# Management's Discussion & Analysis

## Year Ended December 31, 2011

**dependable.**

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K-Bro Linen Inc.

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

The following Management's Discussion and Analysis ("MD&A") is supplemental to, and should be read in conjunction with, audited Consolidated Financial Statements for the years ended December 31, 2011 and 2010, and the unaudited interim consolidated financial statements for the periods ended March 31, 2011, June 30, 2011 and September 30, 2011. All references to "K-Bro", "the Corporation", "us", "our" or "we" in this MD&A includes K-Bro Linen Inc. and its wholly owned subsidiaries, and, as applicable, its predecessor, K-Bro Linen Income Fund (the "Fund"), including the operations controlled and consolidated by them, unless otherwise indicated. All references to "Management" refer to directors and senior officers of the Corporation.

Management is responsible for the information contained in this MD&A and its consistency with information presented to the Audit Committee and Board of Directors. All information in this document has been reviewed and approved by the Audit Committee and Board of Directors. This review was performed by management with information available as of March 13, 2012.

In the interest of providing current Shareholders and potential investors with information regarding current results and future prospects, our public communications often include written or verbal forward-looking statements. Forward-looking statements are disclosures regarding possible events, conditions, or results of operations that are based on assumptions about future economic conditions and courses of action, and include future-oriented financial information.

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 with the associated renewal risk; (v) increased capital expenditure requirements; (vi) reliance on key personnel; (vii) changing trends in government outsourcing; and (viii) 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, the Corporation disclaims any intention or obligation to update or revise any forward-looking statements to reflect subsequent events or circumstances.

This MD&A also makes reference to certain measures in this document that do not have any standardized meaning as prescribed by IFRS and, therefore, are considered additional GAAP measures. These measures may not be comparable to similar measures presented by other issuers. Please see "*Terminology*" for further discussion.

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# INTRODUCTION

## Core Business

K-Bro is one of the largest operators 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 eight processing facilities in seven Canadian cities including Québec City, Montréal, Toronto, Edmonton, Calgary, Vancouver and Victoria.

## 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.

Our partnerships with healthcare institutions and hospitality clients across Canada demonstrate K-Bro's commitment to build relationships that foster continuous improvement, provide flexibility to adjust to changing circumstances as required and which incorporate incentives, penalties and sharing of risks and rewards as circumstances warrant. As a result, clients across the country have entered into long-term relationships with us, with most having renewed their contracts several times.

In this competitive industry, K-Bro is distinctive in Canada in its ability to deliver products and services that provide value to our customers. 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 in which K-Bro operates exhibits the following characteristics and trends:

*Stable Industry with Moderate Cyclicality* – 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 generally formalized through contracts in the healthcare sector that are typically long term (from seven to ten years), while contracts in the hospitality sector usually range from two to five years.

*Outsourcing and Privatization* – Healthcare institutions and regional authorities are facing funding pressures and must continually evaluate the allocation of scarce resources. Consequently 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 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 institutions and hospitality providers 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 million pounds of linen per year. Most healthcare customers generate between 500,000 pounds of linen per year for a hospital and up to 30 million pounds of linen per year for a healthcare region.

# 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 bases. Since 2005, K-Bro has entered four new geographic markets across Canada. 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 and hospitality linen to be processed and the policies of applicable governments.

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

## FOURTH QUARTER OVERVIEW

In the fourth quarter of 2011, revenue was $29.2 million which was 9.1% higher than the $26.7 million generated in the comparative quarter of 2010. This year-over-year increase was due to a combination of the acquisition of the plant in Montréal, the full impact of increased volumes from the Tilbury laundry contracts and organic growth from new volume at existing customers, as well as price increases on existing customers, across the remainder of the plants. EBITDA increased from $4.0 million in Q4, 2010 to $4.6 million in Q4, 2011, as the result of the combination of profits from the newly acquired Montreal plant, volume growth from the remaining plants, and effective cost control efforts.

Indirect and administrative expenses amounted to $1.4 million in the quarter, compared to $1.8 million in the comparable period of 2010. The Q4, 2010, costs included professional fees relating to the conversion to a corporation from an income trust structure. Indirect and administrative costs increased as a result of professional fees associated with the conversion.

## SELECTED ANNUAL FINANCIAL INFORMATION

| *(thousands, except share and per share amounts)* | **2011** | 2010 | 2009[1] |
|---|---|---|---|
| Revenue | **$ 116,859** | $ 104,051 | $ 87,533 |
| Earnings before income taxes | **10,888** | 7,116 | 7,677 |
| Net earnings | **7,928** | 6,953 | 7,802 |
| *Net earnings per share:* | | | |
| Basic | **$ 1.15** | $ 1.01 | $ 1.12 |
| Diluted | **$ 1.14** | $ 0.99 | $ 1.11 |
| Total assets | **91,425** | 90,679 | 82,816 |
| Long-term debt | **6,095** | 10,763 | 4,043 |
| Dividends declared to Shareholders | **7,706** | 7,706 | 7,706 |
| Dividends declared to Shareholders per share | **$ 1.100** | $ 1.100 | $ 1.100 |
| *Number of shares outstanding:* | | | |
| Basic | **6,918,955** | 6,905,369 | 6,946,495 |
| Diluted | **6,980,489** | 6,992,400 | 6,999,719 |

[1] K-Bro's IFRS transition date was January 1, 2010, accordingly 2010 comparative figures have been restated; 2009 comparative information has not been restated and is presented under Canadian GAAP.

