas, electricity and interest rates through forward contracts or swaps. With the lowering of commodity prices such as natural gas, K-Bro will benefit on its unhedged portion as this is a major input cost.

## **Taxation**

On July 14, 2008 the Department of Finance released proposed amendments to the Income Tax Act (Canada) to facilitate the conversion of income trusts into corporations on a tax-deferred basis. These proposed amendments are being evaluated and will be utilized in evaluating the options available to K-Bro in light of the impact of Bill C-52 Budget Implementation Act 2007, which contained legislation creating a new 31.5 per cent tax on distributions from publicly traded income trusts in Canada, was substantively enacted by the Canadian Federal Government. Subsequent substantively enacted tax rate changes have reduced the tax rate applicable to distributions from Canadian public income trusts to 29.5 per cent in 2011 (reducing further to 28.0 per cent in 2012). The new tax is not expected to apply to the Fund until 2011 as a transition period applies to publicly traded trusts that existed prior to November 1, 2006. There was no future income tax expense or recovery that needed to be recorded by the Fund as a result of this legislation as the Fund has no taxable temporary differences that would exist in 2011. Future income taxes are already recorded by the Fund's wholly-owned subsidiary K-Bro Linen Systems Inc.

## ACHIEVEMENT OF KEY PERFORMANCE DRIVERS

K-Bro's key performance drivers focus on growth, profitability, and stability in order to maintain distributions and maximize unitholder value. The following outlines our level of success in each of these areas:

Category	Specific Indicator	Q2 2009	Q2 2008 <sup>2</sup>	YTD 2009	YTD 2008 <sup>2</sup>
Growth (% change from comparative period)	Revenue	-0.4%	17.7%	4.2%	14.3%
	EBITDA <sup>1</sup>	24.5%	31.5%	38.9%	12.3%
	Distributable cash	16.2%	34.9%	42.5%	13.0%
Profitability (actual for the period)	EBITDA	\$4,111	\$3,301	\$7,603	\$5,473
	EBITDA margin	18.9%	15.1%	17.6%	13.2%
	Net income	\$2,168	\$1,011	\$3,760	\$1,727
Stability	Payout ratio	56.2%	65.4%	57.7%	79.0%
	Distributions per Unit	\$1.10	\$1.10	\$1.10	\$1.10
	Debt to total Capitalization	9.6%	12.2%	9.6%	12.2%
	Unutilized line of credit	\$23,015	\$20,555	\$23,015	\$20,555

- Notes:
1. EBITDA is defined as revenue less operating expenses as reflected in the table above (which equates to net earnings before income tax recovery, gain or loss on disposals, financial charges and amortization). See *Non-GAAP Measures*.
  2. Restated for the adoption of CICA accounting standard 3064, which requires the expensing of certain expenditures related to a pre-operating period of a facility rather than recording them as assets (discussed further in *Changes in Accounting Policies Including Initial Adoption – Goodwill and intangible assets*)

## OUTLOOK

Management believes that 2009 will continue to show a meaningful increase in EBITDA compared to 2008 with a conservative payout ratio (see *Non-GAAP Measures*), despite the downturn in the hospitality segment as a result of the weakened economy. Given this outlook, management believes that the current level of cash distributions is sustainable for the Fund in its current structure.

This belief is predicated on:

- The continued success of the new Calgary plant with increased volumes, price adjustments and operating efficiencies for a full year versus ten months in 2008;
- The anticipated continuing organic growth from existing customers;
- The anticipated positive impact of the labour initiatives that is expected to be realized on an ongoing basis; and
- The reduction in energy costs currently being experienced.

The potential long-term impact of the Federal Government's implementation of its income tax changes (see *Taxation* above) will continue to unfold as capital markets, investors and the government react to the changes. The Fund, with the assistance of its professional advisers, continues to monitor the possible long-term impact they will have on the Fund and its investors, and what, if any, steps to take in respect of the Fund. However, this legislation is not expected to have an immediate impact on the Fund's tax treatment or distribution policy or the tax treatment of distributions to investors. There can be no assurance that the Fund will be able to undertake any measures to minimize the long-term impact.

## RESULTS OF OPERATIONS

(all amounts in this section in \$000's except per unit amounts and percentages)

### Overall Performance

The second quarter of 2009 saw revenue decrease by \$94 or 0.4% over the second quarter of 2008 (but increases of \$1,736 and 4.2% for the first six months of 2009 compared to 2008). See the previous discussion under *Summary of Results and Key Events for the Period* and the *Revenues* section below for an analysis of this change. Operating costs decreased to 81.1% of revenue in the current quarter compared to 84.9% in 2008 (82.4% of revenue for the six months of 2009 compared to 86.8% in 2008). The causes of this are discussed later under *Operating Expenses*.

As a result, EBITDA increased in the current quarter by \$810 (24.5%) over the second quarter of 2008 (\$2,129 or 38.9% for the first six months of 2009 compared to 2008).

### Selected Annual and Quarterly (Unaudited) Financial Information

The following table provides certain selected consolidated financial and operating data prepared by K-Bro management for the periods indicated:

