Ulta Salon, Cosmetics & Fragrance, Inc.
Form 10-Q
December 10, 2009

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 October 31, 2009

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 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). o Yes o No

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition 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 þ	Non-accelerated filer o (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 3, 2009 was 58,103,711 shares.

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

Item 1. Financial Statements

Ulta Salon, Cosmetics & Fragrance, Inc.
Balance Sheets

(In thousands)	October 31, 2009 (unaudited)	January 31, 2009	November 1, 2008 (unaudited)
Assets			
Current assets:			
Cash and cash equivalents	$ 3,795	$ 3,638	$ 3,648
Receivables, net	13,340	18,268	20,488
Merchandise inventories, net	273,978	213,602	268,928
Prepaid expenses and other current assets	28,386	24,294	24,960
Prepaid income taxes		8,628	
Deferred income taxes	7,984	8,278	9,088
Total current assets	327,483	276,708	327,112
Property and equipment, net	293,746	292,224	292,120
Deferred income taxes			4,080
Total assets	$621,229	$568,932	$623,312
Liabilities and stockholders equity			
Current liabilities:			
Current portion notes payable	$ 14,635	$ 18,000	$ 51,590
Accounts payable	117,520	47,811	97,768
Accrued liabilities	57,811	51,202	50,532
Accrued income taxes	5,682		5,798
Total current liabilities	195,648	117,013	205,688
Notes payable less current portion	24,527	88,047	86,390
Deferred rent	113,184	101,288	100,126
Deferred income taxes	17,616	17,616	
Total liabilities	350,975	323,964	392,204
Commitments and contingencies (note 3)			

See accompanying notes to financial statements.

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

(In thousands, except per share data)	October 31, 2009 (unaudited)	January 31, 2009	November 1, 2008 (unaudited)
Stockholders equity:			
Common stock, $.01 par value, 400,000 shares authorized; 58,609, 58,245 and 58,168 shares issued; 58,104, 57,740 and 57,663 shares outstanding; at October 31, 2009 (unaudited), January 31, 2009 and November 1, 2008 (unaudited), respectively	$ 586	$ 582	$ 582
Treasury stock-common, at cost	(4,179)	(4,179)	(4,179)
Additional paid-in capital	298,762	293,052	291,362
Accumulated deficit	(24,726)	(43,856)	(56,144)
Accumulated other comprehensive loss	(189)	(631)	(513)
Total stockholders equity	270,254	244,968	231,108
Total liabilities and stockholders equity	$621,229	$568,932	$623,312

See accompanying notes to financial statements.

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

(In thousands, except per share data)	Three months ended October 31, 2009	Three months ended November 1, 2008	Nine months ended October 31, 2009	Nine months ended November 1, 2008
Net sales	$284,043	$254,843	$826,407	$743,252
Cost of sales	193,498	175,368	578,008	516,710
Gross profit	90,545	79,475	248,399	226,542
Selling, general and administrative expenses	73,671	65,176	209,130	189,130
Pre-opening expenses	2,183	4,693	5,388	12,515
Operating income	14,691	9,606	33,881	24,897
Interest expense	441	1,124	1,757	3,055
Income before income taxes	14,250	8,482	32,124	21,842
Income tax expense	5,790	3,465	12,994	8,862
Net income	$ 8,460	$ 5,017	$ 19,130	$ 12,980
Net income per common share:				
Basic	$ 0.15	$ 0.09	$ 0.33	$ 0.23
Diluted	$ 0.14	$ 0.09	$ 0.32	$ 0.22
Weighted average common shares outstanding:				
Basic	57,979	57,591	57,847	57,328
Diluted	59,376	59,013	59,081	59,005

See accompanying notes to financial statements.

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

(In thousands)	Nine months ended October 31, 2009	Nine months ended November 1, 2008
Operating activities		
Net income	$ 19,130	$ 12,980
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	46,766	37,619
Non-cash stock compensation charges	4,214	2,644
Excess tax benefits from stock-based compensation	(602)	(1,565)
Loss on disposal of property and equipment	199	219
Change in operating assets and liabilities:		
Receivables	4,928	155
Merchandise inventories	(60,376)	(92,819)
Prepaid expenses and other assets	(4,092)	(5,776)
Income taxes	14,310	734
Accounts payable	69,709	45,646
Accrued liabilities	8,850	754
Deferred rent	11,896	28,891
Net cash provided by operating activities	114,932	29,482
Investing activities		
Purchases of property and equipment	(49,390)	(96,608)
Net cash used in investing activities	(49,390)	(96,608)
Financing activities		
Proceeds on long-term borrowings	863,237	874,139
Payments on long-term borrowings	(930,122)	(810,929)
Proceeds from issuance of common stock under stock plans	898	2,269
Excess tax benefits from stock-based compensation	602	1,565
Initial public offering issuance costs		(59)
Net cash (used in) provided by financing activities	(65,385)	66,985
Net increase (decrease) in cash and cash equivalents	157	(141)
Cash and cash equivalents at beginning of period	3,638	3,789
Cash and cash equivalents at end of period	$ 3,795	$ 3,648

See accompanying notes to financial statements.

