MICHAELS STORES INC
Form 10-Q
September 04, 2009
Table of Contents

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 1, 2009

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	(I.R.S. employer

incorporation or organization)	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 o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). * Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of August 31, 2009, 118,942,246 shares of the Registrant s Common Stock were outstanding.

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*The Registrant has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, but is not required to file such reports under such sections.

Table of Contents

MICHAELS STORES, INC.

FORM 10-Q

Table of Contents

MICHAELS STORES, INC.

Part I FINANCIAL INFORMATION

Item 1. Financial Statements.

MICHAELS STORES, INC.

CONSOLIDATED BALANCE SHEETS

(In millions, except share data)

(Unaudited)

	August 1, 2009	January 31, 2009	August 2, 2008
ASSETS			
Current assets:			
Cash and equivalents	$ 36	$ 33	$ 45
Merchandise inventories	950	900	938
Prepaid expenses and other	75	73	71
Deferred income taxes	41	41	31
Income tax receivable	16	2	42
Total current assets	1,118	1,049	1,127
Property and equipment, at cost	1,228	1,214	1,187
Less accumulated depreciation	(883)	(832)	(777)
	345	382	410
Goodwill	94	94	94
Debt issuance costs, net of accumulated amortization of $47, $39, and $30, respectively	78	86	95
Deferred income taxes	14	12	
Other assets	26	2	2
	212	194	191
Total assets	$ 1,675	$ 1,625	$ 1,728
LIABILITIES AND STOCKHOLDERS DEFICIT			
Current liabilities:			
Accounts payable	$ 216	$ 230	$ 244
Accrued liabilities and other	288	275	304
Current portion of long-term debt	198	173	286
Income taxes payable		2	
Current liabilities - discontinued operations	1	1	2
Total current liabilities	703	681	836
Long-term debt	3,766	3,756	3,748
Deferred income taxes			4
Other long-term liabilities	79	74	78
Long-term liabilities - discontinued operations	1	1	1
Total long-term liabilities	3,846	3,831	3,831

		4,549		4,512		4,667
Commitments and contingencies						
Stockholders deficit:						
Common Stock, $0.10 par value, 220,000,000 shares authorized; 118,387,229 shares issued and outstanding at August 1, 2009; 118,376,402 shares issued and outstanding at January 31, 2009; 118,382,402 shares issued and outstanding at August 2, 2008		12		12		12
Additional paid-in capital		32		27		15
Accumulated deficit		(2,925)		(2,931)		(2,976)
Accumulated other comprehensive income		7		5		10
Total stockholders deficit		(2,874)		(2,887)		(2,939)
Total liabilities and stockholders deficit	$	1,675	$	1,625	$	1,728

See accompanying notes to consolidated financial statements.

Table of Contents

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions)

(Unaudited)

	Quarter Ended		Six Months Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
Net sales	$ 807	$ 796	$ 1,659	$ 1,643
Cost of sales and occupancy expense	521	518	1,058	1,039
Gross profit	286	278	601	604
Selling, general, and administrative expense	232	246	478	518
Related party expenses	3	4	7	8
Store pre-opening costs	1	1	2	3
Operating income	50	27	114	75
Interest expense	62	76	125	154
Other (income) and expense, net	(14)		(20)	
Income (loss) before income taxes	2	(49)	9	(79)
Provision (benefit) for income taxes		(19)	3	(29)
Net income (loss)	$ 2	$ (30)	$ 6	$ (50)

See accompanying notes to consolidated financial statements.

Table of Contents

MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

	Six Months Ended	
	August 1, 2009	**August 2, 2008**
Operating activities:		
Net income (loss)	$ 6	$ (50)
Adjustments:		
Depreciation and amortization	58	63
Share-based compensation	4	4
Deferred financing costs amortization	8	8
Accretion of subordinated discount notes	22	19
Change in fair value of interest rate cap	(15)	
Changes in assets and liabilities:		
Merchandise inventories	(43)	(94)
Prepaid expenses and other	(5)	
Deferred income taxes and other	(8)	2
Accounts payable	7	18
Accrued interest	1	(34)
Accrued liabilities and other	7	6
Income taxes receivable	(17)	(37)
Other long-term liabilities	5	(3)
Net cash provided by (used in) operating activities	30	(98)
Investing activities:		
Additions to property and equipment	(17)	(39)
Net cash used in investing activities	(17)	(39)
Financing activities:		
Borrowings on asset-based revolving credit facility	441	506
Payments on asset-based revolving credit facility	(415)	(341)
Repayments on senior secured term loan facility	(12)	(12)
Repurchase of new Common Stock		(1)
Payments of capital leases		(4)
Change in cash overdraft	(23)	6
Other	(1)	(1)
Net cash (used in) provided by financing activities	(10)	153
Net increase in cash and equivalents	3	16
Cash and equivalents at beginning of period	33	29
Cash and equivalents at end of period	$ 36	$ 45
Supplemental Cash Flow Information:		
Cash paid for interest	$ 93	$ 160
Cash paid for income taxes	$ 19	$ 11

See accompanying notes to consolidated financial statements.

Table of Contents

MICHAELS STORES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Six Months Ended August 1, 2009

(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 the Company , 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. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended January 31, 2009. We have evaluated all subsequent events through the issuance of the financial statements, which occurred on September 4, 2009.

The balance sheet at January 31, 2009 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 January 31, 2009.

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 1, 2009 are not indicative of the results to be expected for the entire year.

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. All references herein to fiscal 2009 relate to the 52 weeks ending January 30, 2010, and all references to fiscal 2008 relate to the 52 weeks ended January 31, 2009. In addition, all references herein to the second quarter of fiscal 2009 relate to the 13 weeks ended August 1, 2009 and all references to the second quarter of fiscal 2008 relate to the 13 weeks ended August 2, 2008. Finally, all references to the six months ended August 1, 2009 relate to the 26 weeks ended August 1, 2009, and the six months ended August 2, 2008 relate to the 26 weeks ended August 2, 2008.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. SFAS 157 was originally effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In November 2007, the FASB placed a one year deferral for the implementation of SFAS 157 for nonfinancial assets and liabilities; however, SFAS 157 is effective for fiscal years beginning after November 15, 2007 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. On February 3, 2008, we adopted the provisions of SFAS 157 related to financial assets and liabilities and on February 1, 2009, we adopted the provisions related to nonfinancial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. These adoptions had no impact on our consolidated financial statements. See Note 6 for further information regarding fair value measurements. Additionally, in April 2009, the FASB issued FASB Staff Position (FSP) No. FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments,* which collectively provide additional guidance and require additional disclosure regarding determining and reporting fair values for certain assets and liabilities. We adopted FSP FAS 107-1 in the second quarter of fiscal 2009 as reflected in Note 3.

