

Edgar Filing: SERVICEMASTER CO - Form 10-Q

SERVICEMASTER CO
Form 10-Q
August 09, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

X QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2004

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

For the transition period from _____ to _____

Commission file number 1-14762

THE SERVICEMASTER COMPANY
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

36-3858106
(IRS Employer Identification No.)

3250 Lacey Road, Ste. 600, Downers Grove, Illinois
(Address of principal executive offices)

60515-1700
(Zip Code)

630-663-2000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No .
--- ---

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes X No .
--- ---

Indicate the number of shares outstanding of each of the issuer's classes of common stock: 290,861,000 shares of common stock on August 2, 2004.

Edgar Filing: SERVICEMASTER CO - Form 10-Q

TABLE OF CONTENTS

	Page NO.
THE SERVICEMASTER COMPANY (Registrant) -	
PART I. FINANCIAL INFORMATION	
Item 1: Financial Statements (Unaudited)	
Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2004 and June 30, 2003	3
Condensed Consolidated Statements of Financial Position as of June 30, 2004 and December 31, 2003	4
Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2004 and June 30, 2003	5
Notes to Condensed Consolidated Financial Statements	6
Item 2: Management Discussion and Analysis of Financial Condition and Results of Operations	13
Item 3: Quantitative and Qualitative Disclosures About Market Risk	22
Item 4: Controls and Procedures	23
PART II. OTHER INFORMATION	
Item 2: Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities	24
Item 4: Submission of Matters to a Vote of Security Holders	24
Item 6: Exhibits and Reports on Form 8-K	25
Signature	26

PART I. FINANCIAL INFORMATION

THE SERVICEMASTER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

Three Months Ended
June 30,

Six M
J

Edgar Filing: SERVICEMASTER CO - Form 10-Q

	2004	2003	2004
	-----	-----	-----
OPERATING REVENUE	\$ 1,088,716	\$ 1,031,470	\$ 1,845,60
OPERATING COSTS AND EXPENSES:			
Cost of services rendered and products sold	697,706	657,883	1,242,76
Selling and administrative expenses	260,128	247,049	439,43
Amortization expense	1,511	1,722	2,93
	-----	-----	-----
Total operating costs and expenses	959,345	906,654	1,685,13
	-----	-----	-----
OPERATING INCOME	129,371	124,816	160,47
NON-OPERATING EXPENSE (INCOME):			
Interest expense	15,007	16,655	29,93
Interest and investment income	(3,036)	(3,125)	(7,60)
Minority interest and other expense, net	2,086	2,046	4,13
	-----	-----	-----
INCOME FROM CONTINUING OPERATIONS BEFORE			
INCOME TAXES	115,314	109,240	134,01
Provision for income taxes.....	44,626	42,911	51,86
	-----	-----	-----
INCOME FROM CONTINUING OPERATIONS	70,688	66,329	82,14
Loss from discontinued operations, net of income taxes	(292)	(779)	(55
	-----	-----	-----
NET INCOME	\$ 70,396	\$ 65,550	\$ 81,59
	=====	=====	=====
PER SHARE:			
BASIC EARNINGS PER SHARE:			
Income from continuing operations	\$ 0.24	\$ 0.22	\$ 0.2
Discontinued operations	-	-	-
	-----	-----	-----
Basic earnings per share	\$ 0.24	\$ 0.22	\$ 0.2
	=====	=====	=====
SHARES	289,887	296,819	290,84
DILUTED EARNINGS PER SHARE:			
Income from continuing operations	\$ 0.24	\$ 0.22	\$ 0.2
Discontinued operations	-	-	-
	-----	-----	-----
Diluted earnings per share	\$ 0.24	\$ 0.22	\$ 0.2
	=====	=====	=====
SHARES	302,944	308,947	295,49

SEE NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Edgar Filing: SERVICEMASTER CO - Form 10-Q

THE SERVICEMASTER COMPANY
 CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UN
 (IN THOUSANDS, EXCEPT PER SHARE DATA)

	As of June 30, 2004
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	\$ 176,196
Marketable securities	87,293
Receivables, less allowance of \$29,266 and \$26,220, respectively	420,568
Inventories	71,507
Prepaid expenses and other assets	74,860
Deferred customer acquisition costs	59,239
Deferred taxes and income taxes receivable	92,206
Assets of discontinued operations	4,894
Total Current Assets	986,763
PROPERTY AND EQUIPMENT:	
At cost	406,417
Less: accumulated depreciation	(221,638)
Net property and equipment	184,779
OTHER ASSETS:	
Goodwill	1,545,466
Intangible assets, primarily trade names	219,782
Notes receivable	40,701
Long-term marketable securities	97,560
Other assets	12,909
Total Assets	\$ 3,087,960
LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Accounts payable	\$ 111,895
Accrued liabilities:	
Payroll and related expenses	99,502
Self-insured claims and related expenses	84,842
Income taxes payable	22,567
Other	114,523
Deferred revenues	467,184
Liabilities of discontinued operations	11,494
Current portion of long-term debt	29,346
Total Current Liabilities	941,353
LONG-TERM DEBT	786,431

Edgar Filing: SERVICEMASTER CO - Form 10-Q

LONG-TERM LIABILITIES:	
Deferred taxes	302,215
Liabilities of discontinued operations	31,064
Other long-term obligations	122,903

Total Long-Term Liabilities	456,182

MINORITY INTEREST	100,000
COMMITMENTS AND CONTINGENCIES	
SHAREHOLDERS' EQUITY:	
Common stock \$0.01 par value, authorized 1,000,000 shares; issued	
317,700 and 317,315 shares, respectively	3,177
Additional paid-in capital	1,065,324
Retained earnings	26,646
Accumulated other comprehensive income	6,539
Restricted stock	(9,583)
Treasury stock	(288,109)

Total Shareholders' Equity	803,994

Total Liabilities and Shareholders' Equity	\$ 3,087,960
	=====

SEE NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THE SERVICEMASTER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UN
(IN THOUSANDS)

	Si
	2004

CASH AND CASH EQUIVALENTS AT JANUARY 1	\$228,16
CASH FLOWS FROM OPERATING ACTIVITIES:	
NET INCOME	81,595
Adjustments to reconcile net income to net cash flows from operating activities:	
Loss from discontinued operations	554
Depreciation expense	24,327
Amortization expense	2,933
Deferred income tax expense	44,961
Change in working capital, net of acquisitions:	
Receivables	(81,111)

Edgar Filing: SERVICEMASTER CO - Form 10-Q

Inventories and other current assets	(57,695)
Accounts payable	25,126
Deferred revenues	40,360
Accrued liabilities	29,200
Other, net	5,446
NET CASH PROVIDED FROM OPERATING ACTIVITIES	115,696
CASH FLOWS FROM INVESTING ACTIVITIES:	
Property additions	(24,226)
Sale of equipment and other assets	1,525
Business acquisitions, net of cash acquired	(20,875)
Notes receivable, financial investments and securities	(3,370)
NET CASH USED FOR INVESTING ACTIVITIES	(46,946)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Net payments of debt	(17,751)
Purchase of ServiceMaster stock	(41,286)
Shareholders' dividends	(61,314)
Other, net	5,648
NET CASH USED FOR FINANCING ACTIVITIES	(114,703)
CASH USED FOR DISCONTINUED OPERATIONS	(6,012)
CASH DECREASE DURING THE PERIOD	(51,965)
CASH AND CASH EQUIVALENTS AT JUNE 30	\$ 176,196

SEE NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

5

THE SERVICEMASTER COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1: The condensed consolidated financial statements include the accounts of ServiceMaster and its subsidiaries, collectively referred to as "the Company". Intercompany transactions and balances have been eliminated in consolidation.

NOTE 2: The condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States (GAAP) and pursuant to the rules and regulations of the Securities and Exchange Commission. The Company recommends that the quarterly condensed consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's latest Annual Report to Shareholders and the Annual Report to the Securities and Exchange Commission on Form 10-K for the year ended December 31, 2003 (2003

Edgar Filing: SERVICEMASTER CO - Form 10-Q

Annual Report). The condensed consolidated financial statements reflect all adjustments, which are, in the opinion of management, necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for any interim period are not necessarily indicative of the results which might be achieved for a full year.