# SUMMARY OF 2011 RESULTS AND KEY EVENTS

## Financial Growth

K-Bro delivered strong financial results in 2011 driven by the operating results from all eight of its processing plants. Net earnings were $7.9 million or $1.15 per share. Cash flow from operating activities was $18.9 million and distributable cash flow was $16.8 million. Revenue increased in fiscal 2011 to $116.9 million or by 12.3% compared to 2010. This growth in the year is due to the acquisition of the new plant in Montréal, increased volumes from the Tilbury laundry contract and growth in the remainder of the plants. EBITDA (see *Terminology*) increased in the year to $19.9 million from $16.9 million in 2010, which is an increase of 18.2% The EBITDA margin increased to 17.1% in 2011 compared 16.2% in 2010. The increase in margin is driven by decreased corporate costs due to a reduction in professional fees compared to 2010 which included professional fees relating to the conversion from an income trust to a corporation. Additionally the margin increase is related to favorable energy costs relating to the floating component of forward contracts.

## Acquisition of Facility in Montréal, Québec

On June 30, 2011, the Corporation acquired all of the assets and operations of *Les Buanderies Pierre R. Dextraze Inc.* (“Dextraze”) for cash consideration of $4.3 million, subject to closing adjustments, including an amount contingent upon achieving certain EBITDA targets. Dextraze is a commercial/industrial laundry which provides services to the hospitality industry in the Montréal area. It is one of the leading processors in Québec and currently operates 7 days per week with over 80 employees. For the year ended July 31, 2010, Dextraze recorded revenue of $4.0 million and adjusted EBITDA of $0.7 million. Dextraze’s customer base is focused on the premium hospitality market, including hotel room linen and towels and banquet linen.

## Selection as Preferred Proponent to Alberta Health Services (Edmonton)

In Q1, 2011 Alberta Health Services (“AHS”) issued a formal request for proposal (“RFP”) for laundry and linen services for the City of Edmonton and surrounding areas in order to select a service provider for a ten-year term commencing in 2013 upon the conclusion of K-Bro’s current two-year contract. On August 25, 2011, the Corporation was informed that it had been selected as the preferred proponent by AHS and of its intention to enter into negotiations with K-Bro for a new long-term contract to service AHS’ laundry and linen requirements in Edmonton and surrounding areas.

## Effects of Economic Volatility and Uncertainty

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

- Approximately 68.6% of our revenues in the year were from large publicly funded healthcare customers which are geographically diversified across four provinces;
- K-Bro has fixed a portion of certain variable cost components such as natural gas, electricity and textile supply through forward contracts. K-Bro routinely enters into natural gas and electricity supply contracts and typically tries to align terms with existing linen processing contract terms; and,
- At December 31, 2011, K-Bro had unutilized borrowing capacity of $33.7 million or 84.1% of the revolving credit line available. K-Bro’s revolving credit facility is secured by a major Canadian bank and expires on June 30, 2013.
- K-Bro’s prudent approach to managing capital coupled with a conservative dividend policy has added operating cash flow and liquidity to the Corporation, thereby improving its ability to withstand the turmoil in the national and global capital markets.

## KEY PERFORMANCE DRIVERS

K-Bro's key performance drivers focus on profitability, growth, stability and cost containment in order to maintain dividends and maximize Shareholder value. The following outlines our results in each of these areas:

| *(thousands, except percentages)* Category | Indicator | Q4, 2011 | Q4, 2010 | 2011 | 2010 |
|---|---|---|---|---|---|
| Growth | EBITDA[(1)] | **13.6%** | 5.4% | **18.2%** | 8.6% |
| | Revenue | **9.1%** | 23.5% | **12.3%** | 18.9% |
| | Distributable cash flow | **0.9%** | 8.2% | **12.0%** | 7.1% |
| Profitability | EBITDA[(1)] | **$ 4,556** | $ 4,011 | **$ 19,946** | $ 16,877 |
| | EBITDA margin | **15.6%** | 15.0% | **17.1%** | 16.2% |
| | Net earnings | **$ 1,643** | $ 1,560 | **$ 7,928** | $ 6,953 |
| Stability | Debt to total capitalization | **8.8%** | 14.7% | **8.8%** | 14.7% |
| | Unutilized line of credit | **$ 33,655** | $ 28,987 | **$ 33,655** | $ 28,987 |
| | Payout ratio | **50.2%** | 50.7% | **45.9%** | 51.4% |
| | Dividends declared per share | **$ 0.275** | $ 0.275 | **$ 1.100** | $ 1.100 |
| Cost containment | Wages and benefits | **46.7%** | 46.2% | **46.4%** | 46.0% |
| | Utilities | **7.2%** | 8.2% | **7.4%** | 8.0% |
| | Operating expenses | **84.4%** | 85.0% | **82.9%** | 83.8% |

(1) EBITDA is defined as revenue less operating expenses (which equates to net earnings before income tax, gain or loss on disposals, financial charges and amortization). See Terminology.

