MICHAELS STORES INC
Form 10-K
April 29, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended February 1, 2014

or

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

For the transition period from to

Commission file number 001-09338

MICHAELS STORES, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**75-1943604** (I.R.S. employer identification number)

8000 Bent Branch Drive

Irving, Texas 75063

(Address of principal executive offices, including zip code)

(972) 409-1300

(Registrant s telephone number, including area code)

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

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

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

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

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

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

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

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

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

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

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

As of April 11, 2014, 100 shares of the Registrant s common stock were outstanding.

* The Registrant has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, but is not required to file such reports under such sections effective February 1, 2014, which was the last day of our fiscal year.

DOCUMENTS INCORPORATED BY REFERENCE

None.

PART I

ITEM 1. Business.

The following discussion, as well as other portions of this Annual Report on Form 10-K, contains forward-looking statements that reflect our plans, estimates and beliefs. Any statements contained herein (including, but not limited to, statements to the effect that Michaels or its management anticipates, plans, estimates, expects, believes, and other similar expressions) that are not statements of historical fact should be considered forward-looking statements. Our actual results could materially differ from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Annual Report on Form 10-K and particularly in Item 1A. Risk Factors and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations. Unless the context otherwise indicates, references in this Annual Report on Form 10-K to we, our, us, the Company , Michaels , MSI mean Michaels Stores, Inc., together with its subsidiaries.

General

With over $4.5 billion in sales in fiscal 2013, Michaels is the largest arts and crafts specialty retailer in North America delivering inspiration for creative projects, from the beginner to expert crafter. With project ideas, private brand products, and on-trend, exclusive merchandise offerings, we strive to provide a customer-centric shopping environment. Through a broad array of in-store events, project sheets and displays, crafting classes and online videos, we can speak with customers through diverse platforms and inspire creativity and confidence in our customers artistic abilities. We believe we can leverage our brand equity to grow new stores, expand our online product offerings, and explore new markets.

Michaels Stores, Inc. was incorporated in Delaware in 1983, and as of April 11, 2014, we operate 1,142 Michaels retail stores in 49 states, as well as in Canada, with approximately 18,000 average square feet of selling space per store. We also operate 118 Aaron Brothers stores in nine states, with approximately 5,600 average square feet of selling space per store, offering photo frames, a full line of ready-made frames, custom framing services and a wide selection of art supplies.

On October 31, 2006, substantially all of the common stock of Michaels Stores, Inc. was acquired through a merger transaction (the Merger) by affiliates of two investment firms: Bain Capital Partners, LLC and The Blackstone Group, L.P. (collectively, together with their applicable affiliates, the Sponsors), with certain shares retained by affiliates of Highfields Capital Partners (a then-existing shareholder of Michaels Stores, Inc.).

In July 2013, the Company s corporate structure was reorganized into a holding company structure (the Reorganization). The Michaels Companies, Inc. (Parent), Michaels FinCo Holdings, LLC (FinCo Holdings), Michaels FinCo, Inc. (FinCo Inc.) and Michaels Funding, Inc. (Holdings) and Michaels Stores MergerCo, Inc. (MergerCo) were formed in connection with the Reorganization and (i) MergerCo was merged with and into MSI with MSI being the surviving corporation; (ii) each share of MSI common stock was converted into the right to receive one share of common stock of the Parent, subject to the same vesting conditions, if any, as applied to the share so converted, and each such share of MSI common stock was cancelled and retired and ceased to exist; and (iii) each option to purchase one or more shares of common stock of MSI was assumed by the Parent and converted into an option to purchase an equivalent number of shares of common stock of the Parent with the remaining terms of each such option remaining unchanged, except as was necessary to reflect the Reorganization. Approximately 118 million shares of MSI common stock were converted into an equivalent number of shares of common stock of the Parent. The MSI shares were then cancelled and retired and an amount equal to the par value of the original shares was transferred from the common stock account to paid-in capital. MSI then issued 100 shares of stock with a $0.10 par value to Holdings. As a result of the Reorganization, FinCo Holdings is wholly owned by the Parent, FinCo Inc. and Holdings are wholly owned by FinCo Holdings, and MSI is wholly owned by Holdings. As a result of the Merger and the Reorganization, Michaels Holdings LLC., an entity controlled by the Sponsors, currently owns approximately 93% of the outstanding common stock of Parent, which is not publicly traded.

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

Merchandising

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

	Fiscal Year		
	2013	2012	2011
General crafts	53%	51%	52%
Home décor and seasonal	20	21	20
Framing	17	17	17
Scrapbooking	10	11	11
	100%	100%	100%

We have a product design team focused on quality, innovation and cost mitigation. Our infrastructure and internal product development and global sourcing team position us to continue delivering a differentiated level of innovation, quality and value to our customers. Our global sourcing network allows us to control new product introductions, maintain quality standards, monitor delivery times, and manage product costs and inventory levels in order to enhance profitability.

We continue to search for ways to leverage our position as a market leader by establishing strategic partnerships and exclusive product relationships to provide our customers with exciting merchandise. During fiscal 2013, we partnered with popular celebrities and brands such as Cake Boss, Craftsy, Disney, Crayola, Martha Stewart Crafts and Rainbow Loom. For fiscal 2014, we will explore opportunities to form future partnerships and exclusive product associations.

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

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

Seasonality

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

Purchasing and Inventory Management

We purchase merchandise from approximately 600 vendors through our wholly-owned subsidiary, Michaels Stores Procurement Company. We believe our buying power and ability to make centralized purchases enable us to acquire products on favorable terms. Centralized merchandising management teams negotiate with vendors in an attempt to obtain the lowest net merchandise costs and to improve product mix and inventory levels. In fiscal 2013, one sourcing agent supplied approximately 13% of our purchases, with no other vendor or sourcing agent 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 and mats from our framing operation, Artistree, which consists of a manufacturing facility and four regional processing centers to support our retail stores. These intercompany transactions are eliminated in consolidation.

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

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

Artistree

We currently operate a vertically integrated framing operation, leveraging Artistree, our wholly-owned manufacturing subsidiary, across our Michaels and Aaron Brothers store networks. Artistree supplies precut mats and high quality custom framing merchandise. We believe Artistree provides a competitive advantage to our Michaels and Aaron Brothers stores and gives us quality control over the entire process.

Our moulding manufacturing plant, located in Kernersville, North Carolina, converts lumber into finished frame moulding and supplies the finished frame moulding to our regional processing centers for custom framing orders for our stores. We manufacture approximately 35% of the moulding we process, import approximately 40% 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 2013, we operated four regional processing centers in City of Industry, California; Coppell, Texas; Kernersville, North Carolina; and Mississauga, Ontario. Our precut mats and custom frame supplies are packaged and distributed out of our Coppell regional processing center. Combined, these facilities occupy approximately 538,000 square feet and, in fiscal 2013, processed approximately 30 million linear feet of frame moulding and approximately 5 million individually custom cut mats for our Michaels and Aaron Brothers stores.

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

Distribution

We currently operate a distribution network through our wholly-owned subsidiary, Michaels Stores Procurement Company, to supply our stores with merchandise. Approximately 90% of Michaels stores merchandise receipts are shipped through the distribution network with the remainder shipped directly from vendors to stores. Approximately 55% of Aaron Brothers stores merchandise is shipped through the distribution network with the remainder shipped directly from vendors. Our seven distribution centers are located in California, Florida, Illinois, Pennsylvania, Texas and Washington. We utilize a third-party warehouse, in addition to four of our distribution centers, to store and supply our seasonal merchandise in preparation for the holiday season.

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

Store Expansion and Relocation

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

	Fiscal Year				
	2013	2012	2011	2010	2009
Michaels stores:					
Retail stores open at beginning of year	1,099	1,064	1,045	1,023	1,009
Retail stores opened during the year	40	38	25	23	18
Retail stores opened relocations during the year	14	13	15	10	5
Retail stores closed during the year	(3)	(3)	(6)	(1)	(4)
Retail stores closed relocations during the year	(14)	(13)	(15)	(10)	(5)
Retail stores open at end of year	1,136	1,099	1,064	1,045	1,023
Aaron Brothers stores:					
Retail stores open at beginning of year	125	134	137	152	161
Retail stores opened during the year					
Retail stores opened relocations during the year	2				
Retail stores closed during the year	(5)	(8)	(3)	(15)	(9)
Retail stores closed relocations during the year	(1)	(1)			
Retail stores open at end of year	121	125	134	137	152
Total store count at end of year	1,257	1,224	1,198	1,182	1,175

We believe, based on an internal real estate and market penetration study of Michaels stores, that the combined U.S. and Canadian markets can support approximately 1,500 Michaels stores. We plan to open 40 to 45 Michaels stores in fiscal 2014. Included in these openings are relocations of 10 to 15 Michaels stores. We continue to pursue a store relocation program to improve the real estate location quality and performance of our store base. During fiscal 2014, we anticipate opening up to 5 Aaron Brothers stores. During 2014, we also plan to close up to 5 Michaels stores and up to 10 Aaron Brothers stores. Many of our store closings are stores that have reached the end of their lease term. We believe our ongoing store evaluation process results in strong performance across our store base.

We have developed a standardized procedure to allow for the efficient opening of new stores and their integration into our information and distribution systems. We develop the floor plan and merchandise layout and organize the advertising and promotions in connection with the opening of each new store. In addition, we maintain qualified store opening teams to provide new store associates with store training.

Our new store operating model, which is based on historical store performance, assumes a target store size of approximately 18,000 selling square feet. Our fiscal 2013 average initial net investment, which varies by site and specific store characteristics, is approximately $1.2 million per store and consists of store build-out costs (net of tenant improvement allowances), pre-opening expenses and average first year inventory (net of payables).

Competition

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

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

- *Multi-store chains.* This category includes several multi-store chains, each operating more than 100 stores, and comprises: Hobby Lobby Stores, Inc., which operates approximately 620 stores in 47 states; Jo-Ann Stores, Inc., which operates approximately 790 stores in 49 states; and A.C. Moore Arts & Crafts, Inc., which operates approximately 140 stores primarily in the Eastern United States.We believe all of these chains are significantly smaller than Michaels with respect to Net sales.

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

• *Internet.* This category includes all internet-based retailers that sell arts and crafts merchandise, completed projects and custom framing online. Our Internet competition is inclusive of those companies discussed in the categories above, as well as others that may only sell products online. These retailers provide consumers with the ability to more easily search and compare products and prices compared to visiting a physical store. These sellers generally offer a wide variety of products but do not offer product expertise or project advice.

Foreign Sales

All of our current international business is in Canada, which accounted for approximately 10% of total sales in both fiscal 2013 and fiscal 2012 and 9% of total sales in fiscal 2011. During the last three years, less than 8% of our assets have been located outside of the U.S. See Note 13 to the Consolidated Financial Statements for Net sales and assets by country.

Trademarks and Service Marks

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

Employees

As of April 11, 2014, we employed approximately 50,600 associates, approximately 39,300 of whom were employed on a part-time basis. The number of part-time associates substantially increases during the Christmas selling season. Of our full-time associates, approximately 3,200 are engaged in various executive, operating, training, distribution and administrative functions in our support center, division offices and distribution centers and the remainder are engaged in store operations. None of our associates are subject to a collective bargaining agreement.

ITEM 1A. Risk Factors.

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

We face risks related to the effect of economic uncertainty.

In the event of a prolonged economic downturn or slow recovery, our growth, prospects, results of operations, cash flows and financial condition could be adversely impacted. Our stores offer arts and crafts supplies and products for the crafter, and custom framing for the do-it-yourself home decorator, which some customers may perceive as discretionary. Pressure on discretionary income brought on by economic downturns and slow recoveries, including housing market declines, rising energy prices and weak labor markets, may cause consumers to reduce the amount they spend on discretionary items. For example, as a result of the recession during fiscal 2007 and fiscal 2008, despite adding a number of new stores, our total Net sales decreased from $3,862 million to $3,817 million. The current economic environment may continue to adversely affect consumer confidence and retail spending, decreasing demand for our merchandise. Current economic conditions also make it difficult for us to accurately forecast future demand trends, which could cause us to purchase excess inventories, resulting in increases in our inventory carrying cost, or limit our ability to satisfy customer demand and potentially lose market share.

We face risks related to our substantial indebtedness.

Our substantial leverage could adversely affect our ability to raise additional capital to fund our operations, limit our ability to react to changes in the economy or our industry, expose us to interest rate risk associated with our variable rate debt and prevent us from meeting our obligations under our notes and credit facilities. As of February 1, 2014, we had total outstanding debt of $2,894 million, of which approximately $1,628 million was subject to variable interest rates and $1,266 million was subject to fixed interest rates, and approximately $589 million of additional borrowing capacity (after giving effect to $61 million of letters of credit then outstanding) under our restated term loan (Restated Revolving Credit Facility).

In July 2013, our indirect parent company, FinCo Holdings and its subsidiary, FinCo Inc. issued $800 million aggregate principal amount of their 7.50% / 8.25% PIK Toggle Notes due 2018 (PIK Notes). Any interest paid in cash on these notes will be funded by us through a dividend payment to our parent, Holdings. These payments could reduce our available cash. The cash interest payment due February 1, 2014 was approximately $30 million and was funded by us through a dividend declared on January 22, 2014. The cash interest payment due August 1, 2014 is approximately $30 million. If interest on the PIK Notes for all interest periods is paid in cash, annual interest payments will total $60 million or a total of approximately $300 million from July 29, 2013 until August 1, 2018, the maturity date.

Our substantial indebtedness could have important consequences to us, including:

• making it more difficult for us to satisfy our obligations with respect to our debt, and any failure to comply with the obligations under our debt instruments, including restrictive covenants, could result in an event of default under the agreements governing our indebtedness

- increasing our vulnerability to general economic and industry conditions

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

- exposing us to the risk of increased interest rates as certain of our borrowings, including under our Senior Secured Credit Facilities, which consist of the Restated Revolving Credit Facility and the restated senior secured term loan facility (the Restated Term Loan Credit Facility), are at variable rates

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

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

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

The occurrence of any one of these events could have an adverse effect on our business, financial condition, results of operations and ability to satisfy our obligations under our indebtedness.

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

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

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

Our recent results of operations have been significantly enhanced by sales of one product, the Rainbow Loom. Sales of the Rainbow Loom and replacement rubber bands were the primary driver of the increase in our Net sales in the fiscal year ended February 1, 2014 compared to the prior fiscal year. Based on our retail experience, we expect that the popularity of this product will diminish over time, and our results of operations could be affected by our inability to anticipate demand for this product and stock the appropriate level of inventory. Similarly, if we identify products in the future that have a significant effect on our results of operations, we could face similar challenges and risks that could affect our profitability.

We have recently experienced a data breach and such data breach and any future failure to adequately maintain security and prevent unauthorized access to electronic and other confidential information could result in an additional data breach which could materially adversely affect our reputation, financial condition and operating results.

The protection of our customer, associate and Company data is critically important to us. Our customers and associates have a high expectation that we will adequately safeguard and protect their sensitive personal information. We have become increasingly centralized and dependent upon automated information technology processes. In addition, a portion of our business operations is conducted electronically, increasing the risk of attack or interception that could cause loss or misuse of data, system failures or disruption of operations. This risk will increase with the launch of our ecommerce platform. Improper activities by third parties, exploitation of encryption technology, new data-hacking tools and discoveries and other events or developments may result in a future compromise or breach of our networks, payment card terminals or other payment systems. In particular, the techniques used by criminals to obtain unauthorized access to sensitive data change frequently and often are not recognized until launched against a target; accordingly, we may be unable to anticipate these techniques or implement adequate preventative measures. Any failure to maintain the security of our customers sensitive information, or data belonging to ourselves or our suppliers, could put us at a competitive disadvantage, result in deterioration of our customers confidence in us, and subject us to potential litigation, liability, fines and penalties, resulting in a possible material adverse impact on our financial condition and results of operations. While we maintain insurance coverage that may, subject to policy terms and conditions, cover certain aspects of cyber risks, such insurance coverage may be insufficient to cover all losses and would not remedy damage to our reputation.

In January 2014, we learned of possible fraudulent activity on some U.S. payment cards that had been used at Michaels, suggesting we may have experienced a data security attack. The Company retained two independent, expert security firms to conduct an extensive investigation. The Company also has been working closely with law enforcement authorities and coordinating with banks and payment processors to determine the facts.

After extensive analysis, we discovered evidence confirming that systems of Michaels stores in the United States and its subsidiary, Aaron Brothers, were attacked by criminals using highly sophisticated malware that had not been encountered previously by either of the security firms (the Data Breach).

The Company believes it has now identified the malware and it no longer presents a threat while shopping at Michaels or Aaron Brothers. During the course of the investigation, we determined the following:

- The affected systems contained certain payment card information, such as payment card number and expiration date, about both Michaels and Aaron Brothers customers. There is no evidence that other customer personal information, such as name, address or PIN, was at risk in connection with this issue.

- Regarding Michaels stores, the attack potentially targeted a limited portion of the point-of-sale systems at a varying number of stores between May 8, 2013 and January 27, 2014. Only a small percentage of payment cards used in the affected stores during the times of exposure were impacted by this issue. The analysis conducted by the security firms and the Company shows that approximately 2.6 million cards may have been impacted, which represents about 7% of payment cards used at Michaels stores in the U.S. during the relevant time period.

- Regarding Aaron Brothers, we have confirmed that between June 26, 2013 and February 27, 2014, 54 Aaron Brothers stores were affected by this malware. We estimate that approximately 400,000 cards were potentially impacted during this period.

- We have received a limited number of reports from the payment card brands and banks of fraudulent use of payment cards potentially connected to Michaels or Aaron Brothers.

