MICHAELS STORES INC
Form 10-Q
December 10, 2008
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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 November 1, 2008

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	**75-1943604**

(State or other jurisdiction of incorporation or organization)	(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 x No o

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. (Check one):

Large accelerated filer o	Accelerated filer o
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of December 8, 2008, 118,497,202 shares of the Registrant s Common Stock were outstanding.

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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)

	November 1, 2008	February 2, 2008	November 3, 2007
ASSETS			
Current assets:			
Cash and equivalents	$ 92	$ 29	$ 57
Merchandise inventories	1,083	845	1,027
Prepaid expenses and other	83	70	74
Deferred income taxes	30	31	35
Income tax receivable	38	5	78
Current assets - discontinued operations			9
Total current assets	1,326	980	1,280
Property and equipment, at cost	1,204	1,155	1,143
Less accumulated depreciation	(802)	(722)	(698)
	402	433	445
Goodwill	94	94	116
Debt issuance costs, net of accumulated amortization of $35 at November 1, 2008; $22 at February 2, 2008; and $18 at November 3, 2007	90	103	107
Other assets		4	7
Non-current assets - discontinued operations			(1)
	184	201	229
Total assets	$ 1,912	$ 1,614	$ 1,954
LIABILITIES AND STOCKHOLDERS DEFICIT			
Current liabilities:			
Accounts payable	$ 274	$ 221	$ 282
Accrued liabilities and other	336	332	333
Current portion of long-term debt	432	122	445
Current liabilities - discontinued operations	1	4	2
Total current liabilities	1,043	679	1,062
Long-term debt	3,751	3,741	3,736
Deferred income taxes	5	4	16
Other long-term liabilities	76	80	81
Long-term liabilities - discontinued operations	1	2	1

Total long-term liabilities		3,833		3,827		3,834
		4,876		4,506		4,896
Commitments and contingencies						
Stockholders deficit:						
Common Stock, $0.10 par value, 220,000,000 shares authorized; 118,376,402 shares issued and outstanding at November 1, 2008; 118,421,069 shares issued and outstanding at February 2, 2008; 118,451,736 shares issued and outstanding at November 3, 2007		12		12		12
Additional paid-in capital		17		12		11
Accumulated deficit		(2,996)		(2,926)		(2,980)
Accumulated other comprehensive income		3		10		15
Total stockholders deficit		(2,964)		(2,892)		(2,942)
Total liabilities and stockholders deficit	$	1,912	$	1,614	$	1,954

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	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
Net sales	$ 906	$ 934	$ 2,549	$ 2,561
Cost of sales and occupancy expense	584	591	1,623	1,602
Gross profit	322	343	926	959
Selling, general, and administrative expense	247	261	765	758
Transaction expenses		8		29
Related party expenses	4	4	12	12
Store pre-opening costs	3	3	6	6
Operating income	68	67	143	154
Interest expense	77	95	231	285
Other (income) and expense, net	3	(6)	3	(11)
Loss before income taxes and discontinued operations	(12)	(22)	(91)	(120)
Provision (benefit) for income taxes	8	(9)	(21)	(42)
Loss before discontinued operations	(20)	(13)	(70)	(78)
Discontinued operations loss, net of income tax		(5)		(7)
Net loss	$ (20)	$ (18)	$ (70)	$ (85)

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	
	November 1, 2008	**November 3, 2007**
Operating activities:		
Net loss	$ (70)	$ (85)
Adjustments:		
Depreciation and amortization	94	94
Share-based compensation	6	4
Deferred financing costs amortization	13	13
Accretion of subordinated discount notes	29	25
Impairment of discontinued operations		6
Other	1	(1)
Changes in assets and liabilities:		
Merchandise inventories	(250)	(188)
Prepaid expenses and other	(5)	
Deferred income taxes and other	3	(14)
Accounts payable	51	56
Accrued interest	(9)	10
Accrued liabilities and other	13	39
Income taxes receivable	(37)	(52)
Other long-term liabilities	(5)	13
Net cash used in operating activities	(166)	(80)
Investing activities:		
Additions to property and equipment	(66)	(86)
Net cash used in investing activities	(66)	(86)
Financing activities:		
Borrowings on asset-based revolving credit facility	749	793
Payments on asset-based revolving credit facility	(439)	(578)
Repayments on senior secured term loan facility	(18)	(18)
Equity investment of Management		8
Repurchase of new Common Stock	(1)	(1)
Payments of capital leases	(4)	(6)
Change in cash overdraft	9	(5)
Other	(1)	
Net cash provided by financing activities	295	193
Net increase in cash and equivalents	63	27
Cash and equivalents at beginning of period	29	30
Cash and equivalents at end of period	$ 92	$ 57

See accompanying notes to consolidated financial statements.

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MICHAELS STORES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Nine Months Ended November 1, 2008

(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 February 2, 2008.

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

Because of the seasonal nature of our business, the results of operations for the three and nine months ended November 1, 2008 are not indicative of the results to be expected for the entire year.

The balance sheet at February 2, 2008 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. For further information, refer to the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended February 2, 2008.

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 2008 relate to the 52 weeks ending January 31, 2009, and all references to fiscal 2007 relate to the 52 weeks ended February 2, 2008. In addition, all references herein to the third quarter of fiscal 2008 relate to the 13 weeks ended November 1, 2008 and all references to the third quarter of fiscal 2007 relate to the 13 weeks ended November 3, 2007. Finally, all references to the nine months ended November 1, 2008 relate to the 39 weeks ended November 1, 2008, and the nine months ended November 3, 2007 relate to the 39 weeks ended November 3, 2007.

Change in Accounting Estimates

During the third quarter of 2008, we reduced our bonus expense accrual by approximately $15 million primarily due to lower than planned results from operations given the soft macroeconomic environment. Bonus expense is included in selling, general and administrative expense on the consolidated statements of operations.

See Note 8 for further information on the change in our effective tax rate.

Reclassifications

Certain prior year amounts were reclassified to conform to current year presentation. These reclassifications consist primarily of the presentation of discontinued operations.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. SFAS 157 was originally effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In November 2007, the FASB placed a one year deferral for the implementation of SFAS 157 for nonfinancial assets and liabilities; however, SFAS 157 is effective for fiscal years beginning after November 15, 2007 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. We adopted all requirements of SFAS 157 as they relate to financial assets and liabilities on February 3, 2008. See Note 7 for further information on the impact of this standard to financial assets and liabilities. The requirements related to nonfinancial assets and liabilities will be adopted on February 1, 2009, as allowed by SFAS 157. We have not yet determined the impact, if any, on our consolidated financial statements for these nonfinancial assets and liabilities.

