

MCGRATH RENTCORP
Form 10-Q
August 03, 2006

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

FORM 10-Q

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

For the quarterly period ended June 30, 2006

Commission file number 0-13292

McGRATH RENTCORP

(Exact name of registrant as specified in its Charter)

California
(State or other jurisdiction of
incorporation or organization)

5700 Las Positas Road, Livermore, CA 94551-7800

94-2579843
(I.R.S. Employer
Identification No.)

(Address of principal executive offices)

Registrant's telephone number: (925) 606-9200

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

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

At August 3, 2006, 24,964,032 shares of Registrant's Common Stock were outstanding.

FORWARD LOOKING STATEMENTS

Statements contained in this Quarterly Report on Form 10-Q which are not historical facts are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. All statements, other than statements of historical facts regarding McGrath RentCorp's (the Company's) business strategy, future operations, financial position, estimated revenues or losses, projected costs, prospects, plans and objectives are forward looking statements. These forward-looking statements appear in a number of places and can be identified by the use of forward-looking terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, future, intend, hopes or certain or the negative of these terms or other variations or comparable terminology.

Management cautions that forward-looking statements are subject to risks and uncertainties that could cause our actual results to differ materially from those projected in such forward-looking statements including, without limitation, the following: the future prospects for and growth of the Company and the industries in which it operates, the level of the Company's future rentals and sales and customer demand, the Company's ability to maintain its business model; the Company's ability to maintain its competitive strengths and to effectively compete against its competitors; the Company's short-term decisions and long-term strategies for the future and its ability to implement and maintain such decisions and strategies, including its strategies (i) to actively maintain and repair rental equipment cost effectively and to maximize the level of proceeds from the sale of such products and (ii) to create internal facilities and infrastructure capabilities that can provide prompt and efficient customer service, experienced assistance, rapid delivery and timely maintenance of the Company's equipment; utilization rates for the Company's rental equipment; the level of future warranty costs on sales of modular equipment; the effect of delays or interruptions in the passage of statewide and local facility bond measures and the effect of such interruptions on the Company's operations; the effect of changes in applicable law and policies relating to the use of temporary buildings on the Company's modular rental and sales revenues, including with respect to class size and building standards; the effects of changes in the level of state funding to public schools and the use of classrooms that meet the Department of Housing requirements; the Company's ability to maintain and upgrade modular equipment to comply with changes in applicable law; the timing and amounts of future capital expenditures and the Company's ability to meet its needs for working capital including its ability to negotiate lines of credit, and capital expenditures through 2006 and beyond; interest rate fluctuations; the effect of changes to the Company's accounting policies (including critical accounting policies) and impact of evolving interpretation and implementation of such policies, including with respect to stock option expensing under SFAS No. 123(R), depreciation, maintenance and refurbishment and impairment; the impact of a change in the Company's overall effective tax rate as a result of the Company's mix of business levels in various tax jurisdictions in which it does business; the impact of the outcome of pending legal proceedings; the adequacy of our insurance coverage; our ability to track technology trends to make good buy-sell decisions with respect to electronic test equipment; and the Company's ability to pass on increases in its costs of rental equipment, including manufacturing costs, operating expenses and interest expense through increases in rental rates and selling prices. Further, our future business, financial condition and results of operations could differ materially from those anticipated by such forward-looking statements and are subject to risks and uncertainties including the risks set forth above and the Risk Factors set forth in this Form 10-Q. Moreover, neither we assume nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements.

Forward-looking statements are made only as of the date of this Form 10-Q and are based on management's reasonable assumptions, however these assumptions can be wrong or affected by known or unknown risks and uncertainties. No forward-looking statement can be guaranteed and subsequent facts or circumstances may contradict, obviate, undermine or otherwise fail to support or substantiate such statements. Readers should not place undue reliance on these forward-looking statements and are cautioned that any such forward-looking statements are not guarantees of future performance. We are under no duty to update any of the forward-looking statements after the date of this Form 10-Q to conform such statements to actual results or to changes in our expectations.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of McGrath RentCorp and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of McGrath RentCorp and Subsidiaries as of June 30, 2006, and the related statements of income for the three-month periods ended June 30, 2006 and 2005 and the statements of income and cash flows for the six-month periods ended June 30, 2006 and 2005. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the United States Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2005, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 8, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Grant Thornton LLP

San Francisco, CA

August 1, 2006

McGRATH RENTCORP

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

<i>(in thousands, except per share amounts)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues				
Rental	\$ 41,168	\$ 36,801	\$ 80,839	\$ 72,760
Rental Related Services	7,099	6,235	14,166	11,510
Rental Operations	48,267	43,036	95,005	84,270
Sales	11,769	20,135	22,267	31,107
Other	637	694	1,257	1,426
Total Revenues	60,673	63,865	118,529	116,803
Costs and Expenses				
Direct Costs of Rental Operations				
Depreciation of Rental Equipment	11,314	10,762	22,172	22,327
Rental Related Services	4,748	4,161	9,708	7,732
Other	9,763	7,479	17,769	14,724
Total Direct Costs of Rental Operations	25,825	22,402	49,649	44,783
Costs of Sales	8,559	14,844	15,888	22,408
Total Costs	34,384	37,246	65,537	67,191
Gross Profit	26,289	26,619	52,992	49,612
Selling and Administrative	10,802	9,420	22,356	18,981
Income from Operations	15,487	17,199	30,636	30,631
Interest	2,773	1,912	5,126	3,631
Income Before Provision for Income Taxes	12,714	15,287	25,510	27,000
Provision for Income Taxes	4,078	5,809	9,069	10,260
Income Before Minority Interest	8,636	9,478	16,441	16,740
Minority Interest in Income (Loss) of Subsidiary	(33)	12	(65)	97
Net Income	\$ 8,669	\$ 9,466	\$ 16,506	\$ 16,643
Earnings Per Share:				
Basic	\$ 0.35	\$ 0.38	\$ 0.66	\$ 0.68
Diluted	\$ 0.34	\$ 0.38	\$ 0.66	\$ 0.66
Shares Used in Per Share Calculation:				
Basic	24,956	24,627	24,911	24,600
Diluted	25,209	25,224	25,211	25,177

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

McGRATH RENTCORP

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

<i>(in thousands)</i>	June 30, 2006	December 31, 2005
Assets		
Cash	\$ 385	\$ 276
Accounts Receivable, net of allowance for doubtful accounts of \$1,000 in 2006 and 2005	53,644	63,702
Rental Equipment, at cost:		
Relocatable Modular Buildings	439,615	408,227
Electronic Test Equipment	175,633	154,708
	615,248	562,935
Less Accumulated Depreciation	(172,648)	(156,502)
Rental Equipment, net	442,600	406,433
Property, Plant and Equipment, net	56,461	56,008
Prepaid Expenses and Other Assets	17,650	16,019
Total Assets	\$ 570,740	\$ 542,438
Liabilities and Shareholders' Equity		
Liabilities:		
Notes Payable	\$ 189,500	\$ 163,232
Accounts Payable and Accrued Liabilities	49,259	51,690
Deferred Income	19,936	27,410
Minority Interest in Subsidiary	3,134	3,199
Deferred Income Taxes, net	98,307	98,438
Total Liabilities	360,136	343,969
Shareholders' Equity:		
Common Stock, no par value - Authorized 40,000 shares		
Issued and Outstanding 24,964 shares in 2006 and 24,832 shares in 2005	29,839	26,224
Retained Earnings	180,765	172,245
Total Shareholders' Equity	210,604	198,469
Total Liabilities and Shareholders' Equity	\$ 570,740	\$ 542,438

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

McGRATH RENTCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

<i>(in thousands)</i>	Six Months Ended June 30,	
	2006	2005
Cash Flows from Operating Activities:		
Net Income	\$ 16,506	\$ 16,643
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Depreciation	23,223	23,477
Provision for Doubtful Accounts	171	219
Non-Cash Stock Compensation	1,548	
Gain on Sale of Rental Equipment	(4,134)	(4,910)
Change In:		
Accounts Receivable	9,887	(8,265)
Prepaid Expenses and Other Assets	(1,631)	(887)
Accounts Payable and Accrued Liabilities	4,375	(1,420)
Deferred Income	(7,474)	(4,579)
Deferred Income Taxes	(131)	5,392
Net Cash Provided by Operating Activities	42,340	25,670
Cash Flows from Investing Activities:		
Purchase of Rental Equipment	(71,047)	(49,272)
Purchase of Property, Plant and Equipment	(1,505)	(1,098)
Proceeds from Sale of Rental Equipment	9,457	15,481
Net Cash Used in Investing Activities	(63,095)	(34,889)
Cash Flows from Financing Activities:		
Net Borrowings Under Bank Lines of Credit	26,268	14,112
Proceeds from the Exercise of Stock Options	1,441	1,265
Excess Tax Benefit from Exercise and Disqualifying Disposition of Stock Options	626	428
Payment of Dividends	(7,471)	(6,146)
Net Cash Provided by Financing Activities	20,864	9,659
Net Increase in Cash	109	440
Cash Balance, beginning of period	276	189
Cash Balance, end of period	\$ 385	\$ 629
Interest Paid, during the period	\$ 5,017	\$ 3,637
Income Taxes Paid, during the period	\$ 8,573	\$ 5,592
Dividends Declared, not yet paid	\$ 3,994	\$ 3,452
Rental Equipment Acquisitions, not yet paid	\$ 7,308	\$ 9,842

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

McGRATH RENTCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006

NOTE 1. CONSOLIDATED FINANCIAL INFORMATION

The consolidated financial information for the six months ended June 30, 2006 and 2005 have not been audited, but in the opinion of management, all adjustments (consisting of only normal recurring accruals, consolidation and eliminating entries) necessary for the fair presentation of the consolidated results of operations, financial position, and cash flows of McGrath RentCorp (the Company) have been made. The consolidated results for the six months ended June 30, 2006 should not be considered as necessarily indicative of the consolidated results for the entire year. It is suggested that these consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company's latest Form 10-K.

NOTE 2. STOCK-BASED COMPENSATION

The Company maintains a stock option plan under which 4,000,000 shares are reserved for the grant of options to purchase common stock to directors, officers and employees of McGrath RentCorp. The plan provides for the award of options at a price not less than the fair market value of the stock as determined by the Board of Directors on the date the options are granted. Most options vest over 5 years and expire 10 years after grant. As of June 30, 2006, 3,629,500 options have been granted with exercise prices ranging from \$7.81 to \$29.56, options have been exercised for the purchase of 1,094,300 shares, options for 385,300 have been terminated, and 2,149,900 shares remain outstanding under the plan. As of June 30, 2006, 755,800 options remain available to issue under the plan.

Beginning on January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R) under the modified prospective method, which requires the expensing of employee stock options at fair value. Under the modified prospective method, compensation expense recognized included the estimated expense for stock options granted on and subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R, and the estimated expense for the portion vesting in the period for options granted prior to, but not vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 Accounting for Stock-Based Compensation (SFAS No. 123). Results for prior periods have not been restated, as provided for under the modified prospective method. Prior to the adoption of SFAS No. 123R, the Company used the intrinsic method of valuing share-based payment transactions allowed under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. Accordingly, because the stock option grant price equaled the market price on the date of grant, no compensation expense was recognized by the Company for stock-based compensation. As permitted by the original provisions of SFAS No. 123, stock-based compensation was historically included as a pro forma disclosure in the notes to the consolidated financial statements.

