Sally Beauty Holdings, Inc.
Form 10-Q
February 09, 2007

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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED: DECEMBER 31, 2006

-OR-

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

Commission File No. 1-33145

SALLY BEAUTY HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**36-2257936**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3001 Colorado Boulevard Denton, Texas	**76210**
(Address of principal executive offices)	(zip code)

Registrant s telephone number, including area code: (940) 898-7500

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 þ NO o

Indicate by checkmark 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). Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.) YES o NO þ

At February 2, 2007, there were 180,198,540 shares of the issuer s common stock outstanding.

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In this report, references to the Company , our company , we , our , ours and us refer to Sally Beauty Holdings, its consolidated subsidiaries for periods after the separation from Alberto-Culver Company (Alberto-Culver) and to Sally Holdings, Inc. and its consolidated subsidiaries for periods prior to the separation from Alberto-Culver unless otherwise indicated or context otherwise requires.

Cautionary Notice Regarding Forward-Looking Statements

Statements in this report which are not purely historical facts or which depend upon future events may be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Words such as anticipate, believe, estimate, expec intend, plan, project, target, can, could, may, should, will, would, or similar expressions may alsc forward-looking statements.

Readers are cautioned not to place undue reliance on forward-looking statements as such statements speak only as of the date they were made. Any forward-looking statements involve risks and uncertainties that could cause actual events or results to differ materially from the events or results described in the forward-looking statements, including, but not limited to, risks and uncertainties related to: our limited history as a stand-alone company; the preparedness of our accounting and other management systems to meet financial reporting and other requirements; the representativeness of our historical consolidated financial information with respect to our future financial position, results of operations or cash flows; realizing the anticipated benefits of our separation from Alberto-Culver; the fact that, as a separate entity, we will not enjoy all of the benefits of scale that Alberto-Culver achieved with the combination of its consumer products business and our business;; being a holding company, with no operations of our own, and depending on our subsidiaries for cash; the highly competitive nature of the beauty products distribution industry; anticipating changes in consumer preferences and buying trends or to manage our product lines and inventory; our dependence upon manufacturers; products sold by us being found to be defective in labeling or content; compliance with laws and regulations or becoming subject to additional or more stringent laws and regulations; product diversion; successfully identifying acquisition candidates or successfully completing desirable acquisitions; integration of businesses acquired in the future; opening and operating new stores profitably; protecting our intellectual property rights, specifically our trademarks; obtaining the consent of third parties under our contracts; conducting business in international markets; disruption in our information technology systems; natural disasters or acts of terrorism; our substantial indebtedness; the possibility that we may incur substantial additional debt; restrictions and limitations in the agreements and instruments governing our debt; generating the significant amount of cash needed to service all of our debt and refinancing all or a portion of our indebtedness or obtaining additional financing; changes in interest rates increasing the cost of servicing our debt or increasing our interest expense due to our interest rate swap agreements; the share distribution of Alberto-Culver common stock in our separation from Alberto-Culver not constituting a tax-free distribution; actions taken by certain large shareholders adversely affecting the tax-free nature of the share distribution of Alberto-Culver common stock; significant restrictions on our ability to issue or repurchase equity securities; the voting power of our largest stockholder discouraging third party acquisitions of us at a premium; and the interests of our largest stockholder differing from the interests of other holders of our common stock.

Additional factors that could cause actual events or results to differ materially from the events or results described in the forward-looking statements can be found in our most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission. Consequently, all forward-looking statements in this release are qualified by the factors, risks and uncertainties contained therein. We assume no obligation to publicly update or revise any forward-looking statements.

PART I

ITEM 1. FINANCIAL STATEMENTS

The following financial statements as of and for the three months ended December 31, 2006 and 2005 are those of Sally Beauty Holdings, Inc. and its consolidated subsidiaries. The following financial statements of financial position as of September 30, 2006 and results of operations and cash flows for the three months ended December 31,

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2005 are of Sally Holdings, Inc. Sally Holdings, Inc., a subsidiary of Sally Beauty Holdings, Inc., was a wholly-owned subsidiary of Alberto-Culver until November 16, 2006 when it was converted to a Delaware limited liability company, was renamed Sally Holdings LLC and became an indirect wholly-owned subsidiary of our company in connection with the separation of our business from Alberto-Culver. Sally Beauty Holdings, Inc. was formed on June 16, 2006 in connection with the separation of our business from Alberto-Culver.

