

Michaels Companies, Inc.  
Form 10-Q  
December 01, 2017  
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

---

FORM 10-Q

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

For the quarterly period ended October 28, 2017

Commission file number 001-36501

---

THE MICHAELS COMPANIES, INC.

A Delaware Corporation

IRS Employer Identification No. 37-1737959

8000 Bent Branch Drive

Irving, Texas 75063

(972) 409-1300

---

The Michaels Companies, Inc. (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.

The Michaels Companies, Inc. has submitted electronically and posted on its corporate website every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

The Michaels Companies, Inc. is a large accelerated filer.

The Michaels Companies, Inc. is not a shell company or emerging growth company (as defined in Rule 12b-2 of the Exchange Act).

As of November 24, 2017, 181,248,635 shares of The Michaels Companies, Inc.'s common stock were outstanding.

994

---

Table of Contents

THE MICHAELS COMPANIES, INC.

TABLE OF CONTENTS

Part I—FINANCIAL INFORMATION

	Page
<u>Item 1.</u>	
<u>Financial Statements</u>	3
<u>Consolidated Statements of Comprehensive Income for the 13 and 39 weeks ended October 28, 2017 and October 29, 2016 (unaudited)</u>	3
<u>Consolidated Balance Sheets as of October 28, 2017, January 28, 2017 and October 29, 2016 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flows for the 39 weeks ended October 28, 2017 and October 29, 2016 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	26

<u>Item 4.</u>	<u>Controls and Procedures</u>	26
<u>Part II—OTHER INFORMATION</u>		
<u>Item 1.</u>	<u>Legal Proceedings</u>	27
<u>Item 1A.</u>	<u>Risk Factors</u>	27
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	27
<u>Item 6.</u>	<u>Exhibits</u>	28
<u>Signatures</u>		29

Table of Contents

## Part I—FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## THE MICHAELS COMPANIES, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, except per share data)

(Unaudited)

	13 Weeks Ended		39 Weeks Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Net sales	\$ 1,240,196	\$ 1,227,206	\$ 3,471,352	\$ 3,446,438
Cost of sales and occupancy expense	756,088	760,598	2,117,100	2,124,383
Gross profit	484,108	466,608	1,354,252	1,322,055
Selling, general and administrative	329,298	318,580	970,561	939,093
Store pre-opening costs	952	1,704	2,592	4,238
Operating income	153,858	146,324	381,099	378,724
Interest expense	32,818	31,538	94,305	95,711
Losses on early extinguishments of debt and refinancing costs	—	6,887	—	7,292
Other (income) expense, net	(360)	259	950	188
Income before income taxes	121,400	107,640	285,844	275,533
Income taxes	41,640	31,181	98,314	92,692
Net income	\$ 79,760	\$ 76,459	\$ 187,530	\$ 182,841
Other comprehensive income, net of tax:				
Foreign currency translation adjustment and other	(4,418)	(3,650)	4,254	5,800
Comprehensive income	\$ 75,342	\$ 72,809	\$ 191,784	\$ 188,641
Earnings per common share:				
Basic	\$ 0.44	\$ 0.37	\$ 1.01	\$ 0.88
Diluted	\$ 0.44	\$ 0.37	\$ 1.00	\$ 0.88
Weighted-average common shares outstanding:				
Basic	180,710	203,864	185,521	205,580
Diluted	181,987	205,313	186,775	207,293

See accompanying notes to consolidated financial statements.

3

---

Table of Contents

## THE MICHAELS COMPANIES, INC.

## CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

(Unaudited)

	October 28, 2017	January 28, 2017	October 29, 2016
<b>ASSETS</b>			
Current Assets:			
Cash and equivalents	\$ 176,771	\$ 298,813	\$ 149,970
Merchandise inventories	1,404,206	1,127,777	1,394,092
Prepaid expenses and other	95,993	87,175	93,691
Accounts receivable, net	30,936	23,215	36,927
Income taxes receivable	5,792	5,825	26,757
Total current assets	1,713,698	1,542,805	1,701,437
Property and equipment, at cost	1,545,004	1,488,136	1,759,229
Less accumulated depreciation and amortization	(1,143,112)	(1,074,972)	(1,347,027)
Property and equipment, net	401,892	413,164	412,202
Goodwill	119,074	119,074	119,074
Other intangible assets, net	22,253	23,702	24,457
Deferred income taxes	36,946	36,834	30,293
Other assets	12,233	12,061	12,016
Total assets	\$ 2,306,096	\$ 2,147,640	\$ 2,299,479

## LIABILITIES AND STOCKHOLDERS' DEFICIT

Current Liabilities:			
Accounts payable	\$ 674,222	\$ 517,268	\$ 714,198
Accrued liabilities and other	400,138	397,497	386,280
Current portion of long-term debt	140,125	31,125	24,900
Income taxes payable	16,673	78,334	—
Total current liabilities	1,231,158	1,024,224	1,125,378
Long-term debt	2,707,120	2,723,187	2,734,758
Other liabilities	100,656	98,655	98,866
Total liabilities	4,038,934	3,846,066	3,959,002

## Commitments and contingencies

## Stockholders' Deficit:

Common stock, \$0.06775 par value, 350,000 shares authorized; 181,263 shares issued and outstanding at October 28, 2017; 193,311 shares issued and outstanding at January 28, 2017; and 204,584 shares issued and outstanding at October 29, 2016	12,159	12,948	13,703
Additional paid-in-capital	7,722	233,129	468,627

Edgar Filing: Michaels Companies, Inc. - Form 10-Q

Accumulated deficit	(1,742,749)	(1,930,279)	(2,125,597)
Accumulated other comprehensive loss	(9,970)	(14,224)	(16,256)
Total stockholders' deficit	(1,732,838)	(1,698,426)	(1,659,523)
Total liabilities and stockholders' deficit	\$ 2,306,096	\$ 2,147,640	\$ 2,299,479

See accompanying notes to consolidated financial statements.

4

---



Table of Contents

## THE MICHAELS COMPANIES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	39 Weeks Ended	
	October 28, 2017	October 29, 2016
Cash flows from operating activities:		
Net income	\$ 187,530	\$ 182,841
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	86,232	86,679
Share-based compensation	18,232	11,884
Debt issuance costs amortization	3,823	5,308
Accretion of long-term debt, net	(379)	(217)
Deferred income taxes	529	10,106
Losses on early extinguishments of debt and refinancing costs	—	7,292
Losses on disposition of property and equipment	—	56
Excess tax benefits from share-based compensation	—	(7,485)
Changes in assets and liabilities, excluding acquired net assets:		
Merchandise inventories	(275,086)	(306,925)
Prepaid expenses and other	(8,818)	(7,554)
Accounts receivable	(7,721)	(4,764)
Other assets	(1,010)	(353)
Accounts payable	150,947	233,266
Accrued interest	(314)	6,716
Accrued liabilities and other	12,685	(18,613)
Income taxes	(61,628)	(63,001)
Other liabilities	1,405	1,280
Net cash provided by operating activities	106,427	136,516
Cash flows from investing activities:		
Additions to property and equipment	(72,640)	(82,163)
Acquisition of Lamrite West, net of cash acquired	—	(151,100)
Purchase of long-term investment	—	(1,325)
Net cash used in investing activities	(72,640)	(234,588)
Cash flows from financing activities:		
Common stock repurchased	(253,595)	(160,287)
Payments on term loan credit facility	(18,675)	(12,450)
Borrowings on asset-based revolving credit facility	357,200	42,000
Payments on asset-based revolving credit facility	(248,200)	(42,000)
Payment of debt issuance costs	—	(11,542)
Payment of dividends	(408)	(415)
Proceeds from stock options exercised	7,849	15,860

Edgar Filing: Michaels Companies, Inc. - Form 10-Q

Excess tax benefits from share-based compensation	—	7,485
Net cash used in financing activities	(155,829)	(161,349)
Net change in cash and equivalents	(122,042)	(259,421)
Cash and equivalents at beginning of period	298,813	409,391
Cash and equivalents at end of period	\$ 176,771	\$ 149,970
Supplemental cash flow information:		
Cash paid for interest	\$ 91,794	\$ 83,958
Cash paid for taxes	\$ 159,013	\$ 144,483
See accompanying notes to consolidated financial statements.		

