

Michaels Companies, Inc.
Form 10-Q
August 31, 2018
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended August 4, 2018

Commission file number 001-36501

THE MICHAELS COMPANIES, INC.

A Delaware Corporation

IRS Employer Identification No. 37-1737959

8000 Bent Branch Drive

Irving, Texas 75063

(972) 409-1300

The Michaels Companies, Inc. (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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

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

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

As of August 23, 2018, 171,367,524 shares of The Michaels Companies, Inc.'s common stock were outstanding.

994

Table of Contents

THE MICHAELS COMPANIES, INC.

TABLE OF CONTENTS

Part I—FINANCIAL INFORMATION

	Page
<u>Item 1.</u> <u>Financial Statements</u>	3
<u>Consolidated Statements of Comprehensive Income for the 13 and 26 weeks ended August 4, 2018 and July 29, 2017 (unaudited)</u>	3
<u>Consolidated Balance Sheets as of August 4, 2018, February 3, 2018 and July 29, 2017 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flows for the 26 weeks ended August 4, 2018 and July 29, 2017 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
<u>Item 2.</u> <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	16
<u>Item 3.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
<u>Item 4.</u> <u>Controls and Procedures</u>	25

Part II—OTHER INFORMATION

<u>Item 1.</u> <u>Legal Proceedings</u>	26
<u>Item 1A.</u> <u>Risk Factors</u>	26

<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	26
<u>Item 6.</u>	<u>Exhibits</u>	27
<u>Signatures</u>		28

Table of Contents

Part I—FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

THE MICHAELS COMPANIES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, except per share data)

(Unaudited)

	13 Weeks Ended		26 Weeks Ended	
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017
Net sales	\$ 1,053,267	\$ 1,072,593	\$ 2,208,778	\$ 2,231,156
Cost of sales and occupancy expense	679,938	670,082	1,378,887	1,361,012
Gross profit	373,329	402,511	829,891	870,144
Selling, general and administrative	300,981	313,867	629,598	641,263
Restructure charge	(3,220)	—	44,278	—
Store pre-opening costs	1,295	662	2,799	1,640
Operating income	74,273	87,982	153,216	227,241
Interest expense	37,101	31,051	71,695	61,488
Losses on early extinguishments of debt and refinancing costs	1,835	—	1,835	—
Other (income) expense, net	(832)	1,353	(2,525)	1,309
Income before income taxes	36,169	55,578	82,211	164,444
Income taxes	8,681	20,016	27,838	56,674
Net income	\$ 27,488	\$ 35,562	\$ 54,373	\$ 107,770
Other comprehensive income, net of tax:				
Foreign currency translation adjustment and other	807	13,944	(6,246)	8,672
Comprehensive income	\$ 28,295	\$ 49,506	\$ 48,127	\$ 116,442
Earnings per common share:				
Basic	\$ 0.15	\$ 0.19	\$ 0.30	\$ 0.57
Diluted	\$ 0.15	\$ 0.19	\$ 0.30	\$ 0.57
Weighted-average common shares outstanding:				
Basic	177,348	186,886	179,436	187,927
Diluted	178,215	187,931	180,426	189,171

See accompanying notes to consolidated financial statements.

3

Table of Contents

THE MICHAELS COMPANIES, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

(Unaudited)

	August 4, 2018	February 3, 2018	July 29, 2017
ASSETS			
Current Assets:			
Cash and equivalents	\$ 123,191	\$ 425,896	\$ 134,119
Merchandise inventories	1,280,095	1,123,288	1,195,495
Prepaid expenses and other	98,742	97,830	87,176
Accounts receivable, net	31,095	26,207	24,311
Income taxes receivable	16,523	3,761	20,085
Total current assets	1,549,646	1,676,982	1,461,186
Property and equipment, at cost	1,613,115	1,593,683	1,530,622
Less accumulated depreciation and amortization	(1,167,985)	(1,173,663)	(1,122,928)
Property and equipment, net	445,130	420,020	407,694
Goodwill	119,074	119,074	119,074
Other intangible assets, net	20,983	21,769	22,736
Deferred income taxes	31,532	34,538	37,137
Other assets	26,180	27,832	12,202
Total assets	\$ 2,192,545	\$ 2,300,215	\$ 2,060,029
LIABILITIES AND STOCKHOLDERS' DEFICIT			
Current Liabilities:			
Accounts payable	\$ 555,270	\$ 483,002	\$ 510,818
Accrued liabilities and other	351,987	370,457	391,784
Current portion of long-term debt	140,261	24,900	112,125
Income taxes payable	427	79,586	823
Total current liabilities	1,047,945	957,945	1,015,550
Long-term debt	2,695,087	2,701,764	2,712,475
Other liabilities	148,893	150,001	99,997
Total liabilities	3,891,925	3,809,710	3,828,022
Commitments and contingencies			
Stockholders' Deficit:			
Common stock, \$0.06775 par value, 350,000 shares authorized; 171,375 shares issued and outstanding at August 4, 2018; 181,919 shares issued and outstanding at February 3, 2018; and 183,414 shares issued and outstanding at July 29, 2017	11,504	12,206	12,330
Additional paid-in-capital	—	21,740	59,099

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

Treasury stock	—	—	(11,361)
Accumulated deficit	(1,700,978)	(1,539,781)	(1,822,509)
Accumulated other comprehensive loss	(9,906)	(3,660)	(5,552)
Total stockholders' deficit	(1,699,380)	(1,509,495)	(1,767,993)
Total liabilities and stockholders' deficit	\$ 2,192,545	\$ 2,300,215	\$ 2,060,029

See accompanying notes to consolidated financial statements.

4

Table of Contents

THE MICHAELS COMPANIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	26 Weeks Ended	
	August 4, 2018	July 29, 2017
Cash flows from operating activities:		
Net income	\$ 54,373	\$ 107,770
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	59,054	57,423
Share-based compensation	12,334	10,557
Debt issuance costs amortization	2,522	2,549
Accretion of long-term debt, net	(256)	(252)
Restructure charge	44,278	—
Deferred income taxes	770	(225)
Losses on early extinguishments of debt and refinancing costs	1,835	—
Changes in assets and liabilities:		
Merchandise inventories	(177,586)	(67,218)
Prepaid expenses and other	2,217	(1)
Accounts receivable	(6,366)	(1,096)
Other assets	(1,165)	(700)
Accounts payable	54,823	(11,841)
Accrued interest	553	(7,691)
Accrued liabilities and other	(49,838)	(2,811)
Income taxes	(87,341)	(91,771)
Other liabilities	3,231	1,272
Net cash used in operating activities	(86,562)	(4,035)
Cash flows used in investing activities:		
Additions to property and equipment	(69,908)	(43,120)
Cash flows from financing activities:		
Common stock repurchased	(252,508)	(191,164)
Payments on term loan credit facility	(11,790)	(12,450)
Borrowings on asset-based revolving credit facility	133,600	139,100
Payments on asset-based revolving credit facility	(15,600)	(58,100)
Payment of debt refinancing costs	(1,069)	—
Payment of dividends	(317)	(408)
Proceeds from stock options exercised	1,449	5,483
Net cash used in financing activities	(146,235)	(117,539)
Net change in cash and equivalents	(302,705)	(164,694)
Cash and equivalents at beginning of period	425,896	298,813

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

Cash and equivalents at end of period	\$ 123,191	\$ 134,119
Supplemental cash flow information:		
Cash paid for interest	\$ 69,101	\$ 67,453
Cash paid for taxes	\$ 114,950	\$ 148,187

See accompanying notes to consolidated financial statements.