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In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits companies to measure certain financial instruments and other items at fair value (at specified measurement dates) that are not currently required to be measured at fair value. Any unrealized gains or losses applicable to those items measured at fair value shall be reported in earnings. The decision to apply fair value shall generally be made on an instrument by instrument basis, is irrevocable, and is applied only to an entire instrument. We adopted SFAS 159 on February 3, 2008, and there was no impact on our consolidated financial statements as we did not choose to measure any eligible financial assets or liabilities at fair value.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141, *Business Combinations*. The statement retains the purchase method of accounting used in business combinations, but replaces SFAS 141 by establishing principles and requirements for the recognition and measurement of assets, liabilities and goodwill, including the requirement that most transaction costs and restructuring costs be expensed. In addition, the statement requires disclosures to enable users to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will adopt SFAS 141R on February 1, 2009 for acquisitions on or after this date.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*. SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of, and gains and losses on, derivative contracts, and details of credit-risk-related contingent features in hedged positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted for in accordance with SFAS 133 and its related interpretation, and how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We will adopt the new disclosure requirements of SFAS 161 in the first quarter of fiscal 2009.

Note 2. Discontinued Operations

On October 16, 2007, we announced plans to align resources around our core retail chains, Michaels and Aaron Brothers. As a result, we discontinued our concept businesses, Recollections and Star Decorators Wholesale. As of the end of fiscal 2007, we had closed 11 Recollections and three of the four Star locations. The remaining Star location has been converted to a Michaels store.

The unaudited consolidated financial statements, accompanying notes and other information provided in this Quarterly Report on Form 10-Q reflect these concept businesses as discontinued operations for all periods presented.

Summarized financial information with respect to the results of operations of these discontinued operations is as follows:

	Quarter Ended November 3, 2007	Nine Months Ended November 3, 2007
	(in millions)	
Net sales	$ 6	$ 16

Loss from discontinued operations before income taxes	$	(8)	$	(10)
Income tax benefit		3		3
Net loss from discontinued operations	$	(5)	$	(7)

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Note 3. Share-Based Compensation

On February 15, 2007, our stockholders and Board of Directors approved the 2006 Equity Incentive Plan (2006 Plan), which provides for the grant of share-based awards exercisable for up to 14.2 million shares of Common Stock. The table below sets forth a summary of stock option activity for the three and nine months ended November 1, 2008 and November 3, 2007. As of November 1, 2008, there were 187,467 shares of restricted stock outstanding, 10.3 million share-based awards outstanding and up to 3.7 million shares of Common Stock remaining available for grant under the 2006 Plan.

	Quarter Ended		Nine Months Ended	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
	(in millions)			
Outstanding at beginning of period	10.4	11.4	11.1	
Grants	0.5	0.4	2.7	13.4
Cancellations	(0.6)	(0.3)	(3.5)	(1.9)
Outstanding at end of period	10.3	11.5	10.3	11.5

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 awards ranged from $15 per share to $52.50 per share, as determined by the Board of Directors. Share-based compensation expense associated with these awards was $2 million and $1 million for the third quarter of fiscal 2008 and 2007, respectively, and $6 million and $4 million for the nine months ended November 1, 2008 and November 3, 2007, respectively.

Note 4. 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.

	November 1, 2008	February 2, 2008	Interest Rate
	(in millions)		
Senior notes	$ 750	$ 750	10.000%
Senior subordinated notes	400	400	11.375%
Subordinated discount notes	322	293	13.000%
Senior secured term loan	2,303	2,321	Variable
Asset-based revolving credit facility	407	97	Variable
Other	1	2	Variable
Total debt	4,183	3,863	
Less current portion	432	122	
Long-term debt	$ 3,751	$ 3,741	

Asset-based revolving credit facility

Our senior secured asset-based revolving credit facility, which we entered into on October 31, 2006, with Banc of America, N.A. and other lenders (the Asset-based revolving credit facility) provides senior secured financing of up to $1.0 billion, subject to a borrowing base as described in our Annual Report on Form 10-K. As of November 1, 2008, the borrowing base was $989 million with $510 million of unused availability.

Senior secured term loan facility

Borrowings under our senior secured term loan facility, which we entered into on October 31, 2006, with Deutsche Bank A.G. New York Branch and other lenders (the Senior secured term loan facility) bore interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the prime rate of Deutsche Bank and (2) the federal funds effective rate plus ½ of 1% or (b) a LIBOR rate, subject to certain adjustments, in each case plus an applicable margin. The applicable margin at November 1, 2008 was 1.25% with respect to base rate borrowings and 2.25% with respect to LIBOR borrowings, subject to adjustments based on the leverage and ratings thresholds set forth in the Senior secured term loan facility agreement.

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Note 5. Comprehensive (Loss) Income

Our comprehensive (loss) income is as follows:

	Quarter Ended		Nine Months Ended	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
	(in millions)			
Net loss	$ (20)	$ (18)	$ (70)	$ (85)
Other comprehensive income (loss):				
Derivative gain (loss)	5	(2)	7	(2)
Foreign currency translation adjustment and other	(12)	6	(14)	10
Comprehensive loss	$ (27)	$ (14)	$ (77)	$ (77)

Note 6. Derivative Instruments

We are exposed to fluctuations in exchange rates between the US and Canadian dollars, as the functional currency of our Canadian subsidiary is the Canadian dollar. During the second quarter of fiscal 2008, we executed foreign currency forward contracts to mitigate the effects of currency fluctuations, which we designated as a cash flow hedge. The objective of the forward contracts is to hedge intercompany payments for forecasted purchases of inventory by our Canadian subsidiary, which are denominated in US dollars. The term of this cash flow hedge extends through the first quarter of fiscal 2009.

To achieve our objective and to minimize the risk of ineffectiveness, the notional values represent a portion of our Canadian subsidiary s forecasted intercompany purchases. Hedge ineffectiveness is recorded in Other income, as required. For the quarter ended November 1, 2008, the ineffective portion of the hedge was immaterial.

For the portion of the hedge that is effective, as defined, the change in fair value of that hedge will initially be recorded in Other comprehensive income. As the underlying inventory is sold to our customers, amounts will be reclassified from Other comprehensive income to Cost of sales and occupancy expense in the statement of operations. The fair value of the hedge for the quarter ended November 1, 2008 was $5 million.

The table below provides the remaining quarterly notional values and the average CAD/USD exchange rate associated with the hedge

(dollars in millions).

Period	CAD Amount	USD Amount	Rate
Quarter 4, 2008	$ 17.4	$ 17.4	1.001
Quarter 1, 2009	12.2	12.2	1.001

	$	29.6	$	29.6	1.001

Note 7. Fair Value Measurements

As defined in SFAS No. 157, 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. SFAS No. 157 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.*

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The following table presents net financial assets (liabilities) accounted for at fair value on a recurring basis as of November 1, 2008 (in millions):

	Level 1	Level 2	Level 3	Total
Cash equivalents	$ 52	$	$	$ 52
Foreign Currency Derivative Instruments		5		5

Cash equivalents consist of highly liquid investments, with a maturity of 90 days or less at the date of purchase, including U.S. Treasury bills, various government obligations, and money market funds.