## OUTLOOK

K-Bro's focus is on profitable growth in the years to come as we execute our strategy of expanding geographically and adding new services for our customers. K-Bro is committed to building value for our shareholders, our vendors and our customers. Consistent with our business model where both hospitality clients and healthcare institutions are under long-term contract, with pricing mainly dictated by macroeconomic factors including inflation and consumer price indices, fiscal 2012 will show a modest increases in revenue, earnings and EBITDA compared to 2011. This belief is predicated on:

- a 2.5% core inflation rate[1] for 2012 helps moderate certain expenses but will also result in lower price adjustments for customers with contracts subject to an annual CPI adjustment factor;
- strong principles in our business operations, including price fixing significant costs through forward supply contracts on energy and textiles, and recruiting temporary foreign labour to alleviate shortages and overtime demands;
- K-Bro securing a portion of the healthcare linen processing business of Saskatoon Health Region under a one-year contract with estimated annual revenues of $1.3mm, during which time the Region will explore its options for longer-term processing arrangements;
- reduced stimulus spending resulting in GDP of 2.5% in fiscal 2012 and 2.6% in fiscal 2013[2]; and,
- continued focus on innovative development and process re-engineering within our internal processes resulting in operating efficiencies.

Profitability and free cash flows for fiscal 2012 are expected to remain stable and management believes that the current dividend policy is sustainable for the Corporation in fiscal 2012. K-Bro currently also has several proposals pending and has entered into discussions with potential new healthcare and hospitality customers. In addition, K-Bro continues to seek potential acquisition candidates. Neither the timing nor the degree of likelihood of success of any of these proposals or acquisitions can be stated with any degree of accuracy.

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[1] Statistics Canada; www.statscan.gc.ca
[2] Royal Bank of Canada; www.rbc.com/economics

# RESULTS OF OPERATIONS

## Overall Performance

For the three month period ended December 31, 2011, K-Bro's revenue was $29.2 million, compared to $26.7 million in the comparable prior year period. The new plant in Montréal, the full impact of the increase in volume from the Tilbury laundry contracts, organic revenue growth and increased volume from existing customers contributed to this revenue growth.

Net income in the fourth quarter of 2011 was consistent with the same period in 2010 at $1.6 million. EBITDA increased in the current quarter by $545 thousand (13.6%) over the fourth quarter of 2010.

## Quarterly Financial Information

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

| *(thousands, except per share amounts and percentages)* | 2011 | | | | 2010 | | | |
|---|---|---|---|---|---|---|---|---|
| | **Q4** | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| Healthcare revenue | **20,432** | 19,730 | 20,042 | 19,941 | 18,833 | 17,839 | 17,646 | 17,137 |
| Hospitality revenue | **8,726** | 11,414 | 8,829 | 7,745 | 7,886 | 9,659 | 8,256 | 6,795 |
| Total revenue | **29,158** | 31,144 | 28,871 | 27,686 | 26,719 | 27,498 | 25,902 | 23,932 |
| Operating expenses | **24,602** | 25,098 | 24,006 | 23,207 | 22,708 | 22,571 | 21,638 | 20,256 |
| EBITDA[(1)] | **4,556** | 6,046 | 4,865 | 4,479 | 4,011 | 4,928 | 4,264 | 3,676 |
| EBITDA as a % of revenue | **15.6%** | 19.4% | 16.9% | 16.2% | 15.0% | 17.9% | 16.5% | 15.4% |
| Depreciation and amortization | **2,082** | 2,232 | 2,036 | 2,216 | 2,261 | 2,254 | 2,251 | 2,164 |
| Financial charges | **93** | 131 | 84 | 104 | 153 | 173 | 189 | 127 |
| Loss on disposal of equipment | **50** | 4 | 20 | 6 | 26 | 105 | 57 | - |
| Earnings before income taxes | **2,331** | 3,679 | 2,725 | 2,153 | 1,571 | 2,396 | 1,767 | 1,385 |
| Income tax expense (recovery) | **688** | 953 | 722 | 597 | 11 | 138 | 55 | (42) |
| Net earnings | **1,643** | 2,726 | 2,003 | 1,556 | 1,560 | 2,257 | 1,712 | 1,427 |
| Net earnings as a % of revenue | **5.6%** | 8.8% | 6.9% | 5.6% | 5.8% | 8.2% | 6.6% | 6.0% |
| Basic earnings per share | **0.237** | 0.290 | 0.290 | 0.226 | 0.230 | 0.328 | 0.250 | 0.206 |
| Diluted earnings per share | **0.235** | 0.288 | 0.288 | 0.223 | 0.220 | 0.323 | 0.250 | 0.204 |
| Total assets | **91,425** | 90,350 | 93,148 | 90,473 | 90,679 | 91,963 | 92,003 | 94,323 |
| Total long-term financial liabilities | **11,203** | 12,096 | 17,554 | 13,079 | 14,775 | 15,109 | 17,716 | 20,010 |
| Funds provided by operations | **3,929** | 8,217 | 2,577 | 4,137 | 3,720 | 5,200 | 4,474 | 3,330 |
| Long-term debt | **6,095** | 7,224 | 13,007 | 8,838 | 10,763 | 11,097 | 13,836 | 15,912 |
| Dividends declared per share | **0.275** | 0.275 | 0.275 | 0.275 | 0.275 | 0.275 | 0.275 | 0.275 |

[(1)] EBITDA is defined as revenue less operating expenses (which equates to net earnings before income tax, gain or loss on disposals, financial charges and amortization). See Terminology.

