MICHAELS STORES INC
Form 10-K
March 15, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended February 2, 2013

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)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: **None**

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: **None**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes x No o

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 o No o

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 x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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 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

The aggregate market value of the registrant s voting and non-voting common equity held by non-affiliates of the registrant is zero. The registrant s common equity is not publicly traded.

As of March 11, 2013, 118,460,909 shares of the Registrant s common stock were outstanding.

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* The Registrant has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, but is not required to file such reports under such sections effective February 2, 2013, which was the last day of our fiscal year.

DOCUMENTS INCORPORATED BY REFERENCE

None.

PART I

ITEM 1. Business.

The following discussion, as well as other portions of this Annual Report on Form 10-K, 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. Our actual results could materially differ from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Annual Report on Form 10-K, and particularly in Item 1A. Risk Factors and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations. Unless the context otherwise indicates, references in this Annual Report on Form 10-K to we, our, us, the Company and Michaels means Michaels Stores, Inc., together with its subsidiaries.

General

With over $4.4 billion in sales in fiscal 2012, Michaels Stores, Inc., together with its subsidiaries, is the largest arts and crafts specialty retailer in North America providing materials, project ideas and education for creative activities. Our mission is to be a world class performer that inspires and enables consumers to experience creativity and leads industry growth and innovation, while creating a fun and rewarding place to work that fosters meaningful connections with our communities. With crafting classes, in-store events, project sheets and displays, mobile applications, and on-line videos, we offer a shopping experience that can inspire creativity and confidence in our customers artistic abilities.

Michaels Stores, Inc. was incorporated in Delaware in 1983, and as of March 11, 2013, we operate 1,106 Michaels retail stores in 49 states, as well as in Canada, with approximately 18,100 average square feet of selling space per store. We also operate 123 Aaron Brothers stores as of March 11, 2013, in nine states, with approximately 5,600 average square feet of selling space per store, offering photo frames, a full line of ready-made frames, custom framing services, and a wide selection of art supplies.

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 two investment firms: Bain Capital Partners, LLC and The Blackstone Group, L.P. (collectively, together with their applicable affiliates, the Sponsors), with certain shares retained by affiliates of Highfields Capital Partners (a then-existing shareholder of Michaels Stores, Inc.). As a result of the Merger, Michaels Holdings, LLC, an entity controlled by the Sponsors, currently owns approximately 93% of our outstanding common stock, which is not publicly traded.

We provide links to our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports, and other documents filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), on our Internet website at *www.michaels.com* under the heading Investor Relations. These Reports are are available as soon as reasonably practicable after we electronically file them with the Securities and Exchange Commission (SEC). These filings are also available through the SEC s EDGAR system at *www.sec.gov.*

Merchandising

Each Michaels store offers approximately 36,000 basic stock-keeping units (SKUs) in a number of product categories. The following table shows a breakdown of sales for Michaels stores by department as a percentage of total Net sales:

	Fiscal Year		
	2012	**2011**	**2010**
General and children s crafts	48%	47%	46%
Home décor and seasonal	21	20	20
Framing	17	17	18
Scrapbooking	14	16	16
	100%	100%	100%

We continue to search for ways to leverage our position as a market leader by establishing strategic partnerships and exclusive product relationships that will provide our customers with exciting merchandise. During fiscal 2012, we partnered with popular celebrities and brands such as Chef Duff Goldman, Tori Spelling, Craftsy, Disney, Crayola, American Girl Crafts, and Martha Stewart Crafts. For fiscal 2013, we are exploring opportunities to form future partnerships and exclusive product associations.

We routinely identify merchandise that requires some price reduction to accelerate sales of the product. The need for this reduction is generally attributable to clearance of seasonal merchandise or product that is being displaced from its assigned location in the store to make room for new merchandise. Additional SKUs that are candidates for repricing are identified using our perpetual inventory data. In each case, the appropriate repricing is determined at our corporate office. Price changes are transmitted electronically to the store and instructions are provided to our stores regarding product placement, signage, and display to ensure the product is effectively cleared.

Our Aaron Brothers stores offer on average approximately 7,100 SKUs, including photo frames, a full line of ready-made frames, art prints, framed art, art supplies and custom framing services. The merchandising strategy for our Aaron Brothers stores is to provide a unique, upscale framing assortment in an appealing environment with attentive customer service.

Seasonality

Our business is highly seasonal, with higher sales in the third and fourth fiscal quarters. Our fourth quarter, which includes the Christmas selling season, has on average accounted for approximately 34% of our Net sales and approximately 46% of our Operating income.

Purchasing and Inventory Management

We purchase merchandise from approximately 600 vendors through our wholly-owned subsidiary, Michaels Stores Procurement Company. We believe our buying power and ability to make centralized purchases enables us to acquire products on favorable terms. Centralized merchandising management teams negotiate with vendors in an attempt to obtain the lowest net merchandise costs and improve product mix and inventory levels. In fiscal 2012, one vendor and one sourcing agent each supplied approximately 11% of our purchases, with no other vendor or sourcing agent accounting for more than 5% of total purchases.

In addition to purchasing from outside vendors, our Michaels and Aaron Brothers stores purchase custom frames, framing supplies and mats from our framing operation, Artistree, which consists of a manufacturing facility and four regional processing centers to support our retail stores. These inter-company transactions are eliminated in consolidation.

Substantially all of the products sold in Michaels stores are manufactured in Asia, Canada, Mexico and the U.S. Goods manufactured in Asia generally require long lead times and are ordered four to six months in advance of delivery. Those products are either imported directly by us or acquired from distributors based in the U.S., and purchase prices are denominated in U.S. dollars.

Our automated replenishment system uses perpetual inventory records to analyze individual store/SKU on-hand quantities, as well as other pertinent information such as sales forecasts, seasonal selling patterns, promotional events, and vendor lead times, to generate recommended merchandise reorder information. These recommended orders are reviewed daily and purchase orders are delivered electronically to our vendors and our distribution centers. In addition to improving our store in-stock position, these systems enable us to better forecast merchandise ordering quantities for our vendors and give us the ability to identify, order and replenish the stores merchandise using less store associate labor. These systems also allow us to react more quickly to selling trends and allow our store associates to devote more time to customer service, thereby improving inventory productivity and sales opportunities. As mentioned above, we are developing processes and systems to improve our inventory management. We plan to complete the upgrade of our replenishment and allocation systems and implementation of a demand

forecasting system in fiscal 2013.

Artistree

We currently operate a vertically integrated framing operation that leverages Artistree, our wholly-owned manufacturing subsidiary, across our Michaels and Aaron Brothers store networks. Artistree supplies precut mats and high quality custom framing merchandise. We believe Artistree provides a competitive advantage to our Michaels and Aaron Brothers stores and gives us quality control over the entire process. Based on the benefits we have received from this vertically integrated solution, we continue to evaluate opportunities to further leverage our strong custom offerings.

Our moulding manufacturing plant, located in Kernersville, North Carolina, converts lumber into finished frame moulding that is supplied to our regional processing centers for custom framing orders for our stores. We manufacture approximately 20% of the moulding we process, import another 50% from quality manufacturers in Indonesia, Malaysia, China, and Italy, and purchase the balance from distributors. We directly source metal moulding for processing in our regional centers. The custom framing orders are processed (frames cut and joined, along with cutting mats and foamboard backing) and shipped to our stores where the custom frame order is completed for customer pick-up.

During fiscal 2012, we operated four regional processing centers in City of Industry, California; Coppell, Texas; Kernersville, North Carolina; and Mississauga, Ontario. Our pre-cut mats and custom frame supplies are packaged and distributed out of our Coppell regional processing center. Combined, these facilities occupy approximately 538,000 square feet and, in fiscal 2012,

processed over 28 million linear feet of frame moulding and over 5 million individually custom cut mats for our Michaels and Aaron Brothers stores.

In July 2012, Michaels completed the implementation of a modified pricing and promotion cadence for its custom framing business. The program establishes a rotational collection cadence to limit the percentage of days that custom framing SKUs are on promotion, to more fully comply with regulatory requirements in various jurisdictions. The program is generally the same as that approved for the Company by the Attorney General for the State of New York. Based on results of this implementation in New York and other jurisdictions, we do not believe that this pricing and promotion cadence will have a material impact on our results of operations.

Distribution

We currently operate a distribution network, through our wholly-owned subsidiary, Michaels Stores Procurement Company, for supplying our stores with merchandise. Approximately 87% of Michaels stores merchandise receipts are shipped through the distribution network with the remainder shipped directly from vendors to stores. Approximately 54% of Aaron Brothers stores merchandise is shipped through the distribution network with the remainder shipped directly from vendors. Our seven distribution centers are located in California, Florida, Illinois, Pennsylvania, Texas, and Washington. In addition, we utilize a third-party warehouse to store and supply our seasonal merchandise in preparation for the holiday season.

Michaels stores generally receive deliveries from the distribution centers weekly through a transportation network using a dedicated fleet of trucks and contract carriers. Aaron Brothers stores generally receive merchandise on a biweekly basis from a dedicated 174,000 square foot distribution center located in the Los Angeles, California area.

Store Expansion and Relocation

The following table shows our total store growth for the last five years:

			Fiscal Year		
	2012	2011	2010	2009	2008
Michaels stores:					
Retail stores open at beginning of year	1,064	1,045	1,023	1,009	963
Retail stores opened during the year	38	25	23	18	51
Retail stores opened relocations during the year	13	15	10	5	11
Retail stores closed during the year	(3)	(6)	(1)	(4)	(5)
Retail stores closed relocations during the year	(13)	(15)	(10)	(5)	(11)
Retail stores open at end of year	1,099	1,064	1,045	1,023	1,009
Aaron Brothers stores:					
Retail stores open at beginning of year	134	137	152	161	166
Retail stores opened during the year					
Retail stores opened relocations during the year					1
Retail stores closed during the year	(8)	(3)	(15)	(9)	(5)

Retail stores closed relocations during the year					(1)
Retail stores open at end of year	126	134	137	152	161
Total store count at end of year	1,225	1,198	1,182	1,175	1,170

We believe, based on an internal real estate and penetration study of Michaels stores, that the combined U.S. and Canadian markets can support approximately 1,500 Michaels stores. We plan to open 50 to 55 Michaels stores in fiscal 2013. Included in these openings are relocations of 10 to 20 Michaels stores. We continue to pursue a store relocation program to improve the real estate location quality and performance of our store base. During fiscal 2013, we anticipate closing 5 to 10 Michaels stores and 5 to 15 Aaron Brothers stores. We plan to relocate up to five Aaron Brothers stores in fiscal 2013. Many of our store closings are stores that have reached the end of their lease term or are being relocated. We believe our ongoing store evaluation process results in strong performance across our store base.

We have developed a standardized procedure that allows for the efficient opening of new stores and their integration into our information and distribution systems. We develop the floor plan and merchandise layout and organize the advertising and promotions

in connection with the opening of each new store. In addition, we maintain qualified store opening teams to provide new store personnel with store training.

Our new store operating model, which is based on historical store performance, assumes a target store size of approximately 19,000 selling square feet. Our fiscal 2012 average initial net investment, which varies by site and specific store characteristics, is approximately $1.2 million per store and consists of store build-out costs (net of tenant improvement allowances), pre-opening expenses and average first year inventory (net of payables).

Competition

We are the largest arts and crafts speciality retailer. The market we compete in is highly fragmented, including stores across the nation operated primarily by small, independent retailers along with a few regional and national chains. We believe customers choose where to shop based upon store location, breadth of selection, price, quality of merchandise, availability of product, and customer service. We compete with many different types of retailers and classify our competition within the following categories:

- *Mass merchandisers.* This category includes companies such as Wal-Mart Stores, Inc., Target Corporation, and other mass merchandisers. These retailers typically dedicate only a small portion of their selling space to a limited selection of home décor, arts and crafts supplies, and seasonal merchandise, but they do seek to capitalize on the latest trends by stocking products that are complimentary to those trends and their current merchandise offerings. These mass merchandisers generally have limited customer service staffs with minimal amounts of experience in crafting projects.

- *Multi-store chains.* This category includes several multi-store chains, each operating more than 30 stores, and comprises: Hobby Lobby Stores, Inc., which operates approximately 525 stores in 42 states, primarily in the Midwestern and Southern U.S.; Jo-Ann Stores, Inc., which operates approximately 790 stores in 49 states; A.C. Moore Arts & Crafts, Inc., which operates approximately 141 stores primarily in the mid-Atlantic and Northeast regions; and Garden Ridge Corporation, which operates approximately 58 stores in 19 states, primarily in the Midwestern and Southern U.S. We believe all of these chains are significantly smaller than Michaels with respect to Net sales.

- *Small, local specialty retailers.* This category includes local independent arts and crafts retailers and custom framing shops. Typically, these are single store operations managed by the owner. These stores generally have limited resources for advertising, purchasing, and distribution. Many of these stores have established a loyal customer base within a given community and compete based on relationships and customer service.

Foreign Sales

All of our current international business is in Canada, which accounted for approximately 10% of total sales in fiscal 2012 and 9% of total sales in fiscal 2011 and fiscal 2010. During the last three years, less than 8% of our assets have been located outside of the U.S. See Note 12 to the Consolidated Financial Statements for Net sales and assets by country.

Trademarks and Service Marks

We own or have rights to trademarks, service marks or trade names that we use in connection with the operation of our business, including Aaron Brothers, Artistree, Michaels, Michaels the Arts and Crafts Store, Recollections, Where Creativity Happens, and the stylized Mich logo. We have registered our primary private brands including Artist s Loft, ArtMinds, Celebrate It, Creatology, Craft Smart, imagin8, Recollections, Loops & Threads, MiDesign@Michaels, Studio Décor, Bead Landing and Ashland, and various sub-brands associated with these primary marks. Solely for convenience, some of the trademarks, service marks and trade names referred to in this Annual Report on Form 10-K are listed without the ©, ® and symbols, but we will assert, to the fullest extent under applicable law, our rights to our copyrights, trademarks, service marks, trade names and domain names.

Employees

As of March 11, 2013, we employed approximately 48,900 associates, approximately 38,100 of whom were employed on a part-time basis. The number of part-time associates substantially increases during the Christmas selling season. Of our full-time associates, approximately 3,100 are engaged in various executive, operating, training, distribution, and administrative functions in our corporate and division offices and distribution centers, and the remainder are engaged in store operations. None of our associates are subject to a collective bargaining agreement.

Iran Sanctions Related Disclosure

Under the Iran Threat Reduction and Syrian Human Rights Act of 2012, which added Section 13(r) of the Exchange Act, 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 Annual Report on Form 10-K. 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 our consolidated subsidiaries have knowingly engaged in any transaction or dealing reportable under Section 13(r) of the Exchange Act during fiscal year 2012.

