

MICHAELS STORES INC  
Form 10-Q  
November 18, 2011  
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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 October 29, 2011

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)

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**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 <input type="checkbox"/>          | Accelerated filer <input type="checkbox"/>         |
| Non-accelerated filer <input checked="" type="checkbox"/> | Smaller reporting company <input type="checkbox"/> |

(Do not check if a 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

As of November 14, 2011, 118,697,395 shares of the Registrant's Common Stock were outstanding.



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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)

|  | October 29,<br>2011 | January 29,<br>2011 | October 30,<br>2010 |
|--|---------------------|---------------------|---------------------|
| <b>ASSETS</b>  |                     |                     |                     |
| <b>Current assets:</b>   |                     |                     |                     |
| Cash and equivalents   | \$ 111              | \$ 319              | \$ 115              |
| Merchandise inventories  | 1,019               | 826                 | 1,004               |
| Prepaid expenses and other   | 80                  | 73                  | 78                  |
| Deferred income taxes  | 56                  | 56                  | 41                  |
| Income tax receivable  | 12                  | 1                   | 48                  |
| Total current assets   | 1,278               | 1,275               | 1,286               |
| <b>Property and equipment, at cost</b>   |                     |                     |                     |
| Less accumulated depreciation  | (1,086)             | (1,028)             | (1,002)             |
| Property and equipment, net  | 316                 | 301                 | 302                 |
| <b>Goodwill</b>  |                     |                     |                     |
| Debt issuance costs, net of accumulated amortization of \$71, \$60, and \$57, respectively | 95                  | 95                  | 95                  |
| Deferred income taxes  | 58                  | 72                  | 78                  |
| Other assets   | 18                  | 18                  | 8                   |
| Total non-current assets   | 5                   | 9                   | 7                   |
| Total assets   | 176                 | 194                 | 188                 |
|  | \$ 1,770            | \$ 1,770            | \$ 1,776            |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>  |                     |                     |                     |
| <b>Current liabilities:</b>  |                     |                     |                     |
| Accounts payable   | \$ 348              | \$ 273              | \$ 324              |
| Accrued liabilities and other  | 405                 | 384                 | 361                 |
| Current portion of long-term debt  | 135                 | 1                   | 1                   |
| Income taxes payable   | 7                   | 29                  | 2                   |
| Total current liabilities  | 895                 | 687                 | 688                 |
| <b>Long-term debt</b>  |                     |                     |                     |
| Deferred income taxes  | 3,376               | 3,667               | 3,764               |
| Other long-term liabilities  | 4                   | 4                   | 2                   |
| Total long-term liabilities  | 77                  | 76                  | 86                  |
|  | 3,457               | 3,747               | 3,852               |
|  | 4,352               | 4,434               | 4,540               |
| <b>Commitments and contingencies</b>   |                     |                     |                     |

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**Stockholders deficit:**

Common Stock, \$0.10 par value, 220,000,000 shares authorized;

118,284,809 shares issued and outstanding at October 29, 2011; 118,419,850

shares issued and outstanding at January 29, 2011; 118,419,850 shares

issued and outstanding at October 30, 2010

|  |          |          |          |
|--|----------|----------|----------|
|  | 12       | 12       | 12       |
| Additional paid-in capital                 | 46       | 43       | 41       |
| Accumulated deficit                        | (2,647)  | (2,726)  | (2,824)  |
| Accumulated other comprehensive income     | 7        | 7        | 7        |
| Total stockholders deficit                 | (2,582)  | (2,664)  | (2,764)  |
| Total liabilities and stockholders deficit | \$ 1,770 | \$ 1,770 | \$ 1,776 |

See accompanying notes to consolidated financial statements.

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## MICHAELS STORES, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions)

(Unaudited)

|  | Quarter Ended       |                     | Nine Months Ended   |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | October 29,<br>2011 | October 30,<br>2010 | October 29,<br>2011 | October 30,<br>2010 |
| <b>Net sales</b>                             | \$ 996              | \$ 968              | \$ 2,806            | \$ 2,700            |
| Cost of sales and occupancy expense          | 594                 | 592                 | 1,683               | 1,659               |
| <b>Gross profit</b>                          | 402                 | 376                 | 1,123               | 1,041               |
| Selling, general, and administrative expense | 279                 | 269                 | 774                 | 747                 |
| Related party expenses                       | 3                   | 3                   | 10                  | 10                  |
| Store pre-opening costs                      | 2                   | 2                   | 4                   | 3                   |
| <b>Operating income</b>                      | 118                 | 102                 | 335                 | 281                 |
| Interest expense                             | 62                  | 69                  | 188                 | 207                 |
| Loss on early extinguishment of debt         | 1                   | 53                  | 16                  | 53                  |
| Other (income) and expense, net              | 4                   | 1                   | 4                   | 12                  |
| <b>Income (loss) before income taxes</b>     | 51                  | (21)                | 127                 | 9                   |
| Provision (benefit) for income taxes         | 19                  | (9)                 | 48                  | 9                   |
| <b>Net income (loss)</b>                     | \$ 32               | \$ (12)             | \$ 79               | \$                  |

See accompanying notes to consolidated financial statements.

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## MICHAELS STORES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

|   | Nine Months Ended   |                     |
|---|---------------------|---------------------|
|   | October 29,<br>2011 | October 30,<br>2010 |
| <b>Operating activities:</b>                        |                     |                     |
| Net income  | \$ 79               | \$                  |
| Adjustments:  |                     |                     |
| Depreciation and amortization                       | 75                  | 77                  |
| Share-based compensation                            | 7                   | 6                   |
| Debt issuance costs amortization                    | 13                  | 14                  |
| Accretion of long-term debt                         | 35                  | 37                  |
| Change in fair value of interest rate cap           | 4                   | 15                  |
| Change in fair value of contingent consideration    | (1)                 |                     |
| Loss on early extinguishment of debt                | 16                  | 53                  |
| Changes in assets and liabilities:                  |                     |                     |
| Merchandise inventories                             | (193)               | (131)               |
| Prepaid expenses and other                          | (8)                 | (6)                 |
| Accounts payable                                    | 85                  | 97                  |
| Accrued interest                                    | 16                  | (9)                 |
| Accrued liabilities and other                       | 2                   | 18                  |
| Income taxes payable                                | (33)                | (57)                |
| Other long-term liabilities                         | 2                   | 1                   |
| Net cash provided by operating activities           | 99                  | 115                 |
| <b>Investing activities:</b>                        |                     |                     |
| Business Acquisition                                |                     | (2)                 |
| Additions to property and equipment                 | (84)                | (61)                |
| Net cash used in investing activities               | (84)                | (63)                |
| <b>Financing activities:</b>                        |                     |                     |
| Issuance of senior notes due 2018                   |                     | 794                 |
| Repayments on senior notes due 2014                 |                     | (791)               |
| Repurchase of subordinated discount notes due 2016  | (148)               |                     |
| Repayments on senior secured term loan facility     | (50)                | (118)               |
| Repurchase of senior subordinated notes due 2016    | (7)                 |                     |
| Borrowings on asset-based revolving credit facility | 102                 | 48                  |
| Payments on asset-based revolving credit facility   | (102)               | (48)                |
| Payment of debt issuance costs                      |                     | (34)                |
| Repurchase of Common Stock                          | (7)                 |                     |
| Proceeds from stock options exercised               | 2                   |                     |
| Change in cash overdraft                            | (13)                | (4)                 |
| Other   |                     | (1)                 |
| Net cash used in financing activities               | (223)               | (154)               |
| <b>Decrease in cash and equivalents</b>             | <b>(208)</b>        | <b>(102)</b>        |
| <b>Cash and equivalents at beginning of period</b>  | <b>319</b>          | <b>217</b>          |



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|  |    |     |    |     |
|--|----|-----|----|-----|
| <b>Cash and equivalents at end of period</b> | \$ | 111 | \$ | 115 |
| <b>Supplemental Cash Flow Information:</b>   |    |     |    |     |
| Cash paid for interest                       | \$ | 123 | \$ | 164 |
| Cash paid for income taxes                   | \$ | 83  | \$ | 64  |
| Non-cash investing activity:                 |    |     |    |     |
| Contingent consideration liability           | \$ |     | \$ | 4   |

See accompanying notes to consolidated financial statements.

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**MICHAELS STORES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**For the Quarter and Nine months Ended October 29, 2011**

**(Unaudited)**

**Note 1. Summary of Significant Accounting Policies**

*Basis of Presentation*

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended January 29, 2011.

The balance sheet at January 29, 2011 has been derived from the audited financial statements at that date, but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals and other items) considered necessary for a fair presentation have been included.

