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Ulta Salon, Cosmetics & Fragrance, Inc.

Form 10-Q

September 02, 2010

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

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Quarterly Period Ended July 31, 2010**

or

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

**Commission File Number: 001-33764  
ULTA SALON, COSMETICS & FRAGRANCE, INC.  
(Exact name of Registrant as specified in its charter)**

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**36-3685240**  
(I.R.S. Employer  
Identification No.)

**1000 Remington Blvd., Suite 120  
Bolingbrook, Illinois**  
(Address of principal executive offices)

**60440**  
(Zip code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller  
reporting company)

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

The number of shares of the registrant's common stock, par value \$0.01 per share, outstanding as of August 26, 2010 was 58,978,447 shares.

**ULTA SALON, COSMETICS & FRAGRANCE, INC.  
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Balance Sheets**

| <b>(In thousands)</b>                                  | <b>July 31,<br/>2010<br/>(unaudited)</b> | <b>January 30,<br/>2010</b> | <b>August 1,<br/>2009<br/>(unaudited)</b> |
|--|--|-----------------------------|---|
| <b>Assets</b>  |  |                             |   |
| Current assets:  |  |                             |   |
| Cash and cash equivalents                              | \$ 15,916                                | \$ 4,017                    | \$ 3,663                                  |
| Receivables, net                                       | 11,418                                   | 13,477                      | 13,135                                    |
| Merchandise inventories, net                           | 224,329                                  | 206,948                     | 209,152                                   |
| Prepaid expenses and other current assets              | 30,989                                   | 30,272                      | 25,373                                    |
| Prepaid income taxes                                   | 7,280                                    |                             |   |
| Deferred income taxes                                  | 8,060                                    | 8,060                       | 8,097                                     |
| Total current assets                                   | 297,992                                  | 262,774                     | 259,420                                   |
| Property and equipment, net                            | 301,333                                  | 290,861                     | 288,537                                   |
| Total assets   | \$599,325                                | \$553,635                   | \$547,957                                 |
| <b>Liabilities and stockholders equity</b>             |  |                             |   |
| Current liabilities:                                   |  |                             |   |
| Current portion notes payable                          | \$                                       | \$                          | \$ 23,086                                 |
| Accounts payable                                       | 61,316                                   | 56,387                      | 40,393                                    |
| Accrued liabilities                                    | 68,833                                   | 59,189                      | 53,350                                    |
| Accrued income taxes                                   |  | 10,781                      | 3,846                                     |
| Total current liabilities                              | 130,149                                  | 126,357                     | 120,675                                   |
| Notes payable less current portion                     |  |                             | 42,365                                    |
| Deferred rent  | 120,313                                  | 113,718                     | 108,245                                   |
| Deferred income taxes                                  | 20,952                                   | 20,952                      | 17,616                                    |
| Total liabilities                                      | 271,414                                  | 261,027                     | 288,901                                   |
| Commitments and contingencies (note 3)                 |  |                             |   |
| <i>See accompanying notes to financial statements.</i> |  |                             |   |

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

| <b>(In thousands, except per share data)</b>  | <b>July 31,<br/>2010<br/>(unaudited)</b> | <b>January 30,<br/>2010</b> | <b>August 1,<br/>2009<br/>(unaudited)</b> |
|---|--|-----------------------------|---|
| Stockholders' equity:   |  |                             |   |
| Common stock, \$.01 par value, 400,000 shares authorized;<br>59,365, 58,674 and 58,389 shares issued; 58,860, 58,169 and<br>57,884 shares outstanding; at July 31, 2010 (unaudited),<br>January 31, 2009 and August 1, 2009 (unaudited), respectively | \$ 594                                   | \$ 586                      | \$ 583                                    |
| Treasury stock-common, at cost  | (4,179)                                  | (4,179)                     | (4,179)                                   |
| Additional paid-in capital  | 309,273                                  | 300,701                     | 296,205                                   |
| Retained earnings (accumulated deficit)   | 22,223                                   | (4,500)                     | (33,186)                                  |
| Accumulated other comprehensive loss  |  |                             | (367)                                     |
| <b>Total stockholders' equity</b>   | <b>327,911</b>                           | <b>292,608</b>              | <b>259,056</b>                            |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$599,325</b>                         | <b>\$553,635</b>            | <b>\$547,957</b>                          |

*See accompanying notes to financial statements.*

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

| <b>(In thousands, except per share data)</b> | <b>Three months ended</b> |                           | <b>Six months ended</b>  |                           |
|--|---------------------------|---------------------------|--------------------------|---------------------------|
|  | <b>July 31,<br/>2010</b>  | <b>August 1,<br/>2009</b> | <b>July 31,<br/>2010</b> | <b>August 1,<br/>2009</b> |
| Net sales                                    | \$ 321,804                | \$ 273,539                | \$ 642,000               | \$ 542,364                |
| Cost of sales                                | 217,846                   | 194,825                   | 433,507                  | 384,108                   |
| Gross profit                                 | 103,958                   | 78,714                    | 208,493                  | 158,256                   |
| Selling, general and administrative expenses | 79,909                    | 66,468                    | 160,638                  | 135,861                   |
| Pre-opening expenses                         | 1,793                     | 2,010                     | 2,267                    | 3,205                     |
| Operating income                             | 22,256                    | 10,236                    | 45,588                   | 19,190                    |
| Interest expense                             | 214                       | 645                       | 332                      | 1,316                     |
| Income before income taxes                   | 22,042                    | 9,591                     | 45,256                   | 17,874                    |
| Income tax expense                           | 8,980                     | 3,841                     | 18,533                   | 7,204                     |
| Net income                                   | \$ 13,062                 | \$ 5,750                  | \$ 26,723                | \$ 10,670                 |
| Net income per common share:                 |                           |                           |                          |                           |
| Basic  | \$ 0.22                   | \$ 0.10                   | \$ 0.46                  | \$ 0.18                   |
| Diluted                                      | \$ 0.22                   | \$ 0.10                   | \$ 0.44                  | \$ 0.18                   |
| Weighted average common shares outstanding:  |                           |                           |                          |                           |
| Basic  | 58,727                    | 57,819                    | 58,517                   | 57,781                    |
| Diluted                                      | 60,672                    | 59,045                    | 60,505                   | 58,914                    |

*See accompanying notes to financial statements.*

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

| <b>(In thousands)</b>   | <b>Six months ended</b>  |                           |
|---|--------------------------|---------------------------|
|   | <b>July 31,<br/>2010</b> | <b>August 1,<br/>2009</b> |
| <b>Operating activities</b>   |                          |                           |
| Net income  | \$ 26,723                | \$ 10,670                 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |                           |
| Depreciation and amortization   | 31,593                   | 31,360                    |
| Non-cash stock compensation charges   | 4,222                    | 2,648                     |
| Excess tax benefits from stock-based compensation                                 | (924)                    | (283)                     |
| Loss on disposal of property and equipment  | 157                      | 184                       |
| Change in operating assets and liabilities:                                       |                          |                           |
| Receivables   | 2,059                    | 5,133                     |
| Merchandise inventories   | (17,381)                 | 4,450                     |
| Prepaid expenses and other assets   | (717)                    | (1,079)                   |
| Income taxes  | (17,137)                 | 12,474                    |
| Accounts payable  | 4,929                    | (7,418)                   |
| Accrued liabilities   | 6                        | 4,775                     |
| Deferred rent   | 6,595                    | 6,957                     |
| Net cash provided by operating activities   | 40,125                   | 69,871                    |
| <b>Investing activities</b>   |                          |                           |
| Purchases of property and equipment   | (32,584)                 | (29,756)                  |
| Net cash used in investing activities   | (32,584)                 | (29,756)                  |
| <b>Financing activities</b>   |                          |                           |
| Proceeds on long-term borrowings  |                          | 561,662                   |
| Payments on long-term borrowings  |                          | (602,258)                 |
| Proceeds from issuance of common stock under stock plans                          | 3,434                    | 223                       |
| Excess tax benefits from stock-based compensation                                 | 924                      | 283                       |
| Net cash provided by (used in) financing activities                               | 4,358                    | (40,090)                  |
| Net increase in cash and cash equivalents   | 11,899                   | 25                        |
| Cash and cash equivalents at beginning of period                                  | 4,017                    | 3,638                     |
| Cash and cash equivalents at end of period  | \$ 15,916                | \$ 3,663                  |

