

Sally Beauty Holdings, Inc.

Form 10-Q

February 05, 2009

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED: DECEMBER 31, 2008

-OR-

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

Commission File No. 1-33145

SALLY BEAUTY HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

**3001 Colorado Boulevard
Denton, Texas**

36-2257936

(I.R.S. Employer Identification
No.)

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(Address of principal executive
offices)

76210

(zip code)

Registrant's telephone number, including area code: (940) 898-7500

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller
reporting company)

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

At January 30, 2009, there were 182,021,272 shares of the issuer's common stock outstanding.

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In this quarterly report, references to the Company, Sally Beauty, our company, we, our, ours and us refer to Sally Beauty Holdings, Inc. and its consolidated subsidiaries for periods after the separation from Alberto-Culver Company (Alberto-Culver) and to Sally Holdings, Inc. and its consolidated subsidiaries for periods prior to the separation from Alberto-Culver unless otherwise indicated or the context otherwise requires.

Cautionary Notice Regarding Forward-Looking Statements

Statements in this report which are not purely historical facts or which depend upon future events may be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Words such as anticipate, believe, estimate, expect, intend, plan, project, target, can, could, may, should, will, would also identify such forward-looking statements.

Readers are cautioned not to place undue reliance on forward-looking statements as such statements speak only as of the date they were made. Any forward-looking statements involve risks and uncertainties that could cause actual events or results to differ materially from the events or results described in the forward-looking statements, including, but not limited to, risks and uncertainties related to:

- the highly competitive nature of, and the increasing consolidation of, the beauty products distribution industry;
- anticipating changes in consumer preferences and buying trends and managing our product lines and inventory;
- potential fluctuation in our same store sales and quarterly financial performance;
- our dependence upon manufacturers who may be unwilling or unable to continue to supply products to us;
- the possibility of material interruptions in the supply of beauty supply products by our manufacturers;
- products sold by us being found to be defective in labeling or content;
- compliance with laws and regulations or becoming subject to additional or more stringent laws and regulations;
- product diversion to mass retailers;
- the operational and financial performance of our Armstrong McCall, L.P. business;
- the success of our new Internet-based business;
- successfully identifying acquisition candidates or successfully completing desirable acquisitions;
- integrating businesses acquired in the future;

- opening and operating new stores profitably;
- the impact of a continued downturn in the economy upon our business;
- the success of our cost control plans;
- protecting our intellectual property rights, specifically our trademarks;
- conducting business outside the United States;
- disruption in our information technology systems;
- natural disasters or acts of terrorism;
- the preparedness of our accounting and other management systems to meet financial reporting and other requirements and the upgrade of our existing financial reporting system;
- being a holding company, with no operations of our own, and depending on our subsidiaries for cash;
- our substantial indebtedness;
- the possibility that we may incur substantial additional debt;
- restrictions and limitations in the agreements and instruments governing our debt;
- generating the significant amount of cash needed to service all of our debt and refinancing all or a portion of our indebtedness or obtaining additional financing;

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- changes in interest rates increasing the cost of servicing our debt or increasing our interest expense due to our interest rate swap agreements;
- the potential impact on us if the financial institutions we deal with become impaired;
- the representativeness of our historical consolidated financial information with respect to our future financial position, results of operations or cash flows;
- our reliance upon Alberto-Culver for the accuracy of certain historical services and information;
- the share distribution of Alberto-Culver common stock in our separation from Alberto-Culver not constituting a tax-free distribution;
- actions taken by certain large stockholders adversely affecting the tax-free nature of the share distribution of Alberto-Culver common stock;
- the voting power of our largest stockholder discouraging third party acquisitions of us at a premium; and
- the interests of our largest stockholder differing from the interests of other holders of our common stock.

Additional factors that could cause actual events or results to differ materially from the events or results described in the forward-looking statements can be found in our Annual Report on Form 10-K for the fiscal year ended September 30, 2008, as filed with the Securities and Exchange Commission. The events described in the forward-looking statements might not occur or might occur to a different extent or at a different time than we have described. As a result, our actual results may differ materially from the results contemplated by these forward-looking statements. We assume no obligation to publicly update or revise any forward-looking statements.

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WHERE YOU CAN FIND MORE INFORMATION

Sally Beauty's quarterly financial results and other important information are available by calling the Investor Relations Department at (940) 297-3877.

Sally Beauty maintains a website at www.sallybeautyholdings.com where investors and other interested parties may obtain, free of charge, press releases and other information as well as gain access to our periodic filings with the SEC. The information contained on this website does not constitute part of this Quarterly Report on Form 10-Q.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

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The following are our consolidated balance sheets as of December 31, 2008 and September 30, 2008 and our consolidated statements of earnings and cash flows for the three months ended December 31, 2008 and 2007. In November 2006, Sally Holdings, Inc. was converted to a Delaware limited liability company, was renamed Sally Holdings LLC and became an indirect wholly owned subsidiary of Sally Beauty Holdings, Inc. in connection with our separation from the Alberto-Culver Company (Alberto-Culver). In these financial statements and elsewhere in this Quarterly Report on Form 10-Q, we refer to these transactions as the Separation Transactions. See the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008 for additional information about the Separation Transactions.

Table of Contents**SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES**

Consolidated Statements of Earnings

(In thousands, except per share data)

(Unaudited)

	Three Months Ended December 31,	
	2008	2007
Net sales	\$ 645,576	\$ 655,787
Cost of products sold and distribution expenses	342,032	349,618
Gross profit	303,544	306,169
Selling, general and administrative expenses (a)	225,528	224,541
Depreciation and amortization	11,747	11,752
Operating earnings	66,269	69,876
Interest expense, net (b)	39,673	46,483
Earnings before provision for income taxes	26,596	23,393
Provision for income taxes	10,537	9,050
Net earnings	\$ 16,059	\$ 14,343
Net earnings per share:		
Basic	\$ 0.09	\$ 0.08
Diluted	\$ 0.09	\$ 0.08
Weighted average shares:		
Basic	181,578	180,995
Diluted	182,985	183,182

(a) Selling, general and administrative expenses include share-based compensation of \$3.6 million and \$5.6 million for the three months ended December 31, 2008 and 2007, respectively.

(b) Interest expense, net of interest income of \$0.1 million and \$0.2 million, includes expense of \$3.0 million and \$5.7 million of marked-to-market adjustments related to interest rate swaps for the three months ended December 31, 2008 and 2007, respectively.

The accompanying condensed notes, together with the Notes to Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008, are an integral part of these financial statements.

