

MICHAELS STORES INC  
Form 10-Q  
August 27, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended July 31, 2010

OR

**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

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**MICHAELS STORES, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**75-1943604**  
(I.R.S. employer  
identification number)

**8000 Bent Branch Drive**

**Irving, Texas 75063**

(Address of principal executive offices, including zip code)

**(972) 409-1300**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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  No

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   
Non-accelerated filer   
(Do not check if a smaller reporting company)

Accelerated filer   
Smaller reporting company

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

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As of August 23, 2010, 118,898,939 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.

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**MICHAELS STORES, INC.**

**FORM 10-Q**

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## MICHAELS STORES, INC.

## Part I FINANCIAL INFORMATION

## Item 1. Financial Statements.

## MICHAELS STORES, INC.

## CONSOLIDATED BALANCE SHEETS

(In millions, except share data)

(Unaudited)

	July 31, 2010	January 30, 2010	August 1, 2009
<b>ASSETS</b>			
<b>Current assets:</b>			
Cash and equivalents	\$ 69	\$ 217	\$ 36
Merchandise inventories	888	873	950
Prepaid expenses and other	70	72	75
Deferred income taxes	42	45	41
Income tax receivable	31		16
Total current assets	1,100	1,207	1,118
<b>Property and equipment, at cost</b>			
Less accumulated depreciation	(981)	(940)	(883)
Property and equipment, net	295	317	345
<b>Goodwill</b>			
	94	94	94
<b>Debt issuance costs, net of accumulated amortization of \$65, \$56, and \$47, respectively</b>			
	80	70	78
<b>Deferred income taxes</b>			
	8	1	14
<b>Other assets</b>			
	7	21	26
Total non-current assets	189	186	212
Total assets	\$ 1,584	\$ 1,710	\$ 1,675
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>			
<b>Current liabilities:</b>			
Accounts payable	\$ 222	\$ 231	\$ 216
Accrued liabilities and other	321	355	288
Current portion of long-term debt	1	119	198
Income taxes payable	1	11	
Current liabilities - discontinued operations		1	1
Total current liabilities	545	717	703
<b>Long-term debt</b>			
	3,707	3,684	3,766
<b>Deferred income taxes</b>			
	2		
<b>Other long-term liabilities</b>			
	84	80	79
<b>Long-term liabilities - discontinued operations</b>			
			1
Total long-term liabilities	3,793	3,764	3,846

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Total liabilities	4,338	4,481	4,549
<b>Commitments and contingencies</b>			
<b>Stockholders deficit:</b>			
Common Stock, \$0.10 par value, 220,000,000 shares authorized; 118,389,571 shares issued and outstanding at July 31, 2010; 118,387,229 shares issued and outstanding at January 30, 2010; 118,387,229 shares issued and outstanding at August 1, 2009	12	12	12
Additional paid-in capital	39	35	32
Accumulated deficit	(2,812)	(2,824)	(2,925)
Accumulated other comprehensive income	7	6	7
Total stockholders deficit	(2,754)	(2,771)	(2,874)
Total liabilities and stockholders deficit	\$ 1,584	\$ 1,710	\$ 1,675

See accompanying notes to consolidated financial statements.

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## MICHAELS STORES, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions)

(Unaudited)

	Quarter Ended		Six Months Ended	
	July 31, 2010	August 1, 2009	July 31, 2010	August 1, 2009
<b>Net sales</b>	\$ 831	\$ 807	\$ 1,732	\$ 1,659
Cost of sales and occupancy expense	520	521	1,067	1,058
<b>Gross profit</b>	311	286	665	601
Selling, general, and administrative expense	233	232	478	478
Related party expenses	4	3	7	7
Store pre-opening costs		1	1	2
<b>Operating income</b>	74	50	179	114
Interest expense	70	62	138	125
Other (income) and expense, net	4	(14)	11	(20)
<b>Income before income taxes</b>		2	30	9
Provision for income taxes	1		18	3
<b>Net (loss) income</b>	\$ (1)	\$ 2	\$ 12	\$ 6

See accompanying notes to consolidated financial statements.

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## MICHAELS STORES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

	Six Months Ended	
	July 31, 2010	August 1, 2009
<b>Operating activities:</b>		
Net income	\$ 12	\$ 6
Adjustments:		
Depreciation and amortization	52	58
Share-based compensation	4	4
Debt issuance costs amortization	9	8
Accretion of subordinated discount notes	24	22
Change in fair value of interest rate cap	13	(15)
Changes in assets and liabilities:		
Merchandise inventories	(15)	(43)
Prepaid expenses and other	2	(5)
Deferred income taxes and other	(1)	(8)
Accounts payable	(9)	7
Accrued interest	(2)	1
Accrued liabilities and other	(29)	7
Income taxes receivable	(41)	(17)
Other long-term liabilities	4	5
Net cash provided by operating activities	23	30
<b>Investing activities:</b>		
Additions to property and equipment	(33)	(17)
Net cash used in investing activities	(33)	(17)
<b>Financing activities:</b>		
Borrowings on asset-based revolving credit facility	13	441
Payments on asset-based revolving credit facility	(13)	(415)
Repayments on senior secured term loan facility	(118)	(12)
Payment of debt issuance costs	(19)	
Change in cash overdraft		(23)
Other	(1)	(1)
Net cash used in financing activities	(138)	(10)
<b>(Decrease) increase in cash and equivalents</b>	<b>(148)</b>	<b>3</b>
<b>Cash and equivalents at beginning of period</b>	<b>217</b>	<b>33</b>
<b>Cash and equivalents at end of period</b>	<b>\$ 69</b>	<b>\$ 36</b>
<b>Supplemental Cash Flow Information:</b>		
Cash paid for interest	\$ 105	\$ 93
Cash paid for income taxes	\$ 58	\$ 19

See accompanying notes to consolidated financial statements.





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**MICHAELS STORES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**For the Six Months Ended July 31, 2010**

**(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 U.S. 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 30, 2010.

The balance sheet at January 30, 2010 has been derived from the audited financial statements at that date but does not include all of the information and notes required by U.S. 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 30, 2010.

In the opinion of management, all adjustments (consisting of normal recurring accruals and other items disclosed herein) 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 July 31, 2010 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 2010 relate to the 52 weeks ending January 29, 2011, and all references to fiscal 2009 relate to the 52 weeks ended January 30, 2010. In addition, all references herein to the second quarter of fiscal 2010 relate to the 13 weeks ended July 31, 2010 and all references to the second quarter of fiscal

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2009 relate to the 13 weeks ended August 1, 2009. Finally, all references to the six months ended July 31, 2010 relate to the 26 weeks ended July 31, 2010, and the six months ended August 1, 2009 relate to the 26 weeks ended August 1, 2009.