The Blackstone Group L.P., one of our Sponsors, informed us that TRW Automotive Holdings Corp., a company that may be considered one of its affiliates, included the disclosure reproduced below in its annual report on Form 10-K as filed with the SEC on February 15, 2013 as required by Section 13(r) of the Exchange Act (the TRW Disclosure). We have no involvement in or control over the activities of TRW Automotive Holdings Corp., any of its predecessor companies or any of its subsidiaries, and we have not independently verified or participated in the preparation of the TRW Disclosure.

TRW Disclosure:

Compliance with Government Regulations

Pursuant to Section 13(r)(1)(D)(iii) of the Securities Exchange Act of 1934, as amended (the Exchange Act), we note that in 2012 certain of our non-U.S. subsidiaries sold products to customers that could be affiliated with, or deemed to be acting on behalf of, the Industrial Development and Renovation Organization, which has been designated as an agency of the Government of Iran. Gross revenue attributable to such sales was approximately $8,326,000, and net profit from such sales was approximately $377,000. Although these activities were not prohibited by U.S. law at the time they were conducted, our subsidiaries have discontinued their dealings with such customers, other than limited wind-down activities (which are permissible), and we do not otherwise intend to continue or enter into any Iran-related activity.

The Blackstone Group L.P., additionally informed us that Travelport Limited, a company that may be considered one of its affiliates, provided the disclosure reproduced below in its annual report on Form 10-K as filed with the SEC on March 12, 2013 as required by Section 13(r)(1)(D)(iii) of the Exchange Act (the Travelport Disclosure). We have no involvement in or control over the activities of Travelport Limited, any of its predecessor companies or any of its subsidiaries, and we have not independently verified or participated in the preparation of the Travelport Disclosure.

Travelport Disclosure:

As part of our global business in the travel industry, we provide certain passenger travel-related GDS and airline IT services to Iran Air. We also provide certain airline IT services to Iran Air Tours. All of these services are either exempt from applicable sanctions prohibitions pursuant to a statutory exemption permitting transactions ordinarily incident to travel or, to the extent not otherwise exempt, specifically licensed by the U.S. Office of Foreign Assets Control. Subject to any changes in the exempt/licensed status of such activities, we intend to continue these business activities, which are directly related to and promote the arrangement of travel for individuals. The gross revenue and net profit

attributable to these activities in 2012 were approximately $127,000 and $45,000, respectively.

ITEM 1A. Risk Factors.

Our financial performance is subject to various risks and uncertainties. The risks described below are those which we believe are the material risks we face. Any of the risk factors described below could significantly and adversely affect our business, prospects, sales, revenues, gross profit, cash flows, financial condition, and results of operations.

We face risks related to the effect of economic uncertainty.

If recovery from the economic downturn continues to be slow or prolonged, our growth, prospects, results of operations, cash flows and financial condition could be adversely impacted. Our stores offer arts and crafts supplies and products for the crafter, and custom framing for the do-it-yourself home decorator, which some customers may perceive as discretionary. Pressure on discretionary income brought on by economic downturns and slow recoveries, including housing market declines, rising energy prices and weak labor markets, may cause consumers to reduce the amount they spend on discretionary items. For example, as a result of the recession

during fiscal 2007 and fiscal 2008, despite adding a number of new stores, our total Net sales decreased from $3,862 million to $3,817 million. The current economic environment 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, resulting in our inability to satisfy our customer demand and potentially lose market share.

We Face Risks Related to Our Substantial Indebtedness.

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 associated with our variable rate debt and prevent us from meeting our obligations under our 7 ¾% Senior Notes due 2018 (2018 Senior Notes), 8 1/8% Senior Subordinated Notes due 2016 (Senior Subordinated Notes), Restated Term Loan Credit Facility and Restated Revolving Credit Facilities, (together with the Restated Term Loan Credit Facilities, Senior Secured Credit Facilities). As of February 2, 2013, we had $3,041 million of indebtedness outstanding, of which $1,641 million was subject to variable interest rates and approximately $1,400 million was subject to fixed interest rates. In addition, as of February 2, 2013, we had approximately $587 million of unused borrowing capacity under our Restated Revolving Credit Facility.

Our high degree of leverage could have important consequences to us, including:

- making it more difficult for us to make payments on our debt.

- increasing our vulnerability to general economic and industry conditions.

- requiring a substantial portion of cash flow from operations to be dedicated to the payment of principal and interest on our debt, thereby reducing our ability to use our cash flow to fund our operations, capital expenditures, and future business opportunities.

- exposing us to the risk of increased interest rates as certain of our borrowings under our Senior Secured Credit Facilities are at variable rates.

- restricting us from making strategic acquisitions or causing us to make non-strategic divestitures.

- limiting our ability to obtain additional financing for working capital, capital expenditures, product development, debt service requirements, acquisitions, and general corporate or other purposes.

- limiting our ability to adjust to changing market conditions and placing us at a competitive disadvantage compared to our competitors who may be less highly leveraged.

We and our subsidiaries may be able to incur substantial additional indebtedness in the future, subject to the restrictions contained in our Senior Secured Credit Facilities and the indentures governing our 2018 Senior Notes and Senior Subordinated Notes. In addition, our Senior Secured Credit Facilities and indentures governing our 2018 Senior Notes and Senior Subordinated Notes do not restrict our owners from creating new holding companies that may be able to incur indebtedness without regard to the restrictions set forth in our credit facilities and indentures. If new indebtedness is added to our current debt levels, the related risks that we now face could intensify.

Our growth depends on our ability to open new stores and increase comparable store sales.

One of our key business strategies is to expand our base of retail stores. If we are unable to continue this strategy, our ability to increase our sales, profitability and cash flow could be impaired. To the extent we are unable to open new stores as we anticipate, our sales growth would come only from increases in comparable store sales. Growth in profitability in that case would depend significantly on our ability to improve gross margin. We may be unable to continue our store growth strategy if we cannot identify suitable sites for additional stores, negotiate acceptable leases, access sufficient capital to support store growth, or hire and train a sufficient number of qualified associates.

Our reliance on foreign suppliers increases our risk of obtaining adequate, timely, and cost-effective product supplies.

We rely to a significant extent on foreign manufacturers of various products that we sell, particularly manufacturers located in China. In addition, many of our domestic suppliers purchase a portion of their products from foreign sources. This reliance

increases the risk that we will not have adequate and timely supplies of various products due to local political, economic, social, or environmental conditions (including acts of terrorism, the outbreak of war, or the occurrence of natural disaster), transportation delays (including dock strikes and other work stoppages), restrictive actions by foreign governments, or changes in U.S. laws and regulations affecting imports or domestic distribution. Reliance on foreign manufacturers also increases our exposure to trade infringement claims and reduces our ability to return product for various reasons.

Additionally, the costs of labor and wage taxes have increased in China, which means we are at risk of higher costs associated with goods manufactured in China. Significant increases in wages or wage taxes paid by contract facilities may increase the cost of goods manufactured, which could have a material adverse effect on our profit margins and profitability.

All of our products manufactured overseas and imported into the U.S. are subject to duties collected by the U.S. Customs Service. We may be subjected to additional duties, significant monetary penalties, the seizure and forfeiture of the products we are attempting to import, or the loss of import privileges if we or our suppliers are found to be in violation of U.S. laws and regulations applicable to the importation of our products.

Damage to the reputation of the Michaels brand or our private and exclusive brands could adversely affect our sales.

We believe the Michaels brand name and many of our private and exclusive brand names are powerful sales and marketing tools and we devote significant resources to promoting and protecting them. To be successful in the future, we must continue to preserve, grow and utilize the value of Michaels reputation. Reputational value is based in large part on perceptions of subjective qualities, and even isolated incidents may erode trust and confidence. In addition, we develop and promote private and exclusive brands, which we believe have generated national recognition. Our private label brands amounted to approximately 49% of total Net sales in fiscal 2012, and represent a growing portion of our overall sales. Damage to the reputations (whether or not justified) of our brand names could arise from product failures, litigation or various forms of adverse publicity, especially in social media outlets, and may generate negative customer sentiment, potentially resulting in a reduction in our sales and earnings.

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.

Significant future increases in commodity prices or inflation could adversely affect our costs, including cost of merchandise and distribution costs. Furthermore, the transportation industry may experience a shortage or reduction of capacity, which could be exacerbated by higher fuel prices. Our results of operations may be adversely affected if we are unable to secure, or are able to secure only at significantly higher costs, adequate transportation resources to fulfill our receipt of goods or delivery schedules to the stores.

Our suppliers may fail us.

Many of our suppliers are small firms that produce a limited number of items. Given their limited resources, these firms are susceptible to cash flow issues, access to capital, production difficulties, quality control issues and problems in delivering agreed-upon quantities on schedule. We may not be able, if necessary, to return products to these suppliers and obtain refunds of our purchase price or obtain reimbursement or indemnification from them if their products prove defective. These suppliers may also be unable to withstand a downturn in economic

conditions. Significant failures on the part of our key suppliers could have a material adverse effect on our results of operations.

In addition, many of these suppliers require extensive advance notice of our requirements in order to supply products in the quantities we desire. This long lead time may limit our ability to respond timely to shifts in demand.

Risks associated with the vendors from whom our products are sourced could materially adversely affect our revenue and gross profit.

The products we sell are sourced from a wide variety of domestic and international vendors. Global sourcing has become an increasingly important part of our business, as we have undertaken efforts to increase the amount of product we source directly from overseas manufacturers. Our ability to find qualified vendors who meet our standards and supply products in a timely and efficient manner is a significant challenge, especially with respect to goods sourced from outside the U.S. Any issues related to transitioning vendors could adversely affect our revenue and gross profit.

Product recalls and/or product liability, as well as changes in product safety and other consumer protection laws, may adversely impact our operations, merchandise offerings, reputation, results of operations, cash flow and financial condition.

We are subject to regulations by a variety of federal, state and international regulatory authorities, including the Consumer Product Safety Commission. In fiscal 2012, we purchased merchandise from approximately 600 vendors. Since a majority of our merchandise is manufactured in foreign countries, one or more of our vendors might not adhere to product safety requirements or our quality control standards, and we might not identify the deficiency before merchandise ships to our stores. Any issues of product safety, including but not limited to those manufactured in foreign countries, could cause us to recall some of those products. If our vendors fail to manufacture or import merchandise that adheres to our quality control standards, our reputation and brands could be damaged, potentially leading to increases in customer litigation against us. Furthermore, to the extent we are unable to replace any recalled products, we may have to reduce our merchandise offerings, resulting in a decrease in sales, especially if a recall occurs near or during a seasonal period. If our vendors are unable or unwilling to recall products failing to meet our quality standards, we may be required to recall those products at a substantial cost to us. 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 Consumer Product Safety Improvement Act of 2008 imposes significant 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 affect our reputation, results of operations, cash flow and financial condition.

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.

Brand recognition, quality and price have a significant influence on consumers choices among competing products and brands. Advertising, promotion, merchandising and the cadence of new product introductions also have a significant impact on consumers buying decisions. If we misjudge consumer responses to our existing or future promotional activities, this could have a material adverse impact on our sales, results of operations, cash flow and financial condition.

We believe improvements in our merchandise offering help drive sales at our stores. We could be materially adversely affected by poor execution of changes to our merchandise offering or by unexpected consumer responses to changes in our merchandise offering.

Improvements to our supply chain may not be fully successful.

An important part of our efforts to achieve efficiencies, cost reductions, and sales and cash flow growth is the identification and implementation of improvements to our supply chain, including merchandise ordering, transportation, and receipt processing. During fiscal 2013, we plan to continue to implement enhancements to our distribution systems and processes, which are designed to improve efficiency through the supply chain and at our stores. Significant changes to our supply chain could have a material adverse impact on our results of operations.

Changes in customer demands could materially adversely affect our sales, results of operations and cash flow.

Our success depends on our ability to anticipate and respond in a timely manner to changing customer demands and preferences for products and supplies used in creative activities. If we misjudge the market, we may significantly overstock unpopular products and be forced to take significant inventory markdowns, or experience shortages of key items, either of which could have a material adverse impact on our operating results and cash flow. In addition, adverse weather conditions, economic instability, and consumer confidence volatility could have a material adverse impact on our sales and operating results.

Our success will depend on how well we manage our business.

Even if we are able to substantially continue our strategy of expanding our store base, or additionally, to expand our business through acquisitions or vertical integration opportunities, we may experience problems, which may adversely impact profitability or cash flow. For example:

- the costs of opening and operating new stores may offset the increased sales generated by the additional stores.

- the closure of unsuccessful stores may result in the retention of liability for expensive leases.

- a significant portion of our management s time and energy may be consumed with issues unrelated to advancing our core business strategies.

- the implementation of future operational efficiency initiatives, which may include the consolidation of certain operations and/or the possible co-sourcing of additional selected functions, may not produce the desired reduction in costs and may result in disruptions arising from such actions.

- failure to maintain stable relations with our labor force.

- our suppliers may be unable to meet the increased demand of additional stores in a timely manner.

- we may be unable to expand our existing distribution centers, or use third party distribution centers, on a cost-effective basis to provide merchandise to our new stores.

Competition, including Internet-based competition, could negatively impact our business.

The retail arts and crafts industry, including custom framing, is competitive, which could result in the reduction of our prices and loss of our market share. We must remain competitive in the areas of quality, price, breadth of selection, customer service, and convenience. We compete with mass merchants (*e.g*., Wal-Mart Stores, Inc. and Target Corporation), which dedicate a portion of their selling space to a limited selection of craft supplies and seasonal and holiday merchandise, along with national and regional chains and local merchants. We also compete with specialty retailers, which include Hobby Lobby Stores, Inc., A.C. Moore Arts & Crafts, Inc., Jo-Ann Stores, Inc. and Garden Ridge Corporation. Some of our competitors, particularly the mass merchants, are larger and have greater financial resources than we do. The Company also faces competition from Internet-based retailers, in addition to traditional store-based retailers. This could result in increased price competition since our customers could more readily search and compare non-private brand products. This could also lead to additional competitors, who may exploit a convenience advantage in the event we cannot offer a similar line of products online in the future. Furthermore, we ultimately compete with alternative sources of entertainment and leisure for our customers.

Failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information and data breaches could materially adversely affect our financial condition and operating results.

We have become increasingly centralized and dependent upon automated information technology processes. In addition, a portion of our business operations is conducted over the Internet, increasing the risk of viruses that could cause system failures and disruptions of operations. Any failure to maintain the security of our customers confidential information, or data belonging to ourselves or our suppliers, could put us at a competitive disadvantage, result in deterioration in our customers confidence in us, and subject us to potential litigation, liability, fines and penalties, resulting in a possible material adverse impact on our financial condition and results of operations.