Table of Contents**SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES**

Consolidated Balance Sheets

(In thousands, except par value data)

	December 31, 2008 (Unaudited)	September 30, 2008
Assets		
Current assets:		
Cash and cash equivalents	\$ 112,617	\$ 99,788
Trade accounts receivable, less allowance for doubtful accounts of \$2,460 at December 31, 2008 and \$2,702 at September 30, 2008	39,812	44,481
Other receivables	31,297	22,692
Inventories	571,650	598,195
Prepaid expenses	18,131	19,748
Deferred income tax assets	20,857	20,742
Total current assets	794,364	805,646
Property and equipment, net of accumulated depreciation of \$245,655 at December 31, 2008 and \$243,185 at September 30, 2008	149,157	156,260
Goodwill	413,580	424,963
Intangible assets, net of accumulated amortization of \$19,665 at December 31, 2008 and \$18,203 at September 30, 2008	81,094	85,434
Other assets	50,645	54,720
Total assets	\$ 1,488,840	\$ 1,527,023
Liabilities and Stockholders Deficit		
Current liabilities:		
Current maturities of long-term debt	\$ 100,360	\$ 100,601
Accounts payable	166,263	171,962
Accrued expenses	144,811	154,708
Income taxes	17,469	11,177
Total current liabilities	428,903	438,448
Long-term debt	1,718,559	1,724,684
Other liabilities	33,315	23,711
Deferred income tax liabilities	28,371	37,256
Total liabilities	2,209,148	2,224,099
Stock options subject to redemption	5,650	5,884
Stockholders deficit:		
Common stock, \$0.01 par value. Authorized 400,000 shares; 182,015 and 181,812 shares issued and 181,621 and 181,516 shares outstanding at December 31, 2008 and September 30, 2008, respectively	1,816	1,815
Additional paid-in capital	626,609	622,511
Retained deficit	(1,319,916)	(1,335,975)
Accumulated other comprehensive (loss) income	(34,467)	8,689
Total stockholders deficit	(725,958)	(702,960)
Total liabilities and stockholders deficit	\$ 1,488,840	\$ 1,527,023

The accompanying condensed notes, together with the Notes to Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008, are an integral part of these financial statements.

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Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Three Months Ended December 31,	
	2008	2007
Cash Flows from Operating Activities:		
Net earnings	\$ 16,059	\$ 14,343
Adjustments to reconcile net earnings to net cash provided (used) by operating activities:		
Depreciation and amortization	11,747	11,752
Share-based compensation expense (net of deferred tax benefit of \$1,378 in 2008 and \$2,021 in 2007)	2,233	3,571
Amortization of deferred financing costs	2,103	2,131
Excess tax shortfall (benefit) from share-based compensation	111	(129)
Net (gain) loss on disposal of leaseholds and other property	(2)	150
Deferred income taxes	612	818
Changes in (exclusive of effects of acquisitions):		
Trade accounts receivable	2,927	3,455
Other receivables	(9,694)	(5,241)
Inventories	9,850	(28,626)
Prepaid expenses	403	(1,008)
Other assets	45	215
Accounts payable and accrued expenses	(5,556)	(28,625)
Income taxes	6,999	2,248
Other liabilities	(6,803)	6,781
Net cash provided (used) by operating activities	31,034	(18,165)
Cash Flows from Investing Activities:		
Capital expenditures	(8,400)	(12,280)
Proceeds from sale of property and equipment	32	115
Acquisitions, net of cash acquired	(1,755)	(3,112)
Net cash used by investing activities	(10,123)	(15,277)
Cash Flows from Financing Activities:		
Change in book cash overdraft	(1,633)	1,175
Proceeds from issuance of long-term debt	82,638	142,976
Repayments of long-term debt	(89,021)	(105,194)
Proceeds from exercises of stock options	252	215
Excess tax (shortfall) benefit from share-based compensation	(111)	129
Net cash (used) provided by financing activities	(7,875)	39,301
Effect of foreign exchange rate changes on cash and cash equivalents	(207)	(984)
Net increase in cash and cash equivalents	12,829	4,875
Cash and cash equivalents, beginning of period	99,788	38,272
Cash and cash equivalents, end of period	\$ 112,617	\$ 43,147
Supplemental Cash Flow Information:		
Cash paid for:		
Interest	\$ 57,732	\$ 63,629
Income taxes	\$ 4,384	\$ 7,926

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The accompanying condensed notes, together with the Notes to Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008, are an integral part of these financial statements.

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Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

1. Description of Business and Basis of Presentation

Description of Business

Sally Beauty Holdings, Inc. and its consolidated subsidiaries (Sally Beauty or the Company) sell professional beauty supplies, primarily through its Sally Beauty Supply retail stores, in the U.S., Puerto Rico, Mexico, Canada, Japan, the United Kingdom and certain other countries in Europe. Additionally, the Company distributes professional beauty products to salons and professional cosmetologists through its Beauty Systems Group (BSG) store operations and a commissioned direct sales force that calls on salons in the U.S., Canada, the United Kingdom and certain other countries in Europe, and to franchises in the southern and southwestern U.S. and in Mexico through the operations of its subsidiary Armstrong McCall, L.P. (Armstrong McCall). Certain beauty products sold by BSG and Armstrong McCall are sold through exclusive territory agreements with the manufacturers of the products.

In November 2006, the stockholders of Alberto-Culver approved a plan to separate its consumer products business and its Sally Beauty Supply/BSG distribution business into two separate, publicly-traded companies. Sally Holdings, Inc. (Sally Holdings) was a wholly-owned subsidiary of Alberto-Culver until November 16, 2006, when it was converted to a Delaware limited liability company, was renamed Sally Holdings LLC, and became an indirect wholly-owned subsidiary of Sally Beauty. Sally Beauty was formed in June 2006, and became the accounting successor company to Sally Holdings upon the completion of the Separation Transactions. See the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008 for more information about the Separation Transactions.

Basis of Presentation

The consolidated interim financial statements included herein are unaudited and have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. The consolidated interim financial statements include the accounts of the Company and its subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. In the opinion of management, these consolidated financial statements reflect all adjustments which are of a normal recurring nature and which are necessary to present fairly the consolidated financial position as of December 31, 2008 and September 30, 2008, the consolidated results of operations and consolidated cash flows for the three months ended December 31, 2008 and 2007. The results of operations for these interim periods are not necessarily indicative of the results that may be expected for the entire fiscal year.

All references in these notes to management are to the management of Sally Beauty. All references in these notes to the Company are to Sally Beauty and, prior to November 16, 2006, Sally Holdings.

These consolidated interim financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008. The Company adheres to the same accounting policies in preparation of interim financial statements. As permitted under GAAP, interim accounting for certain expenses, including income taxes, are based on full year assumptions. Such amounts are expensed in full in the year incurred. For interim financial reporting purposes, income taxes are recorded based upon estimated annual effective income tax rates.

Certain amounts for prior periods have been reclassified to conform to the current period's presentation.

2. Recent Accounting Pronouncements

The Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157), as it relates to its financial instruments, effective as of October 1, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; rather, it amends other accounting pronouncements that require or permit fair value

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Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

measurements. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. SFAS 157 establishes a three-level hierarchy for measuring fair value and requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

This valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability on the measurement date. The three levels of that hierarchy are defined as follows:

Level 1 - Unadjusted quoted prices in active markets for identical assets or liabilities

Level 2 - Unadjusted quoted prices in active markets for similar assets or liabilities; or

Unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active; or

Inputs other than quoted prices that are observable for the asset and liability

Level 3 - Unobservable inputs for the asset or liability

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including interest rate swaps. In accordance with SFAS 157, the Company categorized certain of its financial assets and liabilities based on priority of the inputs to the valuation technique for the instruments, as follows (in thousands):

	Total	As of December 31, 2008		Level 3
		Level 1	Level 2	
Liabilities				
Hedged interest rate swaps (1)	\$ 16,522		\$ 16,522	
Non-hedged interest rate swaps (1)	10,661		10,661	
Total	\$ 27,183		\$ 27,183	

(1) Interest rate swaps are valued using internal models based on market observable inputs, including market interest rates.

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In October 2008, the FASB issued Staff Position FAS No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which clarifies the application of SFAS 157. FSP-FAS 157-3 was effective upon issuance and its adoption did not have a material impact on the Company's financial statements.