### *Recent Accounting Pronouncements*

In January 2010, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2010-06, *Improving Disclosures About Fair Value Measurements* an amendment to Accounting Standards Codification ( ASC ) topic 820, *Fair Value Measurements and Disclosures*. ASU 2010-06 requires expanded disclosures related to fair value measurements including (i) disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers and (ii) present separate information for Level 3 activity pertaining to gross purchases, sales, issuances, and settlements. The new disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 activity disclosures, which are effective for fiscal years beginning after December 15, 2010. We adopted all requirements of ASU 2010-06 related to significant transfers in and out of Level 1 and Level 2 fair value measurements on January 31, 2010, with no material impact on our consolidated financial statements. See Note 6 for further information regarding fair value measurements. We will adopt the new disclosure requirements related to the Level 3 activity on January 30, 2011, with no material impact expected 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. As of July 31, 2010, there were 10.1 million stock option awards outstanding. In addition, there were a total of 589,204 shares of restricted stock outstanding under the 2006 Plan, of which 79,836 are vested. 3.5 million shares of Common Stock remain available for grant under the 2006 Plan. The table below sets forth a summary of stock option activity:

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	<b>Six Months Ended July 31, 2010 (in millions)</b>
Outstanding at beginning of period	9.5
Grants	0.9
Canceled/Forfeited	(0.3)
Outstanding at end of period	10.1

Generally, awards granted under the 2006 Plan vest ratably over five years and expire eight years from the grant date. The exercise prices of the options range from \$7.50 per share to \$22.50 per share, as determined by the Board of Directors. Share-based compensation expense associated with the stock options and the restricted stock was approximately \$2 million for the second quarter of each of fiscal 2010 and fiscal 2009, and \$4 million during each of the six months ended July 31, 2010 and August 1, 2009.

**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.

	<b>July 31, 2010</b>	<b>January 30, 2010 (in millions)</b>	<b>August 1, 2009</b>
Senior secured term loan	\$ 2,156	\$ 2,274	\$ 2,285
Senior notes	750	750	750
Senior subordinated notes	400	400	400
Subordinated discount notes	401	377	354
Asset-based revolving credit facility			174
Other	1	2	1
<b>Total debt</b>	<b>3,708</b>	<b>3,803</b>	<b>3,964</b>
Less current portion	1	119	198
<b>Long-term debt</b>	<b>\$ 3,707</b>	<b>\$ 3,684</b>	<b>\$ 3,766</b>

*Asset-based revolving credit facility*

On February 18, 2010, we entered into an agreement to amend and restate various terms of the then existing asset-based revolving credit facility dated as of October 31, 2006 (the Amended Asset-based revolving credit facility).

The Amended Asset-based revolving credit facility extended an aggregate amount of \$850 million of the tranche A commitments and \$50 million of the FILO (as defined below) commitments, with respect to certain lenders (the Extending Lenders), from October 31, 2011 to the

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earlier of April 15, 2014, or 45 days prior to the maturity date of any class of term loans in the Company's senior secured term loan facility. In addition, \$202 million of commitments from the other lenders under the existing asset-based revolving credit facility (the "Non-Extending Lenders") shall terminate on October 31, 2011. Simultaneously with entering into the Amended Asset-based revolving credit facility, the Company exercised its ability to increase tranche A commitments in the aggregate amount of \$152 million.

The borrowing base on the Amended Asset-based revolving credit facility equals the sum of (i) 90% of eligible credit card receivables and debit card receivables; (ii) between 85% and 87.5% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit; (iii) a percentage of eligible in-transit inventory, less certain reserves; and (iv) the sum of an additional 5% of the appraised net orderly liquidation value of eligible inventory and of eligible letters of credit plus an additional 5% of eligible credit card receivables and debit card receivables under a last out tranche (the first in last out tranche "FILO").

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The Amended Asset-based revolving credit facility provides us with the right to request up to \$200 million of additional commitments under this facility, of which \$48 million remains available, prior to the maturity of the existing asset-based revolving credit facility on October 31, 2011. The lenders under this facility are not under any obligation to provide any such additional commitments, and any increase in commitments is subject to customary conditions precedent. If we were to request any such additional commitments, and the existing lenders or new lenders were to agree to provide such commitments, the facility size under the Amended Asset-based revolving credit facility could be increased to up to \$1.2 billion after the maturity of the loans with respect to Non-Extending Lenders. However, our ability to borrow under this facility would still be limited by the amount of the borrowing base.

With respect to the Extending Lenders, borrowings under the Amended Asset-based revolving credit facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the highest of (1) the prime rate of Bank of America, N.A., (2) the federal funds effective rate plus 0.50% and (3) a LIBOR rate subject to certain adjustments plus 1.00% or (b) a LIBOR rate subject to certain adjustments, in each case plus an applicable margin. With respect to the Non-Extending Lenders, borrowings under the Amended Asset-based revolving credit 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 Bank of America, N.A. and (2) the federal funds effective rate plus 0.50% or (b) a LIBOR rate subject to certain adjustments, in each case plus an applicable margin. The initial applicable margin with respect to Extending Lenders is (a) 2.50% for non-FILO base rate borrowings and 3.50% for non-FILO LIBOR borrowings and (b) 4.50% for FILO base rate borrowings and 5.50% for FILO LIBOR borrowings. The initial applicable margin with respect to Non-Extending Lenders is 0.50% for base rate borrowings and 1.50% for LIBOR borrowings. The applicable margin is subject to adjustment each fiscal quarter based on the excess availability under the Amended Asset-based revolving credit facility. Same-day borrowings bear interest at a rate per annum equal to a base rate determined by reference to the highest of (a) the prime rate of Bank of America, N.A., (b) the federal funds effective rate plus 0.50% and (c) a LIBOR rate subject to certain adjustments plus 1.00%, in each case, plus an applicable margin. The initial applicable margin with respect to same-day borrowings is 2.50%.

We are required to pay a commitment fee of 0.625% per annum on the unutilized commitments with respect to Extending Lenders and 0.25% with respect to Non-Extending Lenders under the Amended Asset-based revolving credit facility. We must also pay customary letter of credit fees and agency fees.

If, at any time, the aggregate amount of outstanding loans, unreimbursed letter of credit drawings and undrawn letters of credit under the Amended Asset-based revolving credit facility exceeds the lesser of (i) the commitment amount or (ii) the borrowing base, we will be required to repay outstanding loans and cash collateralize letters of credit in an aggregate amount equal to such excess, with no reduction of the commitment amount. If the amount available under the Amended Asset-based revolving credit facility is less than \$75 million at any time, or for five consecutive business days is less than the greater of \$100 million and 15% of the lesser of the (i) then borrowing base and (ii) Revolving Credit Ceiling (as defined below), or if certain events of default have occurred, we will be required to repay outstanding loans and cash collateralize letters of credit with the cash we are required to deposit daily in a collection account maintained with the agent under the Amended Asset-based revolving credit facility. We may voluntarily reduce the unutilized portion of the commitment amount and repay outstanding loans at any time without premium or penalty other than customary breakage costs with respect to LIBOR loans.

We must not permit excess availability at any time to be less than the greater of (a) \$75 million and (b) 10% of the lesser of (1) the then borrowing base under the Amended Asset-based revolving credit facility or (2) \$1,102 million (as reduced or increased in accordance with the terms of the Amended Asset-based credit facility, the Revolving Credit Ceiling). Excess availability under the Amended Asset-based revolving credit facility means the lesser of (a) the Revolving Credit Ceiling minus the outstanding credit extensions and (b) the then borrowing base minus the outstanding credit extensions.

Although the Amended Asset-based revolving credit facility does not require us to comply with any financial ratio maintenance, it does contain a number of covenants that, among other things and subject to certain exceptions, restricts the Company's ability and the ability of its subsidiaries

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to:

- incur additional indebtedness;
- pay dividends on the Company's capital stock or redeem, repurchase or retire the Company's capital stock or its other indebtedness;
- make investments, loans, advances and acquisitions;
- create restrictions on the payment of dividends or other amounts to the Company from its restricted subsidiaries;
- engage in transactions with affiliates of the Company;
- sell assets, including capital stock of the Company's subsidiaries;
- consolidate or merge; and
- create liens.