Fiscal year	2009		2008 <sup>2</sup>					2007	
	Q2	Q1	Total	Q4	Q3	Q2	Q1	Q4	Q3
Revenue	21,746	21,493	85,113	21,547	22,063	21,840	19,663	18,725	19,059
Operating expenses	17,635	18,001	72,718	18,223	18,466	18,539	17,490	16,842	16,630
EBITDA <sup>1</sup>	4,111	3,492	12,395	3,324	3,597	3,301	2,173	1,883	2,429
EBITDA as a % of revenue	18.9%	16.2%	14.6%	15.4%	16.3%	15.1%	11.1%	10.1%	12.7%
Amortization	1,871	1,892	7,203	1,950	1,903	1,896	1,454	1,408	1,443
Financial charges	64	91	687	142	148	140	257	318	230
Loss (gain) on disposal of equipment	-	3	507	49	-	458	-	(28)	-
Write-off of new plant start-up costs	-	-	132	-	-	27	105	-	-
Earnings before income taxes	2,176	1,506	3,866	1,183	1,546	780	357	185	756
Income tax (expense) recovery	(8)	85	856	202	64	231	359	859	262
Net earnings	2,168	1,591	4,722	1,385	1,610	1,011	716	1,044	1,018
Net earnings as a % of revenue	10.0%	7.4%	5.5%	6.4%	7.3%	4.6%	3.6%	5.6%	5.3%
Diluted earnings per Unit	0.31	0.23	0.70	0.21	0.23	0.14	0.12	0.19	0.19
Total assets	84,639	86,344	85,793	85,793	88,241	89,398	89,463	83,342	76,384
Total long-term financial liabilities	11,263	11,536	8,501	8,501	10,825	13,718	8,872	21,948	18,335
Funds provided by (used in) operations	3,539	(796)	15,322	5,594	5,570	470	3,688	2,966	207
Long-term debt, end of period	6,735	7,210	4,061	4,061	6,219	9,010	4,000	16,627	12,734
Distributions declared per unit	0.27	0.28	1.10	0.27	0.28	0.28	0.27	0.27	0.28

- Notes:
- EBITDA is defined as revenue less operating expenses as reflected in the table above (which equates to net earnings before income tax recovery, gain or loss on disposals, financial charges and amortization). See *Non-GAAP Measures*.
  - Restated for the adoption of CICA accounting standard 3064, which requires the expensing of certain expenditures related to a pre-operating period of a facility rather than recording them as assets (discussed further in *Changes in Accounting Policies Including Initial Adoption – Goodwill and intangible assets*)

## Revenues

See previous discussion under *Summary of Results and Key Events for the Period and Overall Performance*. Revenues by sector consist of:

Fiscal year	2009		2008					2007	
	Q2	Q1	Total	Q4	Q3	Q2	Q1	Q4	Q3
Sector									
Healthcare	16,723	16,937	64,698	16,782	16,226	16,448	15,242	14,806	14,318
Hospitality	5,023	4,556	20,415	4,765	5,837	5,392	4,421	3,919	4,741
Total	21,746	21,493	85,113	21,547	22,063	21,840	19,663	18,725	19,059

## Operating Expenses

*Wages and benefits* - The major cause of the quarterly and annual improvement in labour costs is the performance of the Alberta plants as outlined under *Labour Cost Improvements Achieved in Summary of Results and Key Events for the Period*.

*Linen* - Costs as a percentage of revenue have decreased for both the three and six months ended June 30, 2009 compared to the same periods in 2008, as the costs of standard and operating room linen items have remained flat in a competitive global market.

*Utilities* - Significant reductions in natural gas and electricity rates occurred in the last half of 2008 and the first six months of 2009, resulting in a decrease in utility costs as a percentage of revenue from 8.5% in the second quarter of 2008 to 6.6% in the second quarter of 2009. This decreased expense was somewhat offset by a decline in the amount of the rebate received through the Alberta Natural Gas Rebate Program as a result of the lower market rates. This program ended on March 31, 2009. K-Bro is evaluating expanding its natural gas and electricity hedges to take advantage of the current low prices as a continuance of its strategy of locking in future variable costs where feasible.

*Delivery* - The decrease in delivery costs for both the three and six months is primarily the result of lower fuel costs.

*Occupancy* - Of the \$194 decrease in quarterly occupancy costs and \$85 decrease in occupancy costs for the six months, substantially all of the decrease is related to the one-time costs of vacating the former Calgary plant recorded in 2008, net of additional expenses related to the new and larger Calgary facility which was occupied at the end of Q1 2008.

*Materials and supplies* - This includes many different categories, including administrative expenses at the plant level. The quarterly and six month increases are in large part due to the one-time recovery of costs related to the new Calgary plant and worker's compensation expense rebates and special dividends received in 2008.

*Repairs and maintenance* - As a percentage of revenue, there was an increase of 0.4 percentage points for the quarter and 0.3 percentage points for the six months in repairs and maintenance costs. All of the \$98 increase in repairs and maintenance in the second quarter of 2009 (\$174 for the six months of 2009) is the result of increased repairs and maintenance as certain equipment ages.

*Corporate* - Costs increased by \$187 over the second quarter of 2008 and \$374 over the first six months of 2008 which is primarily attributable to an increase in the accrual for the Long Term Incentive Plan (see below) as a result of exceeding performance targets for the period.



### *Long Term Incentive Plan*

In April 2006, a trust (the “LTIP Trust”) was formed to hold Units of the Fund on behalf of the participants of K-Bro’s long-term incentive plan (the “LTIP”). K-Bro is neither a trustee nor a direct participant of the LTIP; however, under certain circumstances K-Bro may be the beneficiary of forfeited Units held by the LTIP Trust. Consequently, the LTIP Trust is considered a variable interest entity for accounting purposes and K-Bro has consolidated the LTIP Trust in accordance with the Canadian Institute of Chartered Accountants (“CICA”) issued Accounting Guideline AcG-15. For a specific performance year, one-quarter of the Units held by the LTIP Trust vest to the participants of the LTIP thirty days after approval of the audited financial statements by the Trustees upon the participant signing a Participation Agreement and Confirmation and three-quarters will vest on the second anniversary of that date upon continued employment, except in limited circumstances. Compensation expense is recorded by K-Bro in the period earned. Distributions made by the Fund with respect to unvested Units held by the LTIP Trust are paid to LTIP participants. Unvested units held by the LTIP Trust are shown as a reduction of unitholders’ equity. At June 30, 2009 a total of 69,692 units were unvested.

### *Effects of Inflation*

The majority of K-Bro’s customer contracts have an annual price adjustment mechanism based on a published price index such as the Consumer Price Index. To the extent that such indices are impacted by inflation, this would be reflected in K-Bro’s revenues and net income. K-Bro’s operating costs may be affected by general inflation but to a much greater extent are impacted by labour market conditions, textile costs in a global environment and commodity prices impacting the cost of energy.