Effective on October 1, 2008, the Company also adopted the provisions of SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities - including an amendment of FASB Statement No. 115* (SFAS 159), which permits entities to choose to measure certain financial assets and liabilities at fair value. The Company elected not to measure at fair value any additional assets or liabilities that were not already measured at fair value prior to such adoption. As a result, the adoption of SFAS 159 did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

We have not yet adopted and are currently assessing any potential effect of the pronouncements discussed below on our consolidated financial statements.

In June 2008, the Emerging Issues Task Force reached consensus on Emerging Issues Task Force Issue No. 08-3, *Accounting by Lessees for Nonrefundable Maintenance Deposits* (EITF 08-3). Under EITF 08-3, lessees should account for nonrefundable maintenance deposits as deposit assets if it is probable that maintenance activities will occur and the deposit is therefore realizable. Amounts on deposit that are not probable of being used to fund future maintenance activities should be expensed. EITF 08-3 is effective for fiscal years beginning after December 15, 2008. Early application is not permitted.

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Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

In April 2008, the Financial Accounting Standards Board (FASB) issued Staff Position FAS No. 142-3, *Determination of the Useful Life of Intangible Assets* (FAS 142-3). FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The objective of the Staff Position is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (Revised 2007): *Business Combinations* (SFAS 141R) and other GAAP. FAS 142-3 is effective for fiscal years beginning after December 15, 2008. Early application is not permitted.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 requires companies to provide qualitative disclosures about the objectives and strategies for using derivatives, quantitative data about the fair value of and gains and losses on derivative contracts, and details of credit-risk-related contingent features in their hedged positions. The statement also requires companies to disclose more information about the location and amounts of derivative instruments in financial statements; how derivatives and related hedges are accounted for under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*; and how the hedges affect the entity's financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51* (SFAS 160), which requires, among other things, that the noncontrolling interest (previously referred to as minority interest) in a consolidated subsidiary's equity be reported as a component of equity separate from the parent's interest and that net income or loss attributable to the noncontrolling interest be included in consolidated net income on the face of the income statement. In addition, purchases and sales of equity interests that do not result in a change in control will be accounted for as equity transactions and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Early application is not permitted.

In December 2007, the FASB issued SFAS 141R, *Business Combinations* (SFAS 141R). Among other things, SFAS 141R generally requires that an acquirer recognize the assets acquired and liabilities assumed measured at their full fair values on the acquisition date. This practice replaces the practice, under predecessor SFAS 141: *Business Combinations*, of allocating the cost of an acquisition to the individual assets acquired and liabilities assumed based on their relative estimated fair values. SFAS 141R further requires that acquisition-related costs be recognized separately from the related acquisition. SFAS 141R must be applied prospectively to business combinations consummated on or after the first annual reporting period beginning on or after December 15, 2008. Early application is not permitted.

3. Net Earnings Per Share

Basic net earnings per share is calculated by dividing net earnings by the weighted-average number of shares of common stock outstanding during the period. Diluted net earnings per share is calculated similarly but includes potential dilution from the exercise of stock options and stock awards, except when the effect would be anti-dilutive.

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Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

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

	Three Months Ended December 31,	
	2008	2007
Net earnings	\$ 16,059	\$ 14,343
Total weighted-average basic shares	181,578	180,995
Dilutive securities:		
Stock option and stock award programs	1,407	2,187
Total weighted average diluted shares	182,985	183,182
Earnings per share:		
Basic	\$ 0.09	\$ 0.08
Diluted	\$ 0.09	\$ 0.08

At December 31, 2008, options to purchase 9,398,497 shares of the Company's common stock were outstanding but not included in the computation of diluted earnings per share, since these options' exercise prices, ranging from \$5.24 to \$9.66, were greater than the average market price per share of the Company's common stock on that date. At December 31, 2007, options to purchase 4,636,894 shares of the Company's common stock were outstanding but not included in the computation of diluted earnings per share, since these options' exercise prices, ranging from \$9.45 to \$9.66, were greater than the average market price per share of the Company's common stock on that date.

4. Comprehensive (Loss) Income

Comprehensive (loss) income consists of net earnings, foreign currency translation adjustments and deferred gains on interest rate swaps as follows (in thousands):

	Three Months Ended December 31,	
	2008	2007
Net earnings	\$ 16,059	\$ 14,343
Other comprehensive (loss) income adjustments:		
Foreign currency translation adjustments	(32,283)	(4,456)
Deferred loss on interest rate swaps, net of income taxes	(10,873)	
Comprehensive (loss) income	\$ (27,097)	\$ 9,887

5. Share-Based Payments

The Company accounts for stock option and stock award plans, which we refer to as share-based payment plans, in accordance with SFAS 123(R) *Share-Based Payment*. Accordingly, the Company measures the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award and recognizes compensation expense on a straight-line basis over the vesting period or to the date a participant becomes eligible for retirement, if earlier. During fiscal year 2007, the Company adopted the Sally Beauty Holdings 2007 Omnibus Incentive Plan (the 2007 Plan), a share-based compensation plan which allows for the issuance of up to 10.0 million shares of the Company's common stock.

The Company granted approximately 2.7 million and 2.6 million stock options to its employees and consultants during the three months ended December 31, 2008 and 2007, respectively, under the 2007 Plan. Upon issuance of such grants, the Company recognized accelerated share-based compensation expense of \$2.0 million and \$3.1 million in the first quarter of fiscal years 2009 and 2008, respectively, in connection

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Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

with certain retirement eligible employees who are eligible to continue vesting awards upon retirement under the terms of the 2007 Plan.

The following table presents the total compensation cost charged against income and included in selling, general and administrative expenses for share-based compensation arrangements and the related tax benefits recognized in the statements of earnings (in thousands):

	Three Months Ended December 31,	
	2008	2007
Share-based compensation expense	\$ 3,611	\$ 5,592
Income tax benefit related to share-based compensation expense	\$ 1,378	\$ 2,021

Stock Options

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Each option has an exercise price that equals 100% of the market price of the Company's common stock on the date of grant and generally has a maximum term of 10 years. Options generally vest ratably over a four year period and are generally subject to forfeiture until the four year vesting period is complete, subject to certain retirement provisions of the 2007 Plan.

The following table presents a summary of the activity for the Company's stock option plans for the three months ended December 31, 2008:

	Number of Outstanding Options (in Thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value (in Thousands)
Outstanding at September 30, 2008	8,272	\$ 8.01		
Granted	2,657	5.24		
Exercised	(105)	2.00		
Forfeited or expired	(109)	8.72		
Outstanding at December 31, 2008	10,715	\$ 7.38	8.4	\$ 6,054
Exercisable at December 31, 2008	4,065	\$ 7.01	7.4	\$ 4,860

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Condensed Notes to Consolidated Financial Statements

The following table summarizes information about stock options under the Company's option plans at December 31, 2008:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding at December 31, 2008 (in Thousands)	Weighted Average Remaining Contractual Term (in Years)	Weighted Average Exercise Price	Number Exercisable at December 31, 2008 (in Thousands)	Weighted Average Exercise Price	
\$2.00	1,317	5.5	\$ 2.00	1,317	\$ 2.00	
\$5.24 - 9.66	9,398	8.8	8.13	2,748	9.40	
Total	10,715	8.4	\$ 7.38	4,065	\$ 7.01	

The Company uses the Black-Scholes option pricing model to value the Company's stock options for each stock option award. Using this option pricing model, the fair value of each stock option award is estimated on the date of grant. The fair value of the Company's stock option awards, which generally vest ratably over a four year period, is expensed on a straight-line basis over the vesting period of the stock options or to the date a participant becomes eligible for retirement, if earlier.