Table of Contents

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141, *Business Combinations*. The statement retains the purchase method of accounting used in business combinations, but replaces SFAS 141 by establishing principles and requirements for the recognition and measurement of assets, liabilities and goodwill, including the requirement that most transaction costs and restructuring costs be expensed. In addition, the statement requires disclosures to enable users to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will apply the provisions of SFAS 141R to any business combinations occurring on or after February 1, 2009.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*. SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of and gains and losses on derivative contracts, and details of credit-risk-related contingent features in hedged positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted for in accordance with SFAS 133 and its related interpretation, and how derivative instruments and related hedged items affect entity s financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We adopted the new disclosure requirements of SFAS 161 in the first quarter of 2009 as reflected in Note 5.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events*. SFAS 165 is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or available to be issued. This standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 is effective for fiscal years and interim periods ending after June 15, 2009. We adopted SFAS 165 during the second quarter of fiscal 2009, but the impact of the adoption will depend on the nature and the extent of transactions that occur subsequent to our interim and annual reporting periods.

In June 2009, the FASB issued SFAS No. 168, *FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162.* SFAS 168 establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the Codification carries an equal level of authority. The U.S. GAAP hierarchy will be modified to include two levels of GAAP: authoritative and nonauthoritative. SFAS 168 is effective for financial statements issued for interim and annual periods ended after September 15, 2009. The adoption of SFAS 168 is not expected to have a material impact on our consolidated financial statements.

Note 2. Share-Based Compensation

The 2006 Equity Incentive Plan (2006 Plan) provides for the grant of share-based awards exercisable for up to 14.2 million shares of Common Stock. On June 3, 2009, the Company announced an offer to exchange certain employee stock options issued under the 2006 Plan (Exchange Offer) for new stock options granted on a one-for-one basis. On July 2, 2009, 8.0 million stock options outstanding were exchanged based on the following terms:

(1) outstanding vested or unvested options to purchase shares of Common Stock that had an exercise price per share of $30.00, $37.50, $45.00 or $52.50 for an equal number of new options to purchase shares of Common Stock with an exercise price equal to $7.50 and a new five-year vesting schedule that commenced on July 2, 2009 and an eight-year term; and

(2) outstanding options that had an exercise price per share of $15.00 and $22.50 were exchanged for an equal number of new options with the same exercise price. A portion of the new options will be vested based on the period of time that the exchanged options had been held in relation to the total term of the option and have identical terms and conditions to the previously issued options, and the remaining options have a new five-year vesting schedule that commenced on July 2, 2009 and an eight-year term.

The fair value for options granted under SFAS No. 123(R) was estimated at the date of grant using the Black-Scholes-Merton option valuation model. Prior year assumptions are not reflected due to all options being cancelled as part of the Exchange Offer and new options granted. The following assumptions were used to estimate the fair value of options granted during the quarter ended August 1, 2009:

Table of Contents

Assumptions (1)	
Risk-free interest rates (2)	2.4% - 3.3%
Expected dividend yield	0.0%
Expected volatility rates of our Common Stock (3)	44.3% - 45.9%
Expected life of options (in years) (4)	5.5 - 8.0
Weighted average fair value of options granted	$ 0.93

(1) Forfeitures were estimated based on historical experience and anticipated events.

(2) Based on constant maturity interest rates for U.S. Treasury instruments with terms consistent with the expected lives of the awards.

(3) We considered both the historical volatility as well as implied volatilities from the exchange-traded options on the common stock from a peer group of companies.

(4) Expected lives were based on an analysis of historical exercise and post-vesting employment termination behavior.

As of August 1, 2009, there were 632,511 shares of restricted stock outstanding, 10.4 million share-based awards outstanding and up to 3.2 million shares of Common Stock remaining available for grant under the 2006 Plan. The table below sets forth a summary of stock option activity and other summary data for the six months ended August 1, 2009.

	Number of Shares (in millions)	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term (in years)**
Outstanding at January 31, 2009	10.1	$ 26.25	
Grants (1)	10.8	15.50	
Canceled/Forfeited (1)	(10.5)	26.25	
Outstanding at August 1, 2009	10.4	$ 15.03	7.5
Vested and Exercisable at August 1, 2009	1.8	$ 18.75	6.0

(1) The number of options granted and canceled/forfeited includes options granted and canceled in connection with the Exchange Offer.

As of August 1, 2009, the total fair value of vested options, subsequent to the Exchange Offer, was $1.4 million. As of August 1, 2009, there were 8.5 million nonvested options with a weighted average fair value of $0.96 per share.

Share-based compensation expense was $2.1 million and $0.9 million for the second quarter of fiscal 2009 and 2008, respectively, and $4.2 million and $3.8 million for the six months ended August 1, 2009 and August 2, 2008, respectively. As a result of the Exchange Offer, share-based compensation expense for fiscal 2009 is expected to decline by $0.5 million, of which $0.1 million was recognized during the 2nd quarter. Share-based compensation expense is expected to increase by $3.5 million over the life of the options granted from the Exchange Offer.

As of August 1, 2009, compensation cost not yet recognized related to nonvested awards totaled $23.4 million and is expected to be recognized over a weighted average period of 4.9 years. To the extent the actual forfeiture rate is different from what we have anticipated, share-based compensation related to these awards will be different from our expectations.

Table of Contents

Note 3. Debt

Our outstanding debt is detailed in the table below. We were in compliance with the terms and conditions of all debt agreements for all periods presented.

	August 1, 2009	January 31, 2009 (in millions)	August 2, 2008	Interest Rate
Senior notes	$ 750	$ 750	$ 750	10.000%
Senior subordinated notes	400	400	400	11.375%
Subordinated discount notes	354	332	312	13.000%
Senior secured term loan	2,285	2,297	2,309	Variable
Asset-based revolving credit facility	174	148	262	Variable
Other	1	2	1	Variable
Total debt	3,964	3,929	4,034	
Less current portion	198	173	286	
Long-term debt	$ 3,766	$ 3,756	$ 3,748	

Asset-based revolving credit facility

Our senior secured asset-based revolving credit facility, which we entered into on October 31, 2006, with Banc of America, N.A. and other lenders (the Asset-based revolving credit facility) provides senior secured financing of up to $1.0 billion, subject to a borrowing base as described in our Annual Report on Form 10-K. As of August 1, 2009, the borrowing base was $749 million, of which we had unused standby letters of credit of $49 million and $526 million of unused availability.