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

(In thousands)	**Nine months ended October 31, 2009**	**November 1, 2008**
Supplemental cash flow information		
Cash paid for interest	$ 1,946	$ 3,437
Cash paid (received) for income taxes	$ (1,918)	$ 6,589
Noncash investing and financing activities:		
Change in property and equipment included in accrued liabilities	$ (903)	$ (3,039)
Unrealized gain on interest rate swap hedge, net of tax	$ 442	$ 206

See accompanying notes to financial statements.

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

(In thousands, except per share data)	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 January 31, 2009	58,245	$582	(505)	$(4,179)	$293,052	$(43,856)	$(631)	$244,968
Common stock options exercised	364	4			894			898
Unrealized gain on interest rate swap hedge, net of $294 income tax							442	442
Net income for the nine months ended October 31, 2009						19,130		19,130
Comprehensive income								19,572
Excess tax benefits from stock-based compensation					602			602
Stock compensation charge					4,214			4,214
Balance October 31, 2009	58,609	$586	(505)	$(4,179)	$298,762	$(24,726)	$(189)	$270,254

See accompanying notes to financial statements.

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

1. Business and basis of presentation

Ulta Salon, Cosmetics & Fragrance, Inc. (Company or Ulta) 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 October 31, 2009, the Company operated 345 stores in 38 states, as shown in the table below:

State	Number of stores
Alabama	7
Arizona	24
Arkansas	1
California	30
Colorado	11
Connecticut	1
Delaware	1
Florida	24
Georgia	17
Illinois	32
Indiana	6
Iowa	3
Kansas	1
Kentucky	2
Louisiana	2
Maryland	6
Massachusetts	4
Michigan	9
Minnesota	6
Mississippi	3
Missouri	3
Nebraska	2
Nevada	6
New Jersey	11
New York	13
North Carolina	13
Ohio	7
Oklahoma	7
Oregon	3
Pennsylvania	16
Rhode Island	1
South Carolina	5
Tennessee	3
Texas	45
Utah	2
Virginia	10
Washington	5

Wisconsin	3
Total	**345**

The accompanying unaudited 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 financial statements reflect all adjustments, which are of a normal recurring nature, necessary to fairly state the 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 October 31, 2009 are not necessarily indicative of the results to be expected for the fiscal year ending January 30, 2010, 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 January 31, 2009. All amounts are stated in thousands, with the exception of per share amounts and number of stores.

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 preferred shares into 41,524 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 January 31, 2009. Presented below in this and the following notes is supplemental information that should be read in conjunction with Notes to financial statements in the Annual Report. The Company has evaluated subsequent events through December 10, 2009, at the time these financial statements were issued.

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 2009 and 2008 ended on October 31, 2009 and November 1, 2008, respectively.

Reclassifications

Certain reclassifications have been made to the 2008 operating activities in the statements of cash flows to separately present income taxes to conform to the 2009 presentation.

Share-based compensation

The Company measures share-based compensation cost on the grant date, based on the fair value of the award, and recognizes the expense over the requisite service period for awards expected to vest. 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	
	October 31, 2009	**November 1, 2008**
Volatility rate	60.6%	48.1%
Average risk-free interest rate	2.5%	2.3%
Average expected life (in years)	5.3	5.1
Dividend yield	None	None

The Company granted 977 and 1,653 stock options during the nine months ended October 31, 2009 and November 1, 2008, respectively. The weighted-average grant date fair value of these options was $6.64 and $5.49, respectively. The Company recorded stock compensation expense of $1,566 and $1,100 for the three months ended October 31, 2009 and November 1, 2008, respectively. The Company recorded stock compensation expense of $4,214 and $2,644 for the nine months ended October 31, 2009 and November 1, 2008, respectively. At October 31, 2009, there was approximately $14,472 of unrecognized compensation expense related to unvested options.

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	
	October 31, 2009	November 1, 2008	October 31, 2009	November 1, 2008
Net income	$8,460	$ 5,017	$19,130	$12,980
Unrealized gain (loss) on interest rate swap hedge, net of income tax	178	(37)	442	206
Comprehensive income	$8,638	$ 4,980	$19,572	$13,186

Recent accounting pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued the Accounting Standards Codification™ (ASC) as the single source of authoritative accounting principles recognized by the FASB to be applied in the preparation of financial statements in conformity with GAAP. The ASC also recognizes rules and interpretive releases of the Securities and Exchange Commission (SEC) under federal securities laws as authoritative GAAP for SEC registrants. The ASC is effective for financial statements issued for fiscal years and interim periods ending after September 15, 2009. The Company adopted the ASC in the third quarter of 2009 and it did not have any impact on its consolidated financial position or results of operations.