5

---

Table of Contents

THE MICHAELS COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) 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 footnotes required by GAAP 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 28, 2017 filed with the Securities and Exchange Commission (“SEC”) pursuant to Section 13 or 15(d) under the Securities Exchange Act of 1934. In the opinion of management, all adjustments (consisting of normal recurring accruals and other items) considered necessary for a fair presentation have been included.

We report on the basis of a 52- or 53-week fiscal year, which ends on the Saturday closest to January 31. All references to fiscal year mean the year in which that fiscal year began. References to “fiscal 2017” relate to the 53 weeks ending February 3, 2018 and references to “fiscal 2016” relate to the 52 weeks ended January 28, 2017. In addition, all references to “the third quarter of fiscal 2017” relate to the 13 weeks ended October 28, 2017 and all references to “the third quarter of fiscal 2016” relate to the 13 weeks ended October 29, 2016. Finally, all references to “the nine months ended October 28, 2017” relate to the 39 weeks ended October 28, 2017 and all references to “the nine months ended October 29, 2016” relate to the 39 weeks ended October 29, 2016. Because of the seasonal nature of our business, the results of operations for the 13 and 39 weeks ended October 28, 2017 are not indicative of the results to be expected for the entire year.

Certain prior year amounts have been reclassified in the accompanying consolidated financial statements to conform to our fiscal 2017 presentation.

### Share Repurchase Program

In June 2017, the Board of Directors authorized a new share repurchase program for the Company to purchase \$500.0 million of the Company's common stock on the open market. The share repurchase program does not have an expiration date, and the timing and number of repurchase transactions under the program will depend on market conditions, corporate considerations, debt agreements and regulatory requirements. Shares repurchased under the program are held as treasury shares until retired. During the nine months ended October 28, 2017, we repurchased 12.7 million shares under our share repurchase programs for an aggregate amount of \$249.5 million, including \$99.4 million repurchased under our previous authorization. As of October 28, 2017, we had \$350.0 million of availability remaining under our current program.

### Accounting Pronouncements Recently Adopted

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, "Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09"). ASU 2016-09 identifies areas for simplification involving several aspects of accounting

## Table of Contents

for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, an option to recognize gross stock compensation expense with actual forfeitures recognized as they occur, as well as certain classifications on the statement of cash flows. We adopted the new guidance on a prospective basis in the first quarter of fiscal 2017. As a result of the adoption, we recognized \$0.1 million of excess tax benefits related to share-based compensation in income tax expense for the third quarter of fiscal 2017 and \$1.1 million for the nine months ended October 28, 2017. Excess tax benefits were historically recorded in additional paid-in capital. In addition, cash flows related to excess tax benefits are now classified as an operating activity. Cash flows were historically classified as a financing activity. We have elected to continue to estimate forfeitures expected to occur to determine the amount of compensation cost to be recognized each period. None of the other provisions in this amended guidance had a material impact on our consolidated financial statements.

## Recent Accounting Pronouncements Not Yet Adopted

In May 2017, the FASB issued ASU 2017-09, “Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting” (“ASU 2017-09”). ASU 2017-09 provides clarity on when a change to the terms or conditions of a share-based payment award would require an entity to apply modification accounting. ASU 2017-09 is effective on a prospective basis for reporting periods beginning after December 15, 2017, with early adoption permitted. We do not anticipate a material impact to the consolidated financial statements once implemented.

In January 2017, the FASB issued ASU 2017-04, “Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment” (“ASU 2017-04”). ASU 2017-04 simplifies the measurement of goodwill impairment by removing the second step of the goodwill impairment test, which requires the determination of the fair value of individual assets and liabilities of a reporting unit. Under ASU 2017-04, goodwill impairment is to be measured as the amount by which a reporting unit’s carrying value exceeds its fair value with the loss recognized not to exceed the total amount of goodwill allocated to the reporting unit. ASU 2017-04 is effective for fiscal years beginning after December 15, 2019, with early adoption permitted for interim or annual goodwill impairment tests performed after January 1, 2017. The standard is to be applied on a prospective basis. We do not anticipate a material impact to the consolidated financial statements once implemented.

In October 2016, the FASB issued ASU No. 2016-16, “Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory” (“ASU 2016-16”). ASU 2016-16 requires entities to recognize income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. ASU 2016-16 is effective for annual periods beginning after December 15, 2017, including interim reporting periods within that reporting period, with early adoption permitted. We do not anticipate a material impact to the consolidated financial statements once implemented.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments” (“ASU 2016-15”). ASU 2016-15 clarifies how companies should present and classify certain cash receipts and cash payments in the statement of cash flows. ASU 2016-15 is effective for annual periods

beginning after December 15, 2017, including interim reporting periods within that reporting period, with early adoption permitted. We have evaluated the new standard and it will not have a material impact to the consolidated financial statements once implemented.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)" ("ASU 2016-02"). Under ASU 2016-02, an entity will be required to recognize right-of-use assets and lease liabilities on its balance sheet and disclose key information about leasing arrangements. ASU 2016-02 offers specific accounting guidance for a lessee, a lessor and sale and leaseback transactions. Lessees and lessors are required to disclose qualitative and quantitative information about leasing arrangements to enable a user of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period, with early adoption permitted. At adoption, this update will be applied using a modified retrospective approach. We are currently evaluating the impact that ASU 2016-02 will have on the consolidated

## Table of Contents

financial statements and related disclosures. We believe the most significant impact relates to our accounting for real estate leases, which will be recorded as right-of-use assets and lease liabilities on our balance sheet upon adoption.

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers” (“ASU 2014 09”). ASU 2014-09 supersedes the revenue recognition requirements in “Revenue Recognition (Topic 605)”, and requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. In March 2016, the FASB issued ASU No. 2016-08, “Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)” which is intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, “Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing” which provides further guidance on identifying performance obligations and improves the operability and understandability of the licensing implementation guidance. In May 2016, the FASB issued ASU No. 2016-12, “Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients” which narrowly amended the revenue recognition guidance regarding collectability, noncash consideration, presentation of sales tax and transition. The guidance under each of these standards is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. We plan to adopt the standard using the modified retrospective approach. While we continue to assess all potential impacts of the guidance, our focus has been on vendor arrangements in which we act as either a principal or an agent and customer incentive arrangements. We do not anticipate that the adoption of ASU 2014-09 will result in a material adjustment on the date of implementation.

## 2. FAIR VALUE MEASUREMENTS

As defined in Accounting Standards Codification (“ASC”) 820, Fair Value Measurements (“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 valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect less transparent active market data, as well as internal 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 with significant unobservable inputs.

Impairment losses related to store-level property and equipment are calculated using significant unobservable inputs including the present value of future cash flows expected to be generated using a risk-adjusted weighted-average cost of capital and comparable store sales growth assumptions and therefore, are classified as a Level 3 measurement in the fair value hierarchy.

