# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

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# FORM 10-Q

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

**FOR THE QUARTERLY PERIOD ENDED: JUNE 30, 2014**

**-OR-**

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

**Commission File No. 1-33145**

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# SALLY BEAUTY HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **36-2257936** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **3001 Colorado Boulevard** | |
| **Denton, Texas** | **76210** |
| (Address of principal executive offices) | (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 x NO o

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

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

| | | | |
|---|---|---|---|
| Large accelerated filer x | Accelerated filer o | 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.) YES o NO x

As of July 25, 2014, there were 155,156,347 shares of the issuer s common stock outstanding.

Table of Contents

**TABLE OF CONTENTS**

Table of Contents

In this Quarterly Report, references to the Company, Sally Beauty, our company, we, our, ours and us refer to Sally Beauty Holdings, its consolidated subsidiaries unless otherwise indicated or the context otherwise requires.

Cautionary Notice Regarding Forward-Looking Statements

Statements in this Quarterly Report on Form 10-Q and in the documents incorporated by reference herein which are not purely historical facts or which depend upon future events may constitute 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, which we refer to as the Exchange Act. Words such as anticipate, believe, estimate, expect, intend, plan, project, target, can, could, may, should, will, would or similar e 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 products by our manufacturers or third-party distributors;
- 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;

- the success of our e-commerce businesses;
- product diversion to mass retailers or other unauthorized resellers;
- the operational and financial performance of our Armstrong McCall, L.P., which we refer to as Armstrong McCall, franchise-based business;
- successfully identifying acquisition candidates and successfully completing desirable acquisitions;
- integrating acquired businesses;
- opening and operating new stores profitably;
- the impact of the health of the economy upon our business;
- the success of our cost control plans;
- protecting our intellectual property rights, particularly our trademarks;
- the risk that our products may infringe on the intellectual property rights of others;
- conducting business outside the United States;
- disruption in our information technology systems;
- a significant data security breach, including misappropriation of our customers or employees confidential information, and the potential costs related thereto;

- the negative impact on our reputation and loss of confidence of our customers, suppliers and others arising from a significant data security breach;
- the costs and diversion of management s attention required to investigate and remediate a data security breach;
- the ultimate determination of the extent or scope of the potential liabilities relating to our recent data security incident;
- severe weather, natural disasters or acts of violence or 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;

Table of Contents

- the possibility that we may incur substantial additional debt, including secured debt, in the future;

- 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;

- changes in interest rates increasing the cost of servicing our debt;

- the potential impact on us if the financial institutions we deal with become impaired; and

- the costs and effects of litigation.

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 Item 1A. Risk Factors contained in Part I of our Annual Report on Form 10-K for the fiscal year ended September 30, 2013 and Part II of our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2014, in each case as filed with the Securities and Exchange Commission, or SEC, and the other periodic reports that we file with the SEC. 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.

Table of Contents

**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 should not be considered to be a part of this or any other report filed with or furnished to the SEC.

Table of Contents

## PART I FINANCIAL INFORMATION

### Item 1. Financial Statements.

The following consolidated balance sheets as of June 30, 2014 and September 30, 2013, the consolidated statements of earnings and consolidated statements of comprehensive income for the three and nine months ended June 30, 2014 and 2013, and the consolidated statements of cash flows for the nine months ended June 30, 2014 and 2013 are those of Sally Beauty Holdings, Inc. and its consolidated subsidiaries.

Table of Contents

**SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES**
Consolidated Statements of Earnings
(In thousands, except per share data)

(Unaudited)

| | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Nine Months Ended June 30, 2014 | Nine Months Ended June 30, 2013 |
|---|---|---|---|---|
| Net sales | $ 949,275 | $ 912,101 | $ 2,809,210 | $ 2,715,781 |
| Cost of products sold and distribution expenses | 473,564 | 455,018 | 1,416,578 | 1,369,876 |
| Gross profit | 475,711 | 457,083 | 1,392,632 | 1,345,905 |
| Selling, general and administrative expenses | 320,726 | 295,719 | 953,016 | 900,778 |
| Depreciation and amortization | 19,989 | 18,798 | 58,739 | 52,853 |
| Operating earnings | 134,996 | 142,566 | 380,877 | 392,274 |
| Interest expense | 29,308 | 27,006 | 87,055 | 80,510 |
| Earnings before provision for income taxes | 105,688 | 115,560 | 293,822 | 311,764 |
| Provision for income taxes | 37,932 | 43,094 | 109,579 | 115,426 |
| Net earnings | $ 67,756 | $ 72,466 | $ 184,243 | $ 196,338 |
| | | | | |
| Earnings per share: | | | | |
| Basic | $ 0.43 | $ 0.43 | $ 1.14 | $ 1.13 |
| Diluted | $ 0.42 | $ 0.42 | $ 1.11 | $ 1.10 |
| | | | | |
| Weighted average shares: | | | | |
| Basic | 158,950 | 168,725 | 161,700 | 173,528 |
| Diluted | 162,524 | 173,762 | 165,389 | 178,278 |

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, 2013, are an integral part of these financial statements.

Table of Contents

**SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES**
Consolidated Statements of Comprehensive Income
(In thousands)

(Unaudited)

| | Three Months Ended June 30, | | Nine Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net earnings | $ 67,756 | $ 72,466 | $ 184,243 | $ 196,338 |
| Other comprehensive income (loss): | | | | |
| Foreign currency translation adjustments | 6,282 | (4,157) | 6,134 | (13,292) |
| Total other comprehensive income, before tax | 6,282 | (4,157) | 6,134 | (13,292) |
| Income taxes related to other comprehensive income | 578 | | 578 | |
| Other comprehensive income (loss), net of tax | 6,860 | (4,157) | 6,712 | (13,292) |
| Total comprehensive income | $ 74,616 | $ 68,309 | $ 190,955 | $ 183,046 |