Senior secured term loan facility

Borrowings under our senior secured term loan facility, which we entered into on October 31, 2006, with Deutsche Bank A.G. New York Branch, and other lenders, (the Senior secured term loan facility) bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Deutsche Bank and (2) the federal funds effective rate plus ½ of 1% or (b) a LIBOR rate, subject to certain adjustments, in each case plus an applicable margin. The applicable margin is subject to downward adjustment based on the ratings threshold set forth in the Senior secured term loan facility agreement. At August 1, 2009, the margin was 1.25% with respect to base rate borrowings and 2.25% with respect to LIBOR borrowings.

The table below provides the carrying and fair values of our Senior and Subordinated term loan and notes. The fair value of these debt instruments was determined based on quoted market prices.

	Carrying Value	Fair Value
	(in millions)	
Senior Secured Term Loan	$ 2,285	$ 1,868
Senior Notes	750	698
Senior Subordinated Notes	400	316
Subordinated Discount Notes	354	142

Table of Contents

Note 4. Comprehensive (Loss) Income

Our comprehensive (loss) income, net of related tax, is as follows:

	Quarter Ended		Six Months Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
	(in millions)			
Net income (loss)	$ 2	$ (30)	$ 6	$ (50)
Other comprehensive income (loss):				
Derivative gain	1	2	3	2
Foreign currency translation adjustment and other	(4)	(1)	(5)	(2)
Comprehensive (loss) income	$ (1)	$ (29)	$ 4	$ (50)

Note 5. Derivative Instruments

We are exposed to fluctuations in interest rates on our Senior secured term loan. During the first quarter of fiscal 2009, we purchased an interest rate cap to mitigate the effects of interest rate fluctuations. The objective of the cap is to hedge the variability of cash flows associated with our interest payments on our Senior secured term loan that result from fluctuations in the three-month LIBOR rate and does not qualify for hedge accounting under SFAS 133. The cap limits our interest exposure on a notional value of $2.0 billion to the lesser of the three-month LIBOR rate or 7.0%. The term of the cap extends to the first quarter of fiscal 2015. The fair value of the cap as of August 1, 2009 was $24 million and is included in Other assets on the Consolidated Balance Sheet. The change in fair value of the cap for the quarter and six months ended August 1, 2009, was $11 million and $15 million, respectively, and is recorded in Other (income) and expense, net in the Consolidated Statement of Operations.

Note 6. Fair Value Measurements

As defined in SFAS No. 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 establishes a three-level valuation hierarchy for fair value measurements. These valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1 Quoted prices for *identical* instruments in active markets;
- Level 2 Quoted prices for *similar* instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose significant inputs are observable; and
- Level 3 Instruments whose significant inputs are *unobservable.*

The following table presents net financial assets (liabilities) accounted for at fair value on a recurring basis as of August 1, 2009 (in millions):

	Level 1	Level 2	Level 3	Total
Cash equivalents	$ 4	$	$	$ 4
Interest Rate Cap		24		24

Cash equivalents consist of highly liquid investments, with a maturity of 90 days or less at the date of purchase, including U.S. Treasury bills, various government obligations, and money market funds. We carry cash equivalents at cost, which approximates fair value.

Derivatives in Level 2 are measured based on a variety of pricing factors, which include the market price of the derivative instrument available in the dealer-market, which have been corroborated with market data. See Note 5 for additional information on our derivative instruments.

We generally apply fair value techniques on a non-recurring basis for the establishment of potential impairment loss related to goodwill pursuant to SFAS 142 and determining the fair value of long-lived assets pursuant to SFAS 144.

Table of Contents

Note 7. Commitments and Contingencies

We are involved in ongoing legal and regulatory proceedings. There were no material changes to our disclosures of commitments and contingencies from our Annual Report on Form 10-K for the fiscal year ended January 31, 2009 and our Quarterly Report on Form 10-Q for the quarterly period ended May 2, 2009.

Note 8. Segments

We consider our Michaels and Aaron Brothers operations to be our operating segments for purposes of determining reportable segments based on the criteria of SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. We determined that our Michaels and Aaron Brothers operating segments have similar economic characteristics and meet the aggregation criteria set forth in paragraph 17 of SFAS No. 131. Therefore, we combine both operating segments into one reporting segment.

Our chief operating decision makers evaluate historical operating performance, plan and forecast future periods operating performance based on earnings before interest, income taxes, depreciation and amortization (EBITDA). In addition, an element of base incentive compensation targets for certain management personnel are based on EBITDA. A reconciliation of EBITDA to income (loss) before income taxes is presented below.

	Quarter Ended		Six Months Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
	(in millions)			
Income (loss) before income taxes	$ 2	$ (49)	$ 9	$ (79)
Interest expense	62	76	125	154
Depreciation and amortization	28	32	58	63
EBITDA	$ 92	$ 59	$ 192	$ 138

Our sales and assets by country are as follows:

	Net Sales	Total Assets
	(in millions)	
Quarter ended August 1, 2009:		
United States	$ 744	$ 1,578
Canada	63	97
Consolidated Total	$ 807	$ 1,675
Quarter ended August 2, 2008:		
United States	$ 731	$ 1,616
Canada	65	112
Consolidated Total	$ 796	$ 1,728
Six Months ended August 1, 2009:		

United States	$	1,536	$	1,578
Canada		123		97
Consolidated Total	$	1,659	$	1,675
Six Months ended August 2, 2008:				
United States	$	1,509	$	1,616
Canada		134		112
Consolidated Total	$	1,643	$	1,728

We present assets based on their physical, geographic location. Certain assets located in the United States are also used to support our Canadian operations, but we do not allocate these assets to Canada.

Table of Contents

Note 9. Related Party Transactions

As previously disclosed, 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 Bain Capital Partners, LLC and The Blackstone Group. We pay annual management fees to Bain Capital Partners, LLC and The Blackstone Group (collectively, together with their applicable affiliates, the Sponsors) and Highfields Capital Management LP in the amount of $12 million and $1 million, respectively. We recognized $3 million of expense related to annual management fees during the second quarter of fiscal 2009 and fiscal 2008, and $7 million during the six months ended August 1, 2009 and August 2, 2008. These expenses are included in related party expenses on the Consolidated Statements of Operations.

