Ulta Salon, Cosmetics & Fragrance, Inc.
Form 10-Q
December 10, 2008

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

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended November 1, 2008

or

o **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	**36-3685240**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1000 Remington Blvd., Suite 120 Bolingbrook, Illinois	**60440**
(Address of principal executive offices)	(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. þ Yes o No

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares of the registrant s common stock, par value $0.01 per share, outstanding as of December 4, 2008 was 57,671,142 shares.

ULTA SALON, COSMETICS & FRAGRANCE, INC.
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Part I Financial Information

Item 1. Consolidated Financial Statements

Ulta Salon, Cosmetics & Fragrance, Inc.

Consolidated Balance Sheets

(In thousands)	November 1, 2008 (unaudited)	February 2, 2008	November 3, 2007 (unaudited)
Assets			
Current assets:			
Cash and cash equivalents	$ 3,648	$ 3,789	$ 3,512
Receivables, net	20,488	20,643	16,089
Merchandise inventories, net	268,928	176,109	219,453
Prepaid expenses and other current assets	24,960	19,184	27,726
Deferred income taxes	9,088	9,219	5,614
Total current assets	327,112	228,944	272,394
Property and equipment, net	292,120	236,389	226,533
Deferred income taxes	4,080	4,080	4,125
Total assets	$623,312	$469,413	$503,052
Liabilities and stockholders equity			
Current liabilities:			
Current portion notes payable	$ 51,590	$	$ 41,962
Accounts payable	97,768	52,122	85,985
Accrued liabilities	50,532	54,719	55,669
Accrued income taxes	5,798	5,064	
Total current liabilities	205,688	111,905	183,616
Notes payable less current portion	86,390	74,770	55,038
Deferred rent	100,126	71,235	66,655
Total liabilities	392,204	257,910	305,309
Commitments and contingencies			

See accompanying notes to consolidated financial statements.

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

(In thousands, except per share data)	November 1, 2008 (unaudited)	February 2, 2008	November 3, 2007 (unaudited)
Stockholders equity:			
Common stock, $.01 par value, 400,000 shares authorized; 58,168, 57,411 and 57,276 shares issued; 57,663, 56,906 and 56,771 shares outstanding; at November 1, 2008 (unaudited), February 2, 2008 and November 3, 2007 (unaudited), respectively	$ 582	$ 574	$ 573
Treasury stock-common, at cost	(4,179)	(4,179)	(4,179)
Additional paid-in capital	291,362	284,951	284,362
Accumulated deficit	(56,144)	(69,124)	(82,728)
Accumulated other comprehensive loss	(513)	(719)	(285)
Total stockholders equity	231,108	211,503	197,743
Total liabilities and stockholders equity	$623,312	$469,413	$503,052

See accompanying notes to consolidated financial statements.

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

(In thousands, except per share data)	Three months ended November 1, 2008	Three months ended November 3, 2007	Nine months ended November 1, 2008	Nine months ended November 3, 2007
Net sales	$254,843	$208,235	$743,252	$602,797
Cost of sales	175,368	140,156	516,710	416,173
Gross profit	79,475	68,079	226,542	186,624
Selling, general and administrative expenses	65,176	55,609	189,130	154,779
Pre-opening expenses	4,693	4,494	12,515	9,064
Operating income	9,606	7,976	24,897	22,781
Interest expense	1,124	1,307	3,055	3,465
Income before income taxes	8,482	6,669	21,842	19,316
Income tax expense	3,465	2,463	8,862	7,585
Net income	$ 5,017	$ 4,206	$ 12,980	$ 11,731
Less preferred stock dividends		3,598		11,219
Net income available to common stockholders	$ 5,017	$ 608	$ 12,980	$ 512
Net income per common share:				
Basic	$ 0.09	$ 0.06	$ 0.23	$ 0.06
Diluted	$ 0.09	$ 0.05	$ 0.22	$ 0.05
Weighted average common shares outstanding:				
Basic	57,591	10,179	57,328	8,252
Diluted	59,013	12,476	59,005	10,447

See accompanying notes to consolidated financial statements.

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

(Dollars in thousands)	Nine months ended November 1, 2008	Nine months ended November 3, 2007
Operating activities		
Net income	$ 12,980	$ 11,731
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	37,619	28,597
Non-cash stock compensation charges	2,644	1,635
Excess tax benefits from stock-based compensation	(1,565)	(1,542)
Loss (gain) on disposal of property and equipment	219	(11)
Change in operating assets and liabilities:		
Receivables	155	2,387
Merchandise inventories	(92,819)	(90,216)
Prepaid expenses and other assets	(5,776)	(10,596)
Accounts payable	45,646	42,914
Accrued liabilities	1,488	(4,065)
Deferred rent	28,891	16,288
Net cash provided by (used in) operating activities	29,482	(2,878)
Investing activities		
Purchases of property and equipment	(96,608)	(74,648)
Receipt of related party notes receivable		4,467
Net cash used in investing activities	(96,608)	(70,181)
Financing activities		
Proceeds on long-term borrowings	874,139	750,262
Payments on long-term borrowings	(810,929)	(703,999)
Proceeds from issuance of common stock under stock plans	2,269	953
Excess tax benefits from stock-based compensation	1,565	1,542
Proceeds from issuance of common stock in initial public offering, net of issuance costs	(59)	123,921
Payment of accumulated dividends in arrears		(93,012)
Redemption of Series III preferred stock		(4,792)
Purchase of treasury stock		(1,949)
Net cash provided by financing activities	66,985	72,926
Net decrease in cash and cash equivalents	(141)	(133)
Cash and cash equivalents at beginning of period	3,789	3,645

Cash and cash equivalents at end of period	$ 3,648	$ 3,512

See accompanying notes to consolidated financial statements.

