Ulta Salon, Cosmetics & Fragrance, Inc.
Form 10-Q
September 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 August 2, 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 September 4, 2008 was 57,529,182 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)	August 2, 2008 (unaudited)	February 2, 2008	August 4, 2007 (unaudited)
Assets			
Current assets:			
Cash and cash equivalents	$ 3,255	$ 3,789	$ 3,165
Receivables, net	19,164	20,643	14,295
Merchandise inventories, net	197,028	176,109	148,559
Prepaid expenses and other current assets	22,699	19,184	23,292
Deferred income taxes	9,063	9,219	5,476
Total current assets	251,209	228,944	194,787
Property and equipment, net	278,378	236,389	196,919
Deferred income taxes	4,080	4,080	4,125
Other assets			1,763
Total assets	$533,667	$469,413	$397,594
Liabilities and stockholders equity			
Current liabilities:			
Current portion notes payable	$ 31,766	$	$ 33,788
Accounts payable	40,630	52,122	41,010
Accrued liabilities	52,865	54,719	45,308
Accrued income taxes	4,374	5,064	
Total current liabilities	129,635	111,905	120,106
Notes payable less current portion	86,390	74,770	55,038
Deferred rent	93,291	71,235	56,651
Total liabilities	309,316	257,910	231,795
Commitments and contingencies			
Series III redeemable preferred stock			4,792

See accompanying notes to consolidated financial statements.

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

(In thousands, except per share data)	**August 2, 2008** (unaudited)	**February 2, 2008**	**August 4, 2007** (unaudited)
Stockholders equity:			
Preferred stock	$	$	$230,680
Treasury stock-preferred, at cost			(1,815)
Common stock, $.01 par value, 400,000 shares authorized; 58,028, 57,411 and 7,733 shares issued; 57,523, 56,906 and 7,482 shares outstanding; at August 2, 2008 (unaudited), February 2, 2008 and August 4, 2007 (unaudited), respectively	580	574	122
Treasury stock-common, at cost	(4,179)	(4,179)	(2,321)
Additional paid-in capital	289,587	284,951	17,753
Accumulated deficit	(61,161)	(69,124)	(83,336)
Accumulated other comprehensive loss	(476)	(719)	(76)
Total stockholders equity	224,351	211,503	161,007
Total liabilities and stockholders equity	$533,667	$469,413	$397,594

See accompanying notes to consolidated financial statements.

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

	Three months ended		Six months ended	
(In thousands, except per share data)	**August 2, 2008**	**August 4, 2007**	**August 2, 2008**	**August 4, 2007**
Net sales	$249,111	$200,449	$488,409	$394,562
Cost of sales	175,965	141,417	341,342	276,017
Gross profit	73,146	59,032	147,067	118,545
Selling, general and administrative expenses	61,889	51,188	123,954	99,170
Pre-opening expenses	4,050	2,914	7,822	4,570
Operating income	7,207	4,930	15,291	14,805
Interest expense	1,016	1,162	1,931	2,158
Income before income taxes	6,191	3,768	13,360	12,647
Income tax expense	2,503	1,562	5,397	5,122
Net income	$ 3,688	$ 2,206	$ 7,963	$ 7,525
Less preferred stock dividends		3,878		7,621
Net income (loss) available to common stockholders	$ 3,688	$ (1,672)	$ 7,963	$ (96)
Net income (loss) per common share:				
Basic	$ 0.06	$ (0.23)	$ 0.14	$ (0.01)
Diluted	$ 0.06	$ (0.23)	$ 0.13	$ (0.01)
Weighted average common shares outstanding:				
Basic	57,435	7,401	57,196	7,289
Diluted	59,012	7,401	59,000	7,289

See accompanying notes to consolidated financial statements.