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, 2013, 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)

| | June 30, 2014 (Unaudited) | September 30, 2013 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 46,329 | $ 47,115 |
| Trade accounts receivable, less allowance for doubtful accounts of $2,488 at June 30, 2014 and $2,556 at September 30, 2013 | 54,199 | 57,049 |
| Accounts receivable, other | 41,425 | 39,196 |
| Inventory | 839,845 | 808,313 |
| Other current assets | 35,598 | 31,658 |
| Deferred income tax assets, net | 32,398 | 32,486 |
| Total current assets | 1,049,794 | 1,015,817 |
| Property and equipment, net of accumulated depreciation of $409,691 at June 30, 2014 and $375,232 at September 30, 2013 | 233,366 | 229,540 |
| Goodwill | 541,979 | 538,278 |
| Intangible assets, excluding goodwill, net of accumulated amortization of $82,597 at June 30, 2014 and $71,759 at September 30, 2013 | 121,507 | 130,097 |
| Other assets | 36,966 | 36,354 |
| Total assets | $ 1,983,612 | $ 1,950,086 |
| **Liabilities and Stockholders Deficit** | | |
| Current liabilities: | | |
| Current maturities of long-term debt | $ 10,336 | $ 78,018 |
| Accounts payable | 254,894 | 273,456 |
| Accrued liabilities | 159,991 | 184,762 |
| Income taxes payable | 7,737 | 6,417 |
| Total current liabilities | 432,958 | 542,653 |
| Long-term debt | 1,811,379 | 1,612,685 |
| Other liabilities | 28,538 | 24,286 |
| Deferred income tax liabilities, net | 73,531 | 73,941 |
| Total liabilities | 2,346,406 | 2,253,565 |
| Stockholders deficit: | | |
| Common stock, $0.01 par value. Authorized 500,000 shares; 155,834 and 164,762 shares issued and 155,391 and 164,425 shares outstanding at June 30, 2014 and September 30, 2013, respectively | 1,554 | 1,644 |
| Preferred stock, $0.01 par value. Authorized 50,000 shares; none issued | | |
| Additional paid-in capital | | 91,022 |
| Accumulated deficit | (361,242) | (385,090) |
| Treasury stock, 47 shares, at cost | | (1,237) |
| Accumulated other comprehensive loss, net of tax | (3,106) | (9,818) |
| Total stockholders deficit | (362,794) | (303,479) |
| Total liabilities and stockholders deficit | $ 1,983,612 | $ 1,950,086 |

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, 2013, are an integral part of these financial statements.

Table of Contents

**SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES**
Consolidated Statements of Cash Flows
(In thousands)

(Unaudited)

| | Nine Months Ended June 30, 2014 | Nine Months Ended June 30, 2013 |
|---|---|---|
| **Cash Flows from Operating Activities:** | | |
| Net earnings | $ 184,243 | $ 196,338 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 58,739 | 52,853 |
| Share-based compensation expense | 18,297 | 15,503 |
| Amortization of deferred financing costs | 2,813 | 2,719 |
| Excess tax benefit from share-based compensation | (12,211) | (11,316) |
| Deferred income taxes | (824) | 12,071 |
| Changes in (exclusive of effects of acquisitions): | | |
| Trade accounts receivable | 3,129 | (659) |
| Accounts receivable, other | (1,817) | 2,432 |
| Inventory | (27,913) | (49,165) |
| Other current assets | (1,386) | 9,824 |
| Other assets | 201 | (35) |
| Accounts payable and accrued liabilities | (45,915) | (38,385) |
| Income taxes payable | 11,952 | 4,312 |
| Other liabilities | 4,155 | 635 |
| Net cash provided by operating activities | 193,463 | 197,127 |
| **Cash Flows from Investing Activities:** | | |
| Capital expenditures | (49,776) | (64,551) |
| Acquisitions, net of cash acquired | (4,765) | (16,070) |
| Net cash used by investing activities | (54,541) | (80,621) |
| **Cash Flows from Financing Activities:** | | |
| Proceeds from issuance of long-term debt | 310,219 | 222,500 |
| Repayments of long-term debt | (178,582) | (148,424) |
| Repurchases of common stock | (301,727) | (407,197) |
| Debt issuance costs | (3,896) | |
| Proceeds from exercises of stock options | 21,854 | 18,722 |
| Excess tax benefit from share-based compensation | 12,211 | 11,316 |
| Net cash used by financing activities | (139,921) | (303,083) |
| Effect of foreign exchange rate changes on cash and cash equivalents | 213 | (199) |
| Net decrease in cash and cash equivalents | (786) | (186,776) |
| Cash and cash equivalents, beginning of period | 47,115 | 240,220 |
| Cash and cash equivalents, end of period | $ 46,329 | $ 53,444 |
| | | |
| **Supplemental Cash Flow Information:** | | |
| Interest paid | $ 107,410 | $ 104,366 |
| Income taxes paid | $ 99,284 | $ 84,735 |

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, 2013, are an integral part of these financial statements.

10

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

**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 through its Sally Beauty Supply retail stores primarily in the U.S., Puerto Rico, Canada, Mexico, Chile, Peru, the United Kingdom, Ireland, Belgium, France, Germany, the Netherlands and Spain. Additionally, the Company distributes professional beauty products to salons and salon professionals through its Beauty Systems Group ( BSG ) store operations and a commissioned direct sales force that calls on salons primarily in the U.S., Puerto Rico, Canada, the United Kingdom and certain other countries in Europe, and to franchises in the southern and southwestern regions of the 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 under exclusive territory agreements with the manufacturers of the products.

**Basis of Presentation**

The accompanying 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 Company s consolidated financial position as of June 30, 2014 and September 30, 2013, its consolidated results of operations for the three and nine months ended June 30, 2014 and 2013, and consolidated cash flows for the nine months ended June 30, 2014 and 2013.

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

All references in these notes to management are to the management of Sally Beauty.

**2. Significant Accounting Policies**

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. 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, 2013. The Company adheres to the same accounting policies in the preparation of its interim financial statements. As permitted under GAAP, interim accounting for certain expenses, including income taxes, is 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.

The results of operations for these interim periods are not necessarily indicative of the results that may be expected for any future interim period or the entire fiscal year.

**3. Recent Accounting Pronouncements and Accounting Changes**

**Recent Accounting Pronouncements**

We have not yet adopted and are currently assessing the potential effect of the following pronouncement on our consolidated financial statements:

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update ( ASU ) No. 2014-09, *Revenue from Contracts with Customers* ( ASU 2014-09 ) which will supersede Accounting Standards Codification ( ASC ) Topic 605, *Revenue Recognition*. A core principle of the new guidance is that an entity should measure revenue in connection with its sale of goods and services to a customer based on an amount that depicts the consideration to which the entity expects to be entitled in exchange for each of those goods and services. For a contract that involves more than one performance obligation, the entity must (a) determine or, if necessary, estimate the standalone selling price at inception of the contract for the distinct goods or services underlying each performance obligation and (b) allocate the transaction price to each performance obligation on the basis of the relative standalone selling prices. In addition, under the new guidance, an entity should recognize revenue when (or as) it satisfies each performance obligation under the contract by transferring the promised good or service to the customer. A good or service is deemed transferred when (or as) the customer obtains control of that good or service. The new standard permits the use of either the retrospective or cumulative effect transition method. For public companies, this amendment is

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early application is not permitted for public companies. The Company has not yet selected a transition method nor determined the effect of the new standard on its financial statements.