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

(Dollars in thousands)	Nine months ended November 1, 2008	Nine months ended November 3, 2007
Supplemental cash flow information		
Cash paid for interest	$ 3,437	$ 3,863
Cash paid for income taxes	$ 6,589	$16,486
Noncash investing and financing activities:		
Change in property and equipment included in accrued liabilities	$(3,039)	$18,390
Unrealized gain (loss) on interest rate swap hedge, net of tax	$ 206	$ (304)

See accompanying notes to consolidated financial statements.

Ulta Salon, Cosmetics & Fragrance, Inc.
Consolidated Statements of Stockholders Equity
(unaudited)

(In thousands)	Common Stock Issued Shares	Common Stock Amount	Treasury Common Stock Treasury Shares	Treasury Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders Equity
Balance February 2, 2008	57,411	$ 574	(505)	$ (4,179)	$ 284,951	$ (69,124)	$ (719)	$ 211,503
Common stock options exercised	757	8			2,261			2,269
Unrealized gain on interest rate swap hedge, net of $131 income tax							206	206
Net income for the nine months ended November 1, 2008						12,980		12,980
Comprehensive income								13,186
Excess tax benefits from stock-based compensation					1,565			1,565
Stock compensation charge					2,644			2,644
Initial public offering issuance costs					(59)			(59)
Balance November 1, 2008	58,168	$ 582	(505)	$ (4,179)	$ 291,362	$ (56,144)	$ (513)	$ 231,108

See accompanying notes to consolidated financial statements.

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

1. Business and basis of presentation

The accompanying consolidated financial statements of Ulta Salon, Cosmetics & Fragrance, Inc. (the Company) include Ulta Salon, Cosmetics & Fragrance, Inc. and its wholly owned subsidiary, Ulta Internet Holdings, Inc. (Internet). All inter-company balances and transactions have been eliminated. The operations of Internet were merged into the Company during 2006, resulting in its dissolution as a separate legal entity on November 30, 2006.

All amounts are stated in thousands, with the exception of per share amounts and number of stores.

The Company 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 November 1, 2008, the Company operated 304 stores in 35 states, as shown in the table below:

State	Number of stores
Alabama	6
Arizona	22
California	28
Colorado	10
Delaware	1
Florida	20
Georgia	16
Illinois	31
Indiana	6
Iowa	2
Kansas	1
Kentucky	2
Louisiana	2
Maryland	6
Massachusetts	3
Michigan	8
Minnesota	6
Missouri	2
Nebraska	2
Nevada	6
New Jersey	9
New York	9
North Carolina	12
Ohio	5
Oklahoma	6
Oregon	3
Pennsylvania	13
Rhode Island	1
South Carolina	4
Tennessee	3
Texas	42
Utah	2
Virginia	9

Washington	4
Wisconsin	2
Total	**304**

The accompanying unaudited consolidated 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 consolidated financial statements reflect all adjustments, which are of a normal recurring nature, necessary to fairly state the consolidated 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 nine months ended November 1, 2008 and November 3, 2007 are not necessarily indicative of the results to be expected for the fiscal year ending January 31, 2009, 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 February 2, 2008.

Reverse stock split

On September 17, 2007, the Company s Board of Directors approved a resolution to effect a reverse stock split of the Company s common stock pursuant to which each share of common stock was to be converted into 0.632 of one share of common stock. The reverse stock split became effective on October 22, 2007. Any fractional shares resulting from the reverse stock split were rounded to the nearest whole share. Common share and per share amounts for all periods presented and the conversion ratio of preferred to common shares have been adjusted for the 0.632 for 1 reverse stock split.

Initial public offering

On October 30, 2007, the Company completed an initial public offering in which the Company sold 7,667 shares of common stock resulting in net proceeds of $123,549 after deducting underwriting discounts and commissions and offering expenses. Selling stockholders sold approximately 2,154 additional shares of common stock. The Company did not receive any proceeds from the sale of shares by the selling stockholders. The Company used the net proceeds from the offering to pay $93,012 of accumulated dividends in arrears on the Company s preferred stock, which satisfied all amounts due with respect to accumulated dividends, $4,792 to redeem the Company s Series III preferred stock, and $25,745 to reduce the Company s borrowings under its third amended and restated loan and security agreement and for general corporate purposes. Also in connection with the offering, the Company converted 41,524 preferred shares into common shares and restated the par value of its common stock to $0.01 per share.

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 February 2, 2008. Presented below in this and the following notes is supplemental information that should be read in conjunction with Notes to consolidated 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 third quarters in fiscal 2008 and 2007 ended on November 1, 2008 and November 3, 2007, respectively.

Share-based compensation

Effective January 29, 2006, the Company adopted the fair value recognition and measurement provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. Pursuant to SFAS 123(R), share-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the requisite service period for awards expected to vest. As a non-public entity that previously used the minimum value method for pro forma disclosure purposes under SFAS 123, the Company was required to adopt the prospective method of accounting under SFAS 123(R). Under this transitional method, the Company is required to record compensation expense in the consolidated statements of income for all awards granted after the adoption date and to awards modified, repurchased, or cancelled after the adoption date using the fair value provisions of SFAS 123(R).