The carrying value of cash and cash equivalents, accounts receivable and accounts payable approximates their estimated fair values due to the short maturities of these instruments.



Table of Contents

The table below provides the fair values of our senior secured term loan facility (“Amended Term Loan Credit Facility”) and our 5.875% senior subordinated notes maturing in 2020 (“2020 Senior Subordinated Notes”). The fair values of our Amended Term Loan Credit Facility and our 2020 Senior Subordinated Notes were determined based on quoted market prices which are considered Level 2 inputs within the fair value hierarchy.

	October 28, 2017	January 28, 2017	October 29, 2016
	(in thousands)		
Term loan credit facility	\$ 2,250,412	\$ 2,266,304	\$ 2,286,723
Senior subordinated notes	520,838	526,575	526,575

## 3. DEBT

Long-term debt consists of the following (in thousands):

	Interest Rate	October 28, 2017	January 28, 2017	October 29, 2016
Term loan credit facility	Variable	\$ 2,244,800	\$ 2,263,475	\$ 2,269,700
Asset-based revolving credit facility	Variable	109,000	—	—
Senior subordinated notes	5.875 %	510,000	510,000	510,000

Edgar Filing: Michaels Companies, Inc. - Form 10-Q

Total debt	2,863,800	2,773,475	2,779,700
Less unamortized discount/premium and debt costs	(16,555)	(19,163)	(20,042)
Total debt, net	2,847,245	2,754,312	2,759,658
Less current portion	(140,125)	(31,125)	(24,900)
Long-term debt	\$ 2,707,120	\$ 2,723,187	\$ 2,734,758

Revolving Credit Facility

As of October 28, 2017 and October 29, 2016, the borrowing base under our senior secured asset-based revolving credit facility was \$850.0 million, of which Michaels Stores, Inc. (“MSI”) had unused borrowing capacity of \$675.7 million and \$792.7 million, respectively. As of October 28, 2017 and October 29, 2016, outstanding standby letters of credit, which reduce our borrowing base, totaled \$65.3 million and \$57.3 million, respectively.

Table of Contents

## 4. ACCUMULATED OTHER COMPREHENSIVE LOSS

The following table includes detail regarding changes in the composition of accumulated other comprehensive loss (in thousands):

	13 Weeks Ended		39 Weeks Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Beginning of period	\$ (5,552)	\$ (12,606)	\$ (14,224)	\$ (22,056)
Foreign currency translation adjustment and other	(4,418)	(3,650)	4,254	5,800
End of period	\$ (9,970)	\$ (16,256)	\$ (9,970)	\$ (16,256)

## 5. INCOME TAXES

The effective tax rate was 34.3% for the third quarter of fiscal 2017 compared to 29.0% for the third quarter of fiscal 2016 and 34.4% for the nine months ended October 28, 2017 compared to 33.6% for the same period in the prior year. The effective tax rate for both periods of fiscal 2017 was higher than the same periods in the prior year due to certain federal tax credits recognized in the prior year and an increase in state taxes, partially offset by benefits realized associated with our direct sourcing initiatives that began in the second half of fiscal 2016.

## 6. EARNINGS PER SHARE

The Company's unvested restricted stock awards contain non-forfeitable rights to dividends and meet the criteria of a participating security as defined by ASC 260, "Earnings Per Share". In applying the two-class method, net income is allocated to both common and participating securities based on their respective weighted-average shares outstanding for the period. Basic earnings per share is computed by dividing net income allocated to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share is computed by dividing income available to common shareholders by the weighted-average common shares outstanding plus the

potential dilutive impact from stock options and restricted stock units. Common equivalent shares are excluded from the computation if their effect is anti-dilutive. There were 5.8 million and 2.7 million anti-dilutive shares during the third quarters of fiscal 2017 and fiscal 2016, respectively. There were 6.0 million and 2.0 million anti-dilutive shares during the nine months ended October 28, 2017 and October 29, 2016, respectively.

Table of Contents

The following table sets forth the computation of basic and diluted earnings per common share (in thousands, except per share data):

	13 Weeks Ended		39 Weeks Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Basic earnings per common share:				
Net income	\$ 79,760	\$ 76,459	\$ 187,530	\$ 182,841
Less income related to unvested restricted shares	(297)	(462)	(789)	(1,180)
Income available to common shareholders - Basic	\$ 79,463	\$ 75,997	\$ 186,741	\$ 181,661
Weighted-average common shares outstanding - Basic	180,710	203,864	185,521	205,580
Basic earnings per common share	\$ 0.44	\$ 0.37	\$ 1.01	\$ 0.88
Diluted earnings per common share:				
Net income	\$ 79,760	\$ 76,459	\$ 187,530	\$ 182,841
Less income related to unvested restricted shares	(295)	(459)	(784)	(1,171)
Income available to common shareholders - Diluted	\$ 79,465	\$ 76,000	\$ 186,746	\$ 181,670
Weighted-average common shares outstanding - Basic	180,710	203,864	185,521	205,580
Effect of dilutive stock options and restricted stock units	1,277	1,449	1,254	1,713
Weighted-average common shares outstanding - Diluted	181,987	205,313	186,775	207,293
Diluted earnings per common share	\$ 0.44	\$ 0.37	\$ 1.00	\$ 0.88

## 7. SEGMENTS AND GEOGRAPHIC INFORMATION

We consider Michaels-U.S., Michaels-Canada, Aaron Brothers, Pat Catan's and Darice to be our operating segments for purposes of determining reportable segments based on the criteria of ASC 280, Segment Reporting ("ASC 280"). We determined that Michaels-U.S., Michaels-Canada, Aaron Brothers and Pat Catan's have similar economic characteristics and meet the aggregation criteria set forth in ASC 280. Therefore, we combine these operating segments into one reporting segment. Darice does not meet the materiality criteria in ASC 280 and, therefore, is not disclosed as a reportable segment. Our chief operating decision makers evaluate historical operating performance and forecast future periods' operating performance based on operating income.

Our net sales by country are as follows (in thousands):

	13 Weeks Ended		39 Weeks Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
United States	\$ 1,117,626	\$ 1,118,273	\$ 3,152,048	\$ 3,152,477
Canada	122,570	108,933	319,304	293,961
Total	\$ 1,240,196	\$ 1,227,206	\$ 3,471,352	\$ 3,446,438

Table of Contents

8. CONTINGENCIES

Rea Claim

On September 15, 2011, MSI was served with a lawsuit filed in the California Superior Court in and for the County of Orange (“Superior Court”) by four former store managers as a class action proceeding on behalf of themselves and certain former and current store managers employed by MSI in California. The lawsuit alleged that MSI improperly classified its store managers as exempt employees and as such failed to pay all wages, overtime and waiting time penalties and failed to provide accurate wage statements. The lawsuit also alleged that the foregoing conduct was in breach of various laws, including California’s unfair competition law. On December 3, 2013, the Superior Court entered an order certifying a class of approximately 200 members. MSI successfully removed the case to the U.S. District Court for the Central District of California and on May 8, 2014, the class was decertified. Three of the four named plaintiffs’ claims were resolved in September 2014 and the remaining one is set for trial on February 18, 2018. The individual claims of 26 former class members remain pending in the Central District of California. In addition, a separate representative action brought on behalf of store managers throughout the state is pending in the California Superior Court, County of San Diego. We believe we have meritorious defenses and intend to defend the lawsuits vigorously. We do not believe the resolution of the lawsuits will have a material effect on our consolidated financial statements.

