Sally Beauty Holdings, Inc.
Form 10-K
December 22, 2006

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

x	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE FISCAL YEAR ENDED: SEPTEMBER 30, 2006

-OR-

o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File No. 1-33145

SALLY BEAUTY HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

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

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, par value $.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by checkmark if the registrant is a well-known seasoned issuer, as defined under Rule 405 of the Securities Act. YES o NO x

Indicate by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES o NO x

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

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

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. (See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act).
Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

At December 14, 2006, there were 180,104,975 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The registrant incorporates by reference in Item 11 hereof portions of the Company s Final Proxy Statement/Prospectus Information Statement (File No. 333-136259), filed pursuant to Rule 424(b)(3) on October 13, 2006.

TABLE OF CONTENTS

Table of Contents

In this report, references to the Company , our company , we , our , ours and us refer to Sally Beauty Holdings, its consolidated subsidiaries for periods after the separation from Alberto-Culver Company (Alberto Culver) and to Sally Holdings, Inc. and its consolidated subsidiaries for periods prior to the separation from Alberto-Culver unless otherwise indicated or context otherwise requires.

PART I

ITEM 1. BUSINESS

Introduction

We are the largest distributor of professional beauty supplies in the United States based on store count. We operate primarily through two business units, Sally Beauty Supply and Beauty Systems Group, which we refer to as BSG. Through Sally Beauty Supply and BSG, we operated a multi-channel platform of 3,169 stores and supplied 170 franchised stores in North America as well as selected European countries and Japan, as of September 30, 2006. As of September 30, 2006, Sally Beauty Supply owned and operated 2,181 stores in the United States and 2,511 stores worldwide and BSG operated 658 company-owned stores and supplied 170 franchised stores. Within BSG, we also have one of the largest networks of professional distributor sales consultants in North America, with approximately 1,200 professional distributor sales consultants who sell directly to salons and salon professionals. We provide our customers with a wide variety of leading third-party branded and private/control label professional beauty supplies, including hair care products, styling appliances, skin and nail care products and other beauty items. Sally Beauty Supply stores target retail consumers and salon professionals, while BSG exclusively targets salons and salon professionals. Over 90% of our net sales were in the U.S. and Canada for each of the last three fiscal years. For the year ended September 30, 2006 our net sales were $2,373.1 million.

Sally Beauty Supply began as a single store in New Orleans in 1964 and was purchased in 1969 by our former parent company, Alberto-Culver Company, or Alberto-Culver. BSG became a subsidiary of Alberto-Culver in 1985. On November 16, 2006, we separated from Alberto-Culver and became an independent company traded on the New York Stock Exchange. Our separation from Alberto-Culver and its consumer products-focused business was pursuant to an investment agreement, dated as of June 19, 2006, as amended, among us, Alberto-Culver, CDRS Acquisition LLC and others. We were formed as a Delaware corporation in June of 2006 in connection with this transaction to be the ultimate parent of Sally Beauty Supply and BSG and other subsidiaries following the separation. When we refer to Alberto-Culver, we mean Alberto-Culver Company prior to the separation or the company from which we separated, which is currently a separate public company, as the context requires.

In connection with the separation from Alberto-Culver, CDRS Acquisition LLC, or CDRS, and CD&R Parallel Fund VII, L.P., which we refer to as Parallel Fund and which we refer to together with CDRS as the CDR investors, invested an aggregate of $575 million in cash equity, representing ownership subsequent to the separation of approximately 48% of the outstanding shares of our common stock on an undiluted basis. CDRS, which owns approximately 47.7% of the outstanding shares of our common stock on an undiluted basis, is a Delaware limited liability company organized by Clayton, Dubilier & Rice Fund VII, L.P., a private investment fund managed by Clayton, Dubilier & Rice, Inc. Also in connection with the separation from Alberto-Culver, certain of our subsidiaries incurred approximately $1.85 billion of indebtedness, as more fully described below.

Professional Beauty Supply Industry

We operate primarily within the large and growing U.S. professional beauty supply industry. Potential growth in the industry is expected to be driven by demographic and fashion trends, which we expect will lead to increased usage of hair color, hair-loss prevention products and hair styling products.