## Revenue, Earnings and EBITDA

For the year ended December 31, 2011, K-Bro's revenue was $116.9 million, compared to $104.1 million in the prior year. This represents a 12.3% increase in revenue and is attributed to the additional revenue from the acquisition of the new plant in Montréal, additional volume from the execution of new healthcare contracts in Vancouver which commenced processing in Q4, 2010 and additional revenue and volume from new and existing clients. In 2011 approximately 68.6% of K-Bro's revenue was generated from healthcare institutions compared to 68.7% in 2010. The addition of the Montréal plant generated increased hospitality revenue but the additional volume from the Tilbury laundry contract offset the increase resulting in a similar mix in K-Bro's revenue segments in 2011 and 2010.

Net earnings increased in 2011 to $7.9 million from $7.0 million in 2010. Net earnings as a percentage of revenue increased slightly to 6.8% compared to 6.7% in 2010. This slight increase in margin resulted from a $3.8 million increase in pre-tax income which was offset by a $2.8 increase in income tax expense due to the conversion from a fund to a corporation. Net earnings before tax increased in 2011 to $10.9 million from $7.1 million in 2010. Net earnings before tax as a percentage of revenues increased to 9.3% compared to 6.8% in 2010.

EBITDA was $19.9 million in 2011, compared to $16.9 million in 2010. This 18.2% improvement is a result of the flow through of the increase in revenue coupled with favorable variances in commodity pricing on fixed price forward supply contracts and overall effective cost control measures. This is offset by increased delivery costs due to higher fuel prices (see *Operating Expenses* for further detail).

## Operating Expenses

Wages and benefits increased from $47.8 million in 2010 to $54.2 million in 2011 and increased as a percentage of revenues to 46.7% from 46.2%. Despite the control over labor costs, pressures continue to increase as the economy recovers, employment rates improve and provincially regulated minimum wage increases. Linen expenses increased to $12.0 million from $10.6 million but remained constant as a percentage of revenues at 10.3%.

Utility costs decreased from 8.0% in 2010 to 7.4% as a percentage of revenue in 2011. The decrease is a result of the execution of natural gas and electricity forward contracts in order to lock in future variable costs, and in certain instances capitalization of favorable market rates for approximately 20% of the commodity that was acquired at the current market rates. This favorable variance has been offset by higher spot market rates on electricity in Alberta.

Delivery costs have increased to $4.9 million or 4.2% of revenues compared to 3.8% in 2010. The increase is attributed primarily to the increasing price of diesel fuel.

Occupancy, repairs and maintenance, and materials and supplies expenses as a percentage of revenue remained stable in 2011 compared to 2010.

Corporate costs were unchanged totaling $5.7 million for both 2011 and 2010. Corporate costs as a percentage of revenues declined to 4.9% compared to 5.5% in 2010. This higher level of costs in 2010 is attributable to the professional fees relating to the conversion from a Fund to a Corporation and the IFRS transition. This is partly offset by an increase in the 2011 accrual for the Long Term Incentive Plan as a result of exceeding pre-established performance targets. LTIP expenses for 2011 were $1.7 million compared to $1.4 million in 2010.

Depreciation of property, plant and equipment and amortization of intangible assets 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 of those assets. Depreciation of property, plant and equipment is reduced due to decreased depreciation expenses related to major computer hardware purchases that have now been fully amortized. Amortization of intangibles assets is in line with the comparable period in 2010. Included in intangible assets are software expenses relating to IT upgrades.

Financial charges for 2011 decreased compared 2010. The decrease is attributable to a lower long term debt balance throughout the year.

# LIQUIDITY AND CAPITAL RESOURCES

Cash provided by operating activities was $18.9 million, compared to $16.7 million of cash generated from operations during 2010. The increase in cash from operations is primarily due to the changes in the working capital accounts year-over-year together with the flow through of increased net earnings for the year.

During 2011, cash used in financing activities amounted to $11.7 million compared to $1.6 million 2010. Financing activities in 2011 included $4.3 million in funding for the acquisition of Dextraze which was offset by $9.0 million in repayments of long term debt and $7.1 million in dividends paid to Shareholders.

The Corporation used cash of $7.1 million for investing activities during 2011 compared to $15.1 million in 2010. The decrease in cash used in investing activities is driven by the difference in business acquisition costs in 2011 compared to 2010. For the 2011 fiscal year, the cash was invested in the acquisition of property, plant and equipment ($2.8 million) and the acquisition of the Montréal facility ($4.3 million) in June, 2011.