The Company estimates the grant date fair value of stock options using a Black-Scholes valuation model. The expected volatility is based on the historical volatilities of a peer group of publicly-traded companies. The risk free interest rate is based on the U.S. Treasury yield curve in effect on the date of grant for the respective expected life of the option. The expected life represents the time the options granted are expected to be outstanding. The Company has elected to use the shortcut approach in accordance with the Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment* and SAB No. 110, *Simplified Method for Plain Vanilla Share Options,* to develop the expected life. Any dividend the Company might declare in the future would be subject to the applicable provisions of its credit agreement, which currently restricts the Company s ability to pay cash dividends. The Company recognizes compensation cost related to the stock options on a straight-line method over the requisite service period.

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:

	Nine months ended	
	November 1, 2008	November 3, 2007
Volatility rate	39% 43%	34% 45%
Risk-free interest rate	1.67% 3.59%	4.12% 5.05%
Average expected life (years)	4.9	4.9
Dividend yield	None	None

The Company granted 1.7 million stock options during the nine months ended November 1, 2008. The weighted-average grant date fair value of options granted in fiscal 2008 was $5.33 per option.

The Company recorded stock compensation expense of $1,100 and $1,082 for the three months ended November 1, 2008 and November 3, 2007, respectively. The Company recorded stock compensation expense of $2,644 and $1,635 for the nine months ended November 1, 2008 and November 3, 2007, respectively. At November 1, 2008, there was approximately $12,407 of unrecognized compensation expense related to unvested options.

Income taxes

The Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* on February 4, 2007. The adoption had no effect on the Company s consolidated financial position or results of operations. The Company does not currently maintain a liability for unrecognized tax benefits. The Company s policy is to recognize income tax-related interest and penalties as part of income tax expense. Income tax-related interest and penalties recorded in the consolidated financial statements were insignificant for the three and nine months ended November 1, 2008 and November 3, 2007. The Company conducts business only in the United States. Accordingly, the tax years that remain open to examination by U.S. federal, state, and local tax jurisdictions are generally three years, or fiscal 2007, 2006, and 2005.

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:

	Three months ended		Nine months ended	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
Net income	$5,017	$ 4,206	$12,980	$ 11,731
Unrealized (loss) gain on interest rate swap hedge, net of income tax	(37)	(209)	206	(304)
Comprehensive income	$4,980	$ 3,997	$13,186	$ 11,427

Recent accounting pronouncements

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of SFAS No. 133*. SFAS No. 161 is intended to help investors better understand how derivative instruments and hedging activities affect an entity s financial position, financial performance and cash flows through enhanced disclosure requirements. The enhanced disclosures primarily surround disclosing the objectives and strategies for using derivative instruments by their underlying risk as well as a tabular format of the fair values of the derivative instruments and their gains and losses. SFAS No. 161 is effective for quarterly interim periods beginning after November 15, 2008, and fiscal years that include those quarterly interim periods. Early application is encouraged. The Company does not expect the adoption of SFAS No. 161 to have a material effect on its consolidated financial position or results of operations as it is disclosure-only in nature.

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 nine months ended November 1, 2008 and November 3, 2007. Total rent expense under operating leases was $17,334 and $13,252 for the three months ended November 1, 2008 and November 3, 2007, respectively. Total rent expense under operating leases was $49,363 and $37,676 for the nine months ended November 1, 2008 and November 3, 2007, respectively.

Securities litigation In December 2007 and January 2008, three putative securities class action lawsuits were filed against the Company and certain of its current and then-current executive officers in the United States District Court for the Northern District of Illinois. Each suit alleges that the prospectus and registration statement filed pursuant to the Company s initial public offering contained materially false and misleading statements and failed to disclose material facts. Each suit claims violations of Sections 11, 12(a)(2) and/or 15 of the Securities Act of 1933, and the two later filed suits added claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as well as the associated Rule 10b-5. In February 2008, two of the plaintiffs filed competing motions to consolidate the actions and appoint lead plaintiffs and lead plaintiffs counsel. On March 18, 2008, after one of the plaintiffs withdrew his motion, the suits were consolidated and plaintiffs in the Mirsky v. ULTA action were appointed lead plaintiffs. Lead plaintiffs filed their amended complaint on May 19, 2008. The amended complaint alleges no new violations of the securities laws not asserted in the prior complaints. It adds no new defendants and drops one of the then-current officers as a defendant. On July 21, 2008, Defendants filed a motion to dismiss the Amended Complaint. On September 24, 2008, Lead Plaintiffs filed their opposition to the motion to dismiss, and on October 24, 2008, Defendants filed their reply memorandum in support of their motion to dismiss.

Although the Company intends to defend itself vigorously in this lawsuit, an adverse resolution may have a material adverse effect on the Company s 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.

General litigation The Company is also involved in various legal proceedings that are incidental to the conduct of its business, including, but not limited to, employment related claims. 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

The Company s credit facility is with LaSalle Bank National Association as the administrative agent, Wachovia Capital Finance Corporation as collateral agent, and JP Morgan Chase Bank as documentation agent. This facility provides maximum credit of $150,000 and a $50,000 accordion option through May 31, 2011. The credit facility agreement contains a restrictive financial covenant on tangible net worth. Substantially all of the Company s assets are pledged as collateral for outstanding borrowings under the facility. Outstanding borrowings bear interest at the prime rate or the Eurodollar rate plus 1.00% up to $100,000 and 1.25% thereafter. The advance rates on owned inventory are 80% (85% from September 1 to January 31).