We are offering identity protection, credit monitoring and fraud assistance services to affected Michaels and Aaron Brothers customers in the U.S. for 12 months at no cost to them. In addition, the Data Breach has given rise to putative class action litigation on behalf of customers and regulatory investigations, as further described under *Legal Proceedings*.

There can be no assurance that we will not suffer a similar criminal attack in the future, that unauthorized parties will not gain access to personal information, or that any such incident will be discovered in a timely way. Regardless of the conclusion of the investigation, the publicity resulting from the Data Breach could adversely affect the Michaels and Aaron Brothers brands, has caused us to incur legal and other fees and could cause us to incur additional material fees, and could discourage customers from shopping in our stores.

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

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

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

We rely to a significant extent on foreign manufacturers for our merchandise, particularly manufacturers located in China. In addition, many of our domestic suppliers purchase a portion of their products from foreign sources. This reliance increases the risk that we will not have adequate and timely supplies of various products due to local political, economic, social, or environmental conditions (including acts of terrorism, the outbreak of war, or the occurrence of natural disaster), transportation delays (including dock strikes and other work stoppages), restrictive actions by foreign governments, or changes in U.S. laws and regulations affecting imports or domestic distribution. Reliance on foreign manufacturers also increases our exposure to trade infringement claims and reduces our ability to return product for various reasons.

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

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

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

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

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

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

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

- the recent launch of our e-commerce platform may be unsuccessful

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

- failure to maintain stable relations with our labor force may impact our store operations and sales

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

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

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

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

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

We believe the Michaels brand name and many of our private and exclusive brand names are powerful sales and marketing tools and we devote significant resources to promoting and protecting them. To be successful in the future, we must continue to preserve, grow and utilize the value of Michaels reputation. Reputational value is based in large part on perceptions of subjective qualities, and even isolated incidents may erode trust and confidence. In addition, we develop and promote private and exclusive brands, which we believe have generated national recognition. Our private brands amounted to approximately 48% of total Net sales in fiscal 2013, and represent a growing portion of our overall sales. Damage to the reputations (whether or not justified) of our brand names could arise from product failures, data privacy or security incidents, litigation or various forms of adverse publicity (including adverse publicity generated as a result of a vendor s or a supplier s failure to comply with general social accountability practices), especially in social media outlets, and may generate negative customer sentiment, potentially resulting in a reduction in our sales and earnings.

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

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

Suppliers from whom our products are sourced may fail us and transitioning to other qualified vendors could materially adversely affect our revenue and gross profit.

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

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

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

Unexpected or unfavorable consumer responses to our promotional or merchandising programs could materially adversely affect our sales, results of operations, cash flow and financial condition.

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

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

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.

We collect, maintain and use data provided to us through our online activities and other customer interactions in our business. Our current and future marketing programs depend on our ability to collect, maintain and use this information, and our ability to do so is subject to certain contractual restrictions in third party contracts as well as evolving international, federal and state laws and enforcement trends. We strive to comply with all applicable laws and other legal obligations relating to privacy, data protection and consumer protection, including those relating to the use of data for marketing purposes. It is possible, however, that these requirements may be interpreted and applied in a manner that is inconsistent from one jurisdiction to another, may conflict with other rules or may conflict with our practices. If so, we may suffer damage to our reputation and be subject to proceedings or actions against us by governmental entities or others. Any such proceeding or action could hurt our reputation, force us to spend significant amounts to defend our practices, distract our management, increase our costs of doing business, and result in monetary liability.

In addition, as data privacy and marketing laws change, we may incur additional costs to ensure we remain in compliance. If applicable data privacy and marketing laws become more restrictive at the federal or state level, our compliance costs may increase, our ability to effectively engage customers via personalized marketing may decrease, our investment in our e-commerce platform may not be fully realized, our opportunities for growth may be curtailed by our compliance capabilities or reputational harm and our potential liability for security breaches may increase.

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

We are subject to regulations by a variety of federal, state and international regulatory authorities, including the Consumer Product Safety Commission. In fiscal 2013, we purchased merchandise from approximately 600 vendors. Since a majority of our merchandise is manufactured in foreign countries, one or more of our vendors might not adhere to product safety requirements or our quality control standards, and we might not identify the deficiency before merchandise ships to our stores. Any issues of product safety, including but not limited to those manufactured in foreign countries, could cause us to recall some of those products. If our vendors fail to manufacture or import merchandise that adheres to our quality control standards, our reputation and brands could be damaged, potentially leading to increases in customer litigation against us. Furthermore, to the extent we are unable to replace any recalled products, we may have to reduce our merchandise offerings, resulting in a decrease in sales, especially if a recall occurs near or during a seasonal period. If our vendors are unable or unwilling to recall products failing to meet our quality standards, we may be required to recall those products at a substantial cost to us. Moreover, changes in product safety or other consumer protection laws could lead to increased costs to us for certain merchandise, or additional labor costs associated with readying merchandise for sale. Long lead times on merchandise ordering cycles increase the difficulty for us to plan and prepare for potential changes to applicable laws. The Consumer Product Safety Improvement Act of 2008 imposes significant requirements on manufacturing, importing, testing and labeling requirements for our products. In the event that we are unable to timely comply with regulatory changes or regulators do not believe we are complying with current regulations applicable to us, significant fines or penalties could result, and could adversely affect our reputation, results of operations, cash flow and financial condition.

Significant increases in inflation or commodity prices such as petroleum, natural gas, electricity, steel, wood and paper may adversely affect our costs, including cost of merchandise.

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

Improvements to our supply chain may not be fully successful.

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

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.

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

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

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

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

We are subject to federal, state, provincial and local regulations with respect to our operations in the U.S. and Canada. There are a number of legislative and regulatory initiatives that could adversely impact our business if they are enacted or enforced. Those initiatives include wage or workforce issues (such as minimum-wage requirements, overtime and other working conditions and citizenship requirements), collective bargaining matters, environmental regulation, price and promotion regulation, trade regulations and others.

We expect that the Patient Protection and Affordable Care Act, which was signed into law on March 23, 2010, will increase our annual associate health care costs. Proposed changes in tax regulations may also change our effective tax rate as our business is subject to a combination of applicable tax rates in the various countries, states and other jurisdictions in which we operate. New accounting pronouncements and interpretations of existing accounting rules and practices have occurred and may occur in the future. A change in accounting standards or practices can have a significant effect on our reported results of operations. Failure to comply with legal requirements could result in, among other things, increased litigation risk that could affect us adversely by subjecting us to significant monetary damages and other remedies or by increasing our litigation expenses, administrative enforcement actions, fines and civil and criminal liability. For example, in fiscal 2012, we settled a pricing and promotion investigation by the New York State Attorney General s office through the payment of a fine and other consideration pursuant to an Assurance of Discontinuance, and could be subject to similar investigations, as well as lawsuits, in the future. We are currently subject to class action lawsuits alleging violations of wage and workforce laws and to a purported class action lawsuit alleging violations of Ohio state law in relation to our advertising and pricing practices (see Item 3. Legal Proceedings). If such issues become more expensive to address, or if new issues arise, they could increase our expenses, generate negative publicity, or otherwise adversely affect us.

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

Our Senior Secured Credit Facilities and the indentures governing our notes contain various covenants that limit our ability to engage in specified types of transactions. The PIK Notes are senior unsecured obligations of FinCo Holdings and FinCo Inc. The PIK Notes are not guaranteed by us, Holdings or any of our subsidiaries, but the indenture governing the PIK Notes contains restrictive covenants that apply to FinCo Holdings and its restricted subsidiaries, including us, Holdings and our subsidiaries, and a breach of such covenants would cause FinCo Holdings and FinCo Inc. to be in default under the indenture governing the PIK Notes. These covenants limit the ability of the relevant borrowers, issuers, guarantors and their restricted subsidiaries (including us and our subsidiaries) to, among other things:

- incur or guarantee additional debt

- pay dividends or distributions on our capital stock or redeem, repurchase or retire our capital stock or indebtedness
- issue stock of subsidiaries
- make certain investments, loans, advances and acquisitions
- create liens on our assets to secure debt
- enter into transactions with affiliates
- merge or consolidate with another company
- sell or otherwise transfer assets

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

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

Any disruption in the capital markets could make it difficult for us to raise additional capital when needed, or to eventually refinance our existing indebtedness on acceptable terms or at all. Similarly, if our suppliers face challenges in obtaining credit when needed, or otherwise face difficult business conditions, they may become unable to offer us the merchandise we use in our business thereby causing reductions in our revenues, or they may demand more favorable payment terms, all of which could adversely affect our results of operations, cash flows and financial condition.

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

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

We have co-sourced certain of our information technology, accounts payable, payroll, accounting and human resources functions and may co-source other administrative functions, which makes us more dependent upon third parties.

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

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

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

We are dependent upon the services of our senior management team.

We are dependent on the services, abilities and experience of our executive officers, including Carl S. Rubin, our Chief Executive Officer, and Charles M. Sonsteby, our Chief Administrative Officer and Chief Financial Officer. The permanent loss of the services of any of these senior executives and any change in the composition of our senior management team could have a negative impact on our ability to execute on our business and operating strategies.

Failure to attract and retain quality sales, distribution center and other associates in appropriate numbers as well as experienced buying and management personnel could adversely affect our performance.

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

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

Unforeseen public health issues, such as pandemics and epidemics, and geo-political events, such as civil unrest in a country in which our suppliers are located or terrorist or military activities disrupting transportation, communication or utility systems, as well as natural disasters such as hurricanes, tornadoes, floods, earthquakes and other adverse weather and climate conditions, whether occurring in the U.S. or abroad, particularly during peak seasonal periods, could disrupt our operations or the operations of one or more of our vendors or could severely damage or destroy one or more of our stores or distribution facilities located in the affected areas. For example, day to day operations, particularly our ability to receive products from our vendors or transport products to our stores could be adversely affected, or we could be required to close stores or distribution centers in the affected areas or in areas served by the affected distribution center. These factors could also cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and global financial markets and economy. Such occurrences could significantly impact our operating results and financial performance. For example, during the fourth quarter of fiscal 2012, our Net sales were adversely affected by Hurricane Sandy.

We are controlled by our indirect parent, FinCo Holdings, and the Sponsors, whose interests as equity holders may conflict with those of our debt investors and those of our Company.

We are controlled by our indirect parent, FinCo Holdings, which is indirectly controlled by our Sponsors, who currently own approximately 93% of the common stock of Parent, our ultimate parent company, in the aggregate. FinCo Holdings and the Sponsors control the election of our directors and thereby have the power to control our affairs and policies, including the appointment of management, the issuance of additional equity and the declaration and payment of dividends if allowed under the terms of the credit agreements governing our Senior Secured Credit Facilities, the terms of the indentures governing our 7¾% Senior Notes due November 1, 2018 and our 57/8% Senior Subordinated Notes due December 15, 2020 , together, our Outstanding Notes and the terms of our other indebtedness outstanding at the time. Neither FinCo Holdings nor the Sponsors have any liability for any obligations under or relating to our Senior Secured Credit Facilities, our Outstanding Notes or our other indebtedness, and their respective interests may be in conflict with those of our debt investors. For example, if we encounter financial difficulties or are unable to pay our debts as they mature, the Sponsors may pursue strategies that favor equity investors over debt investors. In addition, our equity holders may have an interest in pursuing acquisitions, divestitures, financing or other transactions that, in their judgment, could enhance their equity investments, even though such transactions may involve risk to our debt investors. In addition, FinCo Holdings, as our indirect parent, may cause us to make equity distributions to fund interest payments on the PIK Notes, which could leave us with insufficient capital to meet our debt obligations. Additionally, the Sponsors may make investments in businesses that directly or indirectly compete with us, or may pursue acquisition opportunities that may be complementary to our business and, as a result, those acquisition opportunities may not be available to us. For information concerning our arrangements with the Sponsors, see Item 10. Directors, Executive Officers and Corporate Governance. and Item 13. Certain Relationships and Related Transactions, and Director Independence.

ITEM 1B. Unresolved Staff Comments.

Not applicable.

ITEM 2. Properties.

We lease substantially all of the sites for our Michaels and Aaron Brothers stores, with the majority of our stores having initial lease terms of approximately 10 years. The leases are generally renewable, with increases in lease rental rates. Lessors have made leasehold improvements to prepare our stores for opening under a majority of our existing leases. As of February 1, 2014, in connection with stores that we plan to open or relocate in future fiscal years, we had signed approximately 45 leases for Michaels stores.

As of April 11, 2014, we lease the following non-store facilities:

Locations	Square Footage
Distribution centers:	
Hazleton, Pennsylvania	692,000
Jacksonville, Florida	506,000
Lancaster, California	763,000
Centralia, Washington	718,000
New Lenox, Illinois	693,000
Tarrant County, Texas	433,000
City of Commerce, California (Aaron Brothers)	174,000
	3,979,000
Artistree:	
Coppell, Texas (regional processing and fulfillment operations center)	230,000
Kernersville, North Carolina (manufacturing plant and regional processing center)	156,000
City of Industry, California (regional processing center)	90,000
Mississauga, Ontario (regional processing center)	62,000
	538,000
Office space:	
Irving, Texas (corporate support center)	296,000
Coppell, Texas (corporate support satellite office)	67,000
Mississauga, Ontario (Canadian regional office)	3,000
	366,000
Coppell, Texas (new store staging warehouse)	82,000
	4,965,000

The following table indicates the number of our retail stores located in each state or province as of April 11, 2014:

	Number of Stores		
State/Province	**Michaels**	**Aaron Brothers**	**Total**
Alabama	12		12
Alaska	3		3
Alberta	17		17
Arizona	27	5	32
Arkansas	4		4
British Columbia	17		17
California	131	79	210
Colorado	22	3	25
Connecticut	16		16
Delaware	4		4
Florida	79		79
Georgia	34	1	35
Idaho	6	1	7
Illinois	38		38
Indiana	17		17
Iowa	7		7
Kansas	8		8
Kentucky	11		11
Louisiana	13		13
Maine	3		3
Manitoba	3		3
Maryland	24		24
Massachusetts	30		30
Michigan	35		35
Minnesota	23		23
Mississippi	6		6
Missouri	21		21
Montana	4		4
Nebraska	4		4
Nevada	10	5	15
New Brunswick	3		3
New Hampshire	8		8
New Jersey	30		30
New Mexico	3		3
New York	54		54
Newfoundland and Labrador	1		1
North Carolina	35		35
North Dakota	2		2
Nova Scotia	4		4
Ohio	31		31
Oklahoma	7		7
Ontario	50		50
Oregon	15	2	17
Pennsylvania	48		48
Prince Edward Island	1		1
Quebec	11		11
Rhode Island	4		4
Saskatchewan	3		3
South Carolina	12		12
South Dakota	2		2

Tennessee	15		15
Texas	78	14	92
Utah	13		13
Vermont	2		2
Virginia	35		35
Washington	23	8	31
West Virginia	5		5
Wisconsin	17		17
Wyoming	1		1
Total	1,142	118	1,260

ITEM 3. Legal Proceedings.

Employee claims

Rea claim

On September 15, 2011, the Company was served with a lawsuit filed in the California Superior Court in and for the County of Orange (Superior Court) by four former store managers as a class action proceeding on behalf of themselves and certain former and current store managers employed by Michaels in California. The lawsuit alleges that the Company stores improperly classified its store managers as exempt employees and as such failed to pay all wages, overtime, waiting time penalties and failed to provide accurate wage statements. The lawsuit also alleges that the foregoing conduct was in breach of various laws, including California s unfair competition law. On December 3, 2013, the Superior Court entered an Order certifying a class of approximately 200 members. The Company subsequently succcesfully removed the case to the United States District Court for the Central District of California and is challenging the class certification order. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of the lawsuit will have a material effect on our Consolidated Financial Statements.

Consumer class action claims

Data security incident

Five putative class actions were filed relating to our recent Data Breach. The plaintiffs generally allege that the Company failed to secure and safeguard customers private information including credit and debit card information and as such, breached an implied contract, violated the Illinois Consumer Fraud Act (and other states similar laws) and are seeking damages including declaratory relief, actual damages, punitive damages, statutory damages, attorneys fees, litigation costs, remedial action, pre and post judgment interest, other relief as available. The cases, are as follows: Christina Moyer v. Michaels Stores, Inc., was filed on January 27, 2014; Michael and Jessica Gouwens v. Michaels Stores, Inc., was filed on January 29, 2014; Nancy Maize and Jessica Gordon v. Michaels Stores, Inc., was filed on February 21, 2014; and Daniel Ripes v. Michaels Stores, Inc., was filed on March 14, 2014. All four of these cases were filed in the United States District Court-Northern District of Illinois, Eastern Division. A case, Mary Jane Whalen v. Michaels Stores, Inc., was filed in the United States District Court for the Eastern District of New York on March 18, 2014, but was voluntarily dismissed by the plaintiff on April 11, 2014, without prejudice to her right to re-file a complaint. On April 16, 2014, an order was entered consolidating the current actions. We believe we have meritorious defenses and intend to defend the lawsuits vigorously.

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

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

California zip code claims

On August 15, 2008, Linda Carson, a consumer, filed a purported class action proceeding against the Company in the Superior Court of California, County of San Diego (San Diego Superior Court), on behalf of herself and all similarly-situated California consumers. The Carson lawsuit alleges that the Company unlawfully requested and recorded personally identifiable information (i.e., her zip code) as part of a credit card transaction. The plaintiff seeks statutory penalties, costs, interest, and attorneys fees. On February 10, 2011, the California Supreme Court ruled, in a similar matter, Williams-Sonoma v. Pineda case, that zip codes are personally identifiable information and therefore the Song-Beverly Credit Card Act of 1971, as amended (Song Act), prohibits businesses from requesting or requiring zip codes in connection with a credit card transaction.