Table of Contents

THE MICHAELS COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10 Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended February 3, 2018 filed with the Securities and Exchange Commission (“SEC”) pursuant to Section 13 or 15(d) under the Securities Exchange Act of 1934. In the opinion of management, all adjustments (consisting of normal recurring accruals and other items) considered necessary for a fair presentation have been included.

We report on the basis of a 52- or 53-week fiscal year, which ends on the Saturday closest to January 31. All references to fiscal year mean the year in which that fiscal year began. References to “fiscal 2018” relate to the 52 weeks ending February 2, 2019 and references to “fiscal 2017” relate to the 53 weeks ended February 3, 2018. In addition, all references to “the second quarter of fiscal 2018” relate to the 13 weeks ended August 4, 2018 and all references to “the second quarter of fiscal 2017” relate to the 13 weeks ended July 29, 2017. Finally, all references to “the six months ended August 4, 2018” relate to the 26 weeks ended August 4, 2018 and all references to “the six months ended July 29, 2017” relate to the 26 weeks ended July 29, 2017. Because of the seasonal nature of our business, the results of operations for the 13 and 26 weeks ended August 4, 2018 are not indicative of the results to be expected for the entire year.

Aaron Brothers

In March 2018, we closed substantially all of our Aaron Brothers stores and began the process of repositioning our Aaron Brothers brand as a store-within-a-store, providing custom framing services in all Michaels stores. In the first six months of fiscal 2018, we recorded a restructure charge totaling \$44.3 million, consisting primarily of costs associated with the termination of the remaining lease obligations, the write-off of fixed assets and employee-related expenses. For the six months ended August 4, 2018 and July 29, 2017, Aaron Brothers net sales totaled approximately \$12.9 million and \$52.8 million, respectively. Excluding the restructure charge, Aaron Brothers did not have a material impact on the Company's operating income in the periods presented.

Share Repurchase Program

In June 2017, the Board of Directors authorized a new share repurchase program for the Company to purchase \$500.0 million of the Company's common stock on the open market or through accelerated share repurchase transactions. The share repurchase program does not have an expiration date, and the timing and number of repurchase transactions under the program will depend on market conditions, corporate considerations, debt agreements and regulatory requirements. Shares repurchased under the program are held as treasury shares until retired. In June 2018, the Company entered into an accelerated share repurchase agreement ("ASR Agreement") with JPMorgan Chase Bank, N.A. ("JPMorgan"). Under the ASR Agreement, we paid JPMorgan a purchase price of \$250.0 million for an initial delivery of 10.7 million shares of our common stock, representing 86% of the shares to be purchased under the agreement. On August 30, 2018, we completed the share repurchase and received an additional 1.7 million shares. The total number of shares

Table of Contents

repurchased was based upon a volume weighted average price of our stock over a predetermined period. As of August 4, 2018, we had \$150.0 million of availability remaining under our current share repurchase program. Upon final settlement of the ASR Agreement, the remaining authorization for future repurchases totaled \$100.0 million.

Accounting Pronouncements Recently Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”). ASU 2014-09 supersedes the revenue recognition requirements in “Revenue Recognition (Topic 605)” and requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. In March 2016, the FASB issued ASU 2016-08, “Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)” which is intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, “Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing” which provides further guidance on identifying performance obligations and improves the operability and understandability of the licensing implementation guidance. In May 2016, the FASB issued ASU 2016-12, “Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients” which narrowly amended the revenue recognition guidance regarding collectability, noncash consideration, presentation of sales tax and transition. We used the modified retrospective transition method to adopt ASU 2014-09 in the first quarter of fiscal 2018 with no adjustments required to our opening retained earnings. The adoption did not have a material impact to the consolidated financial statements, however, it did result in additional disclosures.

Recent Accounting Pronouncements Not Yet Adopted

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

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)” (“ASU 2016-02”). Under ASU 2016-02, an entity will be required to recognize right-of-use assets and lease liabilities on its balance sheet and disclose key information about leasing arrangements. ASU 2016-02 offers specific accounting guidance for a lessee, a lessor and sale and leaseback transactions. Lessees and lessors are required to disclose qualitative and quantitative information

about leasing arrangements to enable a user of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. The lease standard requires companies to use a modified retrospective transition approach as of the beginning of the earliest comparable period presented in the company's financial statements. In July 2018, the FASB issued ASU 2018-11, "Leases (Topic 842): Targeted Improvements" which provided an additional transition option that allows companies to continue applying the guidance under the current lease standard in the comparative periods presented in the consolidated financial statements. Companies that elect this option would record a cumulative-effect adjustment to the opening balance of retained earnings on the date of adoption. We are in the process of determining which transition method to apply. The guidance under these standards is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period, with early adoption permitted. We are currently evaluating the impact that ASU 2016-02 will have on the consolidated financial statements and related disclosures. We believe the most significant impact relates to our accounting for real estate leases, which will be recorded as right-of-use assets and lease liabilities on our balance sheet upon adoption.

7

Table of Contents

2. REVENUE RECOGNITION

Our revenue is primarily associated with sales of merchandise to customers within our stores, customers utilizing our e-commerce platforms and through our Darice wholesale business (“Darice”). Revenue is measured based on the amount of consideration that we expect to receive, reduced by estimates for return allowances, point-of-sale coupons and discounts. Revenue also excludes any amounts collected on behalf of third parties, including sales tax. Revenue from sales of our merchandise is recognized when the customer takes possession of the merchandise. Payment for our retail sales is typically due at the time of the sale.

Right of Return

We allow for merchandise to be returned under most circumstances up to 180 days after purchase. A sales return reserve is established using historical customer return behavior and reduces both revenue and cost of goods sold. Historically, the sales returns reserve was presented net of cost of sales in other current liabilities in the consolidated balance sheets. As a result of adopting ASU 2014-09, the Company presents the gross sales return reserve in other current liabilities and the estimated value of the merchandise expected to be returned in prepaid expenses and other in the consolidated balance sheets. The change did not have a material impact on our consolidated balance sheet as of August 4, 2018.

Customer Receivables

As of August 4, 2018, February 3, 2018 and July 29, 2017, receivables from customers, which consist primarily of trade receivables related to Darice, were approximately \$23.9 million, \$19.2 million and \$17.9 million, respectively, and are included in accounts receivable, net in the consolidated balance sheets.

Gift Cards

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 or when the likelihood of redemption by the customer is remote (“gift card breakage”). We estimate gift card breakage using the expected value method based on customers’ historical redemption rates and patterns. Gift card breakage income is recorded in net sales in the consolidated statements of comprehensive income over the estimated redemption period. The gift card liability is included in accrued liabilities and other in the consolidated balance sheets.