### *Amortization of Property and Equipment*

Amortization of property and equipment represents the expense related to the appropriate matching of certain of K-Bro's long-term assets to the estimated useful life and period of economic benefit to K-Bro of those assets. Amortization of plant and equipment for the quarter and first six months of 2009 has increased from the comparable period in 2008 primarily due to the capital expense of the new Calgary plant.

### *Amortization of Intangible Assets*

Amortization of intangible assets represents the expense related with matching K-Bro’s finite life intangible assets to the estimated useful life and period of economic benefit to K-Bro of those assets. Amortization expense in the first six months of 2009 increased compared to 2008 as a result of the HMR acquisition on January 31, 2008.

### *Financial Charges*

Financial charges in the current quarter decreased by \$76 over 2008 (and decreased by \$243 for the first six months of 2009 compared to 2008) as a result of a reduced long-term debt balance (see *Liquidity and Capital Resources – Financing Activities*).

### *Income Tax Recovery*

Income tax recovery includes current and future income taxes based on taxable income and the temporary timing differences between the tax and accounting bases of assets and liabilities. Income tax recovery reflects the structure as an income trust whereby the Fund’s unitholders bear the tax obligations with respect to distributions.

On June 12, 2007, Bill C-52 Budget Implementation Act 2007, which contained legislation creating a new 31.5 per cent tax on distributions from publicly traded income trusts in Canada, was substantively enacted by the Canadian Federal Government. Subsequent substantively enacted tax rate changes have reduced the tax rate applicable to distributions from Canadian public income trusts to 29.5 per cent in 2011 (reducing further to 28.0 per cent in 2012). The new tax is not expected to apply to the Fund until 2011 as a transition period applies to publicly traded trusts that existed prior to November 1, 2006. There was no future income tax expense or recovery that needed to be recorded by the Fund as a result of this legislation as the Fund has no taxable temporary differences that would exist in 2011. Future income taxes

are already recorded by the Fund's wholly-owned subsidiary K-Bro Linen Systems Inc.

Currently, the Fund is only taxable on amounts that are not distributed to Unitholders. Once the Fund is subject to the new rules (which is not expected to be until 2011), the Fund will be subject to income tax on its earnings regardless of whether amounts are distributed to the Unitholders or not.

## **LIQUIDITY AND CAPITAL RESOURCES**

(all amounts in this section in \$000's except per unit amounts and percentages)

### **Cash Provided by Operating Activities**

Cash provided by operating activities was \$3,539 in the second quarter of 2009, an increase of \$3,069 from the funds provided by operating activities in the second quarter of 2008. This \$3,069 increase is attributable to an increase in cashflow from operations of \$913 and a decreased working capital requirement of \$2,156 in the quarter compared to the corresponding period in 2008. For the six months, cash provided by operating activities was \$2,743 in 2009, a decrease of \$1,415 from the funds provided by operating activities in 2008. This \$1,415 decrease is attributable to an increase in cashflow from operations of \$2,491 offset by an increased working capital requirement of \$3,906 compared to the corresponding period in 2008.

The changes in working capital requirements are the result of: changes in accounts receivable resulting from the timing of receipts from major customers and growth in revenues; and, changes in accounts payable and prepaid expenses and deposits as the result of timing differences in payments (primarily associated with the payment of accrued volume rebates in Q1 2009 and reduced construction expenditure accruals in 2009 vs. 2008).

### **Financing Activities**

In the first quarter of 2008, the Fund raised proceeds (net of offering costs before tax) of \$18,252 from the issuance of 1,362,000 units on a bought deal basis and 146,700 additional units when a portion of the related over-allotment option was exercised. As planned, these funds financed the acquisition of HMR (\$3,852 including the escrowed funds) and were used for the retrofit and equipping of the new Calgary plant and for general corporate purposes. No equity issuances occurred in the first six months of 2009.

During the quarter ended June 30, 2009, the Fund declared distributions to unitholders at an annualized rate of \$1.10 per unit for a total amount of \$1,926 (\$1,926 for the second quarter of 2008). For the six months ended June 30, 2009, the Fund declared distributions to unitholders at an annualized rate of \$1.10 per unit for a total amount of \$3,853 (\$3,701 for 2008.) The increase in 2009 is reflective of the increased number of units outstanding as a result of the equity offering on February 27, 2008 and the related over-allotment option exercised on March 28, 2008.

Long-term debt at June 30, 2009 was \$6,735 compared with \$4,061 at December 31, 2008 and \$9,010 at June 30, 2008. The increase from the fourth quarter of 2008 is primarily the result of the increase in working capital requirements and the purchase of property, plant and equipment.

The existing long-term debt of \$6,735 consists of draw downs on a secured revolving, interest only, credit facility (the "Credit Facility") of up to \$30,000. The Credit Facility is a two-year committed facility maturing February 28, 2011 and is extendable annually for an additional year at the lender's option. It is subject to customary terms and conditions and is also subject to the maintenance of a maximum ratio of funded debt to EBITDA of 2.75 (increased to 3.25 for the two fiscal quarters immediately following an acquisition), and minimum ratios of 1.50 for the defined current ratio and 1.00 for fixed charge coverage. K-Bro has incurred no events of default under the terms of its credit facility agreement.

On June 24, 2005, K-Bro entered into an interest rate swap arrangement whereby the interest rate paid on a notional amount of \$4,000 of this debt has been fixed at 5.95% for a period of five years. The floating rate of interest that was swapped for this fixed rate is currently at 2.90%.

In the second quarter of 2009, the Fund entered into a foreign exchange forward contract at an exchange rate of 1.0865

Canadian per US dollar to cover its foreign exchange exposure with respect to its liability for certain equipment purchases. The Canadian dollar weakened between the time the contract was set up and June 30, 2009 which resulted in a gain on derivative instruments being recorded in other comprehensive income for the current quarter. This foreign exchange forward contract was exercised in July, 2009.