Derivatives in Level 2 are measured based on a variety of pricing factors, which include the market price of the derivative instrument available in the dealer-market, which have been corroborated with market data. See Note 6 for additional information on our derivative instruments.

Note 8. Income Taxes

The Company recorded an income tax provision of $8 million for the third quarter of fiscal 2008. The expense relates primarily to a projected annual tax rate decrease due to changes in our results of operations, combined with the Company s limited ability to recognize foreign tax credits related to its profitable Canadian operations. During the third quarter of fiscal 2007, the Company recorded a tax benefit of $9 million at an effective tax rate of 39.0%.

The Company s effective tax rate was 23.0% and 34.9% for the first nine months of fiscal 2008 and fiscal 2007, respectively. The decrease in our effective tax rate is the result of the Company s limited ability to recognize foreign tax credits related to its profitable Canadian operations. Our effective tax rate is highly sensitive to changes as a result of the low base of expected income or loss for the period and the comparatively significant effect on the tax rate caused by permanent differences.

Our policy is to evaluate the appropriateness of our deferred tax assets and record a valuation allowance to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized. If different assumptions had been used, our tax expense, assets, and liabilities could have varied from recorded amounts. If actual results differ from estimated results or if we adjust theses assumptions in the future, we may need to adjust our deferred tax assets or liabilities, which could impact our effective tax rate.

Note 9. 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 2, 2008 and our Quarterly Reports on Form 10-Q for the quarterly periods ended May 3, 2008 and August 2, 2008.

Employee Class Action Claims

Cotton Claim

On December 20, 2002, James Cotton, a former store manager of Michaels of Canada, ULC, our wholly-owned subsidiary, and Suzette Kennedy, a former assistant manager of Michaels of Canada, commenced a purported class proceeding against Michaels of Canada and Michaels Stores, Inc. on behalf of themselves and current and former employees employed in Canada. The Cotton claim was filed in the Ontario Superior Court of Justice and alleges that the defendants violated employment standards legislation in Ontario and other provinces and territories of Canada by failing to pay overtime compensation as required by that legislation. The Cotton claim also alleges that this conduct was in breach of the contracts of employment of those individuals. The Cotton claim seeks a declaration that the defendants have acted in breach of applicable legislation, payment to current and former employees for overtime, damages for breach of contract, punitive, aggravated and exemplary damages, interest, and costs. In May of 2005, the plaintiffs delivered material in support of their request that this action be certified as a class proceeding. Michaels filed and served its responding materials opposing class certification on January 31, 2006. A hearing with respect to certification has been set for early 2009. We intend to contest certification of this claim as a class action. Further, we believe we have certain defenses on the merits and intend to defend this lawsuit vigorously. We are unable to estimate a range of possible loss, if any, in this claim.

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Hernandez Claim

On April 12, 2007, Antonio Hernandez and five other floor care contractor employees filed a purported class action proceeding in Superior Court of California, County of Orange. The plaintiffs filed this action against Michaels Stores, Inc., Marshalls and TJ Maxx on behalf of themselves and all similarly-situated individuals in California. The Hernandez suit alleged that they were joint employees with Michaels, Marshalls, TJ Maxx, and Creative Building Maintenance. The suit also alleged that Michaels conduct violates California s unfair competition law. The plaintiffs sought injunctive relief, damages for unpaid overtime, itemized wage statement penalties, meal and rest break penalties, interest, and attorneys fees. The parties reached a settlement for an immaterial amount in September 2008, and on November 14, 2008, the Court dismissed the case.

Consumer Class Action Claims

Carson Claim

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding in Superior Court of California, County of San Diego. Carson filed this action against Michaels Stores, Inc., on behalf of herself and all similarly-situated California consumers. The Carson suit alleges that Michaels unlawfully requested and recorded personally identifiable information (i.e., her zip code) as part of a credit card transaction. The plaintiff seeks statutory penalties, costs, interest, and attorneys fees. We intend to contest certification of this claim as a class action. Further, we believe we have certain defenses on the merits and intend to defend this lawsuit vigorously. We are unable to estimate a range of possible loss, if any, in this claim.

Note 10. Segments

We consider our Michaels and Aaron Brothers operations to be our operating segments for purposes of determining reportable segments based on the criteria of SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. We determined that our Michaels and Aaron Brothers operating segments have similar economic characteristics and meet the aggregation criteria set forth in paragraph 17 of SFAS No. 131. 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, discontinued operations, goodwill impairment, depreciation and amortization (EBITDA). In addition, an element of base incentive compensation targets for certain management personnel are based on EBITDA. A reconciliation of EBITDA to loss before income taxes and discontinued operations is presented below.

	Quarter Ended		Nine Months Ended	
	November 1, 2008	**November 3, 2007**	**November 1, 2008**	**November 3, 2007**

(in millions)

Loss before income taxes and discontinued operations	$	(12)	$	(22)	$	(91)	$	(120)
Interest expense		77		95		231		285
Interest income								(1)
Depreciation and amortization		31		31		94		93
EBITDA	$	96	$	104	$	234	$	257

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Our sales and assets by country are as follows:

		Net Sales		Total Assets
		(in millions)		
Quarter ended November 1, 2008:				
United States	$	833	$	1,801
Canada		73		111
Consolidated Total	$	906	$	1,912
Quarter ended November 3, 2007:				
United States	$	856	$	1,850
Canada		78		104
Consolidated Total	$	934	$	1,954
Nine Months ended November 1, 2008:				
United States	$	2,342	$	1,801
Canada		207		111
Consolidated Total	$	2,549	$	1,912
Nine Months ended November 3, 2007:				
United States	$	2,364	$	1,850
Canada		197		104
Consolidated Total	$	2,561	$	1,954

We present assets based on their physical, geographic location. Certain assets located in the United States are also used to support our Canadian operations, but we do not allocate these assets to Canada.

Note 11. Related Party Transactions

As previously disclosed, on October 31, 2006, substantially all of the Common Stock of Michaels Stores, Inc. was acquired through a merger transaction (the Merger) by affiliates of Bain Capital Partners, LLC and The Blackstone Group. 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 2008 and fiscal 2007, and $10 million during each of the nine months ended November 1, 2008 and November 3, 2007. These expenses are included in related party expenses on the statement of operations.

Bain Capital owns a majority ownership stake in an external vendor we utilize to print our circular advertisements. Expenses associated with this vendor during the third quarter of fiscal 2008 and fiscal 2007 were $10 million and $11 million, respectively, and $26 million and $29 million for the nine months ended November 1, 2008 and November 3, 2007, respectively. These expenses are included in selling, general and administrative expense on the consolidated statements of operations.