The weighted average assumptions relating to the valuation of the Company's stock options are as follows:

	Three Months Ended December 31,	
	2008	2007
Expected lives (years)	5.0	5.0
Expected volatility	47.9%	37.5%
Risk-free interest rate	2.6%	4.0%
Dividend yield	0.0%	0.0%

The expected life of options represents the period of time that the options granted are expected to be outstanding and is based on historical experience of employees of the Company who have been granted stock options, including grants under stock option plans of Alberto-Culver prior to the Separation Transactions. Expected volatility is derived using the average volatility of both the Company and similar companies (based on industry sector) since it is not practicable to estimate the Company's expected volatility on a stand alone basis due to a lack of sufficient trading history. The risk-free interest rate is based on the zero-coupon U.S. Treasury issue as of the date of the grant. Since the Company does not expect to pay dividends, the dividend yield is 0%.

The weighted average fair value of the stock options issued, in the three months ended December 31, 2008 and 2007, to the Company's grantees at the date of grant was \$2.33 and \$3.46 per option, respectively. The total intrinsic value of options exercised during the three months ended December 31, 2008 was \$0.2 million. The total cash received from these option exercises was \$0.2 million and the tax benefit realized for the tax deductions from these option exercises was \$0.07 million.

At December 31, 2008, approximately \$13.3 million of total unrecognized compensation cost related to non-vested stock option awards is expected to be recognized over the weighted average period of 3.0 years.

Stock Awards

Restricted Stock Awards

A restricted stock award is an award of shares of the Company's common stock (which have full voting rights but are restricted with regards to sale or transfer) the restrictions over which lapse ratably over a specified period of time (generally 5 years). Restricted stock awards are independent of stock option grants and are generally subject to forfeiture if employment terminates prior to the restrictions lapsing, subject to certain retirement provisions of the 2007 Plan.

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The Company expenses the cost of the restricted stock awards, which is determined to be the fair value of the restricted stock award at the date of grant, on a straight-line basis over the period in which the restrictions lapse (the vesting period). For these purposes, the fair value of the restricted stock award is determined based on the closing price of the Company's common stock on the grant date.

The following table presents a summary of the activity for the Company's restricted stock awards for the three months ended December 31, 2008:

	Number of Shares (In Thousands)	Weighted Average Fair Value Per Share	Weighted Average Remaining Vesting Term (In Years)
Restricted Stock Awards			
Non-vested at September 30, 2008	296	\$ 8.44	3.8
Granted	103	5.24	
Vested	(21)	8.80	
Forfeited			
Non-vested at December 31, 2008	378	\$ 7.55	4.0

At December 31, 2008, approximately \$2.5 million of total unrecognized compensation cost related to non-vested restricted stock awards is expected to be recognized over the weighted average period of 4.0 years.

Restricted Stock Units (RSUs)

The Company grants RSUs, which generally vest into deferred stock units less than one year from date of grant pursuant to its 2007 Plan. To date the Company has only granted RSU awards to its non-employee directors. RSUs represent an unsecured promise of the Company to issue shares of common stock of the Company. RSUs are independent of stock option grants and are generally subject to forfeiture if service terminates prior to the vesting of the units. Participants have no voting rights with respect to non-vested RSUs.

The Company expenses the cost of the RSUs, which is determined to be the fair value of the RSUs at the date of grant, on a straight-line basis over the vesting period (generally less than one year). For these purposes, the fair value of the RSU is determined based on the closing price of the Company's common stock on the grant date.

The following table presents a summary of the activity for the Company's RSUs for the three months ended December 31, 2008:

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Restricted Stock Units	Number of Shares (In Thousands)	Weighted Average Fair Value Per Share	Weighted Average Remaining Vesting Term (In Years)
Non-vested at September 30, 2008		\$	
Granted	94	5.24	
Vested			
Forfeited			
Non-vested at December 31, 2008	94	\$ 5.24	0.8

At December 31, 2008, approximately \$0.4 million of total unrecognized compensation cost related to non-vested RSUs is expected to be recognized over the weighted average period of 0.8 years.

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*Condensed Notes to Consolidated Financial Statements***6. Goodwill and Other Intangibles**

The change in the carrying amounts of goodwill by operating segment for the three months ended December 31, 2008 is as follows (in thousands):

	Sally Beauty Supply		Beauty Systems Group		Total
Balance at September 30, 2008	\$	65,188	\$	359,775	\$ 424,963
Additions, net of purchase price adjustments		359		195	554
Foreign currency translation		(5,366)		(6,571)	(11,937)
Balance at December 31, 2008	\$	60,181	\$	353,399	\$ 413,580

The following table provides the gross carrying value and accumulated amortization for intangible assets with indefinite lives and intangible assets subject to amortization by operating segment at December 31, 2008 (in thousands):

	Sally Beauty Supply		Beauty Systems Group		Total
Balance at December 31, 2008					
Intangible assets with indefinite lives:					
Trade names	\$	18,803	\$	33,491	\$ 52,294
Other intangibles				6,053	6,053
Total		18,803		39,544	58,347
Intangible assets subject to amortization:					
Gross carrying amount		6,676		35,736	42,412
Accumulated amortization		(1,506)		(18,159)	(19,665)
Net value		5,170		17,577	22,747
Total intangible assets, net	\$	23,973	\$	57,121	\$ 81,094

Amortization expense was \$1.5 million and \$1.9 million for the three months ended December 31, 2008 and 2007, respectively. There have been no material changes to the Company's future amortization expense schedule since September 30, 2008.

7. Long-Term Debt

In connection with the Separation Transactions on November 16, 2006, the Company, through its subsidiaries (Sally Investment Holdings LLC and Sally Holdings), incurred \$1,850.0 million of indebtedness by (i) drawing on a revolving (asset-based lending) facility (the "ABL facility") in an amount equal to \$70.0 million, (ii) entering into two term loan facilities (term loans A and B) in an aggregate amount of \$1,070.0 million and

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(iii) issuing senior notes in an aggregate amount of \$430.0 million and senior subordinated notes in an aggregate amount of \$280.0 million.

The term loan facilities and the ABL facility are secured by substantially all of our assets, those of Sally Investment Holdings LLC, a wholly-owned subsidiary of Sally Beauty and the direct parent of Sally Holdings, those of our domestic subsidiaries and, in the case of the ABL facility, those of our Canadian subsidiaries. The term loan facilities may be prepaid at our option at any time without premium or penalty and are subject to mandatory prepayment in an amount equal to 50% of excess cash flow (as defined in the agreement governing the term loan facilities) for any fiscal year (commencing in fiscal year 2008) unless a specified leverage ratio is met. In January 2009, the Company made a mandatory repayment on the term loan facilities in the amount of \$16.7 million. Amounts paid pursuant to said provision may be applied, at

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Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

the option of the Company, against minimum loan repayments otherwise required over the twelve month period following any such payment, under the terms of the loan agreement. Additionally, borrowings under the term loan facility would be subject to mandatory prepayment in an amount equal to 100% of the proceeds of specified asset sales that are not reinvested in the business or applied to repay borrowings under the ABL facility.

The senior notes and senior subordinated notes are unsecured obligations of the issuers and are guaranteed on a senior basis (in the case of the senior notes) and on a senior subordinated basis (in the case of the senior subordinated notes) by each material domestic subsidiary of the Company. Furthermore, the agreements underlying the Company's credit facilities contain terms, which significantly restrict the ability of Sally Beauty's subsidiaries to pay dividends or otherwise transfer assets to Sally Beauty. Please see the Company's Annual Report on Form 10-K for fiscal year ended September 30, 2008 for additional information about the Company's long-term debt.