### Investing Activities

During the current quarter, K-Bro used \$608 (2008 – \$172) of funds for maintenance capital expenditures and \$529 (2008 – \$3,938) of funds for strategic capital expenditures for a total cash investment of \$1,137 (2008 – \$4,110) for the quarter. For the six months, K-Bro used \$741 of funds for maintenance capital expenditures in 2009 (2008 – \$242) and \$829 of funds for strategic capital expenditures (2008 – \$7,142) for a total cash investment of \$1,570 (2008 – \$7,384). Management defines maintenance capital expenditures as additions to, or replacements of, property and equipment to maintain K-Bro's current business operations. K-Bro has embarked on a computer software upgrade that commenced in the first quarter of 2009. Total costs of phase one of this two phase project, including software and hardware, are estimated to be \$1,000, of which \$438 was incurred in Q2 2009 as a maintenance capital expenditure. Management estimates that ongoing annual average maintenance capital expenditures are approximately \$850. The modest level of maintenance capital expenditures is due to the long life of the majority of the processing equipment.

Expenditures on parts such as motors, belts and ironer pads are expensed as incurred. These expenditures and an extensive preventative maintenance program performed at each plant by a full complement of qualified maintenance engineers has resulted in a repairs and maintenance expense (including personnel costs) totaling \$1,318 in the second quarter of 2009 (\$1,149 in 2008) which are included in the calculation of EBITDA. This amount as a percentage of revenue is up 0.8 percentage points for the current quarter over the second quarter of 2008.

Strategic capital expenditures are defined by management as those expenditures utilized for improvements to, and expansion of, K-Bro's property and equipment to enhance efficiencies and capacity to process incremental volumes. The strategic capital expenditures in 2009 are primarily related to the requirements of handling additional volume and gaining efficiencies.

No disposals of equipment were recorded in the second quarter of 2009.

### Contractual Obligations

At June 30, 2009, payments due under contractual obligations for the next five years and thereafter are as follows:

	Payments Due by Period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Long-term debt	6,735	–	6,735	–	–
Operating leases and utility commitments	15,601	2,454	5,387	3,786	3,974
Linen purchase obligations	2,504	2,504	–	–	–

The source of funds for these commitments will be from operating cash flow and the undrawn portion of the Credit Facility.

## Financial Position

<b>Capital Structure at June 30</b>		
	<b>2009</b>	<b>2008</b>
Long-term debt	\$6,735	\$9,010
Unitholders' equity	63,458	64,659
Total capitalization	70,193	73,669
Debt to total capitalization	9.6%	12.2%

For the three months ended June 30, 2009, the Fund had a payout ratio (see *Non-GAAP Measures*) of 56.2%, a debt to total capitalization of 9.6%, an unused line of credit of \$23,015 and has not incurred any events of default under the terms of its credit facility agreement. Based on this, management believes that K-Bro has sufficient liquidity and is able to generate sufficient amounts of cash to meet its planned growth and has access to the equity market, if available and cost effective, to fund additional growth as acquisition opportunities arise.

## DISTRIBUTIONS FOR THE PERIOD

<b>Fiscal year</b>		<b>2009</b>		<b>2008</b>	
<b>Period</b>	<b>Payment Date</b>	<b>Per Unit Distribution</b>	<b>Distribution Amount (\$)</b>	<b>Per Unit Distribution</b>	<b>Distribution Amount (\$)</b>
<b>Fund Units</b>					
First quarter		\$0.27501	\$1,906,524	\$0.27501	\$1,754,774
April	May 15	\$0.09167	\$635,508	\$0.09167	\$635,508
May	June 15	\$0.09167	\$635,508	\$0.09167	\$635,508
June	July 15	\$0.09167	\$635,508	\$0.09167	\$635,508
Second quarter		\$0.27501	\$1,906,524	\$0.27501	\$1,906,524
Year to date		\$0.55002	\$3,813,048	\$0.55002	\$3,661,298
<b>Exchangeable Shares</b>					
First quarter		\$0.27501	\$19,914	\$0.27501	\$19,913
April	May 15	\$0.09167	\$6,638	\$0.09167	\$6,638
May	June 15	\$0.09167	\$6,638	\$0.09167	\$6,638
June	July 15	\$0.09167	\$6,637	\$0.09167	\$6,638
Second quarter		\$0.27501	\$19,913	\$0.27501	\$19,914
Year to date		\$0.55002	\$39,827	\$0.55002	\$39,827
<b>Total Distributions</b>		<b>\$0.55002</b>	<b>\$3,852,875</b>	<b>\$0.55002</b>	<b>\$3,701,125</b>

For the six months ended June 30, 2009, the Fund distributed \$0.55002 per unit compared with Distributable Cash (see *Non-GAAP Measures*) per unit of \$0.95. The actual payout ratio was 57.7%.

The Fund's policy is to make distributions to unitholders of its available cash to the maximum extent possible consistent with good business practices considering requirements for capital expenditures, working capital, growth capital and other reserves considered advisable by the Trustees of the Fund. All such distributions are discretionary. Distributions are declared payable each month in equal amounts to the Fund unitholders and exchangeable shareholders on the last business day of each month and are paid by the 15<sup>th</sup> of the following month.