During the first quarter of fiscal 2007, The Blackstone Group acquired a majority ownership stake in an external vendor we utilize to count our store inventory. Expenses associated with this vendor during the third quarter of each of fiscal 2008 and 2007 were $2 million. Expenses for the nine months ended November 1, 2008 and November 3, 2007 were $5 million and $4 million, respectively. These expenses are included in selling, general and administrative expense on the consolidated statements of operations.

During the third quarter of fiscal 2007, Bain Capital acquired an ownership stake in an external vendor we utilize for non-merchandise supplies. Expenses associated with this vendor during the third quarter of fiscal 2008 and the nine months ended November 1, 2008 were $1 million and $2 million, respectively. These expenses are included in selling, general and administrative expense on the consolidated statements of operations.

During fiscal 2008, we began utilizing an external vendor for waste management services that is partially owned by The Blackstone Group. Expenses associated with this vendor during the first nine months of fiscal 2008 were $2 million. These expenses are included in selling, general and administrative expense on the consolidated statements of operations.

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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 the first nine months of fiscal 2008. During the first nine months of fiscal 2007, the Company sold 541,006 shares to officers. Also, during the third quarter and first nine months of fiscal 2008, we repurchased 6,000 and 111,334 shares, respectively, from officers who are no longer with the Company. During the third quarter and first nine months of fiscal 2007, the Company repurchased 13,333 and 62,666 shares, respectively, from officers who are no longer with the Company.

In connection with the consummation of the Merger, the Company entered into a Separation Agreement with each of Charles Wyly and Sam Wyly, executive officers and directors of the Company prior to the Merger. Under the Separation Agreements, each of Charles Wyly and Sam Wyly received a lump sum payment of $3.0 million in exchange for his agreement to adhere to certain non-competition, non-solicitation and confidentiality restrictions. We are amortizing these Separation Agreements over two years. These expenses are included in related party expenses on the consolidated statements of operations.

Note 12. Condensed Consolidating Financial Information

All of the Company s obligations under the Senior notes, Senior subordinated notes, Subordinated discount notes, Senior secured term loan, and Asset-based revolving credit facility are guaranteed by the Parent and Guarantor subsidiaries. Currently, Aaron Brothers Card Services, LLC is a non-guarantor subsidiary that was organized on July 11, 2008. As of November 1, 2008, the financial statements of Aaron Brothers Card Services, LLC were immaterial.

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

	November 1, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 86	$ 6	$	$ 92
Merchandise inventories	776	307		1,083
Intercompany receivables		410	(410)	
Other	97	54		151
Total current assets	959	777	(410)	$ 1,326
Property and equipment, net	294	108		402
Goodwill, net	94			94
Investment in subsidiaries	517		(517)	
Other assets	76	14		90
Total assets	$ 1,940	$ 899	$ (927)	$ 1,912
LIABILITIES AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	$ 30	$ 244	$	$ 274
Accrued liabilities and other	258	78		336
Current portion of long-term debt	432			432
Intercompany payable	410		(410)	
Other	(39)	40		1
Total current liabilities	1,091	362	(410)	1,043
Long-term debt	3,751			3,751
Other long-term liabilities	62	20		82
Total stockholders equity (deficit)	(2,964)	517	(517)	(2,964)
Total liabilities and stockholders equity (deficit)	$ 1,940	$ 899	$ (927)	$ 1,912

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Supplemental Condensed Consolidating Balance Sheet

	February 2, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
ASSETS				
Current assets:				
Cash and equivalents	$ 26	$ 3	$	$ 29
Merchandise inventories	622	223		845
Intercompany receivables		250	(250)	
Other	61	45		106
Total current assets	709	521	(250)	980
Property and equipment, net	308	125		433
Goodwill, net	94			94
Investment in subsidiaries	325		(325)	
Other assets	91	16		107
Total assets	$ 1,527	$ 662	$ (575)	$ 1,614
LIABILITIES AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	$ 29	$ 192	$	$ 221
Accrued liabilities and other	249	83		332
Current portion of long-term debt	122			122
Intercompany payable	250		(250)	
Other	(37)	41		4
Total current liabilities	613	316	(250)	679
Long-term debt	3,741			3,741
Other long-term liabilities	65	21		86
Total stockholders equity (deficit)	(2,892)	325	(325)	(2,892)
Total liabilities and stockholders equity (deficit)	$ 1,527	$ 662	$ (575)	$ 1,614

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Supplemental Condensed Consolidating Balance Sheet

	November 3, 2007			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
		(in millions)		
ASSETS				
Current assets:				
Cash and equivalents	$ 40	$ 17	$	$ 57
Merchandise inventories	756	271		1,027
Intercompany receivables		275	(275)	
Other	176	20		196
Total current assets	972	583	(275)	1,280
Property and equipment, net	316	129		445
Goodwill, net	94	22		116
Investment in subsidiaries	320		(320)	
Other assets	97	16		113
Total assets	$ 1,799	$ 750	$ (595)	$ 1,954
LIABILITIES AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	$ 40	$ 242	$	$ 282
Accrued liabilities and other	255	78		333
Current portion of long-term debt	445			445
Intercompany payable	275		(275)	
Other	(83)	85		2
Total current liabilities	932	405	(275)	1,062
Long-term debt	3,736			3,736
Other long-term liabilities	73	25		98
Total stockholders equity (deficit)	(2,942)	320	(320)	(2,942)
Total liabilities and stockholders equity (deficit)	$ 1,799	$ 750	$ (595)	$ 1,954

Supplemental Condensed Consolidating Statement of Operations

	Quarter Ended November 1, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
		(in millions)		
Net sales	$ 796	618	$ (508)	$ 906
Cost of sales and occupancy expense	554	538	(508)	584
Gross profit	242	80		322
Selling, general, and administrative expense	221	26		247
Transaction expenses				
Related party expenses	4			4
Store pre-opening costs	2	1		3
Operating income	15	53		68
Interest expense	77			77
Other (income) and expense, net		3		3
Intercompany charges (income)	23	(23)		
Equity in earnings of subsidiaries	73		(73)	
	(12)	73	(73)	(12)

Income (loss) before income taxes and discontinued operations								
Provision (benefit) for income taxes		8		28		(28)		8
Income (loss) before discontinued operations		(20)		45		(45)		(20)
Discontinued operations loss, net of income tax								
Net income (loss)	$	(20)	$	45	$	(45)	$	(20)

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Supplemental Condensed Consolidating Statement of Operations

	Quarter Ended November 3, 2007			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 818	587	$ (471)	$ 934
Cost of sales and occupancy expense	555	507	(471)	591
Gross profit	263	80		343
Selling, general, and administrative expense	229	32		261
Transaction expenses	8			8
Related party expenses	4			4
Store pre-opening costs	3			3
Operating income	19	48		67
Interest expense	95			95
Other (income) and expense, net	(1)	(5)		(6)
Intercompany charges (income)	24	(24)		
Equity in earnings of subsidiaries	77		(77)	
Income (loss) before income taxes and discontinued operations	(22)	77	(77)	(22)
Provision (benefit) for income taxes	(9)	32	(32)	(9)
Income (loss) before discontinued operations	(13)	45	(45)	(13)
Discontinued operations loss, net of income tax	(5)			(5)
Net income (loss)	$ (18)	$ 45	$ (45)	$ (18)