Because of the seasonal nature of our business, the results of operations for the quarter ended October 29, 2011 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 2011 relate to the 52 weeks ending January 28, 2012, and all references to fiscal 2010 relate to the 52 weeks ended January 29, 2011. In addition, all references herein to the third quarter of fiscal 2011 relate to the 13 weeks ended October 29, 2011, and all references to the third quarter of fiscal 2010 relate to the 13 weeks ended October 30, 2010. Finally, all references to the nine months ended October 29, 2011 relate to the 39 weeks ended October 29, 2011, and the nine months ended October 30, 2010 relate to the 39 weeks ended October 30, 2010.

*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 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. We adopted the new disclosure requirements related to the Level 3 activity on January 30, 2011, with no material impact on our consolidated financial statements. See Note 6 for further information regarding fair value measurements.

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*, an amendment to ASC topic 220, *Comprehensive Income*. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of shareholders equity. Instead, comprehensive income must be reported in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. The amended guidance, which must be applied retroactively, is effective for interim and annual periods beginning after December 15, 2011, with earlier adoption permitted. We will adopt all requirements of ASU 2011-05 on January 29, 2012, the beginning of our 2012 fiscal year.

In September 2011, the FASB issued ASU No. 2011-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. ASU 2011-08 allows entities testing for goodwill impairment to have the option of performing a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If an entity believes, as a result of its qualitative assessment, it is more-likely-than-not the fair value of a reporting unit is less than its carrying amount, the currently prescribed two-step goodwill impairment test must be performed. Otherwise, no further testing is required. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. We plan to early adopt ASU 2011-08 in the fourth quarter of fiscal 2011.

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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 October 29, 2011, there were 10.7 million stock option awards outstanding. In addition, there were a total of 579,661 shares of restricted stock outstanding under the 2006 Plan, of which 167,075 are vested. Under the 2006 Plan, there are 2.7 million shares of Common Stock remaining available for grant. The table below sets forth a summary of stock option activity for the nine months ended October 29, 2011:

|                                    | <b>Nine Months Ended<br/>October 29, 2011<br/>(in millions)</b> |
|------------------------------------|---|
| Outstanding at beginning of period | 10.9  |
| Granted                            | 0.2   |
| Exercised                          | (0.1)   |
| Cancelled/Forfeited                | (0.3)   |
| Outstanding at end of period       | 10.7  |

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 ranged 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 \$3 million and \$2 million for the third quarter of fiscal 2011 and fiscal 2010, respectively, and \$7 million and \$6 million for the nine months ended October 29, 2011 and October 30, 2010, respectively.

**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>October 29, 2011</b> | <b>January 29, 2011</b> | <b>October 30, 2010</b> | <b>Interest Rate</b> |
|---------------------------------------|-------------------------|-------------------------|-------------------------|----------------------|
|                                       | <b>(in millions)</b>    |                         |                         |                      |
| Senior secured term loan              | \$ 1,996                | \$ 2,046                | \$ 2,156                | Variable             |
| Senior notes                          | 795                     | 794                     | 794                     | 7.750%               |
| Senior subordinated notes             | 393                     | 400                     | 400                     | 11.375%              |
| Subordinated discount notes           | 327                     | 427                     | 414                     | 13.000%              |
| Asset-based revolving credit facility |                         |                         |                         | Variable             |
| Other                                 |                         | 1                       | 1                       | 5.970%               |
| Total debt                            | 3,511                   | 3,668                   | 3,765                   |                      |
| Less current portion                  | 135                     | 1                       | 1                       |                      |
| Long-term debt                        | \$ 3,376                | \$ 3,667                | \$ 3,764                |                      |



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*7¾% Senior Notes due 2018*

On October 21, 2010, we issued \$800.0 million aggregate principal amount of 7¾% Senior Notes that mature on November 1, 2018 (the 2018 Senior Notes), which were sold at a discounted price of 99.262% of face value, resulting in an effective interest rate of 77/8%. The 2018 Senior Notes are guaranteed, jointly and severally, on an unsecured senior basis, by each of our subsidiaries that guarantee indebtedness under our senior secured asset-based revolving credit facility and senior secured term loan facility.

In connection with the issuance of the 2018 Senior Notes, we entered into a registration rights agreement. Under the terms of the registration rights agreement, we were required to file, and did initially file on April 28, 2011, an exchange offer registration statement, as amended (the Exchange Offer Registration Statement), enabling holders to exchange the 2018 Senior Notes for registered notes with terms identical in all material respects to the terms of the 2018 Senior Notes, except the exchange notes would be freely tradable. We also agreed to use our reasonable best efforts to have the Exchange Offer Registration Statement declared effective by the Securities and Exchange Commission (the SEC) no later than 360 days after the date of the issuance of the 2018 Senior Notes. On June 20, 2011, the Exchange Offer Registration Statement was declared effective by the SEC. We completed the exchange offer on August 1, 2011.

*113/8% Senior Subordinated Notes due 2016*

During the third quarter of fiscal 2011, we completed open market repurchases of our outstanding 113/8% Senior Subordinated Notes due 2016 (Senior Subordinated Notes) totaling \$7 million. Pursuant to the terms of the repurchases, we agreed to pay the holders of the Senior Subordinated Notes face value plus a purchase premium. In accordance with ASC 470, *Debt*, we recorded a loss related to the early extinguishment of the repurchased Senior Subordinated Notes, which was immaterial to the consolidated financial statements.

*13% Subordinated Discount Notes due 2016*

During the third quarter of fiscal 2011, we completed open market repurchases of our outstanding 13% Subordinated Discount Notes due 2016 (Subordinated Discount Notes) totaling \$18 million. During the first nine months of fiscal 2011, we completed open market repurchases of our outstanding Subordinated Discount Notes totaling \$142 million face value, or \$134 million accreted value. Pursuant to the terms of the repurchases, we agreed to pay the holders of the Subordinated Discount Notes face value plus a purchase premium.

In accordance with ASC 470, we recorded a loss of \$1 million and \$16 million during the third quarter and nine months ended October 29, 2011, respectively, related to the early extinguishment of the repurchased Subordinated Discount Notes. The \$1 million loss is for the purchase premiums paid. The \$16 million loss is comprised of \$10 million to recognize the unrealized interest accretion and the write off of related debt issuance costs, as well as \$6 million in purchase premiums.

On May 1, 2012, and, if necessary, any interest payment date thereafter prior to the maturity date of the Subordinated Discount Notes, we are required to redeem a portion of each Subordinated Discount Note outstanding on such date equal to an amount sufficient, but not in excess of the amount necessary, to ensure that such Subordinated Discount Note will not be an applicable high yield discount obligation (AHYDO) within the

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meaning of Section 163(i)(1) of the Internal Revenue Code of 1986, as amended. These redemptions are to be at a price equal to 100% of the Accreted Value of such portion as of the date of redemption. As of October 29, 2011, the payment required to ensure the Subordinated Discount Notes will not be an AHYDO was \$135 million and is classified as Current portion of long-term debt on the Consolidated Balance Sheets.

### *Senior Secured Asset-Based Revolving Credit Facility*

Our senior secured asset-based revolving credit facility, provides an aggregate amount of \$850 million in tranche A commitments, which are scheduled to terminate on the 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. On April 8, 2011, the Company elected to permanently terminate \$50 million in commitments under a last out tranche.

The borrowing base under the senior secured 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; and (iii) a percentage of eligible in-transit inventory, less certain reserves. As of October 29, 2011, the borrowing base was \$802 million, of which we had no outstanding borrowings, \$55 million of outstanding letters of credit, and \$747 million of excess availability.

### **Note 4. Comprehensive Income (Loss)**

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

|   | Quarter Ended    |                  | Nine Months Ended |                  |
|---|------------------|------------------|-------------------|------------------|
|   | October 29, 2011 | October 30, 2010 | October 29, 2011  | October 30, 2010 |
|   | (in millions)    |                  |                   |                  |
| Net income (loss)                                 | \$ 32            | \$ (12)          | \$ 79             | \$               |
| Other comprehensive income:                       |                  |                  |                   |                  |
| Foreign currency translation adjustment and other | (1)              |                  |                   | 1                |
| Comprehensive income                              | \$ 31            | \$ (12)          | \$ 79             | \$ 1             |

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

|   | <b>Foreign Currency<br/>Translation<br/>and Other<br/>(in millions)</b> |   |
|---|---|---|
| Balance at January 29, 2011             | \$  | 7 |
| Foreign currency translation adjustment |   |   |
| Balance at October 29, 2011             | \$  | 7 |

**Note 5. Derivative Instruments**

We are exposed to fluctuations in interest rates on our senior secured term loan facility. During 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 facility 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 October 29, 2011, January 29, 2011 and October 30, 2010 was \$2 million, \$6 million and \$3 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 nine months ended October 29, 2011 resulted in a loss of \$1 million and a loss of \$4 million, respectively. The change in fair value of the cap for the quarter and nine months ended October 30, 2010, resulted in a loss of \$2 million and a loss of \$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 Measurements and Disclosures*, 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 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 October 29, 2011 (in millions):



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|                          | Level 1 | Level 2 | Level 3 | Total  |
|--------------------------|---------|---------|---------|--------|
| Interest Rate Cap        | \$      | \$      | 2       | \$ 2   |
| Contingent consideration | \$      | \$      | \$ (3)  | \$ (3) |

The interest rate cap is measured using widely accepted valuation techniques including a 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 discounting the future expected variable cash receipts that would occur if variable interest rates rise above the strike rate of the cap. 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.