## DISTRIBUTABLE CASH (see *Non-GAAP Measures*)

(all amounts in this section in \$000's except per unit amounts and percentages)

The Fund's source of cash for distributions is cash provided by operating activities. Distributable cash, reconciled to cash provided by operating activities as calculated under GAAP, is presented as follows:

Fiscal year <sup>1</sup>	2009		2008 <sup>2</sup>				2007		
	Q2	Q1	Total	Q4	Q3	Q2	Q1	Q4	Q3
<b>Per consolidated financial statements:</b>									
Cash (used in) provided by operating activities	\$3,539	\$(796)	\$15,322	\$5,594	\$5,570	\$470	\$3,688	\$2,966	\$207
Add (deduct):									
Net changes in non-cash working capital items <sup>3</sup>	494	4,183	(3,788)	(2,424)	(2,135)	2,649	(1,878)	(1,398)	1,991
Maintenance capital expenditures <sup>4</sup>	(608)	(133)	(490)	(180)	(68)	(172)	(70)	(58)	(150)
<b>Distributable cash</b>	<b>\$3,425</b>	<b>\$3,254</b>	<b>\$11,044</b>	<b>\$2,990</b>	<b>\$3,367</b>	<b>\$2,947</b>	<b>\$1,740</b>	<b>\$1,510</b>	<b>\$2,048</b>
<b>Distributable cash per weighted average diluted Units outstanding</b>	<b>\$0.49</b>	<b>\$0.46</b>	<b>\$1.63</b>	<b>\$0.44</b>	<b>\$0.48</b>	<b>\$0.42</b>	<b>\$0.29</b>	<b>\$0.26</b>	<b>\$0.38</b>
Distributions declared <sup>5</sup>	\$1,926	\$1,926	\$7,554	\$1,927	\$1,926	\$1,926	\$1,775	\$1,511	\$1,512
<b>Distributions declared per unit (see "Non-GAAP Measures")</b>	<b>\$0.27</b>	<b>\$0.28</b>	<b>\$1.10</b>	<b>\$0.27</b>	<b>\$0.28</b>	<b>\$0.28</b>	<b>\$0.27</b>	<b>\$0.27</b>	<b>\$0.28</b>
<b>Payout ratio (see "Non-GAAP Measures")<sup>5</sup></b>	<b>56.2%</b>	<b>59.2%</b>	<b>68.4%</b>	<b>64.4%</b>	<b>57.2%</b>	<b>65.4%</b>	<b>102.0%</b>	<b>100.0%</b>	<b>73.8%</b>
Weighted average units outstanding during the period — Basic	6,946	6,970	6,719	6,969	6,969	6,961	5,972	5,459	5,459
Weighted average units outstanding during the period — Diluted	7,010	6,999	6,747	6,998	6,996	6,985	5,997	5,493	5,493
<b>12-month trailing</b>									
Distributable cash	13,036	12,558		11,044	9,564	8,245	7,483	7,704	8,225
Distributions	7,705	7,705		7,554	7,138	6,724	6,309	6,046	6,046
Payout ratio	59.1%	61.4%		68.4%	74.6%	81.6%	84.3%	78.5%	73.5%
<b>Cumulative since IPO February 3, 2005</b>									
Distributable cash	38,834	35,409		32,155	29,165	25,798	22,851	21,111	19,601
Distributions	27,424	25,498		23,572	21,645	19,719	17,793	16,018	14,507
Payout ratio	70.7%	72.0%		73.3%	74.2%	76.4%	77.9%	75.9%	74.0%

- Following the revised Staff Notice 52-306 issued by the Canadian Securities Administrators on distributable cash presentation, we adopted their recommendations retroactive to February 3, 2005 in order to disclose comparable results.
- Restated for the adoption of CICA accounting standard 3064, which requires the expensing of certain expenditures related to a pre-operating period of a facility rather than recording them as assets (discussed further in *Changes in Accounting Policies Including Initial Adoption – Goodwill and intangible assets*).
- Net changes in non-cash working capital is excluded from the calculation as management believes it would introduce significant cash flow variability and affect underlying cash flow from operating activities. Significant variability can be caused by such things as the timing of receipts (which individually are large because of the nature of K-Bro's customer base and timing may vary due to the timing of customer approval, vacations of customer personnel, etc.) and the timing of disbursements (such as the payment of large volume rebates done once annually). As well, large increases in working capital are generally required when contracts with new customers are signed as linen is purchased and accounts receivable increase. Management feels that this amount should be excluded from the distributable cash figure which is used as the basis for determining the distributions to be paid.
- Maintenance capital expenditure is discussed under *Investing Activities*.
- The level of distributions paid compared to distributable cash is reviewed periodically to take into account the current and prospective performance of the business and other items considered to be prudent.

## **OUTSTANDING UNITS**

At June 30, 2009, the Fund had 6,932,562 Fund Units outstanding and 72,411 Special Trust Units outstanding (unchanged from March 31, 2009 and December 31, 2008). The basic and the diluted weighted average number of units outstanding for the first six months of 2009 were 6,957,894 and 7,022,075 respectively (6,595,029 and 6,619,370 respectively for the first six months of 2008).

In accordance with the LTIP agreement and in conjunction with the performance of the Fund in the prior fiscal year, the Compensation, Nominating and Corporate Governance Committee of the Trustees of the Fund in 2009 approved LTIP compensation of \$0.8 million (2008 – \$0.3 million) and approved the funding and transfer of \$0.8 million (2008 – \$0.3 million) of cash to the LTIP Trust in April 2009 and March 2008 respectively in order to fund the purchase of Units by the LTIP Trust. In April 2009, the LTIP Trust purchased 68,171 Units of the Fund (2008 – 24,751). As at June 30, 2009, 72,729 Units held by the LTIP Trust have vested (December 31, 2008 – 38,961). The basic net earnings per unit calculation exclude the unvested units held by the LTIP Trust.

## **RELATED PARTY TRANSACTION**

The Fund has incurred expenses in the normal course of business for advisory consulting services provided by a Trustee primarily relating to acquisitions. The amounts charged are recorded at their exchange amounts and are subject to normal trade terms. For the three months ended June 30, 2009, the Fund incurred such fees totalling \$34,500 (three months ended June 30, 2008 – \$nil). For the six months ended June 30, 2009, the Fund incurred such fees totalling \$69,000 (six months ended June 30, 2008 – \$28,000).

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of the financial statements, in conformity with GAAP, requires management of K-Bro to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Management regularly evaluates these estimates and assumptions which are based on past experience and other factors that are deemed reasonable under the circumstances. This involves varying degrees of judgment and uncertainty and, therefore, amounts currently reported in the financial statements could differ in the future. There have been no changes in these accounting estimates from those reported at December 31, 2008.