The following table includes activity related to gift cards (in thousands):

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

	13 Weeks Ended		26 Weeks Ended	
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017
Balance at beginning of period	\$ 51,513	\$ 44,856	\$ 56,729	\$ 49,869
Issuance of gift cards	13,522	13,528	24,796	24,954
Revenue recognized (1)	(13,484)	(13,464)	(29,138)	(29,512)
Gift card breakage	(1,038)	(735)	(1,874)	(1,126)
Balance at end of period	\$ 50,513	\$ 44,185	\$ 50,513	\$ 44,185

(1) Revenue recognized from the beginning liability during the second quarters of fiscal 2018 and fiscal 2017 totaled \$7.2 million and \$7.1 million, respectively. Revenue recognized from the beginning liability during the first six months of fiscal 2018 and fiscal 2017 totaled \$15.1 million and \$15.3 million, respectively.

Table of Contents

3. FAIR VALUE MEASUREMENTS

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

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

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

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

The table below provides the fair values of our senior secured term loan facility (“Amended Term Loan Credit Facility”), our 5.875% senior subordinated notes maturing in 2020 (“2020 Senior Subordinated Notes”) and our interest rate swaps executed in April 2018.

	August 4, 2018 (in thousands)	February 3, 2018	July 29, 2017
Assets			
Interest rate swaps	\$ 2,342	\$ —	\$ —
Liabilities			

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

Term loan credit facility	\$ 2,217,784	\$ 2,246,302	\$ 2,251,025
Senior subordinated notes	513,825	518,288	522,750
Interest rate swaps	3,233	—	—

The fair values of our Amended Term Loan Credit Facility and our 2020 Senior Subordinated Notes were determined based on quoted market prices which are considered Level 1 inputs within the fair value hierarchy.

The fair value of our interest rate swaps was calculated using significant observable inputs including the present value of estimated future cash flows using the applicable interest rate curves and therefore, were classified as Level 2 inputs within the fair value hierarchy.

Table of Contents

4. DEBT

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

	Interest Rate	August 4, 2018	February 3, 2018	July 29, 2017
Term loan credit facility	Variable	\$ 2,220,560	\$ 2,232,350	\$ 2,251,025
Asset-based revolving credit facility	Variable	118,000	—	81,000
Senior subordinated notes	5.875 %	510,000	510,000	510,000
Total debt		2,848,560	2,742,350	2,842,025
Less unamortized discount/premium and debt costs		(13,212)	(15,686)	(17,425)
Total debt, net		2,835,348	2,726,664	2,824,600
Less current portion		(140,261)	(24,900)	(112,125)
Long-term debt		\$ 2,695,087	\$ 2,701,764	\$ 2,712,475

Revolving Credit Facility

As of August 4, 2018 and July 29, 2017, the borrowing base under our senior secured asset-based revolving credit facility was \$850.0 million and \$827.7 million, respectively, of which Michaels Stores, Inc. (“MSI”) had unused borrowing capacity of \$644.8 million and \$681.4 million, respectively. As of August 4, 2018 and July 29, 2017, outstanding standby letters of credit, which reduce our borrowing base, totaled \$87.2 million and \$65.3 million, respectively.

Term Loan Credit Facility

On May 23, 2018, MSI entered into an amendment with JPMorgan and other lenders to amend and restate our term loan credit facility. The amended and restated credit agreement, together with the related security, guarantee and other agreements, is referred to as the “Amended and Restated Term Loan Credit Facility”. Borrowings under the Amended and Restated Term Loan Credit Facility bear interest at a rate per annum, at MSI’s option, of either (a) a margin of 1.50% plus a base rate defined as the highest of (1) the prime rate of JPMorgan, (2) the federal funds effective rate plus 0.5%, and (3) the one-month London Interbank Offered Rate (“LIBOR”) plus 1% or (b) a margin of 2.50% plus the applicable LIBOR. MSI is required to make scheduled quarterly payments equal to 0.25% of the original principal amount of the term loans (subject to adjustments relating to the incurrence of additional term loans) for the first four years and two quarters of the Amended and Restated Term Loan Credit Facility, with the balance to be paid on January 28, 2023. All other terms under the Amended Term Loan Credit Facility have remained unchanged. As a result of this refinancing, we recorded a loss on the early extinguishment of debt of \$1.8 million during the second quarter of fiscal 2018.

Interest Rate Swaps

In April 2018, we executed two interest rate swaps with an aggregate notional value of \$1.0 billion associated with our outstanding Amended Term Loan Credit Facility. The interest rate swaps have a maturity date of April 30, 2021 and were executed for risk management and are not held for trading purposes. The objective of the interest rate swaps is to hedge the variability of cash flows resulting from fluctuations in the one-month LIBOR. The swaps replaced the one-month LIBOR with a fixed interest rate of 2.7765% and payments are settled monthly. The swaps qualify as cash flow hedges and changes in the fair values are recorded in accumulated other comprehensive income in the consolidated balance sheet. The changes in fair value are reclassified from accumulated other comprehensive income to interest expense in the same period that the hedged items affect earnings. We reclassified \$2.0 million and \$2.1 million from accumulated other comprehensive income to interest expense during the three and six months ended August 4, 2018, respectively. As of August 4, 2018, the fair value of the interest rate swaps was a net liability of \$0.9 million, consisting of \$3.2 million recorded in accrued liabilities and other and \$2.3 million recorded in other assets in our consolidated balance sheets.

Table of Contents

5. ACCUMULATED OTHER COMPREHENSIVE LOSS

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

	13 Weeks Ended		26 Weeks Ended	
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017
Beginning of period	\$ (10,713)	\$ (19,496)	\$ (3,660)	\$ (14,224)
Foreign currency translation adjustment and other	(1,440)	13,944	(5,587)	8,672
Interest rate swaps	2,247	—	(659)	—
End of period	\$ (9,906)	\$ (5,552)	\$ (9,906)	\$ (5,552)

6. INCOME TAXES

The effective tax rate was 24.0% for the second quarter of fiscal 2018 compared to 36.0% for the second quarter of fiscal 2017 and 33.9% for the six months ended August 4, 2018 compared to 34.5% for the same period in the prior year. The effective tax rate for both the second quarter of fiscal 2018 and the six months ended August 4, 2018 were lower than the same period in the prior year due to the reduction of the federal statutory tax rate from 35% to 21% associated with the enactment of the Tax Cuts and Jobs Act (“Tax Act”) in the fourth quarter of fiscal 2017. The decrease in tax rate for the six months ended August 4, 2018 was partially offset by provisional adjustments of \$8.1 million related to repatriation taxes for accumulated earnings of foreign subsidiaries. The U.S. Treasury is expected to issue additional regulations and guidance in connection with the Tax Act, which may alter interpretations of the new tax law and could materially change our estimated provisional adjustments.

7. EARNINGS PER SHARE

The Company’s unvested restricted stock awards contain non-forfeitable rights to dividends and meet the criteria of a participating security as defined by ASC 260, “Earnings Per Share”. In applying the two-class method, net income is

allocated to both common and participating securities based on their respective weighted-average shares outstanding for the period. Basic earnings per share is computed by dividing net income allocated to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share is computed by dividing income available to common shareholders by the weighted-average common shares outstanding plus the potential dilutive impact from stock options and restricted stock units. Common equivalent shares are excluded from the computation if their effect is anti-dilutive. There were 7.3 million and 6.7 million anti-dilutive shares during the second quarters of fiscal 2018 and fiscal 2017, respectively. There were 7.0 million and 5.9 million anti-dilutive shares during the six months ended August 4, 2018 and July 29, 2017, respectively.