**Supplemental cash flow information**

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|  |           |            |
|--|-----------|------------|
| Cash paid for interest   | \$ 189    | \$ 1,406   |
| Cash paid (received) for income taxes                            | \$ 35,670 | \$ (5,553) |
| Noncash investing and financing activities:                      |           |            |
| Change in property and equipment included in accrued liabilities | \$ 9,638  | \$ (1,899) |
| Unrealized gain on interest rate swap hedge, net of tax          | \$        | \$ 264     |

*See accompanying notes to financial statements.*

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

| (In thousands, except per share data)             | Common Stock<br>Issued<br>Shares | Common Stock<br>Amount | Treasury<br>Common Stock<br>Shares | Treasury<br>Amount | Additional<br>Paid-In<br>Capital | Retained<br>Earnings<br>(Accumulated<br>Deficit) | Total<br>Stockholders<br>Equity |
|---|----------------------------------|------------------------|------------------------------------|--------------------|----------------------------------|--|---------------------------------|
| Balance January 30, 2010                          | 58,674                           | \$586                  | (505)                              | \$(4,179)          | \$300,701                        | \$ (4,500)                                       | \$292,608                       |
| Common stock options exercised                    | 691                              | 8                      |                                    |                    | 3,426                            |  | 3,434                           |
| Net income for the six months ended July 31, 2010 |                                  |                        |                                    |                    |                                  | 26,723   | 26,723                          |
| Excess tax benefits from stock-based compensation |                                  |                        |                                    |                    | 924                              |  | 924                             |
| Stock compensation charge                         |                                  |                        |                                    |                    | 4,222                            |  | 4,222                           |
| Balance July 31, 2010                             | 59,365                           | \$594                  | (505)                              | \$(4,179)          | \$309,273                        | \$22,223   | \$327,911                       |

*See accompanying notes to financial statements.*

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

**1. Business and basis of presentation**

Ulta Salon, Cosmetics & Fragrance, Inc. (Company or Ulta) was incorporated in the state of Delaware on January 9, 1990, to operate specialty retail stores selling cosmetics, fragrance, haircare and skincare products, and related accessories and services. The stores also feature full-service salons. As of July 31, 2010, the Company operated 356 stores in 38 states, as shown in the table below:

| <b>State</b>   | <b>Number of stores</b> |
|----------------|-------------------------|
| Alabama        | 7                       |
| Arizona        | 23                      |
| Arkansas       | 1                       |
| California     | 32                      |
| Colorado       | 11                      |
| Connecticut    | 2                       |
| Delaware       | 1                       |
| Florida        | 25                      |
| Georgia        | 16                      |
| Illinois       | 33                      |
| Indiana        | 6                       |
| Iowa           | 3                       |
| Kansas         | 1                       |
| Kentucky       | 2                       |
| Louisiana      | 3                       |
| Maryland       | 6                       |
| Massachusetts  | 4                       |
| Michigan       | 9                       |
| Minnesota      | 8                       |
| Mississippi    | 3                       |
| Missouri       | 3                       |
| Nebraska       | 2                       |
| Nevada         | 6                       |
| New Jersey     | 11                      |
| New York       | 12                      |
| North Carolina | 13                      |
| Ohio           | 8                       |
| Oklahoma       | 7                       |
| Oregon         | 3                       |
| Pennsylvania   | 17                      |
| Rhode Island   | 1                       |
| South Carolina | 6                       |
| Tennessee      | 4                       |
| Texas          | 46                      |
| Utah           | 2                       |
| Virginia       | 10                      |
| Washington     | 6                       |
| Wisconsin      | 3                       |

**Total**

**356**

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

The Company's business is subject to seasonal fluctuation. Significant portions of the Company's net sales and net income are realized during the fourth quarter of the fiscal year due to the holiday selling season. The results for the three and six months ended July 31, 2010 are not necessarily indicative of the results to be expected for the fiscal year ending January 29, 2011, or for any other future interim period or for any future year.

These interim financial statements and the related notes should be read in conjunction with the financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended January 30, 2010. All amounts are stated in thousands, with the exception of per share amounts and number of stores.

**2. Summary of significant accounting policies**

Information regarding the Company's significant accounting policies is contained in Note 2, Summary of significant accounting policies, to the financial statements in the Company's Annual Report on Form 10-K for the year ended January 30, 2010. Presented

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below in this and the following notes is supplemental information that should be read in conjunction with Notes to Financial Statements in the Annual Report.

**Fiscal quarter**

The Company's quarterly periods are the 13 weeks ending on the Saturday closest to April 30, July 31, October 31, and January 31. The Company's second quarters in fiscal 2010 and 2009 ended on July 31, 2010 and August 1, 2009, respectively.

**Reclassifications**

The Company made reclassifications in the 2009 statements of income for the three and six month periods of \$203 and \$402, respectively, to decrease cost of sales and increase selling, general and administrative expenses to conform to the presentation for the three and six months ended July 31, 2010.

**Share-based compensation**

The Company measures share-based compensation cost on the grant date, based on the fair value of the award, and recognizes the expense over the requisite service period for awards expected to vest. The Company estimated the grant date fair value of stock options using a Black-Scholes valuation model using the following assumptions for the periods indicated:

|                                  | <b>Six months ended</b>  |                           |
|----------------------------------|--------------------------|---------------------------|
|                                  | <b>July 31,<br/>2010</b> | <b>August 1,<br/>2009</b> |
| Volatility rate                  | 58.8%                    | 62.5%                     |
| Average risk-free interest rate  | 2.2%                     | 2.0%                      |
| Average expected life (in years) | 4.8                      | 4.6                       |
| Dividend yield                   | None                     | None                      |

The Company granted 745 and 403 stock options during the six months ended July 31, 2010 and August 1, 2009, respectively. The weighted-average grant date fair value of these options was \$11.38 and \$4.74, respectively. The Company also granted 119 shares of restricted stock with a fair value of \$23.32 per share during the six months ended July 31, 2010.

The Company recorded stock compensation expense of \$2,487 and \$1,353 for the three months ended July 31, 2010 and August 1, 2009, respectively. The Company recorded stock compensation expense of \$4,222 and \$2,648 for the six months ended July 31, 2010 and August 1, 2009, respectively. At July 31, 2010, there was approximately \$19,018 of unrecognized compensation expense related to unvested options and restricted stock.