On May 3, 2011, we were advised by the U.S. Secret Service that they were investigating certain fraudulent debit card transactions that occurred on accounts that had been used for legitimate purchases in selected Michaels stores. A subsequent internal investigation revealed that approximately 90 payment card terminals in certain Michaels stores had been physically tampered with, potentially resulting in the compromise of customer debit and credit card information. The Company fully cooperated with various governmental entities and law enforcement authorities in investigating the payment card terminal tampering, and we believe we have taken appropriate steps to stop the use of the stolen information and have resolved all other related claims for an amount that will not have a material effect on our Consolidated Financial Statements.

Improper activities by third parties, advances in technical capabilities and encryption technology, new tools and discoveries and other events or developments may facilitate or result in a further compromise or breach of our payment card terminals or other payment systems. Any such further compromises or breaches could cause interruptions in our operations, damage to our reputation and customers willingness to shop in our stores, and subject us to additional costs and potential litigation, liability, fines and penalties, resulting in a possible material adverse impact on our financial condition and results of operations.

The Company may be subject to information technology system failures or network disruptions, or our information systems may prove inadequate, resulting in damage to the Company s reputation, business operations and financial conditions.

We depend on our management information systems for many aspects of our business, including our perpetual inventory, automated replenishment, and weighted average cost stock ledger systems which are necessary to properly forecast, manage, and analyze our inventory. The Company may be subject to information technology system failures and network disruptions. These may be caused by natural disasters, accidents, power disruptions, telecommunications failures, acts of terrorism or war, computer viruses, physical or electronic break-ins, or similar events or disruptions. System redundancy may be ineffective or inadequate, and the Company s disaster recovery planning may not be sufficient for all eventualities. Such failures or disruptions could prevent access to the Company s online services and preclude store transactions. System failures and disruptions could also impede the manufacturing and shipping of products, transactions processing and financial reporting. Additionally, we will be materially adversely affected if we are unable to improve, upgrade, maintain, and expand our systems.

We are dependent upon the services of our senior management team, and the failure to attract and retain such individuals could adversely affect our operations.

We are dependent on the services, abilities and experience of our executive officers. The permanent loss of the services of any of these senior executives and any change in the composition of our senior management team could have a negative impact on our ability to execute on our business and operating strategies.

A weak fourth quarter would materially adversely affect our result of operations.

Our business is highly seasonal. Our inventories and short-term borrowings may grow in the third fiscal quarter as we prepare for our peak selling season in the third and fourth fiscal quarters. Our most important quarter in terms of sales, profitability, and cash flow historically has been the fourth fiscal quarter. If for any reason our fourth fiscal quarter results were substantially below expectations, our operating results for the full year would be materially adversely affected, and we could have substantial excess inventory, especially in seasonal merchandise that is difficult to liquidate.

Changes in newspaper subscription rates may result in reduced exposure to our circular advertisements.

A substantial portion of our promotional activities utilize circular advertisements in local newspapers. A continued decline in consumer subscriptions of these newspapers could reduce the frequency with which consumers receive our circular advertisements, thereby negatively affecting sales, results of operations and cash flow.

Changes in regulations or enforcement, or our failure to comply with existing or future regulations, may adversely impact our business.

We are subject to federal, state, provincial and local regulations with respect to our operations in the U.S. and Canada. There are a number of legislative and regulatory initiatives that could adversely impact our business if they are enacted or enforced. Those initiatives include wage or

workforce issues (such as minimum-wage requirements, overtime and other working conditions and citizenship requirements), collective bargaining matters, environmental regulation, price and promotion regulation, trade regulations and others. For example, in fiscal 2012, we settled a pricing and promotion investigation by the New York State Attorney General s office through the payment of a fine and other consideration pursuant to an Assurance of Discontinuance, and could be subject to similar investigations, as well as lawsuits, in the future. We are currently subject to multiple class action lawsuits alleging violations of wage and workforce laws and to a purported class action lawsuit alleging violations of Ohio state law in relation to our advertising and pricing practices (see Item 3. Legal Proceedings).

In addition, we expect that the Patient Protection and Affordable Care Act, which was signed into law on March 23, 2010, will increase our annual associate health care costs, with the most significant increases coming in 2014. Proposed changes in tax regulations may also change our effective tax rate as our business is subject to a combination of applicable tax rates in the various countries, states and other jurisdictions in which we operate. New accounting pronouncements and interpretations of existing accounting rules and practices have occurred and may occur in the future. A change in accounting standards or practices can have a significant effect on our reported results of operations. Failure to comply with legal requirements could result in, among other things, increased litigation risk that could affect us adversely by subjecting us to significant monetary damages and other remedies or by increasing our litigation expenses, administrative enforcement actions, fines and civil and criminal liability. If such issues become more expensive to address, or if new issues arise, they could increase our expenses, generate negative publicity, or otherwise adversely affect us.

Our debt agreements contain restrictions that limit our flexibility in operating our business.

Our Senior Secured Credit Facilities and the indentures governing our 2018 Senior Notes and Senior Subordinated Notes contain various covenants that limit our ability to engage in specified types of transactions. These covenants limit our ability and the ability of our restricted subsidiaries to, among other things:

- incur additional debt.
- pay dividends or distributions on our capital stock or repurchase our capital stock.
- issue stock of subsidiaries.
- make certain investments.
- create liens on our assets to secure debt.
- enter into transactions with affiliates.
- merge or consolidate with another company.
- sell or otherwise transfer assets.

In addition, under our Restated Term Loan Credit Facility and our Restated Revolving Credit Facility, we are required to meet specified financial ratios in order to undertake certain actions, and under certain circumstances, we may be required to maintain a specified fixed charge coverage ratio. Our ability to meet those tests can be affected by events beyond our control, and we cannot be assured that we will meet them. A breach of any of these covenants or any other covenant could result in a default under our Senior Secured Credit Facilities. Upon the occurrence of an event of default under our Senior Secured Credit Facilities, the lenders could elect to declare all amounts outstanding under our Senior Secured Credit Facilities to be immediately due and payable and terminate all commitments to extend further credit. If we were unable to repay those amounts, the lenders under our Senior Secured Credit Facilities could proceed against the collateral granted to them to secure such indebtedness. We have pledged substantially all of our assets as collateral under our Senior Secured Credit Facilities. If the lenders under our Senior Secured Credit Facilities accelerate the repayment of borrowings, we cannot be assured that we will have sufficient assets to repay our Senior Secured Credit Facilities, as well as our unsecured indebtedness, including the notes.

Disruptions in the capital markets could increase our costs of doing business.

Any 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 obtaining credit when needed, or otherwise face difficult business conditions, they may become unable to offer us the merchandise we use in our business thereby causing reductions in our revenues, or they may demand more favorable payment terms, all of which could adversely affect our results of operations, cash flows and financial condition.

Our real estate leases generally obligate us for long periods, which subjects us to various financial risks.

We lease virtually all of our store, distribution center, and administrative locations, generally for long terms. While we have the right to terminate some of our leases under specified conditions by making specified payments, we may not be able to terminate a particular lease if or when we would like to do so. If we decide to close stores, we are generally required to continue to perform obligations under the applicable leases, which generally includes, among other things, paying rent and operating expenses for the balance of the lease term, or paying to exercise rights to terminate, and the performance of any of these obligations may be expensive. When we assign or sublease vacated locations, we may remain liable on the lease obligations if the assignee or sublessee does not perform. In addition, when leases for the stores in our ongoing operations expire, we may be unable to negotiate renewals, either on commercially acceptable terms, or at all, which could cause us to close stores. Accordingly, we are subject to the risks associated with leasing real estate, which can have a material adverse effect on our results.

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 place significant reliance on third party providers for the co-sourcing of certain of our information technology (IT), accounts payable, payroll, accounting and human resources functions. This co-sourcing initiative is a component of our ongoing strategy to increase efficiencies, increase our IT capabilities, monitor our costs and seek additional cost savings. These functions are generally performed in offshore locations, with Michaels oversight. As a result, we are relying on third parties to ensure that certain functional needs are sufficiently met. This reliance subjects us to risks arising from the loss of control over these processes, changes in pricing that may affect our operating results and, potentially, termination of provision of these services by our supplier. If our service providers fail to perform, we may have difficulty arranging for an alternate supplier or rebuilding our own internal resources, and we could incur significant costs, all of which may have a significant adverse effect on our business. We may co-source other administrative functions in the future, which would further increase our reliance on third parties. Further, the use of offshore service providers may expose us to risks related to local political, economic, social or environmental conditions (including acts of terrorism, the outbreak of war, or the occurrence of natural disaster), restrictive actions by foreign governments or changes in U.S. laws and regulations.

We are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiary.

Our Canadian subsidiary purchases inventory in U.S. dollars, which is sold in Canadian dollars and exposes us to foreign exchange rate fluctuations. As well, our customers at border locations can be sensitive to cross-border price differences. Substantial foreign currency fluctuations could adversely affect our business.

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 performance depends on recruiting, developing, training and retaining quality sales, distribution center and other associates in large numbers as well as experienced buying and management personnel. Many of our store level associates are in entry level or part-time positions with historically high rates of turnover. Our ability to meet our labor needs while controlling labor costs is subject to external factors such as unemployment levels, prevailing wage rates, minimum wage legislation, changing demographics, health and other insurance costs and governmental labor and employment requirements. In the event of increasing wage rates, if we fail to increase our wages competitively, the quality of our workforce could decline, causing our customer service to suffer, while increasing our wages could cause our earnings to decrease. The market for retail management is highly competitive and, similar to other retailers, we face challenges in securing sufficient management talent. If we do not continue to attract, train and retain quality associates and management personnel, our performance could be adversely affected.

Our results may be adversely affected by serious disruptions or catastrophic events, including geo-political events and weather.

Unforeseen public health issues, such as pandemics and epidemics, and geo-political events, such as civil unrest in a country in which our suppliers are located or terrorist or military activities disrupting transportation, communication or utility systems, as well as natural disasters such as hurricanes, tornadoes, floods, earthquakes and other adverse weather and climate conditions, whether occurring in the U.S. or abroad, particularly during peak seasonal periods, could disrupt our operations or the operations of one or more of our vendors or could severely damage or destroy one or more of our stores or distribution facilities located in the affected areas. Day to day operations, particularly our ability to

receive products from our vendors or transport products to our stores could be adversely affected, or we could be required to close stores or distribution centers in the affected areas or in areas served by the affected distribution center. These factors could also cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and global financial markets and economy. Such occurrences could significantly impact our operating results and financial performance. As a result, our business could be adversely affected.

We are controlled by the Sponsors, whose interests as an equity holder may conflict with those of our debt investors and those of our Company.

We are controlled by the Sponsors, who currently indirectly own approximately 93% of our common stock in the aggregate. The Sponsors control the election of our directors and thereby have the power to control our affairs and policies, including the appointment of management, the issuance of additional equity and the declaration and payment of dividends if allowed under the terms of the credit agreement governing our Senior Secured Credit Facilities, the terms of the indenture governing the senior notes and the terms of our other indebtedness outstanding at the time. The Sponsors do not have any liability for any obligations under or relating to the notes offered hereby and their respective interests may be in conflict with those of our debt investors. For example, if we encounter financial difficulties or are unable to pay our debts as they mature, the Sponsors may pursue strategies that favor equity investors over debt investors. In addition, our equity holders may have an interest in pursuing acquisitions, divestitures, financing or other transactions

that, in their judgment, could enhance their equity investments, even though such transactions may involve risk to holders of our notes. Additionally, the Sponsors may make investments in businesses that directly or indirectly compete with us, or may pursue acquisition opportunities that may be complementary to our business and, as a result, those acquisition opportunities may not be available to us. For information concerning our arrangements with the Sponsors, see Item 10. Directors, Executive Officers and Corporate Governance and Item 13. Certain Relationships and Related Transactions, and Director Independence.

ITEM 1B. Unresolved Staff Comments.

Not applicable.

ITEM 2. Properties.

We lease substantially all of the sites for our Michaels and Aaron Brothers stores, with the majority of our stores having initial lease terms of approximately 10 years. The leases are generally renewable, with increases in lease rental rates. Lessors have made leasehold improvements to prepare our stores for opening under a majority of our existing leases. As of February 2, 2013, in connection with stores that we plan to open or relocate in future fiscal years, we had signed over 55 leases for Michaels stores.

As of March 11, 2013, we lease the following non-store facilities:

	Square Footage
Distribution centers:	
Hazleton, Pennsylvania	1,005,000
Jacksonville, Florida	776,000
Lancaster, California	763,000
Centralia, Washington	718,000
New Lenox, Illinois	693,000
Tarrant County, Texas	433,000
City of Commerce, California (Aaron Brothers)	174,000
	4,562,000
Artistree:	
Coppell, Texas (regional processing and fulfillment operations center)	230,000
Kernersville, North Carolina (manufacturing plant and regional processing center)	156,000
City of Industry, California (regional processing center)	90,000
Mississauga, Ontario (regional processing center)	62,000
	538,000
Office space:	
Irving, Texas (corporate headquarters)	296,000
Coppell, Texas (corporate satellite office)	67,000
Mississauga, Ontario (Canadian regional office)	3,000
	366,000

Coppell, Texas (new store staging warehouse)	29,000
	5,495,000

The following table indicates the number of our retail stores located in each state or province as of March 11, 2013:

	Number of Stores		
State/Province	**Michaels**	**Aaron Brothers**	**Total**
Alabama	12		12
Alaska	3		3
Alberta	17		17
Arizona	27	5	32
Arkansas	4		4
British Columbia	17		17
California	130	82	212
Colorado	21	3	24
Connecticut	15		15
Delaware	4		4
Florida	75		75
Georgia	32	1	33
Idaho	6	1	7
Illinois	38		38
Indiana	17		17
Iowa	7		7
Kansas	8		8
Kentucky	10		10
Louisiana	12		12
Maine	3		3
Manitoba	3		3
Maryland	23		23
Massachusetts	26		26
Michigan	35		35
Minnesota	23		23
Mississippi	6		6
Missouri	21		21
Montana	4		4
Nebraska	4		4
Nevada	10	5	15
New Brunswick	3		3
Newfoundland and Labrador	1		1
New Hampshire	8		8
New Jersey	29		29
New Mexico	3		3
New York	52		52
North Carolina	33		33
North Dakota	2		2
Nova Scotia	4		4
Ohio	32		32
Oklahoma	7		7
Ontario	45		45
Oregon	15	2	17
Pennsylvania	47		47
Prince Edward Island	1		1
Quebec	7		7
Rhode Island	3		3
Saskatchewan	3		3
South Carolina	12		12
South Dakota	2		2
Tennessee	14		14

Texas	77	15	92
Utah	12		12
Vermont	2		2
Virginia	34		34
Washington	22	9	31
West Virginia	5		5
Wisconsin	17		17
Wyoming	1		1
Total	1,106	123	1,229

ITEM 3. Legal Proceedings.