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The covenants limiting dividends and other restricted payments; investments, loans, advances and acquisitions; and prepayments or redemptions of indebtedness, each permit the restricted actions in an unlimited amount, subject to the satisfaction of certain payment conditions, principally that we must meet certain specified excess availability requirements and minimum consolidated fixed charge coverage ratios, to be tested on a pro forma and 12 months projected basis. Adjusted EBITDA is used in the calculation of the consolidated fixed charge coverage ratios.

In addition, (a) for the period of thirty consecutive days preceding the maturity of the loans of the Non-Extending Lenders and (b) on a projected pro forma basis, giving effect to the repayment of the loans of the Non-Extending Lenders and termination or reduction, as applicable, of the commitments of such lenders, for the six-month period following the maturity of the loans of the Non-Extending Lenders, we must not permit excess availability at any time to be less than \$125 million. The Amended Asset-based revolving credit facility also contains certain customary affirmative covenants and events of default.

In the first quarter of fiscal 2010, we recorded \$19 million in debt issuance costs related to the amendment to the asset-based revolving credit facility that will be amortized as interest expense over the life of the Amended Asset-based revolving credit facility in accordance with ASC 470, *Debt*. In addition, we will amortize \$5 million of the unamortized debt issuance costs related to the asset-based revolving credit facility over the revised life, with the remaining \$1 million being amortized over the original life.

As of July 31, 2010, the borrowing base was \$661 million, of which we had no outstanding borrowings, \$53 million of outstanding letters of credit, and \$608 million of excess 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 ( *Deutsche Bank* ) 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 0.5% or (b) a LIBOR rate, subject to certain adjustments, in each case plus an applicable margin as described below.

On November 5, 2009, we amended the Senior secured term loan facility to extend \$1.0 billion of existing term loans (the *B-2 Term Loans* ) to July 31, 2016, with the remaining \$1.28 billion of existing term loans (the *B-1 Term Loans* and together with the *B-2 Term Loans*, the *Term Loans* ) keeping the original maturity date of October 31, 2013. The *B-2 Term Loans* are subject to (i) a springing maturity date of July 31, 2014, unless we have either (x) refinanced our Senior Notes by July 30, 2014 with new indebtedness that does not mature or require any principal payments prior to 91 days after the extended maturity date of the *B-2 Term Loans* or (y) met a pro forma secured leverage ratio of 3.25:1.00 for the test period ending April 30, 2014; and (ii) a minimum increase in interest rates on the *B-2 Term Loans* in connection with any future extensions of term loans to the extent that any such future extension has an increase in effective yield in excess of 0.25% above the effective yield of the *B-2 Term Loans*. As of July 31, 2010, the applicable margin for the *B-1* and *B-2 Term Loans* was 1.25% and 3.50%, respectively, with respect to base rate borrowings and 2.25% and 4.50%, respectively, with respect to LIBOR borrowings.

The Senior secured term loan facility requires us to prepay outstanding loans to the extent we have Excess Cash Flow, as fully described in our Annual Report on Form 10-K for the fiscal year ended January 30, 2010. Under the facilities, excess cash flow payments serve to reduce future scheduled quarterly principal payments. The fiscal 2009 excess cash flow payment effectively satisfies all scheduled quarterly principal



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payments until maturity of the B-1 Term Loans and required payments under the B-2 Term Loans until the end of fiscal 2014. The excess cash flow calculation used to determine the required payment amount, if any, is calculated at the end of each fiscal year. Due to the nature of the calculation, we are unable to estimate if there will be a required payment for fiscal 2010.

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

	Quarter Ended		Six Months Ended	
	July 31, 2010	August 1, 2009	July 31, 2010	August 1, 2009
	(in millions)			
Net (loss) income	\$ (1)	\$ 2	\$ 12	\$ 6
Other comprehensive (loss) income:				
Derivative loss		(1)		(3)
Foreign currency translation adjustment and other		4	1	5
Comprehensive (loss) income	\$ (1)	\$ 5	\$ 13	\$ 8

Accumulated other comprehensive income, net of tax, is reflected in the Consolidated Balance Sheets as follows:

(in millions)	Foreign Currency Translation and Other
Balance at January 30, 2010	\$ 6
Foreign currency translation adjustment	1
Balance at July 31, 2010	\$ 7

**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 derivative with the objective to cap our exposure to interest rate increases 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 extends to the first quarter of fiscal 2015. The interest rate cap does not qualify for hedge accounting under ASC 815, *Derivatives and Hedging*. The fair value of the cap as of July 31, 2010 and August 1, 2009 was \$5 million and \$24 million, respectively, and is included in Other assets on the Consolidated Balance Sheets. The change in fair value of the cap for the quarter and six months ended July 31, 2010, resulted in a loss of \$3 million and \$13 million, respectively. The change in fair value of the cap for the quarter and six months ended August 1, 2009, resulted in a gain of \$11 million and \$15 million, respectively. These amounts are recorded in Other (income) and expense, net in the Consolidated Statements of Operations.

**Note 6. Fair Value Measurements**

As defined in ASC 820, 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. ASC 820 establishes a three-level valuation hierarchy for fair value measurements. These

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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 July 31, 2010 (in millions):

	Level 1	Level 2	Level 3	Total
Interest Rate Cap	\$	\$ 5	\$	\$ 5

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The interest rate cap is measured using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The fair value of the interest rate cap is determined using the market standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on an expectation of future interest rates (forward curves) derived from observable market interest rate curves. See Note 5 for additional information on our derivative instruments.

We apply fair value techniques on a non-recurring basis associated for the establishment of potential impairment loss related to goodwill pursuant to ASC 350, *Intangibles - Goodwill and Other* and determining the fair value of long-lived assets pursuant to ASC 360, *Property, Plant, and Equipment*. During the six months ended July 31, 2010, there were no events or changes in circumstances indicating the carry amounts of our long-lived assets may not be recoverable.

The table below provides the carrying and fair values of our loan and notes. The fair value of these debt instruments were determined based on quoted market prices or recent trades.

	Carrying Value	Fair Value
	(in millions)	
Senior secured term loan	\$ 2,156	\$ 2,016
Senior notes	750	789
Senior subordinated notes	400	432
Subordinated discount notes	401	364

### **Note 7. Income Taxes**

During the second quarter of fiscal 2010, we recorded a tax provision of \$1 million, primarily due to additional expense related to discrete items. The effective tax rate was 19.5% for the second quarter of fiscal 2009. As a result of our low income base for the second quarter of each of fiscal 2010 and fiscal 2009, our effective rate is highly sensitive to changes caused by discrete items and permanent differences (i.e. differences between book income and tax income that are not expected to reverse in future periods).

Our effective income tax rate for the first six months of fiscal 2010 was 59.8% compared to 36.6% for the first six months of fiscal 2009. During the first quarter of fiscal 2010, we recorded a correction to our federal deferred tax liability relating to state income taxes which unfavorably impacted our effective income tax rate by 16.7%. We currently estimate our annualized effective tax rate for fiscal 2010 to be 41%, including a 2.7% unfavorable impact from the deferred tax liability correction recorded during the first quarter.