**Accounting Changes**

The Company made no accounting changes during the nine months ended June 30, 2014.

**4. Fair Value Measurements**

The Company s financial instruments consist of cash equivalents, trade and other accounts receivable, accounts payable, foreign currency derivative instruments and debt. The carrying amounts of cash equivalents, trade and other accounts receivable and accounts payable approximate their respective fair values due to the short-term nature of these financial instruments.

The Company measures on a recurring basis and discloses the fair value of its financial instruments under the provisions of ASC Topic 820*, Fair Value Measurement,* as amended ( ASC 820 ). The Company defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date. ASC 820 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 or liability; or inputs that are derived principally from or corroborated by observable market data; and

Level 3 - Unobservable inputs for the asset or liability.

Consistent with this hierarchy, the Company categorized certain of its financial assets and liabilities as follows at June 30, 2014 and September 30, 2013 (in thousands):

| | As of June 30, 2014 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Assets | | | | |
| Foreign exchange contracts (a) | $ 114 | $ | $ 114 | |
| Total assets | $ 114 | $ | $ 114 | |
| Liabilities | | | | |
| Long-term debt (b) | $ 1,942,596 | $ 1,928,563 | $ 14,033 | |
| Foreign exchange contracts (a) | 285 | | 285 | |
| Total liabilities | $ 1,942,881 | $ 1,928,563 | $ 14,318 | |

| | As of September 30, 2013 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Assets | | | | |
| Foreign exchange contracts (a) | $ 152 | $ | $ 152 | |
| Total assets | $ 152 | $ | $ 152 | |
| Liabilities | | | | |
| Long-term debt (b) | $ 1,753,822 | $ 1,671,500 | $ 82,322 | |
| Foreign exchange contracts (a) | 36 | | 36 | |
| Total liabilities | $ 1,753,858 | $ 1,671,500 | $ 82,358 | |

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

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(a) Foreign exchange contracts (including foreign currency forwards and options) are valued for purposes of this disclosure using widely accepted valuation techniques, such as discounted cash flow analyses, and reasonable estimates, such as market foreign currency exchange rates. Please see Note 11 for more information about the Company s foreign exchange contracts.

(b) Long-term debt (including current maturities and borrowings under the ABL facility, if any) is carried in the Company s consolidated financial statements at amortized cost of $1,821.7 million at June 30, 2014 and $1,690.7 million at September 30, 2013. The Company s senior notes are valued for purposes of this disclosure using unadjusted quoted market prices for such debt securities. Other long-term debt (consisting primarily of borrowings under the ABL facility, if any, and capital lease obligations) is generally valued for purposes of this disclosure using widely accepted valuation techniques, such as discounted cash flow analyses, and observable inputs, such as market interest rates. Please see Note 10 for more information about the Company s debt.

**5. Accumulated Stockholders Equity (Deficit)**

In August 2012, the Company announced that its Board of Directors approved a share repurchase program authorizing the Company to repurchase up to $300.0 million of its common stock (the 2012 Share Repurchase Program ). In addition, in March 2013, the Company announced that its Board of Directors approved a new share repurchase program authorizing the Company to repurchase up to $700.0 million of its common stock over the eight quarters commencing on such date (the 2013 Share Repurchase Program ). In connection with the authorization of the 2013 Share Repurchase Program, the Company s Board of Directors terminated the 2012 Share Repurchase Program.

During the nine months ended June 30, 2014, the Company repurchased and subsequently retired approximately 11.4 million shares of its common stock under the 2013 Share Repurchase Program at an aggregate cost of $301.7 million and, during the nine months ended June 30, 2013, the Company repurchased and subsequently retired approximately 15.1 million shares of its common stock (under the 2012 Share Repurchase Program and the 2013 Share Repurchase Program) at an aggregate cost of $407.2 million. The Company reduced common stock and additional paid-in capital, in the aggregate, by these amounts. As required by GAAP, the Company recorded any amounts paid to repurchase shares in excess of the balance of additional paid-in capital in accumulated deficit.

At June 30, 2014 and September 30, 2013, accumulated other comprehensive loss consists of cumulative foreign currency translation adjustments of $3.1 million and $9.8 million, respectively, and is net of income taxes of $2.3 million and $2.9 million, respectively. Comprehensive income reflects changes in accumulated stockholders equity (deficit) from sources other than transactions with stockholders and, as such, includes net earnings and certain other specified components. Currently, the Company s only component of comprehensive income, other than net earnings, is foreign currency translation adjustments, net of income tax.

**6. Earnings Per Share**

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

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

| | Three Months Ended June 30, | | Nine Months Ended June 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Net earnings | $ 67,756 | $ 72,466 | $ 184,243 | $ 196,338 |
| Total weighted average basic shares | 158,950 | 168,725 | 161,700 | 173,528 |
| Dilutive securities: | | | | |
| Stock options and stock award programs | 3,574 | 5,037 | 3,689 | 4,750 |
| Total weighted average diluted shares | 162,524 | 173,762 | 165,389 | 178,278 |
| Earnings per share: | | | | |
| Basic | $ 0.43 | $ 0.43 | $ 1.14 | $ 1.13 |
| Diluted | $ 0.42 | $ 0.42 | $ 1.11 | $ 1.10 |

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

At June 30, 2014, options to purchase 1,509,515 shares of the Company s common stock were outstanding but not included in the computations of diluted earnings per share since these options were anti-dilutive. Anti-dilutive options are: (a) out-of-the-money options (options the exercise price of which is greater than the average price per share of the Company s common stock during the period), and (b) in-the-money options (options the exercise price of which is less than the average price per share of the Company s common stock during the period) for which the sum of assumed proceeds, including any unrecognized compensation expense related to such options, exceeds the average price per share for the period. At June 30, 2013, all outstanding options to purchase shares of the Company s common stock were dilutive.

**7. Share-Based Payments**

The Company measures the cost of services received from employees, directors and consultants in exchange for an award of equity instruments based on the fair value of the award on the date of grant, and recognizes compensation expense on a straight-line basis over the vesting period or over the period ending on the date a participant becomes eligible for retirement, if earlier.