NOTE 3: The Company has identified the most important accounting policies with respect to its financial position and results of operations. These relate primarily to revenue recognition and the deferral of customer acquisition costs. The following revenue recognition policies have not changed since year-end. Revenues from lawn care, pest control, liquid and fumigation termite applications, as well as heating/air conditioning and plumbing services are recognized as the services are provided. Revenues from landscaping services are recognized as they are earned based upon agreed monthly contract arrangements or when services are performed for non-contractual arrangements. Revenues from the Company's commercial installation contracts, primarily relating to heating, ventilation and air conditioning (HVAC), and electrical are recognized on the percentage of completion method in the ratio that total incurred costs bear to total estimated costs. The Company eradicates termites through the use of baiting systems, as well as through non-baiting methods (e.g., fumigation or liquid treatment). Termite services using baiting systems as well as home warranty services typically are sold through annual contracts for a one-time, upfront payment. Direct costs of these contracts (service costs for termite contracts and claim costs for warranty contracts) are expensed as incurred. The Company recognizes revenue over the life of these contracts in proportion to the expected direct costs. Revenue from trade name licensing arrangements is recognized when earned. Franchised revenues (which in the aggregate represent approximately three percent of consolidated revenue) consist principally of monthly fee revenue, which is recognized when the related customer level revenue is reported by the franchisee and collectibility is assured. Franchise revenue also includes initial fees resulting from the sale of a franchise. These fees are fixed and are recognized as revenue when collectibility is assured and all material services or conditions relating to the sale have been substantially performed. Income from franchised revenue represented nine percent and 13 percent of consolidated operating income for the three month periods and the six month periods ended June 30, 2004 and 2003, respectively. The portion of total franchise fee income related to initial fees received from the sale of a franchise were immaterial to the Company's consolidated financial statements for all periods.

The Company had \$467 million and \$420 million of deferred revenue at June 30, 2004 and December 31, 2003, respectively, which consist primarily of payments received for annual contracts relating to home warranty, termite baiting, pest control and lawn care services. The revenue related to these services is recognized over the contractual period as the direct costs occur, such as when the services are performed or claims are incurred.

Customer acquisition costs, which are incremental and direct costs of obtaining a customer, are deferred and amortized over the life of the related contract in proportion to revenue recognized. These costs include sales commissions and direct selling costs which can be shown to have resulted in a successful sale.

TruGreen ChemLawn has significant seasonality to its business. In the winter and early spring, this business sells a series of lawn applications to customers which are rendered primarily in March through October. The Company incurs and defers incremental selling expenses at the beginning of the year that directly relate to successful sales for which the revenues will be recognized in later quarters. This business

Edgar Filing: SERVICEMASTER CO - Form 10-Q

also defers, on an interim basis, pre-season advertising costs and the costs of annual repairs and maintenance procedures that are performed in the first quarter. These costs are deferred and recognized approximately in proportion to the contract revenue over the production season, and are not deferred beyond the calendar year-end.

As noted above, TruGreen's pre-season advertising costs are deferred and recognized approximately in proportion to the contract revenue over the production season. Terminix and ARS also defer advertising costs in the first quarter and recognize the expense over the year approximately in proportion to their revenue. These costs are not deferred beyond the calendar year-end. The cost of direct-response advertising at Terminix is capitalized and amortized over its expected period of future benefits. This direct-response advertising consists primarily of direct-mail promotions, for which the cost is capitalized and amortized over the one-year customer contract life.

The preparation of the financial statements requires management to make certain estimates and assumptions required under GAAP which may differ materially from the actual results. Disclosures in the 2003 Annual Report presented the significant areas that require the use of management's estimates and discussed how management formed its judgments. The areas discussed included the allowance for receivables, accruals for self-insured retention limits related to medical, workers compensation, auto and general liability insurance, accruals for home warranty claims, the possible outcome of outstanding litigation, accruals for income tax liabilities as well as deferred tax accounts, useful lives for depreciation and amortization expense, and the valuation of tangible and intangible assets. In 2004, there have been no changes in these significant areas that require estimates or in the methodologies which underlie these associated estimates. In the second quarter of 2004, there was a change in the estimated allocation of annual fertilizer and weed control costs to first half applications, which are relatively more costly. This change accelerated recognition of approximately \$6 million of expense into the second quarter that will result in a corresponding benefit in later quarters of 2004.

NOTE 4: The Company carries insurance policies on insurable risks at levels which it believes to be appropriate, including workers' compensation, auto and general liability risks. The Company has self-insured retention limits and insured layers of excess insurance coverage above those limits. Accruals for self-insurance losses and warranty claims in the American Home Shield business are made based on the Company's claims experience and actuarial projections. Current activity could differ causing a change in estimates. The Company has certain liabilities with respect to existing or potential claims, lawsuits, and other proceedings. The Company accrues for these liabilities when it is probable that future costs will be incurred and such costs can be reasonably estimated.

The Company records deferred income tax balances based on the net tax effects of temporary differences between the carrying value of assets and liabilities for financial reporting purposes and income tax purposes. There are significant amortizable intangible assets for tax reporting purposes (not for financial reporting purposes) which arose as a result of the Company's reincorporation from partnership to corporate form in 1997. The Company records its deferred tax items based on the estimated ultimate value of the tax basis. The Company's tax estimates are adjusted when required to reflect changes based on factors such as changes in tax laws, results of tax authority reviews and statutory limitations.

In the event that actual results differ from the estimates discussed in this note, the Company would reflect those changes, which could be material, in the period that the difference is identified.

NOTE 5: In accordance with Statement of Financial Accounting Standards (SFAS)

Edgar Filing: SERVICEMASTER CO - Form 10-Q

142, goodwill and intangible assets that are not amortized are subject to assessment for impairment by applying a fair-value based test on an annual basis or more frequently if circumstances indicate a potential impairment. Such circumstances could include actual earnings being significantly below management's estimates. The Company's annual assessment date is October 1.

In April 2004, TruGreen ChemLawn acquired the assets of Greenspace Services Limited, Canada's largest professional lawn care service company. Intangible assets recorded were less than \$15 million. The preliminary allocation of purchase price is subject to change later this year as additional information is obtained.

7

The table below summarizes the goodwill and intangible asset activity and balances:

(In thousands)	As of Dec. 31, 2003	Additions	Amort.	As of June 30, 2004
	-----	-----	-----	-----
Goodwill(1)	\$ 1,516,206	\$ 29,260	\$ -	\$ 1,545,466
Trade names(1)	204,793	-	-	204,793
Other intangible assets	35,432	6,262	-	41,694
Accumulated amortization(2)	(23,772)	-	(2,933)	(26,705)
	-----	-----	-----	-----
Net other intangibles	11,660	6,262	(2,933)	14,989
	-----	-----	-----	-----
Total	\$ 1,732,659	\$ 35,522	\$ (2,933)	\$ 1,765,248
	=====	=====	=====	=====

(1) Not subject to amortization.

(2) Annual amortization expense of approximately \$6 million in 2004 is expected to decline over the next five years.

The table below presents, by segment, the goodwill that is not subject to amortization:

(In thousands)	June 30, 2004	Dec. 31, 2003
	-----	-----
TruGreen	\$ 672,638	\$ 652,534
Terminix	631,374	622,351
American Home Shield	72,085	72,085
ARS/AMS	56,171	56,171
Other Operations	113,198	113,065
	-----	-----
Total	\$1,545,466	\$1,516,206
	=====	=====

NOTE 6: Basic earnings per share is computed by dividing income available to common stockholders by the weighted-average number of shares outstanding for the period. The weighted-average common shares for the diluted earnings per share

Edgar Filing: SERVICEMASTER CO - Form 10-Q

calculation includes the incremental effect related to outstanding options whose market price is in excess of the exercise price. Shares potentially issuable under convertible securities have been considered outstanding for purposes of the diluted earnings per share calculations. In computing diluted earnings per share, the after-tax interest expense related to convertible debentures is added back to net income in the numerator, while the diluted shares in the denominator include the shares issuable upon conversion of the debentures. Shares potentially issuable under convertible securities have been considered outstanding for the three months ended June 30, 2004 and 2003. However, for the six months ended June 30, 2004 and 2003, shares potentially issuable under convertible securities have not been considered outstanding as their inclusion results in a less dilutive computation. Had the inclusion of convertible securities not resulted in a less dilutive computation for the six months ended June 30, 2004 and 2003, incremental shares attributable to the assumed conversion of the debentures would have increased shares outstanding by 8.0 million shares and 8.2 million shares, respectively, and the after-tax interest expense related to the convertible debentures that would have been added to net income in the numerator would have been \$2.4 million for both periods.