The professional beauty supply industry serves end-users through four channels: full-service exclusive distribution, open-line distribution, direct and mega-salon stores.

Full Service/Exclusive

This channel exclusively serves salons and salon professionals and distributes professional-only products for use and re-sale to consumers in salons. Many brands are distributed through arrangements with suppliers by geographic territory. BSG is a leading full-service distributor in the U.S.

Open-Line

This channel serves retail consumers and salon professionals through retail stores. This channel is served by a large number of localized retailers and distributors, with only a few having a regional presence and significant market share. We believe that Sally Beauty Supply is the only open-line distributor in the U.S. with a national network of retail stores.

Direct

This channel focuses on direct sales to salons and salon professionals by large manufacturers. This is the dominant form of distribution in Europe, but represents a small channel in the U.S. due to the highly fragmented nature of the U.S. market, which tends to make direct distribution cost prohibitive for manufacturers.

Mega-Salon Stores

In this channel, large-format salons are supplied directly by manufacturers due to their large scale.

Key Future Industry Trends

We believe the following key industry trends and characteristics will influence our business, going forward:

High Level of Customer Fragmentation

The U.S. salon market is highly fragmented with over 230,000 salons. Given the fragmented and small-scale nature of the salon industry, we believe that salon operators will continue to depend on full service/exclusive distributors and open-line channels for a majority of their beauty supply purchases.

Growth in Booth Renting

Many professional stylists are individual operators who rent booth space from salons, which we refer to as booth renters, and are responsible for purchasing their own supplies. Over time, the number of booth renters has significantly increased as a percentage of total salon professionals, and we expect this trend to continue. Given their smaller individual purchases and relative capital constraints, booth renters are likely to be dependent on frequent trips to professional beauty supply stores, like those that BSG and Sally Beauty Supply operate.

Frequent Re-Stocking Needs

Salon professionals primarily rely on just-in-time inventory due to capital constraints and a lack of warehouse and shelf space at salons. These factors are key to driving demand for conveniently located professional beauty supply stores.

Continuing Consolidation

There is continuing consolidation among professional beauty product distributors and among professional beauty supply manufacturers. We believe that suppliers are increasingly likely to focus on larger distributors and retailers with broader scale and a retail footprint. We also believe that we are well positioned to capitalize on this trend as well as to participate in the ongoing consolidation at the distributor / retail level. However, changes often occur in our relationships with suppliers that positively or negatively affect the net sales and operating profits of each business segment. Consolidation among suppliers could exacerbate the effects of these relationship changes and could increase pricing pressures. See Risk Factors We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us.

Table of Contents

Favorable Demographic and Consumer Trends

The aging baby-boomer population is expected to drive future growth in professional beauty supply sales through increased usage of hair color and hair-loss products. Additionally, continuously changing fashion-related trends that drive new hair styles are expected to result in continued demand for hair styling products.

Business Segments, Geographic Area Information and Seasonality

We operate two business segments: (1) Sally Beauty Supply, a domestic and international open-line distributor of professional beauty supplies offering professional beauty supplies to both retail consumers and salon professionals, and (2) BSG, a full-service beauty supply distributor offering professional brands directly to salons and salon professionals through our own sales force and professional-only stores, many in exclusive geographical territories in North America. BSG also franchises beauty supply outlets in the United States and Mexico, and supplies sub-distributors in Europe. Sales of Sally Beauty Supply accounted for approximately 60%, 60% and 62% of the company s consolidated net sales for the years ended September 30, 2006, 2005 and 2004, respectively. BSG accounted for approximately 40%, 40% and 38% of the company s consolidated net sales for the years ended September 30, 2006, 2005 and 2004, respectively.

Financial information about business segments and geographic area information is incorporated herein by reference to the Business Segments and Geographic Area Information note 18 of the Notes to the Consolidated Financial Statements in Item 8 Financial Statements and Supplementary Data of this report.

Neither the sales or product assortment for Sally Beauty Supply or BSG are seasonal in nature.