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

(Dollars in thousands)	**Six months ended August 2, 2008**	**Six months ended August 4, 2007**
Operating activities		
Net income	$ 7,963	$ 7,525
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	24,354	19,103
Non-cash stock compensation charges	1,544	554
Excess tax benefits from stock-based compensation	(1,101)	(918)
Loss (gain) on disposal of property and equipment	252	(65)
Change in operating assets and liabilities:		
Receivables	1,479	4,180
Merchandise inventories	(20,919)	(19,322)
Prepaid expenses and other assets	(3,515)	(8,546)
Accounts payable	(11,492)	(2,062)
Accrued liabilities	433	(6,676)
Deferred rent	22,056	6,284
Net cash provided by operating activities	21,054	57
Investing activities		
Purchases of property and equipment	(68,072)	(42,889)
Receipt of related party notes receivable		4,467
Net cash used in investing activities	(68,072)	(38,422)
Financing activities		
Proceeds on long-term borrowings	579,492	468,668
Payments on long-term borrowings	(536,106)	(430,579)
Proceeds from issuance of common stock under stock plans	2,056	785
Excess tax benefits from stock-based compensation	1,101	918
Initial public offering issuance costs	(59)	
Purchase of treasury stock		(1,907)
Net cash provided by financing activities	46,484	37,885
Net decrease in cash and cash equivalents	(534)	(480)
Cash and cash equivalents at beginning of period	3,789	3,645
Cash and cash equivalents at end of period	$ 3,255	$ 3,165

See accompanying notes to consolidated financial statements.

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

	Six months ended	
(Dollars in thousands)	**August 2, 2008**	**August 4, 2007**
Supplemental cash flow information		
Cash paid for interest	$ 2,175	$ 2,019
Cash paid for income taxes	$ 4,987	$ 12,076
Noncash investing and financing activities:		
Change in property and equipment included in accrued liabilities	$ (1,477)	$ 10,988
Unrealized (gain) loss on interest rate swap hedge, net of tax	$ (243)	$ 95

See accompanying notes to consolidated financial statements.

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

(In thousands, except per share data)	Common Stock Issued Shares	Common Stock Issued 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	617	6			2,050			2,056
Unrealized gain on interest rate swap hedge, net of $156 income tax							243	243
Net income for the six months ended August 2, 2008						7,963		7,963
Comprehensive income								8,206
Excess tax benefits from stock-based compensation					1,101			1,101
Stock compensation charge					1,544			1,544
Initial public offering issuance costs					(59)			(59)
Balance August 2, 2008	58,028	$580	(505)	$(4,179)	$289,587	$(61,161)	$(476)	$224,351

See accompanying notes to consolidated financial statements.

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 August 2, 2008, the Company operated 283 stores in 34 states, as shown in the table below:

State	Number of stores
Alabama	5
Arizona	22
California	28
Colorado	9
Delaware	1
Florida	19
Georgia	15
Illinois	30
Indiana	5
Iowa	2
Kansas	1
Kentucky	2
Louisiana	1
Maryland	6
Massachusetts	3
Michigan	7
Minnesota	6
Nebraska	1
Nevada	6
New Jersey	9
New York	8
North Carolina	12
Ohio	4
Oklahoma	6
Oregon	3
Pennsylvania	13
Rhode Island	1
South Carolina	4
Tennessee	3
Texas	36
Utah	1
Virginia	8
Washington	4
Wisconsin	2

Total	**283**

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 six months ended August 2, 2008 and August 4, 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 second quarters in fiscal 2008 and 2007 ended on August 2, 2008 and August 4, 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:

	Six months ended	
	August 2, 2008	**August 4, 2007**
Volatility rate	39% 43%	34% 45%
Risk-free interest rate	1.67% 3.59%	4.54% 5.05%
Average expected life (years)	3.4	4.7
Dividend yield	None	None

The Company granted 1.1 million stock options during the six months ended August 2, 2008. The weighted-average grant date fair value of options granted in fiscal 2008 was $4.97 per option.