### **Note 8. Commitments and Contingencies**

We are involved in ongoing legal and regulatory proceedings. Other than those described in the following paragraphs, 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 30, 2010

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and our Quarterly Report on Form 10-Q for the quarterly period ended May 1, 2010.

### *Consumer Class Action Claims*

#### *Acevedo Claim*

On March 12, 2010, Arthur Acevedo, a consumer, filed a purported class action proceeding against Aaron Brothers, Inc. in the Superior Court of California, Los Angeles County, on behalf of himself and all similarly-situated mobility impaired/wheelchair bound persons. The suit alleges that certain of Aaron Brothers retail stores in California are not compliant with disability access non-discrimination statutes of California and the plaintiffs seek injunctive relief, statutory damages, attorneys' fees and costs. The parties have reached an agreement in principle to settle the matter on an individual basis for an immaterial amount and with certain improvements or repairs to be made at selected Aaron Brothers stores.

#### *Carson Claim*

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the Superior Court of California, County of San Diego, on behalf of herself and all similarly-situated California consumers. The Carson suit alleges that Michaels unlawfully requested and recorded personally identifiable information (i.e., her zip code) as part of a credit card transaction. The plaintiff sought statutory penalties, costs, interest, and attorneys' fees. We contested certification of this claim as a class action and filed a motion to dismiss the claim. On March 9, 2009, the Court dismissed the case with prejudice. The plaintiff appealed this decision to the California Court of Appeal for the Fourth District, San Diego. On July 22, 2010, the Court of Appeal ruled in favor Michaels and the case was dismissed.

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*Governmental Inquiries and Related Matters*

*Non-U.S. Trust Inquiry*

In early 2005, the District Attorney's office of the County of New York and the SEC opened inquiries concerning non-U.S. trusts that directly or indirectly held shares of Michaels Common Stock and Common Stock options. A federal grand jury requested information with respect to the same facts. We are cooperating in these inquiries and have provided information in response to the requests.

Certain of these trusts and corporate subsidiaries of the trusts acquired securities of Michaels in transactions directly or indirectly with Charles J. Wyly, Jr. and Sam Wyly, who were, respectively, Chairman and Vice Chairman of the Board of Directors prior to the consummation of the Merger, or with other Wyly family members. In addition, subsidiaries of certain of these trusts acquired securities directly from us in private placement transactions in 1996 and 1997 and upon the exercise of stock options transferred, directly or indirectly, to the trusts or their subsidiaries by Charles Wyly, Sam Wyly, or other Wyly family members.

We understand that Charles Wyly and Sam Wyly and/or certain of their family members are beneficiaries of irrevocable non-U.S. trusts. The 1996 and 1997 private placement sales by us of Michaels securities to subsidiaries of certain of these trusts were disclosed by us in filings with the SEC. The transfer by Charles Wyly and/or Sam Wyly (or by other Wyly family members or family-related entities) of Michaels securities to certain of these trusts and subsidiaries was also disclosed in filings with the SEC by us and/or by Charles Wyly and Sam Wyly. Based on information provided to us, our SEC filings prior to 2005 did not report securities owned by the non-U.S. trusts or their corporate subsidiaries as beneficially owned by Charles Wyly and Sam Wyly.

Charles Wyly and Sam Wyly filed an amended Schedule 13D with the SEC on April 8, 2005, stating that they may be deemed the beneficial owners of Michaels securities held directly or indirectly by the non-U.S. trusts. In our 2005 and 2006 proxy statements, we included the securities held in the non-U.S. trusts or their separate subsidiaries, as reported by the Wyllys, in the beneficial ownership table of our principal stockholders and management, with appropriate footnotes.

On July 29, 2010, the SEC filed a civil enforcement action in federal district court for the Southern District of New York against Charles Wyly, Sam Wyly and others alleging, among other things, violations of various federal securities laws, including those governing ownership reporting and trading of securities, in connection with the non-U.S. trusts and their subsidiaries. Additional information may be obtained at the SEC's website.

**Note 9. 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 ASC 280, *Segment Reporting*. We determined that our Michaels and Aaron Brothers operating segments have similar economic characteristics and meet the aggregation criteria set forth in ASC 280. Therefore, we combine both operating segments into one reporting segment.

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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 ). We believe EBITDA represents the financial measure that more closely reflects the operating effectiveness of factors over which management has control. As such, an element of base incentive compensation targets for certain management personnel are based on EBITDA. A reconciliation of EBITDA to income before income taxes is presented below.

	Quarter Ended		Six Months Ended					
	July 31, 2010	August 1, 2009	July 31, 2010	August 1, 2009				
	(in millions)							
Income before income taxes	\$	\$	2	\$	30	\$	9	
Interest expense		70	62		138		125	
Depreciation and amortization		26	28		52		58	
EBITDA	\$	96	\$	92	\$	220	\$	192

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Our sales and assets by country are as follows:

	Quarter Ended		Six Months Ended	
	July 31, 2010	August 1, 2009	July 31, 2010	August 1, 2009
	(in millions)		(in millions)	
<b>Net Sales:</b>				
United States	\$ 760	\$ 744	\$ 1,585	\$ 1,536
Canada	71	63	147	123
Consolidated Total	\$ 831	\$ 807	\$ 1,732	\$ 1,659
<b>Total Assets:</b>				
United States	\$ 1,506	\$ 1,578	\$ 1,506	\$ 1,578
Canada	78	97	78	97
Consolidated Total	\$ 1,584	\$ 1,675	\$ 1,584	\$ 1,675

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.

### **Note 10. Related Party Transactions**

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 (Highfields) in the amount of \$12 million and \$1 million, respectively. We recognized \$4 million and \$3 million of expense related to annual management fees and expenses during the second quarter of fiscal 2010 and fiscal 2009, respectively, and \$7 million during each of the six months ended July 31, 2010 and August 1, 2009. These expenses are included in related party expenses on the Consolidated Statements of Operations.

Bain Capital owns a majority equity position in an external vendor we utilize to print our circular advertisements. Payments associated with this vendor during the second quarter of fiscal 2010 and fiscal 2009 were \$5 million and \$6 million, respectively, and \$14 million for each of the six months ended July 31, 2010 and August 1, 2009. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

Bain Capital owns an equity position in an external vendor we utilized for non-merchandise supplies. Payments for the six months ended August 1, 2009 were \$1 million. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

The Blackstone Group owns a majority equity position in an external vendor we utilize to count our store inventory. Payments associated with this vendor during the second quarter of fiscal 2010 and fiscal 2009 were \$1 million and \$2 million, respectively. Payments for each of the six months ended July 31, 2010 and August 1, 2009 were \$3 million and \$4 million, respectively. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.



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The Blackstone Group owns an equity position in an external vendor we utilize for waste management services. Payments associated with this vendor during the second quarter of both fiscal 2010 and fiscal 2009 were \$2 million, and payments for the six months ended July 31, 2010 and August 1, 2009 were \$3 million and \$4 million, respectively. These expenses are included in selling, general and administrative expense on the Consolidated Statements of Operations.

The Blackstone Group owns an equity position 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 2010 and fiscal 2009 were \$5 million and \$6 million, respectively, and \$9 million for each of the six months ended July 31, 2010 and August 1, 2009. These expenses are recognized in cost of sales as the sales are recorded.