Table of Contents

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

	13 Weeks Ended		26 Weeks Ended	
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017
Basic earnings per common share:				
Net income	\$ 27,488	\$ 35,562	\$ 54,373	\$ 107,770
Less income related to unvested restricted shares	(56)	(150)	(123)	(478)
Income available to common shareholders - Basic	\$ 27,432	\$ 35,412	\$ 54,250	\$ 107,292
Weighted-average common shares outstanding - Basic	177,348	186,886	179,436	187,927
Basic earnings per common share	\$ 0.15	\$ 0.19	\$ 0.30	\$ 0.57
Diluted earnings per common share:				
Net income	\$ 27,488	\$ 35,562	\$ 54,373	\$ 107,770
Less income related to unvested restricted shares	(56)	(149)	(122)	(475)
Income available to common shareholders - Diluted	\$ 27,432	\$ 35,413	\$ 54,251	\$ 107,295
Weighted-average common shares outstanding - Basic	177,348	186,886	179,436	187,927
Effect of dilutive stock options and restricted stock units	867	1,045	990	1,244
Weighted-average common shares outstanding - Diluted	178,215	187,931	180,426	189,171
Diluted earnings per common share	\$ 0.15	\$ 0.19	\$ 0.30	\$ 0.57

8. SEGMENTS AND GEOGRAPHIC INFORMATION

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

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

	13 Weeks Ended		26 Weeks Ended	
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017
United States(1)	\$ 956,608	\$ 977,779	\$ 2,004,609	\$ 2,034,422
Canada	96,659	94,814	204,169	196,734
Total	\$ 1,053,267	\$ 1,072,593	\$ 2,208,778	\$ 2,231,156

(1) In March 2018, we closed substantially all of our Aaron Brothers stores. There were no Aaron Brothers net sales in the second quarter of fiscal 2018 and net sales totaled approximately \$27.3 million in the second quarter of fiscal 2017. For the six months ended August 4, 2018 and July 29, 2017, Aaron Brothers net sales totaled approximately \$12.9 million and \$52.8 million, respectively.

Table of Contents

9. CONTINGENCIES

Fair Credit Reporting Claim

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

Following the filing of the *Graham* case in New Jersey, five additional purported class action lawsuits with six plaintiffs were filed, *Michele Castro and Janice Bercut v. Michaels Stores, Inc.*, in the U.S. District Court for the Northern District of Texas, *Michelle Bercut v. Michaels Stores, Inc.* in the Superior Court of California for Sonoma County, *Raini Burnside v. Michaels Stores, Inc.*, in the U.S. District Court for the Western District of Missouri, *Sue Gettings v. Michaels Stores, Inc.*, in the U.S. District Court for the Southern District of New York, and *Barbara Horton v. Michaels Stores, Inc.*, in the U.S. District Court for the Central District of California. All of the plaintiffs alleged violations of the FCRA. In addition, the *Castro*, *Horton* and *Janice Bercut* lawsuits also alleged violations of California's unfair competition law. The *Burnside*, *Horton* and *Gettings* lawsuits, as well as the claims by *Michele Castro*, have been dismissed. The *Graham*, *Janice Bercut* and *Michelle Bercut* lawsuits were transferred for centralized pretrial proceedings to the District of New Jersey. On January 24, 2017, the Company's motion to dismiss for lack of standing was granted, and the court declined to rule on the merits of plaintiffs' claims. The dismissal order was stayed for 30 days to allow the plaintiffs to amend their complaints. Because there were no amendments filed, two of the three centralized cases were dismissed and subsequently appealed to the U.S. Court of Appeals for the Third Circuit, and the remaining case (*Michelle Bercut*) was remanded to California Superior Court. We reached a tentative settlement on all pending lawsuits and a preliminary approval of the settlement was granted by the Court on April 18, 2018. The final approval hearing is scheduled for September 19, 2018. We do not believe the resolution of the lawsuits will have a material effect on our consolidated financial statements.

General

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

10. RELATED PARTY TRANSACTIONS

Affiliates of, or funds advised by, Bain Capital Private Equity, L.P. (“Bain Capital”) and The Blackstone Group L.P. (“The Blackstone Group”, together with Bain Capital and their applicable affiliates, the “Sponsors”) owned approximately 43% of our outstanding common stock as of August 4, 2018.

The Blackstone Group owns a majority equity position in RGIS, a vendor we utilized until February 2018 to count our store inventory. There were no payments associated with this vendor during the second quarter of fiscal 2018. Payments associated with this vendor during the second quarter of fiscal 2017 were \$1.7 million. Payments associated with this vendor during the six months ended August 4, 2018 and July 29, 2017 were \$0.7 million and \$3.7 million, respectively. These expenses are included in selling, general and administrative (“SG&A”) in the consolidated statements of comprehensive income.

Table of Contents

The Blackstone Group owns a majority equity position in Excel Trust, Inc., Blackstone Real Estate DDR Retail Holdings III, LLC and Blackstone Real Estate RC Retail Holdings, LLC, vendors we utilize to lease certain properties. Payments associated with these vendors during the second quarters of fiscal 2018 and fiscal 2017 were \$1.5 million. Payments made during the six months ended August 4, 2018 and July 29, 2017 were \$3.3 million and \$3.4 million, respectively. These expenses are included in cost of sales and occupancy expense in the consolidated statements of comprehensive income.

Three of our current directors, Joshua Bekenstein, Ryan Cotton and Peter F. Wallace, are affiliates of either Bain Capital or The Blackstone Group. As such, some or all of such directors may have an indirect material interest in payments with respect to debt securities of the Company that have been purchased by affiliates of Bain Capital and The Blackstone Group. As of August 4, 2018, affiliates of The Blackstone Group held \$89.2 million of our Amended Term Loan Credit Facility.

11. CONDENSED CONSOLIDATED FINANCIAL INFORMATION

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

Michaels Stores, Inc.

Condensed Consolidated Balance Sheets

(in thousands)

	August 4, 2018	February 3, 2018	July 29, 2017
ASSETS			
Current assets:			
Cash and equivalents	\$ 122,419	\$ 425,129	\$ 133,356
Merchandise inventories	1,280,095	1,123,288	1,195,495
Prepaid expenses and other current assets	135,480	127,656	115,662
Total current assets	1,537,994	1,676,073	1,444,513
Property and equipment, net	445,130	420,020	407,694
Goodwill	119,074	119,074	119,074
Other assets	79,093	84,537	72,679
Total assets	\$ 2,181,291	\$ 2,299,704	\$ 2,043,960

LIABILITIES AND STOCKHOLDERS' DEFICIT

Current liabilities:			
Accounts payable	\$ 555,270	\$ 483,002	\$ 510,818
Accrued liabilities and other	351,584	369,647	391,047
Current portion of long-term debt	140,261	24,900	112,125
Other current liabilities	35,020	124,881	30,022
Total current liabilities	1,082,135	1,002,430	1,044,012
Long-term debt	2,695,087	2,701,764	2,712,475
Other liabilities	162,693	165,662	107,853
Total stockholders' deficit	(1,758,624)	(1,570,152)	(1,820,380)
Total liabilities and stockholders' deficit	\$ 2,181,291	\$ 2,299,704	\$ 2,043,960

Table of Contents

Michaels Stores, Inc.