The Company granted approximately 1.6 million stock options during both the nine months ended June 30, 2014 and the nine months ended June 30, 2013. In addition the Company granted approximately 247,000 and 128,000 restricted share awards to its employees and consultants during the nine months ended June 30, 2014 and 2013, respectively. These amounts include 130,952 stock options issued and 210,820 restricted stock awards made during the three months ended June 30, 2014 in connection with the executive management transition plan announced in May 2014. Upon issuance of such grants, the Company recognized accelerated share-based compensation expense of $8.8 million and $5.9 million in the nine months ended June 30, 2014 and 2013, respectively, in connection with certain retirement eligible employees who are eligible to continue vesting awards upon retirement under the provisions of the Sally Beauty Holdings, Inc. 2010 Omnibus Incentive Plan (the 2010 Plan ) and certain predecessor share-based compensation plans such as the Sally Beauty Holdings, Inc. 2007 Omnibus Incentive Plan (the 2007 Plan ). During the three months ended June 30, 2014, the accelerated share-based compensation expense was $3.5 million. In addition, the Company granted approximately 27,000 and 36,000 restricted stock units to its non-employee directors during the nine months ended June 30, 2014 and 2013, respectively.

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

| | Three Months Ended June 30, | | Nine Months Ended June 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Share-based compensation expense | $ 6,507 | $ 3,190 | $ 18,297 | $ 15,503 |
| Income tax benefit related to share-based compensation expense | $ 2,472 | $ 1,161 | $ 6,819 | $ 5,731 |

**Stock Option Awards**

Each option has an exercise price equal to the closing 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 vesting period is complete, subject to certain retirement provisions contained in the 2010 Plan and certain predecessor share-based compensation plans such as the 2007 Plan.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

The following table presents a summary of the activity for the Company s stock option awards for the nine months ended June 30, 2014:

| | 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, 2013 | 10,408 | $ 12.89 | 6.2 | $ 138,139 |
| Granted | 1,596 | 26.22 | | |
| Exercised | (2,207) | 9.90 | | |
| Forfeited or expired | (288) | 21.16 | | |
| Outstanding at June 30, 2014 | 9,509 | $ 15.57 | 6.4 | $ 92,175 |
| | | | | |
| Exercisable at June 30, 2014 | 5,411 | $ 10.92 | 5.1 | $ 76,636 |

The following table summarizes additional information about stock options outstanding under the Company s share-based compensation plans:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number Outstanding at June 30, 2014 (in Thousands) | Weighted Average Remaining Contractual Term (in Years) | Weighted Average Exercise Price | Number Exercisable at June 30, 2014 (in Thousands) | Weighted Average Exercise Price |
| $2.00 9.66 | 3,145 | 3.9 | $ 7.60 | 3,145 | $ 7.60 |
| $11.39 26.30 | 6,364 | 7.5 | 19.50 | 2,266 | 15.52 |
| Total | 9,509 | 6.4 | $ 15.57 | 5,411 | $ 10.92 |

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 is expensed on a straight-line basis over the vesting period (generally four years) 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:

| | Nine Months Ended June 30, 2014 | Nine Months Ended June 30, 2013 |
|---|---|---|
| Expected life (in years) | 5.0 | 5.0 |
| Expected volatility for the Company s stock | 47.3% | 56.3% |
| Risk-free interest rate | 1.3% | 0.8% |
| 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. The risk-free interest rate is based on the zero-coupon U.S. Treasury notes with a comparable term as of the date of the grant. Since the Company does not currently expect to pay dividends, the dividend yield used is 0%.

The weighted average fair value at the date of grant of the stock options issued by the Company in the nine months ended June 30, 2014 and 2013 was $11.08 and $11.29 per option, respectively. The total intrinsic value of options exercised during the nine months ended June 30, 2014 was $40.9 million. The cash proceeds from these option exercises were $21.9 million and the tax benefit realized from these option exercises was $15.1 million.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

At June 30, 2014, approximately $16.3 million of total unrecognized compensation costs related to unvested stock option awards are expected to be recognized over the weighted average period of 2.4 years.

**Stock Awards**

***Restricted Stock Awards***

The Company from time to time grants restricted stock awards to employees and consultants under the 2010 Plan. A restricted stock award is an award of shares of the Company s common stock (which have full voting and dividend rights but are restricted with regard to sale or transfer) the restrictions over which lapse ratably over a specified period of time (generally five years). Restricted stock awards are independent of stock option grants and are generally subject to forfeiture if employment terminates prior to these restrictions lapsing, subject to certain retirement provisions of the 2010 Plan and certain predecessor share-based compensation plans such as the 2007 Plan.

The fair value of the Company s restricted stock awards is expensed on a straight-line basis over the period (generally five years) in which the restrictions on these stock awards lapse ( vesting ) or over the period ending on the date a participant becomes eligible for retirement, if earlier. For these purposes, the fair value of the restricted stock award is determined based on the closing market price of the Company s common stock on the date of grant.

During the three months ended June 30, 2014, the Company granted 210,820 restricted stock awards in connection with the executive management transition plan announced in May 2014.

The following table presents a summary of the activity for the Company s restricted stock awards for the nine months ended June 30, 2014:

| **Restricted Stock Awards** | **Number of Shares (in Thousands)** | | **Weighted Average Fair Value Per Share** | **Weighted Average Remaining Vesting Term (in Years)** |
|---|---|---|---|---|
| Unvested at September 30, 2013 | 337 | $ | 16.30 | 3.1 |
| Granted | 247 | | 26.57 | |
| Vested | (108) | | 12.95 | |
| Forfeited | (33) | | 21.10 | |

| | | | | |
|---|---|---|---|---|
| Unvested at June 30, 2014 | 443 | $ | 22.49 | 3.5 |

At June 30, 2014, approximately $3.8 million of total unrecognized compensation costs related to unvested restricted stock awards are expected to be recognized over the weighted average period of 3.5 years.

***Restricted Stock Units***

The Company currently grants Restricted Stock Unit ( RSU or RSUs ) awards, which generally vest within one year from the date of grant, pursuant to the 2010 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 the Company s common stock. Unless forfeited prior to the vesting date, RSUs are converted into shares of the Company s common stock generally on the vesting date. An independent director who receives an RSU award may elect, upon receipt of such award, to defer until a later date delivery of the shares of common stock of the Company that would otherwise be issued to such director on the vesting date. RSUs granted prior to the fiscal year 2012, are generally retained by the Company as deferred stock units that are not distributed until six months after the independent director s service as a director terminates. 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 unvested RSUs. Under the 2010 Plan, the Company may settle the vested deferred stock units with shares of the Company s common stock or in cash.