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. During the first six months of fiscal 2010, such affiliates sold approximately \$199 million face amount of our Subordinated Discount Notes due 2016. As of July 31, 2010, such affiliates did not hold any of our debt securities.

Table of Contents**Note 11. 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 Amended asset-based revolving credit facility are guaranteed by each of our subsidiaries other than Aaron Brothers Card Services, LLC and Artistree of Canada, ULC. As of July 31, 2010, the financial statements of Aaron Brothers Card Services, LLC and Artistree of Canada, ULC were immaterial. Each subsidiary guarantor is 100% owned by the parent and all guarantees are joint and several.

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.

Certain prior year balance sheet amounts were reclassified to conform to the current year presentation. These reclassifications consist primarily of the presentation of deferred taxes.

**Supplemental Condensed Consolidating Balance Sheet**

	July 31, 2010				
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated	
	(in millions)				
<b>ASSETS</b>					
<b>Current assets:</b>					
Cash and equivalents	\$ 60	\$ 9	\$	\$	69
Merchandise inventories	588	300			888
Intercompany receivables		364	(364)		
Other	127	16			143
Total current assets	775	689	(364)		1,100
<b>Property and equipment, net</b>	226	69			295
<b>Goodwill, net</b>	94				94
<b>Investment in subsidiaries</b>	434		(434)		
<b>Other assets</b>	94	1			95
Total assets	\$ 1,623	\$ 759	\$ (798)	\$	1,584
<b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY</b>					
<b>Current liabilities:</b>					
Accounts payable	\$ (2)	\$ 224	\$	\$	222
Accrued liabilities and other	231	90			321
Current portion of long-term debt	1				1
Intercompany payable	364		(364)		
Other	1				1
Total current liabilities	595	314	(364)		545
<b>Long-term debt</b>	3,707				3,707

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<b>Other long-term liabilities</b>	75		11		86
<b>Total stockholders (deficit) equity</b>	(2,754)		434	(434)	(2,754)
<b>Total liabilities and stockholders (deficit) equity</b>	\$ 1,623	\$	759	\$ (798)	\$ 1,584

Table of Contents**Supplemental Condensed Consolidating Balance Sheet**

	January 30, 2010				
	Parent Company	Guarantor Subsidiaries	Eliminations	(in millions)	Consolidated
<b>ASSETS</b>					
<b>Current assets:</b>					
Cash and equivalents	\$ 207	\$ 10	\$		\$ 217
Merchandise inventories	599	274			873
Intercompany receivables		243	(243)		
Other	103	14			117
Total current assets	909	541	(243)		1,207
<b>Property and equipment, net</b>	<b>238</b>	<b>79</b>			<b>317</b>
<b>Goodwill, net</b>	<b>94</b>				<b>94</b>
<b>Investment in subsidiaries</b>	<b>288</b>		<b>(288)</b>		
<b>Other assets</b>	<b>90</b>	<b>2</b>			<b>92</b>
Total assets	\$ 1,619	\$ 622	\$ (531)		\$ 1,710
<b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY</b>					
<b>Current liabilities:</b>					
Accounts payable	\$ 10	\$ 221	\$		\$ 231
Accrued liabilities and other	256	99			355
Current portion of long-term debt	119				119
Intercompany payable	243		(243)		
Other	11	1			12
Total current liabilities	639	321	(243)		717
<b>Long-term debt</b>	<b>3,684</b>				<b>3,684</b>
<b>Other long-term liabilities</b>	<b>67</b>	<b>13</b>			<b>80</b>
<b>Total stockholders (deficit) equity</b>	<b>(2,771)</b>	<b>288</b>	<b>(288)</b>		<b>(2,771)</b>
Total liabilities and stockholders (deficit) equity	\$ 1,619	\$ 622	\$ (531)		\$ 1,710

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## Supplemental Condensed Consolidating Balance Sheet

	August 1, 2009				
	Parent Company	Guarantor Subsidiaries	Eliminations	(in millions)	Consolidated
<b>ASSETS</b>					
<b>Current assets:</b>					
Cash and equivalents	\$ 29	\$ 7	\$		\$ 36
Merchandise inventories	633	317			950
Intercompany receivables		524	(524)		
Other	117	15			132
Total current assets	779	863	(524)		1,118
<b>Property and equipment, net</b>	257	88			345
<b>Goodwill, net</b>	94				94
<b>Investment in subsidiaries</b>	655		(655)		
<b>Other assets</b>	116	2			118
Total assets	\$ 1,901	\$ 953	\$ (1,179)		\$ 1,675
<b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY</b>					
<b>Current liabilities:</b>					
Accounts payable	\$ 13	\$ 203	\$		\$ 216
Accrued liabilities and other	207	81			288
Current portion of long-term debt	198				198
Intercompany payable	524		(524)		
Other	1				1
Total current liabilities	943	284	(524)		703
<b>Long-term debt</b>	3,766				3,766
<b>Other long-term liabilities</b>	66	14			80
<b>Total stockholders (deficit) equity</b>	(2,874)	655	(655)		(2,874)
Total liabilities and stockholders (deficit) equity	\$ 1,901	\$ 953	\$ (1,179)		\$ 1,675

Table of Contents**Supplemental Condensed Consolidating Statement of Operations**

	Parent Company	Quarter Ended July 31, 2010		Consolidated
		Guarantor Subsidiaries	Eliminations (in millions)	
<b>Net sales</b>	\$ 724	\$ 481	\$ (374)	\$ 831
Cost of sales and occupancy expense	493	401	(374)	520
<b>Gross profit</b>	231	80		311
Selling, general, and administrative expense	202	31		233
Related party expenses	4			4
Store pre-opening costs				
<b>Operating income</b>	25	49		74
Interest expense	70			70
Other (income) and expense, net	4			4
Intercompany charges (income)	15	(15)		
Equity in earnings of subsidiaries	64		(64)	
<b>Income before income taxes</b>		64	(64)	
Provision for income taxes	1	26	(26)	1
<b>Net loss</b>	\$ (1)	\$ 38	\$ (38)	\$ (1)

**Supplemental Condensed Consolidating Statement of Operations**

	Parent Company	Quarter Ended August 1, 2009		Consolidated
		Guarantor Subsidiaries	Eliminations (in millions)	
<b>Net sales</b>	\$ 707	\$ 471	\$ (371)	\$ 807
Cost of sales and occupancy expense	498	394	(371)	521
<b>Gross profit</b>	209	77		286
Selling, general, and administrative expense	202	30		232
Related party expenses	3			3
Store pre-opening costs	1			1
<b>Operating income</b>	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)	
<b>Income before income taxes</b>	2	66	(66)	2
Provision for income taxes		13	(13)	
<b>Net income</b>	\$ 2	\$ 53	\$ (53)	\$ 2

Table of Contents**Supplemental Condensed Consolidating Statement of Operations**

	Six Months Ended July 31, 2010				Consolidated
	Parent Company	Guarantor Subsidiaries	Eliminations		
	(in millions)				
<b>Net sales</b>	\$ 1,518	\$ 965	\$ (751)	\$ 1,732	
Cost of sales and occupancy expense	1,021	797	(751)	1,067	
<b>Gross profit</b>	497	168		665	
Selling, general, and administrative expense	414	64		478	
Related party expenses	7			7	
Store pre-opening costs	1			1	
<b>Operating income</b>	75	104		179	
Interest expense	138			138	
Other (income) and expense, net	14	(3)		11	
Intercompany charges (income)	31	(31)			
Equity in earnings of subsidiaries	138		(138)		
<b>Income before income taxes</b>	30	138	(138)	30	
Provision for income taxes	18	57	(57)	18	
<b>Net income</b>	\$ 12	\$ 81	\$ (81)	\$ 12	