In connection with the acquisition of certain assets of ScrapHD, the Company has a contingent obligation, to be paid in cash, to the owners of ScrapHD based on future operating performance, up to \$10 million. The fair value of this contingent consideration is determined using an expected present value technique. Expected operating results are determined using the probability-weighted average of possible outcomes that would occur should certain financial metrics be reached. There is no market data available to use in valuing the contingent consideration; therefore, the Company developed its own assumptions related to the future financial performance of the business to estimate the fair value of the liability which was then discounted to present value using the weighted average cost of capital. The weighted average cost of capital was derived from comparable companies and management's estimates. The contingent consideration was established at the time of acquisition and will be evaluated at each reporting period. We reduced the fair value of our contingent consideration liability from \$4 million as of January 29, 2011 to \$3 million as of July 30, 2011. The \$1 million gain from the change in the fair value of the contingent consideration is recorded in Selling, general, and administrative expense on the Consolidated Statements of Operations. The liability is recorded in Other long-term liabilities on the Consolidated Balance Sheets. There have been no material changes to the fair value since July 30, 2011.

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We apply fair value techniques on a non-recurring basis 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 quarter and nine months ended October 29, 2011, there were no events or changes in circumstances indicating the carrying amounts of our long-lived assets may not be recoverable.

The table below provides the carrying and fair values of our loan and notes as of October 29, 2011. The fair value of these debt instruments was determined based on quoted market prices or recent trades.

|                             | Carrying Value |       | Fair Value |
|-----------------------------|----------------|-------|------------|
|                             | (in millions)  |       |            |
| Senior secured term loan    | \$             | 1,996 | \$ 1,968   |
| Senior notes                |                | 795   | 816        |
| Senior subordinated notes   |                | 393   | 417        |
| Subordinated discount notes |                | 327   | 349        |

**Note 7. Income Taxes**

During the third quarter of fiscal 2011, we recorded a tax provision of \$19 million at an effective tax rate of 36.8%. During the third quarter of fiscal 2010, we recorded a tax benefit of \$9 million at an effective rate of 41.4%. The higher effective tax rate in fiscal 2010 was driven primarily by the impact of discrete items for the quarter.

The effective tax rate was 37.7% for the first nine months of fiscal 2011. For the first nine months of fiscal 2010, we recorded a tax provision of \$9 million, of which \$5 million was to correct the federal deferred tax liability relating to state income taxes and \$1 million related to other discrete items. We currently estimate our annualized effective tax rate for fiscal 2011 to be 37.6%.

**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 29, 2011 and our Quarterly Reports on Form 10-Q for the quarterly periods ended April 30, 2011 and July 30, 2011.

*Employee Claims**Rea Claim*

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On September 15, 2011, the Company was served with a lawsuit filed on September 13, 2011 in the California Superior Court in and for the County of Orange ( Superior Court ) by four former store managers as a purported class action proceeding on behalf of themselves and certain former and current store managers employed by Michaels stores in California. We removed the lawsuit to the United States District Court for the Central District of California on October 17, 2011, which removal is being contested by plaintiffs. The lawsuit alleges that the Company stores improperly classified its store managers as exempt employees and as such failed to pay all wages, overtime, waiting time penalties and failed to provide accurate wage statements. The lawsuit also alleges that the foregoing conduct was in breach of various laws, including California's unfair competition law. The plaintiffs have pled less than five million dollars in damages, penalties, costs of suit and attorneys' fees, exclusive of interest. We believe we have meritorious defenses and intend to defend the lawsuit vigorously.

### *Consumer Class Action Claims*

### *Zip Code Claims*

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 ( San Diego Superior Court ), on behalf of herself and all similarly-situated California consumers. The Carson lawsuit 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

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July 22, 2010, the Court of Appeal upheld the dismissal of the case. The plaintiff appealed this decision to the Supreme Court of California ( California Supreme Court ). On September 29, 2010, the California Supreme Court granted the plaintiff's petition for review; however, it stayed any further proceedings in the case until another similar zip code case pending before the court, Pineda v. Williams-Sonoma, was decided. On February 10, 2011, the California Supreme Court ruled, in the Williams-Sonoma case, that zip codes are personally identifiable information and therefore the Song-Beverly Credit Card Act of 1971, as amended ( Song Act ) prohibits businesses from requesting or requiring zip codes in connection with a credit card transaction. On or about April 6, 2011, the Supreme Court transferred the Carson case back to the Court of Appeal with directions to the Court to reconsider its decision in light of Pineda decision. Upon reconsideration the Court of Appeal remanded the case back to the San Diego Superior Court. We are reviewing the matter in light of this recent decision and, at this time, we are unable to estimate a range of loss, if any, in this case.

Additionally, since the California Supreme Court decision on February 10, 2011, three additional purported class action lawsuits alleging violations of the Song Act have been filed against the Company: Carolyn Austin v. Michaels Stores, Inc. and Tiffany Heon v. Michaels Stores, Inc., both in the San Diego Superior Court and Sandra A. Rubinstein v. Michaels Stores, Inc. in the Superior Court of California, County of Los Angeles, Central Division. Unopposed motions to coordinate these actions have been filed and an order recommending the coordination has been entered. Also, relying in part on the California Supreme Court decision, an additional purported class action lawsuit was filed on May 20, 2011 against the Company: Melissa Tyler v. Michaels Stores, Inc. in the United States District Court-District of Massachusetts, alleging violation of a similar Massachusetts statute regarding the collection of personally identifiable information in connection with a credit card transaction. A hearing was held on October 20, 2011 on our Motion to Dismiss the claims and the decision is pending. We intend to vigorously defend each of these cases and we are unable, at this time, to estimate a range of loss, if any.

*Gift Card Claims*

On April 9, 2010, Ross Rattray, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the San Diego Superior Court, on behalf of himself and all similarly-situated California consumers. The Rattray lawsuit alleges causes of action for unlawful and unfair business practices and false advertising under the California Business and Professions Code, and a violation of the Consumer Legal Remedies Act, for misrepresentation that Michaels gift cards are not redeemable for cash and for failure to disclose that the plaintiff could redeem the unused cash balance on a gift card when the value fell below \$10.00. On March 15, 2011, the matter was mediated and a tentative settlement agreement was reached with the plaintiff. The settlement was approved by the Court and was finalized on October 21, 2011, for an immaterial amount.

*Data Breach Claims*

*Payment Card Terminal Tampering*

On May 3, 2011, we were advised by the U.S. Secret Service that they were investigating certain fraudulent debit card transactions that occurred on accounts that had been used for legitimate purchases in selected Michaels stores. A subsequent internal investigation revealed that approximately 90 payment card terminals in certain Michaels stores had been physically tampered with, potentially resulting in customer debit and credit card information to be compromised. We have since removed and replaced approximately 7,200 payment card terminals comparable to the identified tampered payment card terminals from our Michaels stores. The Company continues to cooperate with various governmental entities and law enforcement authorities in investigating the payment card terminal tampering, but we do not know the full extent of any fraudulent use of such information.

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On May 18, 2011, Brandi F. Ramundo, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the United States District Court for the Northern District of Illinois, on behalf of herself and all similarly-situated U.S. consumers. The Ramundo lawsuit alleges that Michaels failed to take commercially reasonable steps to protect consumer financial data, and was in breach of contract and various laws, including the Federal Stored Communications Act and the Illinois Consumer Fraud and Deceptive Practices Act. The plaintiff seeks compensatory, statutory and punitive damages, costs, credit card fraud monitoring services, interest and attorneys' fees. Subsequently three additional purported class action lawsuits significantly mirroring the claims in the Ramundo complaint were filed against the Company: Mary Allen v. Michaels Stores, Inc., Kimberly Siprut v. Michaels Stores, Inc., and Jeremy Williams v. Michaels Stores, Inc., all in the United States District Court for the Northern District of Illinois. On June 8, 2011, an order was entered consolidating all four matters, which also provided for future consolidation of all related actions subsequently filed or transferred. On July 8, 2011, a Consolidated Amended Class Action Complaint styled In Re Michaels Stores Pin Pad Litigation ( In Re Michaels Stores Consolidated Complaint ) was filed in the United States District Court for the Northern District of Illinois and on August 8, 2011, we filed a Motion to Dismiss the In Re Michaels Stores Consolidated Complaint. A hearing on this motion was held on October 27, 2011 and the decision is pending. On August 25, 2011, subsequent to the filing of the Consolidated Complaint and our Motion to Dismiss, a fifth class action, Sherry v. Michaels Stores, Inc., was filed in the United States District Court for the Northern District of Illinois. On September 29, 2011, the Sherry case was reassigned and consolidated into the Consolidated Complaint. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We are unable to estimate a range of loss, if any, in the case.