Employee Claims

Adams Claim

On March 20, 2009, 114 individuals commenced an action against the Company styled Adams, et al. v. Michaels Stores, Inc. in the U.S. District Court for the Central District of California. The complaint was later amended to add 15 additional plaintiffs. In 2010, two additional lawsuits making the same allegations were filed in the Central District Court by eight additional plaintiffs, styled Borgen, et al. v. Michaels Stores, Inc. and Langstaff v. Michaels Stores, Inc., and were later consolidated with the Adams suit. The Adams consolidated suit (Adams) alleges that the plaintiffs, certain former and current store managers in California, were improperly classified as exempt employees and, as such, Michaels failed to pay overtime wages, provide meal and rest periods (or compensation in lieu thereof), accurately record hours worked and provide itemized employee wage statements. The Adams suit additionally alleges that the foregoing conduct was in breach of California s unfair competition law. The plaintiffs seek injunctive relief, damages for unpaid wages, penalties, restitution, interest, and attorneys   fees and costs. A number of the individual plaintiff claims have been settled for immaterial amounts. A bench trial on one of the plaintiff s cases occurred in December 2010. The Court has orally advised that Michaels was successful at trial, but has not yet provided its decision in writing. We believe we have meritorious defenses and intend to defend the remaining individual claims vigorously. We do not believe the resolution of these cases will have a material effect on our consolidated financial statements.

Ragano Claim

On July 11, 2011, the Company was served with a lawsuit filed in the California Superior Court in and for the County of San Mateo by Anita Ragano, as a purported class action proceeding on behalf of herself and all current and former hourly retail employees employed by Michaels stores in California. We removed the matter to the U.S. District Court for the Northern District of California on August 9, 2011. The complaint was subsequently amended to add an additional named plaintiff, Terri McDonald. The lawsuit alleges Michaels stores failed to pay all wages and overtime, failed to provide its hourly employees with adequate meal and rest breaks (or compensation in lieu thereof), failed to timely pay final wages, unlawfully withheld wages and failed to provide accurate wage statements and further alleges that the foregoing conduct was in breach of various laws, including California s unfair competition law. The plaintiffs seek injunctive relief, compensatory damages, meal and rest break penalties, waiting time penalties, interest, and attorneys   fees and costs. On August 10, 2012, we reached a tentative class-wide settlement with plaintiffs and the Court granted preliminary approval on October 26, 2012. A final approval hearing is scheduled for April 5, 2013. The settlement, if approval is granted, will not have a material effect on our consolidated financial statements, and was accrued as of February 2, 2013.

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 purported class action proceeding on behalf of themselves and certain former and current store managers employed by Michaels stores 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 the foregoing conduct was in breach of various laws, including California s unfair competition law. The plaintiffs have pled less than five million dollars in damages, penalties, costs of suit and attorneys   fees, exclusive of interest. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of the lawsuit will have a material effect on our

Consolidated Financial Statements.

Tijero and Godfrey Consolidated Claim

On February 12, 2010, the Company and its wholly owned subsidiary, Aaron Brothers, was served with a lawsuit filed in the California Superior Court in and for the County of Alameda by Jose Tijero, a former assistant manager for Aaron Brothers, as a purported class action proceeding on behalf of himself and all current and former hourly retail employees employed by Aaron Brothers in California. On July 12, 2010, Aaron Brothers was served with a lawsuit filed in the California Superior Court in and for the County of Orange by Amanda Godfrey, a former Aaron Brothers hourly employee alleging similar allegations as in the Tijero suit. On October 15, 2010, the cases were consolidated against Aaron Brothers and re-filed in the U.S. District Court Northern District of California. These suits allege that Aaron Brothers failed to pay all wages and overtime, failed to provide its hourly employees with adequate meal and rest breaks (or compensation in lieu thereof), failed to timely pay final wages, unlawfully withheld wages and failed to provide accurate wage statements and further alleges that the foregoing conduct was in breach of various laws, including California s unfair competition law. The plaintiff seeks injunctive relief, compensatory damages, meal and rest break penalties, waiting time penalties, interest, and attorneys fees and costs. On April 4, 2012, we reached a class-wide settlement with

plaintiffs that is subject to the Court s approval. The Court has denied the approval of the settlement, without prejudice, however, a renewed motion seeking approval of the settlement has been filed. The settlement, if approved, will not have a material effect on our consolidated financial statements, and was accrued as of February 2, 2013.

Irene Barreras Claim

On July 24, 2012, Irene Barreras, a former employee, filed a purported class action proceeding against Michaels Stores, Inc. in the Superior Court of the State of California for the County of Alameda (Alameda Superior Court), alleging unfair business competition and unjust enrichment, wrongful termination, disability discrimination, failure to prevent discrimination, failure to engage in the interactive process, and failure to accommodate mental or physical disabilities. The suit is brought on Ms. Barreras behalf and on behalf of a class of all retail store employees who were terminated from July 24, 2008 to the present, allegedly due to Michaels refusal to engage in the interactive process with, or provide accommodations to, the terminated employees who did not meet the qualifications for medical leaves. The plaintiff seeks injunctive relief, compensatory damages, punitive damages, consequential damages, general damages, interest, attorneys fees and costs. On August 24, 2012, we removed the case to the United States District Court, Northern District of California. Plaintiffs deadline to file its Motion for Class Certification is September 25, 2013.We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of the lawsuit will have a material effect on our consolidated financial statements.

Consumer Class Action Claims

Zip Code Claims

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the Superior Court of California, County of San Diego (San Diego Superior Court), on behalf of herself and all similarly-situated California consumers. The Carson lawsuit alleges that Michaels unlawfully requested and recorded personally identifiable information (i.e., her zip code) as part of a credit card transaction. The plaintiff sought statutory penalties, costs, interest, and attorneys fees. We contested certification of this claim as a class action and filed a motion to dismiss the claim. On March 9, 2009, the Court dismissed the case with prejudice. The plaintiff appealed this decision to the California Court of Appeals for the Fourth District, San Diego. On July 22, 2010, the Court of Appeals upheld the dismissal of the case. The plaintiff appealed this decision to the Supreme Court of California (California Supreme Court). On September 29, 2010, the California Supreme Court granted the plaintiff s petition for review; however, it stayed any further proceedings in the case until another similar zip code case pending before the court, Pineda v. Williams-Sonoma, was decided. On February 10, 2011, the California Supreme Court ruled, in the Williams-Sonoma case, that zip codes are personally identifiable information and therefore the Song-Beverly Credit Card Act of 1971, as amended (Song Act), prohibits businesses from requesting or requiring zip codes in connection with a credit card transaction. On or about April 6, 2011, the Supreme Court transferred the Carson case back to the Court of Appeals with directions to the Court to reconsider its decision in light of the Pineda decision. Upon reconsideration, the Court of Appeals remanded the case back to the San Diego Superior Court on May 31, 2011.

Additionally, since the California Supreme Court decision on February 10, 2011, three additional purported class action lawsuits alleging violations of the Song Act have been filed against the Company: Carolyn Austin v. Michaels Stores, Inc. and Tiffany Heon v. Michaels Stores, Inc., both in the San Diego Superior Court and Sandra A. Rubinstein v. Michaels Stores, Inc. in the Superior Court of California, County of Los Angeles, Central Division. The Rubinstein case was transferred to the San Diego Superior Court. An order coordinating the cases has been entered and plaintiffs filed a Consolidated Complaint on April 24, 2012. Plaintiffs seek damages, civil penalties, common settlement fund recovery, attorney fees, costs of suit and prejudgment interest.

Also, relying in part on the California Supreme Court decision, an additional purported class action lawsuit was filed on May 20, 2011 against the Company: Melissa Tyler v. Michaels Stores, Inc. in the U.S. District Court-District of Massachusetts, alleging violation of a similar Massachusetts statute regarding the collection of personally identifiable information in connection with a credit card transaction. A hearing was held on October 20, 2011 on our Motion to Dismiss the claims. On January 6, 2012, the Court granted our Motion to Dismiss. The Court thereafter certified questions of law to the Massachusetts Supreme Judicial Court regarding the interpretation of the Statute. On March 11, 2013, the District Court s dismissal of the action was reversed and it was remanded back to the District Court for further proceedings.

We intend to vigorously defend each of these zip code claim cases and we are unable, at this time, to estimate a range of loss, if any.

Pricing and Promotion

On April 30, 2012, William J. Henry, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the Court of Common Pleas, Lake County, Ohio, on behalf of himself and all similarly-situated Ohio consumers who purchased framing products and/or services from Michaels during weeks where Michaels was advertising a discount for framing products and/or services. The lawsuit alleges Michaels advertised discounts on its framing products and/or services without actually providing a discount to its customers. The plaintiff claims violation of Ohio law ORC 1345.01 et seq., breach of contract, unjust enrichment and fraud. The plaintiff has alleged damages, penalties and fees not to exceed $5 million, exclusive of interest and costs. We filed a Motion to Dismiss on July 3, 2012. On October 23, 2012, the Court granted our Motion to Dismiss, in part, dismissing the Plaintiff s breach of contract claim and denying the motion as to the other claims. A trial is scheduled for February 2014. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of this lawsuit will have a material effect on our consolidated financial statements.

Website Tracking and Coding

On June 19, 2012, Jerome Jurgens, a citizen of Missouri, filed a purported class action proceeding against Michaels Stores, Inc. in the 25th Judicial Circuit Court, Phelps County, Missouri, on behalf of himself, Wendy Poepsel and all other similarly-situated Missouri individuals who, on or after June 19, 2007, accessed the Michaels website and had Flash cookies attach to their computers. Plaintiffs allege that Michaels, through the use of its website, makes use of cookies in order to ascertain user s web browsing habits. Specifically, the plaintiffs allege violations of the Missouri Computer Tampering and Merchandising Practices Act statutes, as well as common law claims of conversion, trespass to chattels, invasion of privacy and unjust enrichment are alleging damages, penalties and fees not to exceed $5 million, inclusive of costs and attorneys fees. We filed a Motion to Dismiss on August 8, 2012, which was subsequently denied. Trial is to commence in September 2013. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. Michaels has tendered the matter to a vendor and the vendor has accepted the indemnity and defense of the case.

Data Breach Claims

Payment Card Terminal Tampering

On May 3, 2011, we were advised by the U.S. Secret Service that they were investigating certain fraudulent debit card transactions that occurred on accounts that had been used for legitimate purchases in selected Michaels stores. A subsequent internal investigation revealed that approximately 90 payment card terminals in certain Michaels stores had been physically tampered with, potentially resulting in customer debit and credit card information to be compromised. We have since removed and replaced approximately 7,100 payment card terminals comparable to the identified tampered payment card terminals from our Michaels stores. The Company continues to cooperate with various governmental entities and law enforcement authorities in investigating the payment card terminal tampering, but we do not know the full extent of any fraudulent use of such information.

On May 18, 2011, Brandi F. Ramundo, a consumer, filed a purported class action proceeding against Michaels Stores, Inc. in the U.S. District Court for the Northern District of Illinois, on behalf of herself and all similarly- situated U.S. consumers. The Ramundo lawsuit alleges that Michaels failed to take commercially reasonable steps to protect consumer financial data, and was in breach of contract and laws, including the Federal Stored Communications Act and the Illinois Consumer Fraud and Deceptive Practices Act. The plaintiff seeks compensatory, statutory and punitive damages, costs, credit card fraud monitoring services, interest and attorneys fees. Subsequently two additional purported class action lawsuits significantly mirroring the claims in the Ramundo complaint were filed against the Company: Mary Allen v. Michaels

Stores, Inc., and Kimberly Siprut v. Michaels Stores, Inc., both in the U.S. District Court for the Northern District of Illinois. On June 8, 2011, an order was entered consolidating these matters, which also provided for consolidation of all related actions subsequently filed in or transferred to the Northern District of Illinois. On July 8, 2011, a Consolidated Amended Class Action Complaint styled In Re Michaels Stores Pin Pad Litigation (In Re Michaels Stores Consolidated Complaint) was filed in the U.S. District Court for the Northern District of Illinois. On August 8, 2011, we filed a Motion to Dismiss the In Re Michaels Stores Consolidated Complaint. On November 23, 2011, the Court dismissed the Stored Communications Act and negligence claims under Illinois law, but denied the motion as to the breach of implied contract and Illinois Consumer Fraud and Deceptive Practices Act claims.

Four other substantially similar putative class action lawsuits have also been filed. Jeremy Williams v. Michaels Stores, Inc. and Fred Sherry v. Michaels Stores, Inc., were filed in the U.S. District Court for the Northern District of Illinois. Sara Rosenfeld and Ilana Soffer v. Michaels Stores, Inc. and Lori Wilson v. Michaels Stores, Inc. were both filed in New Jersey state court, removed to the United States District Court for the District of New Jersey, and transferred to the United States District Court for the Northern District of Illinois. The New Jersey cases assert negligence and New Jersey Consumer Fraud Act claims. All four cases are subject to the consolidation order. The Court has held that Michaels is not required to respond to those complaints.

On August 20, 2012, we reached a tentative class-wide settlement with plaintiffs and the Court granted preliminary approval of the settlement on December 19, 2012. A final approval hearing is scheduled for April 4, 2013. The settlement, will not have a material effect on our consolidated financial statements, and was accrued as of February 2, 2013.

Governmental Inquiries and Related Matters

Non-U.S. Trust Inquiry

In early 2005, the District Attorney s office of the County of New York and the SEC opened inquiries concerning non-U.S. trusts that directly or indirectly held shares of Michaels Common Stock and Common Stock options. On July 29, 2010, the SEC filed a civil enforcement action in federal district court for the Southern District of New York against Charles Wyly, Sam Wyly, the Wylys attorney - Michael French, and others alleging, among other things, violations of various federal securities laws, including those governing ownership reporting and trading of securities, in connection with the non-U.S. trusts and their subsidiaries. Additional information may be obtained at the SEC s website. Sam Wyly, the estate of Charles Wyly and Mr. French, also a former director of the Company, have requested indemnification from the Company for certain legal costs with respect to these matters. The Company has resolved all claims with regards to Sam Wyly and the estate of Charles Wyly for an immaterial amount.

On April 12, 2012, Mr. French filed a lawsuit against the Company and the non-U.S. trusts in the District Court of Dallas County, Texas. The matter was dismissed as to the non-U.S. trusts. Mr. French seeks damages from the Company for breach of contract, attorneys fees and costs related to the Company s alleged indemnification obligations to Mr. French and attorneys fees and costs related to the lawsuit. We believe we have meritorious defenses and intend to defend the claims vigorously. We do not believe the resolution of this case will have a material effect on our Consolidated Financial Statements.