**Comprehensive income**

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

|  | <b>Three months ended</b> |                           | <b>Six months ended</b>  |                           |
|--|---------------------------|---------------------------|--------------------------|---------------------------|
|  | <b>July 31,<br/>2010</b>  | <b>August 1,<br/>2009</b> | <b>July 31,<br/>2010</b> | <b>August 1,<br/>2009</b> |
| Net income   | \$ 13,062                 | \$ 5,750                  | \$ 26,723                | 10,670                    |
| Unrealized gain on interest rate swap hedge, net of income tax |                           | 157                       |                          | 264                       |
| Comprehensive income   | \$ 13,062                 | \$ 5,907                  | \$ 26,723                | \$ 10,934                 |

**3. Commitments and contingencies**

**Leases** The Company leases stores, distribution and office facilities, and certain equipment. Original non-cancelable lease terms range from three to ten years, and store leases generally contain renewal options for additional years. A

number of the Company's store leases provide for contingent rentals based upon sales. Contingent rent amounts were insignificant in the three and six months ended July 31, 2010 and August 1, 2009. Total rent expense under operating leases was \$20,135 and \$17,823 for the three months

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ended July 31, 2010 and August 1, 2009, respectively. Total rent expense under operating leases was \$39,594 and \$35,759 for the six months ended July 31, 2010 and August 1, 2009, respectively.

**General litigation** As previously disclosed, in July 2009 a putative employment class action lawsuit was filed against the Company and certain unnamed defendants in state court in California. The suit alleges that Ulta misclassified its store General Managers and Salon Managers as exempt from the Fair Labor Standards Act and California Labor Code. The suit seeks to recover damages and penalties as a result of this alleged misclassification. On August 27, 2009, the Company filed its answer to the lawsuit, and on August 31, 2009 the Company moved the action to the United States District Court for the Northern District of California. On November 2, 2009, the plaintiffs filed an amended complaint adding another named plaintiff. On May 26, 2010, the Company and plaintiffs engaged in a voluntary mediation. Although the Company continues to deny plaintiffs' allegations, in the interest of putting the Salon Manager claims behind it, the Company agreed in principle to settle all claims of the putative Salon Manager class. The settlement, which is not an admission of liability, is subject to final documentation and Court approval. Counsel for the plaintiffs has agreed to dismiss without prejudice the claims of the General Managers. The settlement amount is not material. In May, 2010, a putative employment class action lawsuit was filed against the Company and certain unnamed defendants in state court in California. The plaintiff and members of the proposed class are alleged to be (or have been) nonexempt hourly employees. The suit alleges that Ulta violated various provisions of the California labor laws and failed to provide plaintiff and members of the proposed class with full meal periods, paid rest breaks, certain wages, overtime compensation and premium pay. The suit seeks to recover damages and penalties as a result of these alleged practices. On June 21, 2010, the Company filed its answer to the lawsuit. Although the Company believes that it has meritorious defenses to the claims made in the putative class action and the Company intends to contest the lawsuit vigorously, an adverse resolution could have a material adverse effect on its financial position and results of operations in the period in which the lawsuit is resolved. The Company is not presently able to reasonably estimate potential losses, if any, related to the lawsuit.

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

**4. Notes payable**

Prior to August 31, 2010, the Company's credit facility was with Bank of America National Association as the administrative agent, Wachovia Capital Finance Corporation as collateral agent, and JP Morgan Chase Bank as documentation agent. This facility provided maximum credit of \$200,000. The facility provided maximum borrowings equal to the lesser of \$200,000 or a percentage of eligible owned inventory. The advance rates on owned inventory were 80% (85% from September 1 to January 31). The credit facility agreement contained a restrictive financial covenant requiring the Company to maintain tangible net worth of not less than \$80,000. On July 31, 2010, the Company's tangible net worth was approximately \$328,000. Substantially all of the Company's assets were pledged as collateral for outstanding borrowings under the facility. Outstanding borrowings bore interest at the prime rate or the Eurodollar rate plus 1.00% up to \$100,000 and 1.25% thereafter.

The Company had no outstanding borrowings under the facility as of July 31, 2010 and January 30, 2010. The Company had approximately \$196,381 and \$196,933 of availability as of July 31, 2010 and January 30, 2010, respectively.

On August 31, 2010, the Company terminated its credit facility with Bank of America and entered into a new credit facility pursuant to a Loan and Security Agreement with Wells Fargo Bank, National Association, as Administrative Agent, Collateral Agent and a Lender thereunder, JPMorgan Chase Bank, N.A. as a Lender, and PNC Bank, National Association, as a Lender. This new facility provides maximum credit of \$200,000 through May 31, 2013 and is available for working capital and general corporate purposes. The facility provides maximum borrowings equal to the lesser of \$200,000 or a percentage of eligible owned inventory, and contains a \$10,000 subfacility for letters of credit. The new credit facility agreement contains a restrictive financial covenant requiring the Company to maintain tangible net worth of not less than \$200,000. Substantially all of the Company's assets are pledged as collateral for outstanding borrowings under the facility. Outstanding borrowings will bear interest at the prime rate or Libor plus 2.00%.

As of August 31, 2010, the Company had no borrowings outstanding under the new credit facility.

**5. Financial instruments**

The Company had an interest rates swap agreement which expired in January 2010 and held no derivative instruments as of July 31, 2010 and January 30, 2010. The Company's derivative financial instrument was designated and qualified as a cash flow hedge. Accordingly, the effective portion of the gain or loss on the derivative instrument was reported as a component of accumulated other comprehensive loss and reclassified into interest expense in the same period or periods during which the hedged transaction affects

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earnings. The remaining gain or loss, the ineffective portion, on the derivative instrument, if other than inconsequential, was recognized in interest expense during the period of change. Hedge ineffectiveness was not material in the three and six months ended August 1, 2009.

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

|                                | <b>Amount of Gain (Loss)<br/>Recognized in AOCL<br/>on<br/>Derivative (Effective<br/>Portion)<br/>Three months ended<br/>July</b> |                           | <b>Amount of Gain<br/>Reclassified<br/>from AOCL into Income<br/>(Effective Portion)<br/>Three months ended</b> |                           | <b>Amount of Gain<br/>Recognized in Income<br/>on<br/>Derivative (Ineffective<br/>Portion)<br/>Three months ended</b> |                           |
|--------------------------------|---|---------------------------|---|---------------------------|---|---------------------------|
|                                | <b>31,<br/>2010</b>   | <b>August 1,<br/>2009</b> | <b>July 31,<br/>2010</b>  | <b>August 1,<br/>2009</b> | <b>July 31,<br/>2010</b>  | <b>August 1,<br/>2009</b> |
| Interest rate swap, net of tax | \$  | \$ 157                    | \$  | \$                        | \$  | \$                        |

|                                | <b>Amount of Gain (Loss)<br/>Recognized in AOCL<br/>on<br/>Derivative (Effective<br/>Portion)<br/>Six months ended<br/>July</b> |                           | <b>Amount of Gain<br/>Reclassified<br/>from AOCL into Income<br/>(Effective Portion)<br/>Six months ended</b> |                           | <b>Amount of Gain<br/>Recognized in Income<br/>on<br/>Derivative (Ineffective<br/>Portion)<br/>Six months ended</b> |                           |
|--------------------------------|---|---------------------------|---|---------------------------|---|---------------------------|
|                                | <b>31,<br/>2010</b>   | <b>August 1,<br/>2009</b> | <b>July 31,<br/>2010</b>  | <b>August 1,<br/>2009</b> | <b>July 31,<br/>2010</b>  | <b>August 1,<br/>2009</b> |
| Interest rate swap, net of tax | \$  | \$ 264                    | \$  | \$                        | \$  | \$                        |

**6. Fair Value Measurements**

The carrying value of cash and cash equivalents, accounts receivable, and accounts payable approximates their estimated fair values due to the short maturities of these instruments. The estimated fair value of any variable rate debt outstanding approximates its carrying value since the rate of interest on the variable rate debt is revised frequently based upon the current prime rate or the Eurodollar rate.