On August 15, 2008, the Company entered into a First Amendment to the Third Amended and Restated Loan and Security Agreement by and between the Company, LaSalle Bank National Association, Wachovia Capital Finance Corporation and JPMorgan Chase Bank, N.A. The amendment exercised the $50,000 accordion option under the same terms and conditions as the existing facility.

The weighted-average interest rate on the outstanding borrowings as of November 1, 2008 and February 2, 2008, was 4.30% and 4.81%, respectively. The Company had approximately $61,694 (including the accordion option) and $73,140 (excluding the accordion option) of availability as of November 1, 2008 and February 2, 2008, respectively. The Company has an ongoing letter of credit that renews annually in October, the balance of which was $326 as of November 1, 2008 and February 2, 2008.

At November 1, 2008, the Company has classified $86,390 of outstanding borrowings under the facility as long-term as this is the minimum amount that the Company believes will remain outstanding for an uninterrupted period over the next year.

5. Financial instruments

On January 31, 2007, the Company entered into an interest rate swap agreement with a notional amount of $25,000 that qualified as a cash flow hedge to obtain a fixed interest rate on variable rate debt and reduce certain exposures to interest rate fluctuations. The swap results in fixed rate payments at an interest rate of 5.11% for a term of three years.

As of November 1, 2008 and February 2, 2008, the interest rate swap had a negative fair value of $847 and $1,184, respectively, and both are included in accrued liabilities. The change in market value during fiscal 2008 related to the effective portion of the cash flow hedge was recorded as an unrecognized gain in the other comprehensive loss section of stockholders equity in the consolidated balance sheets. Amounts related to any ineffectiveness, which are insignificant, are recorded as interest expense.

Interest rate differentials paid or received under this agreement are recognized as adjustments to interest expense. The Company does not hold or issue interest rate swap agreements for trading purposes. In the event that a counter-party fails to meet the terms of the interest rate swap agreement, the Company s exposure is limited to the interest rate differential. The Company manages the credit risk of counterparties by dealing only with institutions that the Company considers financially sound. The Company considers the risk of non-performance to be remote.

On February 3, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements,* for financial assets and liabilities. The adoption had no impact on the Company s consolidated financial statements. SFAS No. 157 established a three-tier hierarchy for fair value measurements, which prioritizes the inputs used in measuring fair value as follows:

Level 1 observable inputs such as quoted prices for identical instruments in active markets.

Level 2 inputs other than quoted prices in active markets that are observable either directly or indirectly through corroboration with observable market data.

Level 3 unobservable inputs in which there is little or no market data, which would require the Company to develop its own assumptions.

The Company s interest rate swap is required to be measured at fair value on a recurring basis. The fair value of the interest rate swap is determined based on inputs that are readily available in public markets or can be derived from information available in publicly quoted markets. Therefore, the Company has categorized the interest rate swap as Level 2. The following table presents the Company s financial liabilities as of November 1, 2008 measured at fair value on a recurring basis:

	Fair value measurement using		
	Level 1	**Level 2**	**Level 3**
Interest rate swap liability	$	$847	$

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6. 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:

	Three months ended		Nine months ended	
	November 1, 2008	**November 3, 2007**	**November 1, 2008**	**November 3, 2007**
Numerator for diluted net income per share net income	$ 5,017	$ 4,206	$12,980	$11,731
Less preferred stock dividends		3,598		11,219
Numerator for basic net income per share	$ 5,017	$ 608	$12,980	$ 512
Denominator for basic net income per share weighted-average common shares	57,591	10,179	57,328	8,252
Dilutive effect of stock options and non-vested stock	1,422	2,297	1,677	2,195
Denominator for diluted net income per share	59,013	12,476	59,005	10,447
Net income per common share:				
Basic	$ 0.09	$ 0.06	$ 0.23	$ 0.06
Diluted	$ 0.09	$ 0.05	$ 0.22	$ 0.05

The denominators for diluted net income per common share for the three and nine months ended November 1, 2008 exclude 3,753 and 3,498 employee stock options, respectively, due to their anti-dilutive effects.

The denominator for diluted net income per common share for the three months ended November 3, 2007 excludes 2,357 employee stock options and 39,242 convertible preferred shares, due to their anti-dilutive effects.

The denominator for diluted net income per common share for the nine months ended November 3, 2007 excludes 2,488 employee stock options and 40,786 convertible preferred shares, 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 consolidated 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 our Annual Report on Form 10-K for the year ended February 2, 2008. 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, off-mall locations such as power centers and lifestyle centers with other destination retailers. As of November 1, 2008, we operated 304 stores across 35 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 Four E s : Escape, Education, Entertainment and Esthetics.

The continued growth of our business and any future increases in net sales, net income, and cash flows is 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 future comparable store sales increases to reflect the levels experienced in prior periods. This is due in part to the difficulty in improving on such significant increases in subsequent periods.

The Company adopted a structured stock option compensation program in July 2007. The award of stock options under this program will result in increased stock-based compensation expense in future periods as compared to the expense reflected in our historical financial statements.

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 be relatively consistent with historical rates given our planned

distribution infrastructure investments and the impact of the rate of new store growth. 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.

On October 30, 2007, we completed an initial public offering in which we sold 7,666,667 shares of common stock resulting in net proceeds of $123.5 million after deducting underwriting discounts and commissions and offering expenses. Selling stockholders sold approximately 2,153,928 additional shares of common stock. We did not receive any proceeds from the sale of shares by the selling stockholders. We used the net proceeds from the offering to pay $93.0 million of accumulated dividends in arrears on the Company s preferred stock, which satisfied all amounts due with respect to accumulated dividends, $4.8 million to redeem the Company s Series III preferred stock, and $25.7 million to reduce our borrowings under our third amended and restated loan and security agreement and for general corporate purposes. Also in connection with the offering, the Company converted 41,524,002 preferred shares into common shares and restated the par value of its common stock to $0.01 per share.