Supplemental Condensed Consolidating Statement of Operations

	Nine Months Ended November 1, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 2,227	1,554	$ (1,232)	$ 2,549
Cost of sales and occupancy expense	1,546	1,309	(1,232)	1,623
Gross profit	681	245		926
Selling, general, and administrative expense	673	92		765
Transaction expenses				
Related party expenses	12			12
Store pre-opening costs	5	1		6
Operating (loss) income	(9)	152		143
Interest expense	231			231
Other (income) and expense, net		3		3
Intercompany charges (income)	57	(57)		
Equity in earnings of subsidiaries	206		(206)	
Income (loss) before income taxes and discontinued operations	(91)	206	(206)	(91)
Provision (benefit) for income taxes	(21)	47	(47)	(21)
Income (loss) before discontinued operations	(70)	159	(159)	(70)
Discontinued operations loss, net of income tax				
Net income (loss)	$ (70)	$ 159	$ (159)	$ (70)

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Supplemental Condensed Consolidating Statement of Operations

	Nine Months Ended November 3, 2007			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Net sales	$ 2,244	1,400	$ (1,083)	$ 2,561
Cost of sales and occupancy expense	1,525	1,160	(1,083)	1,602
Gross profit	719	240		959
Selling, general, and administrative expense	664	94		758
Transaction expenses	29			29
Related party expenses	12			12
Store pre-opening costs	5	1		6
Operating income	9	145		154
Interest expense	285			285
Other (income) and expense, net	(2)	(9)		(11)
Intercompany charges (income)	58	(58)		
Equity in earnings of subsidiaries	212		(212)	
Income (loss) before income taxes and discontinued operations	(120)	212	(212)	(120)
Provision (benefit) for income taxes	(42)	74	(74)	(42)
Income (loss) before discontinued operations	(78)	138	(138)	(78)
Discontinued operations loss, net of income tax	(7)			(7)
Net income (loss)	$ (85)	$ 138	$ (138)	$ (85)

Supplemental Condensed Consolidating Statement of Cash Flows

	Nine Months Ended November 1, 2008			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating activities:				
Net cash (used in) provided by operating activities	$ (176)	$ 113	$ (103)	$ (166)
Investing activities:				
Cash paid for property and equipment	(59)	(7)		(66)
Net cash used in investing activities	(59)	(7)		(66)
Financing activities:				
Net borrowings of long-term debt	292			292
Intercompany dividends		(103)	103	
Other financing activities	3			3
Net cash provided by (used in) financing activities	295	(103)	103	295
Increase in cash and equivalents	60	3		63
Beginning cash and cash equivalents	26	3		29
Ending cash and cash equivalents	$ 86	$ 6	$	$ 92

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Supplemental Condensed Consolidating Statement of Cash Flows

	Nine Months Ended November 3, 2007			
	Parent Company	Guarantor Subsidiaries	Eliminations	Consolidated
	(in millions)			
Operating Activities:				
Net cash (used in) provided by operating activities	$ (123)	$ 149	$ (106)	$ (80)
Investing Activities:				
Cash paid for property and equipment	(56)	(30)		(86)
Net cash used in investing activities	(56)	(30)		(86)
Financing Activities:				
Net borrowings of long-term debt	197			197
Intercompany dividends		(106)	106	
Other financing activities	(4)			(4)
Net cash provided by (used in) financing activities	193	(106)	106	193
Increase in cash and equivalents	14	13		27
Beginning cash and cash equivalents	26	4		30
Ending cash and equivalents	$ 40	$ 17	$	$ 57

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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 a 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 2, 2008. 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:

- the continuation or further deterioration of the current worldwide economic downturn;
- government *or consumer concerns about product safety and recalls or changes to laws, including the recently enacted* Consumer Product Safety Improvement Act of 2008, *could harm our reputation, financial position, earnings or cash flow*;
- if the Employee Free Choice Act is adopted, it would be easier for our employees to obtain union representation and our businesses could be impacted as a result;
- changes in customer demand could materially adversely affect our sales, operating results, and cash flow;
- unexpected or unfavorable consumer responses to our promotional or merchandising programs could materially adversely affect our sales, operating results, and cash flow;

- risks related to our substantial indebtedness, as our substantial 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;

- our ability to open new stores, as our growth depends on our strategy of increasing our number of stores and if we are unable to continue this strategy, our ability to increase our sales, profitability, and cash flow could be impaired;

- how well we manage our business;

- we may fail to optimize or adequately maintain our perpetual inventory and automated replenishment systems;

- improvements to our supply chain may not be fully successful;

- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements;

- changes in consumer confidence could result in a reduction in consumer spending on items perceived to be discretionary;

- failure to adequately maintain the security of our electronic and other confidential information could materially adversely affect our financial condition and operating results;

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- our suppliers may fail us;
- our reliance on foreign suppliers increases our risk of obtaining adequate, timely, and cost-effective product supplies;
- product recalls and/or product liability may adversely impact our operations and merchandise offerings;
- 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;
- our information systems may prove inadequate;
- a weak fourth quarter would materially adversely affect our operating results;
- competition could negatively impact our operations; and
- the interests of our controlling stockholders may conflict with the interests of our creditors.

For more details on factors that may cause actual results to differ materially from such forward-looking statements, please see Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended February 2, 2008, Item 1A of Part II to our Quarterly Report on Form 10-Q for the quarter ended May 3, 2008, Item 1A of Part II of this Quarterly Report on Form 10-Q, 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 2008 relate to the 52 weeks ending January 31, 2009 and all references to fiscal 2007 relate to the 52 weeks ended February 2, 2008. In addition, all references herein to the third quarter of fiscal 2008 relate to the 13 weeks ended November 1, 2008 and all references to the third quarter of fiscal 2007 relate to the 13 weeks ended November 3, 2007. Finally, all references to the nine months ended November 1, 2008 relate to the 39 weeks ended November 1, 2008, and the nine months ended November 3, 2007 relate to the 39 weeks ended November 3, 2007, respectively.