**7. Net income per common share**

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

|  | <b>Three months ended</b> |                           | <b>Six months ended</b>  |                           |
|--|---------------------------|---------------------------|--------------------------|---------------------------|
|  | <b>July 31,<br/>2010</b>  | <b>August 1,<br/>2009</b> | <b>July 31,<br/>2010</b> | <b>August 1,<br/>2009</b> |
| Net income   | \$13,062                  | \$ 5,750                  | \$26,723                 | \$10,670                  |
| Denominator for basic net income per share<br>weighted-average common shares | 58,727                    | 57,819                    | 58,517                   | 57,781                    |
| Dilutive effect of stock options and non-vested<br>stock                     | 1,945                     | 1,226                     | 1,988                    | 1,133                     |

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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Denominator for diluted net income per share | 60,672  | 59,045  | 60,505  | 58,914  |
| Net income per common share:                 |         |         |         |         |
| Basic  | \$ 0.22 | \$ 0.10 | \$ 0.46 | \$ 0.18 |
| Diluted                                      | \$ 0.22 | \$ 0.10 | \$ 0.44 | \$ 0.18 |

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The denominators for diluted net income per common share for the three months ended July 31, 2010 and August 1, 2009 exclude 1,061 and 3,407 employee stock options, respectively, due to their anti-dilutive effects.

The denominators for diluted net income per common share for the six months ended July 31, 2010 and August 1, 2009 exclude 1,061 and 3,790 employee stock options, respectively, due to their anti-dilutive effects.

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

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our financial statements and related notes included elsewhere in this quarterly report. This discussion contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, which reflect our current views with respect to, among other things, future events and financial performance. You can identify these forward-looking statements by the use of forward-looking words such as outlook, believes, expects, plans, estimates, or other comparable words. Any forward-looking statements contained in this Form 10-Q are based upon our historical performance and on current plans, estimates and expectations. The inclusion of this forward-looking information should not be regarded as a representation by us or any other person that the future plans, estimates or expectations contemplated by us will be achieved. Such forward-looking statements are subject to various risks and uncertainties, which include, without limitation: the impact of weakness in the economy; changes in the overall level of consumer spending; changes in the wholesale cost of our products; the possibility that we may be unable to compete effectively in our highly competitive markets; the possibility that our continued opening of new stores could strain our resources and have a material adverse effect on our business and financial performance; the possibility that new store openings may be impacted by developer or co-tenant issues; the possibility that the capacity of our distribution and order fulfillment infrastructure may not be adequate to support our recent growth and expected future growth plans; the possibility of material disruptions to our information systems; weather conditions that could negatively impact sales; and other risk factors detailed in our public filings with the Securities and Exchange Commission (the SEC), including risk factors contained in Item 1A, Risk Factors of our Annual Report on Form 10-K for the year ended January 30, 2010. We assume no obligation to update any forward-looking statements as a result of new information, future events or developments. References in the following discussion to we, us, our, the Company, Ulta and similar references mean Ulta Salon, Cosmetics & Fragrance, Inc. unless otherwise expressly stated or the context otherwise requires.*

#### **Overview**

We were founded in 1990 as a discount beauty retailer at a time when prestige, mass and salon products were sold through separate distribution channels. In 1999 we embarked on a multi-year strategy to understand and embrace what women want in a beauty retailer and transform Ulta into the shopping experience that it is today. We pioneered what we believe to be our unique combination of beauty superstore and specialty store attributes. We believe our strategy provides us with the competitive advantages that have contributed to our strong financial performance.

We are currently the largest beauty retailer that provides one-stop shopping for prestige, mass and salon products and salon services in the United States. We combine the unique elements of a beauty superstore with the distinctive environment and experience of a specialty retailer. Key aspects of our beauty superstore strategy include our ability to offer our customers a broad selection of over 21,000 beauty products across the categories of cosmetics, fragrance, haircare, skincare, bath and body products and salon styling tools, as well as salon haircare products. We focus on delivering a compelling value proposition to our customers across all of our product categories. Our stores are conveniently located in high-traffic, primarily off-mall locations such as power centers and lifestyle centers with other destination retailers. As of July 31, 2010, we operated 356 stores across 38 states. In addition to these fundamental elements of a beauty superstore, we strive to offer an uplifting shopping experience through what we refer to as The Five E's: Escape, Education, Entertainment, Esthetics and Empowerment.

The continued growth of our business and any future increases in net sales, net income and cash flows are dependent on our ability to execute our growth strategy, including growing our store base, expanding our prestige brand offerings, driving incremental salon traffic, expanding our online business and continuing to enhance our brand awareness. We believe that the steadily expanding U.S. beauty products and services industry, the shift in distribution of prestige beauty products from department stores to specialty retail stores, coupled with Ulta's competitive strengths,

positions us to capture additional market share in the industry through successful execution of our growth strategy. Comparable store sales is a key metric that is monitored closely within the retail industry. We do not expect our comparable store sales increases over the next five years to reflect the sustained high single digit to low double digit increases we experienced in 2005 through early 2007. We believe the sequential decline in our quarterly comparable store sales during 2008 and the comparable store sales declines in first and second quarter 2009 were due primarily to the difficult economic environment. Our comparables store sales

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trend improved during the second half of fiscal 2009 and into the first half of fiscal 2010. We believe the continuing economic uncertainty and related impact on consumer sentiment may affect the level of comparable store sales we can achieve.

Over the long-term, our growth strategy is to increase total net sales through increases in our comparable store sales and by opening new stores. Gross profit as a percentage of net sales is expected to increase as a result of our ability to leverage our supply chain infrastructure and fixed store costs with comparable store sales increases. We plan to continue to improve our operating results by leveraging our fixed costs and decreasing our selling, general and administrative expenses, as a percentage of our net sales.

### **Global economic conditions**

The global economic crisis and the continued volatility and disruption to the capital and credit markets have had a significant, adverse impact on global economic conditions, resulting in additional significant recessionary pressures and declines in consumer confidence and economic growth. As a result of these market conditions, the cost and availability of credit has been and may continue to be adversely affected by illiquid credit markets and wider credit spreads. Concern about the stability of the markets generally and the strength of counterparties specifically has led many lenders and institutional investors to reduce, and in some cases, cease to provide credit to businesses and consumers. These factors have led to a decrease in spending by businesses and consumers alike, and a corresponding decrease in global infrastructure spending. Continued turbulence in the United States and international markets and economies and prolonged declines in business and consumer spending may adversely affect our liquidity and financial condition, and the liquidity and financial condition of our customers, including our ability to refinance maturing liabilities and access the capital markets to meet liquidity needs.