General

In addition to the litigation discussed above, we are, and in the future, may be involved in various other lawsuits, claims and proceedings incidental to the ordinary course of business.

PART II

ITEM 4. Submission of Matters to a Vote of Security Holders.

By a written consent dated March 19, 2012 holders of 93% of the common stock of the Company voted their shares to ratify prior transactions between the Company and certain affiliates. The affirmative vote of more than 50% of the stockholders was required to take such action.

By a written consent dated September 13, 2012, holders of 93% of the common stock of the Company voted their shares to allow the Company to enter into the Restated Revolving Credit Facility. The affirmative vote of more than 50% of the stockholders was required to take such action.

By a written consent dated January 28, 2013, holders of 93% of the common stock of the Company voted their shares to allow the Company to enter into the Restated Term Loan Credit Facility. The affirmative vote of more than 50% of the stockholders was required to take such action.

ITEM 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market Information

Our Common Stock is privately held and there is no established public trading market for our stock.

Holders

As of March 11, 2013, there were 31 holders of record of our common stock.

Dividends

The Company has not declared or paid any cash dividends on its common stock in fiscal 2012 and fiscal 2011. The Company does not anticipate paying any cash dividends in the near future.

ITEM 6. Selected Financial Data.

The following financial information for the five most recent fiscal years has been derived from our Consolidated Financial Statements. This information should be read in conjunction with the Consolidated Financial Statements and related notes thereto included elsewhere herein.

	Fiscal Year				
	2012(1)	2011	2010	2009	2008
	(In millions, except operating and store count data)				
Results of Operations Data:					
Net sales	$ 4,408	$ 4,210	$ 4,031	$ 3,888	$ 3,817
Operating income	615	569	488	397	304
Interest expense	245	254	276	257	302
Refinancing costs and losses on early extinguishments of debt(2)	33	18	53		
Net income (loss)	214	176	103	103	(7)
Comprehensive income (loss)	214	175	104	104	(12)
Balance Sheet Data:					
Cash and equivalents	$ 56	$ 371	$ 319	$ 217	$ 33
Merchandise inventories	865	840	826	873	900
Total current assets	1,047	1,334	1,271	1,199	1,047
Total assets	1,541	1,822	1,780	1,722	1,639
Total current liabilities	824	837	685	719	683
Current debt	150	127	1	119	173
Long-term debt	2,891	3,363	3,667	3,684	3,756
Total liabilities	3,800	4,296	4,434	4,488	4,517
Stockholders deficit	(2,259)	(2,474)	(2,654)	(2,766)	(2,878)
Other Financial Data:					
Cash flows provided by operating activities	$ 302	$ 413	$ 438	$ 405	$ 59
Cash flows used in investing activities	(124)	(109)	(83)	(43)	(85)
Cash flow (used in) provided by financing activities	(493)	(252)	(253)	(178)	30
Other Operating Data:					
Average net sales per selling square foot (3)	$ 215	$ 212	$ 205	$ 201	$ 202
Comparable store sales increase (decrease) (4)	1.5%	3.2%	2.5%	0.2%	(4.6)%
Total selling square footage (in millions)	20.6	20.1	19.9	19.6	19.4
Stores Open at End of Year:					
Michaels	1,099	1,064	1,045	1,023	1,009
Aaron Brothers	126	134	137	152	161
Total stores open at end of year	1,225	1,198	1,182	1,175	1,170

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(1) Fiscal 2012 consisted of 53 weeks while all other periods presented consisted of 52 weeks.

(2) Fiscal 2012 refinancing costs and losses on early extinguishments of debt includes $12 million of refinancing costs associated with our Restated Term Loan Credit Facility, an $8 million loss related to our amended and restated senior secured term loan facility and prepayment of our B-1 Term Loans, an $11 million loss related to the redemption of our remaining outstanding 13% Subordinate Discount Notes due November 1, 2016 (Subordinated Discount Notes), and a $2 million loss related to our senior secured asset-based Revolving Credit Facility. Fiscal 2011 refinancing costs and losses on early extinguishments of debt includes an $18 million loss related to the early extinguishment of $163 million face value, or $155 million accreted value, of our outstanding Subordinated Discount Notes and $7 million face value of our Senior Subordinated Notes. Fiscal 2010 refinancing costs and losses on early extinguishments of debt includes a $53 million loss related to the early extinguishment of our 10% Senior Notes.

(3) The calculation of average net sales per selling square foot includes only Michaels comparable stores, as defined below. Aaron Brothers, which is a smaller store model, is excluded from the calculation.

(4) Comparable store sales increase (decrease) represents the increase (decrease) in net sales for stores open the same number of months in the indicated and 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 is closed. If a store is closed longer than two weeks but less than two months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than two months becomes comparable in its 14th month of operation after its reopening.

ITEM 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with our Consolidated Financial Statements and the related notes included elsewhere in this Annual Report on Form 10-K. The following discussion, as well as other portions of this Annual Report on Form 10-K, 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, intends, and other similar expressions) that are not statements of historical fact should be considered forward-looking statements and should be read in conjunction with our Consolidated Financial Statements and related notes contained elsewhere in this report. Specific examples of forward-looking statements include, but are not limited to, statements regarding our forecasts of financial performance, capital expenditures, working capital requirements, and forecasts of effective tax rate. Our actual results could materially differ from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Annual Report on Form 10-K, and particularly in Item 1A. Risk Factors.

We report on the basis of a 52- or 53-week fiscal year, which ends on the Saturday closest to January 31. References to fiscal year mean the year in which that fiscal year began. Fiscal 2012 ended on February 2, 2013, fiscal 2011 ended on January 28, 2012, and fiscal 2010 ended on January 29, 2011. Fiscal 2012 contained 53 weeks, while fiscal 2011 and fiscal 2010 each contained 52 weeks.

Executive Overview

We believe Michaels is where creativity happens. With over $4.4 billion in sales, we are the largest arts and crafts specialty retailer in North America. Our primary business is the operation of 1,106 Michaels stores across the U.S. and Canada. We also operate 123 Aaron Brothers stores, a custom frame, framing, and art supply chain (all store counts are as of March 11, 2013).

Highlights for fiscal 2012 include the following:

- Net sales increased to $4,408 million, a 4.7% improvement over last year, driven by a 1.5% increase in comparable store sales, the opening of 38 new stores and a 53rd week in fiscal 2012. Our new store growth included five urban market stores as well as three small market stores. In addition, we completed 13 store relocations during the year.

- The estimated impact of the 53rd week in fiscal 2012 was an increase in Net sales of approximately $66 million.

- Our Michaels retail stores   private brand merchandise drove 49% of Net sales, up from 44% in fiscal 2011.

- Direct import penetration, as a percent of total receipts, increased to 29% compared to 26% in fiscal 2011.

- Gross profit improved by 30 basis points to 40.3% for fiscal 2012.

- We reported record operating income of $615 million, an increase of 8.1% from prior year.

- Net income increased by $38 million to $214 million. Adjusted EBITDA, a non-GAAP measure that is a required calculation in our debt agreements, improved by 6.7%, from $706 million in fiscal 2011 to $753 million fiscal 2012 (see Non-GAAP Measures).

- We reduced our outstanding indebtedness by $449 million.

- We redeemed our remaining outstanding Subordinated Discount Notes totaling $306 million.

- We prepaid the remaining $501 million of B-1 Term Loans under our Senior Secured Term Loan Facility and subsequently amended and restated various terms of our Senior Secured Term Loan Facility to provide senior secured financing of $1,640 million due to mature on or after July 28, 2018.

- We amended and restated various terms of our senior secured asset-based revolving credit facility.

- We continued to build our relationship with our customers through our marketing vehicles, internet site, mobile platform, in-store experience, and social media outlets.

In fiscal 2013, we will continue to lead industry growth and innovation through strategic initiatives such as:

- deepening our customer relationship through in-store experiences and multi-channel marketing.

- offering inspirational new products through frequent merchandise resets.

- continuously improving processes to achieve cost savings and cash flow increases.

- growing private brand penetration.

- continuing to improve pricing and promotional strategies.

- opening 50 to 55 new stores, including 10 to 20 relocations.

Critical Accounting Policies and Estimates

We have prepared our financial statements in conformity with U.S. generally accepted accounting principles (GAAP), and these financial statements necessarily include some amounts that are based on our informed judgments and estimates. Our senior management has discussed the development and selection of these critical accounting estimates, and the disclosure in this section of this report regarding them, with the Audit Committee of our Board. Our significant accounting policies are discussed in Note 1 to the Consolidated Financial Statements. Our critical accounting policies represent those policies that are subject to judgments and uncertainties. As discussed below, our financial position and results of operations may be materially different when reported under different conditions or when using different assumptions in the application of these policies. In the event estimates or assumptions prove to be different from actual amounts, adjustments are made in subsequent periods to reflect more current information. Our critical accounting policies include:

Merchandise Inventories Merchandise inventories are valued at the lower of cost or market, with cost determined using a weighted average method. Cost is calculated based upon the price paid for an item at the time it is received by us, and also includes the cost of warehousing, handling, purchasing, and importing the inventory, as well as inbound and outbound transportation, partially offset by vendor allowances. This net inventory cost is recognized through Cost of sales when the inventory is sold. It is impractical for us to assign specific allocated overhead costs and vendor allowances to individual units of inventory. As such, to match net inventory costs against the related revenues, we estimate the net inventory costs to be deferred and recognized each period as the inventory is sold.

Vendor allowances, which primarily represent volume rebates and cooperative advertising funds, are recorded as a reduction of the cost of the merchandise inventories and a subsequent reduction in Cost of sales when the inventory is sold. We generally earn vendor allowances as a percentage of certain merchandise purchases with no minimum purchase requirements. Typically, our vendor allowance programs extend for a period of 12 months. We recognized vendor allowances of $110 million, or 2.5% of Net sales in fiscal 2012, $115 million, or 2.7% of Net sales in fiscal 2011, and $112 million, or 2.8% of Net sales in fiscal 2010. During the three fiscal years ended February 2, 2013, the number of vendors from which vendor allowances were received ranged from approximately 650 to 670. As a result of our increased direct import penetration, vendor allowances, as a percentage of Net sales, have been declining and we expect this trend to continue in future years.

We utilize perpetual inventory records to value inventory in our stores. Physical inventory counts are performed in a significant number of stores during each fiscal quarter by a third party inventory counting service. Substantially all stores open longer than one year are subject to at least one count each fiscal year. We adjust our perpetual records based on the results of the physical counts. We maintain a provision for estimated shrinkage based on the actual historical results of our physical inventories. We compare our estimates to the actual results of the physical inventory counts as they are taken and adjust the shrink estimates accordingly. A 10% change in our estimated shrinkage would have affected Net income by $2 million for fiscal 2012. We also evaluate our merchandise to ensure that the expected net realizable value of the merchandise held at the end of a fiscal period exceeds cost. In the event that the expected net realizable value is less than cost, we reduce the value of that inventory accordingly. A 10% change in our inventory valuation reserve would have affected Net income by $1 million for fiscal 2012.

Goodwill We review goodwill for impairment each year in the fourth quarter, or more frequently if required. Beginning in fiscal 2011, in conducting our impairment review, we elected to first perform a qualitative assessment to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) the fair value of our reporting units is less than its carrying value. Factors used in our qualitative assessment include, but are not limited to, macroeconomic conditions, industry and market conditions, cost factors, overall financial performance, company and reporting unit specific events, and the margin between the fair value and carrying value of each reporting unit in recent valuations.

If, after assessing the totality of events or circumstances such as those described above, we determine that it is more likely than not that the fair value of our reporting units is greater than its carrying amount, no further action is required. If we determine that it is more likely than not that the fair value of our reporting unit is less than its carrying amount, we will compare the reporting unit s carrying value to its estimated fair value, determined through estimated discounted future cash flows and market-based methodologies. If the carrying value exceeds the estimated fair value, we determine the fair value of all assets and liabilities of the reporting unit, including the implied fair value of goodwill. If the carrying value of goodwill exceeds the implied fair value, we recognize an impairment charge equal to the difference.

Factors used in the valuation of goodwill include, but are not limited to, management s plans for future operations, recent operating results and discounted projected future cash flows. Material assumptions used in our impairment analysis include the weighted average cost of capital percentage, terminal growth rate and forecasted long-term sales growth. During fiscal 2012, we recognized a goodwill impairment charge of $1 million for our online scrapbooking business. See Note 8 to our Consolidated Financial Statements for further information. During fiscal 2011 and fiscal 2010, there was no impairment charge taken on our goodwill.

Impairment of Long-Lived Assets We evaluate long-lived assets, other than goodwill and assets with indefinite lives, for indicators of impairment whenever events or changes in circumstances indicate their carrying amounts may not be recoverable. Additionally, for store assets, we evaluate the performance of individual stores for indicators of impairment and underperforming stores are selected for further evaluation of the recoverability of the carrying amounts. The evaluation of long-lived assets is performed at the lowest level of identifiable cash flows, which is at the individual store level.

Our evaluation requires consideration of a number of factors including changes in consumer demographics and uncertain future events. Accordingly, our accounting estimates may change from period to period. These factors could cause management to conclude impairment

indicators exist and require that tests be performed, which could result in a determination that the value of long-lived assets is impaired, resulting in a writedown to fair value.

Our initial indicator that store assets are considered to be recoverable is that the estimated undiscounted cash flows for the remaining lease term, assuming zero growth over current year store performance, exceed the carrying value of the assets. This evaluation is performed on stores open longer than 36 months (unless significant impairment indicators exist), as we consider a store to become mature after that time period. Any stores that do not meet the initial criteria are further evaluated taking into consideration the estimated undiscounted store-specific cash flows for the remaining lease term compared to the carrying value of the assets. To estimate store-specific future cash flows, management must make assumptions about key store variables, including sales, growth rate,

gross margin, payroll and other controllable expenses. Furthermore, management considers other factors when evaluating stores for impairment, including the individual store s execution of its operating plan and other local market conditions.

An impairment is recognized once all the factors noted above are taken into consideration and it is determined the carrying amount of the store s assets are not recoverable. The impairment is based on estimated fair value of the assets, excluding assets that can be redeployed. In fiscal 2012, we recorded an impairment charge, net of tax, of $4 million related to the write off of long-lived assets associated with our online scrapbooking business. We recorded an impairment charge, net of tax, of less than $1 million in each of fiscal 2011 and fiscal 2010. In addition to recording impairment charges on certain stores based on the previously discussed criteria, we maintain a list of stores we consider at risk and monitor those stores closely. As of February 2, 2013, we had three stores we considered at risk for impairment with a minimal carrying value of assets.