The following table reconciles both the numerator and the denominator of the basic earnings per share from continuing operations computation to the numerator and the denominator of the diluted earnings per share from continuing operations computation.

(In thousands, except per share data)

	Three Months Ended June 30, 2004			T Ended
CONTINUING OPERATIONS:	Income	Shares	EPS	Income
Basic earnings per share	\$70,688	289,887	\$0.24	\$66,329
Effect of dilutive securities, net of tax:			=====	
Options		5,057		
Convertible Securities	1,178	8,000		1,195
Diluted earnings per share	\$71,866	302,944	\$0.24	\$67,524
	=====	=====	=====	=====

8

(In thousands, except per share data)

	Six Months Ended June 30, 2004			Ende
CONTINUING OPERATIONS:	Income	Shares	EPS	Income
Basic earnings per share	\$82,149	290,843	\$0.28	\$71,172
Effect of dilutive securities, net of tax:			=====	

Edgar Filing: SERVICEMASTER CO - Form 10-Q

Options		4,647	
	-----	-----	-----
Diluted earnings per share	\$82,149	295,490	\$0.28
	=====	=====	=====

NOTE 7: The Company is accounting for employee stock options as compensation expense in accordance with SFAS 123, "Accounting for Stock-Based Compensation." SFAS 148 "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123", provides alternative methods of transitioning to the fair-value based method of accounting for employee stock options as compensation expense. The Company is using the "prospective method" of SFAS 148 and is expensing the fair-value of new employee option grants awarded subsequent to 2002.

Prior to 2003, the Company accounted for employee share options under the intrinsic method of Accounting Principles Board Opinion No. 25, as permitted under GAAP. Had compensation expense for employee options been determined under the fair-value based method of SFAS 123 for all periods, proforma reported net income and net earnings per share would reflect the following:

(In thousands, except per share data)	Three Months Ended June 30,		Six Mon Jun
	2004	2003	2004
	-----	-----	-----
Net income as reported	\$ 70,396	\$ 65,550	\$ 81,595
Add back: Stock-based compensation expense included in reported net income, net of related tax effects	290	313	539
Deduct: Stock-based compensation expense determined under fair-value method, net of related tax effects	(1,396)	(1,884)	(2,820)
	-----	-----	-----
Proforma net income	\$ 69,290	\$ 63,979	\$ 79,314
	=====	=====	=====
Basic Earnings Per Share:			
As reported	\$0.24	\$0.22	\$0.28
Proforma	\$0.24	\$0.22	\$0.27
Diluted Earnings Per Share:			
As reported	\$0.24	\$0.22	\$0.28
Proforma	\$0.23	\$0.21	\$0.27

In March 2004, the Financial Accounting Standards Board (FASB) issued an Exposure Draft, "Share-Based Payment, an Amendment of FASB Statements No. 123 and 95". In its current form, this Exposure Draft would require companies to record stock options and share grants at fair value and recognize this value as compensation expense over their vesting period. The Exposure Draft would require

Edgar Filing: SERVICEMASTER CO - Form 10-Q

companies to record compensation expense for newly issued awards as well as the unvested portion of previously issued awards that remain outstanding as of the date of the adoption of the Exposure Draft. ServiceMaster has recorded compensation expense relating to the vesting of awards granted subsequent to 2002. If adopted in its current form, the Exposure Draft would be effective for fiscal years beginning after December 15, 2004. ServiceMaster is currently assessing the potential impact of this Exposure Draft.

NOTE 8: In the Condensed Consolidated Statements of Cash Flows, the caption Cash and Cash Equivalents includes investments in short-term, highly-liquid securities having a maturity of three months or less. Supplemental information relating to the Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2004 and 2003 is presented in the following table:

9

	(IN THOUSANDS)	
	2004	2003
	-----	-----
CASH PAID FOR OR (RECEIVED FROM):		
Interest expense.....	\$ 29,829	\$ 30,799
Interest and investment income.....	\$ (8,446)	\$ (3,850)
Income taxes.....	\$ 6,296	\$ 5,617

The increase in cash received from interest and investment income reflects a higher level of gains realized on the investment portfolio at American Home Shield.

NOTE 9: Total comprehensive income was \$69 million and \$72 million for the three months ended June 30, 2004 and 2003, respectively and \$80 million and \$75 million for the six months ended June 30, 2004 and 2003, respectively. Total comprehensive income includes primarily net income, changes in unrealized gains and losses on marketable securities and foreign currency translation balances.

NOTE 10: The Company has an agreement which provides for the ongoing revolving sale of a designated pool of accounts receivable of TruGreen and Terminix to a wholly owned, bankruptcy-remote subsidiary, ServiceMaster Funding LLC. ServiceMaster Funding LLC has entered into an agreement to transfer, on a revolving basis, an undivided percentage ownership interest in a pool of accounts receivable to unrelated third party purchasers. ServiceMaster Funding LLC retains an undivided percentage interest in the pool of accounts receivable and bad debt losses for the entire pool are allocated first to this retained interest. During the six months ended June 30, 2004 and 2003, there were no receivables sold to third parties under this agreement. However, the Company may sell its receivables in the future, which would provide an additional funding source. The agreement is a 364-day facility that is renewable at the option of the purchasers. The Company may sell up to \$65 million of its receivables to these purchasers in the future and therefore has immediate access to cash proceeds from these sales. The amount of the eligible receivables varies during the year based on seasonality of the business and will at times limit the amount available to the Company.

NOTE 11: Total debt was \$816 million at June 30, 2004, slightly below the prior year end level. Approximately 65 percent of the Company's debt matures beyond five years and 35 percent beyond fifteen years. The Company's next public debt maturity of approximately \$138 million is in April 2005. The Company has both

Edgar Filing: SERVICEMASTER CO - Form 10-Q

the intent and ability to pay this debt with other long term financing, and it is classified as long-term debt in the Consolidated Statements of Financial Position.

NOTE 12: During the third quarter of 2003, the Company sold substantially all of the assets and related operational obligations of Trees, Inc., the utility line clearing operations of TruGreen LandCare. The results of the utility line clearing operations of Trees, Inc. have been reclassified as "Discontinued Operations" and are not included in continuing operations.

In October 2001, the Company's Board of Directors approved a series of strategic actions, which were the culmination of an extensive portfolio review process. As part of this portfolio review, the Company sold or exited certain non-strategic or under-performing businesses in 2001 and 2002. The results of these discontinued business units have been reclassified as "Discontinued Operations" in the accompanying financial statements.

The following table summarizes the activity during the six months ended June 30, 2004 for the remaining liabilities from the discontinued operations. The Company believes that the remaining reserves continue to be adequate and reasonable.

10

(IN THOUSANDS)	Balance at December 31, 2003 -----	Cash Payments -----	Balance at June 30, 2004 -----
Remaining liabilities from discontinued operations			
LandCare Construction	\$ 7,152	\$ 2,015	\$ 5,137
LandCare utility line clearing business	9,011	1,705	7,306
Certified Systems, Inc.	11,024	1,436	9,588
Management Services	283	56	227
International businesses	12,017	1,006	11,011
Other	9,289	-	9,289

NOTE 13: In the ordinary course, the Company is subject to review by domestic and foreign taxing authorities, including the Internal Revenue Service ("IRS"). From 1986 through 1997 most operations of the Company were conducted in partnership form, free of federal corporate income tax. During that period, the Company was not reviewed by the IRS. In 1997, the Company converted from partnership to corporate form. In 2003, the IRS commenced an examination of the Company's consolidated income tax returns for 2002, 2001 and 2000. The Company expects the IRS' examination to be in its final stages in late 2004 and completed early in 2005. As with any review of this nature, the outcome of the IRS examination is not known at this time.

NOTE 14: The business of the Company is conducted through five operating segments: TruGreen, Terminix, American Home Shield, ARS/AMS and Other Operations. In accordance with SFAS 131, the Company's reportable segments are

Edgar Filing: SERVICEMASTER CO - Form 10-Q

strategic business units that offer different services. The TruGreen segment provides residential and commercial lawn care and landscaping services through the TruGreen ChemLawn and TruGreen LandCare companies. The Terminix segment provides termite and pest control services to residential and commercial customers. The American Home Shield segment provides home warranties to consumers that cover HVAC, plumbing and other home systems and appliances. This segment also includes home inspection services provided by AmeriSpec. The ARS/AMS segment provides HVAC and plumbing installation and repair services provided under the ARS Service Express, American Mechanical Services and Rescue Rooter brand names. The Other Operations segment includes the franchise and company-owned operations of ServiceMaster Clean, Furniture Medic and Merry Maids, which provide disaster restoration, cleaning, furniture repair and maid services. The segment also includes the Company's headquarters operations, which provide various technology, marketing, finance and other support services to the business units. Segment information is presented in the following table.