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 one year). For these purposes, the fair value of the RSU is determined based on the closing market price of the Company s common stock on the date of grant.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

The following table presents a summary of the activity for the Company s RSUs for the nine months ended June 30, 2014:

| Restricted Stock Units | Number of Shares (in Thousands) | | Weighted Average Fair Value Per Share | Weighted Average Remaining Vesting Term (in Years) |
|---|---|---|---|---|
| Unvested at September 30, 2013 | | $ | | |
| Granted | 27 | | 26.30 | |
| Vested | | | | |
| Forfeited | | | | |
| Unvested at June 30, 2014 | 27 | $ | 26.30 | 0.3 |

At June 30, 2014, approximately $0.2 million of total unrecognized compensation costs related to unvested RSUs are expected to be recognized over the weighted average period of 0.3 years.

**8. Goodwill and Intangible Assets**

The Company completed its annual assessment for impairment of goodwill during its fiscal quarter ended March 31, 2014. No impairment losses were recognized in the current or prior periods presented in connection with the Company s goodwill.

The Company also completed its annual assessment for impairment of intangible assets, other than goodwill, including indefinite-lived intangible assets, during its fiscal quarter ended March 31, 2014. There were no material impairment losses recognized in the current or prior periods presented in connection with the Company s intangible assets.

Amortization expense was $3.7 million and $3.1 million for the three months ended June 30, 2014 and 2013; and $10.8 million and $9.4 million for the nine months ended June 30, 2014 and 2013, respectively.

**9. Commitments and Contingencies**

In March 2014, the Company disclosed that it had experienced a data security incident in February 2014. The costs that the Company has incurred to date in connection with the data security incident primarily include professional advisory and legal costs. For the nine months ended June 30, 2014, selling, general and administrative expenses reflect a charge of $2.0 million, consisting primarily of these costs relating to the data security incident.

The Company expects to incur additional costs and expenses related to the data security incident in the future. These costs may also result from potential liabilities to payment card networks, governmental or third party investigations, proceedings or litigation and legal and other fees necessary to defend against any potential liabilities or claims. As of June 30, 2014, the scope of these additional costs, or a range thereof, cannot be reasonably estimated.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

**10. Short-term Borrowings and Long-term Debt**

Details of long-term debt as of June 30, 2014 and September 30, 2013 are as follows (dollars in thousands):

| | As of | | | | |
|---|---|---|---|---|---|
| | | **June 30, 2014** | | **September 30, 2013** | **Interest Rates** |
| ABL facility | $ | 9,000 | $ | 76,000 | (i) Prime plus (0.50% to 0.75%) or; |
| | | | | | (ii) LIBOR(a) plus (1.50% to 1.75%) |
| Senior notes due Nov. 2019 | | 750,000 | | 750,000 | 6.875% |
| Senior notes due Jun. 2022(b) | | 857,681 | | 858,381 | 5.750%(b) |
| Senior notes due Nov. 2023 | | 200,000 | | | 5.50% |
| Other, due 2014-2015(c) | | 410 | | 1,310 | 4.93% to 5.79% |
| Total | $ | 1,817,091 | $ | 1,685,691 | |
| | | | | | |
| Capital leases and other | | 4,624 | | 5,012 | |
| Less: current portion | | 10,336 | | 78,018 | |
| Total long-term debt | $ | 1,811,379 | $ | 1,612,685 | |

(a) London Interbank Offered Rate ( LIBOR ).

(b) Amounts include unamortized premium of $7.7 million and $8.4 million as of June 30, 2014 and September 30, 2013, respectively, related to notes with an aggregate principal amount of $150.0 million. The 5.75% interest rate relates to notes in the aggregate principal amount of $850.0 million.

(c) Represents pre-acquisition debt of Pro-Duo NV and Sinelco Group BVBA ( Sinelco ).

In November 2006, the Company, through its subsidiaries (Sally Investment Holdings LLC and Sally Holdings LLC, which we refer to as Sally Investment and Sally Holdings, respectively) incurred $1,850.0 million of indebtedness in connection with the Company s separation from its former parent, Alberto-Culver. Please see our Annual Report on Form 10-K for the fiscal year ended September 30, 2013 for additional information about the Company s separation from Alberto-Culver.

In the fiscal year ended September 30, 2011, Sally Holdings entered into a $400 million, five-year asset-based senior secured loan facility (the ABL facility ). The availability of funds under the ABL facility, as amended in June 2012, is subject to a customary borrowing base comprised of: (i) a specified percentage of our eligible credit card and trade accounts receivable (as defined therein) and (ii) a specified percentage of our eligible inventory (as defined therein), and reduced by (iii) certain customary reserves and adjustments and by certain outstanding letters of credit. The ABL facility includes a $25.0 million Canadian sub-facility for our Canadian operations. In July 2013, the Company, Sally Holdings and other parties to the ABL facility entered into a second amendment to the ABL facility which, among other things, increased the maximum availability under the ABL facility to $500.0 million (subject to borrowing base limitations), reduced pricing, relaxed the restrictions regarding the making of Restricted Payments, extended the maturity to July 26, 2018 and improved certain other covenant terms.

At June 30, 2014, the Company had $468.7 million available for borrowing under the ABL facility, including the Canadian sub-facility. Borrowings under the ABL facility are secured by the accounts, inventory and credit card receivables of our domestic subsidiaries and Canadian subsidiaries (in the case of borrowings under the Canadian sub-facility), together with general intangibles and certain other personal property of our domestic subsidiaries and Canadian subsidiaries (in the case of borrowings under the Canadian sub-facility) relating to the accounts and inventory, as well as deposit accounts of our domestic subsidiaries and Canadian subsidiaries (in the case of borrowings under the Canadian sub-facility) and, solely with respect to borrowings by SBH Finance B.V., intercompany notes owed to SBH Finance B.V. by our foreign subsidiaries. In addition, the terms of the ABL facility contain a commitment fee of 0.25% on the unused portion of the facility.