Subsequent to the California Supreme Court decision, three additional purported class action lawsuits, seeking similar relief, have been filed against the Company: Carolyn Austin v. Michaels Stores, Inc. and Tiffany Heon v. Michaels Stores, Inc., both in the San Diego Superior Court and Sandra A. Rubinstein v. Michaels Stores, Inc. in the Superior Court of California, County of Los Angeles, Central Division. An order coordinating the cases has been entered and plaintiffs filed a Consolidated Complaint on April 24, 2012. The parties settled the lawsuit for an amount that will not have a material effect on our Consolidated Financial Statements. On February 14, 2014, the Court granted preliminary approval of the settlement agreement and a final Fairness Hearing is set for July 11, 2014.

Massachusetts zip code claims

Relying in part on the California Supreme Court decision, a purported class action lawsuit was filed on May 20, 2011 against the Company, Melissa Tyler v. Michaels Stores, Inc. in the U.S. District Court-District of Massachusetts, alleging violation of a Massachusetts statute regarding the collection of personally identification information in connection with a credit card transaction. An additional purported class action lawsuit asserting the same allegations was filed in the U.S. District Court-District of Massachusetts by Susan D Esposito, and the two cases were consolidated. On August 12, 2013, a settlement was reached for an amount that will not have a material effect on our Consolidated Financial Statements. On February 12, 2014, the Court granted preliminary approval of the settlement and a final Fairness Hearing is set for May 20, 2014.

Pricing and promotion

On April 30, 2012, William J. Henry, a consumer, filed a purported class action proceeding against the Company in the Court of Common Pleas, Lake County, Ohio, on behalf of himself and all similarly-situated Ohio consumers who purchased framing products and/or services from Michaels during weeks where Michaels was advertising a discount for framing products and/or services. The lawsuit alleges that Michaels advertised discounts on its framing products and/or services without actually providing a discount to its customers. The plaintiff is claiming violation of Ohio law ORC 1345.01 et seq., unjust enrichment and fraud. The plaintiff has alleged damages, penalties and fees not to exceed $5 million, exclusive of interest and costs. We believe we have meritorious defenses and intend to defend the lawsuit vigorously. We do not believe the resolution of this lawsuit will have a material effect on our Consolidated Financial Statements.

General

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

For some of the matters disclosed above, the Company is currently able to estimate a reasonably possible loss or range of loss in excess of amounts accrued (if any). For some of the matters included within this estimation, an accrual has been made because a loss is believed to be both probable and reasonably estimable, but an exposure to loss exists in excess of the amount accrued; in these cases, the estimate reflects the reasonably possible range of loss in excess of the accrued amount. For other matters included within this estimation, no accrual has been made because a loss, although estimable, is believed to be reasonably possible, but not probable; in these cases the estimate reflects the reasonably possible loss or range of loss within the ranges identified. For the various ranges identified, the aggregate of these estimated amounts is approximately $9 million as of February 1, 2014, which is also inclusive of amounts accrued by the Company.

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

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

PART II

ITEM 4. Mine Safety Disclosures.

Not applicable.

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

Market Information

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

Holders

As of April 11, 2014, there was 1 holder of record of our common stock.

Dividends

On January 22, 2014, the Company declared a dividend of approximately $30 million to its parent company, Holdings, to fund the February 1, 2014 cash interest payment due on the PIK Notes. The Company anticipates paying additional dividends to its parent to fund the August 1, 2014 cash interest payment due on the outstanding amount of PIK Notes at that time. If interest on the PIK Notes for all interest periods is paid in cash, annual interest payments will total $60 million or a total of approximately $300 million from July 29, 2013, until August 1, 2018, the maturity date. Any future cash interest payments will also be funded by us through a cash dividend to Holdings.

ITEM 6. Selected Financial Data.

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

	Fiscal Year(1) 2013	2012	2011	2010	2009
	(In millions, except operating and store count data)				
Results of Operations Data:					
Net sales	$ 4,570	$ 4,408	$ 4,210	$ 4,031	$ 3,888
Operating income	611	592	538	488	397
Interest expense	183	245	254	276	257
Refinancing costs and losses on early extinguishments of debt(2)	14	33	18	53	
Net income	264	200	157	103	103
Comprehensive income	258	200	156	104	104
Balance Sheet Data:					
Cash and equivalents	$ 234	$ 56	$ 371	$ 319	$ 217
Merchandise inventories	901	862	845	826	873
Total current assets	1,273	1,044	1,339	1,271	1,199
Total assets	1,801	1,555	1,838	1,780	1,722
Total current liabilities	834	856	861	685	719
Current portion of long term debt	16	150	127	1	119
Long-term debt	2,878	2,891	3,363	3,667	3,684
Total liabilities	3,802	3,859	4,339	4,434	4,488
Stockholders deficit	(2,001)	(2,304)	(2,501)	(2,654)	(2,766)
Other Financial Data:					
Cash flows provided by operating activities	$ 468	$ 299	$ 409	$ 438	$ 405
Cash flows used in investing activities	(112)	(124)	(109)	(83)	(43)
Cash flows used in financing activities	(178)	(490)	(248)	(253)	(178)
Other Operating Data:					
Average net sales per selling square foot (3)	$ 218	$ 215	$ 212	$ 205	$ 201
Comparable store sales increase(4)	2.9%	1.5%	3.2%	2.5%	0.2%
Total selling square footage (in millions)	21.1	20.6	20.1	19.9	19.6
Stores Open at End of Year:					
Michaels	1,136	1,099	1,064	1,045	1,023
Aaron Brothers	121	125	134	137	152
Total stores open at end of year	1,257	1,224	1,198	1,182	1,175

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

(2) Fiscal 2013 refinancing costs and losses on early extinguishments of debt include $7 million of refinancing costs associated with our 5 7/8% Senior Subordinated Notes due December 15, 2020 (2020 Senior Subordinated Notes) and a $7 million loss related to the redemption of $137 million in aggregate principal amount of our 11 3/8% Senior Subordinated Notes due November 1, 2016 (2016 Senior Subordinated Notes). Fiscal 2012 refinancing costs and losses on early extinguishments of debt include $12 million of refinancing costs associated with our Restated Term Loan Credit Facility, an $8 million loss related to our amended and restated senior secured term loan facility and prepayment of

our B-1 Term Loans, an $11 million loss related to the redemption of our remaining outstanding 13% Subordinated Discount Notes due November 1, 2016 (Subordinated Discount Notes), and a $2 million loss related to our senior secured asset-based Revolving Credit Facility. Fiscal 2011 refinancing costs and losses on early extinguishments of debt include an $18 million loss related to the early extinguishment of $163 million face value, or $155 million accreted value, of our outstanding Subordinated Discount Notes and $7 million face value of our 2016 Senior Subordinated Notes. Fiscal 2010 refinancing costs and losses on early extinguishments of debt includes a $53 million loss related to the early extinguishment of our 2014 Senior Notes (as defined below).

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

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

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

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

We report on the basis of a 52- or 53-week fiscal year, which ends on the Saturday closest to January 31. References to fiscal year mean the year in which that fiscal year began. Fiscal 2013 ended on February 1, 2014, fiscal 2012 ended on February 2, 2013, and fiscal 2011 ended on January 28, 2012. Fiscal 2013 contained 52 weeks, while fiscal 2012 contained 53 weeks and fiscal 2011 contained 52 weeks.

Executive Overview

We believe Michaels is where creativity happens. With over $4.5 billion in sales in fiscal 2013, we are the largest arts and crafts specialty retailer in North America. Our primary business is the operation of 1,142 Michaels stores across the U.S. and Canada. We also operate 118 Aaron Brothers stores, offering ready-made frames, custom framing services and art supplies. All store counts are as of April 11, 2014.

Highlights for fiscal 2013 include the following:

- Net sales increased to $4,570 million, a 3.7% improvement over last year, which included a 53rd week and the opening of 56 new Michaels and Aaron Brothers stores, including the relocation of 14 Michaels and 2 Aaron Brothers stores.

- In the first half of fiscal 2013, Net sales increased by $26 million or 1.4% and in the second half of fiscal 2013, Net sales increased by $136 million, or 5.4% over the second half of fiscal 2012.

- Comparable store sales increased 2.9% for fiscal 2013. Comparable store sales for the first half of fiscal 2013 decreased 1.0% and for the second half, increased 5.9%.

- During the third quarter of fiscal 2013, we introduced, and are the exclusive big-box retailer of, the Rainbow Loom. In an effort to drive sales of the Rainbow Loom, we dedicated significant advertising and marketing efforts to this on-trend children s craft product. Sales of the Rainbow Loom and replacement rubber bands contributed 2.9% to our comparable stores sales increase for fiscal 2013.

- Our Michaels retail stores private brand merchandise drove 48% of Net sales in fiscal 2013 compared to 49% of Net sales in fiscal 2012.

- We reported record operating income of $611 million, an increase of 3.2% from the prior year.

- Net income increased by $64 million to $264 million. Adjusted EBITDA, a non-GAAP measure that is a required calculation in our debt agreements, improved by 6.2%, from $747 million in fiscal 2012 to $793 million in fiscal 2013 (see Non-GAAP Measures).

- We reduced our outstanding indebtedness by $147 million.

- We refinanced our remaining outstanding 11 3/8% 2016 Subordinated Notes totaling $256 million with $260 million of 5 7/8% Senior Subordinated Notes due December 15, 2020.

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

In fiscal 2014, we intend to continue to lead industry growth and innovation through strategic initiatives such as:

- making our stores more inviting to a broader set of customers, including those new to do-it-youself projects and more experienced crafters;

- enhancing our in-store shopping experience by creating a more visually appealing environment and making it easier for our customers to shop;

- becoming a true multi-channel retailer by launching an e-commerce platform to complement our existing web and mobile platforms;

- strengthening our connections with customers through an expanded marketing program including print, digital, direct mail, broadcast and community events;

- broadening our merchandising and sourcing capabilities to better identify and source new trends, merchandise and categories that enhance our portfolio of exclusive brands and products; and

- developing flexible store formats to facilitate expansion.

Critical Accounting Policies and Estimates

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

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

Vendor allowances, which primarily represent volume rebates and cooperative advertising funds, are recorded as a reduction of the cost of the merchandise inventories and a subsequent reduction in cost of sales when the inventory is sold. We generally earn vendor allowances as a percentage of certain merchandise purchases with no minimum purchase requirements. Typically, our vendor allowance programs extend for a period of 12 months. We recognized vendor allowances of $102 million, or 2.2% of Net sales in fiscal 2013, $110 million, or 2.5% of Net sales in fiscal 2012, and $115 million, or 2.7% of Net sales in fiscal 2011. During the three fiscal years ended February 1, 2014, the number of vendors from which vendor allowances were received ranged from approximately 620 to 660. As a result of our increased direct import volume, vendor allowances, as a percentage of Net sales, have been declining and we expect this trend to continue in future years.

We utilize perpetual inventory records to value inventory in our stores. Physical inventory counts are performed in a significant number of stores during each fiscal quarter by a third party inventory counting service. Substantially all stores open longer than one year are subject to at least one count each fiscal year. We adjust our perpetual records based on the results of the physical counts. We maintain a provision for estimated shrinkage based on the actual historical results of our physical inventories. We compare our estimates to the actual results of the physical inventory counts as they are taken and adjust the shrink estimates accordingly. A 10% change in our estimated shrinkage reserve would have affected Net income by approximately $1 million for fiscal 2013. We also evaluate our merchandise to ensure that the expected net realizable value of the merchandise held at the end of a fiscal period exceeds cost. In the event that the expected net realizable value is less than cost, we reduce the value of that inventory accordingly. A 10% change in our inventory valuation reserve would have affected Net income by approximately $1 million for fiscal 2013.

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

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

Factors used in the valuation of goodwill include, but are not limited to, management s plans for future operations, recent operating results and discounted projected future cash flows. Material assumptions used in our impairment analysis include the weighted average cost of capital percentage, terminal growth rate and forecasted long-term sales growth. During fiscal 2012, we recognized a goodwill impairment charge of $1 million for our online scrapbooking business. See Note 9 to our Consolidated Financial Statements for further information. During fiscal 2013 and fiscal 2011, there was no impairment charge taken on our goodwill.

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

Our evaluation requires consideration of a number of factors including changes in consumer demographics and uncertain future events. Accordingly, our accounting estimates may change from period to period. These factors could cause management to conclude impairment indicators exist and require that tests be performed, which could result in a determination that the value of long-lived assets is impaired, resulting in a writedown to fair value.

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

An impairment is recognized once all the factors noted above are taken into consideration and it is determined the carrying amount of the store s assets are not recoverable. The impairment is based on estimated fair value of the assets, excluding assets that can be redeployed. In fiscal 2013, we recorded an impairment charge, net of tax, of approximately $1 million. In fiscal 2012, we recorded an impairment charge, net of tax, of $4 million related to the write off of long-lived assets associated with our online scrapbooking business. We recorded an impairment charge, net of tax, of less than $1 million in fiscal 2011. In addition to recording impairment charges based on the previously discussed criteria, we maintain a list of stores we consider at risk and monitor those stores closely. As of February 1, 2014, we had one Michaels store which had been open longer than 36 months, which we considered at risk for impairment.

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

The cost of closing a store or facility is calculated as the lesser of the present value of future rental obligations remaining under the lease (less estimated sublease rental income) or the lease termination fee. The determination of the reserves is dependent on our ability to make reasonable estimates of costs to be incurred post-closure and of rental income to be received from subleases. In planning our store closures, we try to time our exits as close to the lease termination date as possible to minimize any remaining lease obligation. As of February 1, 2014 and February 2, 2013, our reserves for closed facilities were $5 million and $8 million, respectively. If our estimates only included rental income under actual subleases and not potential future subleases, the reserves would increase by approximately $4 million.

Self-Insurance We have insurance coverage for losses in excess of self-insurance limits for medical liability, general liability and workers compensation claims. Health care reserves are based on actual claims experience and an estimate of claims incurred but not reported. Reserves for general liability and workers compensation are determined through the use of actuarial studies. Due to the significant judgments and estimates utilized in determining these reserves, they are subject to a high degree of variability. In the event our insurance carriers are unable to pay claims submitted to them, we would record a liability for such estimated payments we expect to incur. A 10% change in our self-insurance liability would have affected Net income by approximately $4 million for fiscal 2013.

Revenue Recognition Revenue from sales of our merchandise is recognized when the customer takes possession of the merchandise. Revenue is presented net of sales taxes collected. Sales related to custom framing are deferred until the order is picked up by the customer, which we estimate based on historical customer behavior. We deferred 9 days of custom framing revenue at the end of fiscal 2013, 10 days at the end of fiscal 2012 and 13 days at the end of fiscal 2011. A one day change in our custom frame deferral would have had a minimal impact on our fiscal 2013 Net income. As of February 1, 2014 and February 2, 2013, our deferred framing revenue was approximately $9 million and $8 million, respectively.

We allow for merchandise to be returned under most circumstances within 60 days of purchase date and provide a reserve for estimated returns. We use historical customer return behavior to estimate our reserve requirements. As of February 1, 2014 and February 2, 2013, our sales returns reserve was approximately $3 million.

We record a gift card liability on the date we issue the gift card to the customer. We record revenue and reduce the gift card liability as the customer redeems the gift card. The deferred revenue associated with outstanding gift cards increased $3 million from $33 million at February 2, 2013 to $36 million as of February 1, 2014. We escheat the value of unredeemed gift cards where required by law. Any remaining liabilities not subject to escheatment are evaluated to determine whether the likelihood of the gift card being redeemed is remote (gift card breakage). We recognize gift card breakage as revenue, by applying our estimate of the rate of gift card breakage over the period of estimated performance. Our estimates of the gift card breakage rate are applied to the estimated amount of gift cards that are expected to go unused and that are not subject to escheatment, and such estimates are based on customers historical redemption rates and patterns. We recognized revenue of approximately $3 million in fiscal 2013, $3 million in fiscal 2012, and $1 million in fiscal 2011 related to such gift card balances. We do not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to recognize income related to unredeemed gift cards. However, if actual results are not consistent with our assumptions, we may record additional income or expense.

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

Costs of sales are included in merchandise inventories and expensed as the merchandise is sold. Included in our Costs of sales are the following:

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

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

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

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

Share-Based Compensation Expenses ASC 718, *Stock Compensation,* (ASC 718) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements. During the first two quarters of fiscal 2011 and the last quarter of fiscal 2013, the Company measured employee stock option expense for new awards using the grant date fair value accounting guidance of ASC 718. During the last two quarters of fiscal 2011, all of fiscal 2012, and the first three quarters of fiscal 2013, the Company determined its employee stock options should be recorded under the liability accounting guidance of ASC 718. As such, we measured share-based compensation based on either the grant date fair value of the equity awards, the fair value of our option awards at the end of the period, or at the fair value as most recently determined. Expense for unvested options and stock awards is recognized ratably over the requisite service period. We estimate the fair value of stock option awards using a Black-Scholes option value model.

All grants of our stock options have an exercise price equal to or greater than the fair market value of our common stock on the date of grant. Because we are privately held and there is no public market for our common stock, the fair value of our equity was estimated by our management, relying in part on an independent appraisal of our fair market value by a third party valuation firm, and approved by our Board at the time option grants are awarded. Since the second quarter of 2011, our management has performed contemporaneous quarterly valuations of our common stock on the last day of each quarterly period; option grants or equity grants occurring between valuations are valued at the last Board approved fair value of our common stock. In estimating the fair value of our common stock, management and the Board consider factors they believe are material to the valuation process including the Company s actual and projected financial results, the principal amount of the Company s indebtedness and formal valuation ranges of the Company, prepared by a third party valuation firm. In fiscal 2013, fiscal 2012 and fiscal 2011, valuations completed relied on projections of our future performance, estimates of our weighted average cost of capital, and metrics based on the performance of a peer group of similar companies, including valuation multiples and stock price volatility.