The Company recorded stock compensation expense of $953 and $265 for the three months ended August 2, 2008 and August 4, 2007, respectively. The Company recorded stock compensation expense of $1,544 and $554 for the six months ended August 2, 2008 and August 4, 2007, respectively. At August 2, 2008, there was approximately $10,300 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 six months ended August 2, 2008 and August 4, 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		Six months ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Net income	$3,688	$2,206	$7,963	$7,525
Unrealized (loss) gain on interest rate swap hedge, net of income tax	100	4	243	(95)
Comprehensive income	$3,788	$2,210	$8,206	$7,430

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 financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application 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 six months ended August 2, 2008 and August 4, 2007. Total rent expense under operating leases was $16,571 and $12,857 for the three months ended August 2, 2008 and August 4, 2007, respectively. Total rent expense under operating leases was $32,030 and $24,424 for the six months ended August 2, 2008 and August 4, 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. Plaintiffs have until September 24, 2008 to respond to the Motion to Dismiss the Amended Complaint, and Defendants have until October 24 to file a Reply in Support of the 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 August 2, 2008 and February 2, 2008, was 3.665% and 4.812%, respectively. The Company had approximately $31,518 and $73,140 of availability as of August 2, 2008 and February 2, 2008, respectively, excluding the accordion option.

The Company has an ongoing letter of credit that renews annually in October, the balance of which was $326 as of August 2, 2008 and February 2, 2008.

At August 2, 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 August 2, 2008 and February 2, 2008, the interest rate swap had a negative fair value of $785 and $1,184 included in accrued liabilities, respectively. 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:

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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 August 2, 2008 measured at fair value on a recurring basis:

	Fair value measurement using		
	Level 1	**Level 2**	**Level 3**
Interest rate swap liability	$	$785	$

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		**Six months ended**	
	August 2, 2008	**August 4, 2007**	**August 2, 2008**	**August 4, 2007**
Numerator for diluted net income per share net income	$ 3,688	$ 2,206	$ 7,963	$7,525
Less preferred stock dividends		3,878		7,621
Numerator for basic net income (loss) per share	$ 3,688	$(1,672)	$ 7,963	$ (96)
Denominator for basic net income per share weighted-average common shares	57,435	7,401	57,196	7,289
Dilutive effect of stock options and non-vested stock	1,577		1,804	
Denominator for diluted net income per share	59,012	7,401	59,000	7,289
Net income (loss) per common share:				
Basic	$ 0.06	$ (0.23)	$ 0.14	$ (0.01)
Diluted	$ 0.06	$ (0.23)	$ 0.13	$ (0.01)

The denominators for diluted net income per common share for the three and six months ended August 2, 2008 exclude 3,221 and 2,993 employee options, respectively, due to their anti-dilutive effects.

The denominator for diluted net loss per common share for the three months ended August 4, 2007 excludes 2,621 employee options and non-vested stock and 41,524 convertible preferred shares, due to their anti-dilutive effects.

The denominator for diluted net loss per common share for the six months ended August 4, 2007 excludes 2,643 employee options and non-vested stock and 41,558 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 August 2, 2008, we operated 283 stores across 34 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.

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. We also expect that cost of sales as a percentage of net sales will be negatively impacted in the next several years as a result of accelerated depreciation related to our store remodel program. The program was adopted in third quarter fiscal 2006. We have accelerated depreciation expense on assets to be disposed of during the remodel process such that those assets will be fully depreciated at the time of the planned remodel. 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 second quarters in fiscal 2008 and 2007 ended on August 2, 2008 and August 4, 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		Six months ended	
(Dollars in thousands)	**August 2, 2008**	**August 4, 2007**	**August 2, 2008**	**August 4, 2007**
Net sales	$249,111	$200,449	$488,409	$394,562
Cost of sales	175,965	141,417	341,342	276,017
Gross profit	73,146	59,032	147,067	118,545
Selling, general and administrative expenses	61,889	51,188	123,954	99,170
Pre-opening expenses	4,050	2,914	7,822	4,570
Operating income	7,207	4,930	15,291	14,805
Interest expense	1,016	1,162	1,931	2,158
Income before income taxes	6,191	3,768	13,360	12,647
Income tax expense	2,503	1,562	5,397	5,122
Net income	$ 3,688	$ 2,206	$ 7,963	$ 7,525
Other operating data:				
Number stores end of period	283	211	283	211
Comparable store sales increase	3.7%	6.5%	3.8%	7.8%