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SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES
Consolidated Statements of Earnings
(In thousands, except per share data)
(Unaudited)

	Three Months Ended December 31,	
	2006	**2005**
Net sales	$ 629,879	$ 586,355
Cost of products sold and distribution expenses	345,387	319,487
Gross profit	284,492	266,868
Selling, general and administrative expenses (1)	213,178	195,724
Depreciation and amortization	9,790	9,136
Sales-based service fee charged by Alberto-Culver	3,779	7,197
Transaction expenses	21,457	
Operating earnings	36,288	54,811
Interest expense, net of interest income of $2,007 in 2006 and $268 in 2005 and $993 of income for marked to market interest rate swaps in 2006	19,103	471
Earnings before provision for income taxes	17,185	54,340
Provision for income taxes	14,044	20,536
Net earnings	$ 3,141	$ 33,804
Net earnings per share: (2)		
Basic	$ 0.02	
Diluted	$ 0.02	
Weighted average shares: (2) (3)		
Basic	180,096	
Diluted	182,329	

(1) Selling, general and administrative expenses include allocated overhead costs from Albert-Culver of $1.0 million and $3.8 million and share-based compensation of $5.7 million and

$2.1 million for the three months ended December 31, 2006 and 2005, respectively.

(2) Net earnings per share was not calculated for the three months ended December 31, 2005 as the Company was a wholly-owned subsidiary of Alberto-Culver during fiscal year 2006. See Note 2 for details on the separation from Alberto-Culver.

(3) Weighted average shares was calculated from November 16, 2006 through December 31, 2006, which represents the actual number of days the Company s shares were publicly traded.

The accompanying condensed notes, together with the Notes to Consolidated Financial Statements contained within Sally Beauty Holding, Inc. s annual report on Form 10-K for the fiscal year ended September 31, 2006, are an integral part of these financial statements.

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SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(In thousands, except per share data)

	December 31, 2006 (Unaudited)	September 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 31,381	$ 107,571
Trade accounts receivable, less allowance for doubtful accounts of $2,422 and $2,246 at December 31, 2006 and September 30, 2006, respectively	46,359	45,462
Other receivables	23,453	21,228
Inventories	556,281	574,983
Prepaid expenses	15,722	10,255
Due from Alberto-Culver		463
Deferred income tax assets	11,084	10,327
Total current assets	684,280	770,289
Property and equipment, net	142,572	142,735
Goodwill	363,953	364,693
Intangible assets, net	52,753	53,238
Other assets	67,193	7,886
Total assets	$ 1,310,751	$ 1,338,841
Liabilities and Stockholders Equity		
Current liabilities:		
Current maturities of long-term debt	$ 17,189	$ 503
Accounts payable	152,744	176,623
Accrued expenses	125,221	114,056
Income taxes	25,841	
Total current liabilities	320,995	291,182
Long-term debt	1,781,017	621
Other liabilities	14,842	11,953
Deferred income tax liabilities	22,578	21,590
Total liabilities	2,139,432	325,346
Stock options subject to redemption	7,528	7,528
Stockholders (deficit) equity:		
Common stock, $0.01 par value. Authorized 400,000,000 shares; issued and outstanding 180,170,068 shares at December 31, 2006	1,802	
Common stock, no par value. Authorized 1,000 shares; issued and outstanding 1,000 shares at September 30, 2006		
Additional paid-in capital	599,857	62,172
Retained (deficit) earnings	(1,453,430)	927,512

Accumulated other comprehensive income foreign currency translation	15,562	16,283
Total stockholders (deficit) equity	(836,209)	1,005,967
Total liabilities and stockholders (deficit) equity	$ 1,310,751	$ 1,338,841

The accompanying condensed notes, together with the Notes to Consolidated Financial Statements contained within Sally Beauty Holding, Inc. s annual report on Form 10-K for the fiscal year ended September 31, 2006, are an integral part of these financial statements.

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SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Three Months Ended December 31,	
	2006	**2005**
Cash Flows from Operating Activities:		
Net earnings	$ 3,141	$ 33,804
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	9,790	9,136
Share-based compensation expense (net of deferred tax benefit of $1,679 and $736 in 2006 and 2005, respectively)	4,028	1,368
Excess tax benefit from share-based compensation	(145)	
Net loss on disposal of leaseholds and other property	631	154
Deferred income taxes	1,437	146
Changes in (exclusive of effects of acquisitions):		
Trade accounts receivable	(1,031)	790
Other receivables	(2,111)	(1,326)
Inventories	19,377	(21,436)
Prepaid expenses	(5,282)	1,029
Other assets	(529)	1,001
Accounts payable and accrued expenses	(5,778)	(4,541)
Income taxes	25,794	
Due from Alberto-Culver	463	20,595
Other liabilities	8,297	(1,233)
Net cash provided by operating activities	58,082	39,487
Cash Flows from Investing Activities:		
Capital expenditures	(9,189)	(6,774)
Proceeds from sale of property and equipment	41	5
Acquisitions, net of cash acquired	(5,738)	(4,247)
Net cash used by investing activities	(14,886)	(11,016)
Cash Flows from Financing Activities:		
Change in book cash overdraft	(6,515)	(13,121)
Proceeds from issuance of long-term debt	1,885,109	
Repayments of long-term debt	(88,021)	(126)
Proceeds related to notes with affiliated companies		15,275
Payments related to notes with affiliated companies		(31,763)
Debt issuance costs	(58,816)	
Equity financing costs	(42,222)	
Equity contributions	575,000	
Proceeds from exercises of stock options	239	
Excess tax benefit from share-based compensation	145	
Special cash dividend paid	(2,342,148)	
Distributions to Alberto-Culver	(41,936)	(597)

