

MICHAELS STORES INC
Form 10-Q
June 02, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended May 3, 2014

OR

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

For the transition period from to

Commission file number 001-09338

MICHAELS STORES, INC.

(Exact name of registrant as specified in its charter)

Delaware

(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)

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 ☐

Accelerated filer ☐

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

Smaller reporting company ☐

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

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As of May 30, 2014, 100 shares of the Registrant's Common Stock were outstanding.

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

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(in millions, except share data)

(Unaudited)

	May 3, 2014	February 1, 2014	May 4, 2013
ASSETS			
Current assets:			
Cash and equivalents	\$ 112	\$ 234	\$ 55
Merchandise inventories	930	901	843
Prepaid expenses and other	95	95	85
Receivable from Parent		2	
Deferred income taxes	37	39	37
Income tax receivables	8	2	8
Total current assets	1,182	1,273	1,028
Property and equipment, at cost	1,628	1,600	1,527
Less accumulated depreciation and amortization	(1,266)	(1,242)	(1,186)
Property and equipment, net	362	358	341
Goodwill	94	94	94
Debt issuance costs, net of accumulated amortization of \$56, \$54, and \$52, respectively	36	37	42
Deferred income taxes	22	28	28
Long-term receivable from Parent	5	8	
Other assets	3	3	2
Total non-current assets	160	170	166
Total assets	\$ 1,704	\$ 1,801	\$ 1,535
LIABILITIES AND STOCKHOLDERS DEFICIT			
Current liabilities:			
Accounts payable	\$ 313	\$ 368	\$ 232
Accrued liabilities and other	315	377	300
Share-based compensation liability			36
Current portion of long-term debt	16	16	198
Dividend payable to Holdings		30	
Deferred income taxes		1	4
Income taxes payable	47	42	27
Total current liabilities	691	834	797
Long-term debt	2,873	2,878	2,887
Deferred income taxes	1	2	2
Share-based compensation liability			28

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Other long-term liabilities	84	88	79
Total long-term liabilities	2,958	2,968	2,996
Total liabilities	3,649	3,802	3,793
Commitments and contingencies			
Stockholders' deficit:			
Common Stock, \$0.10 par value, 100 shares authorized; 100 shares issued and outstanding at May 3, 2014, February 1, 2014, and May 4, 2013			
Additional paid-in capital	125	124	50
Accumulated deficit	(2,069)	(2,125)	(2,313)
Accumulated other comprehensive (loss) income	(1)		5
Total stockholders' deficit	(1,945)	(2,001)	(2,258)
Total liabilities and stockholders' deficit	\$ 1,704	\$ 1,801	\$ 1,535

See accompanying notes to consolidated financial statements.

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MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(Unaudited)

	Quarter Ended	
	May 3, 2014	May 4, 2013
Net sales	\$ 1,052	\$ 993
Cost of sales and occupancy expense	623	584
Gross profit	429	409
Selling, general, and administrative expense	282	272
Share-based compensation	4	3
Related party expenses	3	4
Store pre-opening costs	1	2
Operating income	139	128
Interest expense	41	47
Refinancing costs and losses on early extinguishment of debt		7
Income before income taxes	98	74
Provision for income taxes	42	28
Net income	56	46
Other comprehensive (loss), net of tax:		
Foreign currency translation adjustment and other	(1)	(1)
Comprehensive income	\$ 55	\$ 45

See accompanying notes to consolidated financial statements.

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MICHAELS STORES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(Unaudited)

	Quarter Ended	
	May 3, 2014	May 4, 2013
Operating activities:		
Net income	\$ 56	\$ 46
Adjustments:		
Depreciation and amortization	27	25
Share-based compensation	4	4
Debt issuance costs amortization	2	2
Refinancing costs expensed and losses on early extinguishment of debt		7
Changes in assets and liabilities:		
Merchandise inventories	(28)	20
Prepaid expenses and other	1	1
Deferred income taxes	5	
Accounts payable	(45)	(14)
Accrued interest	(16)	(30)
Accrued liabilities and other	(45)	(41)
Income taxes		(14)
Other long-term liabilities	(3)	(4)
Net cash (used in) provided by operating activities	(42)	2
Investing activities:		
Additions to property and equipment	(31)	(22)
Net cash used in investing activities	(31)	(22)
Financing activities:		
Redemption of senior subordinated notes due 2016		(142)
Borrowings on asset-based revolving credit facility		306
Payments on asset-based revolving credit facility		(125)
Repayments on senior secured term loan facility	(4)	
Payments of dividends to Holdings	(30)	
Payment of capital leases		(1)
Change in cash overdraft	(12)	(19)
Other	(3)	
Net cash (used in) provided by financing activities	(49)	19
Net decrease in cash and equivalents	(122)	(1)
Cash and equivalents at beginning of period	234	56
Cash and equivalents at end of period	\$ 112	\$ 55
Supplemental Cash Flow Information:		
Cash paid for interest	\$ 56	\$ 75
Cash paid for income taxes	\$ 36	\$ 44

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See accompanying notes to consolidated financial statements.

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MICHAELS STORES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Quarter Ended May 3, 2014

(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 (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

The balance sheet at February 1, 2014, has been derived from the audited financial statements at that date, but does not include all of the information and notes required by GAAP 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 May 3, 2014 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 2014 relate to the 52 weeks ending January 31, 2015 and all references to fiscal 2013 relate to the 52 weeks ended February 1, 2014. In addition, all references herein to the first quarter of fiscal 2014 relate to the 13 weeks ended May 3, 2014, and all references to the first quarter of fiscal 2013 relate to the 13 weeks ended May 4, 2013.

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 supersedes the revenue recognition requirements in *Revenue Recognition (Topic 605)*, and requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period and is to be applied retrospectively, with early application not permitted. We are evaluating the new standard, but do not, at this time, anticipate a material impact to the financial statements once implemented.

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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.

