

MICHAELS STORES INC
Form 10-K
March 31, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended January 30, 2010

or

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

For the transition period from to

Commission file number 001-09338

MICHAELS STORES, INC.

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(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

75-1943604
(I.R.S. employer
identification number)

8000 Bent Branch Drive

Irving, Texas 75063

(Address of principal executive offices, including zip code)

(972) 409-1300

(Registrant's telephone number, including area code)

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 No

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 No

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. * Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark 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.

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Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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 27, 2010, 118,898,939 shares of the Registrant's Common Stock were outstanding.

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

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 approximately \$3.9 billion in sales in fiscal 2009, Michaels Stores, Inc., together with its subsidiaries, is the largest arts and crafts specialty retailer in North America providing materials, ideas and education for creative activities. Our mission is to be a world class performer that inspires and enables consumers to experience creativity and to lead industry growth and innovation, while creating a fun and rewarding place to work that fosters meaningful connections with our communities. Through our broad product assortments, educational in-store events, project sheets and displays, and on-line information, we offer a shopping experience that inspires creativity in the areas of arts, crafts, floral displays, framing, home accents, and children's hobbies and activities.

Michaels Stores, Inc. was incorporated in Delaware in 1983, and as of March 27, 2010, we operate 1,028 Michaels retail stores in 49 states, as well as in Canada, averaging 18,300 square feet of selling space per store. Our stores offer arts and crafts supplies and products for the crafter and do-it-yourself home decorator. We also operate 148 Aaron Brothers stores as of March 27, 2010, in 9 states, averaging 5,600 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 private investment firms, Bain Capital Partners, LLC and The Blackstone Group (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, owns approximately 93% of our outstanding Common Stock, which is no longer publicly traded.

On October 16, 2007, we announced plans to align resources around our core retail chains, Michaels and Aaron Brothers stores. As a result, we discontinued our concept businesses, Recollections and Star Decorators Wholesale (Star). As of the end of fiscal 2007, we had closed all 11 Recollections and three of the four Star locations. The Star Decorators Wholesale Los Angeles store, the sole remaining Star location, is now being operated as a Michaels store. The operations of Recollections and Star have been reflected as discontinued operations.

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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, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, free of charge on our Internet website at www.michaels.com under the heading Corporate Information. These links are automatically updated, so the filings are available immediately after they are made publicly available by the Securities and Exchange Commission (SEC). These filings are also available through the SEC's EDGAR system at www.sec.gov.

Industry Overview

We are the largest specialty retailer in North America providing materials, project ideas, and education for creative activities in arts and crafts, home, and scrapbooking. We believe we are well positioned to benefit from favorable demographics, particularly a more affluent baby boomer population, and an increasing focus on savings and home-based, family activities. According to industry consumer participation surveys from December 2007 and 2009, approximately 56% of U.S. households participate in an arts and crafts category and our typical customer is:

- Female 90% are women and 63% are married.
- Young 71% of crafters are under 55, with 46% of them between the ages of 35 and 54.
- Middle class 64% of our crafters have household incomes greater than \$50,000, with a median income of about \$65,000.

- **Loyal** Most crafters shop for craft supplies at least twice a month, with approximately half of their visits to Michaels.

We compete across many segments of the industry, including adult and kids crafts, scrapbooking and paper crafting, jewelry making, art supplies, home, floral, celebrations, and ready-made and custom framing. Industry association reports estimate that the addressable market size associated with the core arts and crafts market is about \$27 billion, and we estimate another \$3 billion is associated with the framing market for a total addressable market size of \$30 billion annually.

The market in which we compete is highly fragmented, containing stores across the nation operated primarily by small, independent retailers along with a few regional chains. We believe customers tend to 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 accents, 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 varying 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, which operates approximately 462 stores in 37 states, primarily in the Midwestern and Southern United States; A.C. Moore Arts & Crafts, Inc., which operates approximately 144 stores primarily in the mid-Atlantic and Northeast regions; Jo-Ann Stores, Inc., which operates approximately 235 large-format stores across the country; and Garden Ridge Corporation, which operates approximately 45 stores in 19 states, primarily in the Midwestern and Southern United States. We believe all of these chains are significantly smaller than Michaels with respect to total 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.