## **NON-GAAP MEASURES**

### **EBITDA**

We report on our EBITDA (Earnings before interest, taxes, depreciation and amortization) because it is a key measure used by management to evaluate performance. EBITDA is utilized in measuring compliance with debt covenants and in making decisions relating to distributions to unitholders. We believe EBITDA assists investors in assessing our performance on a consistent basis as it is an indication of our capacity to generate income from operations before taking into account management's financing decisions and costs of consuming tangible and intangible capital assets, which vary according to their vintage, technological currency and management's estimate their useful life. Accordingly, EBITDA comprises revenues less operating costs before: financing costs, capital asset amortization, disposal and impairment charges, and income taxes.

EBITDA is not a calculation based on GAAP and is not considered an alternative to net earnings in measuring K-Bro's performance. EBITDA does not have a standardized meaning and is therefore not likely to be comparable with similar measures used by other issuers. For reconciliation with GAAP, please refer to "Selected Annual and Quarterly Information". EBITDA should not be used as an exclusive measure of cash flow since it does not account for the impact of working capital changes, capital expenditures, debt changes and other sources and uses of cash, which are disclosed in the consolidated statements of cash flows.

## **Distributable Cash**

Distributable cash is a non-GAAP measure generally used by Canadian income trusts as an indicator of financial performance but it should not be seen as a measurement of liquidity or a substitute for comparable metrics prepared in accordance with GAAP. Management believes that this measure is commonly used by investors, management and other stakeholders to evaluate the ongoing performance of K-Bro. For reconciliation with GAAP, please refer to the *Distributable Cash* section.

## **Cash Distributions per Unit and Payout Ratios**

We report on cash distributions per unit and payout ratios (actual cash distribution divided by distributable cash) because they are believed to be key measures used by investors to value K-Bro, assess its performance and provide an indication of the sustainability of distributions. Cash distributions per unit and the payout ratio depend on the amount of distributable cash generated and the Fund's distribution policy.

The Fund's policy is to make distributions to unitholders of its available cash to the maximum extent possible consistent with good business practices considering requirements for capital expenditures, working capital, growth capital and other reserves considered advisable by the Trustees of the Fund. Distributions are declared payable each month to the Fund unitholders and exchangeable shareholders on the last business day of each month and are paid by the 15<sup>th</sup> of the following month. All distributions are discretionary. We periodically review cash distributions taking into account our current and prospective performance.

## **CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION**

The Fund has adopted one new accounting standard:

### **Goodwill and intangible assets**

In February 2008, the CICA issued a new accounting standard – Section 3064 “Goodwill and intangible assets” replacing accounting standards Section 3062 “Goodwill and other intangible assets” and Section 3450 “Research and development costs.” Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. The new Section is applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Fund adopted the new standard for its fiscal year beginning January 1, 2009. The provisions of Section 3064 were adopted retrospectively, with restatement of prior periods.

As a result of this adoption, the Fund has retroactively expensed certain expenditures related to the pre-operating period of the new Calgary plant, rather than recording them as assets in “Deferred charges.” The adoption of Section 3064 resulted in an increase to opening deficit of \$nil at January 1, 2008 and \$96,217 at January 1, 2009. For the three months ended June 30, 2008, the adoption of this standard resulted in an increase of \$26,909 in the “Write-off of new plant start-up costs” expense and an increase in the “Future income tax recovery” of \$7,510, and reduced diluted earnings per unit by \$0.01. For the six months ended June 30, 2008, the adoption of this standard resulted in an increase of \$132,631 in the “Write-off of new plant start-up costs” expense and an increase in the “Future income tax recovery” of \$36,414, and reduced both basic and diluted earnings per unit by \$0.02.

## International Financial Reporting Standards

The Accounting Standards Board of Canada has announced that accounting standards in Canada, as used by public companies, will be converged to International Financial Reporting Standards (“IFRS”) effective January 1, 2011. The changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011.

IFRS uses a conceptual framework similar to Canadian GAAP but there are significant differences in recognition, measurement and disclosure requirements. As a result, the Fund has established a changeover plan to convert to these new standards according to the timetable set with these new rules. An implementation plan has been created and will be executed with internal and external resources. The Fund will complete the scoping and diagnostic phase in the first quarter of 2009 and will then move to the impact analysis and design phase. The Fund’s preliminary analysis of IFRS in comparison to Canadian GAAP has identified a number of differences. At this time, the impact on our future financial position and results of operations is not reasonably determinable or estimable. The Fund will continually review and adjust the changeover plan to ensure the implementation process properly addresses the key elements of the plan.

Key activities, milestones/deadlines and status are as follows:

Key Activity	Milestones/Deadlines	Status
<b>Financial Statement Preparation:</b> <ul style="list-style-type: none"> <li>▪ Identify differences between IFRS and Canadian GAAP accounting policies</li> <li>▪ Selection of IFRS policies</li> <li>▪ Select choices under IFRS 1</li> <li>▪ Develop financial statement format</li> <li>▪ Quantify effects of change in initial IFRS1 disclosures and 2010 financial statements</li> </ul>	Senior Management sign-off and audit committee review for all items by fourth quarter, 2009.	Analysis of issues currently underway.
<b>Staffing:</b> Define and introduce appropriate level of IFRS expertise for each of the following: <ul style="list-style-type: none"> <li>▪ Accounting staff</li> <li>▪ Senior executives and Board, including Audit Committee</li> </ul>	Appropriate level of expertise to be in place by second quarter 2009.	Experienced consultant contracted in July for duration of project. Internal resource assessment ongoing.
<b>Infrastructure:</b> Ensure information technology is fully compliant for IFRS as follows: <ul style="list-style-type: none"> <li>▪ Capability of system to produce dual financial statements (Canadian GAAP and IFRS) during the transition years</li> <li>▪ Programs upgrades/changes</li> <li>▪ Gathering disclosure data</li> <li>▪ Budget/forecast monitoring process</li> </ul>	Ready for parallel processing of 2010 general ledgers and for planning/monitoring process.	Process currently underway in conjunction with financial systems software upgrade.
<b>Business Policy Assessment: Financial Covenants</b> <ul style="list-style-type: none"> <li>▪ Identify impact of IFRS on financial covenants</li> <li>▪ Complete any required renegotiations/changes</li> </ul>	Renegotiations to be completed by third quarter 2010.	Process of identifying metrics affected by conversion to IFRS currently underway.
<b>Business Policy Assessment: Compensation Arrangements</b> <ul style="list-style-type: none"> <li>▪ Identify impact on compensation arrangements</li> <li>▪ Make any required changes</li> </ul>	Fourth quarter 2010.	Process of identifying metrics affected by conversion to IFRS currently underway.
<b>Business Policy Assessment: Customer and Supplier Contracts</b> <ul style="list-style-type: none"> <li>▪ Evaluate impact of IFRS on current customer or supplier contracts.</li> </ul>	Complete review by first quarter 2010.	Process of identifying IFRS consequences in process.