	May 3, 2014	February 1, 2014 (in millions)	May 4, 2013	Interest Rate
Senior secured term loan	\$ 1,623	\$ 1,628	\$ 1,640	Variable
Senior notes	1,006	1,006	1,007	7.750%
Senior subordinated notes	260	260		5.875%
Senior subordinated notes			256	11.375%
Asset-based revolving credit facility			182	Variable
Total debt	2,889	2,894	3,085	
Less current portion	16	16	198	
Long-term debt	\$ 2,873	\$ 2,878	\$ 2,887	

Restated Revolving Credit Facility

As of May 3, 2014, the borrowing base of our restated senior secured asset-based revolving credit facility (Restated Revolving Credit Facility) was \$650 million, of which we had no borrowings, \$61 million of outstanding letters of credit and the unused borrowing capacity was \$589 million.

Note 3. Comprehensive Loss

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

	Foreign Currency Translation and Other (in millions)
Balance at February 1, 2014	\$
Foreign currency translation adjustment and other	(1)
Balance at May 3, 2014	\$ (1)

Note 4. Fair Value Measurements

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As defined in Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures* (ASC 820), fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes a three-level valuation hierarchy for fair value measurements. These valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect less transparent active market data, as well as internal assumptions. These two types of inputs create the following fair value hierarchy:

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

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The table below provides the carrying and fair values of our senior secured term loan facility (Restated Term Loan Credit Facility), our 73/4% Senior Notes that are due in 2018 (2018 Senior Notes) and our 57/8% Senior Subordinated Notes that are due in 2020 (the 2020 Senior Subordinated Notes), and together, with our 2018 Senior Notes, (our notes) as of May 3, 2014. The fair value of our Restated Term Loan Credit Facility was determined based on quoted market prices of similar instruments which are considered Level 2 inputs within the fair value hierarchy. The fair value of our notes was determined based on recent trades which are considered Level 1 inputs within the fair value hierarchy.

	Carrying Value	(in millions)	Fair Value
Senior secured term loan	\$	1,623	\$ 1,626
Senior notes		1,006	1,060
Senior subordinated notes		260	263

Note 5. Income Taxes

The effective tax rate was 42.9% for the first quarter of fiscal 2014. The effective rate was 37.8% for the first quarter of fiscal 2013. The current rate is higher than the prior year due to certain discrete items required to be recognized as a result of a change in tax status of our Canadian subsidiary. On February 2, 2014, the Company changed the corporate structure of our Canadian operations from a branch for U.S. tax purposes to a controlled foreign corporation of an indirect foreign subsidiary of Michaels Stores, Inc. As a result of the change in tax status, the net deferred tax assets related to U.S. temporary differences for the branch were written off. In addition, the Company recognized as discrete events, a tax gain on the contribution of certain assets to the new entity as part of the transaction, as well as previously unrecognized currency losses. The effects of the write-off, the gain on the contribution, and the currency losses were discrete charges to the income tax provision of \$6 million, \$1 million, and (\$1) million respectively, during the first quarter. We currently estimate our effective tax rate for fiscal 2014 to be approximately 38.5%.

Note 6. 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 February 1, 2014.

Employee claims*Rea claim*

On September 15, 2011, the Company was served with a lawsuit filed in the California Superior Court in and for the County of Orange (Superior Court) by four former store managers as a class action proceeding on behalf of themselves and certain former and current store managers employed by Michaels in California. 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

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the foregoing conduct was in breach of various laws, including California's unfair competition law. On December 3, 2013, the Superior Court entered an Order certifying a class of approximately 200 members. The Company subsequently successfully removed the case to the United States District Court for the Central District of California and on May 8, 2014, the class was de-certified. We believe we have meritorious defenses and intend to defend the lawsuits vigorously. We do not believe the resolution of the lawsuits will have a material effect on our Consolidated Financial Statements.

Consumer class action claims

Data security incident

Five putative class actions were filed relating to our recent Data Breach. The plaintiffs generally allege that the Company failed to secure and safeguard customers' private information including credit and debit card information and as such, breached an implied contract, violated the Illinois Consumer Fraud Act (and other states' similar laws) and are seeking damages including declaratory relief, actual damages, punitive damages, statutory damages, attorneys' fees, litigation costs, remedial action, pre and post judgment interest, and other relief as available. The cases are as follows: Christina Moyer v. Michaels Stores, Inc. was filed on January 27, 2014; Michael and Jessica Gouwens v. Michaels Stores, Inc., was filed on January 29, 2014; Nancy Maize and Jessica Gordon v.

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Michaels Stores, Inc., was filed on February 21, 2014; and Daniel Ripes v. Michaels Stores, Inc. was filed on March 14, 2014. All four of these cases were filed in the United States District Court-Northern District of Illinois, Eastern Division. A case, Mary Jane Whalen v. Michaels Stores, Inc., was filed in the United States District Court for the Eastern District of New York on March 18, 2014, but was voluntarily dismissed by the plaintiff on April 11, 2014, without prejudice to her right to re-file a complaint. On April 16, 2014, an order was entered consolidating the current actions. We believe we have meritorious defenses and intend to defend the lawsuits vigorously.

In addition, payment card companies and associations may require us to reimburse them for unauthorized card charges and costs to replace cards and may also impose fines or penalties in connection with the Data Breach, and enforcement authorities may also impose fines or other remedies against us. We have also incurred other costs associated with the Data Breach, including legal fees, investigative fees, costs of communications with customers and credit monitoring services provided to our customers. In addition, state and federal agencies, including the State Attorneys General and the Federal Trade Commission may investigate events related to the Data Breach, including how it occurred, its consequences and our responses. Although we intend to cooperate in these investigations, we may be subject to fines or other obligations, which may have an adverse effect on how we operate our business and our results of operations.

While a loss from these matters is reasonably possible, we cannot reasonably estimate a range of possible losses because our investigation into the matter is ongoing, the proceedings remain in the early stages, alleged damages have not been specified, there is uncertainty as to the likelihood of a class or classes being certified or the ultimate size of any class if certified, and there are significant factual and legal issues to be resolved.