Details of long-term debt are as follows (in thousands):

	As of December 31, 2008	Maturity dates (Fiscal Year)	Interest Rates
ABL facility	\$ 75,000	2012	(i) PRIME and up to 0.50% or; (ii) LIBOR plus (1.00% to 1.50%)
Term Loan A	131,250	2013	(i) PRIME plus (1.00% to 1.50%) or; (ii) LIBOR plus (2.00% to 2.50%)
Term Loan B	899,300	2014	(i) PRIME plus (1.25% to 1.50%) or; (ii) LIBOR plus (2.25% to 2.50%)
Other (a)	2,695	2009-2014	4.05% to 7.00%
Total	\$ 1,108,245		
Senior notes	\$ 430,000	2015	9.25%
Senior subordinated notes	280,000	2017	10.50%
Total	\$ 710,000		
Capitalized leases and other	\$ 674		
Less: current portion	(100,360)		
Total long-term debt	\$ 1,718,559		

(a) Represents pre-acquisition debt of Pro-Duo, N.V.

Maturities of the Company's long-term debt are as follows (in thousands):

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Fiscal Year:		
2009	\$	94,206
2010		24,816
2011		39,558
2012		84,520
2013		9,390
Thereafter		1,565,755
	\$	1,818,245
Capital leases and other		674
Less: current portion		(100,360)
Total	\$	1,718,559

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Condensed Notes to Consolidated Financial Statements

8. Interest Rate Swaps

The Company utilizes interest rate swap agreements to manage its cash flow exposure associated with changing interest rates in connection with its term loan obligations. The Company does not currently purchase or hold any derivative instruments for trading or speculative purposes.

In connection with the Separation Transactions, effective November 2006, the Company entered into four interest rate swap agreements with an aggregate notional amount of \$500 million. Interest rate swap agreements with an aggregate notional amount of \$150.0 million expired in November 2008 and interest rate swap agreements with a notional amount of \$350.0 million expire in November 2009. These interest rate swap agreements do not currently qualify as hedges and, therefore, the change in fair value of these interest rate swap agreements, which are adjusted quarterly, are recorded in the results of operations. Effective May 2008, the Company entered into two additional interest rate swap agreements with an aggregate notional amount of \$300 million. These interest rate swap agreements are designated as effective cash flow hedges, in accordance with SFAS 133. Adjustments to reflect the change in the fair values of these interest rate swap agreements, which are adjusted quarterly, are recorded, net of income tax, in accumulated other comprehensive (loss) income until the hedged obligation is settled or the swap agreements expire, whichever is earlier. Any hedge ineffectiveness, as this term is used in SFAS 133, is recognized in net interest expense in the consolidated statements of earnings. Please see the Company's Annual Report on Form 10-K for fiscal year ended September 30, 2008 for additional information about the Company's interest rate swap agreements.

The aggregate fair value of all interest rate swap agreements held at December 31, 2008 was an aggregate liability of \$27.2 million, consisting of \$10.7 million included in accrued expenses and \$16.5 million in other liabilities. Fair value estimates used for the swap agreements held by the Company are based on third-party information and were determined using proprietary models based upon well-recognized financial principles and reasonable estimates about relevant future market conditions.

The counterparties to all our interest rate swap instruments are deemed by the Company to be of substantial resources and strong creditworthiness. However, these transactions result in exposure to credit risks in the event of default by a counterparty. The current financial crisis affecting the banking systems and financial markets has resulted in many well-known financial institutions becoming less creditworthy or having diminished liquidity and, thus, we could be exposed to an increased level of counterparty risk. In the event that a counterparty defaults in its obligation under our interest rate swaps, we could incur substantial financial losses. However, at the present time, no such losses are deemed probable.

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There were no gains or losses reclassified into earnings, from accumulated other comprehensive (loss) income, in connection with the swap agreements during the three months ended December 31, 2008 or 2007. The marked-to-market impact of the swap arrangements on interest expense was an increase of approximately \$3.0 million and \$5.7 million in the three months ended December 31, 2008 and 2007, respectively.

9. Income Taxes

The Company and its subsidiaries, file income tax returns in the U.S. federal jurisdiction and most state jurisdictions, as well as in various foreign jurisdictions.

The Separation Transactions were intended to qualify as a reorganization under Section 368(a)(1)(D) of the Internal Revenue Code of 1986, as amended (the Code) and a distribution eligible for non-recognition under Sections 355(a) and 361(c) of the Code. In connection with the share distribution of Alberto-Culver common stock in the Separation Transactions, the Company received: (i) a private letter ruling from the Internal Revenue Service (IRS) and (ii) an opinion of Sidley Austin LLP, counsel to Alberto-Culver, in each case, to the effect that the transactions qualify as a reorganization under Section 368(a)(1)(D) of the Code and a distribution eligible for non-recognition under Sections 355(a) and 361(c) of the Code. Certain internal restructurings also occurred at or immediately prior to the Separation Transactions. As a result of the internal restructurings and Separation Transactions, the Company inherited the federal tax identification number of the old Alberto-Culver parent for U.S. federal income tax purposes.

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The Company and Alberto-Culver entered into a tax allocation agreement as part of the Separation Transactions. The agreement provides generally that the Company is responsible for its pre-separation income tax liabilities, calculated on a stand-alone basis, and Alberto-Culver is responsible for the remainder. In the event an additional U.S. federal income tax liability related to the period prior to the Separation Transactions were determined, the Company would be jointly and severally liable for these taxes, and there can be no assurance that Alberto-Culver would be able to fulfill its indemnification obligations to the Company under the tax allocation agreement if Alberto-Culver was determined to be responsible for these taxes thereunder.

In addition, as the successor entity to Alberto-Culver after the Separation Transactions, the Company relies upon the prior year federal income tax returns of Alberto-Culver, and accounting methods established therein, for certain calculations that affect our current U.S. federal income tax liability.

10. Business Segments

The Company's business is organized into two separate segments: (i) Sally Beauty Supply, a domestic and international chain of cash and carry retail stores which offers professional beauty supplies to both salon professionals and retail customers and (ii) BSG, including its franchise-based business Armstrong McCall, a full service beauty supply distributor which offers professional brands of beauty products directly to salons through its own sales force and professional only stores (including franchise stores) in generally exclusive geographical territories in North America and parts of Europe.

The Company does not sell between segments. Segment data for the three months ended December 31, 2008 and 2007 is as follows (in thousands):

	Three Months Ended December 31,	
	2008	2007
Net sales:		
Sally Beauty Supply	\$ 410,537	\$ 409,564
BSG	235,039	246,223
Total net sales	\$ 645,576	\$ 655,787
Earnings before provision for income taxes:		
Segment operating profit:		
Sally Beauty Supply	\$ 65,286	\$ 71,733
BSG	20,236	21,030
Segment operating profit	85,522	92,763
Unallocated corporate expenses (1)	(15,642)	(17,295)
Share-based compensation expense	(3,611)	(5,592)
Interest expense, net of interest income	(39,673)	(46,483)

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Earnings before provision for income taxes	\$	26,596	\$	23,393
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(1) Unallocated corporate expenses consist of corporate and shared costs.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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The following section discusses management's view of the financial condition, results of operations and cash flows of Sally Beauty Holdings, Inc. and its consolidated subsidiaries. This section should be read in conjunction with the audited consolidated financial statements and the related notes included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2008, as well as the Risk Factors section of that Annual Report, and information contained elsewhere in this Quarterly Report, including the consolidated financial statements and condensed notes to those statements. This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements. See "Cautionary Notice Regarding Forward-Looking Statements," included at the beginning of this Quarterly Report, for a discussion of the uncertainties, risks and assumptions associated with these forward-looking statements that could cause results to differ materially from those reflected in such forward-looking statements.