Fair Credit Reporting Claim

On December 11, 2014, MSI was served with a lawsuit, *Christina Graham v. Michaels Stores, Inc.*, filed in the U.S. District Court for the District of New Jersey by a former employee. The lawsuit is a purported class action, bringing plaintiff’s individual claims, as well as claims on behalf of a putative class of applicants who applied for employment with Michaels through an online application, and on whom a background check for employment was procured. The lawsuit alleges that MSI violated the Fair Credit Reporting Act (“FCRA”) and the New Jersey Fair Credit Reporting Act by failing to provide the proper disclosure and obtain the proper authorization to conduct background checks. Since the initial filing, another named plaintiff joined the lawsuit, which was amended in February 2015, *Christina Graham and Gary Anderson v. Michaels Stores, Inc.*, with substantially similar allegations. The plaintiffs seek statutory and punitive damages as well as attorneys’ fees and costs.

Following the filing of the *Graham* case in New Jersey, five additional purported class action lawsuits with six plaintiffs were filed, *Michele Castro and Janice Bercut v. Michaels Stores, Inc.*, in the U.S. District Court for the Northern District of Texas, *Michelle Bercut v. Michaels Stores, Inc.* in the Superior Court of California for Sonoma County, *Raini Burnside v. Michaels Stores, Inc.*, in the U.S. District Court for the Western District of Missouri, *Sue Gettings v. Michaels Stores, Inc.*, in the U.S. District Court for the Southern District of New York, and *Barbara Horton v. Michaels Stores, Inc.*, in the U.S. District Court for the Central District of California. All of the plaintiffs alleged violations of the FCRA. In addition, the *Castro*, *Horton* and *Janice Bercut* lawsuits also alleged violations of California’s unfair competition law. The *Burnside*, *Horton* and *Gettings* lawsuits, as well as the claims by *Michele Castro*, have been dismissed. The *Graham*, *Janice Bercut* and *Michelle Bercut* lawsuits were transferred for centralized pretrial proceedings to the District of New Jersey. On January 24, 2017, the Company’s motion to dismiss for lack of standing was granted, and the court declined to rule on the merits of plaintiffs’ claims. The dismissal order was stayed for 30 days to allow the plaintiffs to amend their complaints. Because there were no amendments filed, two of the three centralized cases were dismissed and subsequently appealed to the U.S. Court of Appeals for the Third Circuit, and the remaining case (*Michelle Bercut*) was remanded to California Superior Court. We do not believe the

resolution of the lawsuits will have a material effect on our consolidated financial statements.

#### Data Security Incident

Five putative class actions were filed against MSI relating to the January 2014 data breach. The plaintiffs generally alleged that MSI failed to secure and safeguard customers' private information including credit and debit card information, and as such, breached an implied contract and violated the Illinois Consumer Fraud Act (and other states' similar laws). The plaintiffs were seeking damages including declaratory relief, actual damages, punitive damages, statutory damages,

12

---



## Table of Contents

attorneys' fees, litigation costs, remedial action, pre and post judgment interest, and other relief as available. The cases were as follows: Christina Moyer v. Michaels Stores, Inc., was filed on January 27, 2014; Michael and Jessica Gouwens v. Michaels Stores, Inc., was filed on January 29, 2014; Nancy Maize and Jessica Gordon v. Michaels Stores, Inc., was filed on February 21, 2014; and Daniel Ripes v. Michaels Stores, Inc., was filed on March 14, 2014. These four cases were filed in the U.S. District Court for the Northern District of Illinois, Eastern Division. On March 18, 2014, an additional putative class action was filed in the U.S. District Court for the Eastern District of New York, Mary Jane Whalen v. Michaels Stores, Inc., but was voluntarily dismissed by the plaintiff on April 11, 2014 without prejudice to her right to re file a complaint. On April 16, 2014, an order was entered consolidating the Illinois actions. On July 14, 2014, the Company's motion to dismiss the consolidated complaint was granted.

On December 2, 2014, Whalen filed a new lawsuit against MSI related to the data breach in the U.S. District Court for the Eastern District of New York, Mary Jane Whalen v. Michaels Stores, Inc., seeking damages including declaratory relief, monetary damages, statutory damages, punitive damages, attorneys' fees and costs, injunctive relief, pre and post judgment interest, and other relief as available. The Company filed a motion to dismiss which was granted on December 28, 2015, and judgment was entered in favor of the Company on January 8, 2016. Plaintiff appealed the judgment to the U.S. Court of Appeals for the Second Circuit and on May 2, 2017, the Second Circuit affirmed the dismissal and Whalen did not appeal further, thereby concluding the matter.

### Consumer Product Safety Commission Claim

On April 21, 2015, the U.S. Department of Justice, on behalf of the Consumer Product Safety Commission (the "CPSC"), filed a complaint against MSI and Michaels Stores Procurement Company, Inc. ("MSPC") in the U.S. District Court for the Northern District of Texas. The complaint seeks civil penalties for an alleged failure to timely report a potential product safety hazard to the CPSC related to the breakage of certain glass vases. The complaint also alleges the report contained a material misrepresentation and seeks injunctive relief requiring MSI and MSPC to, among other things, establish internal recordkeeping and compliance monitoring systems. On April 4, 2017, the CPSC filed an amended complaint eliminating their misrepresentation claim. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of the lawsuit will have a material effect on our consolidated financial statements.

### General

In addition to the litigation discussed above, we are now, and may be in the future, involved in various other lawsuits, claims and proceedings incident to the ordinary course of business. The results of litigation are inherently unpredictable. Any claims against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in diversion of significant resources.

For some of the matters disclosed above, as well as other lawsuits involving the Company, we are able to estimate a range of losses in excess of the amounts recorded, if any, in the accompanying consolidated financial statements. As of October 28, 2017, the aggregate estimated loss was approximately \$10 million, which includes amounts recorded by the Company.

9. RELATED PARTY TRANSACTIONS

Affiliates of, or funds advised by, Bain Capital Partners, LLC (“Bain Capital”) and The Blackstone Group L.P. (“The Blackstone Group”, together with Bain Capital and their applicable affiliates, the “Sponsors”) owned approximately 40% of our outstanding common stock as of October 28, 2017.

The Blackstone Group owns a majority equity position in RGIS, a vendor we utilize to count our store inventory. Payments associated with this vendor during the third quarters of fiscal 2017 and fiscal 2016 were \$2.3 million and \$2.1 million, respectively. Payments made during the nine months ended October 28, 2017 and October 29, 2016 were \$6.0

13

---

Table of Contents

million and \$5.9 million, respectively. These expenses are included in selling, general and administrative (“SG&A”) in the consolidated statements of comprehensive income.

The Blackstone Group owns a majority equity position in Excel Trust, Inc., Blackstone Real Estate DDR Retail Holdings III, LLC and Blackstone Real Estate RC Retail Holdings, LLC, vendors we utilize to lease certain properties. Payments associated with these vendors during the third quarters of fiscal 2017 and fiscal 2016 were \$1.9 million and \$1.4 million, respectively. Payments made during the nine months ended October 28, 2017 and October 29, 2016 were \$5.1 million and \$3.5 million, respectively. These expenses are included in cost of sales and occupancy expense in the consolidated statements of comprehensive income.

Certain affiliates of The Blackstone Group have significant influence over US Xpress Enterprises, Inc., a vendor we utilize for transportation services. Payments associated with this vendor during the third quarters of fiscal 2017 and fiscal 2016 were \$0.3 million and \$0.2 million, respectively. Payments made during the nine months ended October 28, 2017 and October 29, 2016 were \$0.7 million. These expenses are recognized in cost of sales and occupancy expense in the consolidated statements of comprehensive income as the sales are incurred.