Excess tax benefit from exercises of Alberto-Culver stock options		16
Net cash used by financing activities	(119,165)	(30,316)
Effect of foreign exchange rate changes on cash and cash equivalents	(221)	(514)
Net decrease in cash and cash equivalents	(76,190)	(2,359)
Cash and cash equivalents, beginning of period	107,571	38,612
Cash and cash equivalents, end of period	$ 31,381	$ 36,253

The accompanying condensed notes, together with the Notes to Consolidated Financial Statements contained within Sally Beauty Holding, Inc. s annual report on Form 10-K for the fiscal year ended September 31, 2006, are an integral part of these financial statements.

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SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES

Consolidated Statement of Stockholders (Deficit) Equity
Three Months Ended December 31, 2006
(In thousands, except share data)
(Unaudited)

	Number of Shares	Dollars				
	Common Stock Issued	Common Stock Issued	Additional Paid-in Capital	Retained (Deficit) Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders (Deficit) Equity
Balance at September 30, 2006	1,000	$	$ 62,172	$ 927,512	$ 16,283	$ 1,005,967
Net earnings				3,141		3,141
Foreign currency translation					(721)	(721)
Total comprehensive income				3,141	(721)	2,420
Adjustment to stockholder contribution			1,067			1,067
Retirement of common stock	(1,000)		(1)	1		
Distributions to Alberto-Culver				(41,936)		(41,936)
Stock issued in connection with separation including equity contribution	180,050,488	1,801	573,199			575,000
Equity financing costs			(42,222)			(42,222)
Special cash dividend				(2,342,148)		(2,342,148)
Share-based compensation, net of tax benefit from exercises			5,404			5,404
Stock issued for stock options	119,580	1	238			239
Balance at December 31, 2006	180,170,068	$1,802	$599,857	$(1,453,430)	$ 15,562	$ (836,209)

The accompanying condensed notes, together with the Notes to Consolidated Financial Statements contained within Sally Beauty Holding, Inc. s annual report on Form 10-K for the fiscal year ended September 31, 2006, are an integral part of these financial statements.

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Sally Beauty Holdings, Inc. and Subsidiaries
Condensed Notes to Consolidated Financial Statements

1. Description of Business and Basis of Presentation

Description of Business

Sally Beauty Holdings, Inc. and its consolidated subsidiaries (the Company) sell professional beauty supplies, primarily through its Sally Beauty Supply retail stores, in the United States, United Kingdom, Puerto Rico, Mexico, Japan, Canada, Ireland and Germany. Additionally, the Company distributes professional beauty products to salons and professional cosmetologists through its Beauty Systems Group (BSG) store operations and a commissioned direct sales force that calls on salons in the United States and portions of Canada and certain European countries and to franchises in the southern and southwestern United States and Mexico through its Armstrong McCall operations. The beauty products sold by BSG and Armstrong McCall are primarily sold through exclusive territory agreements with the manufacturers of the products. Until November 16, 2006, the Company was a wholly-owned subsidiary of Alberto-Culver Company (Alberto-Culver).

On November 10, 2006, the stockholders of Alberto-Culver approved a plan to separate its consumer products business and its Sally Beauty Supply/BSG distribution business into two separate, publicly traded companies. This is more fully discussed in Note 2. The separation was completed on November 16, 2006. The transactions were effected pursuant to an Investment Agreement dated as of June 19, 2006, among Alberto-Culver and certain of its subsidiaries, including Sally Holdings, Inc., and CDRS Acquisition LLC. Sally Beauty Holdings, Inc. became the accounting successor company to Sally Holdings, Inc. upon the completion of the transactions. See Note 2 that describes certain transaction expenses incurred by the Company as a result of the separation.