Highlights of First Quarter of Fiscal Year 2009:

- Our same store sales increased slightly for the three months ended December 31, 2008;
- Our consolidated net sales for the three months ended December 31, 2008 decreased by \$10.2 million, or 1.6%, to \$645.6 million compared to \$655.8 million for the three months ended December 31, 2007;
- Net sales reported for the three months ended December 31, 2008 were impacted by an unfavorable foreign currency exchange impact of \$24.8 million, or 3.8%;
- Our consolidated gross profit for the three months ended December 31, 2008 decreased \$2.6 million, or 0.9%, to \$303.5 million compared to \$306.2 million for the three months ended December 31, 2007. As a percentage of net sales, gross profit increased 30 basis points to 47.0% for the three months ended December 31, 2008 compared to 46.7% for the three months ended December 31, 2007;
- Our consolidated operating earnings for the three months ended December 31, 2008 decreased \$3.6 million, or 5.2%, to \$66.3 million compared to \$69.9 million for the three months ended December 31, 2007. As a percentage of net sales, operating earnings were 10.3% for the three months ended December 31, 2008 compared to 10.7% for the three months ended December 31, 2007;
- Net earnings increased \$1.7 million, or 12.0%, to \$16.1 million for the three months ended December 31, 2008 compared to \$14.3 million for the three months ended December 31, 2007; and
- Cash flows from operations for the three months ended December 31, 2008 increased by \$49.2 million to net cash provided of \$31.0 million, compared to net cash used of \$18.2 million for the three months ended December 31, 2007.

Overview

Description of Business

We are the largest distributor of professional beauty supplies in the U.S. based on store count. We operate primarily through two business units, Sally Beauty Supply and BSG. Through Sally Beauty Supply and BSG (which operates stores under the CosmoProf service mark), we operated a multi-channel platform of 3,582 stores and supplied 187 franchised stores in North America, as well as in certain European countries and Japan, as of December 31, 2008. Within BSG, we also have one of the largest networks of professional distributor sales consultants in North America, with approximately 977 professional distributor sales consultants who sell directly to salons and salon professionals. We provide our

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customers with a wide variety of leading third-party branded and exclusive-label professional beauty supplies, including hair care products, styling appliances, skin and nail care products and other beauty items. Sally Beauty Supply stores target retail consumers and salon professionals, while BSG exclusively targets salons and salon professionals. For the three months ended December 31, 2008, our net sales and operating earnings were \$645.6 million and \$66.3 million, respectively.

We believe that Sally Beauty Supply is the largest open-line distributor of professional beauty supplies in the U.S. based on store count. As of December 31, 2008, Sally Beauty Supply operated 2,824 company-operated retail stores and supplied 25 franchised stores (all located outside the U.S.). Of these stores, 2,309 are located in the U.S. (with the remainder in the United Kingdom and certain other countries in Europe, Canada, Puerto Rico, Mexico and Japan). Sally Beauty Supply stores average 1,700 square feet and are primarily located in strip shopping centers. The product selection in Sally Beauty Supply stores ranges between 5,000 and 8,000 SKUs of beauty products and includes products for hair care, skin and nail care, beauty sundries and electrical appliances targeting retail consumers and salon professionals. Sally Beauty Supply stores carry leading third-party brands such as Clairol, Revlon and Conair, as well as an extensive selection of exclusive-label merchandise.

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We believe that BSG is the largest full-service distributor of professional beauty supplies in the U.S. As of December 31, 2008, BSG had 758 company-operated stores, supplied 162 franchised stores and had a sales force of approximately 977 professional distributor sales consultants selling exclusively to salons and salon professionals in substantially all states in the U.S. and in portions of Canada, Mexico and certain European countries. BSG stores average 2,700 square feet and are primarily located in secondary strip shopping centers. Through BSG's large store base and sales force, BSG is able to access a significant portion of the highly fragmented U.S. salon channel. The product selection in BSG stores, ranging between 4,000 and 9,600 SKUs of beauty products, includes hair care and color, skin and nail care, beauty sundries and electrical appliances targeting salons and salon professionals. BSG carries leading professional beauty product brands, intended for use in salons and for resale by the salon to consumers. Certain BSG products are sold under exclusive distribution agreements with suppliers, whereby BSG is designated as the sole distributor for a product line within certain geographic territories.

Industry and Business Trends

We operate within the large and growing U.S. professional beauty supply industry. Potential growth in the industry is expected to be driven by increases in hair color, hair loss prevention and hair styling products, offset by lower sales of electrical products during periods of prolonged economic slowdown. We believe the following key industry and business trends and characteristics will influence our business and our financial results going forward:

- *High level of customer fragmentation.* The U.S. salon channel is highly fragmented with over 225,000 salons. Given the fragmented and small-scale nature of the salon industry, we believe that salon operators will continue to depend on full-service/exclusive distributors and open-line channels for a majority of their beauty supply purchases.
- *Growth in booth renting and frequent stocking needs.* Salon professionals primarily rely on just-in-time inventory due to capital constraints and a lack of warehouse and shelf space at salons. In addition, booth renters, who comprise a significant percentage of total U.S. salon professionals, are often responsible for purchasing their own supplies. Historically, booth renters have significantly increased as a percentage of total salon professionals and we expect this trend to continue. Given their smaller individual purchases and relative lack of financial resources, booth renters are likely to be dependent on frequent trips to professional beauty supply stores, like BSG and Sally Beauty Supply. These factors continue to drive demand for conveniently located professional beauty supply stores.
- *Increasing Use of Exclusive-Label Products.* We offer a broad range of private label and control label products, which we generally refer to collectively as exclusive-label products. Private label products are brands for which we own or license the trademark and, in some instances, the formula. Control label products are brands that are owned by the manufacturer, but for which we have been granted sole distribution rights. Generally, our exclusive-label products have higher gross margins than the leading third-party branded products and we believe this area offers potential growth. Please see Risk Factors - We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2008.

- *International Growth Strategies.* A key element of our growth strategy depends on our ability to capitalize on growth in the international marketplace and to grow our current level of non-U.S. operations. In May 2008, we acquired Pro-Duo, N.V., a cash and carry retailer of both professional and retail hair products with approximately 40 stores located in Belgium, France and Spain. In February 2007, we acquired Chapelton 21 Limited, a private company based in Scotland with almost 100 stores located in the United Kingdom, Ireland, Germany, France and Spain, which we refer to as Salon Services. These acquisitions furthered our expansion plans in Europe, a significant part of Sally Beauty Supply's international growth initiative. We intend to continue to identify and evaluate non-U.S. acquisition targets and are actively considering expansion into South America. Our ability to grow our non-U.S. operations, integrate our new non-U.S. acquisitions and successfully pursue additional non-U.S. acquisitions may be affected by business, legal, regulatory and economic risks. Please see Risk Factors - We may not be able to successfully identify acquisition candidates and complete desirable acquisitions, If we acquire any businesses in the future they could prove difficult to integrate, disrupt our business or have an adverse effect on our results of operations and Our ability to conduct business in international marketplaces may be affected by legal, regulatory and economic risks in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2008.