Business Strategy

We continue to strive to increase sales and productivity by strengthening our position as a world class performer, and as the largest arts and crafts retailer in North America through the following strategies:

- **Merchandise.** Our goal is to drive sales by inspiring our customers with a broad assortment of products at competitive prices and to create an excellent in-store experience. We expect to continue to expand the custom framing business with exciting new offerings.

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- *Improving our merchandise assortment.* We are focused on introducing greater newness in our categories to inspire the creativity of our customers. We believe that frequent merchandise resets to provide more new products, inspiration, and excitement to our customers is a key. We plan to test new merchandising assortments in selected markets before implementing regional or national rollouts. Our assortments include highly differentiated and exclusive product lines, which we believe help us further maximize our opportunities within arts and crafts trends.

- *Ideas and inspiration.* We believe that our customer experience can be a key advantage that differentiates us from our competitors and is a critical component of our merchandising strategy. Many of the craft supplies sold in our Michaels stores can be assembled into unique end products with an appropriate amount of guidance and direction. Accordingly, we have in-store displays to stimulate creativity with new project ideas and we supply free project sheets with detailed instructions on how to assemble the finished product. We also offer project sheets on our Internet site, www.michaels.com, and webisodes demonstrating techniques to make seasonal crafts, gifts, and more at www.WhereCreativityHappens.com. In addition, we offer a variety of classes, demonstrations, and family focused make-it and take-it events to inspire our customers with product ideas and information. We believe this strategy enhances incremental sales, drives frequency of customer visits, and is core to our brand positioning.

- *Pricing and promotional strategy.* We are developing an integrated pricing and promotion strategy based on customer behavior, while improving our long-term organizational capabilities, processes, and tools. Our promotional activity is item-price based, with promotions spanning across categories and limited regional differentiation. We believe we can improve margins by applying more sophisticated pricing models and regional promotional programs, with a focus on the optimization

of promotional prices and improvements in clearance pricing through enhanced merchandise planning and merchandising systems upgrades. We further believe that we will be able to increase our core market as we improve our ability to more precisely identify the promotional items that drive customer traffic.

- *Custom Framing.* We are executing on strategies, and evaluating new opportunities, to drive the custom frame business. We have a heightened focus on ensuring that we have well trained custom framing sales associates that provide our customers with new products and service offerings. As part of our custom framing initiative, we plan to upgrade the capabilities of our manufacturing subsidiary that provides framing merchandise to our stores.

- *Direct Imports and Private Brands.*

- *Global sourcing.* We believe that importing product directly, primarily from Asia, presents a significant long-term opportunity to enhance our margin, improve our product quality, and mitigate external cost pressures. We will continue to identify and leverage key strategic domestic vendors who will work with us to bring fresh ideas, quality products and exceptional value to our customers. We have expanded our relationships internationally, both through agents and directly with manufacturers, and will collaboratively plan to bring a compelling assortment to market. In fiscal 2009, as a percent of total receipts, we sourced approximately 17% of our merchandise through direct relationships with international manufacturers or through agents, compared to 10% in fiscal 2008. We anticipate that we will continue to significantly expand our direct import business.

- *Private Brand Development.* Currently, we sell numerous products under hundreds of labels. We believe that by focusing on a few, strong, private brands, we will help drive differentiation, improve our image, and provide the framework for Michaels to more effectively market our globally sourced products. We have chosen a few select consumer driven brands which we believe will strengthen our value proposition in the marketplace, differentiate Michaels from its competitors, enhance customer loyalty, and increase market share by supporting Michaels position in selection, newness, and value.

- *Store Experience.*

- *The in-store experience.* We want our stores to be the destination for Where Creativity Happens by providing not just the products for which our customer is looking, but also ideas and inspiration that allow for an entertaining and enjoyable shopping experience. Since its implementation in fiscal 2008, our internet based customer relationship management platform has provided us timely, actionable feedback on our customers in-store experience and has shown continued improvement in our stores overall service levels. We successfully implemented an automated labor scheduling module in all stores during fiscal 2008 that continues to improve store efficiencies and produce lower payroll expense per store. These efficiencies allow our associates to focus more time on driving sales and customer service. In support of our ongoing commitment to improve the in-store experience, we plan to develop a workload planning system to establish baseline staffing models to balance time for service versus tasks. In addition, we intend to identify non-productive work that can be eliminated through process re-engineering.