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 three and nine months ended October 31, 2009 and November 1, 2008. Total rent expense under operating leases was $18,663 and $17,334 for the three months ended October 31, 2009 and November 1, 2008, respectively. Total rent expense under operating leases was $54,422 and $49,363 for the nine months ended October 31, 2009 and November 1, 2008, 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 alleged 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 claimed 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 alleged no new violations of the securities laws not asserted in the prior complaints. It added no new defendants and dropped 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. On March 19, 2009, defendants motion to dismiss was denied.

On May 29, 2009, the Company and its primary insurance carrier engaged in a mediation with counsel representing the putative class. Although defendants continue to deny plaintiffs allegations, in the interest of putting this matter behind it, the Company and its insurer reached a settlement with plaintiffs. On August 7, 2009, the Court entered an order preliminarily approving the settlement, approving the form and manner of notice to putative class members, and setting a final hearing to determine whether to approve the settlement. On November 16, 2009, the Court held a final hearing and, no class members having objected to the settlement or having requested exclusion from the settlement class, the Court entered a final order dismissing all three consolidated cases with prejudice. All amounts paid under the settlement have been paid out of proceeds of the Company s directors and officers liability insurance coverage.

General litigation In July 2009, a putative employment class action lawsuit was filed against the Company and certain unnamed defendants in State Court in California. The suit alleges that Ulta misclassified its store General Managers and Salon Managers as exempt (from the Fair Labor Standards Act and California Labor Code). The suit seeks to recover damages and penalties as a result of this alleged misclassification. On August 27, 2009 the Company filed its answer to the lawsuit and on August 31, 2009 the Company moved the action to the United States District Court for the Northern District of California. On November 2, 2009, the plaintiffs filed an amended complaint adding another named plaintiff. Although the Company believes that it has meritorious defenses to the claims made in the putative class action and intends to contest the lawsuit vigorously, an adverse resolution could have a material adverse effect on its 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.

The Company is also involved in various legal proceedings that are incidental to the conduct of its business. 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 Bank of America 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 $200,000 through May 31, 2011. The facility provides maximum borrowings equal to the lesser of $200,000 or a percentage of eligible owned inventory. The advance rates on owned inventory are 80% (85% from September 1 to January 31). The credit facility agreement contains a restrictive financial covenant requiring the Company to maintain tangible net worth of not less than $80,000. On October 31, 2009, the Company s tangible net worth was approximately $270,000. 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 weighted-average interest rate on the outstanding borrowings as of October 31, 2009 and January 31, 2009, was 1.46% and 1.52%, respectively. At October 31, 2009, the Company had $39,162 of outstanding borrowings under the facility. The Company has classified $24,527 as long-term as this is the minimum amount that the Company believes will remain outstanding for an uninterrupted period over the next year. The Company had approximately $160,838 and $86,764 of availability as of October 31, 2009 and January 31, 2009, respectively. The Company also had a letter of credit that expired in September 2009; the balance was $326 as of January 31, 2009.

5. Financial instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risk managed by using derivative instruments is interest rate risk. Interest rate swaps are entered into to manage interest rate risk associated with the Company s variable-rate borrowings. The Company accounts for derivative financial instruments in accordance with the ASC rules for derivatives and hedging activities.

On February 1, 2009, the Company adopted the ASC disclosure requirements for derivatives and hedging activities. The adoption had no impact on amounts recognized in the Company s financial statements. The new rules are 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.

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. 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.

The Company s derivative financial instrument is designated and qualifies as a cash flow hedge. Accordingly, the effective portion of the gain or loss on the derivative instrument is reported as a component of accumulated other comprehensive loss and reclassified into interest expense in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss, the ineffective portion, on the derivative instrument, if other than inconsequential, is recognized in interest expense during the period of change. The following table summarizes the fair value and presentation within the balance sheets for derivatives designated as hedging instruments:

	Derivative Liabilities			
	October 31, 2009 (unaudited)		**January 31, 2009**	
	Balance Sheet Location	**Fair Value**	**Balance Sheet Location**	**Fair Value**
Interest rate swap liability	Accrued liabilities	$ 306	Accrued liabilities	$ 1,042

The following table presents the impact of derivatives in cash flow hedging relationships and their location within the unaudited statements of income and accumulated other comprehensive loss (AOCL):

	Amount of Gain (Loss) Recognized in AOCL on Derivative (Effective Portion)		**Amount of Gain Reclassfied from AOCL into Income (Effective Portion)**		**Amount of Gain Recognized in Income on Derivative (Ineffective Portion)**	
	Three months ended		**Three months ended**		**Three months ended**	
	October 31, 2009	**November 1, 2008**	**October 31, 2009**	**November 1, 2008**	**October 31, 2009**	**November 1, 2008**
Interest rate swap, net of tax	$ 178	$ (37)	$	$	$	$