### **Current business trends**

We recorded a 10.8% increase in our comparable store sales during the first half of fiscal 2010 which extended the sequential comparable store sales improvement which began in the second half of fiscal 2009. We believe the improvement in our comparable store sales trends is due to a combination of factors including our ability to better plan our marketing and merchandise programs for the current economic environment and the relatively lower comparable in the first half of 2009. We also believe that overall consumer sentiment and shopping patterns began to improve in the second half of 2009 which may have contributed to our improving trends. In light of the current economic uncertainty in both the U.S. and world financial markets, consumer sentiment could turn negative which could result in a deceleration of the favorable comparable store sales trends we have experienced in recent quarters.

### **Change in Management**

On April 26, 2010, we announced that Mr. Carl ( Chuck ) Rubin would be appointed President and Chief Operating Officer and as a member of our Board of Directors effective May 10, 2010. The Company completed the previously announced transition period and on August 31, 2010, Ms. Kirby informed the Board of Directors that she intends to resign as Chief Executive Officer effective after the close of business on September 2, 2010. On August 31, 2010 Mr. Rubin was appointed Chief Executive Officer and President of Ulta effective upon Ms. Kirby's resignation. Lyn Kirby is expected to continue providing guidance and counsel to the Company as a member of the Company's Board of Directors through March 17, 2011.

On May 10, 2010, Mr. Rubin received a restricted share grant of 119 shares valued at \$2,775 which will vest in full on December 29, 2011. Mr. Rubin also received a grant of 319 stock options valued at \$3,694 which will vest and become exercisable in four equal installments commencing on February 1, 2011 and each subsequent anniversary, such that all such options will be fully vested on February 1, 2014. Mr. Rubin also received a one-time cash payment of \$2,800 in August 2010 as part of his employment agreement.

### **Basis of presentation**

Net sales include store and e-commerce merchandise sales as well as salon service revenue. Salon service revenue represented less than 10% of our combined product sales and services revenues for the three and six months ended July 31, 2010 and August 1, 2009 and therefore, these revenues are combined with product sales. We recognize merchandise revenue at the point of sale (POS) in our retail stores and the time of shipment in the case of Internet sales. Merchandise sales are recorded net of estimated returns. Salon service revenue is recognized at the time the service is provided. Gift card sales revenue is deferred until the customer redeems the gift card. Company coupons and

other incentives are recorded as a reduction of net sales.

Comparable store sales reflect sales for stores beginning on the first day of the 14th month of operation. Therefore, a store is included in our comparable store base on the first day of the period after one year of operations plus the initial one month grand opening period. Non-comparable store sales include sales from new stores that have not yet completed their 13th month of operation and stores that

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were closed for part or all of the period in either year as a result of remodel activity. Remodeled stores are included in comparable store sales unless the store was closed for a portion of the current or prior period. E-commerce merchandise sales are excluded from comparable store sales. There may be variations in the way in which some of our competitors and other retailers calculate comparable or same store sales. As a result, data herein regarding our comparable store sales may not be comparable to similar data made available by our competitors or other retailers. Comparable store sales is a critical measure that allows us to evaluate the performance of our store base as well as several other aspects of our overall strategy. Several factors could positively or negatively impact our comparable store sales results:

- the general national, regional and local economic conditions and corresponding impact on customer spending levels;

- the introduction of new products or brands;

- the location of new stores in existing store markets;

- competition;

- our ability to respond on a timely basis to changes in consumer preferences;

- the effectiveness of our various marketing activities; and

- the number of new stores opened and the impact on the average age of all of our comparable stores.

Cost of sales includes:

- the cost of merchandise sold, including all vendor allowances, which are treated as a reduction of merchandise costs;

- warehousing and distribution costs including labor and related benefits, freight, rent, depreciation and amortization, real estate taxes, utilities, and insurance;

- store occupancy costs including rent, depreciation and amortization, real estate taxes, utilities, repairs and maintenance, insurance, licenses, and cleaning expenses;

- salon payroll and benefits;

- customer loyalty program expense; and

- shrink and inventory valuation reserves.

Our cost of sales may be negatively impacted as we open an increasing number of stores. Changes in our merchandise mix may also have an impact on cost of sales. This presentation of items included in cost of sales may not be comparable to the way in which our competitors or other retailers compute their cost of sales.

Selling, general and administrative expenses include:

- payroll, bonus and benefit costs for retail and corporate employees;

- advertising and marketing costs;

- occupancy costs related to our corporate office facilities;

- stock-based compensation expense;

depreciation and amortization for all assets except those related to our retail and warehouse operations, which are included in cost of sales; and

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legal, finance, information systems and other corporate overhead costs.

This presentation of items in selling, general and administrative expenses may not be comparable to the way in which our competitors or other retailers compute their selling, general and administrative expenses.

Pre-opening expense includes non-capital expenditures during the period prior to store opening for new and remodeled stores including rent during the construction period for new stores, store set-up labor, management and employee training, and grand opening advertising.

Interest expense includes interest costs associated with our credit facility, which is structured as an asset based lending instrument. Our interest expense will fluctuate based on the seasonal borrowing requirements associated with acquiring inventory in advance of key holiday selling periods and fluctuation in the variable interest rates we are charged on outstanding balances. Our credit facility is used to fund seasonal inventory needs and new and remodel store capital requirements in excess of our cash flow from operations. Our credit facility interest is based on a variable interest rate structure which can result in increased cost in periods of rising interest rates.

Income tax expense reflects the federal statutory tax rate and the weighted average state statutory tax rate for the states in which we operate stores.

**Table of Contents****Results of operations**

Our quarterly periods are the 13 weeks ending on the Saturday closest to April 30, July 31, October 31, and January 31. The Company's second quarters in fiscal 2010 and 2009 ended on July 31, 2010 and August 1, 2009, respectively. Our quarterly results of operations have varied in the past and are likely to do so again in the future. As such, we believe that period-to-period comparisons of our results of operations should not be relied upon as an indication of our future performance.

The following tables present the components of our results of operations for the periods indicated:

| <b>(Dollars in thousands)</b>                | <b>Three months ended</b>    |                               | <b>Six months ended</b>      |                               |
|--|------------------------------|-------------------------------|------------------------------|-------------------------------|
|  | <b>July 31,<br/>2010</b>     | <b>August 1,<br/>2009</b>     | <b>July 31,<br/>2010</b>     | <b>August 1,<br/>2009</b>     |
| Net sales                                    | \$ 321,804                   | \$ 273,539                    | \$ 642,000                   | \$ 542,364                    |
| Cost of sales                                | 217,846                      | 194,825                       | 433,507                      | 384,108                       |
| Gross profit                                 | 103,958                      | 78,714                        | 208,493                      | 158,256                       |
| Selling, general and administrative expenses | 79,909                       | 66,468                        | 160,638                      | 135,861                       |
| Pre-opening expenses                         | 1,793                        | 2,010                         | 2,267                        | 3,205                         |
| Operating income                             | 22,256                       | 10,236                        | 45,588                       | 19,190                        |
| Interest expense                             | 214                          | 645                           | 332                          | 1,316                         |
| Income before income taxes                   | 22,042                       | 9,591                         | 45,256                       | 17,874                        |
| Income tax expense                           | 8,980                        | 3,841                         | 18,533                       | 7,204                         |
| Net income                                   | \$ 13,062                    | \$ 5,750                      | \$ 26,723                    | \$ 10,670                     |
| Other operating data:                        |                              |                               |                              |                               |
| Number stores end of period                  | 356                          | 333                           | 356                          | 333                           |
| Comparable store sales increase (decrease)   | 10.8%                        | (1.7)%                        | 10.8%                        | (2.0)%                        |
| <b>(Percentage of net sales)</b>             | <b>Three months ended</b>    |                               | <b>Six months ended</b>      |                               |
|  | <b>July<br/>31,<br/>2010</b> | <b>August<br/>1,<br/>2009</b> | <b>July<br/>31,<br/>2010</b> | <b>August<br/>1,<br/>2009</b> |
| Net sales                                    | 100.0%                       | 100.0%                        | 100.0%                       | 100.0%                        |
| Cost of sales                                | 67.7%                        | 71.2%                         | 67.5%                        | 70.8%                         |
| Gross profit                                 | 32.3%                        | 28.8%                         | 32.5%                        | 29.2%                         |
| Selling, general and administrative expenses | 24.8%                        | 24.3%                         | 25.0%                        | 25.0%                         |
| Pre-opening expenses                         | 0.6%                         | 0.7%                          | 0.4%                         | 0.6%                          |
| Operating income                             | 6.9%                         | 3.7%                          | 7.1%                         | 3.5%                          |
| Interest expense                             | 0.1%                         | 0.2%                          | 0.1%                         | 0.2%                          |