Condensed Consolidated Statements of Comprehensive Income

(in thousands)

	13 Weeks Ended		26 Weeks Ended	
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017
Net sales	\$ 1,053,267	\$ 1,072,593	\$ 2,208,778	\$ 2,231,156
Cost of sales and occupancy expense	679,938	670,082	1,378,887	1,361,012
Gross profit	373,329	402,511	829,891	870,144
Selling, general and administrative	300,734	313,473	629,126	640,938
Restructure charge	(3,220)	—	44,278	—
Store pre-opening costs	1,295	662	2,799	1,640
Operating income	74,520	88,376	153,688	227,566
Interest and other expense	36,272	32,405	69,176	62,801
Losses on early extinguishment of debt and refinancing costs	1,835	—	1,835	—
Income before income taxes	36,413	55,971	82,677	164,765
Income taxes	8,740	20,162	27,951	56,795
Net income	\$ 27,673	\$ 35,809	\$ 54,726	\$ 107,970
Other comprehensive income, net of tax:				
Foreign currency translation adjustment and other	807	13,944	(6,246)	8,672
Comprehensive income	\$ 28,480	\$ 49,753	\$ 48,480	\$ 116,642

Michaels Stores, Inc.

Condensed Consolidated Statements of Cash Flows

(in thousands)

26 Weeks Ended
August 4, July 29,

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

	2018	2017
Cash flows from operating activities:		
Net cash used in operating activities	\$ (87,943)	\$ (644)
Cash flows used in investing activities:		
Additions to property and equipment	(69,908)	(43,120)
Cash flows from financing activities:		
Net repayments of debt	(27,390)	(70,550)
Net borrowings of debt	133,600	139,100
Payment of debt refinancing costs	(1,069)	—
Payment of dividend to Michaels Funding, Inc.	(250,000)	(185,484)
Net cash used in financing activities	(144,859)	(116,934)
Net change in cash and equivalents	(302,710)	(160,698)
Cash and equivalents at beginning of period	425,129	294,054
Cash and equivalents at end of period	\$ 122,419	\$ 133,356

Table of Contents

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

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements of the Company (and the related notes thereto included elsewhere in this quarterly report), the audited consolidated financial statements of the Company (and the related notes thereto) and the Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the fiscal year ended February 3, 2018 ("Annual Report") filed with the Securities and Exchange Commission ("SEC") pursuant to Section 13 or 15(d) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") on March 20, 2018.

All of the "Company", "us", "we", "our", and similar expressions are references to The Michaels Companies, Inc. ("Michaels") and our consolidated wholly-owned subsidiaries, unless otherwise expressly stated or the context otherwise requires.

We report on the basis of a 52- or 53-week fiscal year, which ends on the Saturday closest to January 31. All references to fiscal year mean the year in which that fiscal year began. References to "fiscal 2018" relate to the 52 weeks ending February 2, 2019 and references to "fiscal 2017" relate to the 53 weeks ended February 3, 2018. In addition, all references to "the second quarter of fiscal 2018" relate to the 13 weeks ended August 4, 2018 and all references to "the second quarter of fiscal 2017" relate to the 13 weeks ended July 29, 2017. Finally, all references to "the six months ended August 4, 2018" relate to the 26 weeks ended August 4, 2018 and all references to "the six months ended July 29, 2017" relate to the 26 weeks ended July 29, 2017. Because of the seasonal nature of our business, the results of operations for the 13 and 26 weeks ended August 4, 2018 are not indicative of the results to be expected for the entire year.

Overview

We are the largest arts and crafts specialty retailer in North America (based on store count) providing materials, project ideas and education for creative activities under the retail brands of Michaels, Aaron Brothers and Pat Catan's. We also operate an international wholesale business under the Darice brand name and a market-leading vertically-integrated custom framing business under the Artistree brand name. As of August 4, 2018, we operated 1,251 Michaels stores and 36 Pat Catan's stores.

In March 2018, we closed substantially all of our Aaron Brothers stores and began the process of repositioning our Aaron Brothers brand as a store-within-a-store, providing custom framing services in all Michaels stores. In the first six months of fiscal 2018, we recorded a restructure charge totaling \$44.3 million, consisting primarily of costs associated with the termination of the remaining lease obligations, the write-off of fixed assets and employee-related expenses. For the six months ended August 4, 2018 and July 29, 2017, Aaron Brothers net sales totaled approximately \$12.9 million and \$52.8 million, respectively. Excluding the restructure charge, Aaron Brothers did not have a

material impact on the Company's operating income in the periods presented.

Net sales for the second quarter of fiscal 2018 decreased 1.8% compared to the same period in the prior year. The decrease in net sales was due to the closure of substantially all of our Aaron Brothers stores and a 0.4% decrease in comparable store sales. The decrease was partially offset by an increase in net sales due to the opening of 21 additional Michaels stores (net of closures) since the second quarter of fiscal 2017 and an increase in wholesale revenue. Gross profit as a percent of net sales decreased 210 basis points to 35.4% during the second quarter of fiscal 2018 due primarily to higher distribution related costs and an increase in promotional activity. Operating income as a percent of net sales decreased to 7.1% for the second quarter of fiscal 2018 compared to 8.2% in the same period in the prior year.

Table of Contents

Comparable Store Sales

Comparable store sales represents the change in net sales for stores open the same number of months in the comparable period of the previous year, including stores that were relocated or expanded during either period, as well as e-commerce sales. A store is deemed to become comparable in its 14th month of operation in order to eliminate grand opening sales distortions. A store temporarily closed more than two weeks is not considered comparable during the month it is closed. If a store is closed longer than two weeks but less than two months, it becomes comparable in the month in which it reopens, subject to a mid-month convention. A store closed longer than two months becomes comparable in its 14th month of operation after its reopening. All Aaron Brothers stores have been excluded from comparable stores sales in fiscal 2018.

Operating Information

The following table sets forth certain operating data:

	13 Weeks Ended		26 Weeks Ended	
	August	July 29,	August	July 29,
	4,	2017	4,	2017
	2018		2018	
Michaels stores:				
Open at beginning of period	1,243	1,225	1,238	1,223
New stores	9	5	15	8
Relocated stores opened	7	1	16	8
Closed stores	(1)	—	(2)	(1)
Relocated stores closed	(7)	(1)	(16)	(8)
Open at end of period	1,251	1,230	1,251	1,230
Aaron Brothers stores:				
Open at beginning of period	3	104	97	109
Closed stores	(3)	(3)	(97)	(8)
Open at end of period	—	101	—	101
Pat Catan's stores:				
Open at beginning and end of period	36	35	36	35
Total store count at end of period	1,287	1,366	1,287	1,366
Other Operating Data:				
Average inventory per Michaels store (in thousands) (1)	\$ 921	\$ 864	\$ 921	\$ 864
Comparable store sales	(0.4)	% 0.6	% —	% (0.3)
Comparable store sales, at constant currency	(0.5)	% 0.8	% (0.3)	% (0.2)

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

17

Table of Contents

Results of Operations

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

	13 Weeks Ended		26 Weeks Ended		
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017	
Net sales	100.0	% 100.0	% 100.0	% 100.0	%
Cost of sales and occupancy expense	64.6	62.5	62.4	61.0	
Gross profit	35.4	37.5	37.6	39.0	
Selling, general and administrative	28.6	29.3	28.5	28.7	
Restructure charge	(0.3)	—	2.0	—	
Store pre-opening costs	0.1	0.1	0.1	0.1	
Operating income	7.1	8.2	6.9	10.2	
Interest expense	3.5	2.9	3.2	2.8	
Losses on early extinguishments of debt and refinancing costs	0.2	—	0.1	—	
Other (income) expense, net	(0.1)	0.1	(0.1)	0.1	
Income before income taxes	3.4	5.2	3.7	7.4	
Income taxes	0.8	1.9	1.3	2.5	
Net income	2.6	% 3.3	% 2.5	% 4.8	%