Basis of Presentation

The consolidated interim financial statements included herein are unaudited and have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. The consolidated interim financial statements include the accounts of the Company and its subsidiaries. In the opinion of management, these condensed consolidated financial statements reflect all adjustments which are of a normal recurring nature and which are necessary to present fairly the consolidated financial position as of December 31, 2006, the results of operations for the three month periods ended December 31, 2006 and 2005, and cash flows for the three months ended December 31, 2006 and 2005. The results of operations for the three months ended December 31, 2006 are not necessarily indicative of the results, which may be expected for the entire fiscal year. All significant inter-company accounts and transactions have been eliminated in consolidation.

These consolidated interim financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2006. The Company adheres to the same accounting policies in preparation of interim financial statements. As permitted under generally accepted accounting principles, interim accounting for certain expenses, including income taxes, are based on full year assumptions. Such amounts are expensed in full in the year incurred. For interim financial reporting purposes, income taxes are recorded based upon estimated annual effective income tax rates.

2. Spin/Merge and Separation Transaction

On January 10, 2006, Alberto-Culver entered into an agreement with Regis Corporation (Regis) to merge the Company with a subsidiary of Regis in a tax-free transaction. Pursuant to the terms and conditions of the merger agreement, the Company was to be spun off to Alberto-Culver s stockholders by way of a tax-free distribution and, immediately thereafter, combined with Regis in a tax-free stock-for-stock merger.

On April 5, 2006, Alberto-Culver provided notice to Regis that its board of directors had withdrawn its recommendation for shareholders to approve the transaction. Following Alberto-Culver s notice to Regis, also on April 5, 2006, Regis provided notice to Alberto-Culver that it was terminating the merger agreement effective

Sally Beauty Holdings, Inc. and Subsidiaries
Condensed Notes to Consolidated Financial Statements

immediately. In connection with the termination of the merger agreement, Alberto-Culver paid Regis a $50.0 million termination fee on April 10, 2006. In addition, Alberto-Culver and the Company incurred transaction expenses, primarily legal and investment banking fees, during the fourth quarter of fiscal year 2005 and the first nine months of fiscal year 2006. The total amount of transaction expenses, including the termination fee, was $56.2 million ($35.2 million after taxes). The Company expensed approximately $37.5 million ($23.2 million after taxes) of this amount in the second and third quarters of fiscal year 2006 in accordance with the terms of the transaction agreements. All transaction related expenses incurred are expected to be deductible for tax purposes.

On June 19, 2006, Alberto-Culver announced a plan to split its beauty supply distribution business, the Company, from its consumer products business. Pursuant to an investment agreement, CDRS Acquisition LLC (CDRS), a limited liability company organized by Clayton, Dubilier & Rice Fund VII, L.P., would invest $575 million to obtain an equity ownership of approximately 48% of the Company on a fully-diluted basis and the Company would incur approximately $1.85 billion of new debt. Upon closing of the transactions, Alberto-Culver shareholders would receive, for each share of Alberto-Culver common stock then owned, (i) one share of common stock of New Alberto-Culver, which will own and operate Alberto-Culver s consumer products business, (ii) one share of common stock of Sally Beauty Holdings, Inc., which will own and operate the Company s beauty supply distribution business and (iii) a $25.00 per share special cash dividend.

On November 16, 2006, we separated from Alberto-Culver, pursuant to the Investment Agreement, dated as of June 19, 2006, as amended, among us, Alberto-Culver, CDRS and others, which we refer to as the Investment Agreement. As a result of the separation, (i) we own and operate the Sally Beauty Supply and BSG distribution businesses that were owned and operated by Alberto-Culver prior to the separation, (ii) at the closing of the separation transaction, the stockholders of Alberto-Culver prior to the separation became the beneficial owners of approximately 52% of our outstanding common stock on an undiluted basis and the CDR investors, who in the aggregate invested $575 million in our company, received an equity interest representing approximately 48% of our outstanding common stock on an fully-diluted basis and (iii) Alberto-Culver continues to own and operate its consumer products business.

In addition, on November 16, 2006, in connection with our separation from Alberto-Culver:

- Sally Holdings and certain of our other subsidiaries incurred approximately $1,850 million of indebtedness, including (i) $1,070 million by drawing on its two senior term loan facilities, (ii) $70 million by drawing on its ABL facility and (iii) $710 million from the issuance of $430 million of senior notes and $280 million of senior subordinated notes;

- We used approximately $2,342 million, a substantial portion of the proceeds of the investment by the CDR investors and the debt incurrence, to pay a $25.00 per share special cash dividend to holders of record Alberto-Culver shares as of the record date for the separation transaction.