Sally Beauty Supply

Sally Beauty Supply is the largest open-line distributor of professional beauty supplies in the U.S. based on store count. It carries an extensive selection of professional beauty products, ranging between 5,400 and 7,400 stock keeping units (SKUs) of beauty products, including hair care, nail care, beauty sundries and appliances. It targets retail consumers and salon professionals. We believe that Sally Beauty Supply has differentiated itself from its competitors through its attractive customer value proposition, attractive pricing, extensive selection of leading third-party branded and private label products, broad ethnic product selection, excellent product knowledge of its sales associates and convenient store locations.

Store Design and Operations

Sally Beauty Supply stores are designed to create an appealing shopping environment that embraces the retail consumer and salon professional and highlights its extensive product offering. Sally Beauty Supply stores average 1,700 square feet in size and are located primarily in strip shopping centers. Generally, Sally Beauty Supply stores follow a consistent format, allowing customers familiarity between Sally Beauty Supply locations.

Sally Beauty Supply stores are segmented into distinctive areas arranged by product type with signs allowing its customers to easily navigate through its stores. Sally Beauty Supply seeks to stimulate cross-selling and impulse buying through strategic product placement and use the front of the store to highlight new products and key promotional items.

Merchandise

Sally Beauty Supply stores carry a broad selection of branded and private label beauty supplies. Sally Beauty Supply manages each category by product and by SKU and uses centrally developed planoguides to maintain a consistent merchandise presentation across its store base. Through its information systems, Sally Beauty Supply actively monitors each store s category performance, allowing maintenance of consistently high levels of in-stock merchandise. We believe Sally Beauty Supply s tailored merchandise strategy enables it to meet local demands and helps drive traffic in its stores. Additionally, its information systems track and automatically replenish inventory levels, generally on a weekly basis.

Table of Contents

Sally Beauty Supply offers a comprehensive ethnic product selection with specific appeal to the African-American markets. Its ethnic product offerings are tailored by store based on market demographics and category performance. For example, sales to the African-American markets represent approximately 11% of net sales in Sally Beauty Supply s U.S. stores. We believe the breadth of selection of ethnic products available in Sally Beauty Supply Stores is unique and differentiates its stores from its competition. Sally Beauty Supply also positions itself to be competitive in price, but not a discount leader.

Sally Beauty Supply s pricing strategy is differentiated by customer segment. Professional salon customers are generally entitled to a price lower than that received by retail customers. Sally Beauty Supply does offer discounts to retail customers through its customer loyalty program.

Leading Third-Party Branded Products

Sally Beauty Supply offers an extensive selection of hair care products, nail care products, beauty sundries and appliances from leading third-party brands such as Clairol, L Oreal, Revlon and Conair. We believe that carrying a broad selection of the latest premier branded merchandise is critical to maintaining long-term relationships with our valued customers. The merchandise Sally Beauty Supply carries includes products from one or more of the leading manufacturers in each category. Sally Beauty Supply s objective is not only to carry leading brands, but also to carry a full range of branded and private label products within each category. As hair trends continue to evolve, we expect to offer the changing professional beauty product assortment necessary to meet the needs of retail consumers and salon professionals.

Private Label Products

Sally Beauty Supply offers a broad range of private label and controlled label products, which we generally refer to collectively as private label products, unless the context requires otherwise. Private label products are brands for which we own the trademark and in some instances the formula. Controlled label products are brands that are owned by the manufacturer for which we have been granted sole distribution rights. Private label products, including controlled label products, provide customers with an attractive alternative to higher-priced leading third-party brands. Private label products accounted for approximately 37% of Sally Beauty Supply s net sales as of September 30, 2006. Generally, the private label brands have higher gross margins than the leading third-party branded products and we believe this area offers significant potential growth. Sally Beauty Supply maintains private label products in a number of categories including hair care, appliances and salon products. Sally Beauty Supply actively promotes its private label brands through in-store promotions and monthly flyers. We believe our customers perceive these private label products to be comparable in quality and name recognition to leading third-party branded products.