Bain Capital owns a majority ownership stake in an external vendor we utilize to print our circular advertisements. Payments associated with this vendor during the second quarter of each of fiscal 2009 and fiscal 2008 were $6 million, and $14 million and $16 million for the six months ended August 1, 2009 and August 2, 2008, respectively. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

Bain Capital owns a majority ownership stake in an external vendor we utilize for non-merchandise supplies. Payments associated with this vendor during the second quarter of fiscal 2008 were $1 million. Payments for the six months ended August 1, 2009 and August 2, 2008 were $1 million and $2 million, respectively. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

The Blackstone Group owns a majority ownership stake in an external vendor we utilize to count our store inventory. Payments associated with this vendor during the second quarter of fiscal 2009 and 2008 were $2 million and $1 million, respectively. Payments for the six months ended August 1, 2009 and August 2, 2008 were $4 million and $3 million, respectively. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

During fiscal 2008, we began utilizing an external vendor for waste management services that is partially owned by The Blackstone Group. Payments associated with this vendor during the second quarter of fiscal 2009 and fiscal 2008 were $2 million and $1 million, respectively, and $4 million and $1 million for the six months ended August 1, 2009 and August 2, 2008, respectively. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

During the first quarter of fiscal 2008, The Blackstone Group acquired an ownership stake in an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during the second quarter of fiscal 2009 and fiscal 2008 were $6 million and $4 million, respectively, and $9 million and $8 million for the six months ended August 1, 2009 and August 2, 2008, respectively. These expenses are recognized in cost of sales as the sales are incurred.

The Blackstone Group owns a partial ownership stake in an external vendor we utilize for newspaper advertisements. Payments associated with this vendor were $1 million during each of the six months ended August 1, 2009 and August 2, 2008. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

Our current directors are affiliates of Bain Capital or The Blackstone Group. As such, some or all of our directors may have an indirect material interest in payments with respect to debt securities of the Company that have been purchased by affiliates of Bain Capital and The Blackstone Group. Such affiliates beneficially own approximately $239 million face amount of our Subordinated Discount Notes due 2016.

The Company periodically provides officers of Michaels Stores, Inc. and its subsidiaries the opportunity to purchase shares of our Common Stock. There were no shares sold to officers during first six months of each of fiscal 2009 and fiscal 2008. Also, during the second quarter of fiscal 2008 and the six months ended August 2, 2008, we repurchased 100,000 and 105,334 shares, respectively, from officers who are no longer with the Company. There have been no shares repurchased during the first six months of fiscal 2009.

In connection with the consummation of the Merger, the Company entered into a Separation Agreement with each of Charles Wyly and Sam Wyly, executive officers and directors of the Company prior to the Merger. Under the Separation Agreements, each of Charles Wyly and Sam Wyly received a lump sum payment of $3.0 million in exchange for his agreement to adhere to certain non-competition, non-solicitation and confidentiality restrictions. We amortized these Separation Agreements over the two year period ended October 31, 2008. These expenses are included in related party expenses on the Consolidated Statements of Operations.

Table of Contents

Note 10. Condensed Consolidating Financial Information

All obligations of Michaels Stores, Inc. under the Senior notes, Senior subordinated notes, Subordinated discount notes, Senior secured term loan, and Asset-based revolving credit facility are guaranteed by each of our subsidiaries other than Aaron Brothers Card Services, LLC and Canada Artistree, Inc. As of August 1, 2009, the financial statements of Aaron Brothers Card Services, LLC and Canada Artistree, Inc. were immaterial.

The following condensed consolidating financial information represents the financial information of Michaels Stores, Inc. and its wholly-owned subsidiary guarantors, prepared on the equity basis of accounting. The information is presented in accordance with the requirements of Rule 3-10 under the SEC s Regulation S-X. The financial information may not necessarily be indicative of results of operations, cash flows, or financial position had the subsidiary guarantors operated as independent entities.

Supplemental Condensed Consolidating Balance Sheet

	August 1, 2009			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 29	$ 7	$	$ 36
Merchandise inventories	633	317		950
Intercompany receivables		515	(515)	
Other	81	51		132
Total current assets	743	890	(515)	1,118
Property and equipment, net	257	88		345
Goodwill, net	94			94
Investment in subsidiaries	655		(655)	
Other assets	96	22		118
Total assets	$ 1,845	$ 1,000	$ (1,170)	$ 1,675
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY				
Current liabilities:				
Accounts payable	$ 13	$ 203	$	$ 216
Accrued liabilities and other	207	81		288
Current portion of long-term debt	198			198
Intercompany payable	515		(515)	
Other	(34)	35		1
Total current liabilities	899	319	(515)	703
Long-term debt	3,766			3,766
Other long-term liabilities	54	26		80
Total stockholders (deficit) equity	(2,874)	655	(655)	(2,874)
Total liabilities and stockholders (deficit) equity	$ 1,845	$ 1,000	$ (1,170)	$ 1,675

Table of Contents

Supplemental Condensed Consolidating Balance Sheet

	January 31, 2009			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 26	$ 7	$	$ 33
Merchandise inventories	627	273		900
Intercompany receivables		387	(387)	
Other	62	54		116
Total current assets	715	721	(387)	1,049
Property and equipment, net	284	98		382
Goodwill, net	94			94
Investment in subsidiaries	488		(488)	
Other assets	80	20		100
Total assets	$ 1,661	$ 839	$ (875)	$ 1,625
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY				
Current liabilities:				
Accounts payable	$ 15	$ 215	$	$ 230
Accrued liabilities and other	200	75		275
Current portion of long-term debt	173			173
Intercompany payable	387		(387)	
Other	(32)	35		3
Total current liabilities	743	325	(387)	681
Long-term debt	3,756			3,756
Other long-term liabilities	49	26		75
Total stockholders (deficit) equity	(2,887)	488	(488)	(2,887)
Total liabilities and stockholders (deficit) equity	$ 1,661	$ 839	$ (875)	$ 1,625

Table of Contents

Supplemental Condensed Consolidating Balance Sheet

	August 2, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 32	$ 13	$	$ 45
Merchandise inventories	665	273		938
Intercompany receivables		374	(374)	
Other	95	49		144
Total current assets	792	709	(374)	1,127
Property and equipment, net	294	116		410
Goodwill, net	94			94
Investment in subsidiaries	474		(474)	
Other assets	82	15		97
Total assets	$ 1,736	$ 840	$ (848)	$ 1,728
LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY				
Current liabilities:				
Accounts payable	$ 18	$ 226	$	$ 244
Accrued liabilities and other	225	79		304
Current portion of long-term debt	286			286
Intercompany payable	374		(374)	
Other	(38)	40		2
Total current liabilities	865	345	(374)	836
Long-term debt	3,748			3,748
Other long-term liabilities	62	21		83
Total stockholders (deficit) equity	(2,939)	474	(474)	(2,939)
Total liabilities and stockholders (deficit) equity	$ 1,736	$ 840	$ (848)	$ 1,728

