Sally Beauty Holdings, Inc.
Form 10-Q
May 01, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 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: MARCH 31, 2019

-OR-

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File No. 1-33145

SALLY BEAUTY HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant 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 such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section13(a) of the Exchange Act.

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

As of April 26, 2019, there were 120,580,929 shares of the issuer’s common stock outstanding.

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

cautionary notice regarding forward-looking statements

Statements in this Quarterly Report on Form 10-Q and in the documents incorporated by reference herein which are not purely historical facts or which depend upon future events may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act. Words such as “anticipate,” “believe,” “estimate,” “expect,” “intend “plan,” “project,” “target,” “can,” “could,” “may,” “should,” “will,” “would” or similar expressions may also identify such forward-looking statements.

Readers are cautioned not to place undue reliance on forward-looking statements as such statements speak only as of the date they were made and involve risks and uncertainties that could cause actual events or results to differ materially from the events or results described in the forward-looking statements. The most important risks, uncertainties and other factors which could cause our actual results to differ from our forward-looking statements are set forth in our description of risk factors in Item 1A contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2018, which should be read in conjunction with the forward-looking statements in this report. Additional risks and uncertainties may also be discussed in this quarterly report and the other reports we file with the SEC. Forward-looking statements speak only as of the date they are made, and we do not undertake any obligation to update any forward-looking statement.

The events described in the forward-looking statements might not occur or might occur to a different extent or at a different time than we have described. As a result, our actual results may differ materially from the results contemplated by these forward-looking statements.

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements.

The following condensed consolidated balance sheets as of March 31, 2019 and September 30, 2018, the condensed consolidated statements of earnings, condensed consolidated statements of comprehensive income, and the condensed statements of stockholders' deficit for the three and six months ended March 31, 2019 and 2018, and the condensed consolidated statements of cash flows for the six months ended March 31, 2019 and 2018 are those of Sally Beauty Holdings, Inc. and its subsidiaries.

SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(In thousands, except par value data)

(Unaudited)

	March 31, 2019	September 30, 2018
Assets		
Current assets:		
Cash and cash equivalents	$89,777	$77,295
Trade accounts receivable, net	41,976	48,417
Accounts receivable, other	49,451	42,073
Inventory	953,043	944,338
Other current assets	39,895	42,960
Total current assets	1,174,142	1,155,083
Property and equipment, net of accumulated depreciation of $636,099 at March 31, 2019 and $611,021 at September 30, 2018	297,124	308,357
Goodwill	533,566	535,925
Intangible assets, excluding goodwill, net of accumulated amortization of $137,767 at March 31, 2019 and $132,724 at September 30, 2018	68,370	72,698
Other assets	19,412	25,351
Total assets	$2,092,614	$2,097,414
Liabilities and Stockholders' Deficit		
Current liabilities:		
Current maturities of long-term debt	$5,503	$5,501
Accounts payable	252,470	303,241
Accrued liabilities	156,490	180,287
Income taxes payable	6,280	2,144
Total current liabilities	420,743	491,173
Long-term debt	1,708,421	1,768,808
Other liabilities	25,917	30,022
Deferred income tax liabilities, net	82,608	75,967
Total liabilities	2,237,689	2,365,970
Stockholders' deficit:		
Common stock, $0.01 par value. Authorized 500,000 shares; 120,566 and 120,145 shares issued and 120,107 and 119,926 shares outstanding at March 31, 2019 and September 30, 2018, respectively	1,201	1,199
Preferred stock, $0.01 par value. Authorized 50,000 shares; none issued	—	—
Additional paid-in capital	7,590	—
Accumulated deficit	(48,312)	(179,764)
Accumulated other comprehensive loss, net of tax	(105,554)	(89,991)

Total stockholders' deficit	(145,075)	(268,556)
Total liabilities and stockholders' deficit	$2,092,614	$2,097,414

The accompanying notes are an integral part of these condensed consolidated financial statements.

SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Earnings

(In thousands, except per share data)

(Unaudited)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2019	2018	2019	2018
Net sales	$945,852	$975,321	$1,935,305	$1,970,286
Cost of goods sold	477,528	488,999	986,275	997,335
Gross profit	468,324	486,322	949,030	972,951
Selling, general and administrative expenses	361,626	368,461	728,614	739,748
Restructuring	(5,814)	6,759	(1,834)	11,969
Operating earnings	112,512	111,102	222,250	221,234
Interest expense	23,821	25,262	48,310	49,277
Earnings before provision for income taxes	88,691	85,840	173,940	171,957
Provision for income taxes	22,966	24,469	42,488	27,322
Net earnings	$65,725	$61,371	$131,452	$144,635
Earnings per share:				
Basic	$0.55	$0.49	$1.10	$1.15
Diluted	$0.54	$0.49	$1.09	$1.14
Weighted average shares:				
Basic	120,077	124,270	120,033	126,046
Diluted	120,991	125,057	120,949	126,834

The accompanying notes are an integral part of these condensed consolidated financial statements.

SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Comprehensive Income

(In thousands)

(Unaudited)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2019	2018	2019	2018
Net earnings	$65,725	$61,371	$131,452	$144,635
Other comprehensive loss:				
Foreign currency translation adjustments	3,040	10,437	(10,425)	10,182
Interest rate caps, net of tax	(2,140)	2,310	(4,970)	1,507
Foreign exchange contracts, net of tax	242	—	(168)	—
Other comprehensive income (loss), net of tax	1,142	12,747	(15,563)	11,689
Total comprehensive income	$66,867	$74,118	$115,889	$156,324

The accompanying notes are an integral part of these condensed consolidated financial statements.

SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended March 31, 2019	2018
Cash Flows from Operating Activities:		
Net earnings	$131,452	$144,635
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	53,275	54,009
Share-based compensation expense	5,871	5,850
Amortization of deferred financing costs	1,979	1,851
(Gain) loss on extinguishment of debt	(473)	876
(Gain) loss on disposal of equipment and other property	(6,548)	42
Deferred income taxes	8,530	(29,379)
Changes in (exclusive of effects of acquisitions):		
Trade accounts receivable	5,950	(1,506)
Accounts receivable, other	(7,554)	(3,990)
Inventory	(14,213)	3,266
Other current assets	2,754	3,508
Other assets	(1,293)	143
Accounts payable and accrued liabilities	(69,704)	(12,175)
Income taxes payable	4,150	(762)
Other liabilities	(4,066)	13,082
Net cash provided by operating activities	110,110	179,450
Cash Flows from Investing Activities:		
Payments for property and equipment	(46,398)	(38,693)
Proceeds from sale of property and equipment	12,010	14
Acquisitions, net of cash acquired	(2,848)	(9,175)
Net cash used by investing activities	(37,236)	(47,854)
Cash Flows from Financing Activities:		
Proceeds from issuance of long-term debt	242,504	246,819
Repayments of long-term debt	(304,157)	(260,142)
Debt issuance costs	—	(1,151)
Payments for common stock repurchased	—	(114,699)
Proceeds from exercises of stock options	1,721	1,112
Net cash used by financing activities	(59,932)	(128,061)
Effect of foreign exchange rate changes on cash and cash equivalents	(460)	762
Net increase in cash and cash equivalents	12,482	4,297
Cash and cash equivalents, beginning of period	77,295	63,759
Cash and cash equivalents, end of period	$89,777	$68,056
Supplemental Cash Flow Information:		

Interest paid	$48,378	$46,574
Income taxes paid	37,518	45,089
Capital expenditures incurred but not paid	$3,763	$1,426

The accompanying notes are an integral part of these condensed consolidated financial statements.

SALLY BEAUTY HOLDINGS, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Stockholders' Deficit

(In thousands)

(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Deficit
Balance at September 30, 2018	119,926	$ 1,199	$ —	$ (179,764)	$ —	$ (89,991)	$ (268,556)
Net earnings	—	—	—	65,727	—	—	65,727
Other comprehensive loss	—	—	—	—	—	(16,705)	(16,705)
Share-based compensation	—	—	3,354	—	—	—	3,354
Stock issued for stock options	115	1	1,448	—	—	—	1,449
Balance at December 31, 2018	120,041	$ 1,200	$ 4,802	$ (114,037)	$ —	$ (106,696)	$ (214,731)
Net earnings	—	—	—	65,725	—	—	65,725
Other comprehensive income	—	—	—	—	—	1,142	1,142
Share-based compensation	—	—	2,517	—	—	—	2,517
Stock issued for stock options	66	1	271	—	—	—	272
Balance at March 31, 2019	120,107	$ 1,201	$ 7,590	$ (48,312)	$ —	$ (105,554)	$ (145,075)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Deficit
Balance at September 30, 2017	129,585	$ 1,296	$ —	$ (283,076)	$ —	$ (81,836)	$ (363,616)
Net earnings	—	—	—	83,264	—	—	83,264
Other comprehensive loss	—	—	—	—	—	(1,058)	(1,058)
Repurchases and cancellations of common stock	(3,848)	(39)	(3,386)	(61,187)	—	—	(64,612)
Share-based compensation	—	—	3,111	—	—	—	3,111
Stock issued for stock options	62	1	275	—	—	—	276
Balance at December 31, 2017	125,799	$ 1,258	$ —	$ (260,999)	$ —	$ (82,894)	$ (342,635)
Net earnings	—	—	—	61,371	—	—	61,371
Other comprehensive income	—	—	—	—	—	12,747	12,747

Repurchases and cancellations of common stock	(2,899)	(29)	(3,573)	(46,484)	—	—	(50,086)
Share-based compensation	—	—	2,738	—	—	—	2,738
Stock issued for stock options	102	1	835	—	—	—	836
Balance at March 31, 2018	123,002	$ 1,230	$ —	$ (246,112)	$ —	$ (70,147)	$ (315,029)

The accompanying notes are an integral part of these condensed consolidated financial statements.