11

(IN THOUSANDS)	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	Six Month Ended June 2004
<hr style="border-top: 1px dashed black;"/>			
Operating Revenue:			
TruGreen	\$ 453,710	\$ 434,290	\$ 678,369
Terminix	282,318	260,588	519,114
American Home Shield	133,462	126,149	236,259
ARS/AMS	179,697	172,977	333,681
Other Operations	39,529	37,466	78,184
<hr style="border-top: 1px dashed black;"/>			
Total Operating Revenue	\$ 1,088,716	\$ 1,031,470	\$ 1,845,607
<hr style="border-top: 3px double black;"/>			
Operating Income:			
TruGreen	\$ 65,897	\$ 67,959	\$ 62,999
Terminix	48,483	41,897	84,737
American Home Shield	23,837	23,162	33,953
ARS/AMS	1,613	3,838	(2,035)
Other Operations	(10,459)	(12,040)	(19,180)
<hr style="border-top: 1px dashed black;"/>			
Total Operating Income	\$ 129,371	\$ 124,816	\$ 160,474
<hr style="border-top: 3px double black;"/>			

(IN THOUSANDS)	As of June 30, 2004	As of Dec. 31,
<hr style="border-top: 1px dashed black;"/>		
Identifiable Assets:		
TruGreen	\$1,031,470	\$ 911

Edgar Filing: SERVICEMASTER CO - Form 10-Q

Terminix	842,813	822
American Home Shield	450,087	422
ARS/AMS	197,443	185
Other Operations (and discontinued operations)	566,147	613

Total Identifiable Assets	\$3,087,960	\$2,956
=====		

(IN THOUSANDS)	As of	As of
	June 30, 2004	June 30,

Capital Employed: (1)		
TruGreen	\$ 895,246	\$ 1,063
Terminix	602,811	577
American Home Shield	144,082	119
ARS/AMS	93,933	387
Other Operations (and discontinued operations)	(16,301)	(26)

Total Capital Employed	\$ 1,719,771	\$ 2,121
=====		

(1) Capital employed is a non-U.S. GAAP measure that is defined as the segment's total assets less liabilities, exclusive of debt balances. The Company believes this information is useful to investors in helping them compute return on capital measures and therefore better understand the performance of the Company's business segments.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

SECOND QUARTER 2004 COMPARED TO SECOND QUARTER 2003

CONSOLIDATED OVERVIEW

ServiceMaster (the "Company") reported second quarter 2004 revenue of \$1.09 billion, six percent above 2003, with all of the business segments achieving growth in revenue. Approximately five percent of the revenue growth was from internal sources. Second quarter 2004 diluted earnings per share was \$.24 compared to \$.22 in 2003. Operating income for the second quarter increased four percent to \$129 million compared to \$125 million in 2003. The increase in

Edgar Filing: SERVICEMASTER CO - Form 10-Q

operating income reflects double-digit growth at Terminix supported by an improved termite swarm season this year and improved profitability in TruGreen's landscape operations. This growth was partially offset by reduced profits at ARS due to higher marketing, insurance and fuel costs and reduced project margins at AMS due to depressed conditions in the commercial construction industry. In addition, second quarter operating income was adversely impacted by an increase in materials expense in the lawn care operations of TruGreen resulting from a change in the estimated allocation of annual fertilizer and weed control costs to first half applications, which are relatively more costly. This change accelerated recognition of approximately \$6 million more of expense into the second quarter that will result in a corresponding benefit in later quarters of 2004.

The Company has re-affirmed its outlook for the year. The Company expects revenue growth to be in the mid-single digits and earnings per share growing somewhat faster than revenues. The Company projects that earnings per share for the last six months of the year should be comparable to last year, reflecting continued solid growth from operating activities offset by a lower level of gains from the American Home Shield investment portfolio and a higher effective tax rate. Economic conditions and consumer confidence continue to be favorable, although the Company's projected results for the year continue to be tempered by large increases in key costs such as variable compensation (returning to more normal levels), insurance, and fuel ("factor costs") as well as the Company's commitment to make appropriate investments in the business to sustain its growth.

Overall, the Company believes it is well poised to continue to achieve solid growth in income from operating activities in the second half of the year, after absorbing the net effects of disproportionate increases in key factor costs, continuing investments to sustain growth, and a few non-comparable items recorded in 2003. There are three key factor costs that the Company has previously discussed and that it believes will continue to increase much faster than general inflation in the second half of 2004; (1) variable compensation expense, which is being earned at more normal levels in 2004, but is up sharply over the modest amounts accrued in 2003, (2) umbrella insurance premiums, which increased significantly in 2004 when a multi-year contract expired, and (3) higher fuel costs for the Company's fleet of over 24,000 vehicles, one of the largest in the U.S. The Company estimates that on a combined basis, these three costs will increase approximately \$.05 per share in the second half of the year, consistent with the first half of the year increase. Partially offsetting the effect of these cost items, second half results should benefit by approximately \$.03 per share from non-recurring items recorded in the fourth quarter of 2003 at Terminix and American Home Shield related to the recognition of certain contract renewal revenues. Overall, the Company expects growth in income from operating activities in the second half of the year, after considering the factor costs, investments and non-recurring items discussed above. However, this growth is projected to be offset at the earnings per share level by a reduced amount of investment gains at American Home Shield (due to softer prevailing market conditions) and a higher consolidated effective tax rate.

Cost of services rendered and products sold increased six percent for the second quarter and increased as a percentage of revenue to 64.1 percent in 2004 from 63.8 percent in 2003. This increase primarily reflects the impact of the aforementioned increased chemical expense in the lawn care operations of TruGreen. Selling and administrative expenses increased five percent for the quarter. As a percentage of revenue, these costs decreased to 23.9 percent for the quarter in 2004 from 24.0 percent in 2003.

Edgar Filing: SERVICEMASTER CO - Form 10-Q

Net non-operating expense decreased \$1.5 million from 2003, primarily reflecting savings resulting from interest rate swap agreements entered into at the end of 2003 and early 2004. Higher investment income from securities gains in the American Home Shield investment portfolio were offset by a decline in investment income in an employee deferred compensation trust. Related to the deferred compensation trust, there was a corresponding reduction in compensation expense within operating income.

SEGMENT REVIEW

The TruGreen segment includes lawn care operations performed under the TruGreen ChemLawn brand name and landscape maintenance services provided under the TruGreen LandCare brand name. The TruGreen segment reported a four percent increase in second quarter revenue to \$454 million compared to \$434 million in 2003. The segment's operating income was \$66 million compared to \$68 million in 2003.

Revenue in the lawn care operations grew six percent over 2003. The comparison to last year is impacted by the timing of lawn care production, with more favorable weather conditions early this year resulting in a greater level of production being completed in the first quarter. An eight percent growth in customer counts was supported by continued significant improvement in customer retention and acquisitions, partially offset by a modest decline in new sales. In April, TruGreen ChemLawn acquired the assets of Greenspace Services Limited ("Greenspace"), Canada's largest professional lawn care service company. Excluding the effects of the Greenspace acquisition, customer counts increased three percent. The gains in customer retention were geographically broad based and resulted from concerted management focus including the impact of using better materials for more visible results, improving customer communication and problem resolution procedures, focused incentive compensation structures at all levels, and favorable weather conditions. The lawn care operations continued to make very meaningful progress in diversifying their sales channels; placing less reliance on telemarketing and more emphasis on direct mail, neighborhood selling, and other efforts. As a result of the enactment of the National Do Not Call Registry last fall, the Company's telemarketing sales for the six months have declined over 10 percent, consistent with management's expectations. This loss has been mostly offset by increases in direct mail and neighborhood sales efforts. Overall, year-to-date sales were down less than four percent. The new sales channels are more costly than telemarketing, but they are also expected to produce customers with higher retention rates. Second quarter operating income of the lawn care operations decreased \$4 million and included the aforementioned \$6 million increase in material expense, offset in part by profits from the Greenspace acquisition.