The Company utilizes the Black-Scholes option pricing model to estimate the fair value of employee stock-based compensation at the date of grant, which requires the use of accounting judgment and financial estimates, including estimates of the expected term option holders will retain their vested stock options before exercising them, the estimated volatility of the Company's stock price over the expected term and the number of options that will be forfeited prior to the completion of their vesting requirements. Application of alternative assumptions could produce significantly different estimates of the fair value of stock-based compensation and consequently, the related amounts recognized in the Consolidated Statements of Income.

For the six months ended June 30, 2006, the non-cash stock-based compensation expense included in Selling and Administrative Expenses in the Consolidated Statements of Income was \$1.5 million, before provision for income taxes. The Company recorded a tax benefit of approximately \$0.6 million related to the aforementioned stock-based compensation expense. The stock-based compensation expense, net of taxes, reduced net income by \$0.9 million, or \$0.04 per diluted share. Tax benefits resulting from the exercise of non-qualified stock options and disqualifying dispositions of incentive stock options were \$0.6 million and \$0.4 million for the

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

six months ended June 30, 2006 and 2005, respectively, and are included as a financing cash inflow in the Consolidated Statements of Cash Flows.

The following table shows on a pro forma basis the effect on net income and earnings per share for the three and six months ended June 30, 2005 had compensation cost for the stock-based compensation plans been determined based upon the fair value at grant in accordance with SFAS No. 123R:

<i>(in thousands, except per share amounts)</i>	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net Income, as reported	\$ 9,466	\$ 16,643
Pro Forma Compensation Charge	(394)	(787)
Pro Forma Net Income	\$ 9,072	\$ 15,856
Earnings Per Share:		
Basic as reported	\$ 0.38	\$ 0.68
Basic pro forma	\$ 0.37	\$ 0.64
Diluted as reported	\$ 0.38	\$ 0.66
Diluted pro forma	\$ 0.36	\$ 0.63

The following table summarizes stock option activity for the six months ended June 30, 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Options outstanding at December 31, 2005	1,852,054	\$ 17.30		
Options granted	465,500	29.34		
Options exercised	(131,804)	10.93		
Options terminated	(35,850)	22.24		
Options outstanding at June 30, 2006	2,149,900	20.21	8.04	\$ 16,339,240
Options exercisable at June 30, 2006	712,175	15.50	6.93	\$ 8,766,874

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company's common stock. The aggregate intrinsic value of options outstanding as of June 30, 2006 was \$16.3 million. The aggregate intrinsic value of options vested as of June 30, 2006 was \$8.8 million. The aggregate intrinsic value of options exercised under our stock option plans was \$2.4 million and \$1.4 million for the six months ended June 30, 2006 and 2005, respectively, determined as of the date of option exercise. As of June 30, 2006, there was approximately \$8.0 million of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under our option plan. That cost is expected to be recognized over a weighted-average period of 3.5 years.

The following table indicates the options outstanding and options exercisable by exercise price with the weighted average remaining contractual life for the options outstanding and the weighted average exercise price at June 30, 2006:

Exercise Price	Number Outstanding at June 30, 2006	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contract Life (Years)	Weighted Average Exercise Price	Number Exercisable at June 30, 2006	Weighted Average Exercise Price
\$ 5 10	103,600	4.17	\$ 8.99	103,600	\$ 8.99
10 15	411,100	6.33	11.80	239,275	11.91
15 20	435,500	7.76	15.72	143,850	15.62
20 25	622,200	8.59	22.27	225,450	22.25
25 30	577,500	9.57	29.38		
5 30	2,149,900	8.04	20.21	712,175	15.50

The fair value of each option award granted was estimated at the date of grant using the Black-Scholes option pricing model using the following weighted average assumptions:

	Six Months Ended June 30,	
	2006	2005
Expected term (in years)	5.2	5.2
Expected volatility	30.2%	38.2%
Risk-free interest rates	4.4%	3.7%
Expected dividend yields	1.9%	2.4%

The expected term of the options represents the estimated period of time until exercised and is based on historical experience, giving consideration to the option terms, vesting schedules and expectations of future employee behavior. Expected stock volatility is based on historical stock price volatility of the Company and the risk free interest rates are based on U. S. Treasury yields in effect on the date of the option grant for the estimated period the options will be outstanding. The expected dividend yield is based upon the current dividend annualized as a percentage of the grant exercise price.

The weighted average grant-date fair value of options granted in the six months ended June 30, 2006 and 2005 was \$8.40 and \$7.05 per share, respectively.

NOTE 3. NEW ACCOUNTING PRONOUNCEMENT

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation Number 48, Accounting for Uncertainty in Income Taxes, (FIN48) an Interpretation of SFAS No. 109, Accounting for Income Taxes . FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company must determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. FIN 48 applies to all tax positions related to income taxes subject to SFAS No. 109. The interpretation clearly scopes out income tax positions related to SFAS No. 5, Accounting for Contingencies . We will adopt the provisions of this statement beginning in the first quarter of 2007. We are currently evaluating the effect the adoption of this statement will have on our financial position and results of operations.

NOTE 4. EARNINGS PER SHARE

Basic earnings per share (EPS) is computed as net income divided by the weighted average number of shares of common stock outstanding for the period. Diluted EPS is computed as net income divided by the weighted average number of shares outstanding of common stock and common stock equivalents for the period, including the dilutive effects of stock options and other potentially dilutive securities. Common stock equivalents result from dilutive stock options computed using the treasury stock method and the average share price for the reported period. The effect of dilutive options on the weighted average number of shares for the three and six months ended June 30, 2006 and 2005 was 259,985 and 598,505, and 300,211 and 576,435, respectively. As of June 30, 2006, stock options to purchase 540,500 shares of the Company's common stock were not included in the computation of diluted EPS because the exercise price exceeded the average market price for the quarter and the effect would have been anti-dilutive. There were no anti-dilutive shares as of June 30, 2005.

NOTE 5. SEGMENT REPORTING

SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, establishes annual and interim reporting standards for an enterprise's operating segments and related disclosures about its products, services, geographic areas and major customers. In accordance with SFAS No. 131, the Company's three reportable segments are Mobile Modular Management Corporation (Modulars), TRS-RenTelco (Electronics), and Enviroplex. The operations of each of these segments are described in Note 1 - Organization and Business, and the accounting policies of the segments are described in Note 2 - Significant Accounting Policies of the Company's latest Form 10-K. Management focuses on several key measures to evaluate and assess each segment's performance including rental revenue growth, gross profit, and income before provision for income taxes. As a separate corporate entity, Enviroplex revenues and expenses are maintained separately from Modulars and Electronics. Excluding interest expense, allocations of revenue and expense not directly associated with Modulars or Electronics are generally allocated to these segments based on their pro-rata share of direct revenues. Interest expense is allocated between Modulars and Electronics based on their pro-rata share of average rental equipment, accounts receivable, deferred income and customer security deposits. The Company does not report total assets by business segment. Summarized financial information for the six months ended June 30, 2006 and 2005 for the Company's reportable segments is shown in the following table:

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

<i>(in thousands)</i>	Modulars	Electronics	Enviroplex ¹	Consolidated
Six Months Ended June 30, 2006				
Rental Revenues	\$ 43,010	\$ 37,829	\$	\$ 80,839
Rental Related Services Revenues	13,545	621		14,166
Sales and Other Revenues	12,456	8,598	2,470	23,524
Total Revenues	69,011	47,048	2,470	118,529
Depreciation of Rental Equipment	5,138	17,034		22,172
Gross Profit	33,365	19,224	403	52,992
Interest Expense (Income) Allocation	3,789	1,580	(243)	5,126
Income before Provision for Income Taxes	17,364	8,680	(534)	25,510
Rental Equipment Acquisitions	35,270	28,392		63,662
Accounts Receivable, net (period end)	32,237	18,493	2,914	53,644
Rental Equipment, at cost (period end)	439,615	175,633		615,248
Rental Equipment, net book value (period end)	335,390	107,210		442,600
Utilization (period end) ²	83.3%	71.3%		
Average Utilization ²	82.8%	70.3%		
2005				
Rental Revenues	\$ 38,612	\$ 34,148	\$	\$ 72,760
Rental Related Services Revenues	10,779	731		11,510
Sales and Other Revenues	14,081	14,345	4,107	32,533
Total Revenues	63,472	49,224	4,107	116,803
Depreciation of Rental Equipment	4,392	17,935		22,327
Gross Profit	31,758	16,234	1,620	49,612
Interest Expense (Income) Allocation	2,575	1,172	(116)	3,631
Income before Provision for Income Taxes	19,786	6,653	561	27,000
Rental Equipment Acquisitions	35,682	16,867		52,549
Accounts Receivable, net (period end)	37,451	19,514	4,927	61,892
Rental Equipment, at cost (period end)	371,592	151,162		522,754
Rental Equipment, net book value (period end)	274,704	103,675		378,379
Utilization (period end) ²	85.9%	66.5%		
Average Utilization ²	85.7%	63.1%		

¹ Gross Enviroplex sales revenues were \$3,337,000 and \$8,093,000 for the six months ended June 30, 2006 and 2005, respectively, which includes inter-segment sales to MMMC of \$867,000 and \$3,986,000, which are eliminated in consolidation.

² Utilization is calculated each month by dividing the cost of rental equipment on rent by the total cost of rental equipment excluding new equipment inventory and accessory equipment. The Average Utilization for the period is calculated using the average costs of rental equipment.

No single customer accounted for more than 10% of total revenues for the six months ended June 30, 2006 and 2005. In addition, total foreign country customers and operations accounted for less than 10% of the Company's revenues and long-lived assets for the same periods.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements under federal securities laws. Forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties. Our actual results could differ materially from those indicated by forward-looking statements as a result of various factors, including but not limited to those set forth under this Item, as well as those discussed in Part II Item 1A, Risk Factors, and elsewhere in this document and those that may be identified from time to time in our reports and registration statements filed with the Securities and Exchange Commission.

This discussion should be read in conjunction with the Consolidated Financial Statements and related Notes included in Part I Item 1 of this Quarterly Report on Form 10-Q and the Consolidated Financial Statements and related Notes and the Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 14, 2006.

General

The Company, incorporated in 1979, is a leading rental provider of modular buildings for classroom and office space, and test equipment for general purpose and communications needs. The Company's primary emphasis is on equipment rentals. The Company is comprised of three business segments: Mobile Modular Management Corporation (MMMC), its modular building rental division, TRS-RenTelco, its electronic test equipment rental division, and Enviroplex, its majority-owned subsidiary classroom manufacturing business. In the six months ended June 30, 2006, MMC, TRS-RenTelco and Enviroplex contributed 68%, 34% and negative 2% of the Company's income before provision for taxes (the equivalent of pretax income), respectively, compared to 73%, 25% and 2% for the same period in 2005. Although managed as a separate business unit, Enviroplex's revenues, pretax income contribution and total assets are not significant relative to the Company's consolidated financial position.

The Company generates the majority of its revenue from the rental of relocatable modular buildings and electronic test equipment on operating leases with sales of equipment occurring in the normal course of business. The Company requires significant capital outlay to purchase its rental inventory and recovers its investment through rental and sales revenues. Rental revenue and other services negotiated as part of the lease agreement with the customer and related costs are recognized on a straight-line basis over the term of the lease. Sales revenue and related costs are recognized upon delivery and installation of the equipment to the customer. Sales revenues are less predictable and can fluctuate quarter to quarter and year to year depending on customer demands and requirements. Generally, rents recover the equipment's capitalized cost in a short period of time relative to the equipment's rental life and when sold, sale proceeds recover a high percentage of its capitalized cost.