Our results of operations are materially affected by conditions in the general economy. We believe that the U.S economy is facing very challenging times, and that general economic conditions could deteriorate further. We continue to review and adjust our business activities to address the changing economic environment and, as a result we believe we are prudently growing our business, carefully managing inventory and liquidity and controlling expenses. Due to the uncertainty in the overall economic environment and the unpredictability of consumer behavior, it is very difficult for us to predict how our business may perform in the future. Our business and results of operations may be adversely affected by current and future economic conditions that cause a decline in business and consumer spending, including a reduction in the availability of credit, increased unemployment levels, higher energy and fuel costs, rising interest rates, financial market volatility and recession.

Basis of presentation

Net sales include store and Internet merchandise sales as well as salon service revenue. Salon service revenue represents less than 10% of our combined product sales and services revenues and therefore, these revenues are combined with product sales. We recognize merchandise revenue at the point of sale, or 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 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. 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 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; and

- shrink and inventory valuation reserves.

Our cost of sales may be 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;

- public company expense including Sarbanes-Oxley compliance expenses;

- stock-based compensation expense related to option grants which will result in increases in expense as we implemented a structured stock option compensation program in 2007;

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

- 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 store set-up labor, management and employee training, and grand opening advertising. Pre-opening expenses also includes rent during the construction period related to new stores.

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.

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 third quarters in fiscal 2008 and 2007 ended on November 1, 2008 and November 3, 2007, 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:

	Three months ended		Nine months ended	
(Dollars in thousands)	**November 1, 2008**	**November 3, 2007**	**November 1, 2008**	**November 3, 2007**
Net sales	$254,843	$208,235	$743,252	$602,797
Cost of sales	175,368	140,156	516,710	416,173
Gross profit	79,475	68,079	226,542	186,624
Selling, general and administrative expenses	65,176	55,609	189,130	154,779
Pre-opening expenses	4,693	4,494	12,515	9,064
Operating income	9,606	7,976	24,897	22,781
Interest expense	1,124	1,307	3,055	3,465
Income before income taxes	8,482	6,669	21,842	19,316
Income tax expense	3,465	2,463	8,862	7,585
Net income	$ 5,017	$ 4,206	$ 12,980	$ 11,731
Other operating data:				
Number stores end of period	304	237	304	237
Comparable store sales increase	2.0%	6.7%	3.2%	7.4%

	Three months ended		Nine months ended	
(Percentage of net sales)	**November 1, 2008**	**November 3, 2007**	**November 1, 2008**	**November 3, 2007**
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	68.8%	67.3%	69.5%	69.0%
Gross profit	31.2%	32.7%	30.5%	31.0%
Selling, general and administrative expenses	25.6%	26.7%	25.4%	25.7%
Pre-opening expenses	1.8%	2.2%	1.7%	1.5%
Operating income	3.8%	3.8%	3.3%	3.8%

Interest expense	0.4%	0.6%	0.4%	0.6%
Income before income taxes	3.3%	3.2%	2.9%	3.2%
Income tax expense	1.4%	1.2%	1.2%	1.3%
Net income	2.0%	2.0%	1.7%	1.9%

Comparison of three months ended November 1, 2008 to three months ended November 3, 2007

Net sales

Net sales increased $46.6 million, or 22.4%, to $254.8 million for the three months ended November 1, 2008, compared to $208.2 million for the three months ended November 3, 2007. The increase is due to an additional 67 net new stores operating since third quarter 2007 and a 2.0% increase in comparable store sales. Non-comparable stores contributed $55.9 million to net sales while comparable stores contributed $198.9 million to net sales. Our comparable store sales growth in 2008 was driven by positive customer traffic.

Gross profit

Gross profit increased $11.4 million, or 16.7%, to $79.5 million for the three months ended November 1, 2008, compared to $68.1 million for the three months ended November 3, 2007. Gross profit as a percentage of net sales decreased 150 basis points to 31.2% for the three months ended November 1, 2008, compared to 32.7% for the three months ended November 3, 2007. The 150 basis point decrease in gross margin rate was primarily driven by 100 basis points of expected de-leverage in fixed store occupancy costs resulting from the acceleration of our new store program over the last twelve months, 30 basis points of expected impact from incremental fixed occupancy costs related to our new distribution center opened in April 2008, and 20 basis points of gross margin investment to drive customer traffic and comparable store sales increases.

Selling, general and administrative expenses

Selling, general and administrative (SG&A) expenses increased $9.6 million, or 17.2%, to $65.2 million for the three months ended November 1, 2008, compared to $55.6 million for the three months ended November 3, 2007. As a percentage of net sales, SG&A expenses decreased 110 basis points to 25.6% for the three months ended November 1, 2008, compared to 26.7% for the three months ended November 3, 2007. The improvement in SG&A expenses as a percentage of net sales was primarily driven by improved leverage in our corporate infrastructure on our growing store base, including a decrease in incentive compensation expense due to the drastic change in the retail environment during October that impacted our business outlook.

Pre-opening expenses

Pre-opening expenses increased $0.2 million, or 4.4%, to $4.7 million for the three months ended November 1, 2008, compared to $4.5 million for the three months ended November 3, 2007. During the three months ended November 1, 2008, we opened 21 new stores and remodeled 2 stores, compared to 26 new store openings and 7 remodeled stores during the three months ended November 3, 2007.