**Supplemental Condensed Consolidating Statement of Operations**

	Six Months Ended August 1, 2009				Consolidated
	Parent Company	Guarantor Subsidiaries	Eliminations		
	(in millions)				
<b>Net sales</b>	\$ 1,468	\$ 950	\$ (759)	\$ 1,659	
Cost of sales and occupancy expense	1,021	796	(759)	1,058	
<b>Gross profit</b>	447	154		601	
Selling, general, and administrative expense	418	60		478	
Related party expenses	7			7	
Store pre-opening costs	2			2	
<b>Operating income</b>	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)		
<b>Income before income taxes</b>	9	132	(132)	9	
Provision for income taxes	3	48	(48)	3	
<b>Net income</b>	\$ 6	\$ 84	\$ (84)	\$ 6	

Table of Contents**Supplemental Condensed Statement of Cash Flows**

	Parent Company	Six Months Ended July 31, 2010			Consolidated
		Guarantor Subsidiaries	Eliminations	(in millions)	
<b>Operating activities:</b>					
Net cash provided by operating activities	\$ 21	\$ 55	\$ (53)	\$	23
<b>Investing activities:</b>					
Cash paid for property and equipment	(31)	(2)			(33)
Net cash used in investing activities	(31)	(2)			(33)
<b>Financing activities:</b>					
Net repayments of long-term debt	(118)				(118)
Intercompany dividends		(53)	53		
Other financing activities	(20)				(20)
Net cash used in financing activities	(138)	(53)	53		(138)
<b>Decrease in cash and equivalents</b>	<b>(148)</b>				<b>(148)</b>
<b>Beginning cash and equivalents</b>	<b>207</b>	<b>10</b>			<b>217</b>
<b>Ending cash and equivalents</b>	<b>\$ 59</b>	<b>\$ 10</b>	<b>\$</b>	<b>\$</b>	<b>69</b>

**Supplemental Condensed Statement of Cash Flows**

	Parent Company	Six Months Ended August 1, 2009			Consolidated
		Guarantor Subsidiaries	Eliminations	(in millions)	
<b>Operating activities:</b>					
Net cash provided by operating activities	\$ 29	\$ 58	\$ (57)	\$	30
<b>Investing activities:</b>					
Cash paid for property and equipment	(16)	(1)			(17)
Net cash used in investing activities	(16)	(1)			(17)
<b>Financing activities:</b>					
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)
<b>Increase in cash and equivalents</b>	<b>3</b>				<b>3</b>
<b>Beginning cash and cash equivalents</b>	<b>26</b>	<b>7</b>			<b>33</b>
<b>Ending cash and cash equivalents</b>	<b>\$ 29</b>	<b>\$ 7</b>	<b>\$</b>	<b>\$</b>	<b>36</b>



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**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 are 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 30, 2010. 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 worldwide economic conditions deteriorate, or if recovery remains slow or prolonged, 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;
- 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;

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- 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 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;

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- we have co-sourced certain of our information technology, accounts payable, payroll, accounting and human resources 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;
- unauthorized access to our electronic and other confidential information could materially adversely affect our financial condition and operating results;
- changes in regulations or enforcement may adversely impact our business;
- 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.

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 30, 2010, and other reports from time to time filed with or furnished to the SEC. We disclaim any intention to, and undertake no obligation to, update or revise any forward-looking statement.

**General**

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 2010 relate to the 52 weeks ending January 29, 2011 and all references to fiscal 2009 relate to the 52 weeks ended January 30, 2010. In addition, all references herein to the second quarter of fiscal 2010 relate to the 13 weeks ended July 31, 2010 and all references to the second quarter of fiscal 2009 relate to the 13 weeks ended August 1, 2009. Finally, all references to the six months ended July 31, 2010 relate to the 26 weeks ended July 31, 2010, and the six months ended August 1, 2009 relate to the 26 weeks ended August 1, 2009.



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

	Quarter Ended		Six Months Ended	
	July 31, 2010	August 1, 2009	July 31, 2010	August 1, 2009
<b>Michaels stores:</b>				
Retail stores open at beginning of period	1,028	1,020	1,023	1,009
Retail stores opened during the period	5	3	10	14
Retail stores opened (relocations) during the period			7	4
Retail stores closed during the period				
Retail stores closed (relocations) during the period			(7)	(4)
Retail stores open at end of period	1,033	1,023	1,033	1,023
<b>Aaron Brothers stores:</b>				
Retail stores open at beginning of period	146	156	152	161
Retail stores opened during the period				
Retail stores opened (relocations) during the period				
Retail stores closed during the period	(1)	(1)	(7)	(6)
Retail stores closed (relocations) during the period				
Retail stores open at end of period	145	155	145	155
Total store count at end of period	1,178	1,178	1,178	1,178
<b>Other operating data:</b>				
Average inventory per Michaels store (in thousands)				
(1)	\$ 823	\$ 889	\$ 823	\$ 889
Comparable store sales (2)	2.3%	(0.8)%	3.6%	(1.4)%

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

(2) Comparable store sales increase (decrease) represents the increase (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	
	July 31, 2010	August 1, 2009	July 31, 2010	August 1, 2009
<b>Net sales</b>	100.0%	100.0%	100.0%	100.0%
Cost of sales and occupancy expense	62.5	64.6	61.6	63.8
<b>Gross profit</b>	37.5	35.4	38.4	36.2
Selling, general, and administrative expense	28.0	28.7	27.6	28.8
Related party expenses	0.5	0.4	0.4	0.4
Store pre-opening costs	0.1	0.1	0.1	0.1
<b>Operating income</b>	8.9	6.2	10.3	6.9
Interest expense	8.4	7.8	8.0	7.5
Other (income) and expense, net	0.5	(1.8)	0.6	(1.2)
<b>Income before income taxes</b>		0.2	1.7	0.6
Income tax provision	0.1		1.0	0.2
<b>Net (loss) income</b>	(0.1)%	0.2%	0.7%	0.4%

*Quarter Ended July 31, 2010 Compared to the Quarter Ended August 1, 2009*

*Net Sales* Net sales increased for the second quarter of fiscal 2010 by \$24 million, or 3.0%, over the second quarter of fiscal 2009 due primarily to an \$18 million increase in comparable store sales. Comparable store sales increased 2.3% due to an increase in customer transactions of 1.4%, an increase in the average ticket of 0.8%, and a positive impact of 0.1% related to deferred custom framing revenue. The fluctuation in the exchange rates between the United States and Canadian dollars positively impacted the average ticket by 70 basis points. In addition, sales from our non-comparable new stores provided incremental revenue of \$6 million.

*Cost of Sales and Occupancy Expense* Cost of sales and occupancy expense was \$520 million, or 62.5% of net sales, for the second quarter of fiscal 2010 compared to \$521 million, or 64.6% of net sales, for the second quarter of fiscal 2009. Cost of sales decreased \$1 million, or 160 basis points, due to increases in direct imports and improved management of promotional and clearance markdowns. In addition, occupancy costs for the second quarter of fiscal 2010 were relatively flat compared to prior year and as a percentage of net sales, decreased 50 basis points primarily due to leveraging of fixed costs on an increase in comparable store sales.