The Company's growth in rental assets has been primarily funded through internal cash flow and conventional bank financing. The Company presents EBITDA as management believes it provides useful information regarding the Company's liquidity and financial condition and because management, as well as the Company's lenders, use this measure in evaluating the performance of the business. EBITDA is defined by the Company as net income before minority interest in income of subsidiary, interest expense, provision for income taxes, depreciation, amortization, and non-cash stock compensation. In addition, several of the loan covenants and the determination of the interest rate related to the Company's revolving line of credit are expressed by reference to this financial measure, similarly calculated. EBITDA should not be considered in isolation or as a substitute for net income, cash flows, or other consolidated income or cash flow data prepared in accordance with generally accepted accounting principles in the United States or as a measure of the Company's profitability or liquidity. The Company's EBITDA may not be comparable to similarly titled measures presented by other companies. Since EBITDA is a non-GAAP financial measure as defined by the Securities and Exchange Commission, the following table reconciles EBITDA to the most directly comparable financial measures calculated and presented in accordance with accounting principles generally accepted in the United States for the three, six and twelve months ended June 30, 2006 and 2005.

Reconciliation of Net Income to EBITDA

<i>(dollar amounts in thousands)</i>	Three Months Ended June 30,		Six Months Ended June 30,		Twelve Months Ended June 30,	
	2006	2005	2006	2005	2006	2005
Net Income	\$ 8,669	\$ 9,466	\$ 16,506	\$ 16,643	\$ 40,682	\$ 34,781
Minority Interest in Income (Loss) of Subsidiary	(33)	12	(65)	97	100	174
Provision for Income Taxes	4,078	5,809	9,069	10,260	23,458	21,249
Interest	2,773	1,912	5,126	3,631	9,385	6,871
Income from Operations	15,487	17,199	30,636	30,631	73,625	63,075
Depreciation and Amortization	11,840	11,338	23,223	23,477	46,180	47,867
Non-Cash Stock Compensation	718		1,548		1,592	57
EBITDA ¹	\$ 28,045	\$ 28,537	\$ 55,407	\$ 54,108	\$ 121,397	\$ 110,999
EBITDA Margin ²	46%	45%	47%	46%	44%	45%
Funded Debt to EBITDA ³					1.56	1.50

¹ EBITDA is defined as net income before minority interest in income of subsidiary, interest expense, provision for income taxes, depreciation, amortization, and other non-cash stock compensation.

² EBITDA Margin is calculated as EBITDA divided by total revenues for the period.

³ Funded Debt to EBITDA is the ratio of notes payable as of the period end compared to the last twelve months of EBITDA. Significant risks of rental equipment ownership are borne by the Company, which include, but are not limited to, uncertainties in the market for its products over the equipment's useful life, use limitations for modular equipment related to updated building codes or legislative changes, technological obsolescence of electronic test equipment, and rental equipment deterioration. The Company believes it mitigates these risks by continued advocacy and collaboration with governing agencies and legislative bodies for ongoing use of its modular product, staying abreast of technology trends in order to make good buy-sell decisions of electronic test equipment, and ongoing investment in repair and maintenance programs to insure both types of rental equipment are in good operating condition.

The Company's modular revenues are primarily affected by demand for classrooms which in turn is affected by shifting and fluctuating school populations, the level of state and local funding to public schools, the need for temporary classroom space during reconstruction of older schools and changes in policies regarding class size. In particular, public schools in the State of California from time to time experience fluctuations in funding from the state. As a result of any reduced funding, lower expenditures by these schools may result in certain planned programs, including the demand for classrooms, such as the Company provides, to be postponed or terminated; however, there can be no assurance that such events will occur. Reduced expenditures may in fact result in schools reducing their long-term facility construction projects in favor of using the Company's modular classroom solutions. At this time, the Company can make no assurances as to whether public schools will either reduce or increase their demand for the Company's modular classrooms as a result of fluctuations in funding of public schools by the State of California. Looking forward, the Company believes that any interruption in the passage of facility bonds or contraction of class size reduction programs by public schools may have a material adverse effect on both rental and sales revenues of the Company. (For more information, see *Item 1. Business Relocatable Modular Buildings Classroom Rentals and Sales to Public Schools (K-12)* in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 and *Item 1A. Risk Factors A significant reduction of funding to public schools could cause the demand for our modular classroom units to decline, which could result in a reduction in our revenues and profitability*, in the Part II Other Information section of this Form 10-Q.)

Revenues of TRS-RenTelco are derived from the rental and sale of general purpose and communications test equipment to a broad range of companies, from Fortune 500 to middle and smaller market companies primarily in the electronics, communications, aerospace and defense industries. Electronics revenues are primarily affected by the business activity within these industries related to research and development, manufacturing, and communication infrastructure installation and maintenance.

The Company's rental operations include rental and rental related service revenues, which comprised approximately 80% and 72% of consolidated revenues for the six months ended June 30, 2006 and 2005 respectively. Of the total rental operations revenues for the six months ended June 30, 2006 and 2005, modulares comprised 60% and 59%, respectively, and electronics comprised 40% and 41%, respectively. The Company's direct costs of rental operations include depreciation of rental equipment, rental related service costs, impairment of rental equipment, and other direct costs of rental operations which include direct labor, supplies, repairs, insurance, property taxes, license fees and amortization of certain lease costs.

The Company also sells both modular and electronic test equipment that is new, previously rented, or manufactured by its majority owned subsidiary, Enviroplex. The renting and selling of some modular equipment requires a dealer's license, which the Company has obtained from the appropriate governmental agencies. For the six months ended June 30, 2006 and 2005, sales and other revenues of both modular and electronic test equipment comprised approximately 20% and 28%, respectively, of the Company's consolidated revenues. Of the total sales and other revenues for the six months ended June 30, 2006 and 2005, modulares comprised 63% and 56%, respectively, and electronics comprised 37% and 44%, respectively. The Company's cost of sales includes the carrying value of the equipment sold and the direct costs associated with the equipment sold such as delivery, installation, modifications and related site work.

Selling and administrative expenses primarily include personnel and benefit costs, (which includes non-cash stock-based compensation), depreciation and amortization, bad debt expense, advertising costs, and professional service fees. The Company believes that sharing of common facilities, financing, senior management, and operating and accounting systems by all of the Company's operations, results in an efficient use of overhead. Historically, the Company's operating margins have been impacted favorably to the extent its costs and expenses are leveraged over a large installed customer base. However, there can be no assurance as to the Company's ability to maintain a large installed customer base or ability to sustain its historical operating margins.

Recent Developments

On May 31, 2006, the Company announced that the board of directors declared a cash dividend of \$0.16 per common share for the quarter ended June 30, 2006, an increase of 14% over the prior year's comparable quarter.

In October 2005, the Company completed the purchase of 122 acres of land in Polk County, Florida for \$8.1 million. The Company intends to develop the land for use as a regional sales and inventory center to rent and sell and repair, refurbish and store modular rental equipment.

In July 2005, the Company amended its existing lines of credit to increase the borrowing capacity from \$135.0 million to \$195.0 million and extended the expiration date to June 30, 2008.

Results of Operations

Three Months Ended June 30, 2006 Compared to

Three Months Ended June 30, 2005

Overview

Consolidated revenues for the three months ended June 30, 2006 decreased \$3.2 million, or 5%, to \$60.7 million from \$63.9 million for the same period in 2005. Consolidated net income for the quarter decreased \$0.8 million, or 8% to \$8.7 million, or \$0.34 per diluted share, from \$9.5 million, or \$0.38 per diluted share, for the same period in 2005.

The Company adopted SFAS No. 123R effective January 1, 2006, which requires the expensing of employee stock options at estimated fair value. The second quarter 2006 included \$0.7 million of non-cash stock compensation expense required under SFAS No. 123R.

For the three months ended June 30, 2006, on a consolidated basis:

Gross profit decreased \$0.3 million, or 1%, to \$26.3 million from \$26.6 million for the same period in 2005, with gross profit of TRS-RenTelco increasing \$0.5 million, or 5%, due to higher gross profit on rents, MMMC decreasing \$0.4 million, or 3%, due to lower sales volume and lower gross margin percentage on rents and Enviroplex decreasing \$0.4 million, or 56%, primarily due to lower sales volume.

Selling and administrative expenses increased \$1.4 million, or 15% to \$10.8 million from \$9.4 million for the same period in 2005, as a result of higher personnel and benefit costs of \$1.4 million, which includes the impact of the non-cash stock compensation expense of \$0.7 million from the adoption of SFAS No. 123R effective January 1, 2006.

Interest expense increased \$0.9 million, or 45%, to \$2.8 million from \$1.9 million for the same period in 2005, due to 26% higher average interest rates of 6.0% compared to 4.8% in 2005 and 15% higher average debt levels of the Company.

Pre-tax income contribution by MMMC and TRS-RenTelco was 65% and 37%, respectively, compared to 69% and 31%, respectively, for the comparable 2005 period. These results are discussed on a segment basis below.

Provision for income taxes was reduced \$0.9 million during the second quarter 2006 to record the impact to the Company's deferred tax liability from a franchise tax law change enacted by the state of Texas in May 2006. As a result, the Company's effective tax rate was 32.1% compared with 38.0% during the same period in 2005. Excluding the impact of the Texas law change, the 2006 provision for income taxes was based on an effective tax rate of 39.0%. The Company's estimated effective tax rate is based on the 2006 expected revenue distribution by state, however, there can be no assurance that such expected business levels will be achieved in 2006, which may cause the Company's effective tax rate to change.

EBITDA decreased \$0.5 million, or 2%, to \$28.0 million compared to \$28.5 million in 2005, with TRS-RenTelco increasing \$0.7 million and MMMC and Enviroplex decreasing \$0.8 million and \$0.4 million, respectively, primarily due to lower sales volume.

MMMC

For the three months ended June 30, 2006, MMMC's total revenues decreased \$0.9 million, or 2%, to \$35.9 million over the same period in 2005, due to \$3.9 million lower sales revenue, offset by higher rental and rental related services revenues during the quarter. Higher operating expenses driven by increased labor and material costs were incurred to prepare a higher volume of used buildings to meet the continued market demand for California classroom inventory for the upcoming school year and increased demand for commercial projects.

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

In addition, higher personnel and benefit costs, including non-cash stock compensation expense related to the adoption of SFAS No. 123R, and allocated interest expense were incurred. The combined effect of the revenue decrease and increased expenses was a decrease in pre-tax income of \$2.2 million, or 21%, to \$8.3 million for the quarter ended June 30, 2006 from \$10.5 million for the same period in 2005.

The following table summarizes quarter over quarter results for each revenue and gross profit category, pre-tax income, and other selected data.