- *Continuing consolidation.* There is continuing consolidation among professional beauty product distributors and professional beauty product manufacturers. We plan to continue to examine ways in which we can benefit from this trend, including reviewing opportunities to shift business from competitive distributors to

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the BSG network as well as seeking opportunistic value-added acquisitions. We believe that suppliers are increasingly likely to focus on larger distributors and retailers with a broader scale and retail footprint. We also believe that we are well positioned to capitalize on this trend as well as participate in the ongoing consolidation at the distributor/retail level. However, changes often occur in our relationships with suppliers that may materially affect the net sales and operating earnings of our business segments. Consolidation among suppliers could exacerbate the effects of these relationship changes and could increase pricing pressures. For example, as we announced in December 2006, our largest supplier, L Oreal, moved a material amount of revenue out of the BSG nationwide distribution network and into competitive regional distribution networks. More recently, L Oreal acquired distributors competing with BSG in the southeastern and west coast of the U.S. and a supplier that does not currently do business with BSG. As a result, L Oreal directly competes with BSG in certain geographic areas. If L Oreal acquired other distributors or suppliers that conduct significant business with BSG, we could lose related revenue. There can be no assurance that there will not be further loss of revenue over time by BSG (including within its franchise-based business) due to potential losses of additional products (both from L Oreal and from other suppliers) as well as from the increased competition from L Oreal-affiliated distribution networks. Please see Relationships with Suppliers and Risk Factors - The beauty products distribution industry is highly competitive and is consolidating and We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us in Item 1A of our Annual report on Form 10-K for the fiscal year ended September 30, 2008.

- *High level of competition.* Sally Beauty Supply competes with other domestic and international beauty product wholesale and retail outlets, including local and regional open-line beauty supply stores, professional-only beauty supply stores, salons, mass merchandisers, drug stores and supermarkets, as well as sellers on the Internet and salons retailing hair care items. BSG competes with other domestic and international beauty product wholesale and retail suppliers and manufacturers selling professional beauty products directly to salons and individual salon professionals. We also face competition from authorized and unauthorized retailers and Internet sites offering professional salon-only products. The increasing availability of unauthorized professional salon products in large format retail stores such as drug stores, grocery stores and others could also have a negative impact on our business.
- *Favorable demographic and consumer trends.* The aging baby-boomer population is expected to drive future growth in professional beauty supply sales through an increase in the usage of hair color and hair loss products. Additionally, continuously changing fashion-related trends that drive new hair styles are expected to result in continued demand for hair styling products. Changes in consumer tastes and fashion trends can have an impact on our financial performance. Our continued success depends in large part on our ability to anticipate, gauge and react in a timely and effective manner to changes in consumer spending patterns and preferences for beauty products. We continuously adapt our marketing and merchandising initiatives for Sally Beauty Supply in an effort to expand our market reach or to respond to changing consumer preferences. If we are unable to anticipate and respond to trends in the marketplace for beauty products and changing consumer demands, our business could suffer.
- *Economic conditions.* We appeal to a wide demographic consumer profile and offer a broad selection of beauty products sold directly to retail consumers and salons and salon professionals. Historically, these factors have provided us with reduced exposure to downturns in economic conditions in the countries in which we operate. However, a continued downturn in the economy, especially for an extended period of time, could adversely impact consumer demand of discretionary items such as beauty products and salon services, particularly affecting our electrical products category and our full-service sales business. In addition, higher freight costs resulting from increases in the cost of fuel, especially for an extended period of time, may impact our expenses at levels that we cannot pass through to our customers. These factors could have a material adverse effect on our business, financial condition and results of operations.

- *Controlling expenses.* Another important aspect of our business is our ability to control costs, especially in our BSG business segment, by right-sizing the business and maximizing the efficiency of our structure. During late fiscal year 2007, we began implementing an approximately \$22.0 million capital spending program to consolidate warehouses and reduce administrative expenses related to BSG's distribution network optimization program. We believe that cost savings from this program could range between \$5 million and \$7 million in fiscal year 2009 and annualized savings of \$10 million beginning in fiscal year 2010. In addition, during the fiscal 2009 first quarter we implemented a temporary hiring freeze for all personnel, deferred merit increases for upper management and instituted variable expense reductions related to benefits and payroll related costs. Please see Risk Factors We are not certain that our ongoing cost control plans will continue to be successful in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2008.

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- *Opening New Stores.* Our future growth strategy depends in part, on our ability to open and profitably operate new stores in existing and additional geographic areas. The capital requirements to open a U.S. based Sally Beauty Supply or BSG store, excluding inventory, average approximately \$70,000 and \$80,000, respectively. However, in response to economic conditions or to allow flexibility to capitalize on potential real estate revaluations in key locations, we may not be able to open all of the new stores we plan to open and any new stores we open may not be profitable, either of which could have a material adverse impact on our financial condition or results of operations. Please see *Risk Factors* If we are unable to profitably open and operate new stores, our business, financial condition and results of operations may be adversely affected in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2008.
- *Changes to our information technology systems.* As our operations grow in both size and scope, we will continuously need to improve and upgrade our information systems and infrastructure while maintaining the reliability and integrity of our systems and infrastructure. The expansion of our systems and infrastructure will require us to commit substantial financial, operational and technical resources in advance of any increase in the volume of our business, with no assurance that the volume of business will increase. For example, in fiscal year 2008 we upgraded our Lawson financial reporting system and implemented Customer Relationship Management, or CRM, programs for our Sally Beauty Supply stores and are currently upgrading our distribution information systems (in connection with our capital spending program to consolidate warehouses, as discussed above), upgrading our AS400 iSeries servers and implementing a new point-of-sale system for tracking customer sales. These and any other required upgrades to our information systems and information technology (or new technology), now or in the future, will require that our management and resources be diverted from our core business to assist in completion of these projects. There can be no assurance that the time and resources our management will need to devote to these upgrades, service outages or delays due to the installation of any new or upgraded technology (and customer issues therewith), or the impact on the reliability of our data from any new or upgraded technology will not have a material adverse effect on our financial reporting, business, financial condition or results of operations. Please see *Risk Factors* We may be adversely affected by any disruption in our information technology systems in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2008.
- *Relationships with suppliers.* We do not manufacture the brand name or exclusive-label products we sell, and instead purchase our products from manufacturers. We depend upon a limited number of manufacturers for a significant percentage of the products we sell, and our relationships with these suppliers change often. Please see *Relationships with Suppliers*.

Relationships with Suppliers

Most of our net sales are generated through retail stores with respect to the Sally Beauty Supply business, and both professional only stores and professional distribution sales consultants with respect to the BSG business. In addition, BSG has a number of franchisees located primarily in the south and southwestern portions of the U.S. and in Mexico, which buy products directly from BSG for resale in their assigned territories. A very small percentage of sales are generated through franchisees or sub-distributors (primarily in Europe), which also buy products directly from Sally Beauty Supply or BSG for resale. Sally Beauty Supply/BSG and their suppliers are dependent on each other for the distribution of beauty

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products. As is typical in distribution businesses, these relationships are subject to change from time to time (including the expansion or loss of distribution rights in various geographies and the addition or loss of product lines).