<p><b>Control Environment: ICFR</b></p> <ul style="list-style-type: none"> <li>▪ For all accounting policy changes identified, assess ICFR design and effectiveness implications.</li> <li>▪ Implement changes where appropriate.</li> </ul>	<p>Fourth quarter 2009.</p>	<p>To be reviewed in conjunction with accounting policies.</p>
<p><b>Control Environment: DC&amp;P</b></p> <ul style="list-style-type: none"> <li>▪ For all accounting policy changes identified, assess DC&amp;P design and effectiveness implications.</li> <li>▪ Implement changes where appropriate.</li> </ul>	<p>See ICFR deadlines above.</p> <p>Publish impact of conversion on Key Performance Indicators in third quarter, 2010 MD&amp;A.</p> <p>Publish material changes in policies and expectations by January 10, 2011.</p> <p>Publish revised 2010 results and MD&amp;A by March 31, 2011.</p>	<p>To be reviewed in conjunction with accounting policies.</p>

## FINANCIAL INSTRUMENTS

K-Bro's financial instruments at June 30, 2009 consist of accounts receivable, accounts payable and accrued liabilities, distribution payable to unitholders, long-term debt, an interest rate swap agreement and a foreign exchange forward contract. The Fund does not enter into financial instruments for trading or speculative purposes. Financial assets are either classified as available for sale, held to maturity, trading or loans and receivables. Financial liabilities are recorded at amortized cost. Initially, all financial assets and financial liabilities must be recorded on the balance sheet at fair value. Subsequent measurement is determined by the classification of each financial asset and liability. Unrealized gains and losses on financial assets that are held as available for sale are recorded in other comprehensive income until realized, at which time they are recorded in the consolidated statement of earnings. All derivatives, including embedded derivatives that must be separately accounted for, are recorded at fair value in the consolidated balance sheet. Transaction costs related to financial instruments are generally capitalized and then amortized over the expected life of the financial instrument using the effective yield method.

Derivative financial instruments are utilized by K-Bro to manage cashflow risk against the volatility in interest rates on its long-term debt and foreign exchange rates on its equipment purchase commitments. K-Bro does not utilize derivative financial instruments for trading or speculative purposes. K-Bro has floating interest rate debt that gives rise to risks that its earnings and cash flows may be adversely impacted by fluctuations in interest rates. In order to manage these risks, K-Bro may enter into interest rate swaps, forward contracts or option contracts. K-Bro has entered into an interest rate swap arrangement as described under "Financing Activities".

It is K-Bro's policy to document all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategy for undertaking various hedge transactions. This process includes linking all derivatives to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. K-Bro also assesses, both at the hedge inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair value or cash flows of hedged items. K-Bro's interest rate swaps, forward contracts or option contracts are designated as hedges when the underlying risks of the hedged and hedging instruments offset to manage K-Bro's exposure. Gains or losses relating to such contracts are accounted for as discussed above.

## CRITICAL RISKS AND UNCERTAINTIES

As at June 30, 2009, there are no material changes in the Fund's risks or risk management activities since December 31, 2008. The Fund's results of operations, business prospects, financial condition, cash distributions to Unitholders and the trading price of the Fund's units are subject to a number of risks. These risk factors include: the effects of market volatility and uncertainty; potential future tax changes; the competitive environment; our ability to acquire and successfully integrate and operate additional businesses; utility costs; the labour markets; the fact that our credit facility imposes numerous covenants and encumbers assets; and, environmental matters.

For a discussion of these risks and other risks associated with an investment in Fund Units, see *Risk Factors – Risks Related to K-Bro and the Laundry and Linen Industry* detailed in the Fund's Annual Information Form that is available at [www.sedar.com](http://www.sedar.com).

In July, a new sixty-six month agreement was ratified by the labor union in K-Bro's Quebec City plant with market based adjustments to wages and benefits.

## **CONTROLS AND PROCEDURES**

In order to ensure that information with regard to reports filed or submitted under securities legislation present fairly in all material respects the financial information of K-Bro, management including the President and Chief Executive Officer and the Vice-President and Chief Financial Officer are responsible for establishing and maintaining disclosure controls and procedures, as well as internal control over financial reporting.

### **Disclosure Controls and Procedures**

As of December 31, 2008, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Multilateral Instrument 52-109 was performed under the supervision of the President and Chief Executive Officer and the Vice-President and Chief Financial Officer who attested that the design and operation of these disclosure controls and procedures were effective, as at December 31, 2008. K-Bro's management can therefore provide reasonable assurance that material information relating to the Fund is reported to it in a timely manner so that it can provide investors with complete and reliable information.

Management also concluded that during the three and six months ended June 30, 2009, no changes were made to internal controls over financial reporting that would have materially affected, or would be reasonably considered to materially affect, these controls.