## Contractual Obligations

At December 31, 2011, payments due under contractual obligations for the next five years and thereafter are as follows:

| *(thousands)* | Payments due by Period | | | | | |
|---|---|---|---|---|---|---|
| | | Total | < 1 Year | 1 - 3 Years | 4 - 5 Years | > 5 Years |
| Long-term debt | $ | 6,095 | - | 6,095 | - | - |
| Operating leases and utility commitments | $ | 16,135 | 5,415 | 5,405 | 3,582 | 1,733 |
| Linen purchase obligations | $ | 1,672 | 1,672 | - | - | - |

Scheduled lease and forward utility contract payments for 2012 are $5.4 million. The operating lease obligations are secured by automotive equipment and are more fully described in note 13(b) of the Notes to the Consolidated Financial Statements. The source of funds for these commitments will be from operating cash flow and, if necessary, the undrawn portion of the revolving credit facility.

## Financial Position

| *(thousands, except percentages)* | | **December 31, 2011** | | December 31, 2010 |
|---|---|---|---|---|
| Long term debt | **$** | **6,095** | $ | 10,763 |
| Shareholders' equity | | **62,933** | | 62,578 |
| Total capitalization | **$** | **69,028** | $ | 73,341 |
| Debt to total capitalization | | **8.8%** | | 14.7% |

For the year ended December 31, 2011, the Corporation had a payout ratio (see *Terminology*) of 45.9%, a debt to total capitalization of 8.8%, an unused revolving credit facility of $33,655 and has not incurred any events of default under the terms of its credit facility agreement.

As at December 31, 2011, the Corporation had net working capital of $7,245 compared to its working capital position of $8,664 at December 31, 2010. The decrease in working capital is primarily attributable to the increase in income taxes payable as a result of the transition from a fund to a corporation in the current year and the dividends payable.

Management believes that K-Bro has the capital resources and liquidity necessary to meet its commitments, support its operations and finance its growth strategies. In addition to K-Bro's ability to generate cash from operations and its revolving credit facility, K-Bro may also be able to access equity financing, depending upon pricing and availability, for capital spending to sustain its property, plant and equipment.

## DIVIDENDS

| Fiscal Period | Payment Date | 2011 Amount per Share | 2011 Total Amount[2] | 2010[1] Amount per Unit | 2010[1] Total Amount[2] |
|---|---|---|---|---|---|
| January | February 15 | $ 0.09167 | $ 642 | $ 0.09167 | $ 642 |
| February | March 15 | 0.09167 | 642 | 0.09167 | 642 |
| March | April 15 | 0.09167 | 642 | 0.09167 | 642 |
| Q1 | | $ 0.27501 | $ 1,927 | $ 0.27501 | $ 1,927 |
| April | May 13 | $ 0.09167 | $ 642 | $ 0.09167 | $ 642 |
| May | June 15 | 0.09167 | 642 | 0.09167 | 642 |
| June | July 15 | 0.09167 | 642 | 0.09167 | 642 |
| Q2 | | $ 0.27501 | $ 1,927 | $ 0.27501 | $ 1,927 |
| July | August 15 | $ 0.09167 | $ 642 | $ 0.09167 | $ 642 |
| August | September 15 | 0.09167 | 642 | 0.09167 | 642 |
| September | October 14 | 0.09167 | 642 | 0.09167 | 642 |
| Q3 | | $ 0.27501 | $ 1,927 | $ 0.27501 | $ 1,927 |
| October | November 15 | $ 0.09167 | $ 642 | $ 0.09167 | $ 642 |
| November | December 15 | 0.09167 | 642 | 0.09167 | 642 |
| December | January 13 | 0.09167 | 642 | 0.09167 | 642 |
| Q4 | | $ 0.27501 | $ 1,927 | $ 0.27501 | $ 1,927 |
| YTD | | $ 1.10004 | $ 7,706 | $ 1.10004 | $ 7,706 |

[1] - On January 1, 2011 the Fund completed a conversion from an income trust into a corporation. Comparative amounts for fiscal 2010 collectively refer to the distributions paid by the Fund in respect of the Units of the Fund and the Exchangeable Shares.

[2] - The total amount of dividends paid was $0.09167 per share for a total of $642,146 per month; when rounded in thousands $1,927 of dividends were paid for each of the quarterly periods, respectively.

For the year ended December 31, 2011, the Corporation distributed $1.10 per share compared with $2.40 per diluted share of Distributable Cash (see *Terminology*). The actual payout ratio was 45.9%.

The Corporation's policy is to pay dividends to Shareholders of its available distributable cash flow 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 Directors of the Corporation. All such dividends are discretionary. Dividends are declared payable each month in equal amounts to the Corporation Shareholders on the last business day of each month and are paid by the 15th of the following month.

The Corporation designates all dividends paid or deemed to be paid as "eligible dividends" for purposes of subsection 89(14) of the Income Tax Act (Canada), and similar provincial and territorial legislation, unless indicated otherwise.