Supplemental Condensed Consolidating Statement of Operations

	Quarter Ended August 1, 2009			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 707	$ 471	$ (371)	$ 807
Cost of sales and occupancy expense	498	394	(371)	521
Gross profit	209	77		286
Selling, general, and administrative expense	202	30		232
Related party expenses	3			3
Store pre-opening costs	1			1
Operating income	3	47		50
Interest expense	62			62
Other (income) and expense, net	(11)	(3)		(14)
Intercompany charges (income)	16	(16)		
Equity in earnings of subsidiaries	66		(66)	

Income before income taxes		2		66		(66)		2
Provision for income taxes				13		(13)		
Net income	$	2	$	53	$	(53)	$	2

Table of Contents

Supplemental Condensed Consolidating Statement of Operations

	Quarter Ended August 2, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
		(in millions)		
Net sales	$ 689	$ 492	$ (385)	$ 796
Cost of sales and occupancy expense	488	415	(385)	518
Gross profit	201	77		278
Selling, general, and administrative expense	211	35		246
Related party expenses	4			4
Store pre-opening costs	1			1
Operating (loss) income	(15)	42		27
Interest expense	76			76
Other (income) and expense, net				
Intercompany charges (income)	18	(18)		
Equity in earnings of subsidiaries	60		(60)	
(Loss) income before income taxes	(49)	60	(60)	(49)
(Benefit) provision for income taxes	(19)	23	(23)	(19)
Net (loss) income	$ (30)	$ 37	$ (37)	$ (30)

Supplemental Condensed Consolidating Statement of Operations

	Six Months Ended August 1, 2009			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
		(in millions)		
Net sales	$ 1,468	$ 950	$ (759)	$ 1,659
Cost of sales and occupancy expense	1,021	796	(759)	1,058
Gross profit	447	154		601
Selling, general, and administrative expense	418	60		478
Related party expenses	7			7
Store pre-opening costs	2			2
Operating income	20	94		114
Interest expense	125			125
Other (income) and expense, net	(15)	(5)		(20)
Intercompany charges (income)	33	(33)		
Equity in earnings of subsidiaries	132		(132)	
Income before income taxes	9	132	(132)	9
Provision for income taxes	3	48	(48)	3
Net income	$ 6	$ 84	$ (84)	$ 6

Table of Contents

Supplemental Condensed Consolidating Statement of Operations

	Six Months Ended August 2, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 1,431	$ 936	$ (724)	$ 1,643
Cost of sales and occupancy expense	992	771	(724)	1,039
Gross profit	439	165		604
Selling, general, and administrative expense	452	66		518
Related party expenses	8			8
Store pre-opening costs	2	1		3
Operating (loss) income	(23)	98		75
Interest expense	154			154
Other (income) and expense, net				
Intercompany charges (income)	35	(35)		
Equity in earnings of subsidiaries	133		(133)	
(Loss) income before income taxes	(79)	133	(133)	(79)
(Benefit) provision for income taxes	(29)	49	(49)	(29)
Net (loss) income	$ (50)	$ 84	$ (84)	$ (50)

Supplemental Condensed Statement of Cash Flows

	Six Months Ended August 1, 2009			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating activities:				
Net cash provided by operating activities	$ 29	$ 58	$ (57)	$ 30
Investing activities:				
Cash paid for property and equipment	(16)	(1)		(17)
Net cash used in investing activities	(16)	(1)		(17)
Financing activities:				
Net borrowings of long-term debt	14			14
Intercompany dividends		(57)	57	
Other financing activities	(24)			(24)
Net cash used in financing activities	(10)	(57)	57	(10)
Increase in cash and equivalents	3			3
Beginning cash and cash equivalents	26	7		33
Ending cash and cash equivalents	$ 29	$ 7	$	$ 36

Table of Contents

Supplemental Condensed Statement of Cash Flows

	Six Months Ended August 2, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating Activities:				
Net cash (used in) provided by operating activities	$ (114)	$ 86	$ (70)	$ (98)
Investing Activities:				
Cash paid for property and equipment	(33)	(6)		(39)
Net cash used in investing activities	(33)	(6)		(39)
Financing Activities:				
Net borrowings of long-term debt	153			153
Intercompany dividends		(70)	70	
Other financing activities				
Net cash provided by (used in) financing activities	153	(70)	70	153
Increase in cash and equivalents	6	10		16
Beginning cash and cash equivalents	26	3		29
Ending cash and equivalents	$ 32	$ 13	$	$ 45

Note 11. Subsequent Event

On August 20, 2009, the Company entered into a Third Amendment to Credit Agreement (the Third Amendment) to the Company s $2.4 billion senior secured term loan facility with Deutsche Bank AG New York Branch, as administrative agent, and the other lenders party thereto (the Term Loan Credit Facility). The Third Amendment amends the Term Loan Credit Facility to permit the issuance or incurrence of indebtedness for the purpose of the repayment of existing term loans under the Term Loan Credit Facility, which new indebtedness could take the form of additional term loans under the Term Loan Credit Facility or secured or unsecured bonds or other loans.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

All expressions of the Company, us, we, our, and all similar expressions are references to Michaels Stores, Inc. and its consolidated wholly-owned subsidiaries, unless otherwise expressly stated or the context otherwise requires.