### **Internal Controls over Financial Reporting**

K-Bro undertook the documentation and assessment of the design of internal controls over financial reporting for its operating and accounting processes. Similar to the evaluation of disclosure controls and procedures referred to above, the design of internal controls over financial reporting was evaluated as defined in Multilateral Instrument 52-109. Based on the results of this evaluation, the President and Chief Executive Officer and the Vice President and Chief Financial Officer attested that the internal controls over financial reporting are designed to provide reasonable assurance that its financial reporting is reliable and that K-Bro's consolidated financial statements were prepared in accordance with Canadian GAAP.

Management also concluded that during the three and six months ended June 30, 2009, no changes were made to internal controls over financial reporting that would have materially affected, or would be reasonably considered to materially affect, these controls.

## VISION

Management believes that K-Bro has the capability to deliver results and can achieve its vision of continuing to grow profitably in existing and new markets by capitalizing on its strengths and competitive advantages which include:

**Long-Term Contracts** – K-Bro's contracts with its healthcare customers typically range from seven to ten years. Contracts in the hospitality sector typically range from two to five years. K-Bro is the exclusive provider of laundry and linen services to most of its customers. Management believes that these long standing relationships, customer knowledge, quality services and value added services may bode well when contract renewals are due such as the contract with Alberta Health Services in Edmonton due to expire December 31, 2010.

**Strong Institutional Customer Base** – K-Bro's customers include a number of leading hospitals, health authorities, continuing care facilities and hotels in Canada. Healthcare customers include: Alberta Health Services (which encompasses the Calgary Health Region and Capital Health in Edmonton); The Hospital For Sick Children, Mount Sinai Hospital and St. Michael's Hospital in Toronto; and, Vancouver Coastal Health and Fraser Health (the central healthcare organizations for the greater Vancouver region). K-Bro's hospitality customers include major hotels from such well known groups as Fairmont, Westin, Delta and Hyatt. This customer base provides a strong reference list for entry into new markets or expanding services in existing markets.

**Modest Maintenance Capital Expenditure Requirements** – Laundry equipment can, with proper ongoing maintenance, remain operative for long periods of time. For example, the useful life of a high capacity, energy efficient tunnel washer can extend beyond 20 years. This allows for competitive pricing for existing and new customers, as well as margin improvement as additional volumes are processed without additional capital expenditure. The longevity of equipment is enhanced by having a full complement of qualified maintenance engineers at each plant performing a comprehensive on-going preventative maintenance program.

**National Brand-Name Recognition and Strong Reputation** – K-Bro is the largest owner and operator of laundry and linen processing plants in Canada and the only service provider with a large operation in several of Canada's largest cities. Management believes that K-Bro's size and presence in multiple markets provide it with enhanced credibility when competing for new accounts in existing markets. As well, opportunity for growth in new markets through acquisitions or new builds is also enhanced. Management believes that this reputation is also enhanced through well established “green programs” including: an extensive reusable operating room linen program (K-Bro's “KOR” program); effective energy use and re-use through direct fired water heaters, heat exchangers and efficient tunnel washer systems; plastic recycling programs; and, replacement of chlorine bleach with more environmentally friendly hydrogen peroxide where feasible.

**Experienced Management Team and Effective Organizational Structure** – The general managers at K-Bro's six laundry facilities have each been in the industry from 14 to 20 years, and four began their careers at K-Bro in other positions before being promoted to their current positions. When combined with the CEO and the CFO, the group of eight senior managers has an average of 17 years of industry experience and an average age of 46. This provides an effective combination of youth and experience which bodes well for the future success of K-Bro in achieving its vision.

K-Bro's organizational structure has been developed to enable the general managers of its plants to focus on growth and operations in their individual markets, while enabling aggressive business development and tight management controls through K-Bro's separate corporate team.

**Scalable Business Model** – Each of K-Bro's plants is highly automated and has a cost structure with a significant fixed cost component. This allows the Company to generate economies of scale as volumes increase. Maintenance capital expenditures are incurred as necessary to maintain productive capacity in each plant. Strategic capital expenditures are incurred as necessary to enhance productive capacity as dictated by growth from existing or new customers. See Liquidity and Capital Resources—*Investing Activities*. Productive capacity can also be increased in each plant through longer operating hours; however, adequate consideration must be given to downtime for preventative maintenance as well as the availability of productive labour to perform efficiently in an expanded day.

**Effective Financing Strategy** – K-Bro maintains a conservative financing strategy to ensure the availability of lines of credit to fund growth as necessary. For major acquisitions or strategic capital expenditures, the equity markets will be accessed when available and it is prudent to do so. Payout ratios are kept at a prudent level giving consideration to business conditions and maintenance capital expenditures.

## **STRATEGY**

K-Bro maintains the following three-part strategic focus:

**Secure and Maintain Long-Term Contracts with Large Healthcare and Hospitality Customers** – K-Bro's core service is providing high quality laundry and linen services at competitive prices to large healthcare and hospitality customers under long-term contracts. K-Bro's contracts in the healthcare sector typically range from seven to ten years in length. Contracts in the hospitality sector typically range from two to five years.

**Extend Core Services To New Markets** – Management has demonstrated its ability to successfully expand K-Bro's business into new markets from its established base in Edmonton and Toronto. K-Bro entered the Calgary market in 1998, the Vancouver market in 2003, the Victoria market in 2006 and the Quebec market in 2008. These new markets have contributed significantly to K-Bro's growth. Management believes that new outsourcing opportunities will continue to arise in the near to medium-term and that K-Bro is well-positioned for continued growth, particularly as healthcare and hospitality institutions continue to increase their focus on core services and confront pressures for capital and cost savings.

Management may in the future expand its core services to new markets either through acquisitions or by establishing new facilities. Its choice of areas for expansion will depend on the availability of suitable acquisition candidates, the volume of healthcare linen to be processed and the policies of applicable governments.

**Introduce Related Services** – In addition to focusing on its core services, K-Bro also attempts to capitalize on attractive business opportunities by introducing closely-related services that enable it to provide more complete solutions to the K-Bro's healthcare customers. These related service offerings include K-Bro Operating Room Services ("KOR") and on-site services. For three major hospitals in Toronto, K-Bro has introduced the sterilization of operating room linen packs to its menu of services.