Second quarter revenue in the landscape maintenance business was consistent with 2003. Base contract maintenance revenues were flat as increases from new sales were offset by lower customer retention. Enhancement revenues (e.g. add-on services such as seasonal flower plantings) continued to experience solid growth, reflecting focused sales efforts and an improving economy. This business achieved modest operating profits in the quarter, a significant improvement over the operating losses incurred last year. This reflects controlled overhead spending and a stronger mix of higher margin enhancement revenues. Key areas of management focus include strengthening the sales team and the maintenance base, continuing to increase enhancement revenues, and improving operating consistency through better process disciplines, especially in labor management and in the pricing and bidding of new work.

Capital employed in the TruGreen segment decreased 16 percent reflecting the impact of the impairment charge recorded in the third quarter of 2003, offset in part by acquisitions. Capital employed is a non-U.S. GAAP measure that is

Edgar Filing: SERVICEMASTER CO - Form 10-Q

defined as the segment's total assets less liabilities, exclusive of debt balances. The Company believes this information is useful to investors in helping them compute return on capital measures and therefore better understand the performance of the Company's business segments.

The Terminix segment, which includes termite and pest control services, reported an eight percent increase in second quarter revenue to \$282 million, compared to \$261 million in 2003 and operating income growth of 16 percent to \$48 million compared to \$42 million in 2003. Strong growth in termite renewal revenue reflected improved pricing, slightly offset by a modest decline in customers available to renew coming out of last year's weather-plagued termite swarm. Terminix also reported strong growth in revenue from termite completions, which resulted from a strong increase in unit sales and improved price realization. As previously disclosed, with the improved efficacy of liquid termite treatments, the Company is providing consumers with the choice of receiving termite services through baiting systems or liquid treatments. With this enhanced

14

termite offering, the Company is expecting, and has experienced, a shift in the mix of its termite customer base from baiting systems to liquid treatments. This change in mix is generally proceeding in line with management's expectations, but at a slightly slower pace. By offering consumers a choice in treatments and by tightening controls over price discounting, Terminix has been able to increase the average price realized for each of the two treatment alternatives, thus offsetting the adverse, short-term revenue and profit impacts of the mix shift. Solid growth in pest control revenue was supported by continued strong improvements in retention. The conversion from monthly to quarterly service is progressing well and management is focused on realizing the resulting labor efficiencies and improvements in customer satisfaction. The growth in operating income reflected good cost controls and favorable leveraging of the strong revenue growth. In both the second quarter of 2004 and 2003, the Terminix operations experienced favorable trending in damage claim costs associated with its acquired Sears termite customer base resulting in a comparable level (approximately \$6 million) of reduced expense in both periods.

In the third quarter, the Company anticipates termite completion revenues to be down as a result of the deferred effects of the mix shift from bait to liquid. A portion of bait completion sales revenue is required to be deferred and recognized in subsequent quarters as periodic inspections of the bait systems occur. In 2004, Terminix had less bait sales during the swarm season, resulting in less deferred revenue to be recognized in quarters subsequent to the swarm. This revenue reduction, as well as increased factor costs, will impair third quarter profit comparisons. However, the Company believes that Terminix is making good overall progress and expects it to achieve solid full year growth in revenues and profits. Capital employed in the Terminix segment increased four percent to \$603 million, reflecting the impact of acquisitions and growth in the business.

The American Home Shield (AHS) segment, which provides home warranties to consumers that cover heating, ventilation and air conditioning (HVAC), plumbing and other home systems and appliances, reported a six percent increase in revenue to \$133 million from \$126 million in 2003 and operating income of \$24 million compared to \$23 million in 2003. Contract sales, which are reflected as earned revenues over the subsequent twelve month contract period, increased 10 percent for the second quarter. Strong new sales growth in the direct-to-consumer channel was supported by an increase in direct mail solicitations, which were delayed last year. The real estate channel showed improved momentum with a solid growth in sales for the second quarter. AHS'

Edgar Filing: SERVICEMASTER CO - Form 10-Q

pilot program to expand sales in under-penetrated markets, launched at the end of the first quarter in two major cities, has performed well and will be expanded in the third quarter. Management is focused on expanding the sales force in these markets, and replicating high performing account executives through increased up-front training and marketing support. Renewal revenues also increased despite a modest decline in retention rates. Part of management's strategic efforts to increase customer satisfaction and retention includes the implementation of pilot programs in two states designed to improve the clarity of coverage and ease of use of the product. As had been anticipated, second quarter operating income grew less rapidly than revenue as the favorable effects of revenue growth were partially offset by a lower level of favorable trending in prior year contract cost activity than was realized in the second quarter of 2003, and as a result of current expenditures in the previously discussed real estate market penetration and customer retention initiatives. The Company also anticipates declines in AHS' margins in the second half of 2004 as a result of the aforementioned strategic investments.

Capital employed increased 21 percent reflecting volume growth in the business resulting in a higher level of cash and marketable securities balances. The calculation of capital employed for the AHS segment includes approximately \$238 million and \$196 million of cash, cash equivalents and marketable securities at June 30, 2004 and 2003, respectively.

The ARS/AMS segment provides direct HVAC and plumbing installation and repair services under the ARS Service Express, Rescue Rooter, and American Mechanical Services (for large commercial accounts) brand names. Second quarter segment revenue of \$180 million increased four percent. Excluding the effects of discontinued branches, revenue grew seven percent. The segment reported operating income of \$2 million compared with operating income of \$4 million in 2003. All three major categories of service (HVAC, plumbing and construction) achieved revenue growth in the second quarter, an improvement over recent unfavorable trends. HVAC revenue increased modestly, reflecting continued growth in add-on-replacement work and a more favorable mix of higher-end, high-efficiency units. Partially offsetting this growth was a reduced level of core service calls, due in part to cooler seasonal temperatures in key parts of the country. Plumbing revenue also increased modestly, reflecting strong

15

increases in sewer line repair and commercial initiatives, partially offset by continued softness in core residential service calls. Residential construction and commercial project revenues reported strong increases in revenue for the quarter. The decrease in the segment's profitability reflects increased marketing, fuel and insurance costs at ARS, as well as lower margins at AMS due to cyclically depressed industry conditions in commercial real estate. Capital employed decreased 76 percent reflecting the impact of the impairment charge recorded in the third quarter of 2003.

The Other Operations segment includes the Company's ServiceMaster Clean and Merry Maids operations as well as its headquarters functions. Revenue in this segment increased six percent to \$40 million compared to \$37 million in 2003, primarily reflecting continued strong growth in disaster restoration services at ServiceMaster Clean and improved internal growth at Merry Maids. The Merry Maids branches have shown improving momentum with a steady increase in the revenue growth rate for the last several months, with July internal growth exceeding eight percent. The reduction in the segment's operating loss for the quarter reflects an increase in profits in the combined franchise operations and lower

Edgar Filing: SERVICEMASTER CO - Form 10-Q

overhead spending, which more than offset increased variable compensation and insurance-related costs at the headquarters level. Capital employed in this segment increased 39% primarily reflecting the Company's increase in cash levels for the twelve months ended June 30, 2004.

RESULTS OF OPERATIONS

SIX MONTHS ENDED JUNE 30, 2004 COMPARED TO JUNE 30, 2003

CONSOLIDATED REVIEW

The Company reported revenue of \$1.85 billion for the six months ended June 30, 2004, a six percent increase over 2003. For the six months, diluted earnings per share was \$.28 compared with \$.23 in 2003. Diluted earnings per share from continuing operations was \$.28, 17 percent above the \$.24 reported in 2003. Operating income increased seven percent to \$160 million compared to \$150 million in 2003. For the six months, all of the Company's business segments reported increases in revenue with meaningful improvements in growth rate trends. Substantially all of the six percent reported revenue growth was derived from internal sources as the impact of acquisitions was offset by a decrease in revenue related to operations shut-down in 2003. Most segments also reported solid increases in profits for the six month period, led by solid double-digit increases in Terminix and the lawn care operations of TruGreen. The cost controls and the focus on improved efficiencies that were evident throughout the enterprise during the second half of last year remained firmly in place, helping the Company to offset large increases in certain key costs such as variable compensation, insurance and fuel.

Cost of services rendered and products sold increased six percent for the six months and as a percentage of revenue was 67.3 in both 2004 and 2003. Selling and administrative expenses increased six percent and decreased as a percentage of revenue to 23.8 percent in 2004 from 23.9 percent in 2003.

Net non-operating expense decreased \$6 million from 2003, reflecting higher investment income from securities gains in the American Home Shield investment portfolio, as well as the favorable impact from interest rate swap agreements entered into at the end of 2003 and early 2004.

16

KEY PERFORMANCE INDICATORS

The table below presents selected metrics related to customer counts and customer retention for the three most profitable businesses of the Company. These measures are presented on a rolling, twelve-month basis in order to avoid seasonal anomalies.

KEY PERFORMANCE INDICATORS
As of June 30,

2004

2003

Edgar Filing: SERVICEMASTER CO - Form 10-Q

TRUGREEN CHEMLAWN-		
Growth in Full Program Contracts	8%	2%
Customer Retention Rate	66.8%	64.1%
TERMINIX -		
Growth in Pest Control Customers	6%	1%
Pest Control Customer Retention Rate	79.3%	75.8%
Growth in Termite Customers	-1%	-2%
Termite Customer Retention Rate	88.7%	88.6%
AMERICAN HOME SHIELD -		
Growth in Warranty Contracts	6%	9%
Customer Retention Rate	54.9%	55.1% *

* Restated to conform with the 2004 calculation.

SEGMENT REVIEW

For the six months, the TruGreen segment reported a six percent increase in revenue to \$678 million compared to \$639 million in 2003. Operating income increased six percent to \$63 million compared to \$59 million in 2003.

Revenue in the lawn care operations increased nine percent over 2003 and operating income grew 11 percent, or \$7 million, for the six months. The strong revenue growth reflects increased production levels and higher customer counts, supported by improved retention rates and acquisitions, and more favorable weather conditions during the first quarter, partially offset by a modest decrease in new sales. As discussed in the second quarter comparison, TruGreen ChemLawn acquired the assets of Greenspace in April and for the six months this acquisition represented three percent of the revenue growth of the lawn care operations. Customer counts increased eight percent over last year reflecting the impacts of continued improvement in customer retention, acquisitions, and a higher base of customers to start the year, partially offset by a modest decrease in new sales. The Company continues to diversify its sales channels to place less reliance on telemarketing, while more emphasis is being placed on direct mail, neighborhood selling and other efforts. The customer retention rates included in the Key Performance Indicators reflect a strong 270 basis point improvement in TruGreen ChemLawn's retention. The increase in operating income for the six months reflects higher revenues and labor and cost efficiencies partially offset by higher marketing costs and the change in estimate for allocating interim material costs that was discussed in the second quarter comparison.

Revenue in the landscape maintenance business was consistent with prior year levels reflecting stronger enhancement sales volume and a comparable level of base contract maintenance revenue, offset by higher snow removal revenue in the first quarter of 2003. Operating income of the landscape maintenance operations declined by \$3 million primarily reflecting a reduction in higher margin snow removal volume, higher insurance and labor-related costs as well as \$1.6 million of branch consolidation costs incurred in the first six months of 2004.

The Terminix segment reported a seven percent increase in revenue for the six months to \$519 million compared to \$486 million in 2003 and operating income growth of 12 percent to \$85 million compared to \$75 million in 2003. The revenue increase was supported by improved pricing on termite renewal contracts. Termite completion revenue grew, reflecting a solid increase in volume following last year's weak termite swarm season and improved price realization, offset by the mix shift from the higher priced

bait product to lower priced liquid treatments. Unit sales growth in pest control has been challenging, however there continues to be very significant improvement in the pest control retention rate. The 350 basis point improvement in pest control retention reflects the impacts of continued management focus and incentive programs, as well as an improving economy. The growth in operating income was driven by improved efficiency from an improved termite swarm season compared to last year.

For the six months the American Home Shield segment reported a seven percent increase in revenue to \$236 million from \$220 million in 2003 and operating income growth of eight percent, to \$34 million compared to \$31 million in 2003. Contract sales, which are reflected as earned revenue over the subsequent twelve month contract period, increased nine percent for the six months. Sales in the direct-to-consumer channel showed strong growth and were favorably impacted by the timing of sales as direct mail solicitations last year were delayed. In addition, the Company continues to expand its marketing efforts with premier mortgage lenders and financial institutions. American Home Shield experienced more moderate growth in its real estate and renewal channels, with the growth in renewal sales being supported by an increase in renewable customers, partially offset by less favorable retention rates. The growth in operating income was consistent with the revenue growth rate. Current year contract costs continue to trend favorably, with per unit cost decreases partially offsetting volume growth.

The ARS/AMS segment reported a three percent increase in revenues for the six months to \$334 million. Excluding the effects of discontinued branches, revenue growth was six percent. The segment reported an operating loss of \$2 million compared to operating income of \$3 million in 2003. The growth in revenue reflected strong increases in residential new construction and commercial project revenue, offset by declines in HVAC service revenue. Plumbing revenue increased less than one percent for the six month period. Within ARS, meaningful progress has been made on specific initiatives to improve brand differentiation (through such measures as on-time arrival guarantee), expand sewer line repair revenue, and increase the average sales ticket prices on replacement HVAC sales. As noted in the second quarter comparison, this business achieved revenue growth in all three major categories of service during the second quarter, reversing the unfavorable trends experienced over the prior several quarters. At AMS, project bidding activity is increasing and contract pricing has shown initial signs of improvement. The segment's decline in profitability for the six months was a result of higher sales, advertising and insurance related costs at ARS, as well as lower margins at AMS due to depressed industry conditions in commercial real estate. Additionally, profitability was negatively impacted by a modest revenue mix shift to the relatively lower margin construction business.

The Other Operations segment reported a six percent increase in revenues to \$78 million for the six months compared with \$74 million in 2003. The combined ServiceMaster Clean and Merry Maids franchise operations reported revenue growth of eight percent and a solid increase in operating income. ServiceMaster Clean continued to experience strong increases in domestic disaster restoration services as well as solid growth in its international operations. At Merry Maids, a better economy and improved sales processes have driven a steady increase in internal revenue growth in both the branch and franchise operations. The segment's operating loss increased slightly over the prior year reflecting increased profits in the combined franchise operations, partially offset by increased insurance costs as well as a higher level of variable compensation expense at the headquarters level.

Edgar Filing: SERVICEMASTER CO - Form 10-Q

FINANCIAL POSITION AND LIQUIDITY

CASH FLOWS FROM OPERATING ACTIVITIES

Net cash provided by operating activities totaled \$116 million for the six months, approximately \$55 million more than last year's level. The majority of the increase was realized in the first quarter and reflects reduced working capital usage and an increased level of profits. The improvement in working capital reflects a lower rate of cash outflows in early 2004 relating to incentive compensation earned in 2003, combined with an increased level of non-cash accruals for 2004 incentives, reflecting a return to more normal incentive rates. Additionally, the Company experienced favorable impacts from the timing and magnitude of other payments, partially offset by earlier spending on certain full year marketing and advertising initiatives. For the full year 2004, the Company expects cash from operating activities to increase at a rate consistent with earnings growth and to continue to substantially exceed net income.

18

The Company receives a significant annual cash benefit from deferred income taxes. Much of this benefit is due to a large base of tax deductible intangible assets which exist for income tax reporting purposes but not for book purposes, a significant portion of which arose in connection with the Company's 1997 conversion from a limited partnership to a corporation. In the ordinary course, the Company is subject to review by domestic and foreign taxing authorities, including the Internal Revenue Service ("IRS"). From 1986 through 1997 most operations of the Company were conducted in partnership form, free of federal corporate income tax. During that period, the Company was not reviewed by the IRS. In 1997 the Company converted from partnership to corporate form. In 2003, the IRS commenced an examination of the Company's consolidated income tax returns for 2002, 2001 and 2000. The Company expects the IRS' examination to be in its final stages in late 2004 and completed in early 2005. As with any review of this nature, the outcome of the IRS examination is not known at this time.

CASH FLOWS FROM INVESTING ACTIVITIES

Capital expenditures, which include recurring capital needs and information technology projects, were above prior year levels. The Company anticipates approximately \$50 million of capital expenditures in 2004 reflecting systems enhancements and other initiatives. The Company has no material capital commitments at this time.

Tuck-in acquisitions for the six months ended June 30, 2004 totaled \$32 million, compared with \$21 million in 2003. Consideration consisted of cash payments and seller financed notes. The increase in acquisitions reflects TruGreen ChemLawn's purchase of Greenspace as well as the resumption of tuck-in acquisition activity at Terminix. The Company continues to expect acquisitions for the full year to increase significantly over last year's level, utilizing approximately \$50 million in cash and note financing.

CASH FLOWS FROM FINANCING ACTIVITIES

Cash dividends paid to shareholders totaled \$61 million or \$.21 per share for the six months ended June 30, 2004. In July 2004, the Company paid a third quarter cash dividend of \$.11 per share, a 4.8 percent increase in the quarterly dividend amount compared to the \$.105 per share paid in the second quarter. The Company records its dividend liability on the record date.

The ServiceMaster Company and its Board of Directors review dividend policy and other capital structure objectives on a regular basis. As part of this review,

Edgar Filing: SERVICEMASTER CO - Form 10-Q

it was determined that prevailing corporate best practice in the United States is to have dividends declared in the same quarter that they are paid. To achieve this result, it will be necessary to slightly modify the Company's historic pattern of dividend declaration and payment dates. The Company plans to continue to pay its dividends quarterly, with the payment schedule for each quarter pushed back one month, to the end of November, February, May and August. This change would become effective for the fourth quarter 2004 dividend payment, which was previously expected to be paid in October, and would now be declared in October and paid in November.

In 2003, the Company recorded its 33rd consecutive year of annual growth in its dividend payment. As a result of the \$.11 per share dividend paid in July 2004, the Company is on track to continue this consecutive growth trend for 2004. The timing and amount of future dividend increases are at the discretion of the Board of Directors and will depend on, among other things, the Company's capital structure objectives and cash requirements.

In July 2000, the Board of Directors authorized \$350 million for share repurchases. For the six months ended June 30, 2004, the Company repurchased approximately \$41 million of its shares with almost all of that activity occurring in the first quarter. There remains approximately \$104 million available for repurchases under the July 2000 authorization. The Company's current expectation is that full year 2004 repurchases will approximate last year's level. The actual level of repurchases will be based on operating trends and business acquisition opportunities, and will be consistent with the Company's strategy to retain its investment grade status.

LIQUIDITY

Cash and short and long-term marketable securities totaled approximately \$361 million at June 30, 2004, with approximately \$276 million of that amount required to support regulatory requirements at American Home Shield and for other purposes. Total debt was \$816 million at June 30, 2004, slightly below the prior year end

19

amount and the lowest level since March of 1997. Approximately 65 percent of the Company's debt matures beyond five years and 35 percent beyond fifteen years. The Company's next public debt maturity of approximately \$138 million is in April 2005. The Company has both the intent and ability to pay this debt with other long term financing.

Management believes that funds generated from operating activities and other existing resources will continue to be adequate to satisfy ongoing working capital needs of the Company. During the second quarter of 2004, the Company replaced its previous \$490 million credit facility with a new five-year revolving credit facility for \$500 million expiring in May 2009. As of June 30, 2004, the Company had issued approximately \$154 million of letters of credit under this facility and had unused commitments of approximately \$346 million. The Company also has \$550 million of senior unsecured debt and equity securities available for issuance under an effective shelf registration statement. In addition, the Company has an arrangement enabling it to sell, on a revolving basis, certain receivables to unrelated third party purchasers. At June 30, 2004, there were no receivables outstanding that had been sold to third parties. The agreement is a 364-day facility that is renewable at the option of the purchasers. The Company may sell up to \$65 million of its receivables to these purchasers in the future and therefore has immediate access to cash proceeds from these sales. The amount of the eligible receivables varies during the year based on seasonality of the business and will at times limit the amount

Edgar Filing: SERVICEMASTER CO - Form 10-Q

available to the Company.

As described in the Company's latest Annual Report to Shareholders, the Company is party to a number of debt agreements that require it to maintain certain financial and other covenants, including limitations on indebtedness and interest coverage ratio. In addition, under certain circumstances, the agreements may limit the Company's ability to pay dividends and repurchase shares of common stock. These limitations are not expected to be a factor in the Company's future dividend and share repurchase plans. Failure by the Company to maintain these covenants could result in the acceleration of the maturity of the debt. At June 30, 2004, the Company was in compliance with the covenants related to these debt agreements and based on its operating outlook for the remainder of 2004, expects to be able to maintain compliance in the future.

The Company maintains operating lease facilities with banks with approximately \$95 million of total availability which provide for the acquisition and development of branch properties to be leased by the Company. There are residual value guarantees of these properties for up to 82 percent of their fair market value. At June 30, 2004, there was approximately \$73 million funded under these facilities. Approximately \$20 million of these leases have been included on the balance sheet as assets with related debt as of June 30, 2004 and December 31, 2003. Of the \$95 million available, \$80 million expires in October 2004 and \$15 million expires in January 2008. The Company intends to refinance the existing facility which expires in October 2004. If the Company does not refinance the facility it may be required to purchase the leased assets which total approximately \$53 million.

The majority of the Company's fleet and some equipment are leased through operating leases. The lease terms are non-cancelable for the first twelve month term, and then are month-to-month, cancelable at the Company's option. There are residual value guarantees (ranging from 70 percent to 87 percent depending on the agreement) on these vehicles and equipment, which historically have not resulted in significant net payments to the lessors. At June 30, 2004, there was approximately \$248 million of residual value relating to the Company's fleet and equipment leases.

The Company's 2003 Annual Report included disclosure of the Company's contractual obligations and commitments as of December 31, 2003. The Company continues to make the contractually required payments and therefore, the 2004 obligations and commitments as listed in the December 31, 2003 Annual Report have been reduced by the required payments. The Company's Board of Directors has authorized commitments for telecommunication services. These agreements, which are in the process of being finalized, total approximately \$30 million to be paid over the next three years.

FINANCIAL POSITION - CONTINUING OPERATIONS

Receivables increased from year-end levels, reflecting general business growth and increased seasonal activity. Prepaid expenses and other assets increased from year end primarily reflecting preseason advertising costs and annual repairs and maintenance procedures that are performed in the first quarter at TruGreen ChemLawn and advertising at Terminix. These costs are deferred and recognized over the production season

and are not deferred beyond the calendar year end. Deferred customer acquisition costs increased reflecting the seasonality in the lawn care operations. In the winter and early spring, this business sells a series of lawn applications to customers which are rendered primarily in March through October. The lawn care

Edgar Filing: SERVICEMASTER CO - Form 10-Q

operations incur incremental selling expenses at the beginning of the year that directly relate to successful sales in which the revenue will be recognized in later quarters. These costs are deferred and recognized over the production season and are not deferred beyond the calendar year-end. Property and equipment increased slightly from year-end levels, reflecting general business growth. Income taxes payable at June 30, 2004 reflects the Company's 2004 estimated federal tax payment expected to be made in the third quarter. Deferred revenue increased from year-end levels, reflecting the impact from the seasonal volume of termite baiting sales and strong growth in customer prepayments at TruGreen ChemLawn. The Company does not have any material capital commitments at this time.

The Company has minority investors in Terminix. This minority ownership reflects an interest issued to Allied Bruce Terminix Companies in connection with the acquisition of its business in 2001. This equity security is convertible into eight million ServiceMaster common shares. The ServiceMaster shares are considered in the shares used for the calculation of diluted earnings per share.

Total shareholders' equity was \$804 million at June 30, 2004 and \$817 million at December 31, 2003. The decrease primarily reflects earnings in the business offset by cash dividend payments and share repurchases.

Dividends paid in 2003 on the Company's common stock were not taxable to shareholders as dividend income for federal income tax purposes, but instead were treated as a non-taxable return of capital. Under federal tax rules, dividends are considered taxable only when paid out of current or accumulated earnings and profits as defined under federal tax laws. As a result of its December 1997 reincorporation, the Company only began generating corporate earnings and profits for tax purposes in 1998. Since 1998, earnings and profits for tax purposes have been reduced by dividend payments, amortization of intangible assets for tax reporting, deductions relating to business closures and the timing of certain other tax-related items. The Company currently expects that approximately 70 percent of its 2004 dividends on common stock will be taxable as dividend income for federal income tax purposes. The Company currently expects that the taxable portion of its dividend income will grow to be fully taxable by the year 2007.

FINANCIAL POSITION - DISCONTINUED OPERATIONS

The assets and liabilities related to discontinued businesses have been classified in separate captions on the Consolidated Statements of Financial Position. Assets from the discontinued operations have declined slightly from year-end levels representing collections on receivables. The remaining liabilities primarily represent obligations related to long-term self-insurance claims.

FORWARD-LOOKING STATEMENTS

THE COMPANY'S ANNUAL REPORT CONTAINS OR INCORPORATES BY REFERENCE STATEMENTS CONCERNING FUTURE RESULTS AND OTHER MATTERS THAT MAY BE DEEMED TO BE "FORWARD-LOOKING STATEMENTS" WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995. THE COMPANY INTENDS THAT THESE FORWARD-LOOKING STATEMENTS, WHICH LOOK FORWARD IN TIME AND INCLUDE EVERYTHING OTHER THAN HISTORICAL INFORMATION, BE SUBJECT TO THE SAFE HARBORS CREATED BY SUCH LEGISLATION. THE COMPANY NOTES THAT THESE FORWARD-LOOKING STATEMENTS INVOLVE RISKS AND UNCERTAINTIES THAT COULD AFFECT ITS RESULTS OF OPERATIONS, FINANCIAL CONDITION OR CASH FLOWS. FACTORS THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED IN A FORWARD-LOOKING STATEMENT INCLUDE THE FOLLOWING (AMONG OTHERS): WEATHER CONDITIONS THAT AFFECT THE DEMAND FOR THE COMPANY'S SERVICES; COMPETITION IN THE MARKETS SERVED BY THE COMPANY; LABOR SHORTAGES OR INCREASES IN WAGE RATES; UNEXPECTED INCREASES IN OPERATING COSTS, SUCH AS HIGHER INSURANCE AND SELF INSURANCE AND HEALTH CARE COSTS; HIGHER FUEL PRICES; INCREASED GOVERNMENTAL REGULATION INCLUDING TELEMARKETING; GENERAL

Edgar Filing: SERVICEMASTER CO - Form 10-Q

ECONOMIC CONDITIONS IN THE UNITED STATES, ESPECIALLY AS THEY MAY AFFECT HOME SALES OR CONSUMER SPENDING LEVELS; TIME AND EXPENSES ASSOCIATED WITH INTEGRATING AND WINDING DOWN BUSINESSES; AND OTHER FACTORS DESCRIBED FROM TIME TO TIME IN DOCUMENTS FILED BY THE COMPANY WITH THE SECURITIES AND EXCHANGE COMMISSION.

21

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The economy and its impact on discretionary consumer spending, labor wages, fuel prices, insurance costs and medical inflation rates could be significant to future operating earnings.

The Company does not hold or issue financial instruments for trading or speculative purposes. The Company has entered into specific financial arrangements, primarily fuel hedges, in the normal course of business to manage certain market risks, with a policy of matching positions and limiting the terms of contracts to relatively short durations. The effect of derivative financial instrument transactions is not material to the Company's financial statements.

In December 2003 and January 2004, the Company entered into interest rate swap agreements with a total notional amount of \$165 million. Under the terms of these agreements, the Company pays a floating rate of interest (based on a specified spread over six-month LIBOR) on the notional amount and the Company receives a fixed rate of interest at 7.88% on the notional amount. The impact of these swap transactions was to convert \$165 million of the Company's debt from a fixed rate of 7.88% to a variable rate based on LIBOR.

The Company generally maintains the majority of its debt at fixed rates. After the effect of the interest swap agreements, approximately 78 percent of total debt at June 30, 2004 was at a fixed rate. With respect to other obligations, the payments on the approximately \$73 million of funding outstanding under the Company's real estate operating lease facilities as well as its fleet and equipment operating leases (approximately \$248 million in residual value) are tied to floating interest rates. The Company's exposure to interest expense based on floating rates is partially offset by floating rate investment income earned on cash and marketable securities. The Company believes its overall exposure to interest rate fluctuations is not material to its overall results of operations.

The Company has several debt and lease agreements where the interest rate or rent payable under the agreements automatically adjusts based on changes in the Company's credit ratings. While the Company is not currently expecting a change in its credit ratings, based on amounts outstanding at June 30, 2004, a one rating category improvement in the Company's credit ratings would reduce annual pre-tax expense by approximately \$0.8 million. A one rating category reduction in the Company's credit ratings would increase pre-tax expense on an annualized basis by approximately \$0.9 million.

The following table summarizes information about the Company's fixed rate debt as of December 31, 2003, including the principal cash payments and related weighted-average interest rates by expected maturity dates. The fair-value of the Company's fixed rate debt was approximately \$862 million at December 31, 2003.

Edgar Filing: SERVICEMASTER CO - Form 10-Q

	Expected Maturity Date						
(In millions)	2004	2005	2006	2007	2008	There- after	Total
Fixed rate debt	\$28	\$151	\$12	\$60	\$8	\$540	\$799
Avg. rate	4.8%	8.3%	6.0%	6.7%	6.1%	7.7%	7.6%

As previously discussed, the Company has entered into interest rate swap agreements, the impact of which was to convert \$165 million of the Company's 2009 maturity debt from a fixed rate of 7.88% to a variable rate based on LIBOR.

22

CONTROLS AND PROCEDURES

The Company's Chairman and Chief Executive Officer, Jonathan P. Ward, and the Company's President and Chief Financial Officer, Ernest J. Mrozek, have evaluated the Company's disclosure controls and procedures as of the end of the period covered by this report.

The Company's disclosure controls and procedures include a roll-up of financial and non-financial reporting that is consolidated in the principal executive office of the Company in Downers Grove, Illinois. The reporting process is designed to ensure that information required to be disclosed by the Company in the reports that it files with or submits to the Securities and Exchange Commission is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Messrs. Ward and Mrozek have concluded that both the design and operation of the Company's disclosure controls and procedures are effective.

There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

23

PART II. OTHER INFORMATION

ITEM 2: CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

SHARE REPURCHASES:

In July 2000, the Board of Directors authorized \$350 million for share repurchases. The following table summarizes the Company's common stock share repurchases for the three months ended June 30, 2004 under its share repurchase authorization. Decisions relating to any future share repurchases will depend on

Edgar Filing: SERVICEMASTER CO - Form 10-Q

various factors such as the Company's commitment to maintain investment grade credit ratings and other strategic investment opportunities.

	Total Number of Shares Purchased (a)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan
April 1, 2004 through April 30, 2004	-	\$ -	-
May 1, 2004 through May 31, 2004	530	\$ 11.85	530
June 1, 2004 through June 30, 2004	-	\$ -	-
Total	530	\$ 11.85	530

(a) Does not include 2,321 shares acquired from employees in connection with the settlement of income tax and related withholding obligations arising from the exercise of stock options or vesting of restricted stock grants.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

(a) The Company's 2004 Annual Meeting of Shareholders ("Annual Meeting") was held on April 30, 2004 in Downers Grove, Illinois.

(b) The following persons were elected as Class of 2007 directors:

NAME	VOTES FOR	VOTES WITHHELD	BROKER NON-VOTES
Brian Griffiths	236,437,014	13,077,337	N/A
Sidney E. Harris	240,437,841	9,076,510	N/A
James D. McLennan	240,303,451	9,210,900	N/A

No votes were cast for any other nominee for directors. The Class of 2005 continuing in office are: Paul W. Berezny, Jr., Roberto R. Herencia, Betty Jane Scheihing and Jonathan P. Ward. The Class of 2006 continuing in office are: John L. Carl, Herbert P. Hess, Dallen W. Peterson and David K. Wessner.

Subsequent to the Annual Meeting, Herbert P. Hess retired from the Board of Directors and the Board of Directors elected Coleman H. Peterson to the Class of 2005.

Edgar Filing: SERVICEMASTER CO - Form 10-Q

(c) The shareholders also voted on three proposals at the Annual Meeting. The following table shows the vote tabulation for the shares represented at the meeting:

24

Proposal	Votes For	Votes Against	Votes Abstained
Ratification of Deloitte & Touche's selection as independent auditor	242,865,722	5,486,433	1,162,13
Approval of the ServiceMaster 2004 Employee Stock Purchase Plan	185,065,463	9,473,614	3,651,13
Shareholder proposal relating to Rights Plan	122,904,731	71,864,739	3,420,72

ITEM 6(A): EXHIBITS

EXHIBIT NO.	DESCRIPTION OF EXHIBIT
4.1	\$500,000,000 Credit Agreement among the ServiceMaster Company, the lenders, JPMorgan Chase Bank and Bank of America N.A. as syndication agents, SunTrust Bank as administrative agent, and U.S. Bank and Wachovia Bank N.A. as documentation agents dated as of May 19, 2004
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a - 14(a) or 15d - 14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a - 14(a) or 15d - 14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

ITEM 6(B): REPORTS ON FORM 8-K

A report on Form 8-K was furnished on April 28, 2004. The purpose of the report was to provide under Item 12, the press release issued by the Company on April 28, 2004 announcing the financial results for the first quarter of 2004.

SIGNATURE

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

Date: August 9, 2004

THE SERVICEMASTER COMPANY
(Registrant)

By: /S/ ERNEST J. MROZEK

Ernest J. Mrozek
President and Chief Financial Officer