- *Marketing.*

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- *Improving marketing execution.* We are committed to deepening our relationship with our customers. We utilize a diversified marketing mix including print, direct mail, email, in-store promotional activities, and online advertising. We are working to develop additional online and social media tools to help us explore and develop new customer segments. We are exploring ways to optimize our print advertising distribution, as well as develop alternative approaches to disseminating our message. These approaches will be specifically targeted towards those customer segments which represent the greatest sales opportunities.

- *Store Growth.*

- *Optimization of existing store portfolio.* Commencing in fiscal 2009, we expanded efforts to reduce occupancy costs in our existing stores through renegotiation of lease terms. We also implemented a program to proactively manage store maintenance to ensure timely preventative maintenance is performed to our stores, consistent with our customers' expectations. We plan to continue these programs in fiscal 2010. In addition, we believe the current macroeconomic environment allows us an opportunity to relocate existing stores to more advantageous sites.

- *New store openings.* We believe the combined United States and Canadian markets can support a total of 1,300 to 1,500 Michaels stores. We continue to make refinements to our store prototype model to maximize the return on our new store investments. We have identified successes in our prototype models and are incorporating those positive results into

merchandise resets across the chain. We are also testing urban and small market formats to further penetrate existing markets. During fiscal 2010, we anticipate opening 30 to 35 new Michaels stores including approximately 10 relocations, funded primarily through cash provided by operating activities and additional borrowings under our revolving credit facility.

- ***Cash Flow and Expense Management.***

- ***Inventory optimization.*** We are working on initiatives to develop processes and systems to improve our inventory turnover. Improvements to our merchandise assortments will allow us to remove unproductive inventory, and we are benchmarking our supply chain with world class companies to identify opportunities to optimize investment in inventory, improve turn and drive sales through improved in-stocks. Additional tools and training for our stores will allow us to reduce shrink, and collaboration with our vendors on packaging standards will yield significant reductions in damaged product and cost.

- ***Continuous improvement.*** In fiscal 2009, we successfully transitioned certain of our information technology, information services, accounts payable, payroll, accounting, and human resources functions, to a third party. We intend to continue to identify potential cost savings through expense control and process improvement, as well as leveraging all elements of our co-sourcing partnership.

- ***Engaged Associates.***

- ***Workforce.*** Our associates are essential to ensuring the success of our strategic initiatives. We plan to invest in and enrich our associates with improved training, development and support. We plan to drive performance of our associates in a sales-focused environment with clear accountability and rewards. Our goal is to create a culture that enhances the experiences of our associates, our customers and the communities we serve.

Merchandising

Our Michaels store merchandising strategy is to provide a broad assortment of products at competitive prices and to inspire our consumer through new products, finished projects, project sheets, and special events. Each Michaels store offers approximately 39,000 basic 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 sales:

	Fiscal Year		
	2009	2008	2007
General and children's crafts	44%	42%	41%
Home and seasonal	21	23	25
Scrapbooking	18	17	16
Framing	17	18	18
	100%	100%	100%

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During the Christmas selling season, a significant portion of floor and shelf space in a typical Michaels store is devoted to Christmas crafts, Christmas decorations, gift making, and gift-giving merchandise. Because of the project-oriented nature of many of these products, the Christmas selling season begins in August and extends through December. Accordingly, a fully developed seasonal merchandising program, including inventory, merchandise layout, and instructional ideas, is implemented during the third quarter of each fiscal year in every Michaels store. This program requires additional inventory investment so that stores are fully stocked during the peak selling season to meet higher demand from increased customer traffic.

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 point of sale (POS) and perpetual inventory data. In each case, the appropriate repricing is determined at our corporate office. Price changes are transmitted electronically to the store through the POS system and instructions are provided to our stores regarding product placement, signage, and display in order to ensure that 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 and shopping experience. In addition, we strive to provide a fashion forward framing merchandise selection in an appealing environment with attentive customer service.

Purchasing and Inventory Management

We purchase merchandise from approximately 1,000 vendors. We believe that our buying power and ability to make centralized purchases enable us to acquire products on favorable terms. Central merchandising management teams negotiate with vendors in an attempt to obtain the lowest net merchandise costs and improve control over product mix and inventory levels. In fiscal 2009, our top 10 vendors accounted for approximately 30% of total purchases with no single vendor accounting for more than 10% of total purchases.