MMMC Segment Q2 2006 compared to Q2 2005 (Unaudited)

<i>(dollar amounts in thousands)</i>	Three Months Ended			
	June 30,		Increase (Decrease)	
	2006	2005	\$	%
Revenues				
Rental Revenues	\$ 21,602	\$ 19,586	\$ 2,016	10%
Rental Related Services	6,779	5,811	968	17%
Rental Operations	28,381	25,397	2,984	12%
Sales	7,332	11,185	(3,853)	-34%
Other	178	161	17	11%
Total Revenues	\$ 35,891	\$ 36,743	\$ (852)	-2%
Gross Profit				
Rental Revenues	\$ 11,858	\$ 12,158	\$ (300)	-2%
Rental Related Services	2,397	1,891	506	27%
Rental Operations	14,255	14,049	206	1%
Sales	1,793	2,439	(646)	-26%
Other	178	161	17	11%
Total Gross Profit	\$ 16,226	\$ 16,649	\$ (423)	-3%
Pre-tax Income	\$ 8,301	\$ 10,493	\$ (2,192)	-21%
Other Information				
Depreciation of Rental Equipment	\$ 2,618	\$ 2,228	\$ 390	18%
Interest Expense Allocation	2,043	1,363	680	50%
Average Rental Equipment ¹	\$ 372,051	\$ 329,024	\$ 43,027	13%
Average Rental Equipment on Rent ¹	307,599	281,787	25,812	9%
Average Monthly Total Yield ²	1.94%	1.98%		-2%
Average Utilization ³	82.7%	85.6%		-3%
Average Monthly Rental Rate ⁴	2.34%	2.32%		1%
Period End Rental Equipment ¹	\$ 375,227	\$ 337,564	\$ 37,663	11%
Period End Utilization ³	83.3%	85.9%		-3%
Period End Floors ¹	23,422	21,666	1,756	8%

¹ Average and Period End Rental Equipment represents the cost of rental equipment excluding new equipment inventory and accessory equipment. Period End Floors excludes new equipment inventory.

² Average Monthly Total Yield is calculated by dividing the averages of monthly rents by the cost of rental equipment, for the period.

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

- ³ Period End Utilization is calculated by dividing the cost of rental equipment on rent by the total cost of rental equipment excluding new equipment inventory and accessory equipment. Average Utilization for the period is calculated using the average costs of the rental equipment.
- ⁴ Average Monthly Rental Rate is calculated by dividing the averages of monthly rents by the cost of rental equipment on rent, for the period.
- MMMC's gross profit for the three months ended June 30, 2006 decreased \$0.4 million, or 3%, to \$16.2 million from \$16.6 million for the same period in 2005. For the three months ended June 30, 2006 compared to the same period in 2005:

Gross Profit on Rents - Rental revenues increased \$2.0 million, or 10%, over 2005, due to the continued education market demand for classrooms and the increased demand for commercial

projects. The rental revenue increase resulted from a 13% increase in average rental equipment, offset by a 2% lower average total yield. As a percentage of rents, depreciation was 12% in 2006 and 11% in 2005 and other direct costs of rental operations increased from 27% in 2005 to 33% in 2006, due to \$1.9 million higher inventory center labor and material costs to prepare a higher volume of used equipment for shipment and higher than customary field repairs, resulting in a lower gross margin percentage of 55% in 2006 compared to 62% in 2005. The higher rental revenues, offset by lower rental margins, resulted in gross profit on rents decreasing \$0.3 million, or 2%, to \$11.9 million from \$12.2 million in 2005.

Gross Profit on Rental Related Services Rental related services revenues increased \$1.0 million, or 17%, compared to 2005, primarily due to the ongoing demand for modular classrooms. Most of these service revenues are negotiated with the initial lease and are recognized on a straight-line basis with the associated costs over the initial term of the lease. The increase in rental related services revenues was primarily attributable to the mix of leases and associated service revenues within the initial lease term during 2006 as compared to 2005. Higher revenues and higher gross margin percentage of 35% in 2006 compared with 33% in 2005, resulted in rental related services gross profit increasing \$0.5 million, or 27%, to \$2.4 million from \$1.9 million in 2005.

Gross Profit on Sales Sales revenues decreased \$3.9 million, or 34%, compared to 2005. Sales occur routinely as a normal part of MMMC's rental business; however, these sales and related gross margins can fluctuate from quarter to quarter and year to year depending on customer requirements, equipment availability and funding. Lower sales revenues were offset by a higher gross margin percentage, 25% in 2006 compared to 22% in 2005, due to higher gross margin percentage on new and used equipment sales, which resulted in sales gross profit decreasing \$0.6 million, or 26%, to \$1.8 million from \$2.4 million in 2005.

For the three months ended June 30, 2006, selling and administrative expenses increased \$1.1 million, or 23%, to \$5.9 million from \$4.8 million in the same period in 2005, primarily due to higher personnel and employee benefit costs to support higher rental activity levels, which included \$0.4 million non-cash stock compensation expense related to the adoption of SFAS No. 123R, and represented 27% of rental revenues compared to 24% in 2005. Allocated interest expense for the second quarter of 2006 increased \$0.7 million, or 50%, to \$2.1 million from \$1.4 million for the comparable period in 2005, as a result of the Company's higher average interest rates and average debt levels in 2006.

TRS-RenTelco

For the three months ended June 30, 2006, TRS-RenTelco's total revenues decreased \$1.7 million, or 7%, to \$23.6 million compared to the same period in 2005, due to lower used equipment sales in 2006, as a result of having less underutilized rental equipment to sell. Despite the decrease in total revenues, pre-tax income remained at \$4.7 million for the three months ended June 30, 2006 and 2005, primarily due to higher gross profit on rental revenues.

The following table summarizes quarter over quarter results for each revenue and gross profit category, pre-tax income, and other selected data.

TRS-RenTelco Q2 2006 compared to Q2 2005 (Unaudited)

<i>(dollar amounts in thousands)</i>	Three Months Ended		Increase (Decrease)	
	June 30, 2006	2005	\$	%
Revenues				
Rental Revenues	\$ 19,566	\$ 17,215	\$ 2,351	14%
Rental Related Services	320	424	(104)	-25%
Rental Operations	19,886	17,639	2,247	13%
Sales	3,223	7,135	(3,912)	-55%
Other	459	533	(74)	-14%
Total Revenues	\$ 23,568	\$ 25,307	\$ (1,739)	-7%
Gross Profit				
Rental Revenues	\$ 8,233	\$ 6,402	\$ 1,831	29%
Rental Related Services	(46)	183	(229)	-125%
Rental Operations	8,187	6,585	1,602	24%
Sales	1,127	2,191	(1,064)	-49%
Other	459	533	(74)	-14%
Total Gross Profit	\$ 9,773	\$ 9,309	\$ 464	5%
Pre-tax Income	\$ 4,688	\$ 4,717	\$ (29)	-1%
Other Information				
Depreciation of Rental Equipment	\$ 8,696	\$ 8,534	\$ 162	2%
Interest Expense Allocation	862	600	262	44%
Average Rental Equipment ¹	\$ 167,478	\$ 149,771	\$ 17,707	12%
Average Rental Equipment on Rent ¹	119,061	96,278	22,783	24%
Average Monthly Total Yield ²	3.89%	3.83%		2%
Average Utilization ³	71.1%	64.3%		11%
Average Monthly Rental Rate ⁴	5.48%	5.96%		-8%
Period End Rental Equipment ¹	\$ 173,910	\$ 150,032	\$ 23,878	16%
Period End Utilization ³	71.3%	66.5%		7%

¹ Average and Period End Rental Equipment represents the cost of rental equipment excluding accessory equipment.

² Average Monthly Total Yield is calculated by dividing the averages of monthly rents by the cost of rental equipment, for the period.

- ³ Period End Utilization is calculated by dividing the cost of rental equipment on rent by the total cost of rental equipment excluding accessory equipment. Average Utilization for the period is calculated using the average costs of the rental equipment.
- ⁴ Average Monthly Rental Rate is calculated by dividing the averages of monthly rents by the cost of rental equipment on rent, for the period.

TRS-RenTelco's gross profit for the three months ended June 30, 2006 increased \$0.5 million, or 5%, to \$9.8 million from \$9.3 million for the same period in 2005. For the quarter ended June 30, 2006 compared to the same period in 2005:

Gross Profit on Rents Rental revenues increased \$2.4 million, or 14%, as compared to 2005, with depreciation expense increasing \$0.2 million, or 2%, resulting in increased gross profit on rents of \$1.8 million, or 29%, to \$8.2 million as compared to the same period in 2005. The increase in gross profit on rents is due to 24% higher average rental equipment on rent as compared to 2005, with average utilization of rental equipment increasing 11% from 64.3% in 2005 to 71.1% in 2006. Other direct costs of rental operations increased \$0.4 million, or 16%, due to higher repair and calibration costs in 2006 compared to the same period in 2005.

Gross Profit on Sales Sales revenues decreased \$3.9 million, or 55%, compared to 2005, as a result of having less underutilized rental equipment to sell. Sales occur routinely as a normal part of TRS-RenTelco's rental business; however, these sales and related gross margins can fluctuate from quarter to quarter depending on customer requirements, equipment availability and funding. Lower sales volume was partially offset by a higher gross margin percentage, 35% in 2006 compared to 31% in 2005, due to higher margin on used equipment sales resulting in sales gross profit decreasing \$1.1 million, or 49%, to \$1.1 million from \$2.2 million in 2005. For the three months ended June 30, 2006, selling and administrative expenses increased \$0.2 million, or 6%, to \$4.2 million from \$4.0 million in the same period in 2005, primarily due to \$0.3 million non-cash stock compensation expense related to the adoption of SFAS No. 123R. Allocated interest expense for the second quarter 2006 increased \$0.3 million, or 44%, to \$0.9 million from \$0.6 million for the same period in 2005, as a result of the Company's higher average interest rates and average debt levels in 2006.

Six Months Ended June 30, 2006 Compared to

Six Months Ended June 30, 2005

Overview

Consolidated revenues for the six months ended June 30, 2006 increased \$1.7 million, or 1%, to \$118.5 million from \$116.8 million for the same period in 2005. Consolidated net income for the six months ended June 30, 2006 decreased \$0.1 million, or 1% to \$16.5 million, or \$0.66 per diluted share, from \$16.6 million, or \$0.66 per diluted share, for the same period in 2005.

The Company adopted SFAS No. 123R effective January 1, 2006, which requires the expensing of employee stock options at estimated fair value. The six months ended June 30, 2006 included \$1.5 million of non-cash stock compensation expense required under SFAS No. 123R.

For the six months ended June 30, 2006, on a consolidated basis:

Gross profit increased \$3.4 million, or 7%, to \$53.0 million from \$49.6 million for the same period in 2005, with gross profit of TRS-RenTelco increasing \$3.0 million, or 18%, due to higher gross profit on rents, MMMC increasing \$1.6 million, or 5%, due to higher gross profit on rents and rental related services and Enviroplex decreasing \$1.2 million, or 75%, due primarily to lower sales volume.

Selling and administrative expenses increased \$3.4 million, or 18% to \$22.4 million from \$19.0 million for the same period in 2005, primarily as a result of higher personnel and benefit costs of \$3.1 million, which includes the impact of the non-cash stock compensation expense of \$1.5 million from the adoption of SFAS No. 123R effective January 1, 2006.

Interest expense increased \$1.5 million, or 41%, to \$5.1 million from \$3.6 million for the same period in 2005, primarily due to 25% higher average interest rates of 5.8% compared to 4.6% in 2005 and 4% higher average debt levels of the Company.

Pre-tax income contribution by MMMC and TRS-RenTelco was 68% and 34%, respectively, compared to 73% and 25%, respectively, for the comparable 2005 period. These results are discussed on a segment basis below.