Reserve for Closed Facilities We maintain a reserve for future rental obligations, carrying costs, and other closing costs related to closed facilities, primarily closed and relocated stores. In accordance with ASC 420, *Exit or Disposal Cost Obligations*, we recognize exit costs for any store closures at the time the store is closed. Such costs are recorded within the Cost of sales and occupancy expense line item on our Consolidated Statements of Comprehensive Income.

The cost of closing a store or facility is calculated as the lesser of the present value of future rental obligations remaining under the lease (less estimated sublease rental income) or the lease termination fee. The determination of the reserves is dependent on our ability to make reasonable estimates of costs to be incurred post-closure and of rental income to be received from subleases. In planning our store closures, we try to time our exits as close to the lease termination date as possible to minimize any remaining lease obligation. As of February 2, 2013 and January 28, 2012, our reserves for closed facilities were $8 million and $9 million, respectively. The reserves could differ materially if market conditions were to vary significantly from our assumptions.

Self-Insurance We have insurance coverage for losses in excess of self-insurance limits for medical liability, general liability and workers compensation claims. Health care reserves are based on actual claims experience and an estimate of claims incurred but not reported. Reserves for general liability and workers compensation are determined through the use of actuarial studies. Due to the significant judgments and estimates utilized in determining these reserves, they are subject to a high degree of variability. In the event our insurance carriers are unable to pay claims submitted to them, we would record a liability for such estimated payments we expect to incur. A 10% change in our self-insurance liability would have affected Net income by approximately $4 million for fiscal 2012.

Revenue Recognition Revenue from sales of our merchandise is recognized when the customer takes possession of the merchandise. Revenue is presented net of sales taxes collected. Sales related to custom framing are deferred until the order is picked up by the customer, which we estimate based on historical customer behavior. We deferred 10 days of custom framing revenue at the end of fiscal 2012, and 13 days at the end of each of fiscal 2011 and 2010. A one day change in our custom frame deferral would have had a minimal impact on our fiscal 2012 Net income. As of February 2, 2013 and January 28, 2012, our deferred framing revenue was approximately $8 million and $10 million, respectively.

We allow for merchandise to be returned under most circumstances and provide a reserve for estimated returns. We use historical customer return behavior to estimate our reserve requirements. As of February 2, 2013 and January 28, 2012, our sales returns reserve was approximately $3 million.

We record a gift card liability on the date we issue the gift card to the customer. We record revenue and reduce the gift card liability as the customer redeems the gift card. The deferred revenue associated with outstanding gift cards increased $3 million from $30 million at January 28, 2012 to $33 million as of February 2, 2013. We escheat the value of unredeemed gift cards where required by law. Any remaining liabilities not subject to escheatment are evaluated to determine whether the likelihood of the gift card being redeemed is remote (gift card breakage). We recognize gift card breakage as revenue, by applying our estimate of the rate of gift card breakage over the period of estimated performance. Our estimates of the gift card breakage rate are applied to the estimated amount of gift cards that are expected to go unused and that are not subject to escheatment, and such estimates are based on customers historical redemption rates and patterns. We recognized revenue of approximately $3 million in fiscal 2012, $1 million in fiscal 2011, and $3 million in fiscal 2010 related to such gift card balances. We do not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to recognize income related to unredeemed gift cards. However, if actual results are not consistent with our assumptions, we may record additional income or expense.

Costs of Sales and Occupancy Expenses Cost of sales and occupancy expenses include the following which may not be comparable to other companies:

Included in our Costs of sales are the following:

- purchase price of merchandise, net of vendor allowances and rebates.
- inbound freight, inspection costs, duties and import agent commissions.
- warehousing, handling, and transportation costs (including internal transfer costs such as distribution center-to-store freight costs) and purchasing and receiving costs.
- share-based compensation costs for those employees involved in preparing inventory for sale.

Costs of sales are included in merchandise inventories and expensed as the merchandise is sold.

Included in our occupancy expenses are the following costs which are recognized as period costs as described below:

- store expenses such as rent, insurance, taxes, common area maintenance, utilities, repairs and maintenance.
- amortization of store buildings and leasehold improvements.
- store closure costs.
- store remodel costs.

We record rent expense ratably over the term of the lease beginning with the date we take possession of or control the physical access to the premises. We record leasehold improvement reimbursements as a liability and ratably adjust the liability as a reduction to rent expense over the lease term beginning with the date we take possession of or control the physical access to the premises. At times, we receive landlord reimbursements for leasehold improvements made during the lease term, which we record as a liability and ratably adjust as a reduction to rent expense over the remaining lease term.

Share-Based Compensation Expenses ASC 718, *Stock Compensation,* requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements, based on their grant date fair value, ratably recognized as an expense over the requisite service period. We estimate the fair value of stock option awards using a Black-Scholes option value model.

All grants of our stock options have an exercise price equal to or greater than the fair market value of our common stock on the date of grant. Because we are privately held and there is no public market for our common stock, the fair value of our equity was estimated by a third party valuation firm and approved by our Board at the time option grants are awarded. In estimating the fair value of our common stock, the Board considers factors it believes are material to the valuation process including the Company s actual and projected financial results, the principal amount of the Company s indebtedness and formal valuations of the Company. In fiscal 2012, fiscal 2011 and fiscal 2010, valuations completed relied on projections of our future performance, estimates of our weighted average cost of capital, and metrics based on the performance of a peer group of similar companies, including valuation multiples and stock price volatility.

From January 28, 2012 to February 2, 2013, the estimated fair value of common stock increased from $24.09 to $26.93 per share. The price per share increased over the period primarily due to the reduction in the amount of our outstanding debt and an increase in our baseline operating results.

Other assumptions used in the option value models for estimating the fair value of stock option awards include expected volatility of our common stock share price, expected terms of the options, expected dividends, and forfeitures. The expected volatility rate is based on both historical volatility as well as implied volatilities from the exchange-traded options on the common stock of a peer group of companies. We utilize historical exercise and post-vesting employment behavior to estimate the expected terms of the options and do not use a dividend rate assumption. Our forfeitures assumption was estimated based on historical experience and anticipated events. The risk-free interest rate is based on the yields of U.S. Treasury instruments with approximately the same term as the expected life of the stock option award. We update our assumptions regularly based on historical trends and current market observations.

As of February 2, 2013, compensation cost not yet recognized related to nonvested awards totaled $10 million and is expected to be recognized over a weighted average period of 2.4 years. In the event of a Change in Control (as defined in the Stockholders Agreement), all nonvested awards will vest and the $10 million would be immediately recognized. A 10% change in the fair value of stock option awards granted in fiscal 2012 would have had an immaterial impact on our fiscal 2012 Net income and compensation cost not yet recognized.

Income Taxes We record income tax expense using the liability method for taxes and are subject to income tax in many jurisdictions, including the U.S., various states and localities, and Canada. A current tax liability or asset is recognized for the estimated taxes payable or refundable on the tax returns for the current year and a deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards. Deferred tax assets and liabilities are measured using enacted income tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates is recognized as income or expense in the period that includes the enactment date. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized. In evaluating our ability to realize our deferred tax asset, we considered the following sources of future taxable income:

- future reversals of existing taxable temporary differences;
- future taxable income, exclusive of reversing temporary differences and carryforwards;
- taxable income in prior carryback years; and
- tax-planning strategies.

Our evaluation regarding whether a valuation allowance is required or should be adjusted also considers, among other things, the nature, frequency, and severity of recent losses, forecasts of future profitability and the duration of statutory carryforward periods. Our forecast of future profitability represents our best estimate of these future events. After conducting this assessment, the valuation allowance recorded against our deferred tax assets was $10 million and $14 million as of February 2, 2013 and January 28, 2012, respectively. If actual results differ from estimated results, or if we adjust these assumptions in the future, we may need to adjust our deferred tax assets or liabilities, which could impact our effective tax rate.

The amount of income taxes we pay is subject to ongoing audits in the taxing jurisdictions in which we operate. During these audits, the taxing authorities may challenge items on our tax returns. Because the tax matters challenged by tax authorities are typically complex, the ultimate outcome of these challenges is uncertain. We recognize tax benefits for uncertain positions only to the extent that we believe it is more likely than not that the tax position will be sustained. Our future results may include favorable or unfavorable adjustments to our unrecognized tax benefits due to closure of income tax audits, new regulatory or judicial pronouncements, or other relevant events. As a result, our effective tax rate may fluctuate significantly on a quarterly and annual basis.

Results of Operations

The following table sets forth the percentage relationship to Net sales of line items of our Consolidated Statements of Comprehensive Income. This table should be read in conjunction with the following discussion and with our Consolidated Financial Statements, including the related notes.

		Fiscal Year	
	2012	**2011**	**2010**
Net sales	100.0%	100.0%	100.0%
Cost of sales and occupancy expense	59.7	60.0	61.2
Gross profit	40.3	40.0	38.8
Selling, general, and administrative expense	25.7	26.1	26.3

Impairment of intangible assets	0.2		
Related party expenses	0.3	0.3	0.3
Store pre-opening costs	0.1	0.1	0.1
Operating income	14.0	13.5	12.1
Interest expense	5.6	6.0	6.8
Refinancing costs and losses on early extinguishments of debt	0.7	0.4	1.3
Other (income) and expense, net		0.2	0.2
Income before income taxes	7.7	6.9	3.8
Provision for income taxes	2.8	2.7	1.2
Net income	4.9%	4.2%	2.6%

Fiscal 2012 Compared to Fiscal 2011

Net Sales Net sales increased for fiscal 2012 by $198 million, or 4.7%, over fiscal 2011 due to $70 million of incremental revenue from our non-comparable stores, $66 million from the 53rd week of fiscal 2012, and a $62 million increase in comparable store sales. Comparable store sales increased 1.5% driven by an increase in transactions of 0.8% and an increase in the average ticket

of 0.7%. Comparable store sales dollar growth was strongest in custom framing within our framing department and percentage growth was strongest in home accents within our seasonal and home décor department.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $106 million to $2,632 million in fiscal 2012 from $2,526 million in fiscal 2011 due primarily to a $95 million increase in merchandise costs associated with higher sales, including $66 million of sales from the 53rd week of fiscal 2012. The increase was partially offset by a $14 million decrease in merchandise costs related to our direct import penetration, private brand initiative, and improved pricing and promotion management. In addition, we had a $7 million increase from favorable shrink experience in fiscal 2011 compared to more normal levels in fiscal 2012, and a $5 million increase from lower recognition of vendor allowances compared to prior year. Finally, rent and related expenses increased $15 million due mainly to $10 million of new store rent and a $3 million increase in occupancy insurance premiums.

Cost of sales and occupancy expense decreased 30 basis points, as a percentage of Net sales, to 59.7% in fiscal 2012 from 60.0% in fiscal 2011. Merchandise cost decreased 30 basis points driven by our direct import penetration, private brand initiative, and improved pricing and promotion management, while occupancy decreased 30 basis points due to increased leverage on higher store sales. These improvements were partially offset by a 20 basis point increase from the recognition of vendor allowances compared to prior year.

Selling, General, and Administrative Expense Selling, general and administrative expense was $1,135 million in fiscal 2012 compared to $1,098 million in fiscal 2011. Selling, general and administrative expense increased $37 million driven by $23 million of incremental store costs for operating 35 additional Michaels stores and a $17 million increase in store payroll from additional payroll associated with the 53rd week of fiscal 2012, as well as a higher average hourly wage rate. In addition, we had a $6 million increase in corporate payroll due primarily to the 53rd week of fiscal 2012, an increase in wage rate and an increased headcount. Finally, we had a $4 million increase in group insurance claims and payroll tax increased $4 million mainly due to an increase in unemployment insurance rates compared to last year. These amounts were partially offset by a $18 million decrease in bonus expense from a lower bonus payout recognized in fiscal 2012 compared to fiscal 2011.

As a percentage of Net sales, Selling, general and administrative expense decreased 40 basis points primarily due to a 50 basis point decrease in bonus expense compared to fiscal 2011.

Impairment of Intangible Assets Impairment of intangible assets for fiscal 2012 is related to an impairment charge of $7 million for long-lived assets associated with our online scrapbooking business and a goodwill impairment charge of $1 million, which represents the carrying amount of the goodwill of our online scrapbooking business.

Related Party Expenses Related party expenses were $13 million for each of fiscal 2012 and fiscal 2011, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, L.P.

Interest Expense Interest expense decreased from $254 million in fiscal 2011 to $245 million in fiscal 2012, as a result of a $449 million reduction in our total debt outstanding, partially offset by a higher average interest rate on our outstanding debt.

Refinancing Costs and Losses on Early Extinguishments of Debt During fiscal 2012, we recorded refinancing costs of $12 million related to our Restated Term Loan Credit Facility. We also recorded a loss of $8 million to write off debt issuance costs related to our Senior Secured Term

Loan Facility and prepayment of our B-1 Term Loans. In addition, we recorded an $11 million loss related to the redemption of our remaining outstanding 13% Subordinated Discount Notes. The $11 million loss was comprised of an $8 million redemption premium and $3 million to write off related debt issuance costs. Finally, we recorded a loss of $2 million to write off debt issuance costs related to our senior secured asset-based Revolving Credit Facility. During fiscal 2011, we recorded a loss of $18 million related to the early extinguishment of $163 million face value, or $155 million accreted value, of our Subordinated Discount Notes and $7 million face value of our Senior Subordinated Notes. The $18 million loss was comprised of $11 million to recognize the unrealized interest accretion and the write off of related debt issuance costs, as well as $7 million of purchase premiums. See Note 3 to the Consolidated Financial Statements for further discussion.

Other (Income) and Expense, Net Other income for fiscal 2012 is primarily related to foreign exchange transaction gains. Other expense for fiscal 2011 is related to a $5 million unfavorable change in the fair value of the interest rate derivative (the interest rate cap), as more fully described in Note 7 to the Consolidated Financial Statements and $4 million in foreign exchange transaction losses.

Provision for Income Taxes The effective tax rate for fiscal 2012 was 36.7%. The effective tax rate for fiscal 2011 was 38.8%. The rate was lower than the statutory rate due primarily to the reversal of accruals for uncertain tax positions as a result of the closure of tax audits and the expiration of the statute of limitations on previously open tax years.

Fiscal 2011 Compared to Fiscal 2010

Net Sales Net sales increased for fiscal 2011 by $179 million, or 4.4%, over fiscal 2010 due primarily to a $128 million increase in comparable store sales. Comparable store sales increased 3.2% driven by an increase in transactions of 2.0% and an increase in the

average ticket of 1.2%. The fluctuation in the exchange rates between the U.S. and Canadian dollars positively impacted the average ticket by 20 basis points. Comparable store sales growth was strongest in bakeware within our general and children s crafts department. In addition, sales from our non-comparable new stores provided incremental revenue of $51 million.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $59 million to $2.526 billion in fiscal 2011 from $2.467 billion in fiscal 2010 due primarily to a $50 million increase in merchandise costs associated with higher sales and an $11 million increase in freight and distribution costs. In addition, occupancy costs increased $24 million, including $7 million from new stores opened in fiscal 2011. These amounts were partially offset by a $16 million reduction from improved inventory management and $8 million from improved efficiencies in our vertically integrated framing operation.