Interest expense

Interest expense was $1.1 million for the three months ended November 1, 2008, compared to $1.3 million for the three months ended November 3, 2007. The increase in our average debt outstanding on our credit facility was offset by a decline in our weighted-average interest rate compared to the same period last year.

Income tax expense

Income tax expense of $3.5 million for the three months ended November 1, 2008 represents an effective tax rate of 40.9%, compared to $2.5 million of tax expense representing an effective tax rate of 36.9% for the three months ended November 3, 2007. The prior year quarter included an adjustment to the state tax rate.

Net income

Net income increased $0.8 million, or 19.3%, to $5.0 million for the three months ended November 1, 2008, compared to $4.2 million for the three months ended November 3, 2007. The increase is primarily related to the $11.4 million increase in gross profit, partially offset by a $9.6 million increase in SG&A expenses.

Comparison of nine months ended November 1, 2008 to nine months ended November 3, 2007

Net sales

Net sales increased $140.5 million, or 23.3%, to $743.3 million for the nine months ended November 1, 2008, compared to $602.8 million for the nine months ended November 3, 2007. The increase is due to an additional 67 net new stores operating since third quarter 2007 and a 3.2% increase in comparable store sales. Non-comparable stores contributed $154.8 million to net sales while comparable stores contributed $588.5 million to net sales. Our comparable store sales growth in 2008 was driven by positive customer traffic.

Gross profit

Gross profit increased $39.9 million, or 21.4%, to $226.5 million for the nine months ended November 1, 2008, compared to $186.6 million for the nine months ended November 3, 2007. Gross profit as a percentage of net sales decreased 50 basis points to 30.5% for the nine months ended November 1, 2008, compared to 31.0% for the nine months ended November 3, 2007. The decrease in gross margin rate was primarily driven by de-leverage of fixed store occupancy costs resulting from the acceleration of our new store program over the last twelve months.

Selling, general and administrative expenses

SG&A expenses increased $34.3 million, or 22.2%, to $189.1 million for the nine months ended November 1, 2008, compared to $154.8 million for the nine months ended November 3, 2007. As a percentage of net sales, SG&A expenses decreased 30 basis points to 25.4% for the nine months ended November 1, 2008, compared to 25.7% for the nine months ended November 3, 2007. The decrease was primarily driven by improved leverage in our corporate infrastructure on our growing store base, including a decrease in incentive compensation expense during the third quarter, net of increases of $1.1 million and $0.7 million in first quarter fiscal 2008 related to an incremental advertising vehicle and the previously announced management departure.

Pre-opening expenses

Pre-opening expenses increased $3.4 million, or 38.1%, to $12.5 million for the nine months ended November 1, 2008, compared to $9.1 million for the nine months ended November 3, 2007. During the nine months ended November 1, 2008, we opened 56 new stores and remodeled 8 stores, compared to 41 new store openings and 14 remodeled stores during the nine months ended November 3, 2007.

Interest expense

Interest expense was $3.1 million for the nine months ended November 1, 2008, compared to $3.5 million for the nine months ended November 3, 2007. The increase in our average debt outstanding on our credit facility was offset by a decline in our weighted-average interest rate compared to the same period last year.

Income tax expense

Income tax expense of $8.9 million for the nine months ended November 1, 2008 represents an effective tax rate of 40.6%, compared to $7.6 million of tax expense representing an effective tax rate of 39.3% for the nine months ended November 3, 2007. The prior year period included an adjustment to the state tax rate.

Net income

Net income increased $1.3 million, or 10.6%, to $13.0 million for the nine months ended November 1, 2008, compared to $11.7 million for the nine months ended November 3, 2007. The increase is primarily related to the $39.9 million increase in gross profit, partially offset by a $34.3 million increase in SG&A expenses and an incremental $3.4 million in pre-opening 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, planned expansion of our headquarters, and for continued improvement in our information technology systems.

Our primary sources of liquidity are cash flows from operations, 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 have not yet collected the landlord allowances due 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, with the accordion option exercised, will satisfy the company s working capital needs, capital expenditure needs, commitments, and other liquidity requirements through at least the next 12 months.

Merchandise inventories were $268.9 million at November 1, 2008, an increase of $49.4 million from November 3, 2007. Average inventory per store decreased 4.5% compared to the prior year quarter. The merchandise inventory increase of $49.4 million was due to the addition of 67 net new stores opened since November 3, 2007.

On October 30, 2007, we completed an initial public offering in which we sold 7,666,667 shares of common stock to the public at a price of $18.00 per share resulting in aggregate gross proceeds from the sale of shares of common stock of $138.0 million. Selling stockholders sold approximately 2,153,928 additional shares of common stock. We did not receive any proceeds from the sale of shares by the selling stockholders. The aggregate net proceeds to us were $123.5 million after deducting $9.7 million in underwriting discounts and commissions and $4.8 million in offering expenses. We used the net proceeds from the offering to pay $93.0 million of accumulated dividends in arrears on the Company s preferred stock, which satisfied all amounts due with respect to accumulated dividends, $4.8 million to redeem the Company s Series III preferred stock, and $25.7 million to reduce our borrowings under our third amended and restated loan and security agreement and for general corporate purposes. Also in connection with the offering, the Company converted 41,524,002 preferred shares into common shares and restated the par value of its common stock to $0.01 per share.