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Two additional purported class action lawsuits significantly mirroring the claims in the In Re Michaels Stores Consolidated Complaint have been filed against the Company in New Jersey: Sara Rosenfeld and Ilana Soffer v. Michaels Stores, Inc. filed in the Superior Court of New Jersey on July 7, 2011, removed to the United States District Court of New Jersey on August 5, 2011, and transferred to the Northern District of Illinois on September 9, 2011 and reassigned and consolidated into the Consolidated Complaint; and Lori Wilson v. Michaels Stores, Inc. filed in the Superior Court of New Jersey on August 10, 2011. We have requested that the Wilson case be transferred and consolidated as well by filing the request with the Judicial Panel on Multi-District Litigation. We believe we have meritorious defenses and intend to defend the lawsuits vigorously. We are unable to estimate a range of loss, if any, in these cases.

*General*

We are a defendant from time to time in lawsuits incidental to our business. Based on currently available information, we believe that resolution of all known contingencies is uncertain. There can be no assurance that future costs of such litigation would not be material to our financial position, results of operations, or cash flows.

**Note 9. Segments and Geographic Information**

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.

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    |                  | Nine Months Ended |                  |
|--------------------------------------|------------------|------------------|-------------------|------------------|
|                                      | October 29, 2011 | October 30, 2010 | October 29, 2011  | October 30, 2010 |
|                                      | (in millions)    |                  |                   |                  |
| Income (loss) before income taxes    | \$ 51            | \$ (21)          | \$ 127            | \$ 9             |
| Interest expense                     | 62               | 69               | 188               | 207              |
| Loss on early extinguishment of debt | 1                | 53               | 16                | 53               |
| Depreciation and amortization        | 25               | 25               | 75                | 77               |
| EBITDA                               | \$ 139           | \$ 126           | \$ 406            | \$ 346           |

Our sales and assets by country are as follows:

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|                      | Quarter Ended    |                  | Nine Months Ended |                  |
|----------------------|------------------|------------------|-------------------|------------------|
|                      | October 29, 2011 | October 30, 2010 | October 29, 2011  | October 30, 2010 |
| (in millions)        |                  |                  |                   |                  |
| <b>Net Sales:</b>    |                  |                  |                   |                  |
| United States        | \$ 906           | \$ 882           | \$ 2,551          | \$ 2,467         |
| Canada               | 90               | 86               | 255               | 233              |
| Consolidated Total   | \$ 996           | \$ 968           | \$ 2,806          | \$ 2,700         |
| <b>Total Assets:</b> |                  |                  |                   |                  |
| United States        | \$ 1,660         | \$ 1,678         | \$ 1,660          | \$ 1,678         |
| Canada               | 110              | 98               | 110               | 98               |
| Consolidated Total   | \$ 1,770         | \$ 1,776         | \$ 1,770          | \$ 1,776         |

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**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 in the amount of \$12 million and \$1 million, respectively. We recognized \$3 million of expense related to annual management fees during the third quarter of each of fiscal 2011 and fiscal 2010 and \$10 million during each of the nine months ended October 29, 2011 and October 30, 2010. 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 utilized to print our circular advertisements. During the first quarter of fiscal 2011, we stopped utilizing this vendor for these services. Payments associated with this vendor during the third quarter of fiscal 2010 were \$9 million. Payments for the nine months ended October 29, 2011 and October 30, 2010 were \$6 million and \$24 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Operations.

Bain Capital owns a majority equity position in an external vendor we began utilizing for print procurement services during the fourth quarter of fiscal 2010. Payments associated with this vendor during the three and nine months ended October 29, 2011, were \$1 million and \$3 million, respectively. 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 third quarter of each of fiscal 2011 and fiscal 2010 were \$2 million. Payments for each of the nine months ended October 29, 2011 and October 30, 2010 were \$6 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 for all of the candy-type items in our stores. Payments associated with this vendor during the third quarter of fiscal 2011 and fiscal 2010 were \$4 million and \$5 million, respectively. Payments for the nine months ended October 29, 2011, and October 30, 2010, were \$17 million and \$14 million, respectively. These expenses are recognized in cost of sales as the sales are recorded.

The Blackstone Group owns a partially equity position in an external vendor we utilize for hospitality services. Payments associated with this vendor during the third quarter and nine months ended October 29, 2011 were \$1 million. These expenses are included in selling, general, and administrative expense on the Consolidated Statements of Operations.

During the second quarter of fiscal 2011, The Blackstone Group acquired a majority equity position in a vendor we utilize to lease certain properties. Payments associated with this vendor during the three and nine months ended October 29, 2011, were \$1 million and \$2 million, respectively. These expenses are included in cost of sales and occupancy expense on the Consolidated Statements of Operations.

The Company periodically provides officers of Michaels Stores, Inc. and its subsidiaries the opportunity to purchase shares of our Common Stock. There were no shares sold to officers during first nine months of each of fiscal 2011 and fiscal 2010. Also, during the third quarter of



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fiscal 2011 and the nine months ended October 29, 2011, we repurchased 17,333 and 192,001 shares, respectively, from officers who are no longer with the Company. There were no shares repurchased during the first nine months of fiscal 2010.

### **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 facility, and senior secured 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 October 29, 2011, 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.

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## Supplemental Condensed Consolidating Balance Sheet

|  | October 29, 2011  |                           |              |              |
|--|-------------------|---------------------------|--------------|--------------|
|  | Parent<br>Company | Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|  | (in millions)     |                           |              |              |
| <b>ASSETS</b>  |                   |                           |              |              |
| <b>Current assets:</b>                                   |                   |                           |              |              |
| Cash and equivalents                                     | \$ 97             | \$ 14                     | \$           | \$ 111       |
| Merchandise inventories                                  | 677               | 342                       |              | 1,019        |
| Intercompany receivables                                 |                   | 512                       | (512)        |              |
| Other  | 125               | 23                        |              | 148          |
| Total current assets                                     | 899               | 891                       | (512)        | 1,278        |
| <b>Property and equipment, net</b>                       | 251               | 65                        |              | 316          |
| <b>Goodwill</b>  | 95                |                           |              | 95           |
| <b>Investment in subsidiaries</b>                        | 481               |                           | (481)        |              |
| <b>Other assets</b>                                      | 80                | 1                         |              | 81           |
| Total assets   | \$ 1,806          | \$ 957                    | \$ (993)     | \$ 1,770     |
| <b>LIABILITIES AND STOCKHOLDERS (DEFICIT)<br/>EQUITY</b> |                   |                           |              |              |
| <b>Current liabilities:</b>                              |                   |                           |              |              |
| Accounts payable   | \$ 9              | \$ 339                    | \$           | \$ 348       |
| Accrued liabilities and other                            | 280               | 125                       |              | 405          |
| Current portion of long-term debt                        | 135               |                           |              | 135          |
| Intercompany payable                                     | 512               |                           | (512)        |              |
| Other  | 7                 |                           |              | 7            |
| Total current liabilities                                | 943               | 464                       | (512)        | 895          |
| <b>Long-term debt</b>                                    | 3,376             |                           |              | 3,376        |
| <b>Other long-term liabilities</b>                       | 69                | 12                        |              | 81           |
| <b>Total stockholders (deficit) equity</b>               | (2,582)           | 481                       | (481)        | (2,582)      |
| Total liabilities and stockholders (deficit) equity      | \$ 1,806          | \$ 957                    | \$ (993)     | \$ 1,770     |