Cost of sales and occupancy expense decreased 120 basis points, as a percentage of Net sales, to 60.0% in fiscal 2011 from 61.2% in fiscal 2010. Merchandise cost decreased 90 basis points driven by our direct import penetration, private brand initiative, and improved pricing and promotion management, while increased focus on inventory management contributed an additional 50 basis points to the reduction in cost of sales; these initiatives more than offset the impact of increases in inflation during the period. These improvements were partially offset by a 30 basis point increase from the recognition of freight and distribution costs.

Selling, General, and Administrative Expense Selling, general and administrative expense was $1.098 billion in fiscal 2011 compared to $1.059 billion in fiscal 2010. Selling, general and administrative expense increased $39 million driven by an $11 million increase in payroll from existing stores, including $3 million of one-time training cost related to our new store labor model. In addition, we had $9 million in costs for new stores opened in fiscal 2011 and a $6 million increase from a full year of expense for stores opened in fiscal 2010. Finally, advertising increased $11 million from digital and targeted marketing campaigns that did not occur last year. As a percentage of Net sales, Selling, general and administrative expense decreased 20 basis points due to increased leverage of payroll and benefits from higher comparable store sales.

Related Party Expenses Related party expenses were $13 million and $14 million for fiscal 2011 and fiscal 2010, respectively, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, L.P.

Interest Expense Interest expense decreased from $276 million in fiscal 2010 to $254 million in fiscal 2011, as a result of a lower average interest rate and a $178 million reduction in our total debt outstanding.

Refinancing Costs and Losses on Early Extinguishments of Debt We recorded a loss of $18 million related to the early extinguishment of $163 million face value, or $155 million accreted value, of our Subordinated Discount Notes during fiscal 2011 and $7 million face value of our Senior Subordinated Notes. The $18 million loss is comprised of $11 million to recognize the unrealized interest accretion and the write off of related debt issuance costs, as well as $7 million of purchase premiums. See Note 4 to the Consolidated Financial Statements for further discussion. During fiscal 2010, we recorded a loss of $53 million related to the early extinguishment of our 10% Senior Notes due November 1, 2014 (the 2014 Senior Notes). The $53 million loss was comprised of $41 million of tender and call premiums and $12 million to write off the remaining unamortized debt issuance costs.

Other (Income) and Expense, Net Other expense for fiscal 2011 is related to a $5 million unfavorable change in the fair value of the interest rate derivative (the interest rate cap), as more fully described in Note 8 to the Consolidated Financial Statements and $4 million in foreign exchange rate losses. Other expense for fiscal 2010 related to a $12 million loss in the fair value of the interest rate cap, partially offset by $2 million of foreign exchange rate gains.

Provision for Income Taxes The effective tax rate for fiscal 2011 was 38.8%. The effective tax rate for fiscal 2010 was 30.9%. The fiscal 2011 rate was lower than the statutory rate due primarily to impacts of 2.8% from audit settlements with taxing authorities, 1.1% from federal manufacturing deductions and 1.1% from our ability to utilize federal tax credits.

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 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 or our failure to meet our debt covenants as described in Liquidity and Capital Resources Cash Flow from Financing Activities .

To finance the Merger, we issued the 2014 Senior Notes, Senior Subordinated Notes and Subordinated Discount Notes and executed a Senior Secured Term Loan Facility and a senior secured asset-based Revolving Credit Facility. 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.

As of February 2, 2013, we had an aggregate principal amount of $393 million of our Senior Subordinated Notes are scheduled to mature in 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. The 7 ¾% Senior Notes mature in 2018, and the Restated Term Loan Credit Facility matures in or after 2018. 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, may be able to incur substantial additional indebtedness in the future, subject to the restrictions contained in our Senior Secured Credit Facilities and the indentures governing our 2018 Senior Notes and Senior Subordinated Notes. If new indebtedness is added to our current debt levels, the related risks we now face could intensify.

We had $3,041 million of indebtedness outstanding at February 2, 2013, of which $1,641 million was subject to variable interest rates and $1,400 million was subject to fixed interest rates. As of February 2, 2013, our Restated Revolving Credit Facility provided for an aggregate amount of $650 million in commitments, subject to a borrowing base, which supported borrowings of $1 million and $62 million of outstanding standby letters of credit and provided $587 million of unused borrowing capacity. On February 27, 2013, we borrowed $142 million under the Restated Revolving Credit Facility to fund the partial redemption of our outstanding Senior Subordinated Notes, resulting in $445 million of unused borrowing capacity under our Restated Revolving Credit Facility as of such date. Our cash and equivalents decreased $315 million from $371 million at the end of fiscal 2011 to $56 million at the end of fiscal 2012.

We and our subsidiaries, affiliates, and significant stockholders 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.

Cash Flow from Operating Activities

Cash flow provided by operating activities in fiscal 2012 was $302 million compared to $413 million in fiscal 2011. The $111 million change was due in part to a $73 million decrease from the timing of accounts payable, $30 million decrease in deferred income taxes, and a $29 million decrease from lower bonuses accrued in fiscal 2012. In addition we had a $13 million decrease from the timing of sales tax payments and an $11 million decrease from the timing of inventory purchases. Average inventory per Michaels store (including supporting distribution centers) was $754,000, down from last year s balance of $757,000. These decreases were partially offset by a $27 millon increase from the timing of income tax payments and an increase in Net income of $15 million before the consideration of non-cash debt related expenses.

Cash Flow from Investing Activities

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

	Fiscal Year		
	2012	2011	2010
		(In millions)	
New and relocated stores and stores not yet opened (1)	$ 42	$ 28	$ 23
Existing stores	30	25	24
Information systems (2)	36	45	27
Corporate and other	16	11	7
	$ 124	$ 109	$ 81

(1) In fiscal 2012, we incurred capital expenditures related to the opening of 38 Michaels stores in addition to the relocation of 13 Michaels stores. In fiscal 2011, we incurred capital expenditures related to the opening of 25 Michaels stores and the relocation of 15 Michaels stores. In fiscal 2010, we incurred capital expenditures related to the opening of 23 Michaels stores and the relocation of 10 Michaels stores. The increase in capital expendidures per store in fiscal 2012 is due mainly to an increase in leasehold improvements for three unique locations. Excluding those locations, the average per store was comparable to fiscal 2011 and fiscal 2010.

(2) Our fiscal 2012 information systems capital expenditures decreased from fiscal 2011 mainly due to the launch of MiDesign@Michaels and the replacement of approximately 7,200 payment card terminals in fiscal 2011. The increase from fiscal 2010 to fiscal 2011 is primarily due to the lauch of MiDesign@Michaels and the payment card terminal replacement, as well as other infrastructure projects to support future growth.

We capitalize and depreciate significant renewals or betterments that substantially extend the life of the asset. We also capitalize certain costs related to the acquisition and development of internal use software that is expected to benefit future periods. In fiscal 2012, fiscal 2011 and fiscal 2010, we capitalized payroll costs of approximately $35 million, $51 million and $14 million, respectively, related to our capital expenditures.

We currently estimate that our capital expenditures will be increased to between $130 million and $140 million in fiscal 2013. We plan to invest in the infrastructure necessary to support the further development of our business and continued growth. In fiscal 2013, we plan to open 50 to 55 stores, including 10 to 20 relocations. We expect our capital expenditures will be financed with cash from operations.

Cash Flow from Financing Activities

Cash flow used in financing activities during fiscal 2012 was $493 million, compared to $252 million during fiscal 2011. Cash flow used in financing activities for fiscal 2012 was impacted by the $1,996 million prepayment of our Senior Secured Term Loan Facility and borrowings under the Restated Term Loan Credit Facility (as defined below) of $1,640 million. In addition, we issued $200 million of additional 7 ¾% Senior Notes due 2018 at a premium, for which we received $213 million. Finally, we made the $127 million applicable high yield discount obligation (AHYDO) payment on our Subordinated Discount Notes during fiscal 2012 and redeemed the remaining $180 million of outstanding Subordinated Discount Notes, for which we paid an $8 million premium.

Cash flow used in financing activities for fiscal 2011 was impacted by the repurchases of $163 million face value, or $155 million accreted value, of our Subordinated Discount Notes and $7 million face value of our Senior Subordinated Notes, for which we paid $7 million in purchase premiums. We also made a voluntary prepayment of $50 million on our Senior Secured Term Loan Facility during the first quarter of fiscal 2011.

Debt

To finance the Merger, we issued the 2014 Senior Notes, the Senior Subordinated Notes and the Subordinated Discount Notes (collectively, the Notes). We also executed an asset-based Revolving Credit Facility as well as a Senior Secured Term Loan Facility (collectively, and as subsequently amended, the Senior Secured Credit Facilities). Borrowings under our revolving credit facility are influenced by a number of factors as more fully described below.

Notes

On October 31, 2006, we issued (i) $750 million in principal amount of 10% Senior Notes due November 1, 2014 (the 2014 Senior Notes); (ii) $400 million in principal amount of 113/8% Senior Subordinated Notes due November 1, 2016 (the Senior Subordinated Notes); and (iii) $469 million in principal amount at maturity of Subordinated Discount Notes. During the third quarter of fiscal 2010, we retired the 2014 Senior Notes and issued $800 million of 7¾% Senior Notes due November 1, 2018 (the 2018 Senior Notes), at a discounted price of 99.262% of face value, resulting in an effective interest rate of 77/8%. On September 27, 2012, we issued an additional $200 million principal amount of 2018 Senior Notes, at a premium of 106.25% of face value, resulting in an effective interest rate of 6½%. On January 28, 2013, we delivered to the holders of our outstanding Senior Subordinated Notes an irrevocable notice of redemption of $137 million in aggregate principal amount of Senior Subordinated Notes. Subsequent to the end of the period, on February 27, 2013, we redeemed the $137 million of Senior Subordinated

Notes at a redemption price equal to 103.792%.

Interest on the 2018 Senior Notes and the Senior Subordinated Notes is payable semi-annually in arrears on each May 1 and November 1, commencing on May 1, 2011 and May 1, 2007, respectively. No cash interest was payable on the Subordinated Discount Notes prior to November 1, 2011.

Beginning on November 1, 2011, cash interest began accruing on the Subordinated Discount Notes and was payable semi-annually in arrears on each May 1 and November 1 (the first cash interest payment was May 1, 2012). On May 1, 2012, as required pursuant to the indenture (Subordinated Discount Notes Indenture) governing our Subordinated Discount Notes, we redeemed that portion of each Subordinated Discount Note outstanding on such date equal to the amount sufficient, but not in excess of the amount necessary, to ensure that such Subordinated Discount Note will not be an AHYDO within the meaning of Section 163(i)(1) of the Internal Revenue Code of 1986, as amended (the AHYDO Amount). These

redemptions were at a price equal to 100% of the Accreted Value (as defined in the Subordinated Discount Notes Indenture) of such portion as of the date of redemption. The aggregate payment of $127 million made on May 1, 2012, was required to ensure the Subordinated Discount Notes would not be AHYDO instruments. On October 1, 2012, we delivered to the holders of our outstanding Subordinated Discount Notes an irrevocable notice of redemption relating to the redemption of all of our outstanding Subordinated Discount Notes. On November 1, 2012, we redeemed a portion of the Subordinated Discount Notes equal to the AHYDO Amount (as defined in the Subordinated Discount Notes Indenture) at a redemption price equal to 100% and the remaining Subordinated Discount Notes at a redemption price equal to 104.333%.

The 2018 Senior Notes are guaranteed, jointly and severally, fully and unconditionally, on an unsecured senior basis and the Senior Subordinated Notes are guaranteed, jointly and severally, fully and unconditionally, on an unsecured senior subordinated basis, in each case, by our subsidiaries (each of which is directly or indirectly owned 100% by Michaels Stores, Inc.), other than certain immaterial subsidiaries.

The indentures governing the 2018 Senior Notes and Senior Subordinated Notes contain covenants limiting, among other things, the Company s ability, and the ability of the Company s restricted subsidiaries, to:

- incur additional debt.
- pay dividends or distributions on the Company s capital stock or repurchase the Company s capital stock.
- issue stock of subsidiaries.
- make certain investments.
- create liens on the Company s and such subsidiaries assets to secure debt.
- enter into transactions with affiliates.
- merge or consolidate with another company.
- sell or otherwise transfer assets.

Restated Revolving Credit Facility

On February 18, 2010, we entered into an agreement to amend and restate various terms of the then existing asset-based Revolving Credit Facility, dated as of October 31, 2006 (as so amended and restated, the senior secured asset-based Revolving Credit Facility). On September 17, 2012, we entered into a second amended and restated credit agreement (the Restated Credit Agreement) to amend various terms of our senior secured asset-based Revolving Credit Facility. The Restated Credit Agreement, together with related security, guarantee and other agreements, is referred to as the Restated Revolving Credit Facility .

The Restated Revolving Credit Facility provides for senior secured financing of up to $650 million, subject to a borrowing base, maturing on September 17, 2017 (the ABL Maturity Date). The borrowing base under the Restated Revolving Credit Facility equals the sum of (i) 90% of eligible credit card receivables and debit card receivables, plus (ii) 90% of the appraised net orderly liquidation value of eligible inventory, plus

(iii) the lesser of (x) 90% of the appraised net orderly liquidation value of inventory supported by eligible letters of credit and (y) 90% of the face amount of eligible letters of credit supported by eligible letters of credit, minus (iv) certain reserves.

The Restated Revolving Credit Facility provides us with the right to request up to $200 million of additional commitments under the Restated Revolving Credit Facility. The lenders under the Restated Revolving Credit Facility will not be under any obligation to provide any such additional commitments, and any increase in commitments is subject to customary conditions precedent. If we were to request any such additional commitments, and the existing lenders or new lenders were to agree to provide such commitments, the facility size could be increased to up to $850 million, but our ability to borrow under the Restated Revolving Credit Facility would still be limited by the borrowing base.

Borrowings under the Restated Revolving Credit Facility bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the highest of (1) the prime rate of Wells Fargo, (2) the federal funds effective rate plus 0.50% and (3) a London Interbank Offered Rate (LIBOR) subject to certain adjustments plus 1.00% or (b) a LIBOR subject to certain adjustments, in each case plus an applicable margin. The initial applicable margin is (a) 0.75% for prime rate borrowings and 1.75% for LIBOR borrowings. The applicable margin is subject to adjustment each fiscal quarter based on the excess availability under the Restated Revolving Credit Facility. Same-day borrowings bear interest at the base rate plus the applicable margin.