Two of our current directors, Joshua Bekenstein and Peter F. Wallace, are affiliates of Bain Capital or The Blackstone Group. As such, some or all of such 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. As of October 28, 2017, affiliates of The Blackstone Group held \$71.7 million of our Amended Term Loan Credit Facility.

## 10. CONDENSED CONSOLIDATED FINANCIAL INFORMATION

Our debt covenants restrict MSI, and certain subsidiaries of MSI, from various activities including the incurrence of additional debt, payment of dividends and the repurchase of MSI’s capital stock (subject to certain exceptions), among other things. The following condensed consolidated financial information represents the financial information of MSI and its wholly-owned subsidiaries subject to these restrictions. The information is presented in accordance with the requirements of Rule 12-04 under the SEC’s Regulation S-X.

Table of Contents

Michaels Stores, Inc.

Condensed Consolidated Balance Sheets

(in thousands)

	October 28, 2017	January 28, 2017	October 29, 2016
<b>ASSETS</b>			
Current assets:			
Cash and equivalents	\$ 176,007	\$ 294,054	\$ 145,217
Merchandise inventories	1,404,206	1,127,777	1,394,092
Prepaid expenses and other current assets	131,695	116,072	147,796
Total current assets	1,711,908	1,537,903	1,687,105
Property and equipment, net	401,892	413,164	412,202
Goodwill	119,074	119,074	119,074
Other assets	72,036	73,201	68,401
Total assets	\$ 2,304,910	\$ 2,143,342	\$ 2,286,782
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>			
Current liabilities:			
Accounts payable	\$ 674,222	\$ 517,268	\$ 714,198
Accrued liabilities and other	399,363	395,745	385,102
Current portion of long-term debt	140,125	31,125	24,900
Other current liabilities	60,884	123,258	36,263
Total current liabilities	1,274,594	1,067,396	1,160,463
Long-term debt	2,707,120	2,723,187	2,734,758
Other liabilities	108,112	103,972	103,615
Total stockholders' deficit	(1,784,916)	(1,751,213)	(1,712,054)
Total liabilities and stockholders' deficit	\$ 2,304,910	\$ 2,143,342	\$ 2,286,782

Michaels Stores, Inc.

Condensed Consolidated Statements of Comprehensive Income

(in thousands)

13 Weeks Ended		39 Weeks Ended	
October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016

Edgar Filing: Michaels Companies, Inc. - Form 10-Q

Net sales	\$ 1,240,196	\$ 1,227,206	\$ 3,471,352	\$ 3,446,438
Cost of sales and occupancy expense	756,088	760,598	2,117,100	2,124,383
Gross profit	484,108	466,608	1,354,252	1,322,055
Selling, general and administrative	328,855	318,438	969,793	937,849
Store pre-opening costs	952	1,704	2,592	4,238
Operating income	154,301	146,466	381,867	379,968
Interest and other expense	32,460	38,689	95,261	103,207
Income before income taxes	121,841	107,777	286,606	276,761
Income taxes	41,806	31,232	98,601	93,149
Net income	\$ 80,035	\$ 76,545	\$ 188,005	\$ 183,612
Other comprehensive income, net of tax:				
Foreign currency translation adjustment and other	(4,418)	(3,650)	4,254	5,800
Comprehensive income	\$ 75,617	\$ 72,895	\$ 192,259	\$ 189,412

15

---

Table of Contents

Michaels Stores, Inc.

Condensed Consolidated Statements of Cash Flows

(in thousands)

	39 Weeks Ended	
	October 28, 2017	October 29, 2016
Cash flows from operating activities:		
Net cash provided by operating activities	\$ 109,782	\$ 148,191
Cash flows from investing activities:		
Additions to property and equipment	(72,640)	(82,163)
Acquisition of Lamrite West, net of cash acquired	—	(151,100)
Purchase of long-term investment	—	(1,325)
Net cash used in investing activities	(72,640)	(234,588)
Cash flows from financing activities:		
Net repayments of debt	(266,875)	(54,450)
Net borrowings of debt	357,200	42,000
Payment of dividend to Michaels Funding, Inc.	(245,514)	(156,529)
Other financing activities	—	(4,057)
Net cash used in financing activities	(155,189)	(173,036)
Net change in cash and equivalents	(118,047)	(259,433)
Cash and equivalents at beginning of period	294,054	404,650
Cash and equivalents at end of period	\$ 176,007	\$ 145,217

Table of Contents

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

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements of the Company (and the related notes thereto included elsewhere in this quarterly report), the audited consolidated financial statements of the Company (and the related notes thereto) and the Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the fiscal year ended January 28, 2017 ("Annual Report") filed with the Securities and Exchange Commission ("SEC") pursuant to Section 13 or 15(d) under the Securities Exchange Act of 1934 on March 7, 2017.

All of the "Company", "us", "we", "our", and similar expressions are references to The Michaels Companies, Inc. ("Michaels") and our consolidated wholly-owned subsidiaries, including Lamrite West, Inc. ("Lamrite") which was acquired in fiscal 2016, unless otherwise expressly stated or the context otherwise requires.

We report on the basis of a 52- or 53-week fiscal year, which ends on the Saturday closest to January 31. All references to fiscal year mean the year in which that fiscal year began. References to "fiscal 2017" relate to the 53 weeks ending February 3, 2018 and references to "fiscal 2016" relate to the 52 weeks ended January 28, 2017. In addition, all references to "the third quarter of fiscal 2017" relate to the 13 weeks ended October 28, 2017 and all references to "the third quarter of fiscal 2016" relate to the 13 weeks ended October 29, 2016. Finally, all references to "the nine months ended October 28, 2017" relate to the 39 weeks ended October 28, 2017 and all references to "the nine months ended October 29, 2016" relate to the 39 weeks ended October 29, 2016. Because of the seasonal nature of our business, the results of operations for the 13 and 39 weeks ended October 28, 2017 are not indicative of the results to be expected for the entire year.

Overview

We are the largest arts and crafts specialty retailer in North America (based on store count) providing materials, project ideas and education for creative activities under the retail brands of Michaels, Aaron Brothers and Pat Catan's. We also operate an international wholesale business under the Darice brand name and a market-leading vertically-integrated custom framing business under the Artistree brand name. As of October 28, 2017, we operated 1,237 Michaels stores, 98 Aaron Brothers stores and 36 Pat Catan's stores.

Net sales for the third quarter of fiscal 2017 increased 1.1% compared to the same period in the prior year. The increase in net sales was due to the opening of 16 additional Michaels stores (net of closures) since October 29, 2016 and a 1.0% increase in comparable store sales. Gross profit as a percent of net sales increased 100 basis points to 39.0% during the third quarter of fiscal 2017 due to our sourcing initiatives that began in fiscal 2016 and the timing of distribution-related costs, partially offset by an increase in inventory shrink. Operating income as a percent of net sales

increased 50 basis points to 12.4% for the third quarter of fiscal 2017 as compared to 11.9% in the same period in the prior year. The increase was primarily due to the increase in gross profit margin.

#### Comparable Store Sales

Comparable store sales represents the change in net sales for stores open the same number of months in the comparable period of the previous year, including stores that were relocated or expanded during either period, as well as e-commerce sales. 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 two weeks is not considered comparable during the month it is closed. If a store is closed longer than two weeks but less than two months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than two months becomes comparable in its 14th month of operation after its reopening.



