

Michaels Companies, Inc.
Form 10-K
March 19, 2019
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

For the fiscal year ended February 2, 2019

Commission file number 001-36501

THE MICHAELS COMPANIES, INC.

A Delaware Corporation

IRS Employer Identification No. 37-1737959

8000 Bent Branch Drive

Irving, Texas 75063

(972) 409-1300

The Michaels Companies, Inc.'s common stock, par value \$0.06775 per share, is registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 (the "Act") and is listed on the NASDAQ Global Select Market. The Michaels Companies, Inc. does not have any securities registered under Section 12(g) of the Act.

The Michaels Companies, Inc. is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

The Michaels Companies, Inc. (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.

The Michaels Companies, Inc. has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

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

The Michaels Companies, Inc. is a large accelerated filer.

The Michaels Companies, Inc. is not (1) a shell company, (2) a small reporting company or (3) an emerging growth company (as defined in Rule 12b-2 of the Exchange Act).

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The aggregate market value of The Michaels Companies, Inc.'s common stock held by non-affiliates as of August 4, 2018 was approximately \$1,978,572,495 based upon the closing sales price of \$20.24 quoted on The NASDAQ Global Select Market as of August 3, 2018. For this purpose, directors and officers have been assumed to be affiliates.

As of March 12, 2019, 157,773,090 shares of The Michaels Companies, Inc.'s common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The registrant will incorporate by reference information required in response to Part III, items 10-14, from its definitive proxy statement for its annual meeting of shareholders, to be held on June 11, 2019.

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THE MICHAELS COMPANIES, INC.

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PART I

ITEM 1. BUSINESS.

The following discussion, as well as other portions of this Annual Report on Form 10-K, contains forward-looking statements that reflect our plans, estimates and beliefs. Any statements contained herein (including, but not limited to, statements to the effect that Michaels or its management “anticipates”, “plans”, “estimates”, “expects”, “believes”, “intends”, and other similar expressions) that are not statements of historical fact should be considered forward-looking statements and should be read in conjunction with our consolidated financial statements and related notes contained elsewhere in this report. Specific examples of forward-looking statements include, but are not limited to, statements regarding our forecasts of financial performance, share repurchases, store openings, capital expenditures and working capital requirements. Our actual results could materially differ from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Annual Report on Form 10-K and particularly in “Item 1A. Risk Factors” and “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations”. Unless the context otherwise indicates, references in this Annual Report on Form 10-K to “we”, “our”, “us”, “our Company”, “the Company”, and “Michaels” mean The Michaels Companies, Inc., together with its subsidiaries.

General

Michaels Stores, Inc. (“MSI”) is headquartered in Irving, Texas and was incorporated in the state of Delaware in 1983. In July 2013, MSI was reorganized into a holding company structure and The Michaels Companies, Inc. was incorporated in the state of Delaware in connection with the reorganization.

With \$5,271.9 million in sales in fiscal 2018, the Company is the largest arts and crafts specialty retailer in North America (based on store count) providing materials, project ideas and education for creative activities. Our mission is to inspire and enable customer creativity, create a fun and rewarding place to work, foster meaningful connections with our communities and lead the industry in growth and innovation. With crafting classes, store events, store displays, mobile applications and online videos, we offer an omnichannel shopping experience that can inspire creativity and build confidence in our customers’ artistic abilities.

As of February 2, 2019, we operated 1,258 Michaels retail stores in 49 states and Canada, with approximately 18,000 average square feet of selling space per store.

In March 2018, we made the decision to close substantially all of our Aaron Brothers stores and in January 2019 we closed all 36 of our Pat Catan's stores. As a result of the store closures, we recorded restructure charges of \$98.9 million in fiscal 2018. The restructure charges are primarily related to the transfer of the rights to sell inventory and other assets to a third party to facilitate the store closures and assist with the disposition of our remaining lease obligations, the impairment of goodwill and employee-related expenses. We believe restructuring activities will be substantially completed in fiscal 2019 and expect to record additional charges of approximately \$6 million.

In addition, we recorded \$5.3 million of employee-related charges as a result of certain organizational changes made to streamline our operations at our corporate support center.