13 Weeks Ended August 4, 2018 Compared to the 13 Weeks Ended July 29, 2017

Net Sales. Net sales decreased \$19.3 million in the second quarter of fiscal 2018, or 1.8%, compared to the second quarter of fiscal 2017. The decrease in net sales was due to a \$27.3 million decrease related to the closure of substantially all of our Aaron Brothers stores and a \$4.3 million decrease in comparable store sales. The decrease was partially offset by a \$10.3 million increase related primarily to 21 additional Michaels stores opened (net of closures) since the second quarter of fiscal 2017 and a \$1.9 million increase in wholesale revenue. Comparable store sales decreased 0.4% compared to the second quarter of fiscal 2017 due to a decrease in customer transactions, partially offset by an increase in average ticket.

Gross Profit. Gross profit was 35.4% of net sales in the second quarter of fiscal 2018 compared to 37.5% in the second quarter of fiscal 2017. The 210 basis point decrease was primarily due to higher distribution related costs, an increase in promotional activity and occupancy cost deleverage. The decrease was partially offset by our ongoing sourcing initiatives.

Selling, General and Administrative. Selling, general and administrative (“SG&A”) was 28.6% of net sales for the second quarter of fiscal 2018 compared to 29.3% for the second quarter of fiscal 2017. SG&A decreased \$12.9 million to \$301.0 million for the second quarter of fiscal 2018. The decrease was primarily due to an \$11.5 million decrease in performance-based compensation and a \$9.3 million decrease related to the Aaron Brothers store closures during the first quarter of fiscal 2018. The decrease was partially offset by a \$4.2 million increase in marketing expenses, \$2.7 million associated with operating 21 additional Michaels stores (net of closures) since the second quarter of fiscal 2017 and \$2.4 million related to the continued rollout of flexible merchandising space in our stores to better present new and seasonally relevant merchandise.

Restructure Charge. We recorded a gain to restructure charge of \$3.2 million in the second quarter of fiscal 2018 related primarily to the settlement of lease obligations associated with the closure of substantially all of our Aaron Brothers stores in the first quarter of fiscal 2018.

Table of Contents

Interest Expense. Interest expense increased \$6.1 million to \$37.1 million in the second quarter of fiscal 2018 compared to the same period in the prior year. The increase was primarily due to \$3.7 million as a result of a higher interest rate on our amended term loan credit facility and \$2.0 million related to settlement payments associated with our interest rate swaps.

Losses on Early Extinguishments of Debt and Refinancing Costs. We recorded a loss on the early extinguishment of debt of \$1.8 million during the second quarter of fiscal 2018 related to the refinancing of our amended and restated term loan credit facility.

Income Taxes. The effective tax rate was 24.0% for the second quarter of fiscal 2018 compared to 36.0% for the second quarter of fiscal 2017. The effective tax rate for the second quarter of fiscal 2018 was lower than the same period in the prior year due a decrease in the federal statutory rate from 35% to 21% as part of the Tax Cuts and Jobs Act of 2017 (“Tax Act”).

26 Weeks Ended August 4, 2018 Compared to the 26 Weeks Ended July 29, 2017

Net Sales. Net sales decreased \$22.4 million in the first six months of fiscal 2018, or 1.0%, compared to the first six months of fiscal 2017. The decrease in net sales was due to a \$39.9 million decrease related to the closure of substantially all of our Aaron Brothers stores and a \$2.4 million decrease in wholesale revenue. The decrease was partially offset by a \$19.7 million increase related primarily to 21 additional Michaels stores opened (net of closures) since the second quarter of fiscal 2017. Comparable store sales were flat compared to the first six months of fiscal 2017 due to an increase in average ticket, offset by a decrease in customer transactions.

Gross Profit. Gross profit was 37.6% of net sales for the first six months of fiscal 2018 compared to 39.0% in the first six months of fiscal 2017. The 140 basis point decrease was primarily due to higher distribution related costs, an increase in promotional activity and occupancy cost deleverage. The decrease was partially offset by our ongoing sourcing initiatives.

Selling, General and Administrative. SG&A was 28.5% of net sales for the first six months of fiscal 2018 compared to 28.7% in the first six months of fiscal 2017. SG&A decreased \$11.7 million to \$629.6 million for the first six months of fiscal 2018. The decrease was primarily due to a \$14.3 million decrease related to the Aaron Brothers store closures during the first quarter of fiscal 2018 and an \$11.5 million decrease in performance-based compensation. The decrease was partially offset by a \$5.2 million increase associated with operating 21 additional Michaels stores (net of closures) since the second quarter of fiscal 2017, \$3.9 million in professional fees related to strategic initiatives and \$2.4 million related to the continued rollout of flexible merchandising space in our stores to better present new and seasonally relevant merchandise.

Restructure Charge. We recorded a restructure charge of \$44.3 million in the first six months of fiscal 2018 primarily related to the closure of substantially all of our Aaron Brothers stores.

Interest Expense. Interest expense increased \$10.2 million to \$71.7 million in the first six months of fiscal 2018 compared to the first six months of fiscal 2017. The increase was primarily due to \$7.6 million as a result of a higher interest rate on our amended term loan credit facility and \$2.1 million related to settlement payments associated with our interest rate swaps.

Losses on Early Extinguishments of Debt and Refinancing Costs. We recorded a loss on the early extinguishment of debt of \$1.8 million during the first six months of fiscal 2018 related to the refinancing of our amended and restated term loan credit facility.

Table of Contents

Income Taxes. The effective tax rate was 33.9% for the first six months of fiscal 2018 compared to 34.5% for the first six months of fiscal 2017. The effective tax rate was lower than the same period in the prior year due to a decrease in the federal statutory rate from 35% to 21% as part of the Tax Act, partially offset by provisional adjustments of \$8.1 million related to repatriation taxes for accumulated earnings of foreign subsidiaries.

Liquidity and Capital Resources

We require cash principally for day-to-day operations, to finance capital investments, purchase inventory, service our outstanding debt and for seasonal working capital needs. We expect that our available cash, cash flow generated from operating activities and funds available under our Amended Revolving Credit Facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and anticipated growth for the foreseeable future. Our ability to satisfy our liquidity needs and continue to refinance or reduce debt could be adversely affected by the occurrence of any of the events described under “Item 1A. Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended February 3, 2018 or our failure to meet our debt covenants. Our Amended Revolving Credit Facility provides senior secured financing of up to \$850.0 million, subject to a borrowing base. As of August 4, 2018, the borrowing base was \$850.0 million, of which we had \$87.2 million of outstanding standby letters of credit and \$644.8 million of unused borrowing capacity. Our cash and cash equivalents totaled \$123.2 million at August 4, 2018.