## DISTRIBUTABLE CASH FLOW (see *Terminology*)

The Corporation's source of cash for dividends is distributable cash flow provided by operating activities. Distributable cash flow, reconciled to cash provided by operating activities is presented as follows:

| *(thousands, except per share amounts and percentages)* | 2011 | | | | 2010 | | | |
|---|---|---|---|---|---|---|---|---|
| | **Q4** | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| Cash provided by operating activities | **$ 3,929** | $ 8,217 | $ 2,577 | $ 4,137 | $ 3,720 | $ 5,200 | $ 4,474 | $ 3,330 |
| *Deduct (add):* | | | | | | | | |
| Net changes in non-cash working capital items[1] | **(80)** | 2,928 | (1,736) | 130 | (110) | 452 | 413 | (205) |
| Maintenance capital expenditures | **179** | 9 | 423 | 224 | 35 | 173 | 451 | 534 |
| Distributable cash flow | **$ 3,830** | $ 5,280 | $ 3,890 | $ 3,783 | $ 3,795 | $ 4,575 | $ 3,610 | $ 3,001 |
| Distributable cash flow per weighted average diluted shares outstanding | **$ 0.548** | $ 0.756 | $ 0.559 | $ 0.541 | $ 0.543 | $ 0.656 | $ 0.519 | $ 0.429 |
| Dividends declared | **1,927** | 1,927 | 1,927 | 1,927 | 1,927 | 1,927 | 1,927 | 1,927 |
| Dividends declared per share | **0.275** | 0.275 | 0.275 | 0.275 | 0.275 | 0.275 | 0.275 | 0.275 |
| Payout ratio[2] | **50.2%** | 36.4% | 49.2% | 50.8% | 50.7% | 41.9% | 53.0% | 64.1% |
| Weighted average shares outstanding during the period, basic | **6,932** | 6,930 | 6,918 | 6,891 | 6,905 | 6,892 | 6,877 | 6,935 |
| Weighted average shares outstanding during the period, diluted | **6,993** | 6,983 | 6,961 | 6,993 | 6,992 | 6,978 | 6,951 | 6,992 |
| **Trailing-twelve months ("TTM")** | | | | | | | | |
| Distributable cash flow | **16,783** | 16,748 | 16,043 | 15,763 | 14,981 | 14,694 | 13,926 | 13,741 |
| Dividends | **7,706** | 7,706 | 7,706 | 7,706 | 7,706 | 7,706 | 7,706 | 7,706 |
| Payout ratio[2] | **45.9%** | 46.0% | 48.0% | 48.9% | 51.4% | 52.4% | 55.3% | 56.1% |

[1] 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 flow calculation.

[2] The ratio of dividends paid compared to distributable cash flow is periodically reviewed by the Board of Directors to take into account the current and prospective performance of the business and other items considered to be prudent. Payout ratio is calculated on the dividends declared per share divided by the distributable cash flow per weighted average diluted shares outstanding.

## OUTSTANDING SHARES

At December 31 2011, the Corporation had 7,006,365 common shares outstanding. Basic and the diluted weighted average number of common shares outstanding for 2011 were 6,918,955 and 6,980,489, respectively, (6,905,369 and 6,992,400, respectively for the comparative 2010 periods).

In accordance with the LTIP agreement and in conjunction with the performance of the Corporation in the prior fiscal year, during 2011 the Compensation, Nominating and Corporate Governance Committee of the Board of Directors of the Corporation approved LTIP compensation of $1.8 million (2010 – $1.4 million) to be paid as $0.3 million in common shares and $1.5 million in cash. As at December 31, 2011, total assets held in trust by the LTIP trustee was $1.9 million (2010 – $1.6 million) and was comprised of 74,511 in unvested common shares (December 31, 2010 – 114,074) with an aggregate cost of $1.3 million (2010 – $1.6 million) and the remainder in cash. The basic net earnings per share calculation excludes the unvested common shares held by the LTIP Trust.

As at March 13, 2012, there were 7,006,365 common shares issued and outstanding.

## RELATED PARTY TRANSACTIONS

The Corporation incurred expenses in the normal course of business for advisory consulting services provided by Mr. Matthew Hills, a director of the Corporation, primarily relating to acquisitions. The amounts charged are recorded at their exchange amounts and are subject to normal trade terms. For the year ended December 31, 2011, the Corporation incurred fees totaling $138 (2010 – $138).

## OFF-BALANCE SHEET ARRANGEMENTS

The Corporation had no off-balance sheet arrangements in place at December 31, 2011.

## CRITICAL ACCOUNTING ESTIMATES

The Corporation's summary of significant accounting policies are contained in Note 2 to the audited consolidated financial statements.

The Corporation's financial statements include estimates and assumptions made by management in respect of operating results, financial conditions, contingencies, commitments, and related disclosures. Actual results may vary from these estimates. The following are, in the opinion of management, the Corporation's most critical accounting estimates, being those that involve the most difficult, subjective and complex judgements, requiring estimates that are inherently uncertain and which may change in subsequent reporting periods.

K-Bro has continuously refined and documented its management and internal reporting systems to ensure that accurate, timely, internal and external information is gathered and disseminated. Management also regularly evaluates these estimates and assumptions which are based on past experience and other factors that are deemed reasonable under the circumstances.

K-Bro has hired individuals and consultants who have the skills required to make such estimates and ensures that individuals or departments with the most knowledge of the activity are responsible for the estimates. Furthermore, past estimates are reviewed and compared to actual results, and actual results are compared to budgets in order to make more informed decisions on future estimates.

K-Bro's leadership team's mandate includes ongoing development of procedures, standards and systems to allow K-Bro staff to make the best decisions possible and ensuring those decisions are in compliance with the Corporation's policies.