Credit facility

Our credit facility is with LaSalle Bank National Association as the administrative agent, Wachovia Capital Finance Corporation as collateral agent, and JP Morgan Chase Bank as documentation agent. This facility provides maximum credit of $150 million and a $50 million accordion option through May 31, 2011. The credit facility agreement contains a restrictive financial covenant on tangible net worth. Substantially all of the Company s assets are pledged as collateral for outstanding borrowings under the facility. Outstanding borrowings bear interest at the prime rate or the Eurodollar rate plus 1.00% up to $100 million and 1.25% thereafter. The advance rates on owned inventory are 80% (85% from September 1 to January 31).

On August 15, 2008, we entered into a First Amendment to the Third Amended and Restated Loan and Security Agreement by and between the Company, LaSalle Bank National Association, Wachovia Capital Finance Corporation and JPMorgan Chase Bank, N.A. The amendment exercised the $50 million accordion option under the same terms and conditions as the existing facility.

The weighted-average interest rate on the outstanding balances under the facility as of November 1, 2008 and February 2, 2008 was 4.30% and 4.81%, respectively. We had approximately $61.7 million (including the accordion option) and $73.1 million (excluding the accordion option) of availability as of November 1, 2008 and February 2, 2008, respectively. We also have an ongoing letter of credit that renews annually. The balance was $0.3 million as of November 1, 2008 and February 2, 2008.

As of November 1, 2008, we had classified $86.4 million of outstanding borrowings under the facility as long-term, as this is the minimum amount we believe will remain outstanding for an uninterrupted period over the next year.

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 and losses on disposal of property and equipment, and the effect of changes in working capital items.

	Nine months ended	
(Dollars in thousands)	**November 1, 2008**	**November 3, 2007**
Net income	$ 12,980	$ 11,731
Items not affecting cash:		
Depreciation and amortization	37,619	28,597
Non-cash stock compensation charges	2,644	1,635
Excess tax benefits from stock-based compensation	(1,565)	(1,542)
Loss (gain) on disposal of property and equipment	219	(11)
Changes in working capital items	(22,415)	(43,288)
Net cash provided by (used in) operating activities	$ 29,482	$ (2,878)

Net cash provided by operating activities was $29.5 million for the nine months ended November 1, 2008 compared to net cash used by operating activities of $2.9 million for the nine months ended November 3, 2007. The increase in net cash provided by operating activities of $32.4 million is primarily attributable to increases of $12.6 million in deferred rent and $9.0 million in depreciation expense. These increases are related to the addition of 67 net new stores opened since November 3, 2007 and our second distribution center which opened in the first quarter of 2008. Deferred rent primarily represents construction allowances from landlords for tenant improvements.

Investing activities
Investing activities consist primarily of capital expenditures for new and remodeled stores as well as investments in information technology systems.

	Nine months ended	
(Dollars in thousands)	**November 1, 2008**	**November 3, 2007**
Purchases of property and equipment	$(96,608)	$(74,648)
Receipt of related party notes receivable		4,467
Net cash used in investing activities	$(96,608)	$(70,181)

Net cash used in investing activities was $96.6 million and $70.2 million for the nine months ended November 1, 2008 and November 3, 2007, respectively, primarily representing new store investments.

Financing activities

Financing activities consist principally of draws and payments on our credit facility and capital stock transactions.

(Dollars in thousands)	Nine months ended November 1, 2008	Nine months ended November 3, 2007
Proceeds on long-term borrowings	$ 874,139	$ 750,262
Payments on long-term borrowings	(810,929)	(703,999)
Proceeds from issuance of common stock under stock plans	2,269	953
Excess tax benefits from stock-based compensation	1,565	1,542
Proceeds from issuance of common stock in initial public offering, net of issuance costs	(59)	123,921
Payment of accumulated dividends in arrears		(93,012)
Redemption of Series III preferred stock		(4,792)
Purchase of treasury stock		(1,949)
Net cash provided by financing activities	$ 66,985	$ 72,926

Net cash provided by financing activities was $67.0 million and $72.9 million for the nine months ended November 1, 2008 and November 3, 2007, respectively. In October 2007, we used the net proceeds of $123.9 million obtained in an initial public offering to pay $93.0 million of accumulated dividends in arrears on our preferred stock and $4.8 million to redeem our Series III preferred stock. The decrease in net cash provided by financing activities is primarily due to the change in long-term debt, net of the IPO proceeds in fiscal 2007.

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 nine months ended November 1, 2008.

Off-balance sheet arrangements

Our off-balance sheet arrangements consist of operating lease obligations and letters of credit. We do not have any non-cancelable purchase commitments as of November 1, 2008. Our letters of credit outstanding under our revolving credit facility were $0.3 million as of November 1, 2008.

Critical accounting policies and estimates

Management s discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with 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 February 2, 2008.

Share-based compensation

Effective January 29, 2006, the Company adopted the fair value recognition and measurement provisions of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* (SFAS No. 123(R)). Pursuant to SFAS No. 123(R), share-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the requisite service period for awards expected to vest. As a non-public entity that previously used the minimum value method for pro forma disclosure purposes under SFAS No. 123, the Company was required to adopt the prospective method of accounting under SFAS No. 123(R). Under this transitional method, the Company is required to record compensation expense in the consolidated statements of income for all awards granted after the adoption date and to awards modified, repurchased, or cancelled after the adoption date using the fair value provisions of SFAS No. 123(R).