We are required to pay a commitment fee on the unutilized commitments under the Restated Revolving Credit Facility, which initially is 0.375% per annum. The commitment fee is subject to adjustment each fiscal quarter. If average daily excess availability is less than or equal to 50% of the total commitments, the commitment fee will be 0.25% per annum, and if average daily excess availability is greater than 50% of the total commitments, the commitment fee will be 0.375%. In addition, we must pay customary letter of credit fees and agency fees.

If, at any time, the aggregate amount of outstanding loans, unreimbursed letter of credit drawings and undrawn letters of credit under the Restated Revolving Credit Facility exceeds the lesser of (i) the commitment amount and (ii) the borrowing base (the Loan Cap), we will be required to repay outstanding loans and cash collateralize letters of credit in an aggregate amount equal to such excess, with no reduction of the commitment amount. If excess availability under the Restated Revolving Credit Facility is less than (i) 12.5% of the Loan Cap for five consecutive business days, or (ii) $65 million at any time, or if certain events of default have occurred, we will be required to repay outstanding loans and cash collateralize letters of credit with the cash we are required to deposit daily in a collection account maintained with the agent under the Restated Revolving Credit Facility. Excess availability under the Restated Revolving Credit Facility means the lesser of the Loan Cap minus the outstanding credit extensions. We may voluntarily reduce the unutilized portion of the commitment amount and repay outstanding loans at any time without premium or penalty other than customary breakage costs with respect to LIBOR loans. There is no scheduled amortization under the Restated Revolving Credit Facility; the principal amount of the loans outstanding is due and payable in full on the ABL Maturity Date.

From the time when we have excess availability less than the greater of (a) 10% of the Loan Cap and (b) $50 million, until the time when we have excess availability greater than the greater of (a) 10% of the Loan Cap and (b) $50 million for 30 consecutive days, the Restated Revolving Credit Facility will require us to maintain a consolidated fixed charge coverage ratio of at least 1.0 to 1.0. The Restated Revolving Credit Facility also contains certain customary representations and warranties, affirmative covenants and provisions relating to events of default (including change of control and cross-default to material indebtedness).

As of February 2, 2013, the borrowing base was $650 million, of which we had $1 million of outstanding borrowings, $62 million of outstanding standby letters of credit, and $587 million of unused borrowing capacity.

Restated Term Loan Credit Facility

On October 31, 2006, we executed a $2.4 billion senior secured term loan facility (the Senior Secured Term Loan Facility) with Deutsche Bank Securities Inc., and other lenders. The full amount was borrowed on October 31, 2006, with the balance payable on October 31, 2013. On November 5, 2009, and December 15, 2011, we amended the Senior Secured Term Loan Facility to extend $1.0 billion and $619 million, respectively, of existing term loans (the B-2 Term Loans and B-3 Term Loans , respectively) to July 31, 2016, with the remaining $501 million of existing term loans (the B-1 Term Loans) keeping the original maturity date of October 31, 2013. During fiscal 2012, we prepaid the $501 million of outstanding B-1 Term Loans.

On January 28, 2013, we entered into an amended and restated credit agreement (the Amended Credit Agreement) to amend various terms of our Senior Secured Term Loan Facility, as amended. The Amended Credit Agreement, together with related security, guarantee and other agreements, is referred to as the Restated Term Loan Credit Facility.

The Restated Term Loan Credit Facility provides for senior secured financing of $1,640 million. The Company has the right under the Restated Term Loan Credit Facility to request additional term loans in an aggregate amount of up to (a) $500 million and (b) at the Company s option, an amount of term loans so long as the Company s Consolidated Secured Debt Ratio (as defined in the Amended Credit Agreement) is no more than 3.25 to 1.00 on a pro forma basis as of the last day of the most recently-ended four fiscal quarter-period for which internal financial statements are available. The lenders under the Restated Term Loan Credit Facility will not be under any obligation to provide any such additional term loans, and the incurrence of any additional term loans is subject to customary conditions precedent.

Borrowings under the Restated Term Loan Credit Facility bear interest at a rate per annum equal to, at the Company s option, either (a) a base rate determined by reference to the highest of (1) the prime rate of Deutsche Bank, (2) the federal funds effective rate plus 1/2 of 1% and (3) LIBOR, subject to certain adjustments, plus 1%, or (b) LIBOR, subject to certain adjustments, in each case plus an applicable margin. The applicable margin is 1.75% with respect to base rate borrowings and 2.75% with respect to LIBOR borrowings. In addition, the applicable margin is subject to a 0.25% decrease based on the Company s Consolidated Secured Debt Ratio.

The Restated Term Loan Credit Facility requires the Company to prepay outstanding term loans with (x) 100% of the net proceeds of any debt issued by the Company or its subsidiaries (with exceptions for certain debt permitted to be incurred under the Restated Term Loan Credit Facility) and (y) 50% (which percentage will be reduced to 25% if the Company s Consolidated Total Leverage Ratio (as defined in the Amended Credit Agreement) is less than 6.00:1.00 and will be reduced to 0% if the Company s Consolidated Total Leverage Ratio is less than 5.00:1.00) of the Company s annual Excess Cash Flow (as defined in the Amended Credit Agreement).

The Company must offer to prepay outstanding term loans at 100% of the principal amount to be prepaid, plus accrued and unpaid interest, with the proceeds of certain asset sales or casualty events under certain circumstances.

The Company may voluntarily prepay outstanding loans under the Restated Term Loan Credit Facility at any time without premium or penalty other than in the case of a Repricing Transaction (as defined in the Amended Credit Agreement) occurring prior to the first anniversary of the closing date, in which case a 1% prepayment fee would apply, and customary breakage costs with respect to LIBOR loans.

The Company is required to make scheduled quarterly payments, each equal to 0.25% of the original principal amount of the term loans, subject to adjustments relating to the incurrence of additional term loans under the Restated Term Loan Credit Facility, for the first six years and three quarters, with the balance paid on January 28, 2020 (the Maturity Date); provided, however, that the Maturity Date of the term loans will automatically become July 28, 2018, if as of July 28, 2018, (i) the Consolidated Secured Debt Ratio is greater than 3.25:1.00 and (ii) the then aggregate outstanding principal amount of the Company s 2018 Senior Notes (and certain refinancings thereof requiring principal payments prior to April 28, 2020) exceeds $250 million.

The Restated Term Loan Credit Facility modified certain covenant baskets. In addition, the Restated Term Loan Credit Facility contains certain customary representations and warranties, affirmative covenants and provisions relating to events of default (including change of control and cross-default to material indebtedness).

The proceeds of the Restated Term Loan Credit Facility were used, among other things, to (i) prepay an aggregate principal amount of $876 million of the Company s B-2 Term Loans and $619 million of the Company s B-3 Term Loans under the Senior Secured Term Loan Facility and (ii) fund the redemption and related fees, on February 27, 2013, of an aggregate principal amount of $137 million of the Company s Senior Subordinated Notes pursuant to a notice of redemption issued to the holders of such notes on January 28, 2013.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of Regulation S-K. We do not typically enter into off-balance sheet arrangements, except for arrangements related to operating lease commitments, service contract commitments and trade letters of credit, as disclosed in the contractual obligations table below. Neither Michaels nor its subsidiaries typically guarantee the obligations of unrelated parties.

Contractual Obligations

All of our significant contractual obligations are recorded on our Consolidated Balance Sheets or disclosed in our Notes to Consolidated Financial Statements.

As of February 2, 2013, our contractual obligations were as follows:

	Payments Due By Fiscal Year				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
			(In millions)		

Operating lease commitments (1)	$	1,731	$	377	$	602	$	386	$	366
Other commitments (2)		78		59		19				
Total debt (3)		3,033		150		33		288		2,562
Interest payments (4)		985		186		370		323		106
	$	5,827	$	772	$	1,024	$	997	$	3,034

(1) Our operating lease commitments generally include non-cancelable leases for property and equipment used in our operations. Excluded from our operating lease commitments are amounts related to insurance, taxes, and common area maintenance associated with property and equipment. Such amounts historically represented approximately 32% of the total lease obligation over the previous three fiscal years.

(2) Other commitments include trade letters of credit and service contract obligations. Our service contract obligations were calculated based on the time period remaining in the contract or to the earliest possible date of termination, if permitted to be terminated by Michaels upon notice, whichever is shorter.

(3) Included in Total debt is $12 million of unamortized premium and $4 million of unamortized discount on the 2018 Senior Notes, which has not been recognized as of February 2, 2013. See Note 3 to the Consolidated Financial Statements.

(4) Debt associated with our Restated Term Loan Credit Facility was $1,640 million at February 2, 2013, and is subject to variable interest rates. The amounts included in interest payments in the table for the Restated Term Loan Credit Facility were based on the indexed interest rate in effect at February 2, 2013. Approximately $1,400 million of debt was subject to fixed interest rates. We had $1 million in outstanding borrowings under our Restated Revolving Credit Facility at February 2, 2013. Under our Restated Revolving Credit Facility, we are required to pay a commitment fee of 0.375% per year on the unutilized commitments, subject to an adjustment each fiscal quarter. The amounts included in interest payments for the Restated Revolving Credit Facility were based on these annual commitment fees.

Additional information regarding our long-term debt and commitments and contingencies is provided in Note 3 and Note 10, respectively, of Notes to Consolidated Financial Statements.

Non-GAAP Measures

The following table sets forth the Company s Earnings before Interest, Taxes, Depreciation, Amortization, and debt costs (EBITDA excluding refinancing costs and losses on early extinguishments of debt). The Company defines EBITDA (excluding refinancing costs and losses on early extinguishments of debt) as Net income before interest, income taxes, depreciation, amortization and refinancing costs and losses on early extinguishments 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 extinguishments of debt) adjusted for certain defined amounts that are added to, or subtracted from, EBITDA (excluding refinancing costs and losses on early extinguishments of debt) (collectively, the Adjustments) in accordance with the Company s $1.6 billion Restated Term Loan Credit Facility and $650 million 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 extinguishments of debt) and Adjusted EBITDA to provide investors with additional information to evaluate our operating performance and our ability to service our debt. The Company uses EBITDA (excluding refinancing costs and losses on early extinguishments of debt), among other metrics, to evaluate operating performance, to plan and forecast future periods operating performance and as an element of its incentive compensation targets. Adjusted EBITDA is a required calculation under the Company s 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 payments as well as the determination of mandatory repayments of the loans. Under the Restated Revolving 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.

As EBITDA (excluding refinancing costs and losses on early extinguishments of debt) and Adjusted EBITDA are not measures of operating performance or liquidity calculated in accordance with U.S. 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 extinguishments of debt) and Adjusted EBITDA may differ from similarly titled measures used by other companies. As EBITDA (excluding refinancing costs and losses on early extinguishments 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 extinguishments of debt) and Adjusted EBITDA to Net income and Net cash provided by operating activities.

	Fiscal Year		
	2012	2011	2010
		(In millions)	
Net cash provided by operating activities	$ 302	$ 413	$ 438
Depreciation and amortization	(97)	(101)	(103)
Share-based compensation	(5)	(9)	(8)
Debt issuance costs amortization	(14)	(17)	(20)
Accretion of long-term debt		(35)	(50)
Change in fair value of contingent consideration		4	
Change in fair value of interest rate cap		(5)	(12)
Refinancing costs and losses on early extinguishments of debt	(33)	(18)	(53)
Impairment of intangible assets	(8)		
Changes in assets and liabilities	69	(56)	(89)
Net income	214	176	103
Interest expense	245	254	276
Refinancing costs and losses on early extinguishment of debt	33	18	53
Provision for income taxes	124	112	46
Depreciation and amortization	97	101	103
EBITDA (excluding refinancing costs and losses on early extinguishment of debt)	713	661	581
Adjustments:			
Share-based compensation	5	9	8
Sponsor fees	13	13	14
Impairment of intangible assets	8		
Termination expense	1	1	1
Store pre-opening costs	5	4	3
Store remodel costs	2	2	
Foreign currency transaction (gains) losses	(1)	4	(2)
Store closing costs	4	7	2
Gain on contingent consideration		(4)	
Loss on interest rate cap		5	12
Other (1)	3	4	3
Adjusted EBITDA	$ 753	$ 706	$ 622

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

Recent Accounting Pronouncements

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, an amendment to ASC topic 220, Comprehensive Income. ASU 2013-02 requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other items not reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. These standards, which are prospective, are effective for reporting periods beginning after December 15, 2012, with earlier adoption permitted. We do not believe the implementation of this standard will result in a material impact to our financials.

ITEM 7A. 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 subsidiary. Our sales, costs and expenses of our Canadian subsidiary, when translated into U.S. dollars, can fluctuate due to exchange rate movement. As of February 2, 2013, a 10% increase or decrease in the exchange rate of the U.S. and Canadian dollar would increase or decrease Net income by approximately $3 million.

We do not believe inflation and changing commodity prices have had a material impact on our Net sales, income from continuing operations, plans for expansion or other capital expenditures for any year during the three-year period ended February 2, 2013. However, we cannot be sure inflation and changing commodity prices will not have an adverse impact on our operating results, financial condition, plans for expansion or other capital expenditures in future periods.

We have market risk exposure arising from changes in interest rates on our Senior Secured Credit Facilities. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources for further detail. The interest rates on our Senior Secured Credit 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 February 2, 2013, 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 impact the fair value of our long-term fixed rate debt by approximately $21 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

We invest cash balances in excess of operating requirements primarily in money market mutual funds and short-term interest-bearing securities, generally with maturities of 90 days or less. Due to the short-term nature of our investments, the fair value of our cash and equivalents at February 2, 2013 approximated carrying value.

ITEM 8. Consolidated Financial Statements and Supplementary Data.

The Consolidated Financial Statements and Supplementary Data are included as an annex to this Annual Report on Form 10-K and incorporated herein by reference. See the Index to Consolidated Financial Statements and Supplementary Data on page F-1.

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

ITEM 9A. Controls and Procedures.

Included in this Annual Report on Form 10-K are certifications of the members of our interim Office of the Chief Executive Officer (Office of the CEO) 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. Page F-3 of this Report includes the attestation report of Ernst & Young LLP, our independent registered public accounting firm, regarding its audit of the effectiveness of our internal control over financial reporting. This section should be read in conjunction with the Ernst & Young attestation for a complete understanding of this section.

Evaluation of Disclosure Controls and Procedures

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

under all potential future conditions.

An evaluation was carried out under the supervision and with the participation of our management, our Office of the CEO 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, the members of the Office of the CEO 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 Office of the CEO 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 p