Disclosure Regarding Forward-Looking Information

The following discussion should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. The following discussion, as well as other portions of this Quarterly Report on Form 10-Q, contains forward-looking statements that reflect our plans, estimates, and beliefs. Any statements contained herein (including, but not limited to, statements to the effect that Michaels or its management anticipates, plans, estimates, expects, believes, and other similar expressions) that a not statements of historical fact should be considered forward-looking statements and should be read in conjunction with our consolidated financial statements and related notes in our Annual Report on Form 10-K for the fiscal year ended January 31, 2009. Such forward-looking statements are based upon management s current knowledge and assumptions about future events and involve risks and uncertainties that could cause actual results, performance or achievements to be materially different from anticipated results, prospects, performance or achievements expressed or implied by such forward-looking statements. Such risks and uncertainties include, but are not limited to:

• risks related to general economic conditions and the current financial crisis; if the worldwide economic downturn continues or deteriorates further, it could continue to adversely affect consumer confidence and retail spending, decreasing demand for our merchandise and adversely impact our results of operations, cash flows and financial condition;

• risks related to our substantial indebtedness, as our leverage could adversely affect our ability to raise additional capital to fund our operations, limit our ability to react to changes in the economy or our industry, expose us to interest rate risk to the extent of our variable rate debt and prevent us from meeting our obligations under our notes and credit facilities;

Table of Contents

- restrictions in our debt agreements that limit our flexibility in operating our business, as our senior secured credit facilities and the indentures governing our notes contain various covenants that limit our ability to engage in specified types of transactions and require that we maintain specified financial ratios upon the occurrence of certain events;

- our ability to open new stores, as our growth depends on our strategy of increasing our number of stores and if we are unable to continue this strategy, our ability to increase our sales, profitability, and cash flow could be impaired;

- how well we manage our business;

- changes in customer demand could materially adversely affect our sales, operating results, and cash flow;

- unexpected or unfavorable consumer responses to our promotional or merchandising programs could materially adversely affect our sales, operating results, and cash flow;

- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements and adversely affect our sales, operating results and cash flow;

- improvements to our supply chain may not be fully successful;

- our suppliers may fail us;

- our reliance on foreign suppliers increases our risk of obtaining adequate, timely, and cost-effective product supplies;

- risks associated with the vendors from whom our products are sourced, including our vendors ability to finance their own operations, could materially adversely affect our revenue and gross profit;

- product recalls and/or product liability, as well as changes in product safety and other consumer protection laws, may adversely impact our operations, merchandise offerings, reputation and financial position;

- significant increases in inflation or commodity prices such as petroleum, natural gas, electricity, steel and paper may adversely affect our costs, including cost of merchandise;

- we are co-sourcing certain of our information technology, accounts payable, payroll and accounting functions, and may co-source other administrative functions, making us more dependent upon third parties;

- our information systems may prove inadequate;

- we may fail to optimize or adequately maintain our perpetual inventory and automated replenishment systems;

- failure to adequately maintain the security of our electronic and other confidential information could materially adversely affect our financial condition and operating results;

- if the Employee Free Choice Act, or similar legislation, is adopted, it would be easier for our associates to obtain union representation and our businesses could be impacted as a result;

- a weak fourth quarter would materially adversely affect our operating results;

- competition could negatively impact our operations; and

- the interests of our controlling stockholders may conflict with the interests of our creditors.

Table of Contents

For more details on factors that may cause actual results to differ materially from such forward-looking statements, please see Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended January 31, 2009, and other reports from time to time filed with or furnished to the SEC. We do not intend to, and undertake no obligation to, update or revise any forward-looking statement.

General

We continue to develop a fully integrated pricing and promotion strategy and may refine our existing strategy in future periods. A significant component of our pricing and promotion strategy involves changes in the breadth and depth of our promotional programs. Sales declines due to the current soft macroeconomic and retail environments could adversely affect operations due to a deleveraging of operating expenses. As a result, our historical trends may not be indicative of future results.

We report on the basis of a 52 or 53-week fiscal year, which ends on the Saturday closest to January 31. All references herein to fiscal 2009 relate to the 52 weeks ending January 30, 2010 and all references to fiscal 2008 relate to the 52 weeks ended January 31, 2009. In addition, all references herein to the second quarter of fiscal 2009 relate to the 13 weeks ended August 1, 2009 and all references to the second quarter of fiscal 2008 relate to the 13 weeks ended August 2, 2008. Finally, all references to the six months ended August 1, 2009 relate to the 26 weeks ended August 1, 2009, and the six months ended August 2, 2008 relate to the 26 weeks ended August 2, 2008, respectively.

The following table sets forth certain of our unaudited operating data:

	Quarter Ended		Six Months Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
Michaels stores:				
Retail stores open at beginning of period	1,020	980	1,009	963
Retail stores opened during the period	3	11	14	28
Retail stores opened (relocations) during the period		3	4	6
Retail stores closed during the period				
Retail stores closed (relocations) during the period		(3)	(4)	(6)
Retail stores open at end of period	1,023	991	1,023	991
Aaron Brothers stores:				
Retail stores open at beginning of period	156	164	161	166
Retail stores opened during the period				
Retail stores opened (relocations) during the period		1		1
Retail stores closed during the period	(1)		(6)	(2)
Retail stores closed (relocations) during the period		(1)		(1)
Retail stores open at end of period	155	164	155	164
Total store count at end of period	1,178	1,155	1,178	1,155
Other operating data:				
Average inventory per Michaels store (in thousands) (1)	$ 889	$ 899	$ 889	$ 899
Comparable store sales (2)	(0.8)%	(2.6)%	(1.4)%	(2.8)%

(1) Average inventory per Michaels store calculation excludes our Aaron Brothers stores.

(2) Comparable store sales decrease represents the decrease in net sales for stores open the same number of months in the indicated period and the comparable period of the previous year, including stores that were relocated or expanded during either period. A store is deemed to become comparable in its 14th month of operation in order to eliminate grand opening sales distortions. A store temporarily closed more than 2 weeks due to a catastrophic event is not considered comparable during the month it closed. If a store is closed longer than 2 weeks but less than 2 months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than 2 months becomes comparable in its 14th month of operation after its reopening.

Table of Contents

Results of Operations

The following table sets forth the percentage relationship to net sales of each line item of our unaudited consolidated statements of operations. This table should be read in conjunction with the following discussion and with our consolidated financial statements, including the related notes, contained herein.

	Quarter Ended		Six Months Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales and occupancy expense	64.6	65.1	63.8	63.2
Gross profit	35.4	34.9	36.2	36.8
Selling, general, and administrative expense	28.7	30.9	28.8	31.5
Related party expenses	0.4	0.5	0.4	0.5
Store pre-opening costs	0.1	0.1	0.1	0.2
Operating income	6.2	3.4	6.9	4.6
Interest expense	7.8	9.5	7.5	9.4
Other (income) and expense, net	(1.8)		(1.2)	
Income (loss) before income taxes	0.2	(6.1)	0.6	(4.8)
Income tax provision (benefit)		(2.3)	0.2	(1.8)
Net income (loss)	0.2%	(3.8)%	0.4%	(3.0)%

Quarter Ended August 1, 2009 Compared to the Quarter Ended August 2, 2008

Net Sales Net sales increased for the second quarter of fiscal 2009 by $11 million, or 1.4%, over the second quarter of fiscal 2008. Comparable store sales decreased 0.8% primarily due to a decrease in the average ticket of 7.0%, partially offset by an increase in customer transactions of 6.2%. The fluctuation in the exchange rates between the United States and Canadian dollars adversely impacted the average ticket by 100 basis points. The decrease in comparable store sales was more than offset by non-comparable new stores. Sales at 43 Michaels stores that were opened during the 13-month period ended August 1, 2009, provided incremental revenue of $18 million.