For fiscal 2018 and fiscal 2017, Aaron Brothers net sales totaled \$12.9 million and \$110.4 million, respectively, and Pat Catan's net sales totaled \$109.6 million and \$113.4 million, respectively. Excluding the restructure charges, Aaron Brothers and Pat Catan's did not have a material impact on the Company's operating income in all fiscal periods presented in the consolidated financial statements.

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Merchandising

Michaels. Each Michaels store offers approximately 45,000 basic and seasonal stock-keeping units (“SKUs”) in a number of product categories. The following table shows a breakdown of sales for Michaels stores by department as a percentage of total net sales:

	Fiscal Year					
	2018		2017		2016	
General crafts	48	%	49	%	50	%
Home décor and seasonal	24		23		22	
Custom and ready-made framing	16		16		17	
Papercrafting	12		12		11	
	100	%	100	%	100	%

We have product development, sourcing and design teams focused on quality, innovation and cost mitigation. Our internal product development and global sourcing teams position us to deliver a differentiated level of innovation, quality and value to our customers. Our global sourcing network allows us to control new product introductions, maintain quality standards, monitor delivery times, and manage product costs and inventory levels to enhance profitability. In an industry with few well-known national brands, our private brands are recognized as a leader in many categories. We continue to expand our private brands and improve the selection of products we design, develop and deliver to our customers. Our private brands totaled approximately 60% of net sales in fiscal 2018 and include, among others, Recollections®, Studio Decor®, Bead Landing®, Creatology®, Ashland®, Celebrate It®, ArtMinds®, Artist’s Loft®, Craft Smart®, Loops & Threads®, Make Market®, Foamies®, LockerLookz®, Imagin8® and Sticky Sticks®.

We continue to search for ways to leverage our position as a market leader by establishing strategic partnerships and exclusive product relationships to provide our customers with exciting merchandise. We have partnerships with popular brands such as Crayola, Elmer’s and Cricut. We will continue to explore opportunities to form future partnerships and exclusive product associations.

Darice. We operate an international wholesale business under the Darice brand name (“Darice”). Darice sources products from domestic and foreign suppliers for resale to a variety of retail outlets worldwide, including our Michaels stores. Darice offers approximately 56,000 SKUs consisting of a wide range of craft and hobby items. We also develop Darice branded products carried by both Michaels and third-party stores reflecting the breadth of our product line and our ability to distribute and source quality products at competitive prices.

E-commerce. While we expect e-commerce to remain a relatively small portion of our business, with over 100,000 basic and seasonal SKUs, we believe it provides an important avenue to communicate with our customers in an interactive way that reinforces the Michaels brand and drives traffic to our stores and websites. We continue to strengthen our omnichannel offering with the expansion of our buy online, pick up in store capabilities and through continuous enhancements to our existing platforms to improve discoverability and product content that will deliver a superior customer experience. Our online platforms currently include Michaels.com, ConsumerCrafts.com, Darice.com, AaronBrothers.com (our online custom framing solution) and our Michaels app, which connects our store and online experiences.

Purchasing and Inventory Management

We purchase merchandise from a variety of different vendors primarily through our wholly-owned subsidiary, Michaels Stores Procurement Company, Inc. We believe our buying power and ability to make centralized purchases enable us to acquire products on favorable terms. Centralized merchandising management teams negotiate with vendors in an attempt to obtain the lowest net merchandise costs and to improve product mix and inventory levels. In fiscal 2018, there were no vendors or sourcing agents who accounted for more than 10% of total purchases.

We continue to develop our direct sourcing capabilities through our wholly-owned subsidiary, Darice International Sourcing Group. We believe our direct sourcing operation allows us to maintain greater control over the manufacturing process resulting in improved product quality and lower costs. In addition, our stores purchase custom frames, framing supplies and mats from our wholly-owned subsidiary, Artistree, Inc. (“Artistree”), which consists of a manufacturing facility and three regional processing centers.

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The majority of the products sold in our stores are manufactured in Asia. Goods manufactured in Asia generally require long lead times and are ordered three to four months in advance of delivery. Those products are either imported directly by us or acquired from distributors based in the U.S.

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

Artistree

We own and operate Artistree, a vertically-integrated framing operation which supplies precut mats and high quality custom framing merchandise in our stores and aaronbrothers.com. We believe Artistree provides a competitive advantage and gives us quality control over the entire framing process. Custom framing orders are processed and shipped to our stores where the custom frame order is completed for customer pick-up.

