MICHAELS STORES INC
Form 10-Q
September 14, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 4, 2007

OR

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

For the transition period from to

Commission file number 001-09338

MICHAELS STORES, INC.

(Exact name of registrant as specified in its charter)

Delaware	**75-1943604**
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification number)

8000 Bent Branch Drive

Irving, Texas 75063

(Address of principal executive offices, including zip code)

(972) 409-1300

(Registrant s telephone number, including area code)

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

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 **o** Accelerated filer **o** Non-accelerated filer **x**

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes **o** No **x**

Indicate the number of shares outstanding of each of the Registrant s classes of Common Stock, as of the latest practicable date.

Title	**Shares Outstanding as of September 7, 2007**
Common Stock, par value $.10 per share	118,465,069

*Although the Registrant has not been subject to such filing requirements for the past 90 days, it has filed all periodic reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months.

MICHAELS STORES, INC.
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MICHAELS STORES, INC.

Part I FINANCIAL INFORMATION

Item 1. Financial Statements.

MICHAELS STORES, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

(Unaudited)

	August 4, 2007	February 3, 2007	July 29, 2006
ASSETS			
Current assets:			
Cash and equivalents	$ 45,029	$ 30,098	$ 379,320
Merchandise inventories	922,860	847,529	875,217
Prepaid expenses and other	74,831	54,435	46,594
Deferred income taxes	35,391	35,216	56,502
Income tax receivable	60,947	32,902	
Total current assets	1,139,058	1,000,180	1,357,633
Property and equipment, at cost	1,169,463	1,122,948	1,073,595
Less accumulated depreciation	(716,644)	(674,275)	(636,349)
	452,819	448,673	437,246
Goodwill	115,839	115,839	115,839
Debt issuance costs, net of accumulated amortization of $13,083 at August 4, 2007 and $4,537 at February 3, 2007	110,757	120,193	
Other assets	7,155	8,117	22,929
	233,751	244,149	138,768
Total assets	$ 1,825,628	$ 1,693,002	$ 1,933,647
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY			
Current liabilities:			
Accounts payable	$ 207,326	$ 214,470	$ 272,886
Accrued interest	75,276	34,551	89
Accrued liabilities and other	279,534	255,880	249,602
Income taxes payable		7,331	
Current portion of long-term debt	364,061	229,765	
Total current liabilities	926,197	741,997	522,577
Long-term debt	3,733,751	3,728,745	
Deferred income taxes	16,356	29,139	
Other long-term liabilities	81,176	68,444	89,173
Total long-term liabilities	3,831,283	3,826,328	89,173
	4,757,480	4,568,325	611,750
Commitments and contingencies Stockholders (deficit) equity:			
Common Stock, $0.10 par value, 220,000,000 shares authorized; 118,213,397 shares issued and outstanding at August 4, 2007; 117,973,396 shares issued and outstanding at February 3, 2007; 1,026,666,666 shares authorized and 398,657,963 shares issued and 390,543,190 shares outstanding at July 29, 2006	11,821	11,797	39,866
Additional paid-in capital	6,309		443,498
Retained (deficit) earnings	(2,961,402)	(2,893,918)	924,749
Accumulated other comprehensive income	11,420	6,798	7,911
Treasury Stock (none at August 4, 2007 and February 3, 2007; 8,114,773 shares at July 29, 2006)			(94,127)
Total stockholders (deficit) equity	(2,931,852)	(2,875,323)	1,321,897

Total liabilities and stockholders (deficit) equity	$ 1,825,628	$ 1,693,002	$ 1,933,647

See accompanying notes to consolidated financial statements.

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands)

(Unaudited)

	Quarter Ended August 4, 2007	July 29, 2006	Six Months Ended August 4, 2007	July 29, 2006
Net sales	$ 792,939	$ 768,264	$ 1,637,072	$ 1,600,745
Cost of sales and occupancy expense	501,841	493,016	1,018,262	1,006,261
Gross profit	291,098	275,248	618,810	594,484
Selling, general, and administrative expense	243,005	233,681	498,909	470,717
Transaction expenses	15,688	8,499	21,252	13,199
Related party expenses	5,403		10,665	
Store pre-opening costs	1,420	1,521	2,968	2,958
Operating income	25,582	31,547	85,016	107,610
Interest expense	95,208	252	190,560	424
Other (income) and expense, net	(2,085)	(3,329)	(4,531)	(10,491)
(Loss) income before income taxes	(67,541)	34,624	(101,013)	117,677
(Benefit) provision for income taxes	(23,594)	13,071	(34,463)	44,423
Net (loss) income	$ (43,947)	$ 21,553	$ (66,550)	$ 73,254

See accompanying notes to consolidated financial statements.

MICHAELS STORES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended August 4, 2007	July 29, 2006
Operating activities:		
Net (loss) income	$ (66,550)	$ 73,254
Adjustments:		
Depreciation and amortization	62,051	56,620
Share-based compensation	2,793	10,867
Tax benefits from stock options exercised		(16,065)
Other	7,673	168
Changes in assets and liabilities:		
Merchandise inventories	(75,248)	(90,817)
Prepaid expenses and other	278	(2,991)
Deferred income taxes and other	(12,801)	(5,892)
Accounts payable	(12,774)	50,560
Accrued interest	69,759	18
Accrued liabilities and other	1,053	(8,725)
Income taxes payable	(21,599)	(27,329)
Other long-term liabilities	15,419	1,845
Net cash (used in) provided by operating activities	(29,946)	41,513
Investing activities:		
Additions to property and equipment	(61,629)	(69,541)
Net cash used in investing activities	(61,629)	(69,541)
Financing activities:		
Borrowings on asset-based revolving credit facility	705,577	
Payments on asset-based revolving credit facility	(571,281)	
Repayments on senior secured term loan facility	(11,750)	
Equity investment of Management	4,280	
Cash dividends paid to stockholders		(26,625)
Repurchase of old Common Stock		(66,182)
Repurchase of new Common Stock	(740)	
Proceeds from stock options exercised		27,870
Tax benefits from stock options exercised		16,065
Proceeds from issuance of old Common Stock and other		1,791
Payment of capital leases	(5,039)	
Change in cash overdraft	(14,541)	1,980
Net cash provided by (used in) financing activities	106,506	(45,101)
Net increase (decrease) in cash and equivalents	14,931	(73,129)
Cash and equivalents at beginning of period	30,098	452,449
Cash and equivalents at end of period	$ 45,029	$ 379,320

See accompanying notes to consolidated financial statements.

MICHAELS STORES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Six Months Ended August 4, 2007
(Unaudited)

Note 1. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of Michaels Stores, Inc. and our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. All expressions of us, we, our, and all similar expressions are references to Michaels Stores, Inc. and our consolidated, wholly-owned subsidiaries, unless otherwise expressly stated or the context otherwise requires.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals and other items, as disclosed) considered necessary for a fair presentation have been included. Because of the seasonal nature of our business, the results of operations for the three and six months ended August 4, 2007 are not indicative of the results to be expected for the entire year.

The balance sheet at February 3, 2007 has been derived from the audited financial statements at that date but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2007.

All references herein to fiscal 2007 relate to the 52 weeks ending February 2, 2008 and all references to fiscal 2006 relate to the 53 weeks ended February 3, 2007. In addition, all references herein to the second quarter of fiscal 2007 relate to the 13 weeks ended August 4, 2007 and all references to the second quarter of fiscal 2006 relate to the 13 weeks ended July 29, 2006. Finally, all references to the six months ended August 4, 2007 relate to the 26 weeks ended August 4, 2007, and the six months ended July 29, 2006 relate to the 26 weeks ended July 29, 2006.

Certain prior year amounts were reclassified to conform to current year presentation.

Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income tax positions. FIN 48 requires that a company recognize in its consolidated financial statements the impact of a tax position that is more likely than not to be sustained upon examination based on the technical merits of the position. We adopted FIN 48 as of the beginning of our first quarter of fiscal 2007 with no material impact to our consolidated statement of operations, balance sheet, shareholders equity, or statement of cash flows.