We continue to evaluate all options available to us for our Aaron Brothers concept, which range from refining the concept to possible store rationalization. Certain of these options, if enacted, may result in material charges to our consolidated statement of operations in future periods.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $3 million or 0.6% to $521 million in the second quarter of 2009 from $518 million in the second quarter of 2008 primarily due to a 1.4% increase in sales, principally as a result of sales from new stores. As a percentage of net sales, cost of sales and occupancy expense decreased approximately 50 basis points driven by a merchandise margin improvement of 20 basis points related to profit optimization and a 30 basis point reduction in occupancy costs due to lower utilities and amortization expense.

Selling, General, and Administrative Expense Selling, general, and administrative expense was $232 or 28.7% of net sales, in the second quarter of fiscal 2009 compared to $246 million, or 30.9% of net sales, in the second quarter of fiscal 2008. Selling, general, and administrative expense decreased $14 million or 220 basis points primarily due to lower payroll, severance expense and depreciation expense. Additionally, prior year amounts include consulting expenses for studies related to consumer insights and other strategic initiatives.

Related Party Expenses Related party expenses were $3 million and $4 million in the second quarter of fiscal 2009 and fiscal 2008, respectively. These costs consist primarily of approximately $3 million of management fees and associated expenses paid to our Sponsors and Highfields Capital Management L.P. (Highfields). Also included in the related party expenses in fiscal 2008 is approximately $1 million of amortization expense related to the Separation Agreements as more fully described in Note 9 to the consolidated financial statements.

Interest Expense Interest expense for the quarter decreased $14 million to $62 million as a result of a lower average interest rate related to our variable-rate debt and lower average debt levels.

Table of Contents

Other (Income) and Expense, net Other income in the second quarter of fiscal 2009 related primarily to an $11 million favorable change in the fair value of the interest rate cap as more fully described in Note 5 to the consolidated financial statements and $4 million related to foreign exchange gains.

Provision (Benefit) for Income Taxes The effective tax rate was 19.5% for the second quarter of fiscal 2009 and 38.6% for the second quarter of fiscal 2008. As a result of our low income base, our effective rate is highly sensitive to changes caused by permanent differences (i.e. differences between book income and tax income that are not expected to reverse in future periods).

Six Months Ended August 1, 2009 Compared to the Six Months Ended August 2, 2008

Net Sales Net sales increased for the first six months of fiscal 2009 by $16 million, or 1.0%, over the first six months of fiscal 2008. Comparable store sales decreased 1.4% primarily due to a decrease in the average ticket of 5.2% and an adverse impact of 0.2% related to deferred custom framing revenue, partially offset by an increase in customer transactions of 4.0%. The fluctuation in the exchange rates between the United States and Canadian dollars adversely impacted the average ticket by 130 basis points. The decrease in comparable store sales was more than offset by non-comparable new stores. Sales at our new stores that were opened during the 13-month period ended August 1, 2009, provided incremental revenue of $40 million.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $19 million or 1.8% to $1,058 million for the first six months of fiscal 2009 from $1,039 million for the first six months of fiscal 2008 primarily due to sales from new stores. As a percentage of net sales, cost of sales and occupancy expense increased approximately 60 basis points primarily driven by a merchandise margin decline of 50 basis points related to higher promotional and clearance sales as we move through old product in preparation of new product and merchandise resets. Occupancy costs increased 10 basis points related to the decreased leverage of fixed costs.

Selling, General, and Administrative Expense Selling, general, and administrative expense was $478 million, or 28.8% of net sales, for the first six months of fiscal 2009 compared to $518 million, or 31.5% of net sales, for the first six months of fiscal 2008. Selling, general and administrative expense decreased $40 million, or 270 basis points, primarily due to a reduction in payroll and bonus expense, severance expense, and depreciation expense. Additionally, prior year amounts include consulting expenses for studies related to consumer insights and other strategic initiatives.

Related Party Expenses Related party expenses were $7 million and $8 million for the first six months of fiscal 2009 and fiscal 2008, respectively, consisting primarily of $7 million of management fees and associated expenses paid to our Sponsors and Highfields. Also included in the related party expenses in fiscal 2008 is approximately $1 million of amortization expense related to the Separation Agreements as more fully described in Note 9 to the consolidated financial statements.

Interest Expense Interest expense decreased $29 million in the six months ended August 1, 2009 compared to the six months ended August 2, 2008, primarily due to a lower average interest rate on our variable-rate debt and lower average debt levels.

Other (Income) and Expense, net Other income for the first six months of fiscal 2009 related primarily to a $15 million favorable change in the fair value of the interest rate cap as more fully described in Note 5 to the consolidated financial statements and $5 million related to foreign exchange gains.

Provision (Benefit) for Income Taxes The effective tax rate was 36.6% for the first six months of fiscal 2009 and 36.9% for the first six months of fiscal 2008. We expect the effective tax rate for fiscal 2009 to range from 38% to 43%.

Liquidity and Capital Resources

We require cash principally for day-to-day operations, to finance capital investments, inventory for new stores, and inventory replenishment for existing stores, to service our outstanding debt, and seasonal working capital needs. We and our subsidiaries, affiliates, and significant shareholders may from time to time seek to retire or purchase our outstanding debt (including publicly issued debt) through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender offer or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. We expect that our available cash, cash flow generated from operating activities, and funds available under our Asset-based revolving credit facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and future growth for the foreseeable future.

Table of Contents

Cash Flow from Operating Activities

Cash flow provided by operating activities during the first six months of fiscal 2009 was $30 million compared to cash used in operating activities of $98 million during the first six months of fiscal 2008. The $128 million change was primarily due to an increase in net income, a smaller increase in merchandise inventories, and a favorable impact from accrued interest. The change in accrued interest is primarily attributable to the timing of payments and a lower average interest rate.