Table of Contents

## Operating Information

The following table sets forth certain operating data:

	13 Weeks Ended		39 Weeks Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Michaels stores:				
Open at beginning of period	1,230	1,209	1,223	1,196
New stores	8	14	16	30
Relocated stores opened	4	4	12	14
Closed stores	(1)	(2)	(2)	(5)
Relocated stores closed	(4)	(4)	(12)	(14)
Open at end of period	1,237	1,221	1,237	1,221
Aaron Brothers stores:				
Open at beginning of period	101	112	109	117
Closed stores	(3)	—	(11)	(5)
Open at end of period	98	112	98	112
Pat Catan's stores:				
Open at beginning of period	35	35	35	—
Acquired stores	—	—	—	32
New stores	1	—	1	3
Open at end of period	36	35	36	35
Total store count at end of period	1,371	1,368	1,371	1,368
Other Operating Data:				
Average inventory per Michaels store (in thousands) (1)	\$ 1,028	\$ 1,040	\$ 1,028	\$ 1,040
Comparable store sales	1.0	% (2.0)	% 0.1	% (0.2)
Comparable store sales, at constant currency	0.5	% (2.0)	% 0.0	% 0.1

(1) The calculation of average inventory per Michaels store excludes our Aaron Brothers and Pat Catan's stores.

Table of Contents

## Results of Operations

The following table sets forth the percentage relationship to net sales of line items of our consolidated statements of comprehensive income. This table should be read in conjunction with the following discussion and with our consolidated financial statements, including the related notes.

	13 Weeks Ended		39 Weeks Ended			
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Net sales	100.0	% 100.0	% 100.0	% 100.0	% 100.0	% 100.0
Cost of sales and occupancy expense	61.0	62.0	61.0	61.6		
Gross profit	39.0	38.0	39.0	38.4		
Selling, general and administrative	26.6	26.0	28.0	27.2		
Store pre-opening costs	0.1	0.1	0.1	0.1		
Operating income	12.4	11.9	11.0	11.0		
Interest expense	2.6	2.6	2.7	2.8		
Losses on early extinguishments of debt and refinancing costs	—	0.6	—	0.2		
Other (income) expense, net	—	—	—	—		
Income before income taxes	9.8	8.8	8.2	8.0		
Income taxes	3.4	2.5	2.8	2.7		
Net income	6.4	% 6.2	% 5.4	% 5.3		%

## 13 Weeks Ended October 28, 2017 Compared to the 13 Weeks Ended October 29, 2016

**Net Sales.** Net sales increased \$13.0 million for the third quarter of fiscal 2017, or 1.1%, compared to the third quarter of fiscal 2016. The increase in net sales was due to an \$11.2 million increase related to 16 additional Michaels stores opened (net of closures) since October 29, 2016 and an \$11.4 million increase in comparable store sales. Comparable store sales increased 1.0%, or 0.5% at constant exchange rates, due to an increase in our average ticket, partially offset by a decrease in customer transactions. Wholesale revenue decreased \$8.6 million primarily due to the timing differences between new customer acquisitions and the expected decline in sales from legacy customers as a result of the Lamrite acquisition in fiscal 2016.

**Gross Profit.** Gross profit was 39.0% of net sales for the third quarter of fiscal 2017 compared to 38.0% for the third quarter of fiscal 2016. The 100 basis point increase was primarily due to our sourcing initiatives that began in fiscal 2016, the timing of distribution-related costs and \$0.7 million of non-recurring purchase accounting adjustments related to inventory recorded in the prior year. The increase was partially offset by an increase in inventory shrink.

Selling, General and Administrative. Selling, general and administrative (“SG&A”) was 26.6% of net sales for the third quarter of fiscal 2017 compared to 26.0% for the third quarter of fiscal 2016. SG&A increased \$10.7 million to \$329.3 million for the third quarter of fiscal 2017. The increase was primarily due to a \$5.0 million increase in incentive-based compensation, a \$3.7 million increase in marketing expenses, \$2.6 million of higher healthcare costs and \$2.3 million of expenses associated with operating 16 additional Michaels stores (net of closures). The increase was partially offset by \$1.6 million of Lamrite integration costs recorded in the prior year.

Interest Expense. Interest expense increased \$1.3 million to \$32.8 million for the third quarter of fiscal 2017 compared to the third quarter of fiscal 2016. The increase was primarily attributable to \$0.9 million associated with increased borrowings and a higher interest rate on our senior secured asset-based revolving credit facility (“Amended Revolving Credit Facility”) and \$0.5 million associated with a higher interest rate on our term loan credit facility (“Amended Term Loan Credit Facility”).

Table of Contents

Losses on Early Extinguishments of Debt and Refinancing Costs. We recorded a loss on the early extinguishment of debt of \$6.9 million during the third quarter of fiscal 2016 related to the refinancing of our term loan credit facility.

Income Taxes. The effective tax rate was 34.3% for the third quarter of fiscal 2017 compared to 29.0% for the third quarter of fiscal 2016. The effective tax rate was higher than the same period in the prior year primarily due to certain federal tax credits recognized in the prior year and an increase in state taxes, partially offset by benefits realized associated with our direct sourcing initiatives that began in the second half of fiscal 2016.

39 Weeks Ended October 28, 2017 Compared to the 39 Weeks Ended October 29, 2016

Net Sales. Net sales increased \$24.9 million for the first nine months of fiscal 2017, or 0.7%, compared to the first nine months of fiscal 2016. The increase in net sales was due to a \$37.1 million increase related to 16 additional Michaels stores opened (net of closures) since October 29, 2016 and a \$4.5 million increase in comparable store sales. Comparable store sales increased 0.1% (flat at constant exchange rates) primarily due to an increase in our average ticket. Wholesale revenue decreased \$15.2 million due to the timing differences between new customer acquisitions and the expected decline in sales from legacy customers as a result of the Lamrite acquisition in fiscal 2016.

Gross Profit. Gross profit was 39.0% of net sales for the first nine months of fiscal 2017 compared to 38.4% for the first nine months of fiscal 2016. The 60 basis point increase was primarily due to our sourcing initiatives that began in fiscal 2016, the timing of distribution-related costs and \$2.9 million of non-recurring purchase accounting adjustments related to inventory recorded in the prior year. The increase was partially offset by an increase in inventory shrink.

Selling, General and Administrative. SG&A was 28.0% of net sales for the first nine months of fiscal 2017 compared to 27.2% for the first nine months of fiscal 2016. SG&A increased \$31.5 million to \$970.6 million for the first nine months of fiscal 2017. The increase was due to a \$14.9 million increase in incentive-based compensation, a \$9.0 million increase in marketing expenses, \$8.1 million of expenses associated with operating 16 additional Michaels stores (net of closures) and \$6.8 million of higher healthcare costs. The increase was partially offset by \$7.6 million of Lamrite integration costs recorded in the prior year.

Interest Expense. Interest expense decreased \$1.4 million to \$94.3 million for the first nine months of fiscal 2017 compared to the first nine months of fiscal 2016. The decrease was primarily attributable to \$1.1 million of interest savings due to the refinancing of our Amended Term Loan Credit Facility in the third quarter of fiscal 2016 and \$0.4 million of interest savings related to the refinancing of our Amended Revolving Credit Facility in the second quarter of fiscal 2016.

Losses on Early Extinguishments of Debt and Refinancing Costs. We recorded a loss on the early extinguishment of debt of \$7.3 million in the first nine months of fiscal 2016, consisting of \$6.9 million related to the refinancing of our term loan credit facility and \$0.4 million related to the refinancing of our senior secured asset-based revolving credit facility.