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|                            |      |      |      |      |
|----------------------------|------|------|------|------|
| Income before income taxes | 6.8% | 3.5% | 7.0% | 3.3% |
| Income tax expense         | 2.8% | 1.4% | 2.9% | 1.3% |
| Net income                 | 4.1% | 2.1% | 4.2% | 2.0% |

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**Comparison of three months ended July 31, 2010 to three months ended August 1, 2009**

***Net sales***

Net sales increased \$48.3 million, or 17.6%, to \$321.8 million for the three months ended July 31, 2010, compared to \$273.5 million for the three months ended August 1, 2009. The increase is primarily due to comparable stores driving an increase of \$28.6 million in net sales when compared to last year and an additional 23 new stores operating since August 1, 2009 which contributed \$19.7 million to net sales.

Our comparable store sales increased 10.8%, which included an 8.0% increase in traffic and a 2.8% increase in average ticket. We attribute the increase in comparable store sales to our successful marketing and merchandising strategies and lower relative comparable in the prior year quarter.

***Gross profit***

Gross profit increased \$25.3 million, or 32.1%, to \$104.0 million for the three months ended July 31, 2010, compared to \$78.7 million for the three months ended August 1, 2009. Gross profit as a percentage of net sales increased 350 basis points to 32.3% for the three months ended July 31, 2010, compared to 28.8% for the three months ended August 1, 2009. The increases in gross profit margin were primarily driven by:

160 basis points of leverage in fixed store costs due to a combination of less drag on the relatively smaller new store program in the first half of fiscal 2010 and increased comparable store sales levels;

120 basis points improvement in merchandise margins driven by our marketing and merchandising strategies; and

20 basis points of leverage in supply chain due to efficiencies and increased comparable store sales levels.

***Selling, general and administrative expenses***

Selling, general and administrative (SG&A) expenses increased \$13.4 million, or 20.2%, to \$79.9 million for the three months ended July 31, 2010, compared to \$66.5 million for the three months ended August 1, 2009. As a percentage of net sales, SG&A expenses increased 50 basis points to 24.8% for the three months ended July 31, 2010, compared to 24.3% for the three months ended August 1, 2009. The deleverage in SG&A expenses is primarily attributed to:

90 basis points of deleverage in corporate overhead attributed to incremental compensation expense related to the Company's new President and COO, net of

40 basis points of leverage in marketing expense attributed to the benefit of our cost efficiencies and stronger comparable store sales levels.

***Pre-opening expenses***

Pre-opening expenses decreased \$0.2 million, or 10.8%, to \$1.8 million for the three months ended July 31, 2010, compared to \$2.0 million for the three months ended August 1, 2009. During the three months ended July 31, 2010, we opened 10 new stores, relocated 1 store and remodeled 3 stores, compared to 13 new store openings during the three months ended August 1, 2009.

***Interest expense***

Interest expense was \$0.2 million for the three months ended July 31, 2010, compared to \$0.6 million for the three months ended August 1, 2009. We did not access our credit facility during the second quarter fiscal 2010. Interest expense for the period represents various fees related to the credit facility.

***Income tax expense***

Income tax expense of \$9.0 million for the three months ended July 31, 2010 represents an effective tax rate of 40.7%, compared to \$3.8 million of tax expense representing an effective tax rate of 40.0% for the three months ended August 1, 2009. The increase in the effective tax rate is primarily due to an increase in the amount of non-deductible executive compensation expense in fiscal 2010.

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***Net income***

Net income increased \$7.3 million, or 127.2%, to \$13.1 million for the three months ended July 31, 2010, compared to \$5.8 million for the three months ended August 1, 2009. The increase is primarily related to the \$25.3 million increase in gross profit, offset by a \$13.4 million increase in SG&A expenses.

**Comparison of six months ended July 31, 2010 to six months ended August 1, 2009**

***Net sales***

Net sales increased \$99.6 million, or 18.4%, to \$642.0 million for the six months ended July 31, 2010, compared to \$542.4 million for the six months ended August 1, 2009. The increase is primarily due to comparable stores driving an increase of \$57.0 million in net sales when compared to last year and an additional 23 new stores operating since August 1, 2009 which contributed \$42.6 million to net sales.

Our comparable store sales increased 10.8%, which included an 8.4% increase in traffic and a 2.4% increase in average ticket. We attribute the increase in comparable store sales to our successful marketing and merchandising strategies and lower relative comparable store sales in the prior year.

***Gross profit***

Gross profit increased \$50.2 million, or 31.7%, to \$208.5 million for the six months ended July 31, 2010, compared to \$158.3 million for the six months ended August 1, 2009. Gross profit as a percentage of net sales increased 330 basis points to 32.5% for the six months ended July 31, 2010, compared to 29.2% for the six months ended August 1, 2009. The increase in gross profit margin was primarily driven by:

160 basis points of leverage in fixed store costs due to a combination of less drag on the relatively smaller new store program in the first half of fiscal 2010 and increased comparable store sales levels;

100 basis points improvement in merchandise margins driven by our marketing and merchandising strategies; and

20 basis points of leverage in supply chain due to efficiencies and increased comparable store sales.

***Selling, general and administrative expenses***

SG&A expenses increased \$24.7 million, or 18.2%, to \$160.6 million for the six months ended July 31, 2010, compared to \$135.9 million for the six months ended August 1, 2009. As a percentage of net sales, SG&A expenses were unchanged at 25.0% for the six months ended July 31, 2010 and August 1, 2009. SG&A as a percentage of net sales is primarily driven by:

40 basis points of leverage in marketing expense attributed to the benefit of our fiscal 2009 cost efficiencies and stronger comparable store sales, net of

40 basis points of deleverage in corporate overhead attributed to incremental compensation expense related to the Company's new President and COO.

***Pre-opening expenses***

Pre-opening expenses decreased \$0.9 million, or 29.3%, to \$2.3 million for the six months ended July 31, 2010, compared to \$3.2 million for the six months ended August 1, 2009. During the six months ended July 31, 2010, we opened 12 new stores, relocated 2 stores and 3 remodeled stores, compared to 22 new store openings during the six months ended August 1, 2009.

***Interest expense***

Interest expense was \$0.3 million for the six months ended July 31, 2010, compared to \$1.3 million for the six months ended August 1, 2009. We did not access our credit facility during the first half of fiscal 2010. Interest expense for the period represents various fees related to the credit facility.