Average inventory per Michaels store (including supporting distribution centers) decreased 1.1% from $899,000 at August 2, 2008 to $889,000 at August 1, 2009 primarily due to lower freight costs. We anticipate average inventory per Michaels store at the end of fiscal 2009 to be down compared to the end of fiscal 2008.

Cash Flow used in Investing Activities

Cash flow used in investing activities was primarily the result of the following capital expenditure activities:

	Six Months Ended	
	August 1, 2009	**August 2, 2008**
	(in millions)	
New and relocated stores and stores not yet opened (1)	$ 7	$ 15
Existing stores	5	7
Distribution system expansion	1	2
Information systems	4	14
Corporate and other		1
	$ 17	$ 39

(1) In the first six months of fiscal 2009, we incurred capital expenditures related to the opening of 14 Michaels in addition to the relocation of four Michaels stores. In the first six months of fiscal 2008, we incurred capital expenditures related to the opening of 28 Michaels stores in addition to the relocation of six Michaels stores and one Aaron Brothers store.

Cash Flow provided by Financing Activities

Cash flow from financing activities are related primarily to borrowings and repayments under our Asset-based revolving credit facility. The borrowed amounts were used to finance inventory purchases and capital expenditures. The Asset-based revolving credit facility provides senior secured financing of up to $1.0 billion, subject to a borrowing base. As of August 1, 2009, the borrowing base was $749 million with $526 million of unused availability.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. SFAS 157 was originally effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In November 2007, the FASB placed a one year deferral for the implementation of SFAS 157 for nonfinancial assets and liabilities; however, SFAS 157 is effective for fiscal years beginning after November 15, 2007 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. On February 3, 2008, we adopted the provisions of SFAS 157 related to financial assets and liabilities and on February 1, 2009, we adopted the provisions related to nonfinancial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. These adoptions had no impact on our consolidated financial statements. See Note 6 for further information regarding fair value measurements. Additionally, in April 2009, the FASB issued FASB Staff Position (FSP) No. FAS 107-1 and APB 28-1, *Interim Disclosures About Fair Value of Financial Instruments,* which collectively provide additional guidance and require additional disclosure regarding determining and reporting fair values for certain assets and liabilities. We adopted FSP FAS 107-1 in the second quarter of fiscal 2009 as reflected in Note 3.

Table of Contents

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141, *Business Combinations*. The statement retains the purchase method of accounting used in business combinations, but replaces SFAS 141 by establishing principles and requirements for the recognition and measurement of assets, liabilities and goodwill, including the requirement that most transaction costs and restructuring costs be expensed. In addition, the statement requires disclosures to enable users to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will apply the provisions of SFAS 141R to any business combinations occurring on or after February 1, 2009.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*. SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of and gains and losses on derivative contracts, and details of credit-risk-related contingent features in hedged positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted for in accordance with SFAS 133 and its related interpretation, and how derivative instruments and related hedged items affect entity s financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We adopted the new disclosure requirements of SFAS 161 in the first quarter of 2009 as reflected in Note 5.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events*. SFAS 165 is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or available to be issued. This standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 is effective for fiscal years and interim periods ending after June 15, 2009. We adopted SFAS 165 during the second quarter of fiscal 2009, but the impact of the adoption will depend on the nature and the extent of transactions that occur subsequent to our interim and annual reporting periods.

In June 2009, the FASB issued SFAS No. 168, *FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162.* SFAS 168 establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the Codification carries an equal level of authority. The U.S. GAAP hierarchy will be modified to include two levels of GAAP: authoritative and nonauthoritative. SFAS 168 is effective for financial statements issued for interim and annual periods ended after September 15, 2009. The adoption of SFAS 168 is not expected to have a material impact on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

During the first quarter of fiscal 2009, we purchased an interest rate cap to hedge the variability of cash flows associated with our interest payments on our Senior secured term loan that result from fluctuations in the three-month LIBOR rate. The cap limits our interest exposure on a notional value of $2.0 billion to the lesser of the three-month LIBOR rate or 7.0%. The term of the cap is from April 15, 2009 through April 15, 2015. The fair value of the cap as of August 1, 2009 was $24 million and is included in Other assets on the Consolidated Balance Sheet. The change in fair value of the cap for the quarter and six months ended August 1, 2009, was $11 million and $15 million, respectively, and is recorded in Other (income) and expense, net in the Consolidated Statement of Operations.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain a set of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated by the SEC under the Securities Exchange Act of 1934). An evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. Such controls and procedures are designed to ensure that information we are required to disclose in our reports is accumulated and communicated to our management, including our principal executive officer and principal financial officer, to allow timely disclosure decisions. We note that the design of any system of controls is based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Table of Contents

Change in Internal Control Over Financial Reporting

There has not been any change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) as promulgated by the SEC under the Securities Exchange Act of 1934) during the quarter covered by this Quarterly Report on Form 10-Q that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

MICHAELS STORES, INC.

Part II OTHER INFORMATION

Item 1. Legal Proceedings.

Information regarding legal proceedings is incorporated herein by reference from Note 7 to our Consolidated Financial Statements.

Item 5. Other Information.

Effective September 4, 2009, Shelley G. Broader separated from employment as President and Chief Operating Officer with Michaels Stores, Inc.

Item 6. Exhibits.

(a) Exhibits:

Exhibit Number	Description of Exhibit
10.1	Amended form of Stock Option Agreement under Michaels Stores, Inc. 2006 Equity Incentive Plan (filed herewith).
10.2	Third Amendment to Credit Agreement, dated as of August 20, 2009, to the Credit Agreement, dated as of October 31, 2006, among Michaels Stores, Inc., Deutsche Bank AG New York Branch, as administrative agent, the other lenders named therein, JPMorgan Chase Bank, N.A., as syndication agent, and Bank of America, N.A. and Credit Suisse, as co-documentation agents, and Deutsche Bank Securities Inc., J.P. Morgan Securities Inc. and Banc of America Securities LLC as co-lead arrangers and joint bookrunners (previously filed as Exhibit 10.1 to Registrant s Current Report on Form 8-K filed August 21, 2009).
31.1	Certifications of John B. Menzer pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certifications of Elaine D. Crowley pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

Table of Contents

MICHAELS STORES, INC.

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.

MICHAELS STORES, INC.

By: /s/ Elaine D. Crowley
Elaine D. Crowley
Executive Vice President - Chief Financial Officer
(Principal Financial Officer)

Dated: September 4, 2009

Table of Contents

INDEX TO EXHIBITS

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