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

	Quarter Ended		Nine Months Ended	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
Michaels stores:				
Retail stores open at beginning of period	991	938	963	921
Retail stores opened during the period	22	23	50	43
Retail stores opened (relocations) during the period	3	4	9	11
Retail stores closed during the period				(3)
Retail stores closed (relocations) during the period	(3)	(4)	(9)	(11)
Retail stores open at end of period	1,013	961	1,013	961
Aaron Brothers stores:				
Retail stores open at beginning of period	164	167	166	166
Retail stores opened during the period				2
Retail stores opened (relocations) during the period			1	
Retail stores closed during the period	(1)		(3)	(1)
Retail stores closed (relocations) during the period			(1)	
Retail stores open at end of period	163	167	163	167
Total store count at end of period	1,176	1,128	1,176	1,128
Other operating data:				
Average inventory per Michaels store (in thousands) (1)	$ 1,022	$ 1,023	$ 1,022	$ 1,023
Comparable store sales (decrease) increase (2)	(6.5)%	1.9%	(4.1)%	0.7%

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

(2) Comparable store sales increase (decrease) represents the increase (decrease) in net sales for stores open the same number of months in the indicated period and the comparable period of the previous year, including stores that were relocated or expanded during either period. A store is deemed to become comparable in its 14th month of operation in order to eliminate grand opening sales distortions. A store temporarily closed more than 2 weeks due to a catastrophic event is not considered comparable during the month it closed. If a store is closed longer than 2 weeks but less than 2 months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than 2 months becomes comparable in its 14th month of operation after its reopening.

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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	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales and occupancy expense	64.5	63.3	63.7	62.6
Gross profit	35.5	36.7	36.3	37.4
Selling, general, and administrative expense	27.3	27.9	30.0	29.6
Transaction expenses		0.9		1.1
Related party expenses	0.4	0.4	0.5	0.5
Store pre-opening costs	0.3	0.3	0.2	0.2
Operating income	7.5	7.2	5.6	6.0
Interest expense	8.5	10.2	9.0	11.1
Other (income) and expense, net	0.3	(0.6)	0.1	(0.4)
Loss before income taxes and discontinued operations	(1.3)	(2.4)	(3.5)	(4.7)
Income tax provision (benefit)	0.9	(1.0)	(0.8)	(1.7)
Loss before discontinued operations	(2.2)	(1.4)	(2.7)	(3.0)
Discontinued operations loss, net of income tax		(0.5)		(0.3)
Net loss	(2.2)%	(1.9)%	(2.7)%	(3.3)%

Quarter Ended November 1, 2008 Compared to the Quarter Ended November 3, 2007

Net Sales Net sales decreased for the third quarter of fiscal 2008 by $28 million, or 3.0%, compared to the third quarter of fiscal 2007. The results for the third quarter of fiscal 2008 include sales from 60 Michaels stores that were opened during the 13-month period ended November 1, 2008. Non-comparable sales increased $32 million, while comparable store sales decreased $60 million.

Comparable store sales declined 6.5% in the third quarter of fiscal 2008 compared to the third quarter of fiscal 2007, reflecting a decrease in customer transactions of 3.9%, a decrease in the average ticket of 2.8%, and a 0.2% increase in custom frame deliveries. The fluctuation in the exchange rate between the United States and Canadian dollars adversely impacted the average ticket change by 70 basis points. Comparable store sales were negatively impacted by the current soft macroeconomic and retail environments, particularly in the home décor and seasonal categories.

We continue to develop a fully integrated pricing and promotion strategy and may refine our existing strategy in future periods. A significant component of our pricing and promotion strategy involves changes in the breadth and depth of our promotional programs. Given the current soft macroeconomic and retail environments, sales declines could adversely affect operating income due to a deleveraging of operating expenses. As a result, our historical trends may not be indicative of future results.

We continue to evaluate all options available to us for our Aaron Brothers concept, which range from refining the concept to possible store rationalization. Certain of these options, if enacted, may result in material charges to our consolidated statement of operations in future periods.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense decreased $7 million from $591 million in the third quarter of fiscal 2007 to $584 million in the third quarter of fiscal 2008 primarily as a result of lower net sales. As a percentage of net sales, cost of sales and occupancy expense increased approximately 120 basis points in the third quarter of fiscal 2008 compared to the third quarter of fiscal 2007. Occupancy costs increased by 130 basis points due to a deleveraging of fixed costs on a decline in comparable store sales, partially offset by a 10 basis point increase in our merchandise margin.

Selling, General, and Administrative Expense Selling, general, and administrative expense decreased $14 million from $261 million in the third quarter of fiscal 2007 to $247 million in the third quarter of fiscal 2008. As a percentage of net sales, selling, general and administrative expense decreased from 27.9% of net sales in the third quarter of fiscal 2007 to 27.3% of net sales in the third quarter of fiscal 2008 primarily due to a reduction in our bonus expense accrual of approximately $15 million, partially offset by an increase in advertising expense.

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Transaction Expenses Transaction expenses incurred during the third quarter of fiscal 2007 related primarily to bonus arrangements associated with the change in control that were ratably recognized for a period of one year following the Merger date, as well as other compensation expenses arising from change in control agreements.

Related Party Expenses Related party expenses were $4 million in each of the third quarters of fiscal 2008 and fiscal 2007. These costs consist primarily of approximately $3 million of management fees and associated expenses paid to our Sponsors and Highfields Capital Management L.P. (Highfields). Also included in the related party expenses was approximately $1 million of amortization expense related to the Separation Agreements as more fully described in Note 11 to the consolidated financial statements.

Interest Expense Interest expense for the third quarter of fiscal 2008 decreased $18 million, from the third quarter of fiscal 2007, to $77 million as a result of a lower average interest rate related to our variable-rate debt and lower average debt levels.

(Benefit) Provision for Income Taxes During the third quarter of fiscal 2008, the Company recorded a tax provision of $8 million for the period. The expense relates primarily to a projected annual tax rate decrease due to changes in our results of operations combined with the Company s limited ability to recognize foreign tax credits related to its profitable Canadian operations. During the third quarter of fiscal 2007, the Company recorded a tax benefit of $9 million at an effective tax rate of 39.0%. As a result of our projected low income base, our effective rate is highly sensitive to changes caused by permanent differences (i.e. differences between book income and tax income that are not expected to reverse in future periods).

Nine Months Ended November 1, 2008 Compared to the Nine Months Ended November 3, 2007

Net Sales Net sales decreased in the first nine months of fiscal 2008 by $12 million, or 0.5%, over the first nine months of fiscal 2007. Sales at our new stores opened since the third quarter of fiscal 2007 provided incremental revenue of $93 million, while comparable store sales decreased $105 million.

Comparable store sales decreased 4.1% in fiscal 2008 compared to fiscal 2007, reflecting declines in customer transactions of 2.9% and average ticket of 1.2%. The fluctuation in the exchange rate between the United States and Canadian dollars positively impacted the average ticket change by 30 basis points.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $21 million due primarily to a 4.3% increase in the number of stores. As a percentage of sales, cost of sales and occupancy expense increased 110 basis points. Merchandise margin decreased approximately 40 basis points primarily related to a greater sales mix of clearance items in the first nine months of fiscal 2008 compared to fiscal 2007. Also, occupancy costs increased 70 basis points, as a percentage of sales, due to a deleveraging of fixed costs on a decline in comparable store sales.