In the fiscal year ended September 30, 2012, Sally Holdings and Sally Capital Inc. (collectively, the Issuers ), both indirect wholly-owned subsidiaries of the Company, issued $750.0 million aggregate principal amount of their 6.875% Senior Notes due 2019 (the senior notes due 2019 ) and $850.0 million aggregate principal amount of their 5.75% Senior Notes due 2022 (the senior notes due 2022 ), including notes in the aggregate principal amount of $150.0 million which were issued at par plus a premium. Such premium is being amortized over the term of the notes using the effective interest method. The net proceeds from these debt issuances were used to retire outstanding indebtedness in the aggregate principal amount of approximately $1,391.9 million and for general corporate purposes.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

On October 29, 2013, the Issuers issued $200.0 million aggregate principal amount of their 5.5% Senior Notes due 2023 (the senior notes due 2023 ). The senior notes due 2023 bear interest at an annual rate of 5.5% and were issued at par. The Company used the net proceeds from this debt issuance, approximately $196.3 million, to repay borrowings outstanding under the ABL facility of $88.5 million and for general corporate purposes.

The senior notes due 2019, the senior notes due 2022 and the senior notes due 2023, which we refer to collectively as the Notes or the senior notes due 2019, 2022 and 2023, are unsecured obligations of the Issuers and are jointly and severally guaranteed by the Company and Sally Investment, and by each material domestic subsidiary of the Company. Interest on the senior notes due 2019, 2022 and 2023 is payable semi-annually, during the Company s first and third fiscal quarters. Please see Note 14 for certain condensed financial statement data pertaining to Sally Beauty, the Issuers, the guarantor subsidiaries and the non-guarantor subsidiaries.

The senior notes due 2019 carry optional redemption features whereby the Company has the option to redeem the notes, in whole or in part, on or after November 15, 2017 at par, plus accrued and unpaid interest, if any, and on or after November 15, 2015 at par plus a premium declining ratably to par, plus accrued and unpaid interest, if any. Prior to November 15, 2015, the notes may be redeemed, in whole or in part, at a redemption price equal to par plus a make-whole premium as provided in the indenture, plus accrued and unpaid interest, if any. In addition, on or prior to November 15, 2014, the Company has the right to redeem at par plus a specified premium, plus accrued and unpaid interest, if any, up to 35% of the aggregate principal amount of notes originally issued, subject to certain limitations, with the proceeds from certain kinds of equity offerings, as defined in the indenture.

The senior notes due 2022 carry optional redemption features whereby the Company has the option to redeem the notes, in whole or in part, on or after June 1, 2020 at par, plus accrued and unpaid interest, if any, and on or after June 1, 2017 at par plus a premium declining ratably to par, plus accrued and unpaid interest, if any. Prior to June 1, 2017, the notes may be redeemed, in whole or in part, at a redemption price equal to par plus a make-whole premium as provided in the indenture, plus accrued and unpaid interest, if any. In addition, on or prior to June 1, 2015, the Company has the right to redeem at par plus a specified premium, plus accrued and unpaid interest, if any, up to 35% of the aggregate principal amount of notes originally issued, subject to certain limitations, with the proceeds from certain kinds of equity offerings, as defined in the indenture.

The senior notes due 2023 carry optional redemption features whereby the Company has the option to redeem the notes, in whole or in part, on or after November 1, 2021 at par, plus accrued and unpaid interest, if any, and on or after November 1, 2018 at par plus a premium declining ratably to par, plus accrued and unpaid interest, if any. Prior to November 1, 2018, the notes may be redeemed, in whole or in part, at a redemption price equal to par plus a make-whole premium as provided in the indenture, plus accrued and unpaid interest, if any. In addition, on or prior to November 1, 2016, the Company has the right to redeem at par plus a specified premium, plus accrued and unpaid interest, if any, up to 35% of the aggregate principal amount of notes originally issued, subject to certain limitations, with the proceeds from certain kinds of equity offerings, as defined in the indenture.

Maturities of the Company s long-term debt are as follows as of June 30, 2014 (in thousands):

| | | |
|---|---|---|
| **Twelve months ending June 30:** | | |
| 2015 | $ | 9,410 |
| 2016-2019 | | |
| Thereafter | | 1,807,681 |
| | $ | 1,817,091 |
| Capital lease obligations | | 4,624 |
| Less: current portion | | 10,336 |
| Total | $ | 1,811,379 |

We are a holding company and do not have any material assets or operations other than ownership of equity interests of our subsidiaries. The agreements and instruments governing the debt of Sally Holdings and its subsidiaries contain material limitations on their ability to pay dividends and other restricted payments to us which, in turn, constitute material limitations on our ability to pay dividends and other payments to our stockholders.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

The ABL facility does not contain any restriction against the incurrence of unsecured indebtedness. However, the ABL facility restricts the incurrence of secured indebtedness if, after giving effect to the incurrence of such secured indebtedness, the Company s Secured Leverage Ratio exceeds 4.0 *to* 1.0. At June 30, 2014, the Company s Secured Leverage Ratio was less than 0.1 *to* 1.0. Secured Leverage Ratio is defined as the ratio of (i) Secured Funded Indebtedness (as defined in the ABL facility) *to* (ii) Consolidated EBITDA, as defined in the ABL facility.

The ABL facility is pre-payable and the commitments thereunder may be terminated, in whole or in part, at any time without penalty or premium.

The indentures governing the senior notes due 2019, 2022 and 2023 contain terms which restrict the ability of Sally Beauty s subsidiaries to incur additional indebtedness. However, in addition to certain other material exceptions, the Company may incur additional indebtedness under the indentures if its Consolidated Coverage Ratio, after giving pro forma effect to the incurrence of such indebtedness, exceeds 2.0 *to* 1.0 ( Incurrence Test ). At June 30, 2014, the Company s Consolidated Coverage Ratio was approximately 5.7 *to* 1.0. Consolidated Coverage Ratio is defined as the ratio of (i) Consolidated EBITDA, as defined in the indentures, for the period containing the most recent four consecutive fiscal quarters, *to* (ii) Consolidated Interest Expense, as defined in the indentures, for such period.