Since we purchase products from many manufacturers on an at-will basis, under contracts which can generally be terminated without cause upon 90 days' notice or less or which expire without express rights of renewal, such manufacturers could discontinue sales to us at any time or upon the expiration of the distribution period. Some of our contracts with manufacturers may be terminated by such manufacturers if we fail to meet specified minimum purchase requirements. In such cases, we do not have contractual assurances of continued supply, pricing or access to new products and vendors may change the terms upon which they sell. Infrequently, a supplier will seek to terminate a distribution relationship through legal action.

Changes in our relationships with suppliers occur often, and could positively or negatively impact our net sales and operating profits. For example, during the 2009 first quarter, BSG gained additional distribution of Henkel's Schwarzkopf brand in stores across four states. In addition, during the second quarter of fiscal year 2007, Farouk Systems, Inc., or Farouk Systems, terminated its distribution agreement with us. Subsequently, effective July 2007, BSG stores and professional distributor sales consultants were once again given approval to distribute Farouk Systems products, with an expanded distribution area. In the first quarter of fiscal 2009, Farouk Systems again terminated its distribution agreement with BSG. The agreement through which our Armstrong McCall franchisees are supplied is currently unaffected by this event. In December 2006, we announced the loss of certain L'Oréal distribution rights,

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including (among other things) distribution rights through our BSG distributor sales consultants and the loss of exclusive rights to distribute L'Oréal products in our BSG stores. These losses have resulted in margin pressure on BSG's remaining L'Oréal revenues, and this pressure has continued into fiscal year 2009. As discussed above, L'Oréal has entered into direct competition with BSG and there can be no assurance that there will not be further revenue losses over time at BSG due to potential losses of additional L'Oréal related products as well as from the increased competition from L'Oréal-affiliated distribution networks. BSG has entered into long-term agreements with L'Oréal under which, as of January 1, 2007, BSG had non-exclusive rights to distribute the same L'Oréal professional products in its stores that it previously had exclusive rights to distribute in its stores and through its sales consultants. Armstrong McCall retained its exclusive rights to distribute Matrix professional products in its territories. Although we have focused on developing new revenue and cost management initiatives to mitigate the negative effects resulting from unfavorable changes in our supplier relationships, there can be no assurance that our efforts will continue to completely offset the loss of these or other distribution rights. Please see "Risk Factors - We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us" in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2008.

We expect to continue to expand our product line offerings and to gain additional distribution rights over time through either further negotiation with suppliers, or by strategic acquisitions of existing distributors. Although we are focused on developing new revenue and cost management initiatives, there can be no assurance that our efforts will partially or completely offset any potential loss of distribution rights in the future. Please see "Risk Factors - We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us" in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2008.

Our Separation from Alberto-Culver

In November 2006, pursuant to an investment agreement among Alberto-Culver and certain of its subsidiaries, including Sally Holdings, and CDRS Acquisition LLC (CDRS), Alberto-Culver separated its consumer products business and its Sally Beauty Supply/BSG distribution business into two separate, publicly-traded companies (the Separation Transactions). Sally Holdings was a wholly-owned subsidiary of Alberto-Culver until the Separation Transactions, when it was converted to a Delaware limited liability company, was renamed Sally Holdings LLC and became an indirect wholly-owned subsidiary of Sally Beauty. Sally Beauty was formed in June 2006 and became the accounting successor company to Sally Holdings upon the completion of the Separation Transactions. See the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008 for more information about the Separation Transactions.

Other Significant Items

Interest Rate Swap Agreements

The Company, through Sally Holdings, utilizes interest rate swap agreements to manage its cash flow risk associated with changing interest rates as it relates to its term loans. We do not currently purchase or hold any derivative instruments for trading or speculative purposes. The counterparties are deemed to be of substantial resources and strong creditworthiness. However, these transactions result in exposure to credit risks in the event of default by a counterparty. The current financial crisis affecting the banking systems and financial markets has resulted in many well-known financial institutions becoming less creditworthy or having diminished liquidity and, thus, we could be exposed to an increased level of counterparty risk. In the event that a counterparty defaults in its obligation under our interest rate swaps, we could incur substantial financial loss. At December 31, 2008, the aggregate fair value of all our interest rate swaps was a net liability of \$27.2 million.

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Effective in November 2006, Sally Holdings entered into four interest rate swap agreements with an aggregate notional amount of \$500.0 million. Interest rate swap agreements with an aggregate notional amount of \$150.0 million expired in November 2008 and interest rate swap agreements with a notional amount of \$350.0 million expire in November 2009. These interest rate swap agreements do not currently qualify as hedges and, therefore, the change in fair value of these interest rate swap agreements is recorded in net interest expense in the consolidated statements of earnings.

Additionally, effective in May 2008, Sally Holdings entered into two interest rate swap agreements with an aggregate notional amount of \$300.0 million. These interest rate swap agreements are designated as effective hedges, consistent with Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Adjustments to reflect the change in the fair values of these interest rate swap agreements are recorded in accumulated other comprehensive (loss) income until the hedged obligation is settled or the swap agreements expire, whichever is earlier. Any ineffectiveness is recognized in net interest expense in the

Additionally, effective in May 2008, Sally Holdings entered into two interest rate swap agreements with an aggregate

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consolidated statements of earnings. Please see **Item 3 Quantitative and Qualitative Disclosures about Market Risk Interest rate risk and Note 14 of the Notes to Consolidated Financial Statements in Item 8 - Financial Statements and Supplementary Data** contained in our **Annual Report on Form 10-K for the fiscal year ended September 30, 2008.**

Results of Operations

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The following table shows the condensed results of operations of our business for the three months ended December 31, 2008 and 2007, expressed as a percentage of net sales for the respective periods (dollars in thousands):

	Three Months Ended December 31,			
	2008		2007	
Net sales	\$ 645,576	100.0%	\$ 655,787	100.0%
Cost of products sold and distribution expenses	342,032	53.0%	349,618	53.3%
Gross profit	303,544	47.0%	306,169	46.7%
Total other operating costs and expenses	237,275	36.7%	236,293	36.0%
Operating earnings	66,269	10.3%	69,876	10.7%
Interest expense, net	39,673	6.2%	46,483	7.1%
Earnings before provision for income taxes	26,596	4.1%	23,393	3.6%
Provision for income taxes	10,537	1.6%	9,050	1.4%
Net earnings	\$ 16,059	2.5%	\$ 14,343	2.2%

Table of Contents**Key Operating Metrics**

The following table sets forth, for the periods indicated, information concerning key measures we rely on to gauge our operating performance (dollars in thousands):

	Three Months Ended December 31,	
	2008	2007(a)
Net sales:		
Sally Beauty Supply	\$ 410,537	\$ 409,564
BSG	235,039	246,223
	\$ 645,576	\$ 655,787
Gross Profit	\$ 303,544	\$ 306,169
Gross profit margin	47.0%	46.7%
Selling, general and administrative expenses	\$ 225,528	\$ 224,541
Depreciation and amortization	\$ 11,747	\$ 11,752
Earnings before provision for income taxes:		
Segment operating profit:		
Sally Beauty Supply	\$ 65,286	\$ 71,733
BSG	20,236	21,030
Segment operating profit	85,522	92,763
Unallocated expenses	(15,642)	(17,295)
Share-based compensation expense	(3,611)	(5,592)
Operating earnings	66,269	69,876
Interest expense, net of interest income	(39,673)	(46,483)
Earnings before provision for income taxes	\$ 26,596	\$ 23,393
Segment operating profit margin:		
Sally Beauty Supply	15.9%	17.5%
BSG	8.6%	8.5%
Consolidated operating profit margin	10.3%	10.7%
Number of stores at end-of-period (including franchises):		