Provision for income taxes was reduced \$0.9 million during the second quarter 2006 to record the impact to the Company's deferred tax liability from a franchise tax law change enacted by the state of Texas in May 2006. As a result, the Company's effective tax rate was 35.6% compared with 38.0% during the same period in 2005. Excluding the impact of the Texas law change, the 2006 provision for income taxes was based on an effective tax rate of 39.0%. The Company's estimated effective tax rate is based on the 2006 expected revenue distribution by state, however, there can be no assurance that such expected business levels will be achieved in 2006, which may cause the Company's effective tax rate to change.

EBITDA increased \$1.3 million, or 2%, to \$55.4 million compared to \$54.1 million in 2005, with TRS-RenTelco increasing \$2.2 million, MMMC increasing \$0.3 million and Enviroplex decreasing \$1.2 million primarily due to lower sales volume.

MMMC

For the six months ended June 30, 2006, MMMC's total revenues increased \$5.5 million, or 9%, to \$69.0 million over the same period in 2005, primarily due to higher rental and rental related services revenues associated with the continued educational market demand for classrooms and increased demand for commercial projects. The revenue increase for the six months ended June 30, 2006 was offset by lower sale revenue and higher operating expenses driven by increased inventory center labor and material costs incurred to prepare a higher volume of

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

used buildings to meet the market demand for California classroom inventory for the upcoming school year and increased demand for commercial projects. In addition, higher personnel and benefit costs, including non-cash stock compensation expense related to the adoption of SFAS No. 123R, and allocated interest expense, further contributed to a decrease in pre-tax income of \$2.4 million, or 12%, to \$17.4 million for the six months ended June 30, 2006 from \$19.8 million for the same period in 2005.

The following table summarizes six months over six months results for each revenue and gross profit category, pre-tax income, and other selected data.

MMMC Segment Six Months Ended 6/30/06 compared to Six Months Ended 6/30/05 (Unaudited)

<i>(dollar amounts in thousands)</i>	Six Months Ended		Increase (Decrease)	
	2006	2005	\$	%
Revenues				
Rental Revenues	\$ 43,010	\$ 38,612	\$ 4,398	11%
Rental Related Services	13,545	10,779	2,766	26%
Rental Operations	56,555	49,391	7,164	15%
Sales	12,095	13,781	(1,686)	-12%
Other	361	300	61	20%
Total Revenues	\$ 69,011	\$ 63,472	\$ 5,539	9%
Gross Profit				
Rental Revenues	\$ 25,234	\$ 24,530	\$ 704	3%
Rental Related Services	4,635	3,532	1,103	31%
Rental Operations	29,869	28,062	1,807	6%
Sales	3,135	3,396	(261)	-8%
Other	361	300	61	20%
Total Gross Profit	\$ 33,365	\$ 31,758	\$ 1,607	5%
Pre-tax Income	\$ 17,364	\$ 19,786	\$ (2,422)	-12%
Other Information				
Depreciation of Rental Equipment	\$ 5,138	\$ 4,392	\$ 746	17%
Interest Expense Allocation	3,789	2,575	1,214	47%
Average Rental Equipment ¹	\$ 370,418	\$ 326,363	\$ 44,055	13%
Average Rental Equipment on Rent ¹	306,861	279,693	27,168	10%
Average Monthly Total Yield ²	1.94%	1.97%		-2%
Average Utilization ³	82.8%	85.7%		-3%
Average Monthly Rental Rate ⁴	2.34%	2.30%		2%
Period End Rental Equipment ¹	\$ 375,227	\$ 337,564	\$ 37,663	11%
Period End Utilization ³	83.3%	85.9%		-3%
Period End Floors ¹	23,422	21,666	1,756	8%

¹ Average and Period End Rental Equipment represents the cost of rental equipment excluding new equipment inventory and accessory equipment. Period End Floors excludes new equipment inventory.

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

- ² Average Monthly Total Yield is calculated by dividing the averages of monthly rents by the cost of rental equipment, for the period.
- ³ Period End Utilization is calculated by dividing the cost of rental equipment on rent by the total cost of rental equipment excluding new equipment inventory and accessory equipment. Average Utilization for the period is calculated using the average costs of the rental equipment.
- ⁴ Average Monthly Rental Rate is calculated by dividing the averages of monthly rents by the cost of rental equipment on rent, for the period.

MMMC's gross profit for the six months ended June 30, 2006 increased \$1.6 million, or 5%, to \$33.4 million from \$31.8 million for the same period in 2005. For the six months ended June 30, 2006 compared to the same period in 2005:

Gross Profit on Rents - Rental revenues increased \$4.4 million, or 11%, over 2005, due to the continued education market demand for classrooms and increased demand for commercial projects. The rental revenue increase resulted from a 13% increase in average rental equipment, offset by a 2% lower average total yield. As a percentage of rents, depreciation was 12%, compared to 11% in 2005 and other direct costs of rental operations increased from 25% in 2005 to 29% in 2006, due to \$2.9 million higher inventory center labor and material costs to prepare a higher volume of used equipment for shipment and higher than customary field repairs, resulting in a lower gross margin percentage of 59% in 2006 compared to 64% in 2005. The higher rental revenues offset by lower rental margins resulted in gross profit on rents increasing \$0.7 million, or 3%, to \$25.2 million from \$24.5 million in 2005.

Gross Profit on Rental Related Services Rental related services revenues increased \$2.8 million, or 26%, compared to 2005, primarily due to the ongoing demand for modular classrooms. Most of these service revenues are negotiated with the initial lease and are recognized on a straight-line basis with the associated costs over the initial term of the lease. The increase in rental related services revenues was primarily attributable to the mix of leases and associated service revenues within the initial lease term during 2006 as compared to 2005. Higher revenues combined with gross margin percentage increase to 34% in 2006 from 33% in 2005, resulted in rental related services gross profit increasing \$1.1 million, or 31%, to \$4.6 million from \$3.5 million in 2005.

Gross Profit on Sales Sales revenues decreased \$1.7 million, or 12%, compared to 2005. Sales occur routinely as a normal part of MMC's rental business; however, these sales and related gross margins can fluctuate from quarter to quarter and year to year depending on customer requirements, equipment availability and funding. Lower sales revenues were offset by a higher gross margin percentage, 26% in 2006 compared to 25% in 2005, due to a lower mix of new equipment sales, which resulted in sales gross profit decreasing \$0.3 million, or 8%, to \$3.1 million from \$3.4 million in 2005.

For the six months ended June 30, 2006, selling and administrative expenses increased \$2.8 million, or 30%, to \$12.2 million from \$9.4 million in the same period in 2005, primarily due to higher personnel and employee benefit costs to support higher rental activity levels, which included \$0.9 million non-cash stock compensation expense related to the adoption of SFAS No. 123R; and represented 28% of rental revenues compared to 24% in 2005. Allocated interest expense for the six months ended June 30, 2006 increased \$1.2 million, or 47%, to \$3.8 million from \$2.6 million for the comparable period in 2005, primarily as a result of the Company's higher average interest rates and average debt levels in 2006.

TRS-RenTelco

For the six months ended June 30, 2006, TRS-RenTelco's total revenues decreased \$2.2 million, or 4%, to \$47.0 million compared to the same period in 2005. Despite the decrease in total revenues, pre-tax income increased \$2.0 million to \$8.7 million for the six months ended June 30, 2006 from \$6.7 million for the same period in 2005, primarily due to higher gross profit on rental revenues.

The following table summarizes six months over six months results for each revenue and gross profit category, pre-tax income, and other selected data.

TRS-RenTelco Six Months Ended 6/30/06 compared to Six Months Ended 6/30/05 (Unaudited)

<i>(dollar amounts in thousands)</i>	Six Months Ended		Increase (Decrease)	
	2006	2005	\$	%
Revenues				
Rental Revenues	\$ 37,829	\$ 34,148	\$ 3,681	11%
Rental Related Services	621	731	(110)	-15%
Rental Operations	38,450	34,879	3,571	10%
Sales	7,702	13,219	(5,517)	-42%
Other	896	1,126	(230)	-20%
Total Revenues	\$ 47,048	\$ 49,224	\$ (2,176)	-4%
Gross Profit				
Rental Revenues	\$ 15,664	\$ 11,179	\$ 4,485	40%
Rental Related Services	(177)	246	(423)	-172%
Rental Operations	15,487	11,425	4,062	36%
Sales	2,841	3,683	(842)	-23%
Other	896	1,126	(230)	-20%
Total Gross Profit	\$ 19,224	\$ 16,234	\$ 2,990	18%
Pre-tax Income	\$ 8,680	\$ 6,653	\$ 2,027	30%
Other Information				
Depreciation of Rental Equipment	\$ 17,034	\$ 17,935	\$ (901)	-5%
Interest Expense Allocation	1,580	1,172	408	35%
Average Rental Equipment ¹	\$ 162,457	\$ 149,720	\$ 12,737	9%
Average Rental Equipment on Rent ¹	114,143	94,501	19,642	21%
Average Monthly Total Yield ²	3.88%	3.80%		2%
Average Utilization ³	70.3%	63.1%		11%
Average Monthly Rental Rate ⁴	5.52%	6.02%		-8%
Period End Rental Equipment ¹	\$ 173,910	\$ 150,032	\$ 23,878	16%
Period End Utilization ³	71.3%	66.5%		7%

¹ Average and Period End Rental Equipment represents the cost of rental equipment excluding accessory equipment.

² Average Monthly Total Yield is calculated by dividing the averages of monthly rents by the cost of rental equipment, for the period.

³ Period End Utilization is calculated by dividing the cost of rental equipment on rent by the total cost of rental equipment excluding accessory equipment. Average Utilization for the period is calculated using the average costs of the rental equipment.

⁴ Average Monthly Rental Rate is calculated by dividing the averages of monthly rents by the cost of rental equipment on rent, for the period.

TRS-RenTelco's gross profit for the six months ended June 30, 2006 increased \$3.0 million, or 18%, to \$19.2 million from \$16.2 million for the same period in 2005. For the six months ended June 30, 2006 compared to the same period in 2005:

Gross Profit on Rents Rental revenues increased \$3.7 million, or 11%, as compared to 2005, combined with lower depreciation expense of \$0.9 million, or 5%, resulting in increased gross profit on rents of \$4.5

million, or 40%, to \$15.7 million as compared to the same period in 2005. The increase in gross profit on rents is due to 21% higher average rental equipment on rent as compared to 2005, with average utilization of rental equipment increasing 11% from 63.1% in 2005 to 70.3% in 2006. Other direct costs of rental operations increased slightly from \$5.0 million in 2005 to \$5.1 million in 2006.

Gross Profit on Sales Sales revenues decreased \$5.5 million, or 42%, compared to 2005, as a result of having less underutilized rental equipment to sell. Sales occur routinely as a normal part of TRS-RenTelco's rental business; however, these sales and related gross margins can fluctuate from quarter to quarter depending on customer requirements, equipment availability and funding. Lower sales volume was offset by a higher gross margin percentage, 37% in 2006 compared to 28% in 2005, due to a higher gross margin percentage on used equipment sales resulting in sales gross profit decreasing \$0.8 million, or 23%, to \$2.8 million from \$3.6 million in 2005.

For the six months ended June 30, 2006, selling and administrative expenses increased \$0.6 million, or 7%, to \$9.0 million from \$8.4 million in the same period in 2005, primarily due to \$0.6 million non-cash stock compensation expense related to the adoption of SFAS No. 123R. Allocated interest expense for the six months ended June 31, 2006 increased \$0.4 million, or 35%, to \$1.6 million from \$1.2 million for the same period in 2005, as a result of the Company's higher average interest rates and average debt levels in 2006.