From February 2, 2013 to February 1, 2014, the estimated fair value of common stock decreased from $26.93 to $23.66 per share. A cash dividend paid to all equity holders in July 2013 decreased the fair value of the common stock by the amount of the cash dividend of $6.47 per share. The fair value decrease from the dividend was partially offset due to recent market trends for guideline company transactions.

The following table details information on stock options granted by quarter for fiscal year 2013. The exercise price and the fair value of common stock at grant in the table below have been reduced by the cash dividend of $6.47 per share, if applicable.

Quarter end date	# of options granted	Exercise Price	Fair Value of Common Stock at Grant	Average Fair Value of Option at February 1, 2014
May 4, 2013	1,346,947	$ 20.37	$ 20.37	$ 6.63
August 3, 2013	639,850	$ 20.51	$ 20.51	$ 7.05
November 2, 2013	77,900	$ 21.78	$ 21.78	$ 7.54
February 1, 2014	114,250	$ 22.96	$ 22.96	$ 5.65

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

As of February 1, 2014, compensation cost not yet recognized related to non-vested awards totaled $24 million and is expected to be recognized over a weighted average period of 2.9 years. In the event of a Change in Control (as defined in the Stockholders Agreement), all non-vested awards will vest and the $24 million would be immediately recognized.

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

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

Our evaluation regarding whether a valuation allowance is required or should be adjusted also considers, among other things, the nature, frequency, and severity of recent losses, forecasts of future profitability and the duration of statutory carryforward periods. Our forecast of future profitability represents our best estimate of these future events. After conducting this assessment, the valuation allowance recorded, net of federal benefit, against our deferred tax assets was $9 million and $10 million as of February 1, 2014 and February 2, 2013, respectively. If actual results differ from estimated results, or if we adjust these assumptions in the future, we may need to adjust our deferred tax assets or liabilities, which could impact our effective tax rate.

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

Results of Operations

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

	Fiscal Year		
	2013	**2012**	**2011**
Net sales	100.0%	100.0%	100.0%
Cost of sales and occupancy expense	60.1	60.0	60.1
Gross profit	39.9	40.0	39.9
Selling, general, and administrative expense	25.6	25.7	25.9
Share-based compensation	0.5	0.3	0.8
Impairment of intangible assets		0.2	
Related party expenses	0.3	0.3	0.3
Store pre-opening costs	0.1	0.1	0.1
Operating income	13.4	13.4	12.8
Interest expense	4.0	5.6	6.0
Refinancing costs and losses on early extinguishments of debt	0.3	0.7	0.4
Other (income) and expense, net			0.2
Income before income taxes	9.0	7.1	6.2
Provision for income taxes	3.2	2.6	2.4
Net income	5.8%	4.5%	3.8%

Fiscal 2013 Compared to Fiscal 2012

Net Sales Net sales increased for fiscal 2013 by $162 million, or 3.7%, over fiscal 2012 due to $102 million of incremental revenue from our non-comparable stores and a $126 million increase in comparable store sales, partially offset by $66 million related to the 53rd week of fiscal 2012. Comparable store sales increased 2.9% driven by an increase in the average ticket of 3.3%, partially offset by a decrease in transactions of 0.4%. Comparable store sales growth was strongest in our children s crafts categories due primarily to sales of the Rainbow Loom and replacement rubber bands.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $105 million to $2,748 million in fiscal 2013 from $2,643 million in fiscal 2012 due primarily to a $68 million increase in merchandise costs associated with higher sales, an $8 million increase in inventory reserve expense due to an increase in discontinued stock keeping units associated with planned merchandise resets and a slower sell-through of this merchandise and an $8 million reduction in the recognition of vendor allowances compared to the prior year, partially offset by a $6 million decrease in freight and distribution costs. In addition, we had a $6 million decrease from favorable shrink experience in fiscal 2013 compared to fiscal 2012. We also had a $32 million increase in occupancy expenses, including $20 million from opening new stores, a $5 million increase in store remodel expenses and a $9 million increase from higher maintenance costs in fiscal 2013 compared to fiscal 2012. These increases were partially offset by $2 million lower utilities expenses due to more favorable weather in fiscal 2013 compared to fiscal 2012.

Cost of sales and occupancy expense increased 10 basis points, as a percentage of Net sales, to 60.1% in fiscal 2013 from 60.0% in fiscal 2012. Occupancy costs increased 20 basis points in fiscal 2013 compared to fiscal 2012 due to higher remodel and maintenance costs. Cost of sales decreased 10 basis points in fiscal 2013 compared to fiscal 2012 primarily due to improved operational efficiencies at our vertically integrated framing operations.

Selling, General, and Administrative Expense Selling, general and administrative expense was $1,169 million in fiscal 2013 compared to $1,132 million in fiscal 2012. Selling, general and administrative expense increased $37 million driven by $26 million of incremental new store costs; Michaels retail store count increased by 37 stores in fiscal 2013 and 35 stores in fiscal 2012. Additionally, Selling, general and administrative expense increased by $7 million for outside professional fees for strategic initiatives and by $27 million for higher store and corporate payroll, benefits and other personnel expenses. The higher payroll, benefits and other personnel expenses were partially offset by approximately $23 million from additional store and corporate payroll associated with the 53rd week of fiscal 2012. As a percentage of Net sales, Selling, general and administrative expense decreased 10 basis points primarily due to increased leverage of payroll and benefits from higher comparable store sales.

Share-based Compensation Share-based compensation expenses increased to $23 million for fiscal 2013 from $15 million in fiscal 2012 due to new option grants and changes in estimates for expected forfeitures.

Impairment of Intangible Assets Impairment of intangible assets for fiscal 2012 was related to an impairment charge of $7 million for long-lived assets and $1 million for goodwill, associated with our online scrapbooking business.

Related Party Expenses Related party expenses were $14 million for fiscal 2013 and $13 million for fiscal 2012, consisting of management fees and associated expenses paid to our Sponsors and Highfields Capital Management, L.P.

Interest expense Interest expense decreased from $245 million in fiscal 2012 to $183 million in fiscal 2013, as a result of a $147 million reduction in our total debt outstanding and a lower average interest rate on our outstanding debt.

Refinancing costs and losses on early extinguishments of debt During fiscal 2013, we recorded a $7 million loss related to the redemption of $137 million of our then outstanding 2016 Senior Subordinated Notes. The $7 million loss was comprised of a $5 million redemption premium and $2 million to write off related debt issuance costs. In addition, we recorded refinancing costs of $7 million related to the subsequent refinancing of our remaining outstanding 2016 Senior Subordinated Notes. During fiscal 2012, we recorded refinancing costs of $12 million related to our Restated Term Loan Credit Facility. We also recorded a loss of $8 million to write off debt issuance costs related to our Senior Secured Term Loan Facility and prepayment of our B-1 Term Loans. In addition, we recorded an $11 million loss related to the redemption of our remaining outstanding Subordinated Discount Notes. The $11 million loss was comprised of an $8 million redemption premium and $3 million to write off related debt issuance costs. Finally, we recorded a loss of $2 million to write off debt issuance costs related to our senior secured asset-based Revolving Credit Facility. See Note 4 to our Consolidated Financial Statements.

Other (income) and expense, net Other income for fiscal 2013 was primarily related to foreign exchange transaction losses. Other income for fiscal 2012 is primarily related to foreign exchange transaction gains.

Provision for income taxes Our effective tax rate for fiscal 2013 was 35.9%. Our effective tax rate for fiscal 2012 was 36.5%. Our rate was higher than the statutory rate due primarily to the impact of state taxes.

Fiscal 2012 Compared to Fiscal 2011

Net Sales Net sales increased for fiscal 2012 by $198 million, or 4.7%, over fiscal 2011 due to $70 million of incremental revenue from our non-comparable stores, $66 million from the 53rd week of fiscal 2012, and a $62 million increase in comparable store sales. Comparable store sales increased 1.5% driven by an increase in transactions of 0.8% and an increase in the average ticket of 0.7%. Comparable store sales dollar growth was strongest in custom framing within our framing department and percentage growth was the strongest in home accents within our seasonal and home décor department.

Cost of Sales and Occupancy Expense Cost of sales and occupancy expense increased $111 million to $2,643 million in fiscal 2012 from $2,532 million in fiscal 2011 due primarily to a $95 million increase in merchandise costs associated with higher sales, including $66 million of sales from the 53rd week of fiscal 2012. The increase was partially offset by a $14 million decrease in merchandise costs related to our increased direct import volume, private brand initiative, and improved pricing and promotion management. These initiatives allowed us to reduce design, sourcing and intermediary product costs. In addition, we had a $7 million increase from favorable shrink experience in fiscal 2011 compared to more normal levels in fiscal 2012, and a $5 million increase from lower recognition of vendor allowances compared to prior year. Finally, rent and related expenses increased $15 million due mainly to $10 million of new store rent and a $3 million increase in occupancy insurance premiums.

Cost of sales and occupancy expense decreased 10 basis points, as a percentage of Net sales, to 60.0% in fiscal 2012 from 60.1% in fiscal 2011. Merchandise cost decreased 30 basis points driven by our increased direct import volume, private brand initiative, and improved pricing and promotion management, while occupancy decreased 30 basis points due to increased leverage on higher store sales. These improvements were partially offset by a 20 basis point increase from the recognition of vendor allowances compared to prior year.

Selling, General, and Administrative Expense Selling, general and administrative expense was $1,132 million in fiscal 2012 compared to $1,090 million in fiscal 2011. Selling, general and administrative expense increased $42 million driven by $23 million of incremental store costs for operating 35 additional Michaels stores and a $17 million increase in store payroll from additional payroll associated with the 53rd week of fiscal 2012, as well as a higher average hourly wage rate. In addition, we had a $6 million increase in corporate payroll due primarily to the 53rd week of fiscal 2012, an increase in wage rate and an increased headcount. Finally, we had a $4 million increase in group insurance claims and payroll tax increased $4 million mainly due to an increase in unemployment insurance rates compared to last year. These amounts were partially offset by an $18 million decrease in bonus expense from a lower bonus payout recognized in fiscal 2012 compared to fiscal 2011. As a percentage of Net sales, Selling, general, and administrative expense decreased 20 basis points primarily due to a 50 basis point decrease in bonus expense compared to fiscal 2011.

Share-based compensation expense Share-based compensation expense decreased to $15 million for fiscal 2012 from $33 million in fiscal 2011 due to the change in fair value of option awards under liability accounting.

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

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

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

Refinancing costs and losses on early extinguishments of debt During fiscal 2012, we recorded refinancing costs of $12 million related to our Restated Term Loan Credit Facility. We also recorded a loss of $8 million to write off debt issuance costs related to our Senior Secured Term Loan Facility and prepayment of our B-1 Term Loans. In addition, we recorded an $11 million loss related to the redemption of our remaining outstanding Subordinated Discount Notes. The $11 million loss was comprised of an $8 million redemption premium and $3 million to write off related debt issuance costs. Finally, we recorded a loss of $2 million to write off debt issuance costs related to our senior secured asset-based Revolving Credit Facility. During fiscal 2011, we recorded a loss of $18 million related to the early extinguishment of $163 million face value, or $155 million accreted value, of our Subordinated Discount Notes and $7 million face value of our 2016 Senior Subordinated Notes. The $18 million loss was comprised of $11 million to recognize the unrealized interest accretion and the write off of related debt issuance costs, as well as $7 million of purchase premiums.

Other (income) and expense, net Other income for fiscal 2012 is primarily related to foreign exchange transaction gains. Other expense for fiscal 2011 is related to a $5 million unfavorable change in the fair value of the interest rate derivative (the interest rate cap), as more fully described in Note 8 to our Consolidated Financial Statements, and $4 million in foreign exchange transaction losses.

Provision for income taxes Our effective tax rate for fiscal 2012 was 36.5%. Our effective tax rate for fiscal 2011 was 38.9%. Our rate was lower than the prior year rate due primarily to the reversal of accruals for uncertain tax positions as a result of the closure of tax audits and the expiration of the statute of limitations on previously open tax years.

Liquidity and Capital Resources

We require cash principally for day-to-day operations, to finance capital investments, to purchase inventory, to service our outstanding debt and for seasonal working capital needs. We expect that our available cash, cash flow generated from operating activities and funds available under our Restated Revolving Credit Facility will be sufficient to fund planned capital expenditures, working capital requirements, debt repayments, debt service requirements and anticipated growth for the foreseeable future. Our ability to satisfy our liquidity needs and continue to refinance or reduce debt could be adversely affected by the occurrence of any of the events described under Item 1A. Risk Factors or our failure to meet our debt covenants as described in Liquidity and Capital Resources Cash Flow from Financing Activities .

To finance the Merger, we issued the 2014 Senior Notes, 2016 Senior Subordinated Notes and Subordinated Discount Notes and executed a Senior Secured Term Loan Facility and a senior secured asset-based Revolving Credit Facility which in the aggregate was approximately $4.0 billion. Since October 31, 2006, we have retired or purchased some of this debt through redemptions, repurchases or exchanges and have issued new debt or amended existing debt facilities in connection with these retirements and purchases. As of February 1, 2014, our total debt outstanding was approximately $2.9 billion. 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 repay portions of our indebtedness, to pay dividends to our parent, Holdings, and to invest in growth opportunities, depending on market conditions. If we use our excess cash flows to repay our debt, it will reduce the amount of excess cash available for additional capital expenditures. While not required, we intend to make dividends to Holdings to fund the August 1, 2014, interest payment due on the PIK Notes of $30 million and, to the extent that such dividends can be made by us in compliance with covenants applicable to us under the terms of our indebtedness, future interest payments on the PIK Notes. If interest on the PIK Notes is paid in cash, annual interest payments will total $60 million or a total of approximately $300 million from July 29, 2013, until August 1, 2018, the maturity date.

As of February 2, 2013, we had an aggregate principal amount of $393 million of our 2016 Senior Subordinated Notes scheduled to mature in November 2016. On February 27, 2013, we redeemed $137 million in aggregate principal amount of the outstanding 2016 Senior Subordinated Notes with cash on hand and borrowings made under the Restated Term Loan Credit Facility for an aggregate redemption price (including the applicable redemption premium and accrued and unpaid interest) of $147 million. On December 19, 2013, we issued an irrevocable notice of redemption to the holders of our remaining outstanding 2016 Senior Subordinated Notes, deposited the proceeds of the offering of our 2020 Senior Subordinated Notes and additional cash with the trustee under the indenture governing the 2016 Senior Subordinated Notes (the 2016 Senior Subordinated Notes Indenture) and instructed the trustee to (a) redeem the 2016 Senior Subordinated Notes on January 21, 2014 and (b) discharge our obligations under the 2016 Senior Subordinated Notes Indenture. Accordingly, our obligations under the 2016 Senior Subordinated Notes Indenture were discharged. Our Senior Notes mature in 2018, the 2020 Senior Subordinated Notes mature in 2020, the PIK Notes mature in 2018 and the Restated Term Loan Credit Facility matures in or after 2018. Although no assurance can be given, depending on market conditions and other factors, we plan to repay or refinance such indebtedness prior to maturity.

We, and our subsidiaries, may be able to incur substantial additional indebtedness in the future, subject to the restrictions contained in our Senior Secured Credit Facilities and the indentures governing our Senior Notes (as defined below) and 2020 Senior Subordinated Notes. In addition, our Senior Secured Credit Facilities and indentures governing our Senior Notes and 2020 Senior Subordinated Notes do not restrict our owners from creating new holding companies that may be able to incur indebtedness without regard to the restrictions set forth in our Senior Secured Credit Facilities and the indentures governing our Senior Notes and 2020 Senior Subordinated Notes. If new indebtedness is added to our current debt levels, the related risks we now face could intensify.

We had $2,894 million of indebtedness outstanding at February 1, 2014, of which $1,628 million was subject to variable interest rates and $1,266 million was subject to fixed interest rates. As of February 1, 2014, our Restated Revolving Credit Facility provided for an aggregate amount of $650 million in commitments, subject to a borrowing base, which supported $61 million of outstanding standby letters of credit and provided $589 million of unused borrowing capacity. Our cash and equivalents increased $178 million from $56 million at the end of fiscal 2012 to $234 million at the end of fiscal 2013.

We and our subsidiaries, affiliates and significant stockholders may from time to time seek to retire or purchase our outstanding debt (including publicly issued debt) through cash purchases and/or exchanges, in open market purchases, privately negotiated transactions, by tender offer or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors.

Cash Flow from Operating Activities

Cash flow provided by operating activities in fiscal 2013 was $468 million compared to $299 million in fiscal 2012. The $169 million change was due in part to a $137 million increase from the timing of accounts payable and $64 million increase in net income. This increase was partially offset by a $19 million decrease in refinancing costs and losses on early extinguishment of debt and $17 million decrease in merchandise inventories. Average inventory per Michaels store (including supporting distribution centers) was $764 thousand, up from last year s average inventory balance of $754 thousand.

Cash Flow from Investing Activities

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

	Fiscal Year 2013	2012 (In millions)	2011
New and relocated stores and stores not yet opened (1)	$ 39	$ 42	$ 28
Existing stores	26	30	25
Information systems (2)	28	36	45
Corporate and other	19	16	11
	$ 112	$ 124	$ 109

(1) In fiscal 2013, we incurred capital expenditures related to the opening of 40 Michaels stores in addition to the relocation of 14 Michaels stores. In fiscal 2012, we incurred capital expenditures related to the opening of 38 Michaels stores and the relocation of 13 Michaels stores. In fiscal 2011, we incurred capital expenditures related to the opening of 25 Michaels stores and the relocation of 15 Michaels stores. The average capital expenditure per store for fiscal 2013 was comparable to fiscal 2011. The increase in capital expenditures per store in fiscal 2012 is due mainly to an increase in leasehold improvements for three unique locations. Excluding those locations, the average per store is comparable for the three years presented.

(2) Our fiscal 2013 information systems capital expenditures decreased from fiscal 2012 primarily due to 2012 projects, not recurring in 2013, for systems to enhance manufacturing capabilities and for system infrastructure for Québec.

We capitalize and depreciate significant renewals or betterments that substantially extend the life of the asset. We also capitalize certain costs related to the acquisition and development of internal use software that is expected to benefit future periods. In fiscal 2013, fiscal 2012 and fiscal 2011, we capitalized payroll and consulting costs of approximately $39 million, $30 million and $34 million, respectively, related to our capital expenditures.

We currently estimate that our capital expenditures will be increased to between $160 million and $180 million in fiscal 2014. We plan to invest in the infrastructure necessary to support the further development of our business and continued growth. In fiscal 2014, we plan to open 40 to 45 stores, including 10 to 15 relocations. We expect our capital expenditures will be financed with cash from operating activities.

Cash Flow from Financing Activities

Cash flow used in financing activities during fiscal 2013 was $178 million, compared to $490 million during fiscal 2012. Cash flow used in financing activities for fiscal 2013 was impacted by the repurchase of $137 million of our 2016 Senior Subordinated Notes at a redemption price of 103.792% or a total of $142 million and the repurchase of $256 million of our 2016 Senior Subordinated Notes at a redemption price of 101.896% or a total of $261 million. We also made payment of $12 million under the Restated Term Loan Credit Facility. In addition, we issued $260 million of the 2020 Senior Subordinated Notes.

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

Debt

We currently have outstanding indebtedness consisting of Senior Notes, 2020 Senior Subordinated Notes, as well as the Restated Term Loan Credit Facility and the Restated Revolving Credit Facility. In addition, our indirect parent company, FinCo Holdings and FinCo Inc. have outstanding indebtedness consisting of the PIK Notes. Borrowings under our revolving credit facility are influenced by a number of factors as more fully described below.

Notes

On October 31, 2006, we issued (i) $750 million in principal amount of 10% Senior Notes due November 1, 2014 (the 2014 Senior Notes); (ii) $400 million in principal amount of (the 2016 Senior Subordinated Notes); and (iii) $469 million in principal amount at maturity of Subordinated Discount Notes. During the third quarter of fiscal 2010, we retired the 2014 Senior Notes and issued $800 million of 73/4% Senior Notes due November 1, 2018 (the 2018 Senior Notes), at a discounted price of 99.262% of face value, resulting in an effective interest rate of 77/8%. On September 27, 2012, we issued an additional $200 million principal amount of 2018 Senior Notes, at a premium of 106.25% of face value, resulting in an effective interest rate of 6½%. On February 27, 2013, we redeemed $137 million in aggregate principal amount of 2016 Senior Subordinated Notes at a redemption price equal to 103.792%. On December 19, 2013, we issued $260 million in principal amount of 57/8% Senior Subordinated Notes that mature December 15, 2020. Interest is payable semi-annually in arrears on each June 15 and December 15, commencing on June 15, 2014. We used the net proceeds of these notes to redeem the outstanding 2016 Senior Subordinated Notes, to pay the applicable redemption premium and accrued and unpaid interest to, but not including, the applicable redemption date and to pay related fees and expenses. As of December 19, 2013, an aggregate principal amount of approximately $255 million of 2016 Senior Subordinated Notes remained outstanding. The 2016 Senior Subordinated Notes were redeemed on January 21, 2014 and our obligations under the 2016 Senior Subordinated Notes indentures were discharged.

The PIK Notes are not guaranteed by us, Holdings or any of our subsidiaries, but the indenture governing the PIK Notes contains restrictive covenants that apply to FinCo Holdings and its restricted subsidiaries, including us, Holdings and our subsidiaries. Interest on the Senior Notes is payable semi-annually in arrears on each May 1 and November 1. Interest on the 2020 Senior Subordinated Notes is payable semi-annually in arrears on each June 15 and December 15, commencing on June 15, 2014. Interest on the PIK Notes is payable semi-annually in arrears on each

February 1 and August 1. If interest on the PIK Notes is paid in cash, annual interest payments will total $60 million, at a rate of 7.50% per annum, or a total of approximately $300 million from July 29, 2013 until August 1, 2018, the maturity date. If interest on the PIK Notes is paid in-kind by increasing the principal amount of the PIK Notes, or by issuing new PIK Notes, the interest rate is 8.25% per annum, which is the cash interest rate plus 75 basis points.

Beginning on November 1, 2011, cash interest began accruing on the Subordinated Discount Notes and was payable semi-annually in arrears on each May 1 and November 1 (the first cash interest payment was May 1, 2012). On May 1, 2012, as required pursuant to the indenture (Subordinated Discount Notes Indenture) governing our Subordinated Discount Notes, we redeemed that portion of each Subordinated Discount Note outstanding on such date equal to the amount sufficient, but not in excess of the amount necessary, to ensure that such Subordinated Discount Note will not be an AHYDO instrument within the meaning of Section 163(i)(1) of the Internal Revenue Code of 1986, as amended (the AHYDO Amount). These redemptions were at a price equal to 100% of the Accreted Value (as defined in the Subordinated Discount Notes Indenture) of such portion as of the date of redemption. The aggregate payment of $127 million made on May 1, 2012, was required to ensure the Subordinated Discount Notes would not be AHYDO instruments. On October 1, 2012, we delivered to the holders of our outstanding Subordinated Discount Notes an irrevocable notice of redemption relating to the redemption of all of our outstanding Subordinated Discount Notes. On November 1, 2012, we redeemed a portion of the Subordinated Discount Notes equal to the AHYDO Amount (as defined in the Subordinated Discount Notes Indenture) at a redemption price equal to 100% and the remaining Subordinated Discount Notes at a redemption price equal to 104.333%.

The Senior Notes are guaranteed, jointly and severally, fully and unconditionally, on an unsecured senior basis and the 2020 Senior Subordinated Notes are guaranteed, jointly and severally, fully and unconditionally, on an unsecured senior subordinated basis, in each case, by each of our subsidiaries (each of which is directly or indirectly owned 100% by Michaels Stores, Inc.) that guarantee indebtedness under our Senior Secured Credit Facilities.

The indentures governing the Senior Notes and 2020 Senior Subordinated Notes contain covenants limiting, among other things, the Company s ability, and the ability of the Company s restricted subsidiaries, to:

- incur or guarantee additional debt
- pay dividends or distributions on the Company s capital stock or repurchase the Company s capital stock or prepay debt that is subordinated to the Senior Notes and 2020 Senior Subordinated Notes, respectively
- issue stock of subsidiaries
- make certain investments, loans, advances and acquisitions
- create liens on the Company s and such subsidiaries assets to secure debt
- enter into transactions with affiliates
- merge or consolidate with another company
- sell or otherwise transfer assets

The indenture governing the PIK Notes contains restrictive covenants and events of default substantially similar to, but less restrictive than, those of the Senior Notes and 2020 Senior Subordinated Notes described above, which restrict FinCo Holdings and its restricted subsidiaries, including us, Holdings and our subsidiaries.

Restated Revolving Credit Facility

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

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

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

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

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

All obligations under the Restated Revolving Credit Facility are unconditionally guaranteed jointly and severally by Holdings and all of our existing domestic material subsidiaries and are required to be guaranteed by certain of our future domestic wholly-owned material subsidiaries. All obligations under the Restated Revolving Credit Facility, and the guarantees of those obligations, are secured, subject to certain exceptions, by substantially all of the assets of Holdings, us and our material subsidiaries (the Subsidiary Guarantors), including:

- first-priority security interest in personal property consisting of inventory and related accounts, cash, deposit accounts, all payments received by Holdings, us or the Subsidiary Guarantors from credit card clearinghouses and processors or otherwise in respect of all credit card charges and debit card charges for sales of inventory by Holdings, MSI and the Subsidiary Guarantors, and certain related assets and proceeds of the foregoing;

- second-priority pledge of all of our capital stock and the capital stock held by us and the Subsidiary Guarantors (which pledge, in the case of the capital stock of any foreign subsidiary, is limited to 65% of the voting stock of such foreign subsidiary and 100% of the non-voting stock of such subsidiary); and

- second-priority security interest in, and mortgages on, substantially all other tangible and intangible assets of Holdings, us and each Subsidiary Guarantor, including substantially all of our and our subsidiaries owned real property and equipment.

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

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

As of February 1, 2014, the borrowing base was $650 million, of which we had no outstanding borrowings, $61 million of outstanding standby letters of credit, and $589 million of unused borrowing capacity.

Restated Term Loan Credit Facility

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

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

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

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

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

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

The Company may voluntarily prepay outstanding loans under the Restated Term Loan Credit Facility at any time without premium or penalty other than customary breakage costs with respect to LIBOR loans.

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

All obligations under the Restated Term Loan Credit Facility are unconditionally guaranteed by Holdings, and each of our direct and indirect wholly-owned domestic subsidiaries that guarantees obligations under the Restated Revolving Credit Facility. All obligations under the Restated Term Loan Credit Facility, and the guarantees of those obligations, are secured, subject to certain exceptions, by substantially all of the assets of Holdings, us and the Subsidiary Guarantors, including:

- a first-priority pledge of our capital stock and all of the capital stock held by us and the Subsidiary Guarantors (which pledge, in the case of any foreign subsidiary, is limited to 65% of the voting stock of such foreign subsidiary and 100% of the non-voting stock of such subsidiary);

- a first-priority security interest in, and mortgages on, substantially all other tangible and intangible assets of Holdings, us and each Subsidiary Guarantor, including substantially all of our and our subsidiaries owned real property and equipment, but excluding, among other things, the collateral described in the following bullet point;

- a second-priority security interest in personal property consisting of inventory and related accounts, cash, deposit accounts; and

- all payments received by Holdings, us or the Subsidiary Guarantors from credit card clearinghouses and processors or otherwise in respect of all credit card charges and debit card charges for sales of inventory by Holdings us and the Subsidiary Guarantors, and certain related assets and proceeds of the foregoing.

The Restated Term Loan Credit Facility contains a number of negative covenants that are substantially similar to, but morerestrictive in certain respects than, those governing the Senior Notes and the 2020 Senior Subordinated Notes, as well as certainother customary representations and warranties, affirmative and negative covenants and events of default.

The proceeds of the Restated Term Loan Credit Facility were used, among other things, to (i) prepay an aggregate principal amount of $876 million of the Company s B-2 Term Loans and $619 million of the Company s B-3 Term Loans under the Senior Secured Term Loan Facility and (ii) fund the redemption and related fees, on February 27, 2013, of an aggregate principal amount of $137 million of the Company s 2016 Senior Subordinated Notes pursuant to a notice of redemption issued to the holders of such notes on January 28, 2013.

Off-Balance Sheet Arrangements

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

Contractual Obligations

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

As of February 1, 2014, our contractual obligations were as follows:

	Payments Due By Fiscal Year				
	Total	**Less Than 1 Year**	**1-3 Years**	**3-5 Years**	**More Than 5 Years**
Operating lease commitments (1)	$ 1,794	$ 390	$ 637	$ 417	$ 350
Other commitments (2)	95	59	36		
Total debt (3)	2,888	16	33	2,579	260
Interest payments (4)	772	156	310	275	31
	$ 5,549	$ 621	$ 1,016	$ 3,271	$ 641

(1) Our operating lease commitments generally include non-cancelable leases for property and equipment used in our operations. Excluded from our operating lease commitments are amounts related to insurance, taxes, and common area maintenance associated with property and equipment. Such amounts historically represented approximately 31% of the total lease obligation over the previous three fiscal years.

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

(3) Included in Total debt is $9 million of unamortized premium and $3 million of unamortized discount on the Senior Notes, which has not been recognized as of February 1, 2014. See Note 4 to the Consolidated Financial Statements.

(4) Debt associated with our Restated Term Loan Credit Facility was $1,628 million at February 1, 2014, and is subject to variable interest rates. The amounts included in interest payments in the table for the Restated Term Loan Credit Facility were based on the indexed interest rate in effect at February 1, 2014. Approximately $1,266 million of debt was subject to fixed interest rates. We had no outstanding borrowings under our Restated Revolving Credit Facility at February 1, 2014. Under our Restated Revolving Credit Facility, we are required to pay a commitment fee of 0.375% per year on the unutilized commitments, subject to an adjustment each fiscal quarter. The amounts included in interest payments for the Restated Revolving Credit Facility were based on these annual commitment fees.

Additional information regarding our long-term debt and commitments and contingencies is provided in Note 4 and Note 11, respectively, of Notes to Consolidated Financial Statements.

Non-GAAP Measures

The following table sets forth the Company s Earnings before Interest, Taxes, Depreciation, Amortization, and debt costs (EBITDA excluding refinancing costs and losses on early extinguishments of debt). The Company defines EBITDA (excluding refinancing costs and losses on early extinguishments of debt) as Net income before interest, income taxes, depreciation, amortization and refinancing costs and losses on early extinguishments of debt. Additionally, the table presents Adjusted Earnings before Interest, Taxes, Depreciation and Amortization (Adjusted EBITDA). The Company defines Adjusted EBITDA as EBITDA (excluding refinancing costs and losses on early extinguishments of debt) adjusted for certain defined amounts that are added to, or subtracted from, EBITDA (excluding refinancing costs and losses on early extinguishments of debt) (collectively, the Adjustments) in accordance with the Company s $1.6 billion Restated Term Loan Credit Facility and $650 million Restated Revolving Credit Facility. The Adjustments are described in further detail in the table, and the footnotes to the table below.

The Company has presented EBITDA (excluding refinancing costs and losses on early extinguishments of debt) and Adjusted EBITDA to provide investors with additional information to evaluate our operating performance and our ability to service our debt. The Company uses EBITDA (excluding refinancing costs and losses on early extinguishments of debt), among other metrics, to evaluate operating performance, to plan and forecast future periods operating performance and as an element of its incentive compensation targets. Adjusted EBITDA is a required calculation under the Company s Restated Term Loan Credit Facility and its Restated Revolving Credit Facility. As it relates to the Restated Term Loan Credit Facility, Adjusted EBITDA is used in the calculations of fixed charge coverage and leverage ratios, which, under certain circumstances may result in limitations on the Company s ability to make restricted payments as well as the determination of mandatory repayments of the loans. Under the Restated Revolving Credit Facility, Adjusted EBITDA is used in the calculation of fixed charge coverage ratios, which under certain circumstances, may restrict the Company s ability to make certain payments (characterized as restricted payments), investments (including acquisitions) and debt repayments, and which under certain circumstances will be used as a maintenance covenant.

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

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

	Fiscal Years 2013	Fiscal Years 2012 (In millions)	Fiscal Years 2011
Net cash provided by operating activities	$ 468	$ 299	$ 409
Depreciation and amortization	(106)	(97)	(101)
Share-based compensation	(34)	(21)	(41)
Debt issuance costs amortization	(9)	(14)	(17)
Accretion of long-term debt	1		(35)
Change in fair value of contingent consideration			4
Change in fair value of interest rate cap			(5)
Refinancing costs and losses on early extinguishments of debt	(14)	(33)	(18)
Impairment of intangible assets		(8)	
Changes in assets and liabilities	(42)	74	(39)
Net income	264	200	157
Interest expense	183	245	254
Refinancing costs and losses on early extinguishment of debt	14	33	18
Provision for income taxes	148	115	100
Depreciation and amortization	106	97	101
EBITDA (excluding refinancing costs and losses on early extinguishment of debt)	715	690	630
Adjustments:			
Share-based compensation and related taxes	35	21	41
Sponsor fees	14	13	13
Impairment of intangible assets		8	
Termination expense	5	1	1
Store pre-opening costs	5	5	4
Store remodel costs	7	2	2
Foreign currency transaction losses(gains)	2	(1)	4
Store closing costs	5	4	7
Gain on contingent consideration			(4)
Loss on interest rate cap			5
Other (1)	5	4	4
Adjusted EBITDA	$ 793	$ 747	$ 707

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

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss or a Tax Credit Carryforward Exists.* ASU 2013-11 requires unrecognized tax benefits to be presented as a decrease in a net operating loss, similar tax loss or tax credit carryforward if certain criteria are met. ASU 2013-11, which is prospective, is effective for reporting periods beginning after December 15, 2013, with earlier adoption permitted. Beginning with the fourth quarter of fiscal year 2012, the Company has reported unrecognized tax benefits consistent with ASU No. 2013-11.

ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk.

We are exposed to fluctuations in exchange rates between the U.S. and Canadian dollar, which is the functional currency of our Canadian subsidiary. Our sales, costs and expenses of our Canadian subsidiary, when translated into U.S. dollars, can fluctuate due to exchange rate movement. As of February 1, 2014, a 10% increase or decrease in the exchange rate of the U.S. and Canadian dollar would increase or decrease Net income by approximately $3 million.

We do not believe inflation and changing commodity prices have had a material impact on our Net sales, income from continuing operations, plans for expansion or other capital expenditures for any year during the three-year period ended February 1, 2014. However, we cannot be sure inflation and changing commodity prices will not have an adverse impact on our operating results, financial condition, plans for expansion or other capital expenditures in future periods.

We have market risk exposure arising from changes in interest rates on our Senior Secured Credit Facilities. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources for further detail. The interest rates on our Senior Secured Credit Facilities will reprice periodically, which will impact our earnings and cash flow. The interest rates on our Senior Notes and Senior Subordinated Notes are fixed. Based on our overall interest rate exposure to variable rate debt outstanding as of February 1, 2014, a 1% increase or decrease in interest rates would increase or decrease Income before income taxes by approximately $16 million. A 1% increase or decrease in interest rates would impact the fair value of our long-term fixed rate debt by approximately $7 million. A change in interest rates would not materially affect the fair value of our variable rate debt as the debt reprices periodically.

We invest cash balances in excess of operating requirements primarily in money market mutual funds and short-term interest-bearing securities, generally with maturities of 90 days or less. Due to the short-term nature of our investments, the fair value of our cash and equivalents at February 1, 2014 approximated carrying value.

ITEM 8. Consolidated Financial Statements and Supplementary Data.

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

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

None.

ITEM 9A. Controls and Procedures.

Included in this Annual Report on Form 10-K are certifications by our Chief Executive Officer and our Chief Financial Officer, which are required in accordance with Rule 15d-14 of the Securities Exchange Act of 1934, as amended. This section includes information concerning the controls and controls evaluation referred to in the certifications. Page F-2 of this Report includes the attestation report of Ernst & Young LLP, our independent registered public accounting firm, regarding its audit of the effectiveness of our internal control over financial reporting. This section should be read in conjunction with the Ernst & Young attestation for a complete understanding of this section.

Evaluation of Disclosure Controls and Procedures

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

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework* (1992). Based on management s assessment, management has concluded that the Company s internal control over financial reporting was effective as of February 1, 2014.

Changes in Internal Control Over Financial Reporting

During the fourth quarter of fiscal 2013, management identified a material weakness in our internal control over financial reporting with respect to the administration of our share repurchases. As a result of this material error, management concluded a material weakness existed in the Company s internal controls related to the administration of share repurchases and controls were ineffective at timely detecting and correcting errors related to share-based compensation in accordance with U.S. generally accepted accounting principles. The accounting error was also material to fiscal 2012 and fiscal 2011 financial statements and those financial statements required restatement. In addition, the unaudited interim financial statements for the three months ended May 4, 2013 and the unaudited interim financial statements for the three and six months ended August 3, 2013 were restated to correct the accounting error. These restatements were completed during the fourth quarter of fiscal 2013.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of a company s annual or interim financial statements will not be prevented or detected on a timely basis. In response to this material weakness, management developed and implemented the following remediation measures to address the control deficiencies described above and to enhance the Company s internal control over financial reporting. The following actions, which the Company believes have remediated the deficiencies in internal control over financial reporting related to the administration of our share repurchases, were completed as of February 1, 2014:

- Established additional policies and internal control procedures related to share repurchases to ensure all required approvals are received prior to repurchase, including our Board, CEO and CFO. In addition, the accounting department will review repurchases for appropriate accounting under ASC 718 prior to a commitment to repurchase.

- Performed a formal review with the Company officers and Board members responsible for the administration of stock repurchases regarding the terms of the Plan and the Stockholders Agreement with recurring training when responsibilities change.

- Provided enhanced education of the Company s financial reporting and corporate accounting staff on ASC 718 and ensured the Company complies with all aspects of the accounting standard.

- Additionally, the Company distributed formal communication to all option holders and stockholders emphasizing the exercise terms under the Plan and related option agreements, and the call feature repurchase restrictions contained in the Stockholders Agreement.

As a result of the completed remediation efforts noted above, there were improvements in internal control over financial reporting during the fourth quarter of fiscal year 2013 materially affecting, or reasonably likely to materially affect, the Company s internal control over financial reporting. There were no other changes in internal control over financial reporting (as defined by Rules13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth quarter of fiscal 2013 materially affecting or are reasonably likely to materially affect, our internal control over financial reporting.

Management Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the company, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and, even when determined to be effective, can only provide reasonable, not absolute, assurance with respect to financial statement preparation and presentation. Projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate as a result of changes in conditions or deterioration in the degree of compliance.

Management assessed the effectiveness of our internal control over financial reporting as of February 1, 2014. Management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its *Internal Control Integrated Framework* (1992). Management s assessment included the evaluation of such elements as the design and operating effectiveness of financial reporting controls, process documentation, accounting policies, and the overall control environment. This assessment is supported by testing and monitoring performed or supervised by our Internal Audit organization.

Based on management s assessment, management has concluded that the Company s internal control over financial reporting was effective as of February 1, 2014. The independent registered public accounting firm, Ernst & Young LLP, issued an attestation report on the effectiveness of our internal control over financial reporting. The Ernst & Young LLP report is included on Page F-2 of this Annual Report on Form 10-K.

ITEM 9B. Other Information.

Iran Threat Reduction and Syria Human Rights Act of 2012

Pursuant to Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012, which added Section 13(r) of the Exchange Act, the Company hereby incorporates by reference herein Exhibit 99.1 of this Annual Report on Form 10-K, which includes disclosures publicly filed and/or provided to The Blackstone Group L.P., one of our Sponsors, by Travelport Limited, Hilton Worldwide, Inc. and Sungard Capital Corp., Sungard Capital Corp II and Sungard Data Systems, Inc., which may be considered its affiliates.

ITEM 10. Directors, Executive Officers and Corporate Governance.

DIRECTORS AND EXECUTIVE OFFICERS

Directors

Set forth below is information concerning each member of our board of directors (the Board), including their ages as of April 25, 2014, present principal occupations, other business experiences during at least the last five years, membership on committees of the Board, public company directorships held during the last five years and certain other directorships. Our current directors serve until their successors are duly elected and qualified or until the earlier of their resignation, death or removal.

Four of our current directors (Josh Bekenstein, Todd M. Cook, Lewis S. Klessel and Matthew S. Levin) are affiliates of Bain and one of our current directors (Peter F. Wallace) is an affiliate of Blackstone. Mr. Quella and Ms. Greenthal are former affiliates, and designees, of Blackstone. Messrs. Bekenstein, Cook, Klessel and Levin have served on our Board since October 31, 2006. Our stockholders elected Mr. Wallace to the Board on March 11, 2009, elected Ms. Greenthal to the Board on May 18, 2011, elected Mr. Rubin to the Board effective March 18, 2013 and elected Mr. Mahoney to the Board effective September 18, 2013, in each case to fill a vacancy on the Board.

Because we have not listed any securities on a national securities exchange or on an inter-dealer quotation system, we are not required to have a Board comprised of a majority of independent directors under SEC rules or any listing standards. Accordingly, our board of directors has not made any determination as to whether our directors satisfy any independence requirements applicable to board members under the rules of the SEC or any national securities exchange, inter-dealer quotation system or any other independence definition.

Name	Age	Since	Committee Membership
Josh Bekenstein	55	October 31, 2006	
Todd M. Cook	43	October 31, 2006	Audit Committee
Jill A. Greenthal	57	May 18, 2011	Audit Committee
Lewis S. Klessel	46	October 31, 2006	Audit Committee
Matthew S. Levin	48	October 31, 2006	Compensation Committee
John J. Mahoney	62	September 18, 2013	Audit Committee
James A. Quella	64	October 31, 2006	Audit Committee
Carl S. Rubin	54	March 18, 2013	
Peter F. Wallace	39	March 11, 2009	Compensation Committee

Mr. Bekenstein is a managing director at Bain. Prior to joining Bain in 1984, Mr. Bekenstein spent several years at Bain & Company, where he was involved with companies in a variety of industries. Mr. Bekenstein received an M.B.A. from Harvard Business School and a B.A. from Yale University. Mr. Bekenstein serves as a director of Bombardier Recreational Products Inc., Dollarama Capital Corporation, Toys R Us, Inc., Burlington Stores, Inc., Bright Horizons Family Solutions Inc., The Gymboree Corporation and Waters Corporation. Mr. Bekenstein s many years of experience both as a senior executive of a large investment firm and as a director of companies in various business sectors make him highly qualified to serve on our Board.

Mr. Cook is a managing director at Bain. Prior to becoming a managing director in December 2008, Mr. Cook served in various capacities, most recently as a principal at Bain from 2003 to 2008. Prior to joining Bain in 1996, Mr. Cook was a consultant at Bain & Company. Mr. Cook received an M.B.A. from Stanford University Graduate School of Business where he was an Arjay Miller Scholar. He also holds a B.E. in electrical engineering and a B.A. in economics from Dartmouth College. Mr. Cook is a director of Blackhawk Specialty Tools, LLC. Mr. Cook was formerly a director of Dollarama Capital Corporation and a director of Dunkin Brands, Inc. Mr. Cook s strong financial background combined with his experiences at Bain and as director of other companies put him in a position to provide important contributions to our Board.

Ms. Greenthal has been a senior advisor at The Blackstone Group in the private equity group since 2007. From 2003 until 2007, Ms. Greenthal was a senior managing director in Blackstone s advisory group. Prior to joining The Blackstone Group, Ms. Greenthal was Co-Head of the Global Media Investment Banking Group, a member of the Executive Board of Investment Banking, and Co-Head of the Boston office of Credit Suisse First Boston. Ms. Greenthal graduated as a member of The Academy from Simmons College and received an M.B.A. from Harvard Business School. Ms. Greenthal currently serves on the board of directors of Akamai Technologies, Inc., Houghton-Mifflin Harcourt Company and The Weather Channel Companies. Ms. Greenthal was formerly a director of Martha Stewart Omnimedia, Orbitz Worldwide, Inc., Universal Orlando and Freedom Communications. Ms. Greenthal s background and understanding of capital markets and financial matters as well as her experiences described above enable her to provide valuable counsel to our management and Board.

Mr. Klessel is a managing director at Bain. Prior to becoming a managing director in December 2011, Mr. Klessel served in various capacities, most recently as an operating partner at Bain from December 2007 to December 2011. Prior to joining Bain in October 2005, Mr. Klessel held a variety of operating and strategy leadership positions from 1997 to 2005 at The Home Depot, Inc., including President of HD Supply s Facilities Maintenance business, Divisional Merchandise Manager and head of Home Depot s Strategic Business Development function. Prior to 1997, Mr. Klessel was a strategy consultant with McKinsey & Company and a senior auditor with Ernst & Young. Mr. Klessel received an M.B.A. from Harvard Business School and a B.S. from the Wharton School at the University of Pennsylvania. Mr. Klessel has formerly served on the boards of Guitar Center, Inc. and HD Supply, Inc. As a result of these and other professional experiences, Mr. Klessel brings to our Board extensive experience in operating and managing complex organizations, particularly in the retail industry, which strengthen the collective qualifications, skills and experience of our Board.

Mr. Levin is a managing director at Bain. Mr. Levin joined Bain Capital in 1992 and was promoted to managing director in 2000. Prior to joining Bain, Mr. Levin was a consultant at Bain & Company in the consumer products and manufacturing industries. Mr. Levin received an M.B.A. from Harvard Business School where he was a Baker Scholar. He received a B.S. from the University of California at Berkeley.

Mr. Levin serves as a board member of Bombardier Recreational Products Inc., Edcon Holdings Pty. Ltd., Guitar Center, Inc., Jupiter Shop Chanel Co., Ltd., Toys R Us, Inc. and Unisource Worldwide, Inc. Mr. Levin s significant experience in and knowledge of corporate finance and managing companies put him in a position to provide important contributions to our Board.

Mr. Mahoney has been a director since September 2013 and retired as Vice Chairman of Staples, Inc. in July 2012, having served as Vice Chairman since January 2006. Mr. Mahoney also served as Chief Financial Officer for Staples, Inc. from 1996 through January 2012. Prior to 1996, Mr. Mahoney was a partner at Ernst & Young, LLP. He currently serves on the Board of Directors of Bloomin Brands, Inc., Burlington Stores, Inc. and Chico s FAS, Inc. Previously, Mr. Mahoney served on the Board of Directors of Advo, Inc. from 2001 to 2007, Tweeter Home Entertainment Group, Inc. from 2004 to 2007 and Zipcar, Inc. from 2010 to 2012. Mr. Mahoney holds an MBA from Northeastern University, as well as an undergraduate degree from the College of the Holy Cross. Mr. Mahoney s strong financial background and experience as a Vice Chairman and former Chief Financial Officer of a Fortune 500 retail company, enables him to provide valuable counsel to our management and Board.

Mr. Quella has been a Senior Advisor at The Blackstone Group in the Private Equity Group since July 2013. Prior to his role as Senior Advisor, Mr. Quella was a Senior Managing Director, Operating Partner and co-head of the Portfolio Operations Group at Blackstone in the Private Equity Group from 2004 to 2013. Prior to joining Blackstone, Mr. Quella was a managing director and senior operating partner with DLJ Merchant Banking Partners CSFB Private Equity from 2000 to 2004. Prior to that, Mr. Quella worked at Mercer Management Consulting and Strategic Planning Associates and served as Vice-Chairman and co-head of the firm. Mr. Quella received a B.A. in International Studies from the University of Chicago/University of Wisconsin-Madison and an M.B.A. with Dean s Honors from the University of Chicago Graduate School of Business. Mr. Quella serves as a director of Catalent Pharma Solutions, Inc., DJO Global, Inc., and Freescale Semiconductor, Inc. Mr. Quella was formerly a director of Allied Waste, Columbia House, Celanese Corporation, Graham Packaging Company, L.P. , Houghton-Mifflin Harcourt Company, Intelenet Global Services, The Nielsen Company and Vanguard Health Systems, Inc. Due to contributions that Mr. Quella can provide to our Board resulting from his financial expertise, as well as his significant experience in working with companies controlled by private equity sponsors, he is qualified to be on and is an asset to our Board.

Mr. Rubin was named our Chief Executive Officer in March 2013. Prior to joining us, Mr. Rubin served as President and Chief Executive Officer of Ulta Salon, Cosmetics & Fragrance, Inc. since September 2010, and served as Chief Operating Officer from April 2010 to September 2010. Prior to joining Ulta, he served as President of the North American Retail division of Office Depot, Inc. beginning in January 2006 and as Executive Vice President, Chief Marketing Officer and Chief Merchandising Officer of Office Depot from 2004 to January 2006. Prior to joining Office Depot, Mr. Rubin spent six years at Accenture Consulting in senior leadership roles including Partner, where he advised clients and led engagements across retail formats and e-commerce businesses. Prior to that, Mr. Rubin held a number of senior merchandising and general management positions in the specialty retail and department store industry including with Federated Department Stores. He was a member of the executive committee of the board of directors of The National Retail Federation from January 2007 to April 2010. Mr. Rubin holds a B.A. degree from Brandeis University. As a result of these experiences, along with Mr. Rubin s service as our current Chief Executive Officer, he is in position to provide invaluable insight and important contributions to our Board.

Mr. Wallace is a senior managing director at The Blackstone Group in the private equity group, which he joined in 1997. Mr. Wallace received a B.A. in Government from Harvard College. Mr. Wallace serves on the board of directors of AlliedBarton Security Services, GCA Services Group, SeaWorld Parks & Entertainment, Vivint and The Weather Channel Companies. Mr. Wallace was formerly a director of Crestwood Midstream Partners, New Skies Satellites and Pelmorex Media. These experiences and knowledge, along with his service on public company boards, enhance Mr. Wallace s contributions and value to our Board.

In connection with the Merger, the Sponsors entered into an agreement providing that Michaels Holdings, LLC will vote its shares of the Company so that each Board member of Michaels Holdings, LLC will serve on the Board.

Executive Officers

Our current executive officers, their ages as of April 25, 2014, and their business experience during at least the past five years are set forth below.

Name	Age	Position
Carl S. Rubin	54	Chief Executive Officer; Director
Charles M. Sonsteby	60	Chief Administrative Officer and Chief Financial Officer
Theodore J. Bachmeier	51	Executive Vice President Store Operations
Thomas C. DeCaro	59	Executive Vice President Supply Chain
Philo T. Pappas	55	Executive Vice President Merchandising
Shawn E. Hearn	48	Senior Vice President Human Resources
Dennis A. Mullahy	49	Senior Vice President Growth Initiatives
Michael J. Veitenheimer	57	Senior Vice President General Counsel and Secretary
Lance A. Weibye	44	Vice President Development

Mr. Sonsteby was named Chief Administrative Officer and Chief Financial Officer in October 2010. Prior to joining Michaels, Mr. Sonsteby served in various capacities at Brinker International, Inc. (which owns and operates casual dining restaurants) beginning in March 1990, including as Executive Vice President and Chief Financial Officer from 2001 until 2010, as Senior Vice President of Finance from 1997 to 2001 and as Vice President and Treasurer from 1994 to 1997. Mr. Sonsteby was formerly a director of Zale Corporation.

Mr. Bachmeier was promoted to Executive Vice President Store Operations in September 2013. Prior to his promotion, he served as Zone Vice President of Stores for Michaels from January 2011, Vice President Aaron Brothers Store Operations from July 2008 to January 2011 and District Manager for Michaels from 1997 to July 2008.

Mr. DeCaro was promoted to Executive Vice President Supply Chain in June 2005. Prior to his promotion, Mr. DeCaro served as Senior Vice President Inventory Management since August 2000 when he joined Michaels. From April 1998 until joining the Company, he was Vice President Merchandise for The Walt Disney Company (a multi-national media conglomerate, which also operates retail stores and theme parks). Prior to this, he held the position of Senior Vice President Merchandise Planning and Allocation for Kohl s Department Stores from February 1996 to April 1998. In addition, Mr. DeCaro has held various positions in Merchandise Planning and Allocation and Finance for The Disney Store, The Limited Stores, May Department Stores, and Sanger Harris Department Stores.

Mr. Pappas was named Executive Vice President Merchandising in February 2009. Prior to joining Michaels, he served as Chief Merchandising Officer at Tweeter Home Entertainment Group, Inc. (a specialty consumer electronics retailer) from April 2003 to October 2008. On June 11, 2007, Tweeter and each of its subsidiaries filed voluntary petitions for reorganization under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware in Wilmington, Delaware. Prior to joining Tweeter, Mr. Pappas served in various management positions at Staples, Inc. (an office supply store chain) from November 1994 to April 2003, most recently as Senior Vice President of Merchandising.

Mr. Hearn was named Senior Vice President Human Resources in February 2007. Prior to his promotion, Mr. Hearn served as our Vice President, Field Human Resources since joining Michaels in November 2002. Prior to joining Michaels, he served in various operations, marketing and human resource management positions at KMart Corporation (a multi-national retailer) from August 1981 to October 2002, most recently as Vice President, Advertising.

Mr. Mullahy was named Senior Vice President Growth Initiatives in November 2013. Prior to joining Michaels, he served as Senior Vice President Supply Chain at Ulta Salon, Cosmetics & Fragrance, Inc. from July 2011 to September 2013. Prior to joining Ulta, Mr. Mullahy served as Group Vice President Merchandising and Supply Chain Management at Meijer, Inc. from May 2005 to July 2011. In addition, Mr. Mullahy served in various capacities at Accenture, including as Partner from June 2000 to May 2005.

Mr. Veitenheimer was named Senior Vice President General Counsel and Secretary in January 2008. Prior to joining Michaels, Mr. Veitenheimer served as Senior Vice President of Law and Human Resources of The Bombay Company, Inc. (a specialty retailer focused on home accessories, wall decor and furniture), from June 2007 to December 2007 after having served as a Senior Vice President since February 2006, its Secretary since July 1985 and its General Counsel since November 1983. On September 20, 2007, The Bombay Company, Inc. and its U.S. wholly-owned subsidiaries filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court, Northern District of Texas, Fort Worth Division. Prior to joining The Bombay Company, Mr. Veitenheimer was in private practice of law in Fort Worth, Texas.

Mr. Weibye was named Vice President Development in November 2012. He previously served as our Vice President Real Estate from June 2010 and Senior Director Real Estate since joining the Company in April 2008. Prior to joining Michaels, he served as Senior Manager of Real Estate Development for Kohl s Corporation from July 2004 to April 2008.

CORPORATE GOVERNANCE

Our Board is responsible for governing Michaels business and affairs. Highlights of Michaels corporate governance practices are described below.

Board Committees

Currently, our Board has two active standing committees, an Audit Committee and a Compensation Committee, each of which is required by its charter to consist of no fewer than two directors.

As a result of the Merger and Reorganization, the Parent s Common Stock is held by a small number of stockholders, including entities managed by Bain and Blackstone (and other private equity funds) and certain current and former members of our senior management. In addition, Bain and Blackstone have agreed that they will each have the right to proportional representation on our Board, which has resulted in a portion of our Board being designated by Bain, and a portion of our Board being designated by Blackstone. As the Company is privately held and the members of our Board are selected by our Sponsors, the Board does not maintain policies and procedures by which Michaels stockholders may submit director candidates to the Board or the stockholders for consideration.

Compensation Committee

The two members of the Compensation Committee are Matthew S. Levin and Peter F. Wallace. Please see Item 11. Executive Compensation Compensation Discussion and Analysis for a description of the roles and responsibilities of our Compensation Committee.

Audit Committee

Our Board of Directors has a separately designated Audit Committee. The current members of the Audit Committee are as follows:

Audit Committee
Todd M. Cook (Chairman)
Jill A. Greenthal
Lewis S. Klessel
John J. Mahoney
James A. Quella

Our Board has determined that each member of the Audit Committee is financially literate and has sufficient business and financial expertise to effectively perform his or her duties as a member of the Audit Committee. As the Company is privately held and controlled by our Sponsors, our Board has determined that it is not necessary to designate one or more of our Audit Committee members as an audit committee financial expert at this time. Our Board has not determined whether any of our Audit Committee members is an independent director.

Under its charter, the Audit Committee is generally responsible for overseeing Michaels financial reporting process and assists the Board in fulfilling the Board s oversight responsibilities with respect to: (i) the integrity of Michaels financial statements; (ii) Michaels compliance with legal and regulatory requirements; (iii) the qualifications and independence of Michaels independent registered public accounting firm; and (iv) the performance of the independent registered public accounting firm and of Michaels internal audit function.

Code of Business Conduct and Ethics

We adopted a Code of Business Conduct and Ethics that applies to, among others, our principal executive officer, principal financial officer, and principal accounting officer or controller, or persons performing similar functions. A copy of our Code of Business Conduct and Ethics is available on our Internet website at www.michaels.com under Corporate Corporate Governance. We will post any amendments to our Code of

Business Conduct and Ethics, or waivers of the Code for our executive officers, to our website.

ITEM 11. Executive Compensation.

COMPENSATION DISCUSSION AND ANALYSIS

Introduction

The following Compensation Discussion and Analysis relates to compensation paid to our executive officers named in the Summary Compensation Table for fiscal 2013.

Named Executive Officers

According to SEC rules, the Summary Compensation Table that immediately follows this Compensation Discussion and Analysis must include specific information for each of the following persons: (i) all individuals serving as principal executive officer or acting in a similar capacity during the last completed fiscal year; (ii) all individuals serving as principal financial officer or acting in a similar capacity during the last completed fiscal year; (iii) the three most highly compensated executive officers other than the principal executive officer and principal financial officer who were serving as executive officers at the end of the last completed fiscal year; and (iv) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year. These individuals are: Carl S. Rubin, Chief Executive Officer (who served as principal executive officer for part of the year); Charles M. Sonsteby, former Member of the Interim Office of the Chief Executive Officer (the Office of the CEO) and our Chief Administrative Officer and Chief Financial Officer (who served as principal executive officer for part of the year and principal financial officer for the full year); Thomas C. DeCaro, Executive Vice President Supply Chain; Philo T. Pappas, Executive Vice President Merchandising; and Paula A. Puleo, former Executive Vice President Chief Marketing Officer (the three other most highly compensated individuals who were serving as executive officers at the end of fiscal 2013); Lewis S. Klessel, former Member of the Office of the CEO and Interim Chief Operating Officer (who served as principal executive officer for part of the year); Nicholas E. Crombie, former Executive Vice President Store Operations (for whom disclosure would have been provided but for the fact that he was not serving as an executive officer at the end of fiscal 2013); and Weizhong Wilson Zhu, former Executive Vice President Private Brands & Global Sourcing (for whom disclosure would have been provided but for the fact that he was not serving as an executive officer at the end of fiscal 2013). These officers are referred to as our Named Executive Officers . This Compensation Discussion and Analysis and the executive compensation discussion and tables that immediately follow describe the process, strategy and elements of the Company s compensation plan as applied to our Named Executive Officers.

Compensation Program

The principal objectives of our compensation program are:

- attracting and retaining highly qualified individuals whose contributions result in Michaels meeting or exceeding its financial and strategic goals;
- motivating officers to achieve exceptional levels of operating and financial performance; and
- aligning officer interests with the long-term goals of our stockholders.

Currently, the total compensation for our officers at the Vice President level and above, including our Named Executive Officers, consists of three main components: base salary, annual cash incentive bonuses and long-term equity-based incentive compensation awards. The strategy of the cash incentive compensation program is to provide higher annual cash incentive compensation for exceptional corporate and business financial performance. We also believe that by placing a significant equity opportunity in the hands of executives who are capable of driving and sustaining growth, our stockholders will benefit along with the executives who helped create stockholder value. The table, immediately below, includes the principal components of our pay-for-performance approach.

Component	Purpose	Form	Pay for Performance
Base Salary	Provide sufficient competitive pay to attract and retain experienced and successful executives; reward good performance and business results.	Cash	Adjustments to base salary are based on individual performance, contributions to the business, competitive practices and internal comparisons.
Annual Bonuses	Provide financial incentives to members of management who were in positions to make important contributions to Michaels success.	Cash	The potential award amount varies with the degree to which we achieve our annual financial objectives, as well as the Named Executive Officer s individual job performance.
Long-Term Equity-Based Compensation	Encourage and reward building long-term stockholder value and employment retention; engage executives in innovation and align them with stockholder interests. We currently provide two equity award types to balance specific objectives.		

	• Stock Options: Reward absolute stock price appreciation.	Stock Options	The potential appreciation in our stock price above the option exercise price motivates our Named Executive Officers to build stockholder value. Named Executive Officers may realize value only if our stock price appreciates over the option term.
	• Restricted Stock Awards: Create retention values even during periods of short-term market volatility.	Restricted Stock Awards	Retain certain Named Executive Officers and align them with stockholders interests by awarding a fixed number of common shares upon vesting, which creates retention value even during periods of short-term market volatility.

Compensation Strategy: Policies and Procedures

Role of Compensation Committee and Chief Executive Officer in Compensation Decisions

The Compensation Committee reviews and recommends to the Board for approval the compensation for all executive officers at the level of Executive Vice President and above. The Board is ultimately responsible for determining the compensation of our executive officers at the level of Executive Vice President and above. Both the Compensation Committee and the Board receive recommendations with respect to compensation-related decisions regarding our executive officers, other than the Chief Executive Officer, by senior management, principally the Chief Executive Officer and the Senior Vice President Human Resources. In determining compensation levels for the executive officers, the Compensation Committee considers the scope of an individual s responsibilities, the competitive market salary at comparable companies, an individual s performance and prior experience, the performance of the Company and the attainment of planned financial and strategic initiatives. These factors are evaluated by the Compensation Committee and the Board, with the attainment of planned financial and strategic initiatives given greater weight with respect to executive bonuses. The Compensation Committee considers overall past compensation and incentives in determining the compensation of executive officers and seeks to assure that the executives have appropriate incentives to achieve high levels of Company performance. The Compensation Committee, through its members involvement in other portfolio companies, has experience regarding compensation programs for executive officers. Approvals by the Compensation Committee and recommendations to the Board by the Compensation Committee are based on a number of factors, including a review of competitive market data (as described below) and executive performance (as described below), the experience of the members of the Compensation Committee and alignment of compensation with the overall strategic direction and goals of the Company.

Competitive Market Data and Use of Compensation Consultants

As part of the compensation review process, management and our human resources department provide the Compensation Committee with market survey data on executive total compensation levels and general information regarding executive compensation practices in our industry, including information provided by The Hay Group, Inc., a compensation consulting firm engaged by the Company. The Hay Group s work in 2013 included a review of total compensation of our executive officers in light of amounts paid and compensation targets at comparable companies gathered from its internal sources as well as from published executive compensation surveys. During fiscal 2013, The Hay Group additionally evaluated our equity compensation program and made recommendations to the Compensation Committee and senior management. The Compensation Committee did not aim to set total compensation, or any compensation element, at a specified level as compared to the survey and other data that it reviewed, but rather used the data above, as well as that gathered through its members involvement in other portfolio companies, as guidelines for the overall executive compensation program.

Highlights of 2013 Performance

The highlights of our fiscal 2013 performance include the following:

- Net sales increased to $4,570 million, a 3.7% improvement over last year, which included a 53rd week, driven by a 2.9% increase in comparable store sales and the opening of 40 new Michaels stores and the relocation of 14 Michaels and 2 Aaron Brothers stores.

- We reported record operating income of $611 million, an increase of 3.2% from prior year.

- Net income increased by $64 million to $264 million.

- Adjusted EBITDA, a non-GAAP measure that is a required calculation in our debt agreements, improved by 6.2%, from $747 million in fiscal 2012 to $793 million in fiscal 2013 (see Non-GAAP Measures).

Throughout this Compensation Discussion and Analysis, we refer to our Adjusted EBITDA, a non-GAAP financial measure. A reconciliation of adjusted EBITDA to the most directly comparable GAAP financial measure is contained on page 37 of this Annual Report on Form 10-K.

Compensation Elements

Base Salaries

Base salaries for our executive officers are established based on the scope of their responsibilities, individual performance and prior experience, Michaels operating and financial performance and the attainment of planned financial and strategic initiatives, taking into account the knowledge of the members of the Compensation Committee regarding competitive market compensation paid by companies for similar positions. The Compensation Committee recommends, and the Board sets, base salaries for officers at the level of Executive Vice President and above at a level designed to attract and retain highly qualified individuals who make contributions that result in Michaels meeting its operating and financial goals. Base salaries are reviewed and adjusted annually as deemed appropriate by the Compensation Committee and the Board, as applicable, based on performance and business results, among other factors. The Compensation Committee and the Board have discretion to adjust base salary during the fiscal year and exercised that discretion in fiscal 2013, as described below.

Effective March 18, 2013, Mr. Rubin was named Chief Executive Officer of the Company. Pursuant to his negotiated employment agreement, Mr. Rubin s base salary was set at $1,100,000, subject to increase at the Board s discretion. In setting Mr. Rubin s base salary, the Compensation Committee considered Mr. Rubin s compensation at his prior employer, the compensation of John B. Menzer, who was Mr. Rubin s predecessor as Chief Executive Officer the Company, and the level of compensation needed to recruit Mr. Rubin to the Company. In the opinion of the members of the Compensation Committee, based on their experience with other companies, including other portfolio companies, this salary level represented a competitive market level for the position.

In March 2013, the Compensation Committee reviewed recommendations regarding 2013 annual base salary rates for the executive officer group based on the criteria set forth under Compensation Discussion and Analysis Compensation Strategy: Policies and Procedures. Merit guidelines are determined by reviewing surveys of market data provided by our management and human resources department, as well as giving consideration to the Company s overall budget for associate compensation. Based upon this information, the Company applied an annual merit rate budget of 3.0%, which provided for median merit based increases at 3.0%, for fiscal 2013 for its corporate support center associates, including our Named Executive Officers.

Annual base salary rates for the Named Executive Officers (other than Mr. Klessel) for fiscal 2012 and 2013, which reflect increases between the two fiscal years, are shown below.

Executive		Base Salary 2013		2012
Carl S. Rubin (1)	$	1,100,000	$	
Lewis S. Klessel (2)				
Charles M. Sonsteby		711,109		687,061
Thomas C. DeCaro		393,437		381,978
Philo T. Pappas		431,897		419,318
Paula A. Puleo (3)		362,000		328,952
Nicholas E. Crombie (4)		362,187		355,085
Weizhong Wilson Zhu (5)		387,777		376,483

(1) Pursuant to Mr. Rubin s employment agreement his base salary was set at $1,100,000, subject to increase at the Board s discretion.

(2) Mr. Klessel is a managing director of, and receives compensation and benefits through, Bain. Effective May 16, 2012, Mr. Klessel was appointed, along with the Company s Chief Administrative Officer and Chief Financial Officer, Charles M. Sonsteby, to the Office of the CEO. Effective as of such date, Mr. Klessel was also appointed to the newly-created position of interim Chief Operating Officer of the Company. The Office of the CEO was discontinued, effective March 18, 2013, Mr. Rubin s start date with the Company and the date Mr. Klessel resigned from his position as interim Chief Operating Officer. Mr. Klessel received no compensation from the Company for his service as Member of the Office of the CEO and Interim Chief Operating Officer.

(3) Ms. Puleo received a base salary increase of 10.0% in connection with her promotion to the position of Executive Vice President Chief Marketing Officer on February 3, 2013 and therefore did not receive an additional base salary adjustment in March 2013.

(4) Mr. Crombie left the Company on July 27, 2013.

(5) Mr. Zhu left the Company on November 15, 2013.

Annual Bonuses

In March 2013, the Compensation Committee recommended that the Board approve the Company s Bonus Plan for executive officers, including the Named Executive Officers (other than Mr. Klessel), for fiscal 2013 (the Bonus Plan) to provide financial incentives to these individuals and those other members of management who were in positions to make important contributions to Michaels success. The Board subsequently approved the Bonus Plan. The structure of the Bonus Plan and the specific objectives relating to bonus payments were proposed by the Members of the Interim Office of the Chief Executive Officer and the Senior Vice President Human Resources and were reviewed by the Compensation Committee. For each of Messrs. Rubin and Sonsteby, the Bonus Plan tied 80% of his respective bonus opportunity to Michaels attainment of a financial objective (EBITDA, less an inventory charge), and 20% to individual job performance. For each of Mr. DeCaro, Mr. Pappas and Mr. Zhu, and Ms. Puleo, the Bonus Plan tied 50% of his or her respective bonus opportunity to Michaels attainment of a financial objective (EBITDA, less an inventory charge), 15% to a business unit sales objective (sales for all U.S. Michaels stores), 15% to a business unit buyer contribution objective (generally margin, plus entitlements, less an inventory charge), and 20% to individual job performance. For Mr. Crombie, the Bonus Plan tied 50% of his bonus opportunity to Michaels attainment of a financial objective (EBITDA, less an inventory charge), 15% to a business unit sales objective (U.S. and Canada sales for all Company stores), 15% to an objective relating to the Company s operating income, and 20% to individual job performance. Individual management business objectives for Mr. Rubin were reviewed with the Compensation Committee prior to the commencement of his employment with the Company on March 18, 2013. Individual management business objectives for Mr. Sonsteby were reviewed with and approved by the Compensation Committee in the early part of fiscal year 2013. Individual management business objectives for Messrs. Crombie, Pappas and Zhu, and Ms. Puleo, were reviewed with and approved by the Members of the Interim Office of the Chief Executive Officer. For Mr. DeCaro, these objectives were reviewed and approved by the Chief Administrative Officer and Chief Financial Officer.