Preparation of the Corporation's consolidated financial statements requires management to make estimates and assumptions that affect:

- volume rebates;
- linen in service;
- intangible assets;
- goodwill;
- income taxes; and,
- allowance for doubtful accounts.

**Volume Rebates**

The Corporation earns revenue from linen management and laundry services based on written service agreements whereby K-Bro has agreed to collect, launder, deliver and replenish linens. K-Bro recognizes revenue in the period in which the services are provided. Volume rebates, where applicable, are recorded based on annualized expected volumes when it is reasonable that the criteria are likely to be met. Based on past

experience, management believes that volumes utilized for any estimates are reasonable and would not expect a material deviation to the balance of accrued liabilities or revenue.

**Linen in Service**

Linen in service is recorded at cost. Operating room linen is amortized on a straight-line method over an estimated service life of 24 months. General linen is amortized based on usage which results in an estimated service life of the linen equal to 24 months. Based on past experience, management believes that a service life of 24 months is representative of the average service life of linen and would not expect a material deviation to the balance of linen in service or linen expense.

**Intangible Assets**

The Corporation accounts for intangible assets and goodwill in accordance with IFRS 3, *Business Combinations* and IAS 38, *Intangible Assets*. In a business combination, K-Bro may acquire the assets and assume certain liabilities of an acquired entity. The allocation of the purchase price for these transactions involves judgment in determining the fair values assigned to the tangible and intangible assets acquired and the liabilities assumed on the acquisition. The determination of these fair values involves a variety of assumptions, including revenue growth rates, expected operating income, discount rates, and earnings multiples. If K-Bro's estimates or assumptions change prior to finalizing the purchase price allocation for a transaction, a revision to the purchase price allocation or the carrying value of the related assets and liabilities acquired may impact our net income in future periods.

At the date of the acquisition, K-Bro must estimate the value of acquired intangible assets that do not have a well defined market value, such as the value of customer lists and relationships and non-competition agreements.

Valuing these assets involves estimates of the future net benefit to K-Bro and the useful life of such benefits and is based upon various internal and external factors. A change in those estimates could cause a material change to the value of the intangible assets.

Although intangible assets are amortized over their useful life, if the estimated value of an intangible asset has declined below its amortized book value, a write-down would be recorded in the period in which the event causing the decline in value occurred, which would increase amortization expense and decrease the intangible assets balance. At this time, K-Bro does not believe any intangible assets have a book value in excess of their fair market value.

## TERMINOLOGY

### 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 dividends to Shareholders. 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 of their useful life. Accordingly, EBITDA comprises revenues less operating costs before: financing costs, capital asset and intangible asset amortization, loss on disposal and impairment charges, and income taxes.

EBITDA is not a calculation based on IFRS 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. 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.

| *Year ended December 31,* | | **2011** | | 2010 |
|---|---|---|---|---|
| Net earnings | **$** | **7,928** | $ | 6,953 |
| *Add:* | | | | |
| Income tax expense | | **2,960** | | 163 |
| Interest expense and financial charges, net | | **412** | | 643 |
| Depreciation of property, plant and equipment | | **5,938** | | 6,391 |
| Amortization of intangible assets | | **2,628** | | 2,540 |
| Loss on disposal of property, plant and equipment | | **80** | | 187 |
| **EBITDA** | **$** | **19,946** | $ | 16,877 |

### Distributable Cash Flow

Distributable cash flow is a measure used by management to evaluate its performance. While the closest IFRS measure is cash provided by operating activities, distributable cash flow is considered relevant because it provides an indication of how much cash generated by operations is available after maintenance capital expenditures. It should be noted that although we consider this measure to be distributable cash flow, financial and non-financial covenants in our credit facilities and dealer agreements may restrict cash from being available for dividends, re-investment in the Corporation, potential acquisitions, or other purposes. Investors should be cautioned that distributable cash flow may not actually be available for growth or distribution from the Corporation. References to "Distributable cash flow" are to cash provided by (used in) operating activities (including the net change in non-cash working capital balances) less capital expenditures.

## CHANGES IN ACCOUNTING POLICIES

The Corporation has prepared its December 31, 2011 audited Consolidated Financial Statements in accordance with IFRS 1, *First-time Adoption of International Financial Reporting Standards*. Previously, the Corporation prepared its annual financial statements in accordance with Canadian GAAP. The adoption of IFRS has not had a material impact on the operations, strategic decisions, cash flow or capital expenditures of the Corporation.

The Corporation's IFRS accounting policies are provided in note 2 to the audited Consolidated Financial Statements. In addition, note 23 to the Consolidated Financial Statements presents reconciliations between the Corporation's fiscal 2010 Canadian GAAP results and the fiscal 2010 IFRS results. The reconciliations include the consolidated statement of financial position as at December 31, 2010, and consolidated statements of earnings, deficit and comprehensive income for the year ended December 31, 2010.

The following discussion explains the significant differences between K-Bro's previous Canadian GAAP accounting policies and those applied by the Corporation under IFRS. IFRS policies have been retrospectively and consistently applied except where specific IFRS 1 optional and mandatory exemptions permitted an alternative treatment upon transition to IFRS for second-time adopters. The accounting policies followed in these audited Consolidated Financial Statements are the same as those applied in the Corporation's interim Consolidated Financial Statements for the periods ended March 31, June 30, 2011 and September 30, 2011.