The indentures governing the senior notes due 2019, 2022 and 2023 restrict Sally Holdings and its subsidiaries from making certain dividends and distributions to equity holders and certain other restricted payments (hereafter, a Restricted Payment or Restricted Payments ) to us. However, the indentures permit the making of such Restricted Payments if, at the time of the making of such Restricted Payment, the Company satisfies the Incurrence Test as described above and the cumulative amount of all Restricted Payments made since the issue date of the applicable senior notes does not exceed the sum of: (i) 50% of Sally Holdings and its subsidiaries cumulative consolidated net earnings since July 1, 2006, *plus* (ii) the proceeds from the issuance of certain equity securities or conversions of indebtedness to equity, in each case, since the issue date of the applicable senior notes *plus* (iii) the net reduction in investments in unrestricted subsidiaries since the issue date of the applicable senior notes *plus* (iv) the return of capital with respect to any sales or dispositions of certain minority investments since the issue date of the applicable senior notes. Further, in addition to certain other baskets, the indentures permit the Company to make additional Restricted Payments in an unlimited amount if, after giving pro forma effect to the incurrence of any indebtedness to make such Restricted Payment, the Company s Consolidated Total Leverage Ratio (as defined in the indentures) is less than 3.25 *to* 1.00. At June 30, 2014, the Company s Consolidated Total Leverage Ratio was approximately 2.9 *to* 1.0. Consolidated Total Leverage Ratio is defined as the ratio of (i) Consolidated Total Indebtedness, as defined in the indentures, *minus* cash and cash equivalents on-hand up to $100.0 million, in each case, as of the end of the most recently-ended fiscal quarter *to* (ii) Consolidated EBITDA, as defined in the indentures, for the period containing the most recent four consecutive fiscal quarters.

The ABL facility also restricts the making of Restricted Payments. More specifically, under the ABL facility, Sally Holdings may make Restricted Payments if availability under the ABL facility equals or exceeds certain thresholds, and no default then exists under the facility. For Restricted Payments up to $30.0 million during each fiscal year, borrowing availability must equal or exceed the lesser of $75.0 million or 15% of the borrowing base for 45 days prior to such Restricted Payment. For Restricted Payments in excess of that amount, borrowing availability must equal or exceed the lesser of $100.0 million or 20% of the borrowing base for 45 days prior to such Restricted Payment and the Consolidated Fixed Charge Coverage Ratio (as defined below) must equal or exceed 1.1 *to* 1.0. Further, if borrowing availability equals or exceeds the lesser of $150.0 million or 30% of the borrowing base, Restricted Payments are not limited by the Consolidated Fixed Charge

Coverage Ratio test. The Consolidated Fixed Charge Coverage Ratio is defined as the ratio of (i) Consolidated EBITDA (as defined in the ABL facility) during the trailing twelve-month period preceding such proposed Restricted Payment *minus* certain unfinanced capital expenditures made during such period and income tax payments paid in cash during such period *to* (ii) fixed charges (as defined in the ABL facility). In addition, during any period that borrowing availability under the ABL facility is less than the greater of $40.0 million or 10% of the borrowing base, the level of the Consolidated Fixed Charge Coverage Ratio that the Company must satisfy is 1.0 *to* 1.0. As of June 30, 2014, the Consolidated Fixed Charge Coverage Ratio was approximately 3.8 *to* 1.0.

When used in this Quarterly Report, the phrase Consolidated EBITDA is intended to have the meaning ascribed to such phrase in the ABL facility or the indentures governing the senior notes due 2019, 2022 and 2023, as appropriate. EBITDA is not a recognized measurement under GAAP and should not be considered a substitute for financial performance and liquidity measures determined in accordance with GAAP, such as net earnings, operating earnings and operating cash flows.

The ABL facility and the indentures governing the senior notes due 2019, 2022 and 2023 contain other covenants regarding restrictions on the disposition of assets, the granting of liens and security interests, the prepayment of certain indebtedness, and other matters and customary events of default, including customary cross-default and/or cross-acceleration provisions. As of June 30, 2014, all the net assets of our consolidated subsidiaries were unrestricted from transfer under our credit arrangements.

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

**11. Derivative Instruments and Hedging Activities**

**Risk Management Objectives of Using Derivative Instruments**

The Company is exposed to a wide variety of risks, including risks arising from changing economic conditions. The Company manages its exposure to certain economic risks (including liquidity, credit risk, and changes in foreign currency exchange rates and in interest rates) primarily: (a) by closely managing its cash flows from operating and investing activities and the amounts and sources of its debt obligations; (b) by assessing periodically the creditworthiness of its business partners; and (c) through the use of derivative instruments from time to time (including, foreign exchange contracts and interest rate swaps) by Sally Holdings.

The Company from time to time uses foreign exchange contracts (including foreign currency forwards and options), as part of its overall economic risk management strategy, to fix the amount of certain foreign assets and obligations relative to its functional and reporting currency (the U.S. dollar) or relative to the functional currency of certain of its consolidated subsidiaries, or to add stability to cash flows resulting from its net investments (including intercompany notes not permanently invested) and earnings denominated in foreign currencies. The Company s foreign currency exposures at times offset each other, sometimes providing a natural hedge against its foreign currency risk. In connection with the remaining foreign currency risk, the Company uses foreign exchange contracts to effectively fix the foreign currency exchange rate applicable to specific anticipated foreign currency-denominated cash flows, thus limiting the potential fluctuations in such cash flows as a result of foreign currency market movements.

The Company from time to time has used interest rate swaps, as part of its overall economic risk management strategy, to add stability to the interest payments due in connection with its debt obligations. At June 30, 2014, our exposure to interest rate fluctuations relates to interest payments under the ABL facility, if any, and the Company held no derivative instruments in connection therewith.

As of June 30, 2014, the Company did not purchase or hold any derivative instruments for trading or speculative purposes.

**Designated Cash Flow Hedges**

The Company may use from time to time derivative instruments designated as hedges to manage its exposure to interest rate or foreign currency exchange rate movements, as appropriate. The Company did not purchase or hold any such derivatives at June 30, 2014.

**Non-designated Cash Flow Hedges**

The Company may use from time to time derivative instruments (such as foreign exchange contracts and interest rate swaps) not designated as hedges or that do not meet the requirements for hedge accounting to manage its exposure to interest rate or foreign currency exchange rate movements, as appropriate.

The Company uses foreign exchange contracts including, at June 30, 2014, foreign currency options with an aggregate notional amount of $3.0 million to manage the exposure to the U.S. dollar resulting from certain of our Sinelco Group subsidiaries purchases of merchandise from third-party suppliers. Sinelco s functional currency is the Euro. These foreign currency options enable Sinelco to buy U.S. dollars at a contractual exchange rate of 1.32, are with a single counterparty and expire ratably through September 15, 2014.