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## Supplemental Condensed Consolidating Balance Sheet

|  | January 29, 2011  |                           |              |              |
|--|-------------------|---------------------------|--------------|--------------|
|  | Parent<br>Company | Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|  | (in millions)     |                           |              |              |
| <b>ASSETS</b>  |                   |                           |              |              |
| <b>Current assets:</b>                               |                   |                           |              |              |
| Cash and equivalents                                 | \$ 309            | \$ 10                     | \$           | \$ 319       |
| Merchandise inventories                              | 571               | 255                       |              | 826          |
| Intercompany receivables                             |                   | 348                       | (348)        |              |
| Other  | 113               | 17                        |              | 130          |
| Total current assets                                 | 993               | 630                       | (348)        | \$ 1,275     |
| <b>Property and equipment, net</b>                   | 234               | 67                        |              | 301          |
| <b>Goodwill</b>                                      | 95                |                           |              | 95           |
| <b>Investment in subsidiaries</b>                    | 295               |                           | (295)        |              |
| <b>Other assets</b>                                  | 98                | 1                         |              | 99           |
| Total assets   | \$ 1,715          | \$ 698                    | \$ (643)     | \$ 1,770     |
| <b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY</b> |                   |                           |              |              |
| <b>Current liabilities:</b>                          |                   |                           |              |              |
| Accounts payable                                     | \$ 7              | \$ 266                    | \$           | \$ 273       |
| Accrued liabilities and other                        | 262               | 122                       |              | 384          |
| Current portion of long-term debt                    | 1                 |                           |              | 1            |
| Intercompany payable                                 | 348               |                           | (348)        |              |
| Other  | 26                | 3                         |              | 29           |
| Total current liabilities                            | 644               | 391                       | (348)        | 687          |
| <b>Long-term debt</b>                                | 3,667             |                           |              | 3,667        |
| <b>Deferred income taxes</b>                         | 2                 | 2                         |              | 4            |
| <b>Other long-term liabilities</b>                   | 66                | 10                        |              | 76           |
| <b>Total stockholders (deficit) equity</b>           | (2,664)           | 295                       | (295)        | (2,664)      |
| Total liabilities and stockholders (deficit) equity  | \$ 1,715          | \$ 698                    | \$ (643)     | \$ 1,770     |

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

|  | October 30, 2010  |                           |                               |    | Consolidated |
|--|-------------------|---------------------------|-------------------------------|----|--------------|
|  | Parent<br>Company | Guarantor<br>Subsidiaries | Eliminations<br>(in millions) |    |              |
| <b>ASSETS</b>  |                   |                           |                               |    |              |
| <b>Current assets:</b>                                   |                   |                           |                               |    |              |
| Cash and equivalents                                     | \$ 96             | \$ 19                     | \$                            | \$ | 115          |
| Merchandise inventories                                  | 678               | 326                       |                               |    | 1,004        |
| Intercompany receivables                                 |                   | 468                       | (468)                         |    |              |
| Other  | 152               | 15                        |                               |    | 167          |
| Total current assets                                     | 926               | 828                       | (468)                         |    | 1,286        |
| <b>Property and equipment, net</b>                       | 234               | 68                        |                               |    | 302          |
| <b>Goodwill, net</b>                                     | 95                |                           |                               |    | 95           |
| <b>Investment in subsidiaries</b>                        | 458               |                           | (458)                         |    |              |
| <b>Other assets</b>                                      | 92                | 1                         |                               |    | 93           |
| Total assets   | \$ 1,805          | \$ 897                    | \$ (926)                      | \$ | 1,776        |
| <b>LIABILITIES AND STOCKHOLDERS (DEFICIT)<br/>EQUITY</b> |                   |                           |                               |    |              |
| <b>Current liabilities:</b>                              |                   |                           |                               |    |              |
| Accounts payable   | \$ 1              | \$ 323                    | \$                            | \$ | 324          |
| Accrued liabilities and other                            | 257               | 104                       |                               |    | 361          |
| Current portion of long-term debt                        | 1                 |                           |                               |    | 1            |
| Intercompany payable                                     | 468               |                           | (468)                         |    |              |
| Other  | 1                 | 1                         |                               |    | 2            |
| Total current liabilities                                | 728               | 428                       | (468)                         |    | 688          |
| <b>Long-term debt</b>                                    | 3,764             |                           |                               |    | 3,764        |
| <b>Other long-term liabilities</b>                       | 77                | 11                        |                               |    | 88           |
| <b>Total stockholders (deficit) equity</b>               | (2,764)           | 458                       | (458)                         |    | (2,764)      |
| Total liabilities and stockholders (deficit) equity      | \$ 1,805          | \$ 897                    | \$ (926)                      | \$ | 1,776        |

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

|  | Parent<br>Company | Quarter Ended October 29, 2011 |              |               | Consolidated |
|--|-------------------|--------------------------------|--------------|---------------|--------------|
|  |                   | Guarantor<br>Subsidiaries      | Eliminations | (in millions) |              |
| <b>Net sales</b>                             | \$ 873            | \$ 635                         | \$ (512)     | \$ 996        |              |
| Cost of sales and occupancy expense          | 561               | 545                            | (512)        | 594           |              |
| <b>Gross profit</b>                          | 312               | 90                             |              | 402           |              |
| Selling, general, and administrative expense | 243               | 36                             |              | 279           |              |
| Related party expenses                       | 3                 |                                |              | 3             |              |
| Store pre-opening costs                      | 1                 | 1                              |              | 2             |              |
| <b>Operating income</b>                      | 65                | 53                             |              | 118           |              |
| Interest expense                             | 62                |                                |              | 62            |              |
| Loss on early extinguishment of debt         | 1                 |                                |              | 1             |              |
| Other (income) and expense, net              | 1                 | 3                              |              | 4             |              |
| Intercompany charges (income)                | 19                | (19)                           |              |               |              |
| Equity in earnings of subsidiaries           | 69                |                                | (69)         |               |              |
| <b>Income before income taxes</b>            | 51                | 69                             | (69)         | 51            |              |
| Provision for income taxes                   | 19                | 26                             | (26)         | 19            |              |
| <b>Net income</b>                            | \$ 32             | \$ 43                          | \$ (43)      | \$ 32         |              |

**Supplemental Condensed Consolidating Statement of Operations**

|  |         |        |          |         |
|--|---------|--------|----------|---------|
| <b>Net sales</b>                             | \$ 849  | \$ 628 | \$ (509) | \$ 968  |
| Cost of sales and occupancy expense          | 560     | 541    | (509)    | 592     |
| <b>Gross profit</b>                          | 289     | 87     |          | 376     |
| Selling, general, and administrative expense | 233     | 36     |          | 269     |
| Related party expenses                       | 3       |        |          | 3       |
| Store pre-opening costs                      | 1       | 1      |          | 2       |
| <b>Operating income</b>                      | 52      | 50     |          | 102     |
| Interest expense                             | 69      |        |          | 69      |
| Loss on early extinguishment of debt         | 53      |        |          | 53      |
| Other (income) and expense, net              | 1       |        |          | 1       |
| Intercompany charges (income)                | 21      | (21)   |          |         |
| Equity in earnings of subsidiaries           | 71      |        | (71)     |         |
| <b>Loss before income taxes</b>              | (21)    | 71     | (71)     | (21)    |
| Income tax benefit                           | (9)     | 29     | (29)     | (9)     |
| <b>Net loss</b>                              | \$ (12) | \$ 42  | \$ (42)  | \$ (12) |

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

|  | Parent<br>Company | Nine Months Ended October 29, 2011 |              | Consolidated |
|--|-------------------|------------------------------------|--------------|--------------|
|  |                   | Guarantor<br>Subsidiaries          | Eliminations |              |
| (in millions)                                |                   |                                    |              |              |
| <b>Net sales</b>                             | \$ 2,454          | \$ 1,654                           | \$ (1,302)   | \$ 2,806     |
| Cost of sales and occupancy expense          | 1,595             | 1,390                              | (1,302)      | 1,683        |
| <b>Gross profit</b>                          | 859               | 264                                |              | 1,123        |
| Selling, general, and administrative expense | 673               | 101                                |              | 774          |
| Related party expenses                       | 10                |                                    |              | 10           |
| Store pre-opening costs                      | 3                 | 1                                  |              | 4            |
| <b>Operating income</b>                      | 173               | 162                                |              | 335          |
| Interest expense                             | 188               |                                    |              | 188          |
| Loss on early extinguishment of debt         | 16                |                                    |              | 16           |
| Other (income) and expense, net              | 4                 |                                    |              | 4            |
| Intercompany charges (income)                | 52                | (52)                               |              |              |
| Equity in earnings of subsidiaries           | 214               |                                    | (214)        |              |
| <b>Income before income taxes</b>            | 127               | 214                                | (214)        | 127          |
| Provision for income taxes                   | 48                | 80                                 | (80)         | 48           |
| <b>Net income</b>                            | \$ 79             | \$ 134                             | \$ (134)     | \$ 79        |