### Spare Parts

Spare parts and servicing equipment were carried as inventory under Canadian GAAP and recognized in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when K-Bro expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they should be accounted for as PPE.

Under IFRS spare parts under five thousand dollars will be expensed as incurred, since they are not significant enough to consider capitalizing and tracking as discrete capital assets, and items over five thousand dollars will be capitalized into a new category of PPE called Spare Parts. Most spare parts used by K-Bro are specific to an item of PPE, and therefore would meet the criteria to be recognized as PPE.

### Business Acquisition Costs

Under IFRS business acquisition costs are accounted for as expenses in the periods in which the costs are incurred and the services are received. Acquisition related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees, advisory, legal, accounting, valuation and other professional or consulting fees. Previously under Canadian GAAP acquisition costs were treated as part of the purchase price in an acquisition and accordingly the acquisition costs for the second Vancouver plant were capitalized as part of the acquired assets. Upon adoption of IFRS in Q1, 2011 this amount has been retrospectively restated.

### Income Tax

Deferred income taxes have been adjusted to reflect the tax effect arising from the differences between IFRS and previous Canadian GAAP. Upon transition to IFRS, the Corporation recognized a $0.1 million reduction in the deferred income tax balance with a corresponding increase to retained earnings. For the twelve months ended December 31, 2010, the application of the IFRS adjustments discussed above resulted in a $0.2 million increase to the Corporation's deferred income tax expense and a corresponding decrease to K-Bro's previous Canadian GAAP net earnings.

## RECENT ACCOUNTING PRONOUNCMENTS

All accounting standards effective for periods beginning on or after January 1, 2011 have been adopted as part of the transition to IFRS. Additionally there are new IFRS pronouncements have been issued but are not effective and may have an impact on the Corporation. See note 3 to the audited Consolidated Financial Statements as at and for year ended December 31, 2011.

## FINANCIAL INSTRUMENTS

K-Bro's financial instruments at December 31, 2011 consist of accounts receivable, accounts payable and accrued liabilities and long-term debt. The Corporation 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 capitalized and then amortized over the expected life of the financial instrument using the effective interest method.

Derivative financial instruments are utilized by K-Bro to manage cash flow 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 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.

# CRITICAL RISKS AND UNCERTAINTIES

As at December 31, 2011, there are no material changes in the Corporation's risks or risk management activities since December 31, 2010. The Corporation's results of operations, business prospects, financial condition, cash dividends to Shareholders and the trading price of the Corporation's Shares are subject to a number of risks. These risk factors include: dependence on long-term contracts and the associated renewal risk thereof; 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 Corporation Shares, see *Risk Factors – Risks Related to K-Bro and the Laundry and Linen Industry* detailed in the Corporation's Annual Information Form that is available at www.sedar.com.

# 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 ("CEO") and the Vice-President and Chief Financial Officer ("CFO"), are responsible for establishing and maintaining disclosure controls and procedures, as well as internal control over financial reporting.

## Disclosure Controls and Procedures

The Corporation has established disclosure controls and procedures to ensure that information disclosed in this MD&A and the related financial statements of K-Bro was properly recorded, processed, summarized and reported to the Board of Directors and the Audit Committee. The Corporation's CEO and CFO have evaluated the effectiveness of these disclosure controls and procedures for the year ended December 31, 2011, and have concluded that they are effective.

## Internal Controls over Financial Reporting

The CEO and CFO acknowledge responsibility for the design of internal controls over financial reporting ("ICFR"). As IFRS requires more judgment as compared to Canadian GAAP with respect to various accounting treatments, additional processes and controls have been put in place. These changes to financial reporting controls ensured that the Corporation has made and will continue to make the appropriate judgments and adhere to IFRS accounting policies.

Consequently the CEO and CFO confirm that the additions to these controls that occurred during the year ended December 31, 2011 did not materially affect, or are reasonably likely to materially affect, the Corporation's ICFR. Based upon their evaluation of these controls for the year ended December 31, 2011, the CEO and CFO have concluded that these controls were operating effectively.

A control system, no matter how well conceived and operated, can provide only reasonable, and not absolute, assurance that the objectives of the control system are met. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, including instance of fraud, if any, have been detected. These inherent limitations include, amongst other items: (i) that managements' assumptions and judgments could ultimately prove to be incorrect under varying conditions and circumstances; or, (ii) the impact of isolated errors.

Additionally, controls may be circumvented by the unauthorized acts of individuals, by collusion of two or more people, or by management override. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential (future) conditions.

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Additional information regarding K-Bro including required securities filings are available on our website at www.k-brolinen.com and on the Canadian Securities Administrators' website at www.sedar.com; the System for Electronic Document Analysis and Retrieval ("SEDAR").

Vous pouvez obtenir des renseignements supplémentaires sur la Société, y compris les documents déposés auprès des autorités de réglementation, sur notre site Web, au www.k-brolinen.com et sur le site Web des autorités canadiennes en valeurs mobilières au www.sedar.com, le site Web du Système électronique de données, d'analyse et de recherche (« SEDAR »).