The Company estimates the grant date fair value of stock options using a Black-Scholes valuation model. The expected volatility is based on volatilities of a peer group of publicly-traded companies. The risk free interest rate is based on the U.S. Treasury yield curve in effect on the date of grant for the respective expected life of the option. The expected life represents the time the options granted are expected to be outstanding. The Company has elected to use the shortcut approach in accordance with SAB No. 107, *Share-Based Payment* and SAB No. 110, *Simplified Method for Plain Vanilla Share Options,* to develop the expected life. The Company recognizes compensation cost related to the stock options on a straight-line method over the requisite service period.

See notes to consolidated financial statements, Summary of significant accounting policies - Share-based compensation, for disclosure related to the Company s stock compensation expense and related valuation model assumptions.

Recent accounting pronouncements

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of SFAS No. 133.* SFAS No. 161 is intended to help investors better understand how derivative instruments and hedging activities affect an entity s financial position, financial performance and cash flows through enhanced disclosure requirements. The enhanced disclosures primarily surround disclosing the objectives and strategies for using derivative instruments by their underlying risk as well as a tabular format of the fair values of the derivative instruments and their gains and losses. SFAS No. 161 is effective for quarterly interim periods beginning after November 15, 2008, and fiscal years that include those quarterly interim periods. Early application is encouraged. We do not expect the adoption of SFAS No. 161 to have a material effect on our consolidated financial position or results of operations as it is disclosure-only in nature.

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 borrowing under our credit facility. Interest on our borrowings is based upon variable rates. We have an interest rate swap agreement in place with a notional amount of $25.0 million which effectively converts variable rate debt to fixed rate debt at an interest rate of 5.11%. The interest rate swap reflected in the consolidated balance sheets as of November 1, 2008 and February 2, 2008 had a negative fair value of $0.8 million and $1.2 million, respectively, and both are included in accrued liabilities. The interest rate swap is designated as a cash flow hedge, the effective portion of which is recorded as an unrecognized gain (loss) in

other comprehensive income in stockholders equity. Our weighted average debt for the nine months ended November 1, 2008 was $76.7 million, adjusted for the $25.0 million hedged amount. A hypothetical 1% increase or decrease in interest rates would have resulted in a $0.6 million change to our interest expense for the nine months ended November 1, 2008.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. 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 the Board of Directors.

Based on management s evaluation as of November 1, 2008, 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 Securities and Exchange Commission s rules and forms.

Changes in Internal Control. There were no changes to our internal controls over financial reporting during the three months ended November 1, 2008 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

Securities litigation In December 2007 and January 2008, three putative securities class action lawsuits were filed against us and certain of our current and then-current executive officers in the United States District Court for the Northern District of Illinois. Each suit alleges that the prospectus and registration statement filed pursuant to our initial public offering contained materially false and misleading statements and failed to disclose material facts. Each suit claims violations of Sections 11, 12(a)(2) and/or 15 of the Securities Act of 1933, and the two later filed suits added claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as well as the associated Rule 10b-5. In February 2008, two of the plaintiffs filed competing motions to consolidate the actions and appoint lead plaintiffs and lead plaintiffs counsel. On March 18, 2008, after one of the plaintiffs withdrew his motion, the suits were consolidated and plaintiffs in the Mirsky v. ULTA action were appointed lead plaintiffs. Lead plaintiffs filed their amended complaint on May 19, 2008. The amended complaint alleges no new violations of the securities laws not asserted in the prior complaints. It adds no new defendants and drops one of the then-current officers as a defendant. On July 21, 2008, Defendants filed a motion to dismiss the Amended Complaint. On September 24, 2008, Lead Plaintiffs filed their opposition to the motion to dismiss, and on October 24, 2008, Defendants filed their reply memorandum in support of their motion to dismiss.

Although we intend to defend ourselves vigorously in this lawsuit, an adverse resolution may 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.

General litigation We are also involved in various legal proceedings that are incidental to the conduct of our business, including, but not limited to, employment related claims. 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 February 2, 2008, which could materially affect our business, financial condition, financial results or future performance. There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended February 2, 2008.

Economic conditions may cause a decline in general business conditions and consumer spending which could adversely affect our business and results of operations

Our results of operations are impacted by the relative condition of the U.S. economy. Our business and results of operations may be adversely affected by current and future economic conditions that cause a decline in general business conditions and consumer spending, including a reduction in the availability of credit, increased unemployment levels, higher energy and fuel costs, rising interest rates, financial market volatility and recession. In addition, the general deterioration of economic conditions could adversely affect real estate developers and landlords which we rely on to construct and operate the centers in which our stores are located. A bankruptcy or

financial failure of a significant or number of real estate developers or shopping center landlords could have a material adverse affect on our results of operations.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

Exhibit number	Description of document
3.1	Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-1 (file No. 333-144405) filed with the Securities and Exchange Commission on August 17, 2007).
3.2	Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 to the Company s Registration Statement on Form S-1 (file No. 333-144405) filed with the Securities and Exchange Commission on August 17, 2007).
4.1	Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-1 (file No. 333-144405) filed with the Securities and Exchange Commission on October 11, 2007).
4.2	Third Amended and Restated Registration Rights Agreement between Ulta Salon, Cosmetics & Fragrance, Inc. and the stockholders party thereto (incorporated by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-1 (file No. 333-144405) filed with the Securities and Exchange Commission on August 17, 2007).
4.3	Stockholder Rights Agreement (incorporated by reference to Exhibit 4.4 to the Company s Registration Statement on Form S-1 (file No. 333-144405) filed with the Securities and Exchange Commission on August 17, 2007).
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.
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.
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.

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 December 10, 2008 on its behalf by the undersigned, thereunto duly authorized.

ULTA SALON, COSMETICS & FRAGRANCE, INC.

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

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