	Three months ended		Six months ended	
(Percentage of net sales)	**August 2, 2008**	**August 4, 2007**	**August 2, 2008**	**August 4, 2007**
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	70.6%	70.6%	69.9%	70.0%
Gross profit	29.4%	29.4%	30.1%	30.0%
Selling, general and administrative expenses	24.8%	25.5%	25.4%	25.1%
Pre-opening expenses	1.6%	1.5%	1.6%	1.2%
Operating income	2.9%	2.5%	3.1%	3.8%
Interest expense	0.4%	0.6%	0.4%	0.5%
Income before income taxes	2.5%	1.9%	2.7%	3.2%

Income tax expense	1.0%	0.8%	1.1%	1.3%
Net income	1.5%	1.1%	1.6%	1.9%

Comparison of three months ended August 2, 2008 to three months ended August 4, 2007

Net sales

Net sales increased $48.7 million, or 24.3%, to $249.1 million for the three months ended August 2, 2008, compared to $200.4 million for the three months ended August 4, 2007. The increase is due to an additional 72 net new stores operating since second quarter 2007 and a 3.7% increase in comparable store sales. Non-comparable stores contributed $41.7 million of the net sales increase while comparable stores contributed $7.0 million of the total net sales increase. Our comparable store sales growth in 2008 was driven by a combination of higher average ticket and positive customer traffic. The increase in average ticket was driven by continued expansion of our prestige brand assortment while customer traffic growth was driven by the successful execution of our marketing strategy.

Gross profit

Gross profit increased $14.1 million, or 23.9%, to $73.1 million for the three months ended August 2, 2008, compared to $59.0 million for the three months ended August 4, 2007. Gross profit as a percentage of net sales remained unchanged at 29.4% for the three months ended August 2, 2008 and August 4, 2007. A 40 basis point de-leverage of store occupancy costs during the second quarter 2008 resulting from new store growth was offset by a one-time benefit from merchandise purchased at favorable terms to fill the new distribution center.

Selling, general and administrative expenses

Selling, general and administrative expenses increased $10.7 million, or 20.9%, to $61.9 million for the three months ended August 2, 2008, compared to $51.2 million for the three months ended August 4, 2007. As a percentage of net sales, selling, general and administrative expenses decreased 70 basis points to 24.8% for the three months ended August 2, 2008, compared to 25.5% for the three months ended August 4, 2007. The improvement was driven by a 100 basis point improvement in leverage of our corporate infrastructure on our growing store base, net of a 30 basis point ($0.7 million) increase in share-based compensation expense.

Pre-opening expenses

Pre-opening expenses increased $1.2 million, or 39.0%, to $4.1 million for the three months ended August 2, 2008, compared to $2.9 million for the three months ended August 4, 2007. During the three months ended August 2, 2008, we opened 18 new stores and remodeled 5 stores, compared to 8 new store openings and 4 remodeled stores during the three months ended August 4, 2007.

Interest expense

Interest expense was $1.0 million for the three months ended August 2, 2008, compared to $1.2 million for the three months ended August 4, 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 $2.5 million for the three months ended August 2, 2008 represents an effective tax rate of 40.4%, compared to $1.6 million of tax expense representing an effective tax rate of 41.5% for the three months ended August 4, 2007. The prior year quarter included an adjustment to the state tax rate.