Alberto-Culver treated our separation from it as though it constituted a change in control for all employees and directors under its equity and incentive compensation plans and as a change in control for our employees under its deferred compensation plan. Accordingly, options to purchase Alberto-Culver common stock issued under Alberto-Culver equity compensation plans outstanding as of the completion of the separation and held by our employees and John A. Miller, who was a non-employee director of Alberto-Culver prior to the separation and is now an independent member of our Board of Directors, became fully exercisable options to purchase our common stock. Restrictions on restricted stock issued under Alberto-Culver equity compensation plans prior to completion of the separation, including restricted stock held by executive officers of Alberto-Culver, lapsed on November 16, 2006. We recorded a one-time charge of $5.3 million during the first quarter of fiscal year 2007 for the amount of future compensation expense that would have been recognized in subsequent periods as the stock options and restricted shares for our employees vested over the original vesting periods.

On November 16, 2006, pursuant to the Investment Agreement, we paid a transaction fee of $30 million to Clayton, Dubilier & Rice, Inc., the manager of both Clayton, Dubilier & Rice Fund VII, L.P., the sole member of CDRS, and Parallel Fund as well as $1.1 million to CDRS for expenses it incurred in connection with its investment in our company and our separation from Alberto-Culver. The majority of the transaction fee paid to Clayton, Dubilier &

Sally Beauty Holdings, Inc. and Subsidiaries
Condensed Notes to Consolidated Financial Statements

Rice, Inc. and of the expenses paid to CDRS, along with other professional services and due diligence fees, were considered to be costs of raising equity and were recorded as a reduction to additional paid-in capital of approximately $42.2 million.

Pursuant to the Investment Agreement, we also paid approximately $20.4 million to Alberto-Culver, $16.4 million during the quarter ended December 31, 2006 and $4.0 million during the fiscal year ended September 30, 2006, for its expenses incurred in connection with the separation. We also paid approximately $58.8 million in fees for the debt financing incurred by our subsidiaries in connection with the separation.

On November 16, 2006, pursuant to the terms of the separation agreement entered into in connection with our separation from Alberto-Culver, all of our and our subsidiaries cash, cash equivalents and short-term investments were transferred to Alberto-Culver other than $91.1 million, equal to the sum of $52.7 million plus an additional amount equal to $38.4 million, which is the sum of (i) an estimate of the amount needed to cover certain income taxes (as specified in the tax allocation agreement entered into in connection with our separation from Alberto-Culver), (ii) an amount determined pursuant to a formula intended to reflect the limitations placed on the number of our shares that the CDR investors were able to acquire without jeopardizing the intended tax-free nature of the share distribution of shares of Alberto-Culver common stock to our stockholders in connection with the separation, and (iii) unpaid balances on certain of our specified liabilities, minus other specified transaction costs. An adjustment to the cash transfer, as determined under the terms of the separation and tax allocation agreements, of approximately $1.9 million is estimated to be paid during the second quarter of fiscal year 2007. All inter-company receivables, payables and loans between us and our subsidiaries, on the one hand, and Alberto-Culver and its subsidiaries, on the other hand, other than those specifically designated in the separation agreement to survive following the separation, were canceled immediately prior to the time of the distributions we made on November 16, 2006, in connection with the separation. In addition, prior thereto, all inter-company agreements between us and our subsidiaries and Alberto-Culver and its subsidiaries terminated, other than certain agreements specifically designated in the separation agreement to survive following the separation.

Upon completion of the separation, Michael H. Renzulli, former Chairman of Sally Holdings, Inc., terminated his employment with Alberto-Culver and us. We agreed to provide Mr. Renzulli with certain benefits primarily consisting of a lump-sum cash payment of $3.6 million. We recorded the expense for the payment during the quarter ending December 31, 2006 and the amount was paid in January 2007.

3. Stockholders (Deficit) / Equity

Sally Beauty Holdings, Inc. has negative stockholders equity as of December 31, 2006 as a result of a deficit in retained earnings. During the three months ended December 31, 2006 retained earnings decreased as a result of the dividend payment of approximately $2,342.1 million to the shareholders of Alberto-Culver, called for under the separation agreement from Alberto-Culver. The proceeds from the equity contribution of $575.0 million from CDRS and the proceeds from the issuance of the debt were used to fund this dividend. In addition, retained earnings decreased by $41.9 million as a result of settlement of the inter-company agreement with Alberto-Culver, treated as a dividend.

During the three months ended December 31, 2006 additional paid-in capital decreased as a result of a portion of the $30.0 million fee paid by Sally Beauty Holdings, Inc. to Clayton, Dubilier & Rice, Inc. and the expenses paid to CDRS along with other professional services and due diligence fees. These were considered to be costs of raising equity and were recorded as a reduction to additional paid-in capital in the amount of approximately $42.2 million.