Upon adoption, we elected to record any interest and penalties associated with audits as a component of income tax expense. The Company identified its federal tax return, Canadian tax return, and its state tax returns in California, Florida, Illinois, New York, North Carolina, Pennsylvania, and Texas as major tax jurisdictions. The periods subject to examination for our federal returns are 2002 to present, 2000 to present for our Canadian returns, and 2003 to present for all state returns except for North Carolina and Texas. North Carolina is subject to examination from 2001 to present, and Texas is subject to examination from 2002 to present.

In September 2006, the FASB issued Statement of Financial Accounting Standard No. 158, *Employers Accounting for Defined Benefit Pensions and Other Postretirement Plans*, which requires an entity to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. It also requires an entity to measure the funded status of a plan as of the date of its year-end balance sheet. As we have no publicly traded equity securities (due to the Merger as described in Note 2 below), FAS 158 is effective for us at the end of fiscal 2007, with early adoption permitted. We plan to adopt FAS 158 at the end of fiscal 2007, with no material impact expected on our consolidated statement of operations, balance sheet, shareholders equity, or statement of cash flows.

In February 2007, the FASB issued Statement of Financial Accounting Standard No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits companies to measure certain financial instruments and other items at fair value (at specified measurement dates) that are not currently required to be measured at fair value. Any unrealized gains or losses applicable to those items measured at fair value shall be reported in earnings. The decision to apply fair value shall generally be made on an instrument by instrument basis, is irrevocable, and is applied only to an entire instrument. The provisions of FAS 159 will be effective for us as of the beginning of fiscal 2008, with early adoption permitted.

Note 2. Merger Transaction

On October 31, 2006, substantially all of the Common Stock of Michaels Stores, Inc. was acquired through a merger transaction (the Merger) by affiliates of two private investment firms, Bain Capital Partners, LLC and The Blackstone Group (collectively, together with their applicable affiliates, the Sponsors), with certain shares retained by affiliates of Highfields Capital Partners (a then-existing shareholder of Michaels Stores, Inc.). As a result of the Merger, Michaels Holdings LLC, an entity controlled by the Sponsors, owns approximately 93.3% of our outstanding Common Stock, which is no longer publicly traded. We accounted for the Merger as a leveraged recapitalization whereby the historical book value of the assets and liabilities of Michaels were maintained with no push down accounting required.

The Merger consideration paid to then-existing equity holders was approximately $5.8 billion, with fees and expenses totaling an additional $239.7 million. The purchase price was funded by:

- Aggregate cash equity contribution by the Sponsors of approximately $1.7 billion;
- Retention of certain shares held by affiliates of Highfields Capital Partners totaling $110.0 million;
- The issuance of the following debt (See Note 4 for further information concerning our issuance of debt):
- $750.0 million of 10% Senior Notes due 2014;
- $400.0 million of 113⁄8% Senior Subordinated Notes due 2016;
- $250.0 million of 13% Subordinated Discount Notes due 2016 (with an accreted value at maturity of $469.4 million);
- $2.4 billion Senior secured term loan facility; and
- $400.0 million of borrowings under our Asset-based revolving credit facility; and
- Our available cash as of the date of the Merger.

The Merger occurred simultaneously with the closing of the financing and equity transactions described above as well as the termination of our previous $300 million senior unsecured credit facility with Bank of America, N.A.

We capitalized $124.7 million of costs related to our issuance of various debt instruments. We amortize the deferred financing costs over the lives of the respective debt agreements (which range from five to ten years) and record the amortization to interest expense. Amortization of the deferred financing costs was $4.3 million and $8.5 million for the three and six months ended August 4, 2007, respectively.

Transaction expenses for the three and six months ended August 4, 2007 relate primarily to compensation arrangements associated with the change in control.

Note 3. Share-Based Compensation

On February 15, 2007, our stockholders and Board of Directors approved the 2006 Equity Incentive Plan (2006 Plan), which provides for the grant of share-based awards exercisable for up to 14.2 million shares of Common Stock. The table below sets forth a summary of stock option activity for the three and six months ended August 4, 2007. As of August 4, 2007, share-based awards exercisable for up to 2.8 million shares of Common Stock remain available for grant.

	Quarter Ended August 4, 2007	Six Months Ended