The Company also uses foreign exchange contracts to mitigate its exposure to changes in foreign currency exchange rates in connection with certain intercompany balances not permanently invested. As such, at June 30, 2014, we hold: (a) foreign currency forwards which enable us to sell approximately 22.0 million ($30.1 million, at the June 30, 2014 exchange rate) at the weighted average contractual exchange rate of 1.3624, (b) a foreign currency forward which enables us to sell approximately $4.1 million Canadian dollars ($3.9 million, at the June 30, 2014 exchange rate) at the contractual exchange rate of 1.0677, (c) a foreign currency forward which enables us to buy approximately $21.7 million Canadian dollars ($20.4 million, at the June 30, 2014 exchange rate) at the contractual exchange rate of 1.0719, (d) a foreign currency forward which enables us to sell approximately 26.5 million Mexican pesos ($2.0 million, at the June 30, 2014 exchange rate) at the contractual exchange rate of 13.0085 and (e) foreign currency forwards which enable us to sell approximately £3.7 million ($6.2 million, at the June 30, 2014 exchange rate) at the weighted average contractual exchange rate of 1.6776. The foreign currency forwards discussed in this paragraph are with a single counterparty (not the same party as the counterparty on the options discussed in the preceding paragraph) and expire ratably through September 30, 2014.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

In addition, the Company uses foreign exchange contracts including, at June 30, 2014, foreign currency forwards with an aggregate notional amount of 0.9 million ($1.2 million, at the June 30, 2014 exchange rate) to mitigate the exposure to the British pound sterling resulting from the sale of products and services among certain European subsidiaries of the Company. The foreign currency forwards discussed in this paragraph enable the Company to buy British pound sterling in exchange for Euro currency at the weighted average contractual exchange rate of 0.8433, are with a single counterparty (the same counterparty as that on the foreign currency forwards discussed in the immediately preceding paragraph) and expire ratably through September 30, 2014.

The Company s foreign exchange contracts are not designated as hedges and do not currently meet the requirements for hedge accounting. Accordingly, the changes in the fair value (i.e., marked-to-market adjustments) of these derivative instruments, which are adjusted quarterly, are recorded in selling, general and administrative expenses in our consolidated statements of earnings. Selling, general and administrative expenses reflect net gains of $0.3 million and net losses of $1.2 million for the three months ended June 30, 2014 and 2013, respectively, and, for the nine months ended June 30, 2014 and 2013, net losses of $1.0 million and $0.9 million, respectively, including marked-to-market adjustments, in connection with all of the Company s foreign currency derivatives.

The table below presents the fair value of the Company s derivative financial instruments as well as their classification on the Company s consolidated balance sheet as of June 30, 2014 and September 30, 2013 (in thousands):

| | | **Asset Derivatives** | | | **Liability Derivatives** | |
|---|---|---|---|---|---|---|
| | **Classification** | **June 30, 2014** | **September 30, 2013** | **Classification** | **June 30, 2014** | **September 30, 2013** |
| **Derivatives designated as hedging instruments:** | | | | | | |
| None | | | | | | |
| **Derivatives not designated as hedging instruments:** | | | | | | |
| Foreign exchange contracts | Other current assets | $ 114 | $ 152 | Accrued liabilities | $ 285 | $ 36 |
| | | $ 114 | $ 152 | | $ 285 | $ 36 |

The table below presents the effect of the Company s derivative financial instruments on the Company s consolidated statements of earnings for the three months ended June 30, 2014 and 2013 (in thousands):

| **Derivatives Designated as Hedging Instruments** | **Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion), net of tax** | **Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)** |
|---|---|---|

None

[redacted]

| | | | |
|---|---|---|---|
| Foreign exchange contracts | Selling, general and administrative expenses | $ 312 | $ (1,163) |

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

The table below presents the effect of the Company s derivative financial instruments on the Company s consolidated statements of earnings for the nine months ended June 30, 2014 and 2013 (in thousands):

| **Derivatives Designated as Hedging Instruments** | **Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion), net of tax** | **Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)** |
|---|---|---|
| None | | |

[redacted]

| | | | |
|---|---|---|---|
| Foreign exchange contracts | Selling, general and administrative expenses | $ (984) | $ (878) |

**Credit-risk-related Contingent Features**

At June 30, 2014, the aggregate fair value of all foreign exchange contracts held which consisted of derivative instruments in a liability position was $0.3 million. The Company was under no obligation to post and had not posted any collateral related to the agreements in a liability position.

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

**12. Income Taxes**

The IRS has concluded the field work associated with their examination of the Company s consolidated federal income tax returns for the fiscal years ended September 30, 2007 through September 30, 2011 and issued their examination reports. The Company is currently seeking relief from double taxation through competent authority on certain cross-border adjustments, and it does not anticipate the ultimate resolution of these items to have a material impact on the Company s financial statements.

The IRS had previously audited the Company s consolidated federal income tax returns through the tax year ended September 30, 2006. Thus, pending the resolution of the adjustments discussed in the preceding paragraph, our statute remains open from the year ended September 30, 2007 forward. Our foreign subsidiaries are impacted by various statutes of limitations, which are generally open from 2008 forward. Generally, states statutes in the United States are open for tax reviews from 2007 forward.

**13. 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 primarily in North America, Puerto Rico, and parts of South America and Europe 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 and salon professionals through its own sales force and professional-only stores (including franchise stores) in partially exclusive geographical territories in North America, Puerto Rico and parts of Europe.

The accounting policies of both of our business segments are the same as described in the summary of significant accounting policies contained in Note 2 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, 2013. Sales between segments, which were eliminated in consolidation, were not material during the three and nine months ended June 30, 2014 and 2013.

Table of Contents

Sally Beauty Holdings, Inc. and Subsidiaries

Condensed Notes to Consolidated Financial Statements

(Unaudited)

Segment data for the three and nine months ended June 30, 2014 and 2013 is as follows (in thousands):

| | Three Months Ended June 30, | | Nine Months Ended June 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Net sales: | | | | |
| Sally Beauty Supply | $ 584,500 | $ 559,150 | $ 1,727,473 | $ 1,673,942 |
| BSG | 364,775 | 352,951 | 1,081,737 | 1,041,839 |
| Total | $ 949,275 | $ 912,101 | $ 2,809,210 | $ 2,715,781 |
| Earnings before provision for income taxes: | | | | |
| Segment operating profit: | | | | |
| Sally Beauty Supply | $ 114,773 | $ 117,672 | $ 323,790 | $ 329,715 |
| BSG | 57,247 | 52,734 | 162,964 | 151,307 |
| Segment operating profit | 172,020 | | | |