During the three months ended December 31, 2006 and prior to its separation from Alberto-Culver, the Company recorded an increase in additional paid-in capital for stock issued by Alberto-Culver. The stock was issued to the former owner of Monarch Beauty Supply Co. Ltd., a subsidiary previously owned by Alberto-Culver and contributed by Alberto-Culver to Sally Beauty Holdings, Inc. in 2003. The additional paid-in capital recorded by Sally Beauty Holdings, Inc., as an adjustment of $1.1 million to stockholder contribution, reflects the effect of certain pre-acquisition tax liabilities fully indemnified by the seller, for which Alberto-Culver retained the proceeds.

Sally Beauty Holdings, Inc. and Subsidiaries
Condensed Notes to Consolidated Financial Statements

The change in common stock resulted from the issuance of stock in connection with the separation agreement with Alberto-Culver and the Investment Agreement with CDRS.

See Note 9 for a discussion of other comprehensive income.

4. Long-Term Debt

In connection with the separation from Alberto-Culver, the Company, through its subsidiaries, incurred $1,850 million of indebtedness by drawing on a revolving (asset-based lending) facility in an amount equal to $70 million, entered into two term loan facilities (term loans A and B) in an aggregate amount of $1,070 million, and issued senior notes in an aggregate amount of $430 million and senior subordinated notes in an aggregate amount of $280 million.

The term loan facilities and asset-based lending facility are secured by substantially all of the assets of the Company and its subsidiaries. The term loan credit facilities may be prepaid at the Company s option at any time without premium or penalty and are subject to mandatory prepayment in an amount equal to 50% of excess cash flow (as defined in the agreements) for any fiscal year (commencing in fiscal year 2008) unless a specified leverage ratio is met and 100% of the proceeds of specified asset sales that are not reinvested in the business or applied to repay borrowings under the asset-based lending credit facility.

The senior and senior subordinated notes are unsecured obligations of the issuers and are guaranteed on a senior basis (in the case of the senior notes) and on a senior subordinated basis (in the case of the senior subordinated notes) by each material domestic subsidiary of the Company. The senior notes and the senior subordinated notes carry optional redemption features whereby the Company has the option to redeem the notes on or before November 15, 2010 and November 15, 2011, respectively, at par plus a premium, plus accrued and unpaid interest, and on or after November 15, 2010 and November 15, 2011, respectively, at par plus a premium declining ratably to par, plus accrued and unpaid interest.

Details of the debt issued on November 16, 2006 are as follows (in thousands):

		Amount as of December 31, 2006	Maturity dates (Fiscal year)		Interest rates
Revolving credit facilities	$	21,200	2012	(i)	PRIME and up to 0.50% or;
				(ii)	LIBOR plus (1.0% to 1.50%)
Term loan A		148,125	2012	(i)	PRIME plus (1.00% to 1.50%) or;
				(ii)	LIBOR plus (2.00% to 2.50%)
Term loan B		917,700	2014	(i)	PRIME plus (1.25% to 1.50%) or;
				(ii)	LIBOR plus (2.25% to 2.50%)
Total	$	1,087,025			
Senior notes	$	430,000	2015		9.25%
Senior subordinated notes		280,000	2017		10.50%
Total	$	710,000			

On November 24, 2006, the Company entered into two interest rate swap agreements relating to $500 million of the $1,070 million term loans A and B due in 2012 and 2014, respectively. See Note 5 for further information on the interest rate swap agreements.

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Maturities of the long-term debt issued November 16, 2006 for the next five fiscal years are as follows (in thousands):

Sally Beauty Holdings, Inc. and Subsidiaries
Condensed Notes to Consolidated Financial Statements

Year ending September 30:	
2007	$ 12,525
2008	16,700
2009	24,200
2010	24,200
2011	39,200
Thereafter	1,680,200
	$ 1,797,025

Note: Maturities schedule is for the debt issued on November 16, 2006 and does not include capital leases of $1.2 million.

5. Interest Rate Swaps

On November 24, 2006, the Company entered into two interest rate swap agreements with a notional amount of $150.0 million and $350.0 million. These agreements expire in two and three years, respectively. Both agreements allow the Company to convert a portion of its variable rate interest to a fixed rate at 4.9975% plus (2.00% to 2.50%) and 4.94% plus (2.25% to 2.50%), respectively. These interest rate swap agreements relate to $500 million of the $1,070 million Term loans A and B due in 2012 and 2014, respectively to manage the Company s risk associated with changing interest rates. Under the swap agreements, the Company will pay a fixed rates of 4.9975% plus (2.00% to 2.50%) and 4.94% plus (2.25% to 2.50%) on a quarterly basis in exchange for receiving floating rate payments based on the three-month LIBOR rate.