*Selling, General, and Administrative Expense* Selling, general, and administrative expense was \$233 million or 28.0% of net sales, in the second quarter of fiscal 2010 compared to \$232 million, or 28.7% of net sales, in the second quarter of fiscal 2009. Selling, general, and administrative expense decreased 70 basis points, as a percentage of net sales, due to increased payroll leverage on higher comparable store sales as well as lower group insurance expense as a result of initiatives to reduce the cost of medical insurance.

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*Related Party Expenses* Related party expenses were \$4 million and \$3 million in the second quarter of fiscal 2010 and fiscal 2009, respectively. These costs consist of management fees and associated expenses paid to our Sponsors and Highfields.

*Interest Expense* Interest expense for the quarter increased \$8 million to \$70 million as a result of increased interest rates associated with our amended credit facilities.

*Other (Income) and Expense, net* Other expense in the second quarter of fiscal 2010 related to a \$3 million unfavorable change in the fair value of our interest rate cap as more fully described in Note 5 to the consolidated financial statements and \$1 million related to foreign exchange losses. 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 and \$4 million related to foreign exchange gains.

*Provision for Income Taxes* During the second quarter of fiscal 2010, we recorded a tax provision of \$1 million, primarily due to additional expense related to discrete items. The effective tax rate was 19.5% for the second quarter of fiscal 2009. As a result of our low income base for the second quarter of each of fiscal 2010 and fiscal 2009, our effective rate is highly sensitive to changes caused by discrete items and permanent differences (i.e. differences between book income and tax income that are not expected to reverse in future periods).

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*Six Months Ended July 31, 2010 Compared to the Six Months Ended August 1, 2009*

*Net Sales* Net sales increased for the first six months of fiscal 2010 by \$73 million, or 4.4%, over the first six months of fiscal 2009 primarily due to a \$59 million increase in comparable store sales. Comparable store sales increased 3.6% due to an increase in the average ticket of 2.2%, an increase in customer transactions of 1.3%, and a positive impact of 0.1% related to deferred custom framing revenue. The fluctuation in the exchange rates between the United States and Canadian dollars positively impacted the average ticket by 110 basis points. In addition, sales from our non-comparable new stores provided incremental revenue of \$14 million.

*Cost of Sales and Occupancy Expense* Cost of sales and occupancy expense increased \$9 million to \$1,067 million for the first six months of fiscal 2010 from \$1,058 million for the first six months of fiscal 2009 as a result of the 3.6% increase in comparable store sales and an increase in sales from non-comparable new stores. Cost of sales and occupancy expense decreased 220 basis points as a percentage of net sales. We realized a 150 basis point decrease in cost of goods sold primarily due to increases in direct imports and improved management of promotional and clearance markdowns. In addition, occupancy costs for the first six months of fiscal 2010 were relatively flat compared to prior year and as a percentage of net sales, decreased 70 basis points primarily due to leveraging of fixed costs on the increase in comparable store sales.

*Selling, General, and Administrative Expense* Selling, general, and administrative expense was flat compared to prior year at \$478 million and decreased to 27.6% of net sales for the first six months of fiscal 2010 compared to 28.8% of net sales for the first six months of fiscal 2009. Selling, general, and administrative expense was consistent with the prior year as increases in costs related to operating ten additional Michaels stores during the first six months of fiscal 2010 and increased performance based bonus expense driven by higher anticipated profitability for fiscal 2010 were offset by a decrease in depreciation expense caused by lower capital expenditures over the last several years and lower group insurance expense due to initiatives to reduce the cost of medical insurance. As a percentage of net sales, selling, general, and administrative expense decreased 120 basis points due to increased advertising and payroll leverage on higher comparable store sales as well as lower group insurance and depreciation expense as indicated above.

*Related Party Expenses* Related party expenses were \$7 million for the first six months of each of fiscal 2010 and fiscal 2009, consisting of management fees and associated expenses paid to our Sponsors and Highfields.

*Interest Expense* Interest expense increased \$13 million for the six months ended July 31, 2010 compared to the six months ended August 1, 2009, as a result of increased interest rates associated with our amended credit facilities.

*Other (Income) and Expense, net* Other expense for the first six months of fiscal 2010 related to a \$13 million unfavorable change in the fair value of our interest rate cap, partially offset by \$2 million related to foreign exchange gains. Other income for the first six months of fiscal 2009 related to a \$15 million favorable change in the fair value of the interest rate cap and \$5 million related to foreign exchange gains.

*Provision for Income Taxes* The effective tax rate was 59.8% for the first six months of fiscal 2010. The rate was higher than the federal tax rate due primarily to additional expense to correct the federal deferred tax liability relating to state income taxes. The effective tax rate was 36.6% for the first six months of fiscal 2009. We currently estimate our annualized effective tax rate for fiscal 2010 to be 41%, including a 2.7% unfavorable impact from the deferred tax liability correction recorded during the first quarter of fiscal 2010.



**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 for seasonal working capital needs. We expect that our available cash, cash flow generated from operating activities, and funds available under our Amended 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. Our Amended asset-based revolving credit facility provides senior secured financing of up to \$1.1 billion, subject to a borrowing base. As of July 31, 2010, the borrowing base was \$661 million, which supported \$53 million of outstanding letters of credit and provided \$608 million of excess availability. Our cash and equivalents decreased \$148 million from \$217 million at January 30, 2010 to \$69 million at July 31, 2010.

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.

Table of Contents*Cash Flow from Operating Activities*

Cash flow provided by operating activities during the first six months of fiscal 2010 was \$23 million compared to \$30 million during the first six months of fiscal 2009. The \$7 million change was primarily due to an unfavorable impact in accrued liabilities, due to higher bonus payments made during the first quarter of fiscal 2010, partially offset by the change in merchandise inventories compared to last year.

Average inventory per Michaels store (including supporting distribution centers) decreased 7.4% from \$889,000 at August 1, 2009 to \$823,000 at July 31, 2010 primarily due to a planned reduction of store inventory levels. We anticipate average inventory per Michaels store at the end of fiscal 2010 to be down compared to the end of fiscal 2009.

*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	
	July 31, 2010	August 1, 2009
	(in millions)	
New and relocated stores and stores not yet opened (1)	\$ 11	\$ 7
Existing stores	10	5
Information systems	9	4
Corporate and other	3	1
	\$ 33	\$ 17

(1) In the first six months of fiscal 2010, we incurred capital expenditures related to the opening of ten Michaels stores in addition to the relocation of seven Michaels stores. In the first six months of fiscal 2009, we incurred capital expenditures related to the opening of 14 Michaels stores in addition to the relocation of four Michaels stores. In fiscal 2009, we opened the majority of our stores in locations where the landlord paid to build the stores to our specifications. During fiscal 2010, we have opened a greater number of stores in locations where we paid to build the stores to our specifications. As a result, our capital expenditures for new and relocated stores have increased in the first six months of fiscal 2010 compared to the first six months of fiscal 2009. This trend may continue in future years.