Sally Beauty Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

The condensed consolidated interim financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") and pursuant to the rules and regulations of the SEC. Accordingly, certain information and note disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC, although we believe that the disclosures are adequate to make the information not misleading. These condensed consolidated interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2018. In the opinion of management, these condensed consolidated interim financial statements reflect all adjustments that are of a normal recurring nature and which are necessary to present fairly our consolidated financial position as of March 31, 2019 and September 30, 2018, our consolidated results of operations and consolidated comprehensive income for the three and six months ended March 31, 2019 and 2018, and our consolidated cash flows for six months ended March 31, 2019 and 2018.

Certain amounts for the prior year have been conformed to the current year's presentation.

2. Significant Accounting Policies

We adhere to the same accounting policies in the preparation of our condensed consolidated interim financial statements as we do in the preparation of our full-year consolidated financial statements. As permitted under GAAP, interim accounting for certain expenses, including income taxes, is based on full-year assumptions. For interim financial reporting purposes, income taxes are recorded based upon estimated annual effective income tax rates.

3. Accounting Changes and Recent Accounting Pronouncements

Accounting Changes

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers ("ASU No. 2014-09"), which introduced new guidance that established how an entity should measure revenue in connection with its sale of goods and services to a customer based on the consideration to which the entity expects to be entitled in exchange for each of those goods and services. On October 1, 2018, we adopted ASU No. 2014-09 using the modified retrospective transition method. Additionally, in connection with the adoption, we designed changes to our internal control procedures and updated processes to ensure appropriate recognition and presentation of financial information. This adoption did not have a material effect on our consolidated financial statements or on our internal controls over financial reporting. We do not believe that the adoption will have a material effect on our consolidated financial statements on an ongoing basis. The comparative periods continue to be presented under the accounting standards in effect during those periods.

In connection with the adoption of ASU No. 2014-09, we now present our sales returns allowance on a gross basis rather than a net liability basis. As such, we recognize a return asset from the right to recover merchandise from customers (included in other current assets) and a return liability from the amount to be returned to the customer (included in accrued liabilities) within our consolidated balance sheets. Additionally, we now recognize revenue for our gift cards not expected to be redeemed ("gift card breakage") within revenue in our consolidated statements of earnings.

The following tables set forth the impact of adopting this standard on our condensed consolidated balance sheets as of March 31, 2019 and our condensed consolidated statements of earnings for the three and six months ended March 31, 2019 (in thousands):

Effect of ASU No. 2014-09 Adoption on Condensed Consolidated Balance Sheet

	As reported	Excluding ASU No. 2014-09 Effect	ASU No. 2014-09 Effect
Other current assets	$ 39,895	$ 37,256	$ 2,639
Accrued liabilities	$ 156,490	$ 153,851	$ 2,639

Effect of ASU No. 2014-09 Adoption on Condensed Consolidated Statement of Earnings

For the three months ended March 31, 2019

	As reported	Excluding ASU No. 2014-09 Effect	ASU No. 2014-09 Effect
Net Sales	$945,852	$945,752	$ 100
Gross Profit	468,324	468,224	100
Selling, general and administrative expenses	$361,626	$361,526	$ 100

For the six months ended March 31, 2019

	As reported	Excluding ASU No. 2014-09 Effect	ASU No. 2014-09 Effect
Net Sales	$1,935,305	$1,935,130	$ 175
Gross Profit	949,030	948,855	175
Selling, general and administrative expenses	$728,614	$728,439	$ 175

See note 4, Revenue Recognition, for additional information related to ASU No. 2014-09.

Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases, which will require most leases to be reported on the balance sheet as a right-of-use asset and a lease liability. Under the new guidance, the lease liability must be measured initially based on the present value of future lease payments, subject to certain conditions. The right-of-use asset must be measured initially based on the amount of the liability, plus certain initial direct costs. The new guidance further requires that leases be classified at inception as either (a) operating leases or (b) finance leases. For operating leases, periodic expense will generally be flat (straight-line) throughout the life of the lease. For finance leases, periodic expense will decline (similar to capital leases under prior rules) over the life of the lease. The new standard must be adopted using a modified retrospective transition method, but companies can adopt using the effective date method or the comparative method. For public companies, this standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We will adopt this pronouncement on October 1, 2019 using the effective date method. We have completed a preliminary assessment of the potential impact of adopting ASU No. 2016-02 on our consolidated financial statements. At March 31, 2019, adoption of ASU No. 2016-02 would have resulted in recognition of a right-of-use asset in the estimated amount of approximately $525.0 million and a lease liability for a similar amount in our consolidated balance sheet. We are currently in the process of implementing changes to our processes, controls and systems in order to be compliant upon adoption of the new standard. We do not believe adoption of ASU No. 2016-02 will have a material impact on our consolidated results of operations or consolidated cash flows. The amount of the right-of-use asset and the lease liability we ultimately recognize may materially differ from this preliminary estimate, including as a result of future organic growth in our business, changes in interest rates, and potential acquisitions.