The Company utilizes interest rate swaps to manage the risk associated with changing interest rates and accounts for them under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities , as amended (SFAS 133). SFAS 133 requires that all derivatives be marked to market (fair value). The Company does not purchase or hold any derivative instruments for trading purposes. The interest rate swap agreements do not currently qualify as hedges and, therefore, the change in fair value of the interest rate swap agreements, which are adjusted quarterly, are recorded in the results of operations. The fair value of the swap agreements at December 31, 2006, was an asset of approximately $1.0 million.

Fair value estimates presented for the swap agreements are based on third-party information and were determined using proprietary models based upon well-recognized financial principals and reasonable estimates about relevant future market conditions.

The counter-parties to these swap instruments are large financial institutions which the Company believes are of high quality creditworthiness. While the Company may be exposed to potential losses due to the credit risk of nonperformance by these counter-parties, such losses are not anticipated.

The marked to market impact of the swap arrangements on interest expense was a decrease of approximately $1.0 million in the three months ended December 31, 2006. However, changes in the fair value of the interest rate swap agreements will increase or decrease our net interest expense and therefore may affect our profitability.

6. Net Earnings Per Share

Basic net earnings per share is computed by dividing net earnings by the weighted average number of shares of common stock outstanding during the period. Diluted net income per share was calculated similarly but includes potential dilution from the exercise of stock options.

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The following table sets forth the computation of basic and diluted earnings per share for the three months ended December 31, 2006 (in thousands, except per share data):

Sally Beauty Holdings, Inc. and Subsidiaries
Condensed Notes to Consolidated Financial Statements

	Three Months Ended December 31, 2006	
Net earnings	$	3,141
Total weighted-average basic shares **(1)**		180,096
Dilutive securities:		
Stock option programs		2,233
Total weighted average diluted shares		182,329
Earnings per share:		
Basic	$	0.02
Diluted	$	0.02

(1) Weighted average shares was calculated from November 16, 2006 through December 31, 2006, which represents the actual number of days the Company s shares were publicly traded.

Net earnings per share was not calculated for the three months ended December 31, 2005 as the Company was a wholly-owned subsidiary of Alberto-Culver during fiscal year 2005. See Note 2 for details on the separation from Alberto-Culver.

At December 31, 2006, options to purchase 2,622,909 shares of common stock were outstanding but not included in the computation of diluted earnings per share, as these options exercise prices, ranging from $9.45 to $9.57, were greater than the average market price of the common shares.

7. Share-Based Payments

The Company accounts for stock option and restricted stock plans in accordance with SFAS 123 (Revised 2004), *Share-Based Payment* SFAS 123 (R) . Accordr advice for the benefit of any purchaser or holder of the Buffered PLUS. The Buffered PLUS have not been designed and will not be administered in a manner intended to reflect the individualized needs and objectives of any purchaser or holder of the Buffered PLUS.

Each purchaser or holder of any Buffered PLUS acknowledges and agrees that:

(i) the purchaser or holder or its fiduciary has made and shall make all investment decisions for the purchaser or holder and the purchaser or holder has not relied and shall not rely in any way upon us or our affiliates to act as a fiduciary or adviser of the purchaser or holder with respect to (A) the design and terms of the Buffered PLUS, (B) the purchaser or holder's investment in the Buffered PLUS, or (C) the exercise of or failure to exercise any rights we have under or with respect to the Buffered PLUS;

(ii) we and our affiliates have acted and will act solely for our own account in connection with (A) all transactions relating to the Buffered PLUS and (B) all hedging transactions in connection with our obligations under the Buffered PLUS;

(iii) any and all assets and positions relating to hedging transactions by us or our affiliates are assets and positions of those entities and are not assets and positions held for the benefit of the purchaser or holder;

(iv) our interests are adverse to the interests of the purchaser or holder; and

(v) neither we nor any of our affiliates is a fiduciary or adviser of the purchaser or holder in connection with any such assets, positions or transactions, and any information that we or any of our affiliates may provide is not intended to be impartial investment advice.

Each purchaser and holder of the Buffered PLUS has exclusive responsibility for ensuring that its purchase, holding and disposition of the Buffered PLUS do not violate the prohibited transaction rules of ERISA or the Code or any Similar Law. The sale of any Buffered PLUS to any Plan or plan subject to Similar Law is in no respect a representation by us or any of our affiliates or representatives that such an investment meets all relevant legal requirements with respect to investments by plans generally or any particular plan, or that such an investment is appropriate for plans generally or any particular plan. In this regard, neither this discussion nor anything provided in this document is or is intended to be investment advice directed at any potential Plan purchaser or at Plan purchasers generally and such purchasers of the Buffered PLUS should consult and rely on their own counsel and advisers as to whether an investment in the Buffered PLUS is suitable.