**Supplemental Condensed Consolidating Statement of Operations**

|  | Parent<br>Company | Nine Months Ended October 30, 2010 |              | Consolidated |
|--|-------------------|------------------------------------|--------------|--------------|
|  |                   | Guarantor<br>Subsidiaries          | Eliminations |              |
| (in millions)                                |                   |                                    |              |              |
| <b>Net sales</b>                             | \$ 2,367          | \$ 1,594                           | \$ (1,261)   | \$ 2,700     |
| Cost of sales and occupancy expense          | 1,580             | 1,340                              | (1,261)      | 1,659        |
| <b>Gross profit</b>                          | 787               | 254                                |              | 1,041        |
| Selling, general, and administrative expense | 647               | 100                                |              | 747          |
| Related party expenses                       | 10                |                                    |              | 10           |
| Store pre-opening costs                      | 2                 | 1                                  |              | 3            |
| <b>Operating income</b>                      | 128               | 153                                |              | 281          |
| Interest expense                             | 207               |                                    |              | 207          |
| Loss on early extinguishment of debt         | 53                |                                    |              | 53           |
| Other (income) and expense, net              | 14                | (2)                                |              | 12           |
| Intercompany charges (income)                | 53                | (53)                               |              |              |
| Equity in earnings of subsidiaries           | 208               |                                    | (208)        |              |
| <b>Income before income taxes</b>            | 9                 | 208                                | (208)        | 9            |
| Provision for income taxes                   | 9                 | 85                                 | (85)         | 9            |
| <b>Net income</b>                            | \$ 9              | \$ 123                             | \$ (123)     | \$ 9         |

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

|   | Parent<br>Company | Nine Months Ended October 29, 2011 |              | Consolidated  |
|---|-------------------|------------------------------------|--------------|---------------|
|   |                   | Guarantor<br>Subsidiaries          | Eliminations |               |
| (in millions)                           |                   |                                    |              |               |
| <b>Operating activities:</b>            |                   |                                    |              |               |
| Net cash used in operating activities   | \$ 79             | \$ 96                              | \$ (76)      | \$ 99         |
| <b>Investing activities:</b>            |                   |                                    |              |               |
| Cash paid for property and equipment    | (68)              | (16)                               |              | (84)          |
| Net cash used in investing activities   | (68)              | (16)                               |              | (84)          |
| <b>Financing activities:</b>            |                   |                                    |              |               |
| Net repayments of long-term debt        | (205)             |                                    |              | (205)         |
| Intercompany dividends                  |                   | (76)                               | 76           |               |
| Other financing activities              | (18)              |                                    |              | (18)          |
| Net cash used in financing activities   | (223)             | (76)                               | 76           | (223)         |
| <b>Decrease in cash and equivalents</b> | <b>(212)</b>      | <b>4</b>                           |              | <b>(208)</b>  |
| <b>Beginning cash and equivalents</b>   | <b>309</b>        | <b>10</b>                          |              | <b>319</b>    |
| <b>Ending cash and equivalents</b>      | <b>\$ 97</b>      | <b>\$ 14</b>                       | <b>\$</b>    | <b>\$ 111</b> |

**Supplemental Condensed Consolidating Statement of Cash Flows**

|   | Parent<br>Company | Nine Months Ended October 30, 2010 |              | Consolidated  |
|---|-------------------|------------------------------------|--------------|---------------|
|   |                   | Guarantor<br>Subsidiaries          | Eliminations |               |
| (in millions)                             |                   |                                    |              |               |
| <b>Operating activities:</b>              |                   |                                    |              |               |
| Net cash provided by operating activities | \$ 98             | \$ 96                              | \$ (79)      | \$ 115        |
| <b>Investing activities:</b>              |                   |                                    |              |               |
| Cost of business acquisition              | (2)               |                                    |              | (2)           |
| Cash paid for property and equipment      | (53)              | (8)                                |              | (61)          |
| Net cash used in investing activities     | (55)              | (8)                                |              | (63)          |
| <b>Financing activities:</b>              |                   |                                    |              |               |
| Net repayments of long-term debt          | (115)             |                                    |              | (115)         |
| Intercompany dividends                    |                   | (79)                               | 79           |               |
| Other financing activities                | (39)              |                                    |              | (39)          |
| Net cash used in financing activities     | (154)             | (79)                               | 79           | (154)         |
| <b>Decrease in cash and equivalents</b>   | <b>(111)</b>      | <b>9</b>                           |              | <b>(102)</b>  |
| <b>Beginning cash and equivalents</b>     | <b>207</b>        | <b>10</b>                          |              | <b>217</b>    |
| <b>Ending cash and equivalents</b>        | <b>\$ 96</b>      | <b>\$ 19</b>                       | <b>\$</b>    | <b>\$ 115</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 29, 2011. 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; if recovery from the economic downturn continues to be 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;
- our reliance on foreign suppliers increases our risk of obtaining adequate, timely, and cost-effective product supplies;
- 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;
- 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;



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- our ability to open new stores and increase comparable store sales growth, as our growth depends on our strategy of increasing the number and productivity of our stores and if we are unable to continue this strategy, our ability to increase our sales, profitability, and cash flow could be impaired;
- how well we manage our business;
- changes in customer demand could materially adversely affect our sales, results of operations, and cash flow;
- unexpected or unfavorable consumer responses to our promotional or merchandising programs could materially adversely affect our sales, results of operations, cash flow and financial condition;
- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements;
- improvements to our supply chain may not be fully successful;
- our suppliers may fail us;
- 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, results of operation, cash flow, and financial condition;
- 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;

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- our information systems may prove inadequate;
  
- failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information and data breaches such as the recent payment card terminal tampering could materially adversely affect our financial condition and results of operations;
  
- changes in regulations or enforcement may adversely impact our business;
  
- a weak fourth quarter would materially adversely affect our results of operations;
  
- competition could negatively impact our business; 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 29, 2011, 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 2011 relate to the 52 weeks ending January 28, 2012 and all references to fiscal 2010 relate to the 52 weeks ended January 29, 2011. In addition, all references herein to the third quarter of fiscal 2011 relate to the 13 weeks ended October 29, 2011 and all references to the third quarter of fiscal 2010 relate to the 13 weeks ended October 30, 2010. Finally, all references to the nine months ended October 29, 2011 relate to the 39 weeks ended October 29, 2011, and the nine months ended October 30, 2010 relate to the 39 weeks ended October 30, 2010.

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

|                         | Quarter Ended       |                     | Nine Months Ended   |                     |
|-------------------------|---------------------|---------------------|---------------------|---------------------|
|                         | October 29,<br>2011 | October 30,<br>2010 | October 29,<br>2011 | October 30,<br>2010 |
| <b>Michaels stores:</b> |                     |                     |                     |                     |

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|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Retail stores open at beginning of period               | 1,054  | 1,033  | 1,045  | 1,023  |
| Retail stores opened during the period                  | 13     | 13     | 23     | 23     |
| Retail stores opened (relocations) during the period    | 6      | 3      | 14     | 10     |
| Retail stores closed during the period                  | (4)    |        | (5)    |        |
| Retail stores closed (relocations) during the period    | (6)    | (3)    | (14)   | (10)   |
| Retail stores open at end of period                     | 1,063  | 1,046  | 1,063  | 1,046  |
| <b>Aaron Brothers stores:</b>                           |        |        |        |        |
| Retail stores open at beginning of period               | 136    | 145    | 137    | 152    |
| Retail stores closed during the period                  | (1)    | (4)    | (2)    | (11)   |
| Retail stores open at end of period                     | 135    | 141    | 135    | 141    |
| Total store count at end of period                      | 1,198  | 1,187  | 1,198  | 1,187  |
| <b>Other operating data:</b>                            |        |        |        |        |
| Average inventory per Michaels store (in thousands) (1) | \$ 922 | \$ 924 | \$ 922 | \$ 924 |
| Comparable store sales increase (2)                     | 1.6%   | 2.9%   | 2.6%   | 3.4%   |

(1) The calculation of average inventory per Michaels store excludes our Aaron Brothers stores.