In addition to purchasing from outside vendors, our Michaels and Aaron Brothers stores purchase custom frames, framing supplies, mats, and art prints from our framing operation, Artistree, which consists of a manufacturing facility and four regional processing centers to support our retail stores.

Substantially all of the products sold in Michaels stores are manufactured in Asia, Canada, Mexico, and the United States. 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 United States, and their purchase prices are denominated in United States dollars.

Our primary objectives for inventory management are (1) maximizing the efficiency of the flow of product to the stores, (2) maintaining high store in-stock levels, (3) enhancing store labor efficiency, (4) reducing clearance inventory levels, and (5) optimizing our overall investment in inventory. We manage our inventory in several ways, including: in-store management using a handheld radio frequency device (RF gun); daily tracking of inventory positions utilizing our perpetual inventory and automated replenishment systems; the use of merchandise planograms to control the merchandise assortment and presentation; and the review of item-level sales information in order to track the performance and sell-through of seasonal and promotional items. The data that we obtain from our POS system is an integral component in the inventory management process. In addition, store and distribution center inventories are verified through periodic physical and cycle counts conducted throughout the year on a rotating systematic schedule.

Our perpetual inventory and automated merchandise replenishment systems provide the capability to achieve our inventory management objectives. 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.

We manage the distribution of seasonal merchandise to our stores by allocating seasonal merchandise based on prior year sales and current store sales trends. For a discussion of the seasonal nature of our business, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - General.

Artistree

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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 high quality custom and specialty framing merchandise, including art prints and precut mats.

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 16% of the moulding we process, import another 45% 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 2009, we operated three regional processing centers in City of Industry, California; Coppell, Texas; and Kernersville, North Carolina. Our art prints and pre-cut mats, along with our custom frame supplies, are packaged and distributed out of our Coppell regional processing center. Combined, these facilities occupy approximately 476,000 square feet and, in fiscal 2009, processed over 24 million linear feet of frame moulding and 5 million individually custom cut mats for our Michaels and Aaron Brothers stores.

In March 2010, we opened a 62,000 square foot regional processing center in Mississauga, Ontario, to service the custom framing orders for our Canadian stores.

We believe Artistree provides a competitive advantage to our Michaels and Aaron Brothers stores. Based on the benefits we have received from this vertically integrated solution, we continue to evaluate additional future vertical integration opportunities leveraging our strong framing operations.

Distribution

We currently operate a distribution network for supplying our stores with merchandise. Approximately 84% of Michaels stores' merchandise receipts, consisting of both seasonal and basic SKUs, are shipped through the distribution network with the remainder shipped directly from vendors. Approximately 59% of Aaron Brothers stores' merchandise, consisting of both seasonal and basic SKUs, 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 currently utilize one third-party warehouse to store and supply our seasonal merchandise in preparation for the holiday season.

In fiscal 2008, we completed the implementation of numerous enhancements to our distribution network, which involved the conversion of approximately 130 vendors who had previously shipped product directly to our stores to a centralized distribution model (hybrid-distribution network). Under our hybrid-distribution network, all distribution centers stock our fast-selling SKUs with slower-selling SKUs only stocked in the distribution center closest to the vendor. This method reduces costs associated with drop-shipping products directly to store locations. This reduction in direct deliveries from vendors to our stores has resulted in the following benefits to our supply chain:

- Product cost reductions shared with our vendors;
- Reduced transportation costs, partially offset by additional handling costs;
- More efficient store labor involved in merchandise receipt processing; and
- Improved service levels to our stores.

Michaels stores generally receive deliveries from the distribution centers weekly through an internal transportation network using a dedicated fleet of trucks and contract carriers. Aaron Brothers stores receive merchandise on a weekly or biweekly basis from a dedicated 174,000 square foot distribution center located in the Los Angeles, California area. In fiscal 2010, Aaron Brothers stores will generally receive merchandise on a biweekly basis.

Store Expansion and Relocation

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

	2009	2008	Fiscal Year (1) 2007	2006	2005
Michaels stores:					
Retail stores open at beginning of year	1,009	963	921	886	845
Retail stores opened during the year	18	51	45	43	46
Retail stores opened (relocations) during the year	5	11	11	7	18
Retail stores closed during the year	(4)	(5)	(3)	(8)	(5)
Retail stores closed (relocations) during the year	(5)	(11)	(11)	(7)	(18)
Retail stores open at end of year	1,023	1,009	963	921	886

Aaron Brothers stores: