Ulta Salon, Cosmetics & Fragrance, Inc.
Form 10-Q
December 10, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended November 1, 2008

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from __________________ to __________________

Commission File Number: 001-33764

ULTA SALON, COSMETICS & FRAGRANCE, INC.
(Exact name of Registrant as specified in its charter)

Delaware	**36-3685240**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1000 Remington Blvd., Suite 120 Bolingbrook, Illinois	**60440**
(Address of principal executive offices)	(Zip code)

Registrant s telephone number, including area code: (630) 410-4800

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. þ Yes o No

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (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). o Yes þ No

The number of shares of the registrant s common stock, par value $0.01 per share, outstanding as of December 4, 2008 was 57,671,142 shares.

ULTA SALON, COSMETICS & FRAGRANCE, INC.
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Part I Financial Information

Item 1. Consolidated Financial Statements

Ulta Salon, Cosmetics & Fragrance, Inc.
Consolidated Balance Sheets

(In thousands)	November 1, 2008 (unaudited)	February 2, 2008	November 3, 2007 (unaudited)
Assets			
Current assets:			
Cash and cash equivalents	$ 3,648	$ 3,789	$ 3,512
Receivables, net	20,488	20,643	16,089
Merchandise inventories, net	268,928	176,109	219,453
Prepaid expenses and other current assets	24,960	19,184	27,726
Deferred income taxes	9,088	9,219	5,614
Total current assets	327,112	228,944	272,394
Property and equipment, net	292,120	236,389	226,533
Deferred income taxes	4,080	4,080	4,125
Total assets	$623,312	$469,413	$503,052
Liabilities and stockholders equity			
Current liabilities:			
Current portion notes payable	$ 51,590	$	$ 41,962
Accounts payable	97,768	52,122	85,985
Accrued liabilities	50,532	54,719	55,669
Accrued income taxes	5,798	5,064	
Total current liabilities	205,688	111,905	183,616
Notes payable less current portion	86,390	74,770	55,038
Deferred rent	100,126	71,235	66,655
Total liabilities	392,204	257,910	305,309
Commitments and contingencies			

See accompanying notes to consolidated financial statements.

Ulta Salon, Cosmetics & Fragrance, Inc.
Consolidated Balance Sheets (continued)

(In thousands, except per share data)	**November 1, 2008** (unaudited)	**February 2, 2008**	**November 3, 2007** (unaudited)
Stockholders equity:			
Common stock, $.01 par value, 400,000 shares authorized; 58,168, 57,411 and 57,276 shares issued; 57,663, 56,906 and 56,771 shares outstanding; at November 1, 2008 (unaudited), February 2, 2008 and November 3, 2007 (unaudited), respectively	$ 582	$ 574	$ 573
Treasury stock-common, at cost	(4,179)	(4,179)	(4,179)
Additional paid-in capital	291,362	284,951	284,362
Accumulated deficit	(56,144)	(69,124)	(82,728)
Accumulated other comprehensive loss	(513)	(719)	(285)
Total stockholders equity	231,108	211,503	197,743
Total liabilities and stockholders equity	$623,312	$469,413	$503,052

See accompanying notes to consolidated financial statements.

Ulta Salon, Cosmetics & Fragrance, Inc.
Consolidated Statements of Income
(unaudited)

	Three months ended		Nine months ended	
(In thousands, except per share data)	**November 1, 2008**	**November 3, 2007**	**November 1, 2008**	**November 3, 2007**
Net sales	$254,843	$208,235	$743,252	$602,797
Cost of sales	175,368	140,156	516,710	416,173
Gross profit	79,475	68,079	226,542	186,624
Selling, general and administrative expenses	65,176	55,609	189,130	154,779
Pre-opening expenses	4,693	4,494	12,515	9,064
Operating income	9,606	7,976	24,897	22,781
Interest expense	1,124	1,307	3,055	3,465
Income before income taxes	8,482	6,669	21,842	19,316
Income tax expense	3,465	2,463	8,862	7,585
Net income	$ 5,017	$ 4,206	$ 12,980	$ 11,731
Less preferred stock dividends		3,598		11,219
Net income available to common stockholders	$ 5,017	$ 608	$ 12,980	$ 512
Net income per common share:				
Basic	$ 0.09	$ 0.06	$ 0.23	$ 0.06
Diluted	$ 0.09	$ 0.05	$ 0.22	$ 0.05
Weighted average common shares outstanding:				
Basic	57,591	10,179	57,328	8,252
Diluted	59,013	12,476	59,005	10,447

See accompanying notes to consolidated financial statements.

Ulta Salon, Cosmetics & Fragrance, Inc.
Consolidated Statements of Cash Flows
(unaudited)

(Dollars in thousands)	Nine months ended November 1, 2008	Nine months ended November 3, 2007
Operating activities		
Net income	$ 12,980	$ 11,731
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	37,619	28,597
Non-cash stock compensation charges	2,644	1,635
Excess tax benefits from stock-based compensation	(1,565)	(1,542)
Loss (gain) on disposal of property and equipment	219	(11)
Change in operating assets and liabilities:		
Receivables	155	2,387
Merchandise inventories	(92,819)	(90,216)
Prepaid expenses and other assets	(5,776)	(10,596)
Accounts payable	45,646	42,914
Accrued liabilities	1,488	(4,065)
Deferred rent	28,891	16,288
Net cash provided by (used in) operating activities	29,482	(2,878)
Investing activities		
Purchases of property and equipment	(96,608)	(74,648)
Receipt of related party notes receivable		4,467
Net cash used in investing activities	(96,608)	(70,181)
Financing activities		
Proceeds on long-term borrowings	874,139	750,262
Payments on long-term borrowings	(810,929)	(703,999)
Proceeds from issuance of common stock under stock plans	2,269	953
Excess tax benefits from stock-based compensation	1,565	1,542
Proceeds from issuance of common stock in initial public offering, net of issuance costs	(59)	123,921
Payment of accumulated dividends in arrears		(93,012)
Redemption of Series III preferred stock		(4,792)
Purchase of treasury stock		(1,949)
Net cash provided by financing activities	66,985	72,926
Net decrease in cash and cash equivalents	(141)	(133)
Cash and cash equivalents at beginning of period	3,789	3,645

Cash and cash equivalents at end of period	$ 3,648	$ 3,512

See accompanying notes to consolidated financial statements.

Ulta Salon, Cosmetics & Fragrance, Inc.
Consolidated Statements of Cash Flows (continued)
(unaudited)

(Dollars in thousands)	Nine months ended November 1, 2008	Nine months ended November 3, 2007
Supplemental cash flow information		
Cash paid for interest	$ 3,437	$ 3,863
Cash paid for income taxes	$ 6,589	$16,486
Noncash investing and financing activities:		
Change in property and equipment included in accrued liabilities	$(3,039)	$18,390
Unrealized gain (loss) on interest rate swap hedge, net of tax	$ 206	$ (304)

See accompanying notes to consolidated financial statements.

Ulta Salon, Cosmetics & Fragrance, Inc.
Consolidated Statements of Stockholders Equity
(unaudited)

(In thousands)	Common Stock Issued Shares	Common Stock Amount	Treasury Common Stock Treasury Shares	Treasury Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders Equity
Balance February 2, 2008	57,411	$ 574	(505)	$ (4,179)	$ 284,951	$ (69,124)	$ (719)	$ 211,503
Common stock options exercised	757	8			2,261			2,269
Unrealized gain on interest rate swap hedge, net of $131 income tax							206	206
Net income for the nine months ended November 1, 2008						12,980		12,980
Comprehensive income								13,186
Excess tax benefits from stock-based compensation					1,565			1,565
Stock compensation charge					2,644			2,644
Initial public offering issuance costs					(59)			(59)
Balance November 1, 2008	58,168	$ 582	(505)	$ (4,179)	$ 291,362	$ (56,144)	$ (513)	$ 231,108

See accompanying notes to consolidated financial statements.

Ulta Salon, Cosmetics & Fragrance, Inc.
Notes to Consolidated Financial Statements
(unaudited)

1. Business and basis of presentation

The accompanying consolidated financial statements of Ulta Salon, Cosmetics & Fragrance, Inc. (the Company) include Ulta Salon, Cosmetics & Fragrance, Inc. and its wholly owned subsidiary, Ulta Internet Holdings, Inc. (Internet). All inter-company balances and transactions have been eliminated. The operations of Internet were merged into the Company during 2006, resulting in its dissolution as a separate legal entity on November 30, 2006.

All amounts are stated in thousands, with the exception of per share amounts and number of stores.

The Company was incorporated in the state of Delaware on January 9, 1990, to operate specialty retail stores selling cosmetics, fragrance, haircare and skincare products, and related accessories and services. The stores also feature full-service salons. As of November 1, 2008, the Company operated 304 stores in 35 states, as shown in the table below:

State	Number of stores
Alabama	6
Arizona	22
California	28
Colorado	10
Delaware	1
Florida	20
Georgia	16
Illinois	31
Indiana	6
Iowa	2
Kansas	1
Kentucky	2
Louisiana	2
Maryland	6
Massachusetts	3
Michigan	8
Minnesota	6
Missouri	2
Nebraska	2
Nevada	6
New Jersey	9
New York	9
North Carolina	12
Ohio	5
Oklahoma	6
Oregon	3
Pennsylvania	13
Rhode Island	1
South Carolina	4
Tennessee	3
Texas	42
Utah	2
Virginia	9

Washington	4
Wisconsin	2
Total	**304**

The accompanying unaudited consolidated financial statements and related notes have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and the U.S. Securities and Exchange Commission s Article 10, Regulation S-X. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments, which are of a normal recurring nature, necessary to fairly state the consolidated financial position and results of operations and cash flows for the interim periods presented.

The Company s business is subject to seasonal fluctuation. Significant portions of the Company s net sales and net income are realized during the fourth quarter of the fiscal year due to the holiday selling season. The results for the three and nine months ended November 1, 2008 and November 3, 2007 are not necessarily indicative of the results to be expected for the fiscal year ending January 31, 2009, or for any other future interim period or for any future year. These interim financial statements and the related notes should be read in conjunction with the financial statements and notes included in the Company s Annual Report on Form 10-K for the year ended February 2, 2008.

Reverse stock split

On September 17, 2007, the Company s Board of Directors approved a resolution to effect a reverse stock split of the Company s common stock pursuant to which each share of common stock was to be converted into 0.632 of one share of common stock. The reverse stock split became effective on October 22, 2007. Any fractional shares resulting from the reverse stock split were rounded to the nearest whole share. Common share and per share amounts for all periods presented and the conversion ratio of preferred to common shares have been adjusted for the 0.632 for 1 reverse stock split.

Initial public offering

On October 30, 2007, the Company completed an initial public offering in which the Company sold 7,667 shares of common stock resulting in net proceeds of $123,549 after deducting underwriting discounts and commissions and offering expenses. Selling stockholders sold approximately 2,154 additional shares of common stock. The Company did not receive any proceeds from the sale of shares by the selling stockholders. The Company used the net proceeds from the offering to pay $93,012 of accumulated dividends in arrears on the Company s preferred stock, which satisfied all amounts due with respect to accumulated dividends, $4,792 to redeem the Company s Series III preferred stock, and $25,745 to reduce the Company s borrowings under its third amended and restated loan and security agreement and for general corporate purposes. Also in connection with the offering, the Company converted 41,524 preferred shares into common shares and restated the par value of its common stock to $0.01 per share.

2. Summary of significant accounting policies

Information regarding the Company s significant accounting policies is contained in Note 2, Summary of significant accounting policies, to the financial statements in the Company s Annual Report on Form 10-K for the year ended February 2, 2008. Presented below in this and the following notes is supplemental information that should be read in conjunction with Notes to consolidated financial statements in the Annual Report.

Fiscal quarter

The Company s quarterly periods are the 13 weeks ending on the Saturday closest to April 30, July 31, October 31, and January 31. The Company s third quarters in fiscal 2008 and 2007 ended on November 1, 2008 and November 3, 2007, respectively.

Share-based compensation

Effective January 29, 2006, the Company adopted the fair value recognition and measurement provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. Pursuant to SFAS 123(R), share-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the requisite service period for awards expected to vest. As a non-public entity that previously used the minimum value method for pro forma disclosure purposes under SFAS 123, the Company was required to adopt the prospective method of accounting under SFAS 123(R). Under this transitional method, the Company is required to record compensation expense in the consolidated statements of income for all awards granted after the adoption date and to awards modified, repurchased, or cancelled after the adoption date using the fair value provisions of SFAS 123(R).

The Company estimates the grant date fair value of stock options using a Black-Scholes valuation model. The expected volatility is based on the historical volatilities of a peer group of publicly-traded companies. The risk free interest rate is based on the U.S. Treasury yield curve in effect on the date of grant for the respective expected life of the option. The expected life represents the time the options granted are expected to be outstanding. The Company has elected to use the shortcut approach in accordance with the Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment* and SAB No. 110, *Simplified Method for Plain Vanilla Share Options,* to develop the expected life. Any dividend the Company might declare in the future would be subject to the applicable provisions of its credit agreement, which currently restricts the Company s ability to pay cash dividends. The Company recognizes compensation cost related to the stock options on a straight-line method over the requisite service period.

The Company estimated the grant date fair value of stock options using a Black-Scholes valuation model using the following assumptions for the periods indicated:

	Nine months ended	
	November 1, 2008	**November 3, 2007**
Volatility rate	39% 43%	34% 45%
Risk-free interest rate	1.67% 3.59%	4.12% 5.05%
Average expected life (years)	4.9	4.9
Dividend yield	None	None

The Company granted 1.7 million stock options during the nine months ended November 1, 2008. The weighted-average grant date fair value of options granted in fiscal 2008 was $5.33 per option.

The Company recorded stock compensation expense of $1,100 and $1,082 for the three months ended November 1, 2008 and November 3, 2007, respectively. The Company recorded stock compensation expense of $2,644 and $1,635 for the nine months ended November 1, 2008 and November 3, 2007, respectively. At November 1, 2008, there was approximately $12,407 of unrecognized compensation expense related to unvested options.

Income taxes

The Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* on February 4, 2007. The adoption had no effect on the Company s consolidated financial position or results of operations. The Company does not currently maintain a liability for unrecognized tax benefits. The Company s policy is to recognize income tax-related interest and penalties as part of income tax expense. Income tax-related interest and penalties recorded in the consolidated financial statements were insignificant for the three and nine months ended November 1, 2008 and November 3, 2007. The Company conducts business only in the United States. Accordingly, the tax years that remain open to examination by U.S. federal, state, and local tax jurisdictions are generally three years, or fiscal 2007, 2006, and 2005.

Comprehensive income

Comprehensive income is comprised of net income and gains and losses from derivative instruments designated as cash flow hedges, net of income tax. Total comprehensive income is as follows:

	Three months ended		Nine months ended	
	November 1, 2008	**November 3, 2007**	**November 1, 2008**	**November 3, 2007**
Net income	$5,017	$ 4,206	$12,980	$ 11,731
Unrealized (loss) gain on interest rate swap hedge, net of income tax	(37)	(209)	206	(304)
Comprehensive income	$4,980	$ 3,997	$13,186	$ 11,427

Recent accounting pronouncements

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of SFAS No. 133.* SFAS No. 161 is intended to help investors better understand how derivative instruments and hedging activities affect an entity s financial position, financial performance and cash flows through enhanced disclosure requirements. The enhanced disclosures primarily surround disclosing the objectives and strategies for using derivative instruments by their underlying risk as well as a tabular format of the fair values of the derivative instruments and their gains and losses. SFAS No. 161 is effective for quarterly interim periods beginning after November 15, 2008, and fiscal years that include those quarterly interim periods. Early application is encouraged. The Company does not expect the adoption of SFAS No. 161 to have a material effect on its consolidated financial position or results of operations as it is disclosure-only in nature.

3. Commitments and contingencies

Leases The Company leases stores, distribution and office facilities, and certain equipment. Original non-cancelable lease terms range from three to ten years, and store leases generally contain renewal options for additional years. A number of the Company s store leases provide for contingent rentals based upon sales. Contingent rent amounts were insignificant in the nine months ended November 1, 2008 and November 3, 2007. Total rent expense under operating leases was $17,334 and $13,252 for the three months ended November 1, 2008 and November 3, 2007, respectively. Total rent expense under operating leases was $49,363 and $37,676 for the nine months ended November 1, 2008 and November 3, 2007, respectively.

Securities litigation In December 2007 and January 2008, three putative securities class action lawsuits were filed against the Company and certain of its current and then-current executive officers in the United States District Court for the Northern District of Illinois. Each suit alleges that the prospectus and registration statement filed pursuant to the Company s initial public offering contained materially false and misleading statements and failed to disclose material facts. Each suit claims violations of Sections 11, 12(a)(2) and/or 15 of the Securities Act of 1933, and the two later filed suits added claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as well as the associated Rule 10b-5. In February 2008, two of the plaintiffs filed competing motions to consolidate the actions and appoint lead plaintiffs and lead plaintiffs counsel. On March 18, 2008, after one of the plaintiffs withdrew his motion, the suits were consolidated and plaintiffs in the Mirsky v. ULTA action were appointed lead plaintiffs. Lead plaintiffs filed their amended complaint on May 19, 2008. The amended complaint alleges no new violations of the securities laws not asserted in the prior complaints. It adds no new defendants and drops one of the then-current officers as a defendant. On July 21, 2008, Defendants filed a motion to dismiss the Amended Complaint. On September 24, 2008, Lead Plaintiffs filed their opposition to the motion to dismiss, and on October 24, 2008, Defendants filed their reply memorandum in support of their motion to dismiss.

Although the Company intends to defend itself vigorously in this lawsuit, an adverse resolution may have a material adverse effect on the Company s financial position and results of operations in the period in which the lawsuit is resolved. The Company is not presently able to reasonably estimate potential losses, if any, related to the lawsuit.

General litigation The Company is also involved in various legal proceedings that are incidental to the conduct of its business, including, but not limited to, employment related claims. In the opinion of management, the amount of any liability with respect to these proceedings, either individually or in the aggregate, will not be material.

4. Notes payable

The Company s credit facility is with LaSalle Bank National Association as the administrative agent, Wachovia Capital Finance Corporation as collateral agent, and JP Morgan Chase Bank as documentation agent. This facility provides maximum credit of $150,000 and a $50,000 accordion option through May 31, 2011. The credit facility agreement contains a restrictive financial covenant on tangible net worth. Substantially all of the Company s assets are pledged as collateral for outstanding borrowings under the facility. Outstanding borrowings bear interest at the prime rate or the Eurodollar rate plus 1.00% up to $100,000 and 1.25% thereafter. The advance rates on owned inventory are 80% (85% from September 1 to January 31).

On August 15, 2008, the Company entered into a First Amendment to the Third Amended and Restated Loan and Security Agreement by and between the Company, LaSalle Bank National Association, Wachovia Capital Finance Corporation and JPMorgan Chase Bank, N.A. The amendment exercised the $50,000 accordion option under the same terms and conditions as the existing facility.

The weighted-average interest rate on the outstanding borrowings as of November 1, 2008 and February 2, 2008, was 4.30% and 4.81%, respectively. The Company had approximately $61,694 (including the accordion option) and $73,140 (excluding the accordion option) of availability as of November 1, 2008 and February 2, 2008, respectively. The Company has an ongoing letter of credit that renews annually in October, the balance of which was $326 as of November 1, 2008 and February 2, 2008.

At November 1, 2008, the Company has classified $86,390 of outstanding borrowings under the facility as long-term as this is the minimum amount that the Company believes will remain outstanding for an uninterrupted period over the next year.

5. Financial instruments

On January 31, 2007, the Company entered into an interest rate swap agreement with a notional amount of $25,000 that qualified as a cash flow hedge to obtain a fixed interest rate on variable rate debt and reduce certain exposures to interest rate fluctuations. The swap results in fixed rate payments at an interest rate of 5.11% for a term of three years.

As of November 1, 2008 and February 2, 2008, the interest rate swap had a negative fair value of $847 and $1,184, respectively, and both are included in accrued liabilities. The change in market value during fiscal 2008 related to the effective portion of the cash flow hedge was recorded as an unrecognized gain in the other comprehensive loss section of stockholders equity in the consolidated balance sheets. Amounts related to any ineffectiveness, which are insignificant, are recorded as interest expense.

Interest rate differentials paid or received under this agreement are recognized as adjustments to interest expense. The Company does not hold or issue interest rate swap agreements for trading purposes. In the event that a counter-party fails to meet the terms of the interest rate swap agreement, the Company s exposure is limited to the interest rate differential. The Company manages the credit risk of counterparties by dealing only with institutions that the Company considers financially sound. The Company considers the risk of non-performance to be remote.

On February 3, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements,* for financial assets and liabilities. The adoption had no impact on the Company s consolidated financial statements. SFAS No. 157 established a three-tier hierarchy for fair value measurements, which prioritizes the inputs used in measuring fair value as follows:

Level 1 observable inputs such as quoted prices for identical instruments in active markets.

Level 2 inputs other than quoted prices in active markets that are observable either directly or indirectly through corroboration with observable market data.

Level 3 unobservable inputs in which there is little or no market data, which would require the Company to develop its own assumptions.

The Company s interest rate swap is required to be measured at fair value on a recurring basis. The fair value of the interest rate swap is determined based on inputs that are readily available in public markets or can be derived from information available in publicly quoted markets. Therefore, the Company has categorized the interest rate swap as Level 2. The following table presents the Company s financial liabilities as of November 1, 2008 measured at fair value on a recurring basis:

	Fair value measurement using		
	Level 1	**Level 2**	**Level 3**
Interest rate swap liability	$	$847	$

6. Net income per common share

The following is a reconciliation of net income and the number of shares of common stock used in the computation of net income per basic and diluted share:

	Three months ended		Nine months ended	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007