Liquidity and Capital Resources

This section contains statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. See the statements at the beginning of this Item for cautionary information with respect to such forward-looking statements.

The Company's rental businesses are capital intensive and generate significant cash flows. Cash flows for the Company for the six months ended June 30, 2006 compared to the same period in 2005 are summarized as follows:

Cash Flow from Operating Activities: The Company's operations provided net cash flow of \$42.3 million, an increase of 65%, during the six months ended June 30, 2006 as compared to \$25.7 million during the same period in 2005. The \$16.6 million increase in net cash provided by operating activities during the first six months was primarily attributable to the reduction in accounts receivable offset by other balance sheet changes.

Cash Flow from Investing Activities: Net cash used in investing activities was \$63.1 million for the six months ended June 30, 2006 as compared to \$34.9 million for the same period in 2005. The \$28.2 million increase in net cash used in investing activities was primarily due to the increase in rental equipment purchases of \$21.7 million to \$71.0 million from \$49.3 million during the same period in 2005 to support expected customer demand, and the decrease in proceeds from the sale of rental equipment occurring in the normal course of business for the first six months by \$6.0 million to \$9.5 million from \$15.5 million during the same period in 2005.

Cash Flow from Financing Activities: Net cash provided by financing activities was \$20.9 million for the six months ended June 30, 2006, compared to \$9.7 million net cash provided during the same period in 2005. For the first six months of 2006, net cash provided by financing activities included net borrowings under the Company's operating lines of credit of \$26.3 million, payment of dividends to shareholders of \$7.5 million, proceeds from the exercise of stock options of \$1.4 million and the excess tax benefit from the exercise and disqualifying disposition of stock options of \$0.6 million. For the first six months of 2005, net cash provided by financing activities included net borrowings under the Company's operating lines of credit of \$14.1 million, payment of dividends to shareholders of \$6.1 million, proceeds from the exercise of stock options of \$1.3 million and the excess tax benefit from the exercise and disqualifying disposition of stock options of \$0.4 million.

The Company had total liabilities to equity ratios of 1.72 to 1 and 1.73 to 1 as of June 30, 2006 and December 31, 2005, respectively. The debt (notes payable) to equity ratios were 0.90 to 1 and 0.82 to 1 as of June 30, 2006 and December 31, 2005, respectively. The Company's credit facility related to its cash management services facilitates automatic borrowings and repayments with the bank on a daily basis depending on the

Company's cash position and allows the Company to maintain minimal cash balances. At June 30, 2006, the Company had unsecured lines of credit that permit it to borrow up to \$195.0 million of which \$129.5 million was outstanding and has capacity to borrow up to an additional \$65.5 million. These unsecured lines of credit expire June 30, 2008.

The Company has in the past made purchases of shares of its common stock from time to time in the over-the-counter market (NASDAQ) and/or through privately negotiated, large block transactions under an authorization of the board of directors. Shares repurchased by the Company are cancelled and returned to the status of authorized but unissued stock. During the six months ended June 30, 2006 and 2005, there were no repurchases. As of August 3, 2006, 2,000,000 shares of the Company's common stock remain authorized for repurchase.

Although no assurance can be given, the Company believes it will continue to be able to negotiate general bank lines of credit adequate to meet capital requirements not otherwise met by operational cash flows and proceeds from sales of rental equipment.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in the Company's market risk exposures from those reported in our Annual Report on Form 10-K for the year ended December 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Company's Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), performed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2006. Based on that evaluation, the CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of June 30, 2006. During the three months ended June 30, 2006, there have been no significant changes in the Company's internal controls or in other factors that have materially affected, or would reasonably be likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is subject to various legal proceedings and claims arising in the ordinary course of business. The Company's management does not expect that the outcome in the current proceedings, individually or collectively, will have a material adverse effect on the Company's financial condition, operating results or cash flows.

ITEM 1A. RISK FACTORS

You should carefully consider the following discussion of various risks and uncertainties. We believe these risk factors are the most relevant to our business and could cause our results to differ materially from the forward-looking statements made by us. The following risk factors are not the only risk factors facing our company. Additional risks that we do not consider material, or of which we are not currently aware, may also have an adverse impact on us. Our business, financial condition, and results of operations could be seriously harmed if any of these risks or uncertainties actually occurs or materializes. In that event, the market price for our common stock could decline, and you may lose all or part of your investment.

We continue to face numerous risks and challenges in the execution of our business strategy. Those risks are described below and in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2006, and we encourage you to review those risk factor disclosures carefully.

Our stock price is subject to fluctuations and the value of your investment may decline.

The market price of our common stock fluctuates on the NASDAQ National Global Select Market and is likely to be affected by a number of factors including but not limited to:

our operating performance and the performance of our competitors, and in particular any variations in our operating results or dividend rate from our stated guidance or from investors' expectations;

changes in general conditions in the economy, the industries in which we operate or the financial markets;

investors' reaction to our press releases, public announcements, or filings with the SEC;

the stock price performance of competitors or other comparable companies;

changes in research analysts' coverage, recommendations or earnings estimates for us or for the stocks of other companies in our industry;

sales of common stock by our directors, executive officers and our other large shareholders, particularly in light of the limited trading volume of our stock;

any merger and acquisition activity that involves us or our competitors; and

other announcements or developments affecting us, our industry, customers, suppliers, or competitors.

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

In addition, in recent years the stock market has experienced significant price and volume fluctuations. These fluctuations are often unrelated to the operating performance of particular companies. These broad market fluctuations may cause declines in the market price of our common stock and are based upon factors that have little or nothing to do with our company or its performance, and these fluctuations could materially reduce our stock price.

Our future operating results may fluctuate, fail to match past performance or fail to meet expectations.

Our operating results may fluctuate in the future, may fail to match our past performance or fail to meet the expectations of analysts and investors. Our results and related ratios, such as gross margin, operating income percentage and effective tax rate may fluctuate as a result of a number of factors, some of which are beyond our control including but not limited to:

general economic conditions in the states and countries where we rent and sell our products;

legislative and educational policies where we rent and sell our products;

seasonality of our rental businesses and our end-markets;

success of our strategic growth initiatives;

the timing and type of equipment purchases, rentals and sales;

the nature and duration of the equipment needs of our customers;

the timing of new product introductions by us, our suppliers and our competitors;

the volume, timing and mix of maintenance and repair work on our rental equipment;

our equipment mix, availability, utilization, and pricing;

the mix, by state and country, of our revenues, personnel and assets;

rental equipment impairment from excess, obsolete, or damaged equipment;

movements in interest rates or tax rates;

changes in and application of accounting rules;

changes in the regulations applicable to us; and

litigation matters.

As a result of these factors, our historical financial results are not necessarily indicative of our future results.

Our ability to retain our executive management and to recruit, retain and motivate key employees is critical to the success of our business.

If we cannot successfully recruit and retain qualified personnel, our operating results and stock price may suffer. We believe that our success is directly linked to the competent people in our organization, including our executive officers, senior managers and other key personnel, in particular, Dennis Kakures our Chief Executive Officer. Personnel turnover can be costly and could materially and adversely impact our operating results and can potentially jeopardize the success of our current strategic initiatives. We need to attract and retain highly qualified personnel to replace personnel when turnover occurs, as well as add to our staff levels as growth occurs. Our business and stock price likely will suffer if we are unable to fill, or experience delays in filling open positions, or fail to retain key personnel when turnover occurs.

We may engage in future acquisitions that could negatively impact our results of operations, financial condition and business.

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

Some of our recent growth has resulted through the acquisition of TRS, an electronic test equipment rental business in 2004. We anticipate that we will continue to consider acquisitions in the future that meet our strategic growth plans. We are unable to predict whether or when any prospective acquisition will be completed. Acquisitions involve numerous risks, including the following:

difficulties in integrating the operations, technologies, products and personnel of the acquired companies;

diversion of management's attention from normal daily operations of the business;

difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;

timely completion of necessary financing and required amendments, if any, to existing agreements, and

an inability to implement uniform standards, controls, procedures and policies;

undiscovered and unknown problems, defects or other issues related to any acquisition that become known to us only after the acquisition;

negative reactions from our customers to an acquisition;

disruptions among employees which may erode employee morale;

potential loss of key employees, including costly litigation resulting from the termination of those employees.
In connection with acquisitions we may:

assume liabilities or acquire damaged assets, some of which may be unknown at the time of such acquisitions;

record goodwill and non-amortizable intangible assets that will be subject to future impairment testing and potential periodic impairment charges;

incur amortization expenses related to certain intangible assets; or

become subject to litigation.

Acquisitions are inherently risky, and no assurance can be given that our future acquisitions will be successful or will not adversely affect our business, operating results, or financial condition. Failure to manage and successfully integrate acquisitions we make could harm our business and operating results in a material way. In addition, if we consummate one or more significant future acquisitions in which the consideration consists of stock or other securities, our existing shareholders' ownership could be diluted significantly. If we were to proceed with one or more significant future acquisitions in which the consideration included cash, we could be required to use a substantial portion of our available credit line, or we may be required to seek additional debt or equity financing.

Our effective tax rate may change and become less predictable as our business expands.

We continue to consider expansion opportunities domestically and internationally for our rental businesses, such as our recent modular expansion in Florida and acquisition of TRS. Since the Company's effective tax rate depends on business levels, personnel and assets located in various jurisdictions, further expansion into new markets or acquisitions may change the effective tax rate in the future and may make it and consequently our earnings less predictable going forward. In addition, the enactment of tax law changes by federal and state taxing authorities may impact the Company's current period tax provision and its deferred tax liabilities.

Changes in financial accounting standards may cause lower than expected operating results and affect our reported results of operations.

Changes in accounting standards and their application may have a significant effect on our reported results on a going forward basis and may also affect the recording and disclosure of previously reported transactions. New accounting pronouncements and varying interpretations of accounting pronouncements have occurred and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, in December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (revised 2004), as amended, Share Based Payment (SFAS No. 123R), which required us to expense stock options at fair value effective January 1, 2006. The implementation of SFAS No. 123R reduced net income by \$0.9 million, or \$0.04 per diluted share, for the six months ended June 30, 2006. Under SFAS No. 123R, the recognition of compensation expense for the fair value of stock options reduces our reported net income and net income per share subsequent to implementation, however, this accounting change will not have any impact on the cash flows of our business. For 2006, we estimate compensation expense of approximately \$3.6 million related to the expensing of stock options, reducing net income by \$2.2 million or \$0.09 per diluted share. Under the prior rules, expensing of stock options was not required and therefore, no compensation expense for stock options was included in reported net income and net income per share. Since 1996, when these rules were originally effective, the Company had adopted the disclosure only provisions of the rules and disclosed on a pro forma basis the impact of compensation expense of stock options on net income and net income per share in the footnotes to the consolidated financial statements.

If we suffer loss to our facilities, equipment or distribution system due to catastrophe, our operations could be seriously harmed.

Our facilities, rental equipment and distribution systems may be subject to catastrophic loss due to fire, flood, hurricane, earthquake, terrorism or other natural or man-made disasters. In particular, we have our headquarters, three operating facilities, and rental equipment in California, which are located in areas with above average seismic activity and could be subject to a catastrophic loss caused by an earthquake. Our rental equipment and facilities in Florida are located in areas subject to hurricanes and other tropical storms. In addition to customers' insurance on rented equipment, we carry property insurance on our rental equipment in inventory and operating facilities as well as business interruption insurance. We believe our insurance policies are adequate with the appropriate limits and deductibles to mitigate the potential loss exposure of our business. We do not have financial reserves for policy deductibles and we do have exclusions under our insurance policies that are

customary for our industry, including earthquakes, flood and terrorism. If any of our facilities or a significant amount of our rental equipment were to experience a catastrophic loss, it could disrupt our operations, delay orders, shipments and revenue recognition and result in expenses to repair or replace the damaged rental equipment and facility not covered by insurance.

The nature of our businesses exposes us to the risk of litigation and liability under environmental, health and safety and products liability laws.

Certain aspects of our businesses involve risks of liability. In general, litigation in our industry, including class actions that seek substantial damages, arises with increasing frequency. Claims may be asserted under environmental, labor, health and safety or product liability laws. Litigation is invariably expensive, regardless of the merit of the plaintiffs' claims. We may be named as a defendant in the future, and there can be no assurance that regardless of the merit of such claims, we will not be required to make substantial settlement payments in the future.

Conducting our routine businesses exposes us to risk of litigation from employees, vendors and other third parties.

We are subject to claims arising from disputes with employees, vendors and other third parties in the normal course of business; these risks may be difficult to assess or quantify and their existence and magnitude may remain unknown for substantial periods of time. If the plaintiffs in any suits against us were to successfully prosecute their claims, or if we were to settle such suits by making significant payments to the plaintiffs, our operating results and financial condition would be harmed. Even if the outcome of a claim proves favorable to us, litigation can be time consuming and costly and may divert management resources. In addition, our organizational documents require us to indemnify our senior executives to the maximum extent permitted by California law. If our senior executives were named in any lawsuit, our indemnification obligations could magnify the costs of these suits.

If we do not effectively manage our credit risk, collect on our accounts receivable, or recover our rental equipment from our customers sites, it could have a material adverse effect on our operating results.

We generally sell to customers on 30-day terms, individually perform credit evaluation procedures on our customers on each transaction and will require security deposits or other forms of security from our customers when a significant credit risk is identified. Historically, accounts receivable write-offs and related equipment not returned by customers has not been significant and, in each of the last five years has been less than 1% of total revenues. Failure to manage our credit risk and receive timely payments on our customer accounts receivable may result in the write-off of customer receivables and loss of equipment, particularly electronic test equipment. If we are not able to manage credit risk issues, or if a large number of customers should have financial difficulties at the same time, our credit and equipment losses would increase above historical levels. If this should occur, our results of operations may be materially and adversely affected.

Failure by third parties to manufacture our products to our specifications or on a timely basis may harm our reputation and financial condition.

We depend on third parties to manufacture our products even though we are able to purchase products from a variety of third-party suppliers. In the future, we may be limited as to the number of third-party suppliers for some of our products. Currently, we do not have any long-term purchase contracts with any third-party supplier. In the future, we may not be able to negotiate arrangements with these third parties on acceptable terms, if at all. If we cannot negotiate arrangements with these third parties to produce our products or the third parties fail to produce our products to our specifications or in a timely manner, our reputation and financial condition could be harmed.

The majority of our indebtedness is subject to variable interest rates, which makes us vulnerable to increases in interest rates.

Our indebtedness exposes us to interest rate increases because the majority of our indebtedness is subject to variable rates. At present, we do not have any derivative financial instruments such as interest rate swaps or hedges to mitigate interest rate variability. The interest rates under our credit facilities will be reset at varying

periods. These interest rate adjustments could expose our operating results and cash flows to periodic fluctuations. Our annual debt service obligations will increase by approximately \$1.3 million per year for each 1% increase in the average interest rate we pay, based on the \$129.5 million balance of variable rate debt outstanding at June 30, 2006. If interest rates rise in the future, particularly, if they rise significantly, our income will be negatively affected.

We may not be able to effectively implement our selected Enterprise Resource Planning system, or ERP.

During June 2005, we entered into an agreement with Rental Results, a rental software application provider, to support the transition of our modular business, certain aspects of our electronics business and our accounting systems to their platform. We expect the ERP implementation project will take approximately 18 to 24 months to complete. These information system upgrades are important to serve and support our strategic growth. The delay or failure to implement these new systems effectively could disrupt our business, distract management's focus and attention from our business operations and growth initiatives, and increase our implementation and operating costs, any of which could negatively impact our operations and operating results.

Failure to comply with internal control attestation requirements could lead to loss of public confidence in our financial statements and negatively impact our stock price.

As a public reporting company, we are required to comply with the Sarbanes-Oxley Act of 2002, including Section 404, and the related rules and regulations of the Securities and Exchange Commission, including expanded disclosures and accelerated reporting requirements. Compliance with Section 404 and other requirements has and will continue to increase our costs and require additional management resources. We may need to continue to implement additional finance and accounting systems, procedures and controls to satisfy new reporting requirements. While we completed a favorable assessment as to the adequacy of our internal control over financial reporting for our fiscal year ended December 31, 2005, there is no assurance that future assessments of the adequacy of our internal control over financial reporting will be favorable. If we are unable to obtain future unqualified reports as to the effectiveness of our internal control over financial reporting, investors could lose confidence in the reliability of our internal controls over financial reporting, which could adversely affect our stock price.

Specific Risks Related to Our Relocatable Modular Buildings Business Segment:

A significant reduction of funding to public schools could cause the demand for our modular classroom units to decline, which could result in a reduction in our revenues and profitability.

Rentals and sales of modulars to public school districts for use as portable classrooms, restroom buildings, and administrative offices for kindergarten through grade twelve represent a significant portion of MMMC's rental and sales revenues. Funding for public school facilities is derived from a variety of sources including the passage of both statewide and local facility bond measures, developer fees and various taxes levied to support school operating budgets. Many of these funding sources are subject to financial and political considerations, which vary from district to district and are not tied to demand. Historically, we have benefited from the passage of facility bond measures and believe these are essential to our business. In California, our largest education market, state and local budgetary constraints have also affected the amount of funding received by public school districts.

To the extent public school districts' funding is reduced for the rental and purchase of modular facilities, our business could be harmed and our results of operations negatively impacted. We believe that interruptions or delays in the passage of facility bond measures, changes in legislative or educational policies at either the state or local level including the contraction or elimination of class size reduction programs, a lack or insufficient amount of fiscal funding, a significant reduction of funding to public schools, or changes negatively impacting enrollment may reduce the rental and sale demand for our educational products and result in lower revenues and lower profitability.

At this time, we are uncertain as to the level of new modernization work that will be commenced in California. This is a function of the current amount of unallocated and unreleased state funds for modernization from the prior state-wide bond measure, the backlog of applications awaiting funding and the actual

commencement of projects. We cannot predict whether current levels of funding will continue after the funds generated in the 2004 bond measure are exhausted, which would likely have a negative impact on our business. For modernization work beyond 2006, a state-wide facilities bond measure in California with significant monies for modernization projects will be on the ballot in November 2006. We believe that this bond measure, if passed, along with the success of local bond measures passed in November 2005, should provide monies to support favorable levels of new modernization projects in both 2007 and 2008.

Public policies that create demand for our products and services may change.

California and Florida have passed legislation to limit the number of students that may be grouped in a single classroom for certain grade levels. School districts with class sizes in excess of these limits have been and continue to be a significant source of our demand for modular classrooms. Further, in California, aging infrastructure and deferred maintenance has resulted in a significant increase in modernization and reconstruction projects by public school districts including seismic retrofitting, asbestos abatement and various building repairs and upgrades. If educational priorities and policies shift away from class-size reduction or modernization and reconstruction projects, demand for our products and services may decline, not grow as quickly as or reach the levels that we anticipate. Significant equipment returns may result in lower utilization until equipment can be redeployed or sold, which may cause rental rates to decline and negatively effect our revenues and operating income.

Failure to comply with applicable regulations could harm our business and financial condition, resulting in lower operating results and cash flows.

Similar to conventionally constructed buildings, the modular building industry, including the manufacturers and lessors of portable classrooms, are subject to evolving regulations by multiple governmental agencies at the federal, state and local level relating to environmental, health, safety and transportation matters, among other matters. Failure to comply with these laws or regulations could impact our business or harm our reputation and result in higher capital or operating expenditures or the imposition of penalties or restrictions on our operations.

As with conventional construction, typically new codes and regulations are not retroactively applied. Nonetheless, new governmental regulations in these or other areas may increase our acquisition cost of new rental equipment, limit the use of or make obsolete the use of some of our existing equipment, or increase our general and administrative costs.

Building codes are generally reviewed tri-annually. All aspects of a given code are subject to change including but not limited to such items as structural specifications for earthquake safety, energy efficiency and environmental standards, fire and life safety, transportation, lighting and noise limits. On occasion state agencies have undertaken studies of indoor air quality and noise levels with a focus on permanent and modular classrooms. These results could impact our existing modular equipment, and effect the future construction of our modular product.

Compliance with building codes and regulations entail a certain amount of risk as municipalities do not necessarily interpret these building codes and regulations in a consistent manner, particularly where applicable regulations may be unclear and subject to interpretation. Many aspects of the construction and modular industry have developed best practices which are constantly evolving. Some of our peers and competitors may adopt practices that are more or less stringent than the Company's. When, and if, regulatory standards are clarified, the effect of the clarification may be to impose rules on our business and practices retroactively, at which time, we may not be in compliance with such regulations and we may be required to incur costly remediation. If we are unable to pass these increased costs on to our customers, our profitability, operating cash flows and financial condition could be negatively impacted.

We are subject to laws and regulations governing government contracts. These laws and regulations make these government contracts more favorable to government entities than other third parties and any changes in these laws and regulations, or the failure to comply with these laws and regulations could harm our business.

We have agreements relating to the sale of our products to government entities and, as a result, we are subject to various statutes and regulations that apply to companies doing business with the government. The laws governing government contracts can differ from the laws governing private contracts. For example, many government contracts contain pricing terms and conditions that are not applicable to private contracts such as clauses that allow government entities not to perform on contractual obligations in the case of a lack of fiscal funding. Also, in the educational markets we serve, we are able to utilize piggyback contracts in marketing our products and services and ultimately to book business. The term piggyback contract refers to contracts for portable classrooms or other products entered into by public school districts following a formal bid process that allows for the use of the same contract terms and conditions with the successful vendor by other public school districts. As a result, piggyback contracts allow us to more readily book orders from our government customers, primarily public school districts, and to reduce the administrative expense associated with booking these orders. The governmental statutes and regulations that allow for use of piggyback contracts are subject to change or elimination in their entirety. A change in the manner of use or the elimination of the use of piggyback contracts would likely negatively impact our ability to book new business from these government customers and could cause our administrative expenses related to processing these orders to increase significantly. In addition, any failure to comply with these laws and regulations might result in administrative penalties or even in the suspension of these contracts and as a result, the loss of the related revenues which would harm our business and results from operations.

Seasonality of our educational business may have adverse consequences for our business.

A significant portion of the modular sale and rental revenues are derived from the educational market. Typically, during each calendar year, our highest numbers of classrooms are shipped for rental and sale orders during the second and third quarters for delivery and installation prior to the start of the upcoming school year. The majority of classrooms shipped in the second and third quarters have rental start dates during the third quarter, thereby making the fourth quarter the first full quarter of rental revenues recognized for these transactions. These factors may impact the quarterly revenues and earnings of each year's second, third and fourth quarters. The differences in quarterly revenues and earnings may also be subject to fluctuations in state funding. In the past, the level of funding available to the school districts from the states in which we do business have caused school districts to experience budget shortfalls and to reduce their demand for our products despite growing student populations, class size reduction initiatives and modernization and reconstruction project needs. Any reductions in funding available to school districts from the states in which we do business, could result in a lower number of orders for our products which could reduce our revenues and operating income and consequently harm our financial condition.