In June 2017, the Board of Directors authorized a new share repurchase program for the Company to purchase \$500.0 million of the Company’s common stock on the open market or through accelerated share repurchase transactions. The share repurchase program does not have an expiration date, and the timing and number of repurchase transactions under the program will depend on market conditions, corporate considerations, debt agreements and regulatory requirements. Shares repurchased under the program are held as treasury shares until retired. In June 2018, the Company entered into an accelerated share repurchase agreement (“ASR Agreement”) with JPMorgan Chase Bank, N.A. (“JPMorgan”). Under the ASR Agreement, we paid JPMorgan a purchase price of \$250.0 million for an initial delivery of 10.7 million shares of our common stock, representing 86% of the shares to be purchased under the agreement. On August 30, 2018, we completed the share repurchase and received an additional 1.7 million shares. The total number of shares repurchased was based upon a volume weighted average price of our stock over a predetermined period. As of August 4, 2018, we had \$150.0 million of availability remaining under our current share repurchase program. Upon final settlement of the ASR Agreement, the remaining authorization for future repurchases totaled \$100.0 million.

On May 23, 2018, Michaels Stores, Inc. (“MSI”) entered into an amendment with JPMorgan and other lenders to amend and restate our term loan credit facility. The amended and restated credit agreement, together with the related security, guarantee and other agreements, is referred to as the “Amended and Restated Term Loan Credit Facility”. Borrowings under the Amended and Restated Term Loan Credit Facility bear interest at a rate per annum, at MSI’s option, of either (a) a margin of 1.50% plus a base rate defined as the highest of (1) the prime rate of JPMorgan, (2) the federal funds effective rate plus 0.5%, and (3) the one-month London Interbank Offered Rate (“LIBOR”) plus 1% or (b) a margin of 2.50% plus the applicable LIBOR. MSI is required to make scheduled quarterly payments equal to 0.25% of the original principal amount of the term loans (subject to adjustments relating to the incurrence of additional term loans)

for the first four years and two quarters of the Amended and Restated Term Loan Credit Facility, with the balance to be paid on January 28, 2023. All other terms under the Amended Term Loan Credit Facility have remained unchanged. As a result of this refinancing, we recorded a loss on the early extinguishment of debt of \$1.8 million during the second quarter of fiscal 2018.

We had total outstanding debt of \$2,848.6 million at August 4, 2018, of which \$2,338.6 million was subject to variable interest rates and \$510.0 million was subject to fixed interest rates. In April 2018, we executed two interest rate swaps with an aggregate notional value of \$1.0 billion associated with our outstanding Amended Term Loan Credit Facility. The interest rate swaps have a maturity date of April 30, 2021 and were executed for risk management and are not held for trading purposes. The objective of the interest rate swaps is to hedge the variability of cash flows resulting from fluctuations in the one-month LIBOR. The swaps replaced the one-month LIBOR with a fixed interest rate of 2.7765% and payments are settled monthly.

20

Table of Contents

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

We intend to use excess operating cash flows to invest in growth opportunities, repurchase outstanding shares and repay portions of our indebtedness, depending on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. As such, we and our subsidiaries, affiliates and significant shareholders may, from time to time, seek to retire or purchase our outstanding debt (including publicly issued debt) through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender offer or otherwise. If we use our excess cash flows to repay our debt, it will reduce the amount of excess cash available for additional capital expenditures.

Cash Flow from Operating Activities

Cash flows used in operating activities were \$86.6 million in the first six months of fiscal 2018 compared to \$4.0 million in the first six months of fiscal 2017. The increase in cash used in operating activities was primarily due to higher inventory levels to maintain better in-stock positions at the stores, partially offset by lower tax payments.

Inventory at the end of the second quarter of fiscal 2018 increased \$84.6 million, or 7.1%, to \$1,280.1 million, compared to \$1,195.5 million at the end of the second quarter of fiscal 2017. The increase in inventory was primarily due to additional inventory associated with the operation of 21 additional Michaels stores (net of closures) since the second quarter of fiscal 2017 and higher inventory levels to maintain better in-stock positions at the stores. The increase was partially offset by a decrease in inventory related to the Aaron Brothers store closures in the first quarter of fiscal 2018. Average inventory per Michaels store (inclusive of distribution centers, in-transit and inventory for the Company's e-commerce site) increased 6.6% to \$921,000 at August 4, 2018 from \$864,000 at July 29, 2017.

Cash Flow from Investing Activities

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

26 Weeks Ended

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

	August 4, 2018	July 29, 2017
New and relocated stores including stores not yet opened (1)	\$ 17,756	\$ 6,535
Existing stores	16,383	16,506
Information systems	25,945	13,097
Corporate and other	9,824	6,982
	\$ 69,908	\$ 43,120

(1) In the first six months of fiscal 2018, we incurred capital expenditures related to the opening of 31 Michaels stores, including the relocation of 16 stores. In the first six months of fiscal 2017, we incurred capital expenditures related to the opening of 16 Michaels stores, including the relocation of eight stores.

Non-GAAP Measures

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

Table of Contents

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

As EBITDA and Adjusted EBITDA are not measures of liquidity calculated in accordance with U.S. generally accepted accounting principles ("GAAP"), these measures should not be considered in isolation of, or as substitutes for, net cash provided by operating activities as an indicator of liquidity. Our computation of EBITDA and Adjusted EBITDA may differ from similarly titled measures used by other companies.

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

	13 Weeks Ended		26 Weeks Ended	
	August 4, 2018	July 29, 2017	August 4, 2018	July 29, 2017
Net cash used in operating activities	\$ (119,065)	\$ (26,980)	\$ (86,562)	\$ (4,035)
Depreciation and amortization	(29,596)	(28,872)	(59,054)	(57,423)
Share-based compensation	(5,365)	(5,615)	(12,334)	(10,557)
Debt issuance costs amortization	(1,248)	(1,275)	(2,522)	(2,549)
Accretion of long-term debt, net	130	126	256	252
Restructure charge	3,220	—	(44,278)	—
Deferred income taxes	1,810	484	(770)	225
Losses on early extinguishments of debt and refinancing costs	(1,835)	—	(1,835)	—
Changes in assets and liabilities	179,437	97,694	261,472	181,857
Net income	27,488	35,562	54,373	107,770
Interest expense	37,101	31,051	71,695	61,488
Income taxes	8,681	20,016	27,838	56,674
Depreciation and amortization	29,596	28,872	59,054	57,423
Interest income	(842)	(110)	(2,248)	(254)
EBITDA	102,024	115,391	210,712	283,101
Adjustments:				
Losses on early extinguishments of debt and refinancing costs	1,835	—	1,835	—
Share-based compensation	5,365	5,615	12,334	10,557
Restructure charge	(3,220)	—	44,278	—
Severance costs	—	243	902	577

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

Store pre-opening costs	1,295	662	2,799	1,640
Store remodel costs	3,239	855	3,754	977
Foreign currency transaction (gains) losses	(231)	1,386	(801)	1,447
Store closing costs	2,587	284	3,649	2,013
Other (1)	555	634	1,281	1,499
Adjusted EBITDA	\$ 113,449	\$ 125,070	\$ 280,743	\$ 301,811