Selling, General, and Administrative Expense Selling, general, and administrative expense increased $7 million to $765 million for the first nine months of fiscal 2008 compared to $758 million in the first nine months of fiscal 2007. The increase was primarily due to increases in store count, corporate payroll and severance costs. The increase was partially offset by reduced bonus expense and a decrease in instructor payroll, with the elimination of classes previously offered in Michaels stores. As a percentage of net sales, selling, general, and administrative expense increased from 29.6% in the first nine months of fiscal 2007 to 30.0% in the first nine months of fiscal 2008 primarily due to planned in-store investments, decreased leverage associated with the decline in comparable store sales and an increase in severance expense, partially offset by a reduction in bonus expense accruals.

Transaction Expenses Transaction expenses incurred during the first nine months of fiscal 2007 related primarily to bonus arrangements associated with the change in control that were ratably recognized for a period of one year following the Merger date, as well as other compensation expenses arising from change in control agreements.

Related Party Expenses Related party expenses were $12 million for each of the first nine months of fiscal 2008 and fiscal 2007 consisting primarily of $10 million of management fees and associated expenses paid to our Sponsors and Highfields. Also included in the related party expenses was approximately $2 million of amortization expense related to the Separation Agreements as more fully described in Note 11 to the consolidated financial statements.

Interest Expense Interest expense decreased $54 million in the nine months ended November 1, 2008 compared to the nine months ended November 3, 2007, primarily due to a lower average interest rate on our variable-rate debt and lower average debt levels.

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Benefit for Income Taxes The effective tax rate was 23.0% for the first nine months of fiscal 2008 and 34.9 % for the first nine months of fiscal 2007. For fiscal 2008, the lower effective tax rate is the result of the Company s limited ability to recognize foreign tax credits related to its profitable Canadian operations. Our effective rate is highly sensitive to changes as a result of the low base of expected income or loss for the period and the comparatively significant effect on rate caused by permanent differences (i.e. differences between book income and tax income that are not expected to reverse in future periods).

Liquidity and Capital Resources

We require cash principally for day-to-day operations, to finance capital investments, inventory for new stores, and inventory replenishment for existing stores, to service our outstanding debt, and seasonal working capital needs. We and our subsidiaries, affiliates, and significant shareholders may from time to time seek to retire or purchase our outstanding debt (including publicly issued debt) through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender offer or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. We expect that our available cash, cash flow generated from operating activities, and funds available under our Asset-based revolving credit facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and future growth for the foreseeable future.

Cash Flow used in Operating Activities

Cash flow used in operating activities during the first nine months of fiscal 2008 was $166 million compared to $80 million during the first nine months of fiscal 2007.

The $86 million change related primarily to our seasonal increase in inventory. Careful inventory management in fiscal 2007 enabled a 4.5% reduction in year-end average Michaels store inventory as compared to the prior fiscal year. Additional inventory purchases for anticipated volume in the fourth quarter of 2008 brought average store inventory (including supporting distribution centers) to a level approximately equal to the third quarter of 2007. In addition, inventory was required to support a greater number of new stores this year. In view of the current economic environment, we expect average inventory per Michaels store at the end of fiscal 2008 to be moderately higher as compared to the end of fiscal 2007. The change in cash flow related to accrued interest and accrued expenses was primarily attributable to the timing of payments.

Cash Flow used in Investing Activities

Cash flow used in investing activities was primarily the result of the following capital expenditure activities:

Nine Months Ended

	November 1, 2008 (1)	November 3, 2007 (2)
	(in millions)	
New and relocated stores and stores not yet opened	$ 23	$ 23
Existing stores	17	26
Distribution system expansion (3)	3	14
Information systems	21	22
Corporate and other	2	1
	$ 66	$ 86

(1) In the first nine months of fiscal 2008, we incurred capital expenditures related to the opening of 50 Michaels stores in addition to the relocation of nine Michaels stores and one Aaron Brothers store.

(2) In the first nine months of fiscal 2007, we incurred capital expenditures related to the opening of 43 Michaels and two Aaron Brothers stores in addition to the relocation of eleven Michaels stores.

(3) The change in capital expenditures related to the distribution system expansion is primarily related to 2007 expenditures associated with our Hybrid distribution network.

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Cash Flow provided by Financing Activities

Cash flows provided by financing activities are related primarily to borrowings and repayments under our Asset-based revolving credit facility. Borrowings under the credit facility are used primarily to fund seasonal working capital needs to support increased inventory levels going into the holiday season, to finance capital expenditures, and fund debt service payments. During the first nine months of fiscal 2008, borrowings under the facility included an aggregate of $120 million drawn on September 19, 2008, to prefund seasonal working capital requirements and to ensure that we had adequate liquidity in the event of potential disruptions in the debt markets. Approximately $52 million of such funds were invested in short term investments as of the end of the third quarter of fiscal 2008. The borrowed amounts were primarily used to support seasonal working capital needs, as well as semi-annual interest payments.. The Asset-based revolving credit facility provides senior secured financing of up to $1.0 billion, subject to a borrowing base. As of November 1, 2008, the borrowing base was $989 million with $510 million of unused availability.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. SFAS 157 was originally effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In November 2007, the FASB placed a one year deferral for the implementation of SFAS 157 for nonfinancial assets and liabilities; however, SFAS 157 is effective for fiscal years beginning after November 15, 2007 for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. We adopted all requirements of SFAS 157 as they relate to financial assets and liabilities on February 3, 2008. See Note 7 to our consolidated financial statements for further information on the impact of this standard to financial assets and liabilities. The requirements related to nonfinancial assets and liabilities will be adopted on February 1, 2009, as allowed by SFAS 157. We have not yet determined the impact, if any, on our consolidated financial statements for these nonfinancial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits companies to measure certain financial instruments and other items at fair value (at specified measurement dates) that are not currently required to be measured at fair value. Any unrealized gains or losses applicable to those items measured at fair value shall be reported in earnings. The decision to apply fair value shall generally be made on an instrument by instrument basis, is irrevocable, and is applied only to an entire instrument. We adopted SFAS 159 on February 3, 2008, and there was no impact on our consolidated financial statements as we did not choose to measure any eligible financial assets or liabilities at fair value.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141, *Business Combinations*. The statement retains the purchase method of accounting used in business combinations, but replaces SFAS 141 by establishing principles and requirements for the recognition and measurement of assets, liabilities and goodwill, including the requirement that most transaction costs and restructuring costs be expensed. In addition, the statement requires disclosures to enable users to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will adopt SFAS 141R on February 1, 2009 for acquisitions on or after this date.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133*. SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of, and gains and losses on, derivative contracts, and details of credit-risk-related contingent features in hedged positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted for in accordance with SFAS 133 and its related interpretation, and how derivative instruments and related hedged items affect entity s financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We will adopt the new disclosure requirements of SFAS 161 in the first quarter of 2009.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We are exposed to fluctuations in exchange rates between the US and Canadian dollars, as the functional currency of our Canadian subsidiary is the Canadian dollar. During the second quarter of fiscal 2008, we executed foreign currency forward contracts to mitigate the effects of currency fluctuations, which we designated as a cash flow hedge. The objective of the

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forward contracts is to hedge intercompany payments for forecasted purchases of inventory by our Canadian subsidiary, which are denominated in US dollars. The term of this cash flow hedge extends through the first quarter of fiscal 2009.