*Cash Flow used in Financing Activities*

Cash flow used in financing activities during the first six months of fiscal 2010 was \$138 million compared to \$10 million during the first six months of fiscal 2009. The \$128 million change was primarily due to the fiscal 2009 excess cash flow payment on our Senior secured term loan facility of \$118 million and \$19 million in debt issuance costs related to the amendment to the asset-based revolving credit facility, both of which were paid during the first quarter of fiscal 2010.

**Non-GAAP Measures**

The following table sets forth the Company's Earnings before Interest, Taxes, Depreciation and Amortization ( EBITDA ). The Company defines EBITDA as net income before interest, income taxes, discontinued operations, depreciation and amortization. Additionally, the table presents Adjusted Earnings before Interest, Taxes, Depreciation and Amortization ( Adjusted EBITDA ). The Company defines Adjusted EBITDA as EBITDA adjusted for certain defined amounts that are added to, or subtracted from, EBITDA (collectively, the Adjustments ) in accordance with the Company's \$2.4 billion Senior secured term loan and \$1.1 billion asset-based revolving credit facilities. The Adjustments are described in further detail in the table, and the footnotes to the table below.

The Company has presented EBITDA and Adjusted EBITDA to provide investors with additional information to evaluate our operating performance and our ability to service our debt. The Company uses EBITDA, among other metrics, to evaluate operating performance, to plan and forecast future periods' operating performance and as an element of its incentive compensation targets. Adjusted EBITDA is a required calculation under the Company's Senior secured term loan and its asset-based revolving credit facilities. As it relates to the Senior secured term loan, Adjusted EBITDA is used in the calculations of fixed charge coverage and leverage ratios, which, under certain circumstances may result in limitations on the Company's ability to make restricted payments as well as the determination of mandatory repayments of the loans. Under the asset-based revolving facility, Adjusted EBITDA is used in the calculation of fixed charge coverage ratios, which, under certain circumstances, may restrict the Company's ability to make certain payments (characterized as restricted payments), investments (including acquisitions) and debt repayments.

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As EBITDA and Adjusted EBITDA are not measures of operating performance or liquidity calculated in accordance with U.S. generally accepted accounting principles ( GAAP ), these measures should not be considered in isolation of, or as a substitute for, net income, as an indicator of operating performance, or net cash provided by operating activities as an indicator of liquidity. Our computation of EBITDA and Adjusted EBITDA may differ from similarly titled measures used by other companies. As EBITDA and Adjusted EBITDA exclude certain financial information compared with net income and net cash provided by operating activities, the most directly comparable GAAP financial measures, users of this financial information should consider the types of events and transactions which are excluded.

The table below shows a reconciliation of EBITDA and Adjusted EBITDA to net income and net cash provided by operating activities.

	Quarter Ended		Six Months Ended	
	July 31, 2010	August 1, 2009	July 31, 2010	August 1, 2009
Net cash (used in) provided by operating activities	\$ (4)	\$ 28	\$ 23	\$ 30
Depreciation and amortization	(26)	(28)	(52)	(58)
Share-based compensation	(2)	(2)	(4)	(4)
Debt issuance costs amortization	(4)	(4)	(9)	(8)
Accretion of subordinated discount notes	(12)	(11)	(24)	(22)
Change in fair value of interest rate cap	(3)	11	(13)	15
Changes in assets and liabilities	50	8	91	53
Net (loss) income	(1)	2	12	6
Interest expense	70	62	138	125
Income tax provision	1		18	3
Depreciation and amortization	26	28	52	58
EBITDA	96	92	220	192
Adjustments:				
Share-based compensation	2	2	4	4
Sponsor Fees	4	3	7	7
Termination expense				3
Pre-opening costs			1	1
Foreign currency translation loss (gain)	1	(4)	(2)	(5)
Store closing costs		2	1	3
Loss (gain) on interest rate cap	3	(11)	13	(15)
Other (1)		1		2
Adjusted EBITDA	\$ 106	\$ 85	\$ 244	\$ 192

(1) Other adjustments relate to items such as moving & relocation expenses, franchise taxes, and foreign currency hedge.

### **Recent Accounting Pronouncements**

In January 2010, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2010-06, *Improving Disclosures About Fair Value Measurements* an amendment to Accounting Standards Codification ( ASC ) topic 820, *Fair Value Measurements and Disclosures*. ASU 2010-06 expands disclosure requirements related to fair value measurements including (i) separately disclosing the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describing the reasons for the

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transfers and (ii) presenting separate information for Level 3 activity pertaining to gross purchases, sales, issuances, and settlements. The new disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 activity disclosures, which are effective for fiscal years beginning after December 15, 2010. We adopted all requirements of ASU 2010-06 related to significant transfers in and out of Level 1 and Level 2 fair value measurements on January 31, 2010, with no material impact on our consolidated financial statements. See Note 6 for further information regarding fair value measurements. We will adopt the new disclosure requirements related to the Level 3 activity on January 30, 2011, with no material impact expected on our consolidated financial statements.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

We are exposed to fluctuations in exchange rates between the US and Canadian dollar, which is the functional currency of our Canadian subsidiaries. Our sales, costs and expenses of our Canadian subsidiaries, when translated into US dollars, can fluctuate due to exchange rate movement. As of July 31, 2010, a 10% increase or decrease in the exchange rate of the US and Canadian dollar would not materially affect net income.

We have market risk exposure arising from changes in interest rates on our Senior secured term loan facility. The interest rates on our Senior Credit Facilities will reprice periodically, which will impact our earnings and cash flow. The interest rates on our notes are fixed. Based on our overall interest rate exposure to variable rate debt outstanding as of July 31, 2010, a 1% increase or decrease in interest rates would increase or decrease income before income taxes by approximately \$22 million. A 1% increase in interest rates would decrease the fair value of our long-term fixed rate debt by approximately \$51 million. A 1% decrease in interest rates would increase the fair value of our long-term fixed rate debt by approximately \$53 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

During the first quarter of fiscal 2009, we purchased an interest rate cap to limit 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 July 31, 2010 was \$5 million and is included in Other assets on the Consolidated Balance Sheets. The change in fair value of the cap for the quarter and six months ended July 31, 2010, resulted in a loss of \$3 million and \$13 million, respectively, and is recorded in Other (income) and expense, net in the Consolidated Statements of Operations. A 1% increase in the interest rates would increase income before income taxes by approximately \$12 million. A 1% decrease in the interest rates would decrease income before income taxes by approximately \$4 million.

**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) that are designed to provide reasonable assurance that information, which is required to be timely disclosed, is accumulated and communicated to management in a timely fashion. 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.

An evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Principal Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and our Principal Financial Officer concluded that our disclosure controls are effective to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to management, including our Chief Executive Officer and our Principal Financial Officer, to

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allow timely decisions regarding required disclosure and are effective to provide reasonable assurance that such information is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms.

### *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.

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**MICHAELS STORES, INC.**

**Part II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

Information regarding legal proceedings is incorporated herein by reference from Note 8 to our Consolidated Financial Statements.

**Item 6. Exhibits.**

(a) Exhibits:

<b>Exhibit Number</b>	<b>Description of Exhibit</b>
31.1	Certifications of John B. Menzer pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certifications of Richard S. Jablonski 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).



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**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/ Richard S. Jablonski  
Richard S. Jablonski  
Vice President Financial Planning and Analysis and  
Interim Controller  
(Principal Accounting Officer)

Dated: August 27, 2010

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**INDEX TO EXHIBITS**

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