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

Table of Contents

Disclosure Regarding Forward-Looking Information

The above discussion, as well as other portions of this Quarterly Report on Form 10-Q, contains forward-looking statements that reflect our plans, estimates and beliefs. Statements regarding sufficiency of capital resources and planned uses of excess cash flow as well as any other statements contained herein (including, but not limited to, statements to the effect that Michaels or its management “anticipates”, “plans”, “estimates”, “expects”, “believes”, “intends” and other similar expressions) that are not statements of historical fact should be considered forward-looking statements and should be read in conjunction with our Annual Report. Such forward-looking statements are based upon management’s current knowledge and assumptions about future events and involve risks and uncertainties that could cause actual results, performance or achievements to be materially different from anticipated results, prospects, performance or achievements expressed or implied by such forward-looking statements. Most of these factors are outside of our control and are difficult to predict. Such risks and uncertainties include, but are not limited to the following:

- risks related to the effect of economic uncertainty;
- risks related to our substantial indebtedness;
- restrictions in our debt agreements that limit our flexibility in operating our business;
- changes in customer demand could materially adversely affect our sales, results of operations and cash flow;
- competition, including internet-based competition, could negatively impact our business;
- a weak fourth quarter would materially adversely affect our results of operations;
- unexpected or unfavorable consumer responses to our promotional or merchandising programs could materially adversely affect our sales, results of operations, cash flows and financial condition;
- our results may be adversely affected by serious disruptions or catastrophic events, including geo-political events and weather;
- our failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information, which could result in an additional data breach, could materially adversely affect our financial condition and operating results;

- our reliance on foreign suppliers increases our risk of obtaining adequate, timely and cost-effective product supplies;
- our failure to increase comparable store sales and open new stores could impair our ability to improve our sales, profitability and cash flows;
- damage to the reputation of the Michaels brand or our private and exclusive brands could adversely affect our sales;
- risks associated with the suppliers from whom our products are sourced may fail us and transitioning to other qualified vendors could materially adversely affect our revenue and profit growth;
- changes in regulations or enforcement, or our failure to comply with existing or future regulations, may adversely impact our business;

Table of Contents

- significant increases in inflation or commodity prices such as petroleum, natural gas, electricity, steel, wood, and paper may adversely affect our costs, including cost of merchandise;
- we may be subject to information technology system failures or network disruptions, or our information systems may prove inadequate, resulting in damage to our reputation, business operations and financial condition;
- improvements to our supply chain may not be fully successful;
- we are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiaries;
- we are dependent upon the services of our senior management team;
- any difficulty executing or integrating an acquisition, a business combination or a major business initiative could adversely affect our business or results of operations;
- our marketing programs, e-commerce initiatives and use of consumer information are governed by an evolving set of laws and enforcement trends and unfavorable changes in those laws or trends, or our failure to comply with existing or future laws, could substantially harm our business and results of operations;
 - product recalls and/or product liability, as well as changes in product safety and other consumer protection laws, may adversely impact our operations, merchandise offerings, reputation, results of operation, cash flow, and financial condition;
- changes in estimates or projections used to assess fair value of intangible assets, goodwill and property and equipment may cause us to incur impairment charges that could adversely affect our results of operations;
- changes in newspaper subscription rates may result in reduced exposure to our circular advertisements;
- disruptions in the capital markets could increase our costs of doing business;
- our real estate leases generally obligate us for long periods, which subjects us to various financial risks;
- we have co-sourced certain of our information technology, accounts payable, payroll, accounting and human resources functions, and may co-source other administrative functions, which makes us more dependent upon third parties;

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

- failure to attract and retain quality sales, distribution center and other team members in appropriate numbers as well as experienced buying and management personnel could adversely affect our performance;
- affiliates of, or funds advised by, Bain Capital Private Equity, L.P. and The Blackstone Group L.P. own approximately 43% of the outstanding shares of our common stock and as a result will have the ability to strongly influence our decisions, and they may have interests that differ from those of other stockholders; and
- our holding company structure makes us, and certain of our direct and indirect subsidiaries, dependent on the operations of our, and their, subsidiaries to meet our financial obligations.

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

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Risk

We are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiaries. Our sales, costs and expenses of our Canadian subsidiaries, when translated into U.S. dollars, can fluctuate due to exchange rate movement. A 10% increase or decrease in the exchange rate of the Canadian dollar would have increased or decreased net income by approximately \$6 million for the 26 weeks ended August 4, 2018.

Interest Rate Risk

We have market risk exposure arising from changes in interest rates on our Amended Term Loan Credit Facility and our Amended Revolving Credit Facility. The interest rates on our Amended Term Loan Credit Facility and our Amended Revolving Credit Facility will reprice periodically, which will impact our earnings and cash flow. In April 2018, we executed two interest rate swap agreements with an aggregate notional value of \$1.0 billion which are intended to mitigate interest rate risk associated with future changes in interest rates for borrowings under our Amended Term Loan Credit Facility. As a result of these interest rate swaps, our exposure to interest rate volatility for \$1.0 billion of our Amended Term Loan Credit Facility was eliminated beginning in the second quarter of fiscal 2018. The interest rate on our 2020 Senior Subordinated Notes is fixed. Based on our overall interest rate exposure to variable rate debt outstanding as of August 4, 2018, a 100 basis point change in interest rates would impact income before income taxes by approximately \$13 million for fiscal 2018. A 100 basis point change in interest rates would impact the fair value of our long-term fixed rate debt by approximately \$20 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

Inflation Risk

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

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

An evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls are effective to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Exchange Act, is accumulated and communicated to management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure and are effective to provide reasonable assurance that such information is recorded, processed, summarized, and reported within the time periods specified by the SEC's rules and forms.

Table of Contents

Change in Internal Control Over Financial Reporting

There have been no changes in our internal controls over financial reporting during the quarter ended August 4, 2018 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information regarding legal proceedings is incorporated by reference from Note 9 to the consolidated financial statements in this Quarterly Report on Form 10-Q.

ITEM 1A. RISK FACTORS

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

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

The following table provides certain information with respect to our purchases of shares of the Company's common stock during the second quarter of fiscal 2018:

Period	Total Number of Shares Purchased (a)	Average Price	Total Number of Shares Purchased as Part of Publicly Announced Plan (b)	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plan (b)

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

		Paid per Share		(in thousands)
May 6, 2018 - June 2, 2018	1,468	\$ 18.36	—	\$ 350,001
June 3, 2018 - July 7, 2018	10,754,378	18.61	10,746,910	150,001
July 8, 2018 - August 4, 2018	885	20.40	—	150,001
Total	10,756,731	\$ 18.61	10,746,910	\$ 150,001

(a) These amounts reflect the following transactions during the second quarter of fiscal 2018: (i) the repurchase of shares as part of our publicly announced share repurchase program and (ii) the surrender of shares of common stock to the Company to satisfy tax withholding obligations in connection with the vesting of employee restricted stock awards.

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

Table of Contents

ITEM 6. EXHIBITS

(a) Exhibits:

Exhibit Number	Description of Exhibit
10.1	<u>Fixed Dollar Accelerated Share Repurchase Transaction Confirmation dated June 28, 2018 between The Michaels Companies, Inc. and JPMorgan Chase Bank, National Association, London Branch (previously filed as Exhibit 10.1 to Form 8-K filed by the Company on July 3, 2018, SEC File No. 001-36501).</u>
31.1	<u>Certifications of Carl S. Rubin pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
31.2	<u>Certifications of Denise A. Paulonis pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
32.1	<u>Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

*Management contract or compensatory plan or agreement.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

THE MICHAELS COMPANIES, INC.

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

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

(Principal Financial Officer)

Date: August 31, 2018