Our moulding manufacturing plant, located in Kernersville, North Carolina, converts lumber into finished frame moulding that is used at our regional processing centers to fulfill custom framing orders for our customers. We manufacture approximately 39% of the moulding that we process and import approximately 55% from quality manufacturers in Brazil, Indonesia, Malaysia, China and Italy. The remaining mouldings are purchased from domestic manufacturers.

We operate three regional processing centers located in DFW Airport, Texas; Kernersville, North Carolina; and Mississauga, Ontario. Combined, these facilities occupy approximately 489,000 square feet and, in fiscal 2018, processed 25.1 million linear feet of frame moulding and 3.8 million individual custom cut mats and foam boards for our customers. Our precut mats and custom frame supplies are packaged and distributed out of our DFW Airport regional processing center.

Distribution

We currently operate seven distribution centers to supply our stores with merchandise. Approximately 92% of our stores' merchandise receipts are shipped through the distribution network with the remainder shipped directly from vendors to stores. Our distribution centers are located in California, Florida, Illinois, Ohio, Pennsylvania, Texas and Washington. We also utilize a third-party fulfillment center for a portion of our e-commerce merchandise. In fiscal 2018, we began developing an internal process to fulfill e-commerce orders through our distribution center in Haslet, Texas. The transition to our internal fulfillment center is expected to be completed in fiscal 2019 and will allow us to maintain greater control over, and lower our costs associated with, our e-commerce order fulfillment process.

Our distribution facilities use warehouse management and control software systems to maintain and support product purchase decisions. Store replenishment order selection is performed using pick-to-light and radio frequency processing technologies. Product is delivered to stores using both a dedicated fleet of trucks and contract carriers.

Marketing

We employ a multi-faceted marketing strategy to increase brand awareness, acquire new customers, improve customer retention and increase frequency of shopping. We communicate with our current and prospective customers through multiple vehicles, including direct mail, email, newspaper inserts, television and digital advertising.

We continue to develop and leverage our customer data analytic capabilities to drive a more customer-centric strategy through targeted marketing and promotions. We believe that targeted marketing and promotions play an important role in today's retail environment by improving the impact of digital media, email, coupons and promotional events. In July 2016, we launched our rewards program, Michaels Rewards, in the U.S. and in July 2018, we launched the program in Canada. Michaels Rewards is an important tool to increase retention of existing customers and enhance their loyalty to

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the Michaels brand. Michaels Rewards continues to grow and has surpassed 34 million customers. Michaels Rewards offers customers tailored, exclusive offers and events such as sneak peeks for new product, early alerts for big sales and receipt-free returns. The program adds to our customer database and, we believe, will allow us to further target our marketing and promotions more effectively.

Seasonality

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

Our Industry

According to internal market research, approximately 53% of U.S. households participated in at least one crafting project during 2018, which represented approximately 67 million households. This research indicated that crafting activities continue to enjoy broad based popularity and market size has been stable, valued at approximately \$36 billion. We believe the broad, multi-generational appeal, high personal attachment and the low-cost, project-based nature of crafting creates a loyal, resilient following.

Store Expansion and Relocation

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

	Fiscal Year				
	2018	2017	2016	2015	2014
Michaels stores:					
Open at beginning of period	1,238	1,223	1,196	1,168	1,136
New stores	24	17	32	30	32
Relocated stores opened	21	12	14	17	13
Closed stores	(4)	(2)	(5)	(2)	—
Relocated stores closed	(21)	(12)	(14)	(17)	(13)
Open at end of period	1,258	1,238	1,223	1,196	1,168
Aaron Brothers stores:					

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Open at beginning of period	97	109	117	120	121
New stores	—	—	1	—	5
Closed stores	(97)	(12)	(9)	(3)	(6)
Open at end of period	—	97	109	117	120
Pat Catan's stores:					
Open at beginning of period	36	35	—	—	—
Acquired stores	—	—	32	—	—
New stores	—	1	3	—	—
Relocated stores opened	—	—	1	—	—
Closed stores	(36)	—	—	—	—
Relocated stores closed	—	—	(1)	—	—
Open at end of period	—	36	35	—	—