**Table of Contents****Income tax expense**

Income tax expense of \$18.5 million for the six months ended July 31, 2010 represents an effective tax rate of 41.0%, compared to \$7.2 million of tax expense representing an effective tax rate of 40.3% for the six months ended August 1, 2009. The increase in the effective tax rate is primarily due to an increase in the amount of non-deductible executive compensation expense in fiscal 2010.

**Net income**

Net income increased \$16.0 million, or 150.4%, to \$26.7 million for the six months ended July 31, 2010, compared to \$10.7 million for the six months ended August 1, 2009. The increase is primarily related to the \$50.2 million increase in gross profit, offset by a \$24.7 million increase in SG&A expenses.

**Liquidity and capital resources**

Our primary cash needs are for capital expenditures for new, relocated and remodeled stores, increased merchandise inventories related to store expansion, and for continued improvement in our information technology systems.

Our primary sources of liquidity are cash flows from operations, including changes in working capital, and borrowings under our credit facility. The most significant component of our working capital is merchandise inventories reduced by related accounts payable and accrued expenses. Our working capital position benefits from the fact that we generally collect cash from sales to customers the same day, or within several days of the related sale, while we typically have up to 30 days to pay our vendors.

Our working capital needs are greatest from August through November each year as a result of our inventory build-up during this period for the approaching holiday season. This is also the time of year when we are at maximum investment levels in our new store class and may not have collected all of the landlord allowances due to us as part of our lease agreements. Based on past performance and current expectations, we believe that cash generated from operations and borrowings under the credit facility will satisfy the Company's working capital needs, capital expenditure needs, commitments, and other liquidity requirements through at least the next 12 months.

The following table presents a summary of our cash flows for the six months ended July 31, 2010 and August 1, 2009:

| (In thousands)                                      | Six months ended |                   |
|---|------------------|-------------------|
|   | July 31,<br>2010 | August 1,<br>2009 |
| Net cash provided by operating activities           | \$ 40,125        | \$ 69,871         |
| Net cash used in investing activities               | (32,584)         | (29,756)          |
| Net cash provided by (used in) financing activities | 4,358            | (40,090)          |
| Net increase in cash and cash equivalents           | \$ 11,899        | \$ 25             |

**Operating activities**

Operating activities consist of net income adjusted for certain non-cash items, including depreciation and amortization, non-cash stock-based compensation, excess tax benefits from stock-based compensation, realized gains or losses on disposal of property and equipment, and the effect of working capital changes.

Merchandise inventories were \$224.3 million at July 31, 2010, compared to \$209.2 million at August 1, 2009, representing an increase of \$15.1 million. The increase is primarily due to the addition of 23 net new stores opened since August 1, 2009.

Deferred rent liabilities were \$120.3 million at July 31, 2010, an increase of \$12.1 million compared to August 1, 2009. Deferred rent includes deferred construction allowances, future rental increases and rent holidays which are all recognized on a straight-line basis over their respective lease term. The increase is primarily due to the addition of 23 net new stores opened since August 1, 2009.

The \$29.8 million decrease in cash provided by operating activities is primarily driven by the change in income taxes. We received an \$8.0 million income tax refund in the second quarter fiscal 2009 related to certain tax planning changes adopted in fiscal 2008.



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Additionally, in fiscal 2010, we have paid in larger amounts of estimated income taxes due to increases in operating results compared to the prior year.

### **Investing activities**

We have historically used cash primarily for new and remodeled stores as well as investments in information technology systems. Investment activities related to capital expenditures were \$32.6 million during the six months ended July 31, 2010, compared to \$29.8 million during the six months ended August 1, 2009. Capital expenditures for the six months ended July 31, 2010 included 12 new stores, 2 relocated stores and 3 remodeled stores, while capital expenditures for the six months ended August 1, 2009 included 22 new stores. The increase in capital expenditures year over year is primarily due to construction in-progress related to third quarter fiscal 2010 when we expect to open 28 stores.

### **Financing activities**

Financing activities consist principally of capital stock transactions. The net increase in net cash provided by financing activities of \$44.5 million for the six months ended July 31, 2010 compared to the six months ended August 1, 2009 is primarily the result of increased payments on long-term borrowings during the six months ended August 1, 2009 and proceeds from the issuance of common stock under stock plans six months ended July 31, 2010.

We had no borrowings outstanding under our credit facility as of July 31, 2010 and January 30, 2010. The zero outstanding borrowings position is due to a combination of factors including stronger than expected sales growth, overall performance of management initiatives including expense control as well as inventory and other working capital reductions. While we expect the level of borrowings under the facility will be lower than historical amounts, we expect that we will require borrowings under the facility from time to time in future periods to support our new store program and seasonal inventory needs.

### **Credit facility**

Prior to August 31, 2010, our credit facility was with Bank of America National Association as the administrative agent, Wachovia Capital Finance Corporation as collateral agent, and JP Morgan Chase Bank as documentation agent. This facility provided maximum credit of \$200 million. The facility provided maximum borrowings equal to the lesser of \$200 million or a percentage of eligible owned inventory. The advance rates on owned inventory were 80% (85% from September 1 to January 31). The credit facility agreement contained a restrictive financial covenant requiring us to maintain tangible net worth of not less than \$80 million. On July 31, 2010, our tangible net worth was approximately \$328 million. Substantially all of our assets were pledged as collateral for outstanding borrowings under the facility. Outstanding borrowings bore interest at the prime rate or the Eurodollar rate plus 1.00% up to \$100 million and 1.25% thereafter.

We had no outstanding borrowings under the facility as of July 31, 2010 and January 30, 2010. We had approximately \$196.4 million and \$196.9 million of availability as of July 31, 2010 and January 30, 2010, respectively.

On August 31, 2010, we terminated our credit facility with Bank of America and entered into a new credit facility pursuant to a Loan and Security Agreement with Wells Fargo Bank, National Association, as Administrative Agent, Collateral Agent and a Lender thereunder, JPMorgan Chase Bank, N.A. as a Lender, and PNC Bank, National Association, as a Lender. This new facility provides maximum credit of \$200 million through May 31, 2013 and is available for working capital and general corporate purposes. The facility provides maximum borrowings equal to the lesser of \$200 million or a percentage of eligible owned inventory, and contains a \$10 million subfacility for letters of credit. The new credit facility agreement contains a restrictive financial covenant requiring us to maintain tangible net worth of not less than \$200 million. Substantially all of our assets are pledged as collateral for outstanding borrowings under the new facility. Outstanding borrowings will bear interest at the prime rate or Libor plus 2.00%.

As of August 31, 2010, we had no borrowings outstanding under the new credit facility.

### **Off-balance sheet arrangements**

Our off-balance sheet arrangements consist of operating lease obligations. We do not have any non-cancelable purchase commitments as of July 31, 2010.

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**Contractual obligations**

Our contractual obligations consist of operating lease obligations and our revolving line of credit. No material changes outside the ordinary course of business have occurred in our contractual obligations during the six months ended July 31, 2010.

**Critical accounting policies and estimates**

Management's discussion and analysis of financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles (GAAP). The preparation of these financial statements required the use of estimates and judgments that affect the reported amounts of our assets, liabilities, revenues and expenses. Management bases estimates on historical experience and other assumptions it believes to be reasonable under the circumstances and evaluates these estimates on an on-going basis. Actual results may differ from these estimates. There have been no significant changes to the critical accounting policies and estimates included in our Annual Report on Form 10-K for the year ended January 30, 2010.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. Our market risk exposure is primarily the result of fluctuations in interest rates. We do not hold or issue financial instruments for trading purposes.