To achieve our objective and to minimize the risk of ineffectiveness, the notional values represent a portion of our Canadian subsidiary s forecasted intercompany purchases. Hedge ineffectiveness is recorded in Other income, as required. For the quarter ended November 1, 2008, the ineffective portion of the hedge was immaterial.

For the portion of the hedge that is effective, as defined, the change in fair value of that hedge will initially be recorded in Other comprehensive income. As the underlying inventory is sold to our customers, amounts will be reclassified from Other comprehensive income to Cost of sales and occupancy expense in the statement of operations. The change in fair value of the hedge for the quarter ended November 1, 2008 was $5 million.

The table below provides the remaining quarterly notional values and the average CAD/USD exchange rate associated with the hedge (dollars in millions).

Period	CAD Amount	USD Amount	Rate
Quarter 4, 2008	$ 17.4	$ 17.4	1.001
Quarter 1, 2009	12.2	12.2	1.001
	$ 29.6	$ 29.6	1.001

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). 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 Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms. Such controls and procedures are designed to ensure that information we are required to disclose in our reports is accumulated and communicated to our management, including our principal executive officer and principal financial officer, to allow timely disclosure decisions. 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.

Change in Internal Control Over Financial Reporting

There has not been any change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) as promulgated by the SEC under the Securities Exchange Act of 1934) during the quarter covered by this Quarterly Report on Form 10-Q that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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MICHAELS STORES, INC.

Part II OTHER INFORMATION

Item 1. Legal Proceedings.

Information regarding legal proceedings is incorporated herein by reference from Note 9 to our Consolidated Financial Statements.

Item 1A. Risk Factors.

Information regarding the Company s risk factors appear in Item 1A. Risk Factors disclosed in our Annual Report on Form 10-K for the fiscal year ended February 2, 2008.

There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended February 2, 2008 other than the risk factors set forth below:

The Effect of General Economic Conditions and the Current Financial Crisis

If the worldwide economic downturn continues or deteriorates further, it could adversely impact our results of operations, cash flows and financial condition. The downturn in the economy may continue to adversely affect consumer confidence and retail spending, decreasing demand for our merchandise. Current economic conditions also make it difficult for us to accurately forecast future demand trends which could cause us to purchase excess inventories, resulting in increases in our inventory carrying cost, or insufficient inventories, resulting in our inability to satisfy our customer demand and potentially lose market share. In addition, we are experiencing significant worldwide disruptions in credit markets. As discussed under Liquidity and Capital Resources, we believe that our current liquidity resources are adequate for the near term. Although the Company does not anticipate needing additional sources of capital in the near term, continued disruption in the capital markets could make it difficult for us to raise additional capital, when needed, or to eventually refinance our existing indebtedness, on acceptable terms or at all. Similarly, if our suppliers face challenges in assessing credit when needed or otherwise face difficult business conditions, they may become unable to offer us the merchandise we use in our business causing reductions in revenues, or may demand more favorable payment terms, all of which could adversely affect our results of operations, cash flows and financial condition.

Government or consumer concerns about product safety and recalls or changes to laws, could harm our reputation, financial position, earnings or cash flow.

We are subject to a variety of product safety regulations by federal, state and international regulatory authorities. Much of our merchandise is manufactured in foreign countries and imported either directly or through domestic sources. One or more of our suppliers might not adhere to product safety requirements or our quality control standards, and we might not identify the deficiency before merchandise is shipped to our stores. Product safety concerns or recalls could result in the rejection of our products by our customers, damage to our reputation, lost sales, and increased costs. Moreover, changes in product safety or other consumer protection laws could lead to increased costs to us for certain merchandise, or additional labor costs associated with readying merchandise for sale. Long lead times on merchandise ordering cycles increase the difficulty for us to plan and prepare for potential changes to applicable laws. The recently enacted Consumer Product Safety Improvement Act of 2008 imposes significant new requirements on manufacturing, importing, testing and labeling requirements for our products. In the event that we are unable to timely comply with regulatory changes, significant fines or penalties could result, and could adversely effect on our reputation, financial position, earnings or cash flow.

If the Employee Free Choice Act is adopted, it would be easier for our employees to obtain union representation and our businesses could be impacted.

Currently, none of our employees are represented by unions. However, our employees have the right at any time under the National Labor Relations Act to form or affiliate with a union. If some or all of our workforce were to become unionized and the terms of the collective bargaining agreement were significantly different from our current compensation arrangements, it could increase our costs and adversely impact our profitability.

The Employee Free Choice Act of 2007: H.R. 800 (EFCA) was passed in the U.S. House of Representatives last year. This bill or a variation of it could be enacted in the future and could have an adverse impact on our businesses. The EFCA

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aims to amend the National Labor Relations Act, by making it easier for workers to obtain union representation and increasing the penalties employers may incur if they engage in labor practices in violation of the National Labor Relations Act. As currently drafted, the EFCA requires the National Labor Relations Board (NLRB) to review petitions filed by employees for the purpose of creating a labor organization and to certify a bargaining representative without directing an election if a majority of the bargaining unit employees have authorized designation of the representative. The EFCA also requires the parties to begin bargaining within 10 days of the receipt of the petition, or longer time if mutually agreed upon. In addition, if the union and employer cannot agree upon the terms of a first collective bargaining agreement within 90 days, which can be extended by mutual agreement, either party can request federal mediation, which could lead to binding arbitration if an agreement still cannot be reached after an additional 30 days which can be extended by mutual agreement. EFCA would also require the NLRB to seek a federal injunction against an employer whenever there is reasonable cause to believe that the employer has discharged or discriminated against an employee to encourage or discourage membership in the labor organization, threatened to discharge or otherwise discriminate against an employee in order to interfere with, restrain, or coerce employees in the exercise of guaranteed collective bargaining rights, or engaged in any other related unfair labor practice that significantly interferes with, restrains, or coerces employees in the exercise of such guaranteed rights. The EFCA adds additional remedies for such violations, including back pay plus liquidated damages and civil penalties to be determined by the NLRB not to exceed $20,000 per infraction.

Item 6. Exhibits.

(a) Exhibits:

Exhibit Number	**Description of Exhibit**
31.1	Certifications of Brian C. Cornell pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certifications of Elaine D. Crowley pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

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MICHAELS STORES, INC.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MICHAELS STORES, INC.

By:	/s/ Elaine D. Crowley Elaine D. Crowley Executive Vice President - Chief Financial Officer (Principal Financial Officer)

Dated: December 10, 2008

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INDEX TO EXHIBITS

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