Net income

Net income increased $1.5 million, or 67.2%, to $3.7 million for the three months ended August 2, 2008, compared to $2.2 million for the three months ended August 4, 2007. The increase is primarily related to the $14.1 million increase in gross profit, partially offset by a $10.7 million increase in selling, general and administrative expenses and an incremental $1.2 million in pre-opening expenses.

Comparison of six months ended August 2, 2008 to six months ended August 4, 2007

Net sales

Net sales increased $93.8 million, or 23.8%, to $488.4 million for the six months ended August 2, 2008, compared to $394.6 million for the six months ended August 4, 2007. The increase is due to an additional 72 net new stores operating since second quarter 2007 and a 3.8% increase in comparable store sales. Non-comparable stores contributed $79.6 million of the net sales increase while comparable stores contributed $14.2 million of the total net sales increase. Our comparable store sales growth in 2008 was driven by a combination of higher average ticket and positive customer traffic. The increase in average ticket was driven by continued expansion of our prestige brand assortment while customer traffic growth was driven by the successful execution of our marketing strategy.

Gross profit

Gross profit increased $28.6 million, or 24.1%, to $147.1 million for the six months ended August 2, 2008, compared to $118.5 million for the six months ended August 4, 2007. Gross profit as a percentage of net sales increased 10 basis points to 30.1% for the six months ended August 2, 2008, compared to 30.0% for the six months ended August 4, 2007. A 30 basis point de-leverage of store occupancy costs during the six months ended August 2, 2008 resulting from new store growth was offset by a one-time benefit from merchandise purchased at favorable terms to fill the new distribution center and advertising allowances during the first quarter of 2008 related to an incremental advertising vehicle.

Selling, general and administrative expenses

Selling, general and administrative expenses increased $24.8 million, or 25.0%, to $124.0 million for the six months ended August 2, 2008, compared to $99.2 million for the six months ended August 4, 2007. As a percentage of net sales, selling, general and administrative expenses increased 30 basis points to 25.4% for the six months ended August 2, 2008, compared to 25.1% for the six months ended August 4, 2007. The increase includes a $1.1 million increase in advertising expense related to one incremental advertising vehicle in the first quarter of 2008. In addition, the first quarter of 2008 included a $0.7 million severance charge related to the previously announced management departure in March 2008.

Pre-opening expenses

Pre-opening expenses increased $3.2 million, or 71.2%, to $7.8 million for the six months ended August 2, 2008, compared to $4.6 million for the six months ended August 4, 2007. During the six months ended August 2, 2008, we opened 35 new stores and remodeled 6 stores, compared to 15 new store openings and 7 remodeled stores during the six months ended August 4, 2007.

Interest expense

Interest expense was $1.9 million for the six months ended August 2, 2008, compared to $2.2 million for the six months ended August 4, 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 $5.4 million for the six months ended August 2, 2008 represents an effective tax rate of 40.4%, compared to $5.1 million of tax expense representing an effective tax rate of 40.5% for the six months ended August 4, 2007.

Net income

Net income increased $0.5 million, or 5.8%, to $8.0 million for the six months ended August 2, 2008, compared to $7.5 million for the six months ended August 4, 2007. The increase is primarily related to the $28.6 million increase in gross profit, partially offset by a $24.8 million increase in selling, general and administrative expenses and an incremental $3.2 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 $197.0 million at August 2, 2008, an increase of $48.4 million from August 4, 2007. Average inventory per store was flat compared to the prior year quarter. The merchandise inventory increase of $48.4 million was due to the addition of 72 net new stores opened since August 4, 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 August 2, 2008 and February 2, 2008 was 3.665% and 4.812%, respectively. We had approximately $31.5 million and $73.1 million of availability as of August 2, 2008 and February 2, 2008, respectively, excluding the accordion option. We also have an ongoing letter of credit that renews annually. The balance was $0.3 million as of August 2, 2008 and February 2, 2008.
As of August 2, 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.