However, individual retirement accounts, individual retirement annuities and Keogh plans, as well as employee benefit plans that permit participants to direct the investment of their accounts, will not be permitted to purchase or hold the Buffered PLUS if the account, plan or annuity is for the benefit of an employee of Morgan Stanley or Morgan Stanley Wealth Management or a family member and the employee receives any compensation (such as, for example, an addition to bonus) based on the purchase of the Buffered PLUS by the account, plan or annuity.

Additional considerations: Client accounts over which Morgan Stanley, Morgan Stanley Wealth Management or any of their respective subsidiaries have investment discretion are not permitted to purchase the Buffered PLUS, either directly or indirectly.**Supplemental information regarding plan of distribution; conflicts of interest:**

MS & Co. expects to sell all of the Buffered PLUS that it purchases from us to an unaffiliated dealer at a price of $988.75 per Buffered PLUS, for further sale to certain fee-based advisory accounts at the price to public of $1,000 per Buffered PLUS. MS & Co. will not receive a sales commission with respect to the Buffered PLUS.

MS & Co. is an affiliate of MSFL and a wholly owned subsidiary of Morgan Stanley, and it and other affiliates of ours expect to make a profit by selling, structuring and, when applicable, hedging the Buffered PLUS.

MS & Co. will conduct this offering in compliance with the requirements of FINRA Rule 5121 of the Financial Industry Regulatory Authority, Inc., which is commonly referred to as FINRA, regarding a FINRA member firm's distribution of the securities of an affiliate and related conflicts of interest. MS & Co. or any of our other affiliates may not make sales in this offering to any discretionary account. See "Plan of Distribution (Conflicts of Interest)" and "Use of Proceeds and Hedging" in the accompanying product supplement for PLUS.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 4, 2024

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

Validity of the Buffered PLUS:	In the opinion of Davis Polk & Wardwell LLP, as special counsel to MSFL and Morgan Stanley, when the Buffered PLUS offered by this pricing supplement have been executed and issued by MSFL, authenticated by the trustee pursuant to the MSFL Senior Debt Indenture (as defined in the accompanying prospectus) and delivered against payment as contemplated herein, such Buffered PLUS will be valid and binding obligations of MSFL and the related guarantee will be a valid and binding obligation of Morgan Stanley, enforceable in accordance with their terms, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith), provided that such counsel expresses no opinion as to (i) the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law on the conclusions expressed above and (ii) any provision of the MSFL Senior Debt Indenture that purports to avoid the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law by limiting the amount of Morgan Stanley's obligation under the related guarantee. This opinion is given as of the date hereof and is limited to the laws of the State of New York, the General Corporation Law of the State of Delaware and the Delaware Limited Liability Company Act. In addition, this opinion is subject to customary assumptions about the trustee's authorization, execution and delivery of the MSFL Senior Debt Indenture and its authentication of the Buffered PLUS and the validity, binding nature and enforceability of the MSFL Senior Debt Indenture with respect to the trustee, all as stated in the letter of such counsel dated November 16, 2017, which is Exhibit 5-a to the Registration Statement on Form S-3 filed by Morgan Stanley on November 16, 2017.
Contact:	Morgan Stanley Wealth Management clients may contact their local Morgan Stanley branch office or our principal executive offices at 1585 Broadway, New York, New York 10036 (telephone number (866) 477-4776). All other clients may contact their local brokerage representative. Third-party distributors may contact Morgan Stanley Structured Investment Sales at (800) 233-1087.
Where you can find more information:	Morgan Stanley and MSFL have filed a registration statement (including a prospectus, as supplemented by the product supplement for PLUS and the index supplement) with the Securities and Exchange Commission, or SEC, for the offering to which this communication relates. You should read the prospectus in that registration statement, the product supplement for PLUS, the index supplement and any other documents relating to this offering that Morgan Stanley and MSFL have filed with the SEC for more complete information about Morgan Stanley, MSFL and this offering. You may get these documents without cost by visiting EDGAR on the SEC web site at.www.sec.gov. Alternatively, Morgan Stanley, MSFL, any underwriter or any dealer participating in the offering will arrange to send you the product supplement for PLUS, index supplement and prospectus if you so request by calling toll-free 1-(800)-584-6837.

You may access these documents on the SEC web site at.www.sec.gov as follows:

Product Supplement for PLUS dated November 16, 2017

Index Supplement dated November 16, 2017

Prospectus dated November 16, 2017

Terms used but not defined in this document are defined in the product supplement for PLUS, in the index supplement or in the prospectus.

"Performance Leveraged Upside Securities^{SM}" and "PLUS^{SM}" are our service marks.