4. Revenue Recognition

Substantially all of our revenue is derived through the sale of merchandise. Revenue is recognized net of estimated sales returns and sales taxes. We estimate sales returns based on historical data. Additionally, we have assessed all revenue streams for principal versus agent considerations and have concluded we are the principal for all transactions.

See Note 13, Business Segments, for additional information regarding the disaggregation of our sales revenue.

Merchandise Revenues

The majority of our revenue comes from the sale of products in our company-operated stores. These sales generally have one single performance obligation and the revenue is recognized at the point of sale. Discounts and incentives issued at the point of sale to entice a customer to a future purchase are treated as a separate performance obligation. As such, we allocate a portion of the revenue generated from the point of sale to each of the additional performance obligations separately using explicitly stated amounts or our best estimate using historical data.

We also sell merchandise on our online platforms, to our franchisees and by using distributor sales consultants. These sales generally have one single performance obligation and revenue is recognized upon the shipment of the merchandise. Any shipping and handling fees charged to the customer are recognized as revenue, while any shipping and handling costs to get the merchandise shipped is recognized in cost of goods sold.

We do extend credit to certain customers, primarily salon professionals, which generally have 30 day payment terms. Based on the nature of theses receivables, no significant financing component exists.

Gift Cards

The revenue from the sale of our gift cards is recognized at the time the gift card is used to purchase merchandise, which is generally within one year from the date of purchase. Our gift cards do not carry expiration dates or impose post-sale fees. Based on historical experience, a certain amount of our gift cards will not be redeemed, also referred to as "gift card breakage." We recognize revenue related to gift card breakage within revenue in our consolidated statements of earnings over time proportionately to historical redemption patterns. The gift cards are issued and represent liabilities of either of our operating entities, Sally Beauty Supply LLC or Beauty Systems Group LLC, which are both limited liability companies formed in the state of Virginia.

Customer Loyalty Rewards

We recently launched our new Sally Beauty Rewards Loyalty Program nationwide during the first quarter of fiscal year 2019 to the U.S. and Canada, which enables customers to earn points based on their status for every dollar spent on merchandise purchased in our Sally Beauty Supply ("SBS") stores and through our sallybeauty.com website. When a specific tier has been reached, a customer will receive a certificate which can be used at any of our U.S. and Canada SBS stores or through our sallybeauty.com website on their next purchase. Based on the rewards loyalty program policies, points expire after twelve months of inactivity and certificates will expire after a specific time period from the date of issuance. Certificates generated from our rewards loyalty program provide a material right to customers and represent a separate performance obligation. Rewards loyalty points are accrued at the standalone value per point, net of estimated breakage, and are included within accrued liabilities on our consolidated balance sheets. We recognize the revenue when the customer redeems the certificate. Points and certificates are issued by and represent liabilities of Sally Beauty Supply LLC.

The following table shows the amount of our gift card and rewards loyalty program liabilities included in accrued liabilities within our condensed consolidated balance sheets as of March 31, 2019 and September 30, 2018 (in thousands):

	March 31, 2019	September 30, 2018
Gift cards	$4,528	$ 4,144
Rewards loyalty program	7,032	1,165
Total liability	$11,560	$ 5,309

5. Fair Value Measurements

Fair value on recurring basis

Consistent with the three-level hierarchy defined in ASC Topic 820, Fair Value Measurement, as amended, we categorize our financial assets and liabilities as follows (in thousands):

		As of March 31, 2019	As of September 30, 2018
Assets			
Foreign exchange contracts	Level 2	$580	$ —
Interest rate caps	Level 2	1,636	8,367
Total assets		$2,216	$ 8,367
Liabilities			
Foreign exchange contracts	Level 2	$333	$ —

Other fair value disclosures

		As of March 31, 2019		As of September 30, 2018	
		Carrying Value	Fair Value	Carrying Value	Fair Value
Long-term debt					
Senior notes	Level 1	$889,946	$888,694	$950,000	$911,490
Other long-term debt	Level 2	842,606	823,421	845,383	824,951
Total debt		$1,732,552	$1,712,115	$1,795,383	$1,736,441

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6. Accumulated Other Comprehensive Loss

The change in accumulated other comprehensive loss ("AOCL") was as follows (in thousands):