(Dollars in thousands)	Six months ended August 2, 2008	Six months ended August 4, 2007
Net income	$ 7,963	$ 7,525
Items not affecting cash:		
Depreciation and amoritzation	24,354	19,103
Non-cash stock compensation charges	1,544	554
Excess tax benefits from stock-based compensation	(1,101)	(918)
Loss (gain) on disposal of property and equipment	252	(65)
Changes in working capital items	(11,958)	(26,142)
Net cash provided by operating activities	$ 21,054	$ 57

Net cash provided by operating activities was $21.1 million and $0.1 million for the six months ended August 2, 2008 and August 4, 2007, respectively. The increase in net cash provided by operating activities of $21.0 million is primarily attributed to an increase of $15.8 million in deferred rent related to the addition of 72 net new stores opened since August 4, 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.

(Dollars in thousands)	Six months ended August 2, 2008	Six months ended August 4, 2007
Purchases of property and equipment, net	$(68,072)	$(42,889)
Receipt of related party notes receivable		4,467
Net cash used in investing activities	$(68,072)	$(38,422)

Net cash used in investing activities was $68.1 million and $38.4 million for the six months ended August 2, 2008 and August 4, 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.

	Six months ended	
(Dollars in thousands)	**August 2, 2008**	**August 4, 2007**
Proceeds on long-term borrowings	$ 579,492	$ 468,668
Payments on long-term borrowings	(536,106)	(430,579)
Proceeds from issuance of common stock under stock plans	2,056	785
Excess tax benefits from stock-based compensation	1,101	918
Initial public offering issuance costs	(59)	
Purchase of treasury stock		(1,907)
Net cash provided by financing activities	$ 46,484	$ 37,885

Net cash provided by financing activities was $46.5 million and $37.9 million for the six months ended August 2, 2008 and August 4, 2007, respectively. The increase in net cash provided by financing activities of $8.6 million is primarily attributed to the net increase in long-term borrowings of $5.3 million, the $1.9 million decrease in purchases of treasury stock and the $1.3 million increase in proceeds from issuance of common stock under stock plans.

Contractual obligations

Our contractual obligations consist of operating lease obligations and our revolving line of credit. No material changes outside the ordinary course of business have occurred in our contractual obligations during the six months ended August 2, 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 August 2, 2008. Our letters of credit outstanding under our revolving credit facility were $0.3 million as of August 2, 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 financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application 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 August 2, 2008 and February 2, 2008 had a negative fair value of $0.8 million and $1.2 million included in accrued liabilities, respectively. 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 six months ended August 2, 2008 was $70.8 million, adjusted for the $25.0 million hedged amount. A hypothetical 1% increase or decrease in interest rates would have resulted in a $0.4 million change to our interest expense for the six months ended August 2, 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 August 2, 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 August 2, 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. Plaintiffs have until September 24, 2008 to respond to the Motion to Dismiss the Amended Complaint, and Defendants have until October 24 to file a Reply in Support of the 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, 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.

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

At our Annual Meeting of Stockholders held on July 16, 2008, the Company s stockholders elected three Class I Directors to hold office until the 2011 Annual Meeting of Stockholders and ratified the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending January 31, 2009.

The table below shows the results of the stockholders votes:

	For	Against	Abstain	Withheld
Election of Class I Directors:				
Dennis K. Eck	44,639,984			6,187,122
Yves Sisteron	43,802,296			7,024,810
Charles J. Philippin	50,571,458			255,648
Ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm	50,688,229	116,439	22,438	

Messrs. Gallagher, Defforey, DiRomualdo, Heilbronn and Lebow and Ms. Kirby are continuing in their terms of office following the Annual Meeting.

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).
10.15	First Amendment to Third Amended and Restated Loan and Security Agreement, dated as of August 15, 2008 (incorporated by reference to Exhibit 10.15 to the Company s Current Report on Form 8-K (file No. 001-33764) filed with the Securities and Exchange Commission on August 20, 2008).

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 September 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