Income Taxes. The effective tax rate was 34.4% for the first nine months of fiscal 2017 compared to 33.6% for the same period in the prior year. The effective tax rate was higher than the same period in the prior year primarily due to certain federal tax credits recognized in the prior year and an increase in state taxes, partially offset by benefits realized associated with our direct sourcing initiatives that began in the second half of fiscal 2016.

#### Liquidity and Capital Resources

We require cash principally for day-to-day operations, to finance capital investments, purchase inventory, 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 Revolving Credit Facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and anticipated growth for

Table of Contents

the foreseeable future. Our ability to satisfy our liquidity needs and continue to refinance or reduce debt could be adversely affected by the occurrence of any of the events described under “Item 1A. Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended January 28, 2017 or our failure to meet our debt covenants. Our Amended Revolving Credit Facility provides senior secured financing of up to \$850.0 million, subject to a borrowing base. As of October 28, 2017, the borrowing base was \$850.0 million, of which we had \$65.3 million of outstanding standby letters of credit and \$675.7 million of unused borrowing capacity. Our cash and cash equivalents totaled \$176.8 million at October 28, 2017, of which \$68.4 million was held by our foreign subsidiaries. If it were necessary to repatriate these funds for use in the U.S., we would be required to pay U.S. taxes in excess of foreign tax credits on the amount distributed out of the earnings and profits of our foreign subsidiaries. However, it is our intent to indefinitely reinvest these funds outside the U.S.

In June 2017, the Board of Directors authorized a new share repurchase program for the Company to purchase \$500.0 million of the Company’s common stock on the open market. The share repurchase program does not have an expiration date, and the timing and number of repurchase transactions under the program will depend on market conditions, corporate considerations, debt agreements and regulatory requirements. Shares repurchased under the program are held as treasury shares until retired. During the nine months ended October 28, 2017, we repurchased 12.7 million shares under our share repurchase programs for an aggregate amount of \$249.5 million, including \$99.4 million repurchased under our previous authorization. As of October 28, 2017, we had \$350.0 million of availability remaining under our current program.

We had total outstanding debt of \$2,863.8 million at October 28, 2017, of which \$2,353.8 million was subject to variable interest rates and \$510.0 million was subject to fixed interest rates.

Our substantial indebtedness could adversely affect our ability to raise additional capital, limit our ability to react to changes in the economy or our industry, expose us to interest rate risk and prevent us from meeting our obligations. Management reacts strategically to changes in economic conditions and monitors compliance with debt covenants to seek to mitigate any potential material impacts to our financial condition and flexibility.

We intend to use excess operating cash flows to invest in growth opportunities, repurchase outstanding shares and repay portions of our indebtedness, depending on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. As such, 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. If we use our excess cash flows to repay our debt, it will reduce the amount of excess cash available for additional capital expenditures.

Cash Flow from Operating Activities

Cash flows provided by operating activities were \$106.4 million in the first nine months of fiscal 2017 compared to \$136.5 million in the first nine months of fiscal 2016. The decrease was primarily due to the timing of vendor payments, partially offset by \$7.6 million of Lamrite integration costs recorded in the prior year.

Inventory at the end of the third quarter of fiscal 2017 increased \$10.1 million, or 0.7%, to \$1,404.2 million, compared to \$1,394.1 million at the end of the third quarter of fiscal 2016. The increase in inventory was primarily due to additional inventory associated with the operation of 16 additional Michaels stores (net of closures). Average inventory per Michaels store (inclusive of distribution centers, in-transit and inventory for the Company's e-commerce site) decreased 1.2% to \$1,028,000 at October 28, 2017 from \$1,040,000 at October 29, 2016.

Table of Contents

## Cash Flow from Investing Activities

The following table includes capital expenditures paid during the periods presented (in thousands):

	39 Weeks Ended	
	October 28, 2017	October 29, 2016
New and relocated stores including stores not yet opened (1)	\$ 12,055	\$ 17,810
Existing stores	23,483	35,395
Information systems	23,929	18,144
Corporate and other	13,173	10,814
	\$ 72,640	\$ 82,163

(1) In the first nine months of fiscal 2017, we incurred capital expenditures related to the opening of 28 Michaels stores, including the relocation of 12 stores, and the opening of one Pat Catan's store. In the first nine months of fiscal 2016, we incurred capital expenditures related to the opening of 44 Michaels stores, including the relocation of 14 stores, and the opening of three Pat Catan's stores.

## Non-GAAP Measures

The following table sets forth certain non-GAAP measures used by the Company to manage our performance and measure compliance with certain debt covenants. The Company defines "EBITDA" as net income before interest, income taxes, depreciation and amortization. The Company defines "Adjusted EBITDA" as EBITDA adjusted for certain defined amounts in accordance with the Company's Amended Term Loan Credit Facility and Amended Revolving Credit Facility (together the "Senior Secured Credit Facilities").

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. Adjusted EBITDA is a required calculation under the Company's Senior Secured Credit Facilities that is used in the calculations of fixed charge coverage and leverage ratios, which, under certain circumstances determine mandatory repayments or maintenance covenants and may restrict the Company's ability to make certain payments (characterized as restricted payments), investments (including acquisitions) and debt repayments.



As EBITDA and Adjusted EBITDA are not measures of liquidity calculated in accordance with U.S. generally accepted accounting principles (“GAAP”), these measures should not be considered in isolation of, or as substitutes for, 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.

Table of Contents

The following table shows a reconciliation of EBITDA and Adjusted EBITDA to net income and net cash used in operating activities (in thousands):

	13 Weeks Ended		39 Weeks Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Net cash provided by operating activities	\$ 110,462	\$ 160,940	\$ 106,427	\$ 136,516
Depreciation and amortization	(28,809)	(28,211)	(86,232)	(86,679)
Share-based compensation	(7,675)	(5,294)	(18,232)	(11,884)
Debt issuance costs amortization	(1,274)	(1,548)	(3,823)	(5,308)
Accretion of long-term debt, net	127	93	379	217
Deferred income taxes	(754)	(9,487)	(529)	(10,106)
Losses on early extinguishments of debt and refinancing costs	—	(6,887)	—	(7,292)
Losses on disposition of property and equipment	—	(21)	—	(56)
Excess tax benefits from share-based compensation	—	214	—	7,485
Changes in assets and liabilities	7,683	(33,340)	189,540	159,948
Net income	79,760	76,459	187,530	182,841
Interest expense	32,818	31,538	94,305	95,711
Income taxes	41,640	31,181	98,314	92,692
Depreciation and amortization	28,809	28,211	86,232	86,679
Interest income	(190)	(68)	(443)	(521)
EBITDA	182,837	167,321	465,938	457,402
Adjustments:				
Losses on early extinguishments of debt and refinancing costs	—	6,887	—	7,292
Share-based compensation	7,675	5,294	18,232	11,884
Severance costs	285	2,181	862	3,101
Store pre-opening costs	952	1,704	2,592	4,238
Store remodel costs	424	905	1,401	895
Foreign currency transaction (gains) losses	(355)	146	1,092	694
Store closing costs	109	924	2,122	3,076
Lamrite integration costs	—	1,586	—	7,605
Other (1)	952	910	2,451	2,470
Adjusted EBITDA	\$ 192,879	\$ 187,858	\$ 494,690	\$ 498,657

(1) Other adjustments primarily relate to items such as moving and relocation expenses, franchise taxes, sign on bonuses and certain legal expenses.