We face strong competition in our modular building markets.

The modular building leasing industry is highly competitive in our states of operation and we expect it to remain so. The competitive market in which we operate may prevent us from raising rental fees or sales prices to pass any increased costs on to our customers. We compete on the basis of a number of factors, including equipment availability, quality, price, service, reliability, appearance, functionality and delivery times. We believe we may experience pricing pressures in our areas of operation in the future as some of our competitors seek to obtain market share by reducing prices.

Some of our larger national competitors in the modular building leasing industry, notably Williams Scotsman International, Inc. and GE Capital Modular Space, have a greater range of products and services, greater financial and marketing resources, larger customer bases, and greater name recognition than we have. These larger competitors may be better able to respond to changes in the relocatable modular building market, to finance acquisitions, to fund internal growth and to compete for market share, any of which could harm our business.

We may not be able to quickly redeploy modular equipment returning from leases.

As of June 30, 2006, rental agreements in our modular portfolio had an average committed rental term of 22 months with 60% of those agreements exceeding the original committed term. Generally, when a customer continues to rent the modular equipment beyond the contractual term, the equipment contractually rents on a month-to-month basis. If a significant number of our rented modular units were returned during a short period of time, particularly those units that are rented on a month-to-month basis, a large supply of units would need to be

remarketed. Our failure to effectively remarket a large influx of units returning from leases could negatively affect our financial performance and our ability to continue expanding our rental fleet.

Significant increases in raw material and labor costs could increase our acquisition cost of new modular rental equipment and repair and maintenance costs of our fleet, which would increase our operating costs and harm our profitability.

We incur labor costs and purchase raw materials, including lumber, siding and roofing and other products to perform periodic repairs, modifications and refurbishments to maintain physical conditions of our modular equipment. The volume, timing and mix of maintenance and repair work on our rental equipment may vary quarter to quarter and year to year. Generally, increases in labor and raw material costs will also increase the acquisition cost of new modular equipment and increase the repair and maintenance costs of our fleet. We also maintain a fleet of service trucks and use subcontractor companies for delivery, set-up, return delivery and dismantle of modulars for our customers. We rely on our subcontractor service companies to meet customer demands for timely shipment and return, and the loss or inadequate number of subcontractor service companies may cause prices to increase, while negatively impacting our reputation and operating performance. During periods of rising prices for labor, raw materials or fuel, and in particular, when the prices increase rapidly or to levels significantly higher than normal, we may incur significant increases in our acquisition costs for new modular equipment and incur higher operating costs that we may not be able to recoup from our customers, which would reduce our profitability.

Failure to properly design, manufacture, repair and maintain the modular product may result in impairment charges and reduction of our operating results and cash flows.

We estimate the useful life of the modular product to be 18 years with a residual value of 50%. However, proper design, manufacture, repairs and maintenance of the modular product during our ownership is required for the product to reach the estimated useful life of 18 years with a residual value of 50%. If we do not appropriately manage the design, manufacture, repair and maintenance of our modular product, or otherwise, delay or defer such repair or maintenance, we may be required to incur impairment charges for equipment that is beyond economic repair, incur significant capital expenditures to acquire new modular product to serve demand and accordingly experience reduction of our future operating results and cash flows.

Our warranty costs may increase.

Sales of new relocatable modular buildings not manufactured by us are typically covered by warranties provided by the manufacturer of the products sold. We provide ninety-day warranties on certain modular sales of used rental equipment and one-year warranties on equipment manufactured by our Enviroplex subsidiary. Historically, our warranty costs have not been significant, and we monitor the quality of our products closely. If a defect were to arise in the installment of our equipment at the customer's facilities or in the equipment acquired from our suppliers or by our Enviroplex subsidiary, we may experience increased warranty claims. Such claims could disrupt our sales operations, damage our reputation and require costly repairs or other remedies, negatively impacting revenues and operating income.

Specific Risks Related to Our Electronic Test Equipment Business Segment:

Market risk and cyclical downturns in the industries using test equipment may result in periods of low demand for our product resulting in excess inventory, impairment charges and reduction of our operating results and cash flows.

TRS-RenTelco's revenues are derived from the rental and sale of general purpose and communications test equipment to a broad range of companies, from Fortune 500 to middle and smaller market companies, in the aerospace, defense and communications industries. Electronics rental and sales revenues are primarily affected by the business activity within these industries related to research and development, manufacturing, and communication infrastructure and maintenance. Historically, these industries have been cyclical and have experienced periodic downturns, which have a material adverse impact on the industry's demand for equipment, including the electronic test equipment rented by us. We experienced this in 2002, as a result of a prolonged downturn in the telecommunications industry, and recorded non-cash impairment charges of \$24.1 million

resulting from the depressed and low projected demand for the rental products coupled with high inventory levels, especially communications equipment.

In addition, the severity and length of any downturn on an industry may also affect overall access to capital, which could adversely affect our customers. During periods of reduced and declining demand for test equipment, we are exposed to additional receivable risk from non-payment and may need to rapidly align our cost structure with prevailing market conditions while at the same time motivating and retaining key employees. While the market demand for communications test equipment has improved from 2002 levels as the telecommunications industry has recovered, no assurance can be given regarding the length or extent of the recovery, and no assurance can be given that our rental utilization rates, operating results and cash flows will not be adversely impacted by the reversal of any current trends or any future downturns or slowdowns in the rate of capital investment in this industry.

Seasonality of our electronics business may impact quarterly results.

Generally, rental activity declines in the fourth quarter month of December and the first quarter months of January and February. These months may have lower rental activity due to holiday closures, particularly by larger companies, inclement weather and its impact on various field related communications equipment rentals, and companies' operational recovery from holiday closures which may impact the start-up of new projects coming online in the first quarter. These seasonal factors may impact quarterly results in each year's first and fourth quarter.

Our rental test equipment may become obsolete and result in an impairment charge.

Electronic test equipment is characterized by changing technology and evolving industry standards that may render our existing equipment obsolete through new product introductions, or enhancements, before the end of its anticipated useful life, causing us to incur impairment charges. Additionally, some manufacturers of our equipment may be acquired or cease to exist, resulting in a future lack of support for equipment purchased from those manufacturers. This could result in the remaining useful life to shorten, causing us to incur an impairment charge. We must monitor our manufacturers support, the introduction of new technologies, and acquire equipment that will be marketable to our current and prospective customers. Failure to properly select, manage and respond to the technological needs of our customers and changes of our products through their technology life cycle may cause certain electronic test equipment to become obsolete, resulting in impairment charges and may negatively impact operating results and cash flows.

If we do not effectively compete in the rental equipment market, our operating results will be materially and adversely affected.

The electronic test equipment rental business is characterized by intense competition from several competitors, including Electro Rent Corporation, Telogy and Continental Resources, some of which may have access to greater financial and other resources than we do. Although no single competitor holds a dominant market share, we face intensifying competition from these established entities and new entrants in the market. We must anticipate and keep pace with the introduction of new products and acquire equipment that will be marketable to our current and prospective customers. We compete on the basis of a number of factors, including product availability, price, service and reliability. Some of our competitors may offer similar equipment for lease, rental or sale at lower prices and may offer more extensive servicing, or financing options. Failure to adequately forecast the adoption of, and demand for, new or existing products may cause us not to meet our customers equipment requirements and may materially and adversely affect our operating results.

If we are not able to obtain equipment at favorable rates, there could be a material adverse effect on our operating results.

The majority of our rental equipment portfolio is comprised of general-purpose test and measurement instruments purchased from leading manufacturers such as Agilent Technologies and Tektronix. We depend on these manufacturers and suppliers to contract for our equipment. If, in the future, we are not able to purchase necessary equipment from one or more of these suppliers on favorable terms, we may not be able to meet our customers' demands in a timely manner or for a rental rate that generates a profit. If this should occur, we may not

be able to secure necessary equipment from an alternative source on acceptable terms and our business may be materially and adversely affected.

If we are not able to anticipate and mitigate the risks associated with operating internationally, there could be a material adverse effect on our operating results.

Currently, total foreign country customers and operations account for less than 10% of the Company's revenues and long-lived assets. Over time, we anticipate the amount of international business may increase if our focus on international market opportunities continues. Operating in foreign countries does subject the Company to additional risks, any of which may adversely impact our future operating results, including:

international political, economic and legal conditions including tariffs and trade barriers;

our ability to comply with customs, import/export and other trade compliance regulations of the countries in which we do business, together with any unexpected changes in such regulations;

greater difficulty in our ability to recover rental equipment and obtain payment of the related trade receivables;

difficulties in attracting and retaining staff and business partners to operate internationally;

language and cultural barriers;

seasonal reductions in business activities in the countries where our international customers are located;

integration of foreign operations;

longer payment cycles;

currency fluctuations; and

potential adverse tax consequences.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
None.

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

Edgar Filing: MCGRATH RENTCORP - Form 10-Q

The Company held its 2006 Annual Meeting of Shareholders on May 31, 2006. The proposals voted on by the Company shareholders and the voting results were as follows:

Proposal 1: Election of Directors

The election of directors was approved as follows:

	In Favor	Against	Abstentions	Non-votes
William J. Dawson	21,579,139	0	518,399	2,852,144
Robert C. Hood	21,152,086	0	945,452	2,852,144
Dennis C. Kakures	20,782,763	0	1,314,775	2,852,144
Joan M. McGrath	20,609,740	0	1,487,798	2,852,144
Robert P. McGrath	21,110,866	0	986,672	2,852,144
Dennis P. Stradford	21,152,086	0	945,452	2,852,144
Ronald H. Zech	20,754,475	0	1,343,063	2,852,144

Elected as directors at the meeting were William J. Dawson, Robert C. Hood, Dennis C. Kakures, Joan M. McGrath, Robert P. McGrath, Dennis P. Stradford and Ronald H. Zech.

Proposal 2: Ratification of Appointment of Independent Auditors

Grant Thornton LLP was ratified as the Company's independent auditors for fiscal year 2006 with 22,031,702 in favor, 62,740 against, 3,096 abstentions and 2,852,144 non-votes.

ITEM 5. OTHER INFORMATION

Dividends

On May 31, 2006, the Company declared a quarterly dividend on its Common Stock; the dividend was \$0.16 per share. Subject to its continued profitability and favorable cash flow, the Company intends to continue the payment of quarterly dividends.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

- 10.14 Amendment No. 2 to the Third Amended and Restated Credit Agreement by and among the Company, certain parties thereto, and Union Bank of California, N.A., dated as of March 28, 2006.
- 10.15 Release from Obligations (TRS-RenTelco Inc.) related to the Note Purchase and Private Shelf Agreement dated June 2, 2004, by and among the Company, certain parties thereto, and Prudential Investment Management, Inc.
- 15.1 Awareness Letter From Grant Thornton LLP
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K.

None.

SIGNATURES

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

Date: August 3, 2006

MCGRATH RENTCORP

By: /s/ Keith E. Pratt
Keith E. Pratt
Vice President and Chief Financial Officer

By: /s/ David M. Whitney
David M. Whitney
Vice President, Controller and Principal Accounting Officer