General

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

ASC 450, Contingencies, governs the disclosure and recognition of loss contingencies, including potential losses from litigation and regulatory matters. It imposes different requirements for the recognition and disclosure of loss contingencies based on the likelihood of occurrence of the contingent future event or events. It distinguishes among degrees of likelihood using the following three terms: probable, meaning that the future event or events are likely to occur; remote, meaning that the chance of the future event or events occurring is slight; and reasonably possible, meaning that the chance of the future event or events occurring is more than remote but less than likely. In accordance with ASC 450, the Company accrues for a loss contingency when we conclude that the likelihood of a loss is probable and the amount of the loss can be reasonably estimated. When the loss cannot be reasonably estimated we estimate the range of amounts, and if no amount in the range constitutes a better estimate than any other amount, we accrue for the amount at the low end of the range. We adjust our accruals from time to time as we receive additional information, but the loss we incur may be significantly greater than or less than the amount we have accrued. We disclose loss contingencies if there is at least a reasonable possibility that a material loss has been incurred. No accrual or disclosure is required for losses that are remote.

For some of the matters disclosed above, as well as other matters previously disclosed in the Company's filings with the Securities and Exchange Commission (SEC), the Company is currently able to estimate a reasonably possible loss or range of loss in excess of amounts accrued (if any). For some of the matters included within this estimation, an accrual has been made because a loss is believed to be both probable and reasonably estimable, but an exposure to loss exists in excess of the amount accrued; in these cases, the estimate reflects the reasonably possible range of

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loss in excess of the accrued amount. For other matters included within this estimation, no accrual has been made because a loss, although estimable, is believed to be reasonably possible, but not probable; in these cases the estimate reflects the reasonably possible loss or range of loss within the ranges identified. For the various ranges identified, the aggregate of these estimated amounts is approximately \$9 million, which is also inclusive of amounts accrued by the Company.

For other matters disclosed above or as previously disclosed in the Company's filings with the SEC, the Company is not currently able to estimate the reasonably possible loss or range of loss, and has indicated such. Many of these matters remain in preliminary stages (even in some cases where a substantial period of time has passed since the commencement of the matter), with few or no substantive legal decisions by the court defining the scope of the claims, the class (if any), or the potentially available damages, and fact discovery is still in progress or has not yet begun. For all these reasons, the Company cannot at this time estimate the reasonably possible loss or range of loss, if any, for these matters.

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It is the opinion of the Company's management, based on current knowledge and after taking into account its current legal accruals, the eventual outcome of all matters described in this Note would not be likely to have a material impact on the consolidated financial condition of the Company. Nonetheless, given the substantial or indeterminate amounts sought in certain of these matters, and the inherent unpredictability of such matters, an adverse outcome in certain of these matters could, from time to time, have a material effect on the Company's consolidated results of operations or cash flows in particular quarterly or annual periods.

Note 7. Segments and Geographic Information

We consider our Michaels - U.S., Michaels - Canada and Aaron Brothers to be our operating segments for purposes of determining reportable segments based on the criteria of ASC 280, *Segment Reporting* (ASC 280). We determined that our Michaels - U.S., Michaels - Canada, and Aaron Brothers operating segments have similar economic characteristics and meet the aggregation criteria set forth in ASC 280. Therefore, we combine those operating segments into one reporting segment.

Our sales and assets by country are as follows:

	May 3, 2014	Quarter Ended (in millions)	May 4, 2013
Net Sales:			
United States	\$	952	\$ 899
Canada		100	94
Consolidated Total	\$	1,052	\$ 993

	May 3, 2014	February 1, 2014 (in millions)	May 4, 2013
Total Assets:			
United States	\$	1,588	\$ 1,678
Canada		116	123
Consolidated Total	\$	1,704	\$ 1,801
			\$ 1,535

Our chief operating decision makers evaluate historical operating performance, plan and forecast future periods' operating performance based on operating income and earnings before interest, income taxes, depreciation, amortization, and refinancing costs and losses on early extinguishment of debt (EBITDA (excluding refinancing costs and losses on early extinguishment of debt)). We believe these metrics more closely reflect the operating effectiveness of factors over which management has control. A reconciliation of Net income to EBITDA (excluding refinancing costs and losses on early extinguishment of debt) is presented below.

	May 3, 2014	Quarter Ended (in millions)	May 4, 2013
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Net income	\$	56	\$	46
Interest expense		41		47
Provision for income taxes		42		28
Refinancing costs and losses on early extinguishments of debt				7
Depreciation and amortization		27		25
EBITDA (excluding refinancing costs and losses on early extinguishments of debt)	\$	166	\$	153

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Note 8. Related Party Transactions

We pay annual management fees to Bain Capital Partners, LLC (Bain Capital) and The Blackstone Group L.P. (The Blackstone Group) and, together with Bain Capital, the Sponsors) and Highfields Capital Management LP in the amount of \$12 million and \$1 million, respectively. We recognized \$3 million and \$4 million of expense related to annual management fees during the first quarters of fiscal 2014 and fiscal 2013, respectively. These expenses are included in Related party expenses on the Consolidated Statements of Comprehensive Income.

Bain Capital owns a majority equity position in LogicSource, an external vendor we utilize for print procurement services. Payments associated with this vendor during each of the first quarters of fiscal 2014 and fiscal 2013 were \$1 million each. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Comprehensive Income.

The Blackstone Group owns a majority equity position in Brixmor Properties Group, a vendor we utilize to lease certain properties. Payments associated with this vendor during each of the first quarters of fiscal 2014 and fiscal 2013 were \$1 million. These expenses are included in Cost of sales and occupancy expense in the Consolidated Statements of Comprehensive Income.

The Blackstone Group owns a majority equity position in RGIS, an external vendor we utilize to count our store inventory. Payments associated with this vendor during the first quarters of fiscal 2014 and fiscal 2013 were \$2 million and \$1 million, respectively. These expenses are included in Selling, general and administrative expense on the Consolidated Statements of Comprehensive Income.

The Blackstone Group owns a majority equity position in Vistar, an external vendor we utilize for all of the candy-type items in our stores. Payments associated with this vendor during the first quarters of fiscal 2014 and fiscal 2013 were \$7 million and \$6 million, respectively. These expenses are recognized in Cost of sales as the sales are recorded.