Table of Contents

Disclosure Regarding Forward-Looking Information

The above 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. Statements regarding sufficiency of capital resources and planned uses of excess cash flow as well as any other statements contained herein (including, but not limited to, statements to the effect that Michaels or its management “anticipates”, “plans”, “estimates”, “expects”, “believes”, “intends” 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 Annual Report. 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. Most of these factors are outside of our control and are difficult to predict. Such risks and uncertainties include, but are not limited to the following:

- risks related to the effect of economic uncertainty;
- risks related to our substantial indebtedness;
- restrictions in our debt agreements that limit our flexibility in operating our business;
- changes in customer demand could materially adversely affect our sales, results of operations and cash flow;
- our failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information, which could result in an additional data breach, could materially adversely affect our financial condition and operating results;
- competition, including internet-based competition, could negatively impact our business;
- our reliance on foreign suppliers increases our risk of obtaining adequate, timely and cost-effective product supplies;
- our ability to open new stores and increase comparable store sales, as our growth depends on our strategy of expanding our base of retail stores; and, if we are unable to continue this strategy, our ability to increase our sales, profitability and cash flow could be impaired;
- damage to the reputation of the Michaels brand or our private and exclusive brands could adversely affect our sales;

- a weak fourth quarter would materially adversely affect our results of operations;
- risks associated with the suppliers from whom our products are sourced may fail us and transitioning to other qualified vendors could materially adversely affect our revenue and profit growth;
- unexpected or unfavorable consumer responses to our promotional or merchandising programs could materially adversely affect our sales, results of operations, cash flows and financial condition;
- our marketing programs, e-commerce initiatives and use of consumer information are governed by an evolving set of laws and enforcement trends and unfavorable changes in those laws or trends, or our failure to comply with existing or future laws, could substantially harm our business and results of operations;

Table of Contents

- 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, results of operation, cash flow, and financial condition;
- changes in regulations or enforcement, or our failure to comply with existing or future regulations, may adversely impact our business;
- significant increases in inflation or commodity prices such as petroleum, natural gas, electricity, steel, wood, and paper may adversely affect our costs, including cost of merchandise;
- we may be subject to information technology system failures or network disruptions, or our information systems may prove inadequate, resulting in damage to our reputation, business operations and financial condition;
- improvements to our supply chain may not be fully successful;
- changes in estimates or projections used to assess fair value of intangible assets, goodwill and property and equipment may cause us to incur impairment charges that could adversely affect our results of operations;
- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements;
- disruptions in the capital markets could increase our costs of doing business;
- our real estate leases generally obligate us for long periods, which subjects us to various financial risks;
- we have co-sourced certain of our information technology, accounts payable, payroll, accounting and human resources functions, and may co-source other administrative functions, which makes us more dependent upon third parties;
- we are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiaries;
- we are dependent upon the services of our senior management team;
- failure to attract and retain quality sales, distribution center and other team members in appropriate numbers as well as experienced buying and management personnel could adversely affect our performance;

Edgar Filing: Michaels Companies, Inc. - Form 10-Q

- our results may be adversely affected by serious disruptions or catastrophic events, including geo-political events and weather;
- any difficulty executing or integrating an acquisition, a business combination or a major business initiative could adversely affect our business or results of operations;
- substantial changes to fiscal and tax policies may adversely affect our business;
- our holding company structure makes us, and certain of our direct and indirect subsidiaries, dependent on the operations of our, and their, subsidiaries to meet our financial obligations; and
- affiliates of or funds advised by the Sponsors own approximately 40% of the outstanding shares of our common stock and as a result will have the ability to strongly influence our decisions, and they may have interests that differ from those of other stockholders.

25

---

Table of Contents

For more details on factors that may cause actual results to differ materially from such forward-looking statements see the Risk Factors section of our Annual Report. Except as required by applicable law, we disclaim any intention to, and undertake no obligation to, update or revise any forward-looking statement.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Risk

We are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiaries. Our sales, costs and expenses of our Canadian subsidiaries, when translated into U.S. dollars, can fluctuate due to exchange rate movement. A 10% increase or decrease in the exchange rate of the Canadian dollar would have increased or decreased net income by approximately \$10 million for the 39 weeks ended October 28, 2017.

Interest Rate Risk

We have market risk exposure arising from changes in interest rates on our Amended Term Loan Credit Facility and our Amended Revolving Credit Facility. The interest rates on our Amended Term Loan Credit Facility and our Amended Revolving Credit Facility will reprice periodically, which will impact our earnings and cash flow. The interest rate on our 2020 Senior Subordinated Notes is fixed. Based on our overall interest rate exposure to variable rate debt outstanding as of October 28, 2017, a 1% change in interest rates would impact income before income taxes by approximately \$24 million for fiscal 2017. A 1% change in interest rates would impact the fair value of our long-term fixed rate debt by approximately \$17 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

Inflation Risk

We do not believe inflation and changing commodity prices have had a material impact on our net sales, income from continuing operations, plans for expansion or other capital expenditures for any period presented in this report. However, we cannot be sure inflation and changing commodity prices will not have an adverse impact on our operating results, financial condition, plans for expansion or other capital expenditures in future periods.

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) 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 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 Chief 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 Chief 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 Exchange Act of 1934, is accumulated and communicated to management, including our Chief Executive Officer and our Chief Financial Officer, to 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.

Table of Contents

Change in Internal Control Over Financial Reporting

There have been no changes in our internal controls over financial reporting during the quarter ended October 28, 2017 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information regarding legal proceedings is incorporated by reference from Note 8 to the consolidated financial statements in this Quarterly Report on Form 10-Q.

ITEM 1A. RISK FACTORS

There have been no material changes to the Risk Factors described in the Annual Report on Form 10-K.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table provides certain information with respect to our purchases of shares of the Company's common stock during the third quarter of fiscal 2017:

	Total Number of	Approximate Dollar Value of Shares That May Yet Be Purchased
Total Number of	Shares Purchased as Part of Publicly	

Edgar Filing: Michaels Companies, Inc. - Form 10-Q

Period	Shares Purchased (a)	Average Price Paid per Share	Announced Plan (b)	Under the Plan (b) (in thousands)
July 30, 2017 - August 26, 2017	2,425,944	\$ 20.13	2,417,647	\$ 350,001
August 27, 2017 - September 30, 2017	101,408	21.61	—	350,001
October 1, 2017 - October 28, 2017	751	21.01	—	350,001
Total	2,528,103	\$ 20.19	2,417,647	\$ 350,001

(a) These amounts reflect the following transactions during the third quarter of fiscal 2017: (i) the repurchase of 2,417,647 shares as part of our publicly announced share repurchase program and (ii) the surrender of shares of common stock to the Company to satisfy tax withholding obligations in connection with the vesting of employee restricted stock awards.

(b) In June 2017, the Board of Directors authorized the Company to purchase up to \$500.0 million of the Company's common stock on the open market. The share repurchase program does not have an expiration date. The Company has retired and intends to continue to retire shares repurchased under the program.

Table of Contents

ITEM 6. EXHIBITS

(a) Exhibits:

Exhibit Number	Description of Exhibit
31.1	<u>Certifications of Carl S. Rubin pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
31.2	<u>Certifications of Denise A. Paulonis pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
32.1	<u>Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

---

\*Management contract or compensatory plan or agreement.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

THE MICHAELS COMPANIES, INC.

By: /s/ Carl S. Rubin  
Carl S. Rubin  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

By: /s/ Denise A. Paulonis  
Denise A. Paulonis  
Executive Vice President and Chief Financial Officer  
  
(Principal Financial Officer)

Date: December 1, 2017