**Interest rate sensitivity**

We are exposed to interest rate risks primarily through borrowings under our credit facility. Interest on our borrowings is based upon variable rates. We did not access our credit facility during the first half of fiscal 2010. The interest expense recognized in our statement of income for the first half of fiscal 2010 represents fees associated with the credit facility.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures over Financial Reporting**

We have established disclosure controls and procedures to ensure that material information relating to the Company is made known to the officers who certify our financial reports and to the members of our senior management and board of directors.

Based on management's evaluation as of July 31, 2010, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective to ensure that the information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

**Changes in Internal Control over Financial Reporting**

There were no changes to our internal controls over financial reporting during the three months ended July 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**Part II Other Information**

**Item 1. Legal Proceedings**

**General litigation** As previously disclosed, in July 2009 a putative employment class action lawsuit was filed against us and certain unnamed defendants in state court in California. The suit alleges that Ulta misclassified its store General Managers and Salon Managers as exempt from the Fair Labor Standards Act and California Labor Code. The suit seeks to recover damages and penalties as a result of this alleged misclassification. On August 27, 2009, we filed our answer to the lawsuit, and on August 31, 2009 we moved the action to the United States District Court for the Northern District of California. On November 2, 2009, the plaintiffs filed an amended complaint adding another named plaintiff. On May 26, 2010, the Company and plaintiffs engaged in a voluntary mediation. Although we continue to deny plaintiffs' allegations, in the interest of putting the Salon Manager claims behind us, we agreed in principle to settle all claims of the putative Salon Manager class. The settlement, which is not an admission of liability, is

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subject to final documentation and Court approval. Counsel for the plaintiffs has agreed to dismiss without prejudice the claims of the General Managers. The settlement amount is not material.

In May, 2010, a putative employment class action lawsuit was filed against us and certain unnamed defendants in state court in California. The plaintiff and members of the proposed class are alleged to be (or have been) nonexempt hourly employees. The suit alleges that Ulta violated various provisions of the California labor laws and failed to provide plaintiff and members of the proposed class with full meal periods, paid rest breaks, certain wages, overtime compensation and premium pay. The suit seeks to recover damages and penalties as a result of these alleged practices. On June 21, 2010, we filed our answer to the lawsuit. Although we believe that we have meritorious defenses to the claims made in the putative class action and we intend to contest the lawsuit vigorously, an adverse resolution could have a material adverse effect on our financial position and results of operations in the period in which the lawsuit is resolved. We are not presently able to reasonably estimate potential losses, if any, related to the lawsuit.

We are also involved in various legal proceedings that are incidental to the conduct of our business. In the opinion of management, the amount of any liability with respect to these proceedings, either individually or in the aggregate, will not be material.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report and the risk factor set forth below, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended January 30, 2010, which could materially affect our business, financial condition, financial results or future performance. Other than the additional risk factor set fourth below, there have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended January 30, 2010.

***We are currently undergoing a leadership change. The execution of our business plan and development strategy may be adversely impacted if we are not able to successfully manage this change.***

As previously announced, Carl Rubin joined the Company as President and Chief Operating Officer and as a member of our Board of Directors effective May 10, 2010. Ms. Kirby has announced her intended resignation as Chief Executive Officer effective September 2, 2010 and effective upon her resignation, Mr. Rubin will assume the role of Chief Executive Officer. Any significant leadership or executive management change involves inherent risks. We may be unable to manage this change smoothly, which could adversely impact our business, financial condition and results of operations.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. [Reserved]**

None

**Item 5. Other Information**

On August 31, 2010, Ms. Lyn Kirby informed the Board of Directors that she intends to resign as Chief Executive Officer effective after the close of business on September 2, 2010. Ms. Kirby is expected to continue providing guidance and counsel to the Company as a member of the Company's Board of Directors through March 17, 2011.

On August 31, 2010, Mr. Carl Rubin was appointed Chief Executive Officer and President of Ulta effective upon Ms. Kirby's resignation on September 2, 2010. Mr. Rubin, age 50, has been serving as the Chief Operating Officer and President of Ulta since May 10, 2010. Before joining Ulta, Mr. Rubin, was President, North American Retail at Office Depot since January 2006. Prior to that he served as Executive Vice President, Marketing and Merchandising for Office Depot from March 2004 to January 2006. Mr. Rubin also serves as a director of Ulta. Mr. Rubin does not have any family relationships with any of Ulta's directors or executive officers and is not a party to any transactions listed in Item 404(a) of Regulation S-K.

**Table of Contents****Item 6. Exhibits**

| Exhibit Number | Description of document   | Filed Herewith | Incorporated by Reference |                |             |             |
|----------------|---|----------------|---------------------------|----------------|-------------|-------------|
|                |   |                | Form                      | Exhibit Number | File Number | Filing Date |
| 3.1            | Amended and Restated Certificate of Incorporation   |                | S-1                       | 3.1            | 333-144405  | 8/17/2007   |
| 3.2            | Amended and Restated Bylaws   |                | S-1                       | 3.2            | 333-144405  | 8/17/2007   |
| 4.1            | Specimen Common Stock Certificate   |                | S-1                       | 4.1            | 333-144405  | 10/11/2007  |
| 4.2            | Third Amended and Restated Registration Rights Agreement between Ulta Salon, Cosmetics & Fragrance, Inc. and the stockholders party thereto   |                | S-1                       | 4.2            | 333-144405  | 8/17/2007   |
| 4.3            | Stockholder Rights Agreement  |                | S-1                       | 4.4            | 333-144405  | 8/17/2007   |
| 10.1           | Succession agreement, dated as of April 23, 2010, by and between Ulta Salon, Cosmetics & Fragrance, Inc. and Lyn Kirby.   |                | 8-K                       | 10.1           | 001-33764   | 4/27/2010   |
| 10.2           | Employment Agreement, dated as of April 12, 2010, by and between Ulta Salon, Cosmetics & Fragrance, Inc. and Carl Rubin.  |                | 8-K                       | 10.2           | 001-33764   | 4/27/2010   |
| 10.2(a)        | First Amendment to Carl Rubin Employment Agreement, dated April 28, 2010.   |                | 10-Q                      | 10.2(a)        | 001-33764   | 6/3/2010    |
| 10.3           | Restricted Stock Award Agreement, dated May 10, 2010, by and between Ulta Salon, Cosmetics & Fragrance, Inc. and Carl Rubin.  |                | 8-K                       | 10.3           | 001-33764   | 4/27/2010   |
| 10.4           | Option Agreement, dated May 10, 2010, by and between Ulta Salon, Cosmetics & Fragrance, Inc. and Carl Rubin.  |                | 8-K                       | 10.4           | 001-33764   | 4/27/2010   |
| 31.1           | Certification of the Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002 | X              |                           |                |             |             |

|      |   |   |
|------|---|---|
| 31.2 | Certification of the Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002 | X |
| 32.1 | Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                   | X |

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on September 2, 2010 on its behalf by the undersigned, thereunto duly authorized.

ULTA SALON, COSMETICS & FRAGRANCE,  
INC.

By: /s/ Lynelle P. Kirby  
Lynelle P. Kirby  
Chief Executive Officer and Director

By: /s/ Gregg R. Bodnar  
Gregg R. Bodnar  
Chief Financial Officer