Our current directors (other than Jill A. Greenthal, John J. Mahoney, James A. Quella, and Carl S. Rubin) are affiliates of Bain Capital or The Blackstone Group. As such, some or all of such directors may have an indirect material interest in payments with respect to debt securities of the Company that have been purchased by affiliates of Bain Capital and The Blackstone Group. As of May 3, 2014, affiliates of The Blackstone Group held approximately \$38 million of our senior secured term loan.

Michaels Stores, Inc. is wholly owned by FinCo Holdings (Holdings). On July 29, 2013, FinCo Holdings co-issued \$800 million aggregate principal amount of 7.50%/8.25% PIK Toggle Notes due 2018 (PIK Notes). The PIK Notes are not guaranteed by the Company, Holdings or any of their subsidiaries, but the indenture governing the PIK Notes contains restrictive covenants that apply to FinCo Holdings and its restricted subsidiaries, including the Company, Holdings and their subsidiaries, and a breach of such covenants would cause FinCo Holdings to be in default under the indenture governing the PIK Notes. In addition, the PIK Notes are not reflected in the financial statements of the Company. If interest on the PIK Notes for all interest periods is paid in cash, annual interest payments will total \$60 million. The Company intends for any cash interest payments to be funded by the Company through a cash dividend to Holdings. In the first quarter of 2014, the Company paid a cash dividend of \$30 million to Holdings. The dividend was declared during the fiscal year ended, February 1, 2014.

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In the first fiscal quarter of 2014, the Company paid \$8 million to repurchase common stock of The Michaels Companies, Inc. (the Parent of FinCo Holdings and Michaels Stores, Inc.) from former employees of Michaels Stores, Inc. The Company also received \$5 million in proceeds from stock options exercised by former employees of Michaels Stores, Inc. The net proceeds of these transactions are recorded as a Long-term receivable from Parent on the Company's Consolidated Balance Sheets.

Note 9. Condensed Consolidating Financial Information

All obligations of Michaels Stores, Inc. (MSI) under the 2018 Senior Notes, 2020 Senior Subordinated Notes, Restated Term Loan Credit Facility, and Restated Revolving Credit Facility are guaranteed by each of our subsidiaries other than Aaron Brothers Card Services, LLC, Artistree of Canada, ULC, Michaels Stores of Puerto Rico, LLC and certain foreign and domestic subsidiary holding companies. In addition, all obligations of Michaels Stores, Inc. under the Restated Term Loan Credit Facility and Restated Revolving Credit Facility are guaranteed by Holdings. As of May 3, 2014, the financial statements of Aaron Brothers Card Services, LLC, Artistree of Canada, ULC, Michaels Stores of Puerto Rico, LLC and certain foreign and domestic subsidiary holding companies were immaterial. Each subsidiary guarantor is 100% owned, directly or indirectly, by the Company and all guarantees are joint and several and full and unconditional.

The following condensed consolidating financial information represents the financial information of MSI 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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		May 3, 2014			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated	
(in millions)					
ASSETS					
Current assets:					
Cash and equivalents	\$ 79	\$ 33	\$	\$ 112	
Merchandise inventories	613	317		930	
Intercompany receivables		684	(684)		
Other	116	24		140	
Total current assets	808	1,058	(684)	1,182	
Property and equipment, net	283	79		362	
Goodwill	94			94	
Investment in subsidiaries	656		(656)		
Long-term receivable from Parent	3	2		5	
Other assets	58	3		61	
Total assets	\$ 1,902	\$ 1,142	\$ (1,340)	\$ 1,704	
LIABILITIES AND STOCKHOLDERS DEFICIT					
Current liabilities:					
Accounts payable	\$ 8	\$ 305	\$	\$ 313	
Accrued liabilities and other	186	129		315	
Current portion of long-term debt	16			16	
Intercompany payable	684		(684)		
Other	47			47	
Total current liabilities	941	434	(684)	691	
Long-term debt	2,873			2,873	
Other long-term liabilities	73	12		85	
Total stockholders deficit	(1,985)	696	(656)	(1,945)	
Total liabilities and stockholders deficit	\$ 1,902	\$ 1,142	\$ (1,340)	\$ 1,704	

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

February 1, 2014					
	Parent Company	Subsidiaries	Eliminations	Consolidated	
(in millions)					
ASSETS					
Current assets:					
Cash and equivalents	\$ 190	\$ 44	\$	\$	234
Merchandise inventories	607	294			901
Intercompany receivables	2	645	(645)		2
Other	114	22			136
Total current assets	913	1,005	(645)		1,273
Property and equipment, net	281	77			358
Goodwill	94				94
Investment in subsidiaries	526		(526)		
Long-term receivable from Parent	5	3			8
Other assets	66	2			68
Total assets	\$ 1,885	\$ 1,087	\$ (1,171)	\$	1,801
LIABILITIES AND STOCKHOLDERS DEFICIT					
Current liabilities:					
Accounts payable	\$ 5	\$ 363	\$	\$	368
Accrued liabilities and other	229	148			377
Current portion of long-term debt	16				16
Dividend payable to Holdings	30				30
Intercompany payable	645		(645)		
Other	43				43
Total current liabilities	968	511	(645)		834
Long-term debt	2,878				2,878
Other long-term liabilities	77	13			90
Total stockholders deficit	(2,038)	563	(526)		(2,001)
Total liabilities and stockholders deficit	\$ 1,885	\$ 1,087	\$ (1,171)	\$	1,801

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

	May 4, 2013				
	Parent Company	Guarantor Subsidiaries	Eliminations		Consolidated
	(in millions)				
ASSETS					
Current assets:					
Cash and equivalents	\$ 32	\$ 23	\$	\$	55
Merchandise inventories	588	255			843
Intercompany receivables		442		(442)	
Other	108	22			130
Total current assets	728	742		(442)	1,028
Property and equipment, net	272	69			341
Goodwill	94				94
Investment in subsidiaries	430			(430)	
Other assets	69	3			72
Total assets	\$ 1,593	\$ 814	\$ (872)	\$	1,535
LIABILITIES AND STOCKHOLDERS DEFICIT					
Current liabilities:					
Accounts payable	\$ 4	\$ 228	\$	\$	232
Accrued liabilities and other	177	123			300
Share-based compensation	23	13			36
Current portion of long-term debt	198				198
Intercompany payable	442			(442)	
Other	31				31
Total current liabilities	875	364		(442)	797
Long-term debt	2,887				2,887
Share-based compensation	19	9			28
Other long-term liabilities	70	11			81
Total stockholders deficit	(2,258)	430		(430)	(2,258)
Total liabilities and stockholders deficit	\$ 1,593	\$ 814	\$ (872)	\$	1,535