(2) Comparable store sales increase represents the increase in net sales for Michaels and Aaron Brothers 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       |                     | Nine Months Ended   |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | October 29,<br>2011 | October 30,<br>2010 | October 29,<br>2011 | October 30,<br>2010 |
| <b>Net sales</b>                             | 100.0%              | 100.0%              | 100.0%              | 100.0%              |
| Cost of sales and occupancy expense          | 59.6                | 61.2                | 60.0                | 61.5                |
| <b>Gross profit</b>                          | 40.4                | 38.8                | 40.0                | 38.5                |
| Selling, general, and administrative expense | 28.1                | 27.8                | 27.6                | 27.7                |
| Related party expenses                       | 0.3                 | 0.3                 | 0.4                 | 0.3                 |
| Store pre-opening costs                      | 0.2                 | 0.2                 | 0.1                 | 0.1                 |
| <b>Operating income</b>                      | 11.8                | 10.5                | 11.9                | 10.4                |
| Interest expense                             | 6.2                 | 7.1                 | 6.7                 | 7.7                 |
| Loss on early extinguishment of debt         | 0.1                 | 5.5                 | 0.6                 | 2.0                 |
| Other (income) and expense, net              | 0.4                 | 0.1                 | 0.1                 | 0.4                 |
| <b>Income (loss) before income taxes</b>     | 5.1                 | (2.2)               | 4.5                 | 0.3                 |
| Provision (benefit) for income taxes         | 1.9                 | (0.9)               | 1.7                 | 0.3%                |
| <b>Net income (loss)</b>                     | 3.2%                | (1.3)%              | 2.8%                |                     |

*Quarter Ended October 29, 2011 Compared to the Quarter Ended October 30, 2010*

*Net Sales* Net sales increased for the third quarter of fiscal 2011 by \$28 million, or 2.9%, over the third quarter of fiscal 2010 due in part to a \$16 million increase in comparable store sales. Comparable store sales increased 1.6% driven by a 1.6% increase in average ticket and a 0.3% increase in transactions, partially offset by an adverse impact of 0.3% 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 20 basis points. Comparable store sales growth was strongest in our bakeware, impulse, and paper fashion categories. In addition, sales from our non-comparable new stores provided incremental revenue of \$12 million.

*Cost of Sales and Occupancy Expense* Cost of sales and occupancy expense increased \$2 million to \$594 million in the third quarter of fiscal 2011 from \$592 million in the third quarter of fiscal 2010 due primarily to a \$4 million increase in occupancy costs, as well as a \$4 million increase in merchandise costs associated with higher sales. These amounts were partially offset by a \$6 million reduction from improved inventory management.

Cost of sales and occupancy expense decreased 160 basis points, as a percentage of net sales, to 59.6% for the third quarter of fiscal 2011 from 61.2% for the third quarter of fiscal 2010. Merchandise cost decreased 90 basis points driven by our direct import initiative and improved pricing and promotion management, while increased focus on inventory management contributed 70 basis points to the reduction in cost of sales.

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*Selling, General and Administrative Expense* Selling, general and administrative expense was \$279 million in the third quarter of fiscal 2011 compared to \$269 million in the third quarter of fiscal 2010. Selling, general and administrative expense increased \$10 million driven by a \$7 million increase in costs from planned initiatives related to existing stores and a \$3 million increase in store costs for incremental locations. In addition, advertising increased \$2 million from digital and targeted marketing campaigns that did not occur last year. Furthermore, prior year amounts included \$3 million favorability in group insurance expense as a result of favorable claims experience. These amounts were partially offset by a \$6 million decrease in bonus expense due to a lower anticipated payout recognized during the third quarter of fiscal 2011 compared to the third quarter of fiscal 2010.

As a percentage of net sales, selling, general and administrative expense increased 30 basis points driven by increases of 30 basis points in both store costs and group insurance, as well as 10 basis points in advertising for the reasons indicated above. These amounts were partially offset by a 60 basis point decrease in bonus expense from the lower anticipated payout recognized during the third quarter of fiscal 2011 compared to the third quarter of fiscal 2010.

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*Related Party Expenses* Related party expenses were \$3 million in the third quarter of each of fiscal 2011 and fiscal 2010, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP.

*Interest Expense* Interest expense decreased \$7 million to \$62 million in the third quarter of fiscal 2011 from \$69 million in the third quarter of fiscal 2010. The decrease is attributable to a lower average interest rate and a \$254 million reduction in our total debt outstanding.

*Loss on Early Extinguishment of Debt* We recorded a loss of \$1 million related to the early extinguishment of \$18 million of our 13% Subordinated Discount Notes during the third quarter of fiscal 2011. The \$1 million loss is for the purchase premiums paid. See Note 3 to the consolidated financial statements for further discussion. During the third quarter of fiscal 2010, we recorded a loss of \$53 million related to the early extinguishment of our 2014 Senior Notes. The \$53 million loss was comprised of \$41 million of tender and call premiums and \$12 million to write off the remaining unamortized debt issuance costs.

*Other (Income) and Expense, net* Other expense in the third quarter of fiscal 2011 is related to a \$1 million unfavorable change in the fair value of the interest rate cap, as more fully described in Note 5 to the consolidated financial statements and \$3 million in foreign exchange rate losses. Other expense in the third quarter of fiscal 2010 was related to a \$2 million unfavorable change in the fair value of the interest rate cap, partially offset by \$1 million in foreign exchange rate gains.

*Provision (Benefit) for Income Taxes* During the third quarter of fiscal 2011, we recorded a tax provision of \$19 million at an effective tax rate of 36.8%. During the third quarter of fiscal 2010, we recorded a tax benefit of \$9 million at an effective rate of 41.4%. The higher effective tax rate in fiscal 2010 was driven primarily by the impact of discrete items for the quarter.

### *Nine months Ended October 29, 2011 Compared to the Nine months Ended October 30, 2010*

*Net Sales* Net sales increased for the first nine months of fiscal 2011 by \$106 million, or 3.9%, over the first nine months of fiscal 2010 due primarily to a \$70 million increase in comparable store sales. Comparable store sales increased 2.6% driven by an increase in average ticket of 1.9% and an increase in transactions of 0.7%. The fluctuation in the exchange rates between the United States and Canadian dollars positively impacted the average ticket by 40 basis points. Comparable store sales growth was strongest in our bakeware, home accents, and scrapbook accessories categories. In addition, sales from our non-comparable new stores provided incremental revenue of \$36 million.

*Cost of Sales and Occupancy Expense* Cost of sales and occupancy expense increased \$24 million to \$1.683 billion for the first nine months of fiscal 2011 from \$1.659 billion for the first nine months of fiscal 2010 due primarily to a \$24 million increase in merchandise costs associated with higher sales, a \$17 million increase in occupancy costs, and a \$10 million increase in freight and distribution costs. These amounts were partially offset by a \$20 million reduction from improved inventory management and \$6 million from improved efficiencies in our vertically integrated framing operation.

Cost of sales and occupancy expense decreased 150 basis points, as a percentage of net sales, to 60.0% for the first nine months of fiscal 2011 from 61.5% for the first nine months of fiscal 2010. Merchandise cost decreased 100 basis points driven by our direct import initiative and

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improved pricing and promotion management, while increased focus on inventory management contributed 80 basis points to the reduction in cost of sales. These amounts were partially offset by a 40 basis point increase in freight and distribution costs.

*Selling, General, and Administrative Expense* Selling, general and administrative expense was \$774 million for the first nine months of fiscal 2011 compared to \$747 million for the first nine months of fiscal 2010. Selling, general and administrative expense increased \$27 million driven by a \$16 million increase in costs from planned initiatives related to existing stores and a \$4 million increase in store costs for incremental locations. In addition, advertising increased \$7 million from digital and targeted marketing campaigns that did not occur last year and corporate payroll expense increased \$4 million. These amounts were partially offset by a \$6 million decrease in bonus expense due to a lower anticipated payout recognized during the first nine months of fiscal 2011 compared to the first nine months of fiscal 2010. As a percentage of net sales, selling, general and administrative expense was consistent with prior year.

*Related Party Expenses* Related party expenses were \$10 million for the first nine months of each of fiscal 2011 and fiscal 2010, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, LP.

*Interest Expense* Interest expense decreased \$19 million for the first nine months of fiscal 2011 compared to the first nine months of 2010 due to a lower average interest rate and a \$254 million reduction in our total debt outstanding.

*Loss on Early Extinguishment of Debt* We recorded a loss of \$16 million related to the early extinguishment of \$142 million face value, or \$134 million accreted value, of our 13% Subordinated Discount Notes during the first nine months of fiscal 2011. The \$16 million loss is comprised of \$10 million to recognize the unrealized interest accretion and the write off of related debt issuance costs, as well as \$6 million of purchase premiums. See Note 3 to the consolidated financial statements for further discussion. During the first nine months of fiscal 2010, we recorded a loss of \$53 million related to the early extinguishment of our 2014 Senior Notes. The \$53 million loss was comprised of \$41 million of tender and call premiums and \$12 million to write off the remaining unamortized debt issuance costs.

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*Other (Income) and Expense, net* Other expense for the first nine months of fiscal 2011 is related to a \$4 million unfavorable change in the fair value of our interest rate cap. Other expense for the first nine months of fiscal 2010 was related to a \$15 million unfavorable change in the fair value of the interest rate cap, partially offset by \$3 million related to foreign exchange rate gains.

*Provision for Income Taxes* The effective tax rate was 37.7% for the first nine months of fiscal 2011. For the first nine months of fiscal 2010, we recorded a tax provision of \$9 million, of which \$5 million was to correct the federal deferred tax liability relating to state income taxes and \$1 million related to other discrete items. We currently estimate our annualized effective tax rate for fiscal 2011 to be 37.6%.

**Liquidity and Capital Resources**

We require cash principally for day-to-day operations, to finance capital investments, to purchase inventory, 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 senior secured asset-based revolving credit facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and growth for the foreseeable future. Our senior secured asset-based revolving credit facility provides senior secured financing of up to \$850 million, subject to a borrowing base. As of October 29, 2011, the borrowing base was \$802 million, which supported \$55 million of outstanding letters of credit and provided \$747 million of excess availability. Our cash and equivalents decreased \$208 million from \$319 million at January 29, 2011, to \$111 million at October 29, 2011.

We and our subsidiaries, affiliates, and significant shareholders may continue from time to time seek to retire or purchase our outstanding 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.

*Cash Flow from Operating Activities*

Cash flow provided by operating activities during the first nine months of fiscal 2011 was \$99 million compared to \$115 million during the first nine months of fiscal 2010. The \$16 million change was primarily due to a \$62 million decrease from the timing of inventory purchases and a \$10 million decrease as a result of the timing of sales tax payments. These amounts were partially offset by an increase in net income of \$31 million before the consideration of the \$16 million and \$53 million loss on the early extinguishment debt in fiscal 2011 and fiscal 2010, respectively and the \$11 million adverse impact of the change in the fair value of the interest rate cap. In addition, the timing of payments related to interest and other payables resulted in increases of \$25 million and \$6 million, respectively.

Average inventory per Michaels store (including supporting distribution centers) decreased 0.2% from \$924,000 at October 30, 2010 to \$922,000 at October 29, 2011 primarily due to a planned reduction of store inventory levels, partially offset by an increase in distribution centers inventory from the timing of recognized purchases. We anticipate average inventory per Michaels store at the end of fiscal 2011 to be down compared to the end of fiscal 2010.

*Cash Flow from Investing Activities*



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Cash flow used in investing activities represents the following capital expenditure activities:

|   | Nine Months Ended   |                     |
|---|---------------------|---------------------|
|   | October 29,<br>2011 | October 30,<br>2010 |
|   | (in millions)       |                     |
| New and relocated stores and stores not yet opened<br>(1) | \$ 23               | \$ 20               |
| Existing stores   | 19                  | 18                  |
| Information systems                                       | 32                  | 17                  |
| Corporate and other                                       | 10                  | 6                   |
|   | \$ 84               | \$ 61               |

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(1) In the first nine months of fiscal 2011, we incurred capital expenditures related to the opening of 23 Michaels stores in addition to the relocation of 14 Michaels stores. In the first nine months of fiscal 2010, we incurred capital expenditures related to the opening of 23 Michaels stores in addition to the relocation of ten Michaels stores.

*Cash Flow from Financing Activities*

Cash flow used in financing activities during the first nine months of fiscal 2011 was \$223 million compared to \$154 million during the first nine months of fiscal 2010. Cash flow used in financing activities for the first nine months of fiscal 2011 was impacted by the repurchases of \$142 million face value of our 13% Subordinated Discount Notes and \$7 million face value of our 113/8% Senior Subordinated Notes. In accordance with ASC 470, we recorded a loss of \$16 million related to these repurchases. The \$16 million loss is comprised of \$10 million to recognize the unrealized interest accretion and the write off of related debt issuance costs, as well as \$6 million in purchase premiums. We also made a voluntary prepayment of \$50 million on our senior secured term loan facility during the first quarter of fiscal 2011.

In the first quarter of fiscal 2010, we made an excess cash flow payment on our senior secured term loan facility of \$118 million and paid \$19 million in debt issuance costs related to the amendment to the senior secured asset-based revolving credit facility. In addition, during the third quarter of fiscal 2010, we retired our 10% Senior Notes due 2014 and issued 7¾% Senior Notes due 2018, for which we paid a \$41 million tender and call premiums and \$15 million in debt issuance costs.

**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 facility and \$850 million senior secured 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 facility and its senior secured asset-based revolving credit facilities. As it relates to the senior secured term loan facility, 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 senior secured 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.

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

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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.

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

|  | Quarter Ended       |                     | Nine Months Ended   |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | October 29,<br>2011 | October 30,<br>2010 | October 29,<br>2011 | October 30,<br>2010 |
|  | (in millions)       |                     |                     |                     |
| Net cash provided by operating activities        | \$ 147              | \$ 92               | \$ 99               | \$ 115              |
| Depreciation and amortization                    | (25)                | (25)                | (75)                | (77)                |
| Share-based compensation                         | (3)                 | (2)                 | (7)                 | (6)                 |
| Debt issuance costs amortization                 | (5)                 | (5)                 | (13)                | (14)                |
| Accretion of long-term debt                      | (11)                | (13)                | (35)                | (37)                |
| Change in fair value of interest rate cap        | (1)                 | (2)                 | (4)                 | (15)                |
| Change in fair value of contingent consideration |                     |                     | 1                   |                     |
| Loss on early extinguishment of debt             | (1)                 | (53)                | (16)                | (53)                |
| Changes in assets and liabilities                | (69)                | (4)                 | 129                 | 87                  |
| Net income (loss)                                | 32                  | (12)                | 79                  |                     |
| Interest expense                                 | 62                  | 69                  | 188                 | 207                 |
| Loss on early extinguishment of debt             | 1                   | 53                  | 16                  | 53                  |
| Income tax provision (benefit)                   | 19                  | (9)                 | 48                  | 9                   |
| Depreciation and amortization                    | 25                  | 25                  | 75                  | 77                  |
| EBITDA   | 139                 | 126                 | 406                 | 346                 |
| Adjustments:                                     |                     |                     |                     |                     |
| Share-based compensation                         | 3                   | 2                   | 7                   | 6                   |
| Sponsor Fees                                     | 3                   | 3                   | 10                  | 10                  |
| Termination expense                              |                     |                     | 1                   |                     |
| Pre-opening costs                                | 2                   | 2                   | 4                   | 3                   |
| Multi-year initiatives (1)                       |                     |                     | 1                   |                     |
| Foreign currency translation losses (gains)      | 3                   | (1)                 |                     | (3)                 |
| Store closing costs                              | 2                   | 1                   | 3                   | 2                   |
| Loss on interest rate cap                        | 1                   | 2                   | 4                   | 15                  |
| Other (2)  | 1                   | 2                   | 3                   | 2                   |
| Adjusted EBITDA                                  | \$ 154              | \$ 137              | \$ 439              | \$ 381              |

(1) Multi-year initiatives relate to store remodel costs.

(2) Other adjustments relate to items such as the moving & relocation expenses, franchise taxes, foreign currency hedge and legal settlements

### **Recent Accounting Pronouncements**

In January 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures About Fair Value Measurements* an amendment to 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 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. We adopted the new disclosure requirements related to the Level 3 activity on January 30, 2011, with no

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material impact on our consolidated financial statements. See Note 6 for further information regarding fair value measurements.

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*, an amendment to ASC topic 220, *Comprehensive Income*. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of shareholders equity. Instead, comprehensive income must be reported in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. The amended guidance, which must be applied retroactively, is effective for interim and annual periods beginning after December 15, 2011, with earlier adoption permitted. We will adopt all requirements of ASU 2011-05 on January 29, 2012, the beginning of our 2012 fiscal year.

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In September 2011, the FASB issued ASU No. 2011-08, *Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. ASU 2011-08 allows entities testing for goodwill impairment to have the option of performing a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If an entity believes, as a result of its qualitative assessment, it is more-likely-than-not the fair value of a reporting unit is less than its carrying amount, the currently prescribed two-step goodwill impairment test must be performed. Otherwise, no further testing is required. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. We plan to early adopt ASU 2011-08 in the fourth quarter of fiscal 2011.

**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 October 29, 2011, a 10% increase or decrease in the exchange rate of the US and Canadian dollar would have had a \$2 million impact on 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 October 29, 2011, a 1% increase or decrease in interest rates would increase or decrease income before income taxes by \$20 million. A 1% increase in interest rates would decrease the fair value of our long-term fixed rate debt by \$42 million. A 1% decrease in interest rates would increase the fair value of our long-term fixed rate debt by \$45 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

During 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 facility 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 October 29, 2011 was \$2 million and is included in Other assets on the Consolidated Balance Sheet. The change in fair value of the cap for the quarter and nine months ended October 29, 2011, resulted in a loss of \$1 million and \$4 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 \$8 million. A 1% decrease in the interest rates would decrease income before income taxes by \$2 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 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 and 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.

*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 are 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<br/>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 Charles M. Sonstebly 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). |
| 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  |



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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/ Charles M. Sonstebly*  
Charles M. Sonstebly  
Chief Administrative Officer & Chief Financial  
Officer  
(Principal Financial Officer)

Dated: November 18, 2011

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**INDEX TO EXHIBITS**

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