Under the Bonus Plan, before any business unit or individual performance payout would be earned, the actual results of the financial objective (EBITDA, less an inventory charge) was required to meet the threshold established by the Compensation Committee, which represented approximately 93% of target. Each participating Named Executive Officer was entitled to a bonus equal to a certain percentage of that executive officer s base salary, depending on the achievement of the threshold, target and maximum performance level. The Compensation Committee set threshold, target and maximum performance levels for all officers of the Company. The final award depended on the actual level of performance achieved; however, the Compensation Committee retained the right to make adjustments in its sole discretion. The target levels of performance for the bonus goals were set at levels that the Compensation Committee and the Board believed to be reasonably achievable in view of Michaels historical annual performance. In the Compensation Committee s view, taking into account comparative data provided to the Committee by management and our human resources department, the compensation payable to the Named Executive Officers upon reaching target levels of performance, when added to their base salaries, creates a level of total cash compensation competitive with that paid by comparable companies for similar positions. Additional information regarding the targets and objectives is set forth below.

The target percentages set for fiscal 2013 and the threshold, target and maximum payments, for each of the Named Executive Officers for fiscal 2013 were as follows:

	Carl S. Rubin (1)	Lewis S. Klessel (2)	Charles M. Sonsteby	Thomas C. DeCaro	Philo T. Pappas	Paula A. Puleo (3)	Nicholas E. Crombie (4)	Weizhong Wilson Zhu (5)
Percentage of Base Salary								
Target	100%		70%	50%	50%	50%	50%	50%
Threshold	18%		13%	9%	9%	9%	9%	9%
Maximum	200%		140%	100%	100%	100%	100%	100%
Financial Weightings								
Overall Company Results	80%		80%	50%	50%	50%	50%	50%
Company Sales				15%	15%	15%	15%	15%
				15%	15%	15%		15%

Buyer Contribution Less Inventory Charge								
Company Operating Income							15%	
Individual Performance	20%		20%	20%	20%	20%	20%	20%

(1) Pursuant to Mr. Rubin s employment agreement his target bonus for fiscal 2013 was set at 100% of base salary, as if he had been employed for the full fiscal year (with a maximum bonus at 200% of his base salary).

(2) Mr. Klessel received no compensation from the Company for his service as Member of the Interim Office of the CEO and Interim Chief Operating Officer and did not participate in the Bonus Plan.

(3) Ms. Puleo separated from the Company on March 9, 2014. Pursuant to the Bonus Plan, Ms. Puleo will receive her full earned bonus for fiscal 2013.

(4) Mr. Crombie retired from the Company on July 27, 2013 and is not eligible for a bonus for fiscal 2013.

(5) Mr. Zhu left the Company on November 15, 2013. In connection with his departure, the Company entered into an agreement with Mr. Zhu, whereby Mr. Zhu will receive his earned pro-rated bonus for fiscal year 2013 pursuant to the Bonus Plan, under established bonus criteria associated with the Bonus Plan, on the same terms as bonuses paid to other executive officers of the Company.

Company Objective Measures

In March 2014, the Compensation Committee reviewed the Company s financial results as applicable to the pre-established fiscal 2013 Bonus Plan objectives for the Named Executive Officers. As described previously, the financial objective of Company performance that was applicable to all the Named Executive Officers was EBITDA, less an inventory charge. At the beginning of fiscal 2013, the Compensation Committee established, and the Board approved, the EBITDA, less an inventory charge, goal for target-level bonuses at $690.8 million, with a maximum at $768.6 million and a threshold at $642.6 million. For the fiscal year, the Company achieved financial performance of $662.1 million, which was between threshold and target. As a result, bonuses above threshold, but below target, were earned for the Company performance element of the plan.

At the beginning of fiscal 2013, the Compensation Committee approved a business unit sales objective goal for target level bonuses for each of Messrs. DeCaro, Pappas, Crombie and Zhu and Ms. Puleo at $4,463.3 million, with a maximum at $4,686.4 million and a threshold at $4,351.7 million. The Compensation Committee also approved a business unit buyer contribution objective goal for target level bonuses for Messrs. DeCaro, Pappas and Zhu and Ms. Puleo at $2,244.9 million, with a maximum at $2,357.1 million and a threshold at $2,188.8 million, and a Company operating income objective goal for a target level bonus for Mr. Crombie at $552.4 million, with a maximum at $607.7 million and a threshold at $519.3 million. For the fiscal year, the Company achieved business unit sales of $4,430.3 million, which was between threshold and target, a business unit buyer contribution of $2,187.8 million, which was below threshold, and Company operating income of $519.0 million, which was below threshold. As a result, bonuses below target were earned for the business unit sales objective element of the plan, and bonuses were not earned for the business unit buyer contribution element of the plan and the Company operating income element of the plan.

Company Subjective Measures

Since the financial objective threshold that is applicable to all Named Executive Officers was met, in March 2014 the Compensation Committee, based upon input and recommendations by Messrs. Rubin and Sonsteby, as applicable, evaluated the individual performance of each of the Named Executive Officers for purposes of determining bonuses based on individual performance. The individual management business objectives are both quantitative and subjective, and are assessed in the aggregate to determine the individual s level of performance and bonus achieved. No specified weight is given to a single measure within the group of individual management business objectives, and the Compensation Committee s assessment of achievement reflects a generalized view of overall achievement of the group of measures. In addition, the individual management business objectives for all executives included an assessment of the executive s job knowledge and skills, communication skills, interpersonal skills, effectiveness of management, judgment and decision-making, drive and commitment, leadership and customer satisfaction.

For fiscal 2013, Mr. Rubin s group of individual management business objectives were focused primarily on EBITDA, margin improvement and year-over-year comparable sales growth, as well as solidifying the Company s leadership team and defining its appropriate long-term strategy. The Compensation Committee determined that Mr. Rubin achieved his individual objectives at 200% of target. Mr. Sonsteby s group of individual management business objectives were focused primarily on new store growth and performance, increasing profitability and cash flow, effective use of capital and development of future strategies. The Compensation Committee determined that Mr. Sonsteby achieved his individual objectives at 100% of target. Mr. DeCaro s group of individual management business objectives focused primarily on increasing profitability and cash flow, improvement in inventory turnover and in-stocks, supply chain cost management, and growth in private brand sales and gross margin. The Compensation Committee determined that Mr. DeCaro achieved his individual objectives at 50% of target. For Mr. Pappas, his group of individual management business objectives focused primarily on increasing profitability and cash flow, store offering competiveness, pricing improvement, new business development, and growth in private brand sales and gross margin. The Compensation Committee determined that Mr. Pappas achieved his individual objectives at 100% of target.

Ms. Puleo left the Company on March 9, 2014. Pursuant to the terms of the Bonus Plan, she will receive her full earned bonus for fiscal 2013. Ms. Puleo was credited as achieving her individual objectives component at a fixed 50% of target, in accordance with the terms of the Bonus Plan. Mr. Crombie retired from the Company on July 27, 2013 and was not eligible to receive a bonus for fiscal 2013 in accordance with the terms of the Bonus Plan. Mr. Zhu left the Company on November 15, 2013. In connection with Mr. Zhu s departure, the Company entered into an agreement with him, whereby he will receive his earned pro-rated bonus for fiscal year 2013 pursuant to the Bonus Plan, under established bonus criteria associated with the Bonus Plan, on the same terms as bonuses paid to other executive officers of the Company. Mr. Zhu was credited as achieving his individual objectives component at a fixed 50% of target, in accordance with the terms of the Bonus Plan.

Actual Payouts

Actual payouts for the Named Executive Officers, as a percentage of target level bonus, were as follows:

	Carl S. Rubin	Lewis S. Klessel (1)	Charles M. Sonsteby	Thomas C. DeCaro	Philo T. Pappas	Paula A. Puleo (2)	Nicholas E. Crombie (3)	Weizhong Wilson Zhu (4)
Percent of Target	77%	N/A	57%	44%	54%	44%	N/A	44%

(1) Mr. Klessel received no compensation from the Company for his service as Member of the Interim Office of the CEO and Interim Chief Operating Officer and did not participate in the Bonus Plan.

(2) Ms. Puleo separated from the Company on March 9, 2014. Pursuant to the Bonus Plan, Ms. Puleo received her full earned bonus for fiscal 2013.

(3) Mr. Crombie retired from the Company on July 27, 2013 and is not eligible for a bonus for fiscal 2013.

(4) Mr. Zhu left the Company on November 15, 2013. In connection with his departure, the Company entered into an agreement with Mr. Zhu, whereby Mr. Zhu received his earned pro-rated bonus for fiscal year 2013 pursuant to the Bonus Plan, under established bonus criteria associated with the Bonus Plan, on the same terms as bonuses paid to other executive officers of the Company.

Long term equity-based compensation

Under our certificate of incorporation, equity-based plans must be approved by a majority of our stockholders. On February 15, 2007, our Board and stockholders approved the Michaels Stores, Inc. 2006 Equity Incentive Plan (as amended, the Equity Incentive Plan or the Plan), as well as certain specific grants under the Equity Incentive Plan to officers. In addition, the stockholders granted the Board authority to make Equity Incentive Plan grants to other eligible participants in the future. The Equity Incentive Plan was established to advance the interests of Michaels and its affiliates by providing for the grant of equity-based awards to eligible officers, associates, directors of, and consultants and advisors to, Michaels or its affiliates. Awards under the Equity Incentive Plan are intended to align the long term incentives of our executives and stockholders. All stock option grants made in fiscal 2013 were at exercise prices set at or above the grant date fair market value of the underlying stock as determined by our Board. In connection with the Reorganization in July 2013, the Equity Incentive Plan was assumed by The Michaels Companies, Inc. (Parent) and the stock underlying outstanding awards became, and the stock upon which future awards will be based will be, the Common Stock of Parent.

Historically, the majority of outstanding options under the Equity Incentive Plan were divided into tranches with escalating exercise prices. The tranche structure of the option awards, with increasing exercise prices in each tranche, was designed to incentivize long term performance by tying the value of the options to long term increases in the value of our Common Stock. These grants were not made on an annual basis; rather, each initial grant was intended to incentivize the executive for a five-year period based on the vesting and exercise structure of the grant. For these options, each tranche vests 20% on each of the first through fifth anniversaries of the grant date, and all unvested options vest immediately upon a Change of Control (as defined in the Stockholders Agreement).

Beginning in 2013, the Company began issuing annual option grants that will vest over four years and accelerate in full on a Change of Control. The Company made the first of such grants in July 2013. Detail regarding option grants made to our Named Executive Officers in fiscal year 2013 and awards outstanding at the end of fiscal year 2013 is provided, respectively, in the Grants of Plan-Based Awards for Fiscal 2013 table and the Outstanding Equity Awards at Fiscal Year-End 2013 table that follow this Compensation Discussion and Analysis.

In July 2013, Parent paid a cash dividend to equity holders. In accordance with the terms of the Equity Incentive Plan, Parent also made cash payments and exercise price adjustments to outstanding equity awards to take account of the decreased fair value of Parent Common Stock as a result of the cash dividend.

Other Benefits and Perquisites

Our Named Executive Officers also receive certain other benefits and perquisites. During fiscal 2013, these benefits included contributions to 401(k) accounts, the payment of life insurance premiums, certain Company-paid medical benefits, car allowances and, in some cases, tax gross-ups and reimbursement for income taxes on taxable benefits. Additionally, our Chief Executive Officer, Mr. Rubin, was also entitled to the use of a Company-owned or leased automobile. The Compensation Committee and the Board believe these benefits and perquisites are reasonable and consistent with the nature of the executives responsibilities, provide a competitive level of total compensation to our executives and serve as an important element in retaining those individuals. The cost to Michaels of these benefits to the Named Executive Officers is set forth in the Summary Compensation Table under the column All Other Compensation and detail about each element is set forth in the table presented in footnote 5 to the Summary Compensation Table.

Employment and Severance Agreements

We entered into an employment agreement with Mr. Rubin, which became effective on March 18, 2013, the date he commenced employment, which includes certain severance benefits in the event of termination other than for cause or by Mr. Rubin for good reason, as such terms are defined in the agreement. The specific terms of Mr. Rubin s employment agreement, are discussed in the section entitled Rubin Employment Agreement following the Grants of Plan-Based Awards Table and under Executive Compensation Potential Payments upon Termination or Change of Control .

In April 2008, the Board approved the Company s Officer Severance Pay Plan (the OSPP), which was amended in July 2008. The OSPP was established by the Company to provide certain severance benefits, subject to the terms and conditions of the OSPP, to designated officers (those with a position of Vice President or above, or an equivalent title as approved by the Compensation Committee, and excluding the Chief Executive Officer) in the event that their employment is terminated as a result of a Qualifying Termination (as defined in the OSPP and described below). A more detailed description of the OSPP may be found under Executive Compensation Potential Payments upon Termination or Change of Control .

Ms. Puleo s employment with the Company ended on March 9, 2014, and her severance benefits under the OSPP were triggered. Ms. Puleo executed a Severance Agreement and Release, which included, in addition to a release of all claims against the Company, a forfeiture of all outstanding unvested stock options and a confidentiality, non-solicitation, non-compete and non-interference agreement. Pursuant to her Severance Agreement and Release under the OSPP, Ms. Puleo is receiving: (i) eighteen months of base salary continuation in accordance with the Company s regular payroll practices; (ii) her earned bonus for fiscal 2013; (iii) a prorated target annual bonus for fiscal 2014; and (iv) the continuation of group medical and dental benefits for the eighteen month salary continuation period. The actual amounts payable to Ms. Puleo in connection with her separation are set forth under Executive and Director Compensation Potential Payments upon Termination or Change in Control .

Tax and Accounting Considerations

Deductibility of Executive Compensation. While the Compensation Committee takes into account tax and accounting considerations in structuring the components of the Company s compensation program, these considerations are secondary to the primary objectives of the program. Section 162(m) of the Code (Section 162(m)) disallows a U.S. federal income tax deduction to any publicly held corporation for compensation exceeding $1 million in any taxable year to any of the corporation s chief executive officer or other three most highly paid named executive officers other than its chief financial officer, except as to compensation that qualifies as performance-based or is otherwise exempt under Section 162(m). Because the equity securities of the Company are not currently publicly traded, the deduction limits of Section 162(m) of the Code do not apply to us.

The Company s Compensation Policies and Practices as They Relate to Risk Management

In accordance with the applicable disclosure requirements, to the extent that risks may arise from the Company s compensation policies and practices that are reasonably likely to have a material adverse effect on the Company, the Company is required to discuss those policies and practices for compensating the employees of the Company (including employees that are not Named Executive Officers) as they relate to the Company s risk management practices and the possibility of incentivizing risk-taking.

The Compensation Committee has evaluated the policies and practices of compensating the Company s employees in light of the relevant factors, including the following:

- the financial performance targets of the Company s annual cash incentive program are the budgeted objectives that are reviewed and approved by the Board and/or the Compensation Committee

- bonus payouts are not based solely on Company performance, but also require achievement of individual performance objectives

- bonus awards generally are not contractual entitlements, but are reviewed by the Compensation Committee and/or the Board and can be modified at their discretion

- the financial opportunity in the Company s long-term equity-based compensation is best realized through long term appreciation of the Company s stock price, which mitigates excessive short-term risk-taking

- the allocation of compensation between cash and equity awards and the focus on stock-based compensation, including options and restricted stock awards generally vesting over a period of years, thereby mitigating against short-term risk taking

Based on such evaluation, the Compensation Committee has determined that the Company s policies and practices are not reasonably likely to have a material adverse effect on the Company.

COMPENSATION COMMITTEE REPORT

The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) of Regulation S-K with management and, based on such review and discussion, the Compensation Committee recommended to the Board that the Compensation Discussion and Analysis be included in this Annual Report on Form 10-K.

THE COMPENSATION COMMITTEE

Matthew S. Levin
Peter F. Wallace

EXECUTIVE AND DIRECTOR COMPENSATION

Summary Compensation Table

According to SEC rules, the Summary Compensation Table must include specific information for each of the Named Executive Officers previously identified in the Compensation Discussion and Analysis above.

Name and Principal Position	Year	Salary ($) (1)	Bonus ($)	Stock Awards ($) (2)	Option Awards ($) (3)	Non-Equity Incentive Plan Compensation ($) (4)	All Other Compensation ($) (5)	Total ($)
Carl S. Rubin *Chief Executive Officer (6)*	2013	$ 930,769	$	$ 6,099,187	$ 10,657,671	$ 847,660(7)	$ 2,142,407	$ 20,677,694
[redacted]								
Lewis S. Klessel *Former Member of the Interim Office of the Chief Executive Officer and Interim Chief Operating Officer (8)*	2013 2012							
Charles M. Sonsteby	2013	706,484		450,026	558,709	284,017	765,464	2,764,700
Chief Administrative Officer and	2012	683,213				382,899	26,469	1,092,581
Chief Financial Officer	2011	662,181				538,576	36,057	1,236,814
[redacted]								
Thomas C. DeCaro	2013	389,720		183,464	227,771	86,871	1,136,701	2,024,527
Executive Vice President -	2012	380,537				105,731	34,987	521,255
Supply Chain	2011	369,473				181,851	39,579	590,903
Philo T. Pappas	2013	429,478		2,573,624	344,671	116,958	1,083,175	4,547,906
Executive Vice President -	2012	416,591				116,067	32,872	565,530
Category Management	2011	399,986				257,506	41,945	699,437
Paula A. Puleo *Former Executive Vice President - Chief Marketing Officer* (9)	2013	360,729		277,624	471,494	79,930(10)	450,682	1,640,459
Nicholas E. Crombie	2013	186,693		183,464				