Table of Contents**Supplemental Condensed Consolidating Statement of Comprehensive Income**

	Quarter Ended May 3, 2014			
	Parent Company	Subsidiaries	Eliminations (in millions)	Consolidated
Net sales	\$ 922	\$ 587	\$ (457)	\$ 1,052
Cost of sales and occupancy expense	587	493	(457)	623
Gross profit	335	94		429
Selling, general, and administrative expense	245	37		282
Share-based compensation	3	1		4
Related party expenses	3			3
Store pre-opening costs	1			1
Operating income	83	56		139
Interest expense	41			41
Intercompany charges (income)	14	(14)		
Equity in earnings of subsidiaries	70		(70)	
Income before income taxes	98	70	(70)	98
Provision for income taxes	42	30	(30)	42
Net income	56	40	(40)	56
Other comprehensive loss, net of tax:				
Foreign currency translation adjustment and other	(1)			(1)
Comprehensive income	\$ 55	\$ 40	\$ (40)	\$ 55

Table of Contents**Supplemental Condensed Consolidating Statement of Comprehensive Income**

	Quarter Ended May 4, 2013			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	\$ 869	\$ 547	\$ (423)	\$ 993
Cost of sales and occupancy expense	555	452	(423)	584
Gross profit	314	95		409
Selling, general, and administrative expense	234	38		272
Share-based compensation	2	1		3
Related party expenses	4			4
Store pre-opening costs	2			2
Operating income	72	56		128
Interest expense	47			47
Refinancing costs and losses on early extinguishment of debt	7			7
Intercompany charges (income)	13	(13)		
Equity in earnings of subsidiaries	69		(69)	
Income before income taxes	74	69	(69)	74
Provision for income taxes	28	26	(26)	28
Net income	46	43	(43)	46
Other comprehensive loss, net of tax:				
Foreign currency translation adjustment and other	(1)			(1)
Comprehensive income	\$ 45	\$ 43	\$ (43)	\$ 45

[Table of Contents](#)**Supplemental Condensed Consolidating Statement of Cash Flows**

	Quarter Ended May 3, 2014			
	Parent Company	Guarantor Subsidiaries	Eliminations (in millions)	Consolidated
Operating activities:				
Net cash (used in) provided by operating activities	\$ (39)	\$ 20	\$ (23)	\$ (42)
Investing activities:				
Cash paid for property and equipment	(24)	(7)		(31)
Net cash used in investing activities	(24)	(7)		(31)
Financing activities:				
Net repayments of long-term debt	(4)			(4)
Payment of dividends to Holdings	(30)			(30)
Intercompany dividends		(23)	23	
Other financing activities	(14)	(1)		(15)
Net cash used in financing activities	(48)	(24)	23	(49)
Decrease in cash and equivalents	(111)	(11)		(122)
Beginning cash and equivalents	190	44		234
Ending cash and equivalents	\$ 79	\$ 33	\$	\$ 112

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

	Quarter Ended May 4, 2013			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating activities:				
Net cash (used in) provided by operating activities	\$ (8)	\$ 34	\$ (24)	\$ 2
Investing activities:				
Cash paid for property and equipment	(16)	(6)		(22)
Net cash used in investing activities	(16)	(6)		(22)
Financing activities:				
Net repayments of long-term debt	39			39
Intercompany dividends		(24)	24	
Other financing activities	(20)			(20)
Net cash provided by (used in) financing activities	19	(24)	24	19
(Decrease) increase in cash and equivalents	(5)	4		(1)
Beginning cash and equivalents	37	19		56
Ending cash and equivalents	\$ 32	\$ 23	\$	\$ 55

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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 February 1, 2014. 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; in the event of a prolonged economic downturn, it could adversely affect consumer confidence and retail spending, decrease demand for our merchandise and adversely impact our results of operations, cash flows and financial condition;
- risks related to our substantial outstanding indebtedness of \$2.9 billion, 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 \$1.6 billion variable rate debt and prevent us from meeting our obligations under our notes and credit facilities;
- changes in customer demand could materially adversely affect our sales, results of operations, and cash flow;
- our recent data breach or our failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information, which could result in an additional data breach, could materially adversely affect our financial condition and operating results;
- competition could negatively impact our business;

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- our reliance on foreign suppliers increases our risk of obtaining adequate, timely, and cost-effective product supplies;
- how well we manage our business;
- our ability to open new stores and increase comparable store sales growth, as our growth depends on our strategy of expanding our base of retail stores; and if, we are unable to continue this strategy, our ability to increase our sales, profitability, and cash flow could be impaired;
- damage to the reputation of the Michaels brand or our private and exclusive brands could adversely affect our sales;
- a weak fourth quarter would materially adversely affect our results of operations;
- risks associated with the vendors from whom our products are sourced could materially adversely affect our revenue and gross profit as our suppliers may fail us;
- 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;
- our marketing programs, e-commerce initiatives and use of consumer information are governed by an evolving set of laws and enforcement trends and unfavorable changes in those laws or trends, or our failure to comply with existing or future laws, could substantially harm our business and results of operations;
- 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;
- significant increases in inflation or commodity prices such as petroleum, natural gas, electricity, steel, wood, and paper may adversely affect our costs, including cost of merchandise;
- improvements to our supply chain may not be fully successful;
- our information systems may prove inadequate;

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- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements;
- changes in regulations or enforcement may adversely impact our business;
- 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;
- disruptions in the capital markets could increase our costs of doing business;
- our real estate leases generally obligate us for long periods, which subjects us to various financial risks;
- we have co-sourced certain of our information technology, accounts payable, payroll, accounting and human resources functions, and may co-source other administrative functions, which makes us more dependent upon third parties;
- we are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiaries;
- failure to attract or retain senior management could adversely affect our operations;
- failure to attract and retain quality sales, distribution center and other associates in appropriate numbers as well as experienced buying and management personnel could adversely affect our performance;
- our results may be adversely affected by serious disruptions or catastrophic events, including geo-political events and weather; and
- the interests of our indirect parent, FinCo Holdings, and the Sponsors may conflict with the interests of our debt holders.

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 February 1, 2014, and other reports from time to time filed with or furnished to the Securities and Exchange Commission (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 2014 relate to the 52 weeks ending January 31, 2015; and all references to fiscal 2013 relate to the 52 weeks ended February 1, 2014. In addition, all references herein to the first quarter of fiscal 2014 relate to the 13 weeks ended May 3, 2014; and all references to the first quarter of fiscal 2013 relate to the 13 weeks ended May 4, 2013.

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

	Quarter Ended	
	May 3, 2014	May 4, 2013
Michaels stores:		
Retail stores open at beginning of period	1,136	1,099
Retail stores opened during the period	8	15
Retail stores opened (relocations) during the period	5	4
Retail stores closed during the period		(1)
Retail stores closed (relocations) during the period	(5)	(4)
Retail stores open at end of period	1,144	1,113
Aaron Brothers stores:		
Retail stores open at beginning of period	121	125
Retail stores opened (relocations) during the period		1
Retail stores closed during the period	(3)	(3)
Retail stores closed (relocations) during the period		(1)
Retail stores open at end of period	118	122
Total store count at end of period	1,262	1,235
Other operating data:		
Average inventory per Michaels store (in thousands) (1)	\$ 783	\$ 723
Comparable store sales increase / (decrease) (2)	3.8%	(0.7)%

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

(2) Comparable store sales increase (decrease) represents the increase (decrease) 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 two weeks is not considered comparable during the month it closed. If a store is closed longer than two weeks but less than two months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than two months becomes comparable in its 14th month of operation after its reopening.

Results of Operations

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

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	Quarter Ended	
	May 3, 2014	May 4, 2013
Net sales	100.0%	100.0%
Cost of sales and occupancy expense	59.2	58.8
Gross profit	40.8	41.2
Selling, general, and administrative expense	26.8	27.4
Share-based compensation	0.4	0.3
Related party expenses	0.3	0.4
Store pre-opening costs	0.1	0.2
Operating income	13.2	12.9
Interest expense	3.9	4.7
Refinancing costs and losses on early extinguishment of debt		0.7
Income before income taxes	9.3	7.5
Provision for income taxes	4.0	2.9
Net income	5.3%	4.6%

Quarter Ended May 3, 2014 Compared to the Quarter Ended May 4, 2013

Net Sales Net sales of \$1,052 million for the first quarter of fiscal 2014 increased by \$59 million, or 5.9%, over the first quarter of fiscal 2013 due primarily to \$37 million of incremental revenue from our comparable store sales, and a \$22 million increase in non-comparable store sales. Comparable store sales increased 3.8% driven by a 1.3% increase in customer transactions, a 2.4% increase in the average ticket and 0.1% increase in custom framing deferred revenue. The fluctuation in the exchange rates between the United States and Canadian dollars adversely impacted the average ticket by 80 basis points. Comparable store sales growth was strongest in our children's crafts category due primarily to sales of the Rainbow Loom and replacement rubber bands. The fine arts supplies category also had strong performance.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased \$39 million to \$623 million in the first quarter of fiscal 2014 from \$584 million in the first quarter of fiscal 2013. Cost of sales increased by \$32 million primarily driven by a \$27 million increase from higher sales and \$3 million from lower recognition of vendor allowances compared to prior year. Occupancy expense increased \$7 million driven primarily by an incremental \$3 million for new stores and \$3 million higher store remodel expenses for the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013.

Cost of sales and occupancy expenses increased by 40 basis points as a percentage of Net sales to 59.2% for the first quarter of fiscal 2014 from 58.8% for the first quarter of fiscal 2013. Cost of sales increased by 50 basis points due primarily to the Rainbow Loom and replacement rubber bands having lower than average margin rates, as well as the lower recognition of vendor allowances compared to prior year. Occupancy costs decreased 10 basis points due to a 40 basis point lift for increased rent leverage on higher store sales, partially offset by a 30 basis point increase for higher remodel costs.

Selling, General and Administrative Expense Selling, general and administrative expense was \$282 million in the first quarter of fiscal 2014 compared to \$272 million in the first quarter of fiscal 2013. Selling, general and administrative expense increased \$5 million due to incremental store costs related to operating 48 additional Michaels stores at the end of the first quarter of fiscal 2014 compared to the end of the first quarter of fiscal 2013. Additionally, Selling, general and administrative expenses increased by \$3 million for 2014 payroll and bonus-related costs. As a percentage of Net sales, Selling, general and administrative expense decreased 60 basis points due to a 70 basis point decrease in payroll and payroll-related costs and a 20 basis point decrease due to lower strategic consulting fees, partially offset by an increase of 40 basis points in new

store costs.

Share-Based Compensation Share-based compensation expense increased to \$4 million in the first quarter of fiscal 2014 from \$3 million in the first quarter of fiscal 2013 primarily due to 2013 grants to certain company officers.

Related Party Expenses Related party expenses were \$3 million and \$4 million for the first quarters of fiscal 2014 and fiscal 2013, respectively, consisting of management fees and associated expenses paid to affiliates of two investment firms: Bain Capital Partners, LLC and The Blackstone Group, L.P. (collectively, together with their applicable affiliates, our Sponsors) and Highfields Capital Management, LP.

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Interest Expense Interest expense decreased \$6 million to \$41 million in the first quarter of fiscal 2014 from \$47 million in the first quarter of fiscal 2013. The decrease is attributable to a \$196 million reduction in our total debt outstanding and a lower average interest rate associated with the refinancing of our Senior Subordinated Notes.

Refinancing Costs and Losses on Early Extinguishment of Debt During the first quarter of fiscal 2013, we recorded a loss on the early extinguishment of debt of \$7 million, consisting of a \$5 million redemption premium and \$2 million to write off debt issuance costs related to the redemption of \$137 million in aggregate principal amount of our 11 3/8% Senior Subordinated Notes due November 1, 2016 (the Senior Subordinated Notes).

Provision for Income Taxes The effective tax rate was 42.9% for the first quarter of fiscal 2014. The effective rate was 37.8% for the first quarter of fiscal 2013. The current rate is higher than the prior year due to certain discrete items required to be recognized as a result of a change in tax status of our Canadian subsidiary. On February 2, 2014, the Company changed the corporate structure of our Canadian operations from a branch for U.S. tax purposes to a controlled foreign corporation of an indirect foreign subsidiary of Michaels Stores, Inc. The change was part of a restructuring to allow for increased flexibility and funding of our international growth. As a result of the change in tax status, the net deferred tax assets related to U.S. temporary differences for the branch were written off. In addition, the Company recognized as discrete events, a tax gain on the contribution of certain assets to the new entity as part of the transaction, as well as previously unrecognized currency losses. The effects of the write-off, the gain on the contribution, and the currency losses were discrete charges to the income tax provision of \$6 million, \$1 million, and (\$1) million respectively, during the first quarter. We currently estimate our effective tax rate for fiscal 2014 to be 38.5%.

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 (Restated Revolving Credit Facility) will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and anticipated growth for the foreseeable future. Our ability to satisfy our liquidity needs and continue to refinance or reduce debt could be adversely affected by the occurrence of any of the events described under Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended February 1, 2014 or our failure to meet our debt covenants as described in Cash Flow from Financing Activities . Our Restated Revolving Credit Facility provides senior secured financing of up to \$650 million, subject to a borrowing base. As of May 3, 2014, the borrowing base was \$650 million, of which we had no outstanding borrowings, \$61 million of outstanding letters of credit and \$589 million of unused borrowing capacity. Our cash and equivalents decreased \$122 million from \$234 million at February 1, 2014 to \$112 million at May 3, 2014.

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

The Company intends to use excess operating cash flows to repay portions of its indebtedness, depending on market conditions and growth opportunities. If the Company uses its excess cash flows to repay its debt, it will reduce the amount of excess cash available for additional capital expenditures. We made a \$30 million dividend payment to Holdings during the first quarter of fiscal year 2014. The Company also intends to continue to make dividend payments to FinCo Holdings to fund the August and February interest payments of \$30 million each on the

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\$800 million aggregate principal amount of 7.50% / 8.25% PIK Toggle Notes due 2018 issued by FinCo Holdings and FinCo Inc. (PIK Notes). To the extent that such dividends can be made by the Company in compliance with covenants applicable to it under the terms of its indebtedness, future interest payments on the PIK Notes, if paid in cash, will total \$60 million annually until maturity.

As of February 2, 2013, we had an aggregate principal amount of \$393 million of our Senior Subordinated Notes due November 2016. On February 27, 2013, we redeemed \$137 million in aggregate principal amount of the outstanding Senior Subordinated Notes with cash on hand and borrowings made under our Restated Revolving Credit Facility for an aggregate redemption price (including the applicable redemption premium and accrued and unpaid interest) of \$147 million. On December 19, 2013, the Company issued \$260 million of 2020 Senior Subordinated Notes. On December 19, 2013, we (i) instructed the trustee for the Senior Subordinated Notes to deliver a notice of redemption to the holders of the remaining outstanding Senior Subordinated Notes and (ii) deposit cash with such trustee to satisfy and discharge our obligations under the indenture governing our Senior Subordinated Notes and to fund the redemption, at a redemption price of 101.896%, of the remaining outstanding Senior Subordinated Notes. The redemption date was January 21, 2014. The 7 3/4% Senior Notes mature in 2018 (2018 Senior Notes), the senior secured term loan facility (Restated Term Loan Credit Facility) mature in or after 2018 and the 4.8% Senior Subordinated Notes mature in 2020 (2020 Senior Subordinated Notes). Although no assurance can be given, depending on market conditions and other factors, we plan to repay or refinance such indebtedness prior to maturity.

We and our subsidiaries, affiliates, and significant shareholders may continue from time to time to seek to retire or purchase our outstanding debt through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender

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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 used in operating activities during the first three months of fiscal 2014 was \$42 million compared to cash flow provided by operating activities of \$2 million during the first three months of fiscal 2013. The \$44 million change was primarily due to a \$48 million decrease due to the timing of inventory purchases and a \$31 million decrease due to the timing of vendor payments, partially offset by a \$14 million increase due to timing of income tax payments, a \$14 million increase due to the timing of interest payments on our senior subordinated notes, and a \$10 million increase due to higher Net income for the first quarter of fiscal year 2014 compared to the first quarter of fiscal year 2013.

Average inventory per Michaels store (including e-commerce and supporting distribution centers) increased 8.3% to \$783,000 at May 3, 2014, from \$723,000 at May 4, 2013, primarily due to timing of inventory receipts.

Cash Flow from Investing Activities

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

	Quarter Ended	
	May 3, 2014	May 4, 2013
	(in millions)	
New and relocated stores and stores not yet opened		
(1)	\$ 9	\$ 9
Existing stores	5	4
Information systems	12	6
Corporate and other	5	3
	\$ 31	\$ 22

(1) In the first three months of fiscal 2014, we incurred capital expenditures related to the opening of 13 Michaels stores including the relocation of 5 Michaels stores. In the first three months of fiscal 2013, we incurred capital expenditures related to the opening of 20 Michaels stores including the relocation of 4 Michaels stores and 1 Aaron Brothers store.

Cash Flow from Financing Activities

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Cash flow used in financing activities during the first three months of fiscal 2014 was \$49 million compared to cash provided by financing activities of \$19 million during the first three months of fiscal 2013. We made a \$30 million dividend payment to Holdings during the first quarter of fiscal year 2014. Cash flow used in financing activities for the first three months of fiscal 2013 was impacted by the redemption of the \$137 million of Senior Subordinated Notes at a redemption price of 103.792%, or a total of \$142 million, and net borrowings of \$181 million under our Restated Revolving Credit Facility.

Non-GAAP Measures

The following table sets forth certain non-GAAP measures the Company uses to manage the Company's performance and measure compliance with certain debt covenants. The Company defines EBITDA (excluding refinancing costs and losses on early extinguishment of debt) as Net income before interest, income taxes, depreciation, amortization and losses on early extinguishment of debt. Additionally, the table presents Adjusted Earnings before Interest, Taxes, Depreciation and Amortization (Adjusted EBITDA). The Company defines Adjusted EBITDA as EBITDA (excluding refinancing costs and losses on early extinguishment of debt) adjusted for certain defined amounts that are added to, or subtracted from, EBITDA (excluding refinancing costs and losses on early extinguishment of debt) (collectively, the Adjustments) in accordance with the Company's Restated Term Loan Credit Facility and Restated Revolving Credit Facility. The Adjustments are described in further detail in the table and the footnotes to the table below.

The Company has presented EBITDA (excluding refinancing costs and losses on early extinguishment of debt) and Adjusted EBITDA to provide investors with additional information to evaluate our operating performance and our ability to service our debt. Adjusted EBITDA is a required calculation under the Company's Restated Term Loan Credit Facility and its Restated Revolving Credit Facility. As it relates to the Restated Term Loan Credit 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

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payments as well as the determination of mandatory repayments of the loans. Under the Restated Term Loan Credit 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, and which under certain circumstances will be used as a maintenance covenant.

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

The table below shows a reconciliation of EBITDA (excluding refinancing costs and losses on early extinguishment of debt) and Adjusted EBITDA to Net income and Net cash (used in) provided by operating activities.

	Quarter Ended	
	May 3, 2014	May 4, 2013
	(in millions)	
Net cash (used in) provided by operating activities	\$ (42)	\$ 2
Depreciation and amortization	(27)	(25)
Share-based compensation	(4)	(4)
Debt issuance costs amortization	(2)	(2)
Refinancing costs and losses on early extinguishments of debt		(7)
Changes in assets and liabilities	131	82
Net income	56	46
Interest expense	41	47
Provision for income taxes	42	28
Refinancing costs and losses on early extinguishment of debt		7
Depreciation and amortization	27	25
EBITDA (excluding refinancing costs and losses on early extinguishment of debt)	166	153
Adjustments:		
Share-based compensation	4	4
Management fees to Sponsors and others	3	4
Store pre-opening costs	1	2
Store remodel costs	3	
Store closing costs	1	
Other (1)	1	2
Adjusted EBITDA	\$ 179	\$ 165

(1) Other adjustments relate to items such as the moving & relocation expenses, franchise taxes and signing bonuses.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiaries. Our sales, costs and expenses of our Canadian subsidiaries, when translated into U.S. dollars, can fluctuate due to exchange rate movement. As of May 3, 2014, a 10% increase or decrease in the exchange rate of the U.S. and Canadian dollar would have an approximate \$1 million impact on Net income for the quarter ended May 3, 2014.

We have market risk exposure arising from changes in interest rates on our Restated Term Loan Credit Facility and our Restated Revolving Credit Facility, together the (Senior Secured Credit Facilities). The interest rates on our Senior Secured Credit

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Facilities will reprice periodically, which will impact our earnings and cash flow. The interest rates on our 2018 Senior Notes and Senior Subordinated Notes are fixed. Based on our overall interest rate exposure to variable rate debt outstanding as of May 3, 2014, a 1% increase or decrease in interest rates would increase or decrease income before income taxes by approximately \$16 million. A 1% increase or decrease in interest rates would decrease or increase the fair value of our long-term fixed rate debt by approximately \$12 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

Item 4. Controls and Procedures.

Included in this Form 10-Q are certifications by our Chief Executive Officer and our Chief Financial Officer, which are required in accordance with Rule 15d-14 of the Securities Exchange Act of 1934, as amended. This section includes information concerning the controls and controls evaluation referred to in the certifications.

Evaluation of Disclosure Controls and Procedures

We maintain a set of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated by the SEC under the Securities Exchange Act of 1934) designed to provide reasonable assurance information, which is required to be timely disclosed, is accumulated and communicated to management in a timely fashion. We note the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

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

MICHAELS STORES, INC.

Part II OTHER INFORMATION

Item 1. Legal Proceedings.

Information regarding legal proceedings is incorporated herein by reference from Note 6 to our Consolidated Financial Statements.

Item 5. Other Information

Iran Sanctions Related Disclosure

Under the Iran Threat Reduction and Syrian Human Rights Act of 2012, which added Section 13(r) of the Securities Exchange Act of 1934, we are required to include certain disclosures in our periodic reports if we or any of our affiliates knowingly engaged in certain specified activities during the period covered by this Quarterly Report on Form 10-Q. Because the SEC defines the term "affiliate" broadly, it includes any entity controlled by us as well as any person or entity that controls us or is under common control with us ("control" is also construed broadly by the SEC). We do not believe we and/or our consolidated subsidiaries have knowingly engaged in any transaction or dealing reportable under Section 13(r) of the Exchange Act during the quarter ended May 3, 2014.

The Blackstone Group L.P., one of our Sponsors, informed us of disclosures publicly filed and/or provided to them by Travelport Limited, which may be considered their affiliates. These disclosures are included in, and the Company hereby incorporates by reference herein, Exhibit 99.1 to this this Quarterly Report on Form 10-Q.

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Item 6. Exhibits.

(a) Exhibits:

Exhibit Number	Description of Exhibit
10.1	Form of Fiscal Year 2014 Bonus Plan for Executive Officers (previously filed as Exhibit 10.1 to Form 8-K filed by the Company on March 31, 2014, SEC file No. 001-09338)
31.1	Certifications of Carl S. Rubin 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).
99.1	Section 13 (r) Disclosure.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

*Management contract or compensatory plan or arrangement.

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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/ Carl S. Rubin
Carl S. Rubin
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Charles M. Sonsteby
Charles M. Sonsteby
Chief Administrative Officer & Chief Financial Officer
(Principal Financial Officer)

Dated: June 2, 2014