The following table sets forth the approximate percentage of Sally Beauty Supply s sales by merchandise category:

	Year Ended September 30, 2006
Hair care	21.1%
Hair color	20.1%
Skin and nail care	16.1%
Electrical appliances	14.3%
Brushes, cutlery and accessories	13.4%

Ethnic products	10.7%
Other beauty items	4.3%
Total	100.0%

Table of Contents

Marketing and Advertising

Sally Beauty Supply s marketing program is designed to promote its extensive selection of brand name products at competitive prices. The program is currently centered on multi-page, color flyers highlighting promotional products. Separate flyers are created and tailored to Sally Beauty Supply s retail customers and salon professionals. These flyers, which are available in Sally Beauty Supply stores, are also mailed to loyalty program customers and salon professionals on a monthly basis and are supplemented by e-mail newsletters. Additionally, a Sally Beauty magazine that provides customers with beauty trends and product information is sold in Sally Beauty Supply stores.

Sally Beauty Supply s customer loyalty and marketing programs allow Sally Beauty Supply to collect point-of-sale customer data and increase our understanding of customers needs. The Sally Beauty Club is a loyalty program for customers who are not salon professionals. Beauty Club members, after paying a small annual fee to join, receive a special, discounted price on almost every non-sale item. Members are also eligible for a special Beauty Club e-mail newsletter that contains additional savings, beauty tips, new product information and coupons. Beauty Club customers are rewarded with additional discounts as their store spending increases. The ProCard is a marketing program for salon professionals. ProCard members receive discounts on all beauty products sold at Sally Beauty Supply stores. We believe these programs are highly effective in developing and maintaining customer relationships.

Store Locations

Sally Beauty Supply selects geographic markets and store sites on the basis of demographic information, quality and nature of neighboring tenants, store visibility and location accessibility. Sally Beauty Supply seeks to locate stores primarily in strip malls, which are occupied by other high traffic retailers including grocery stores, mass merchants and home centers.

Sally Beauty Supply balances its store expansion between new and existing markets. In its existing markets, Sally Beauty Supply adds stores as necessary to provide additional coverage. In new markets, Sally Beauty Supply generally seeks to expand in geographically contiguous areas to leverage its experience. We believe that Sally Beauty Supply s knowledge of local markets is an important part of its success.

The following table provides a history of Sally Beauty Supply store openings since the beginning of fiscal year 2002:

	Year Ended September 30,				
	2006	**2005**	**2004**	**2003**	**2002**
Stores open at beginning of period	2,419	2,355	2,272	2,177	2,112
Net store openings during period	92	62	83	95	64
Stores acquired during period		2			1
Stores open at end of period	2,511	2,419	2,355	2,272	2,177

Beauty Systems Group

We believe that BSG is the largest full-service distributor of professional beauty supplies in the U.S. As of September 30, 2006, BSG operated 658 company-owned stores, supplied 170 franchised stores and had a sales force of approximately 1,200 professional distributor sales consultants selling exclusively to salons and salon professionals in 43 U.S. states and portions of Canada, Mexico and certain European countries.

Store Design and Operations

BSG stores are designed to create a professional shopping environment that embraces the salon professional and highlights its extensive product offering. Company-owned BSG stores average 2,800 square feet and are located primarily in secondary strip shopping centers. BSG store layout is designed to provide optimal variety and options to the salon professional. Stores are segmented into distinctive areas arranged by product type with certain areas

Table of Contents

dedicated to leading third-party brands; such as Matrix, Redken, Paul Mitchell, Graham Webb, Rusk and TIGI. The selection of these varies by territory.

Professional Distributor Sales Consultants

BSG has a network of approximately 1,200 professional distributor sales consultants, which exclusively serve salons and salon professionals.

The number of consultants in the BSG network has increased since fiscal 2002, as set forth in the following table:

	Year Ended September 30,				
	2006	**2005**	**2004**	**2003**	**2002**
Professional distributor sales consultants	1,192	1,244	1,167	989	930

In order to provide a knowledgeable consultant team, BSG actively recruits professional cosmetologists and individuals with sales experience, as we believe that new consultants with either broad knowledge about the products or direct sales experience will be more successful.

BSG provides extensive training to new consultants beginning with an intensive one-week training program, followed by an extensive, continuing program of media-based training, delivered through audio, video and web-based e-learning. The program is designed to develop product knowledge as well as techniques on how best to serve salon professionals. In addition to selling professional beauty products, these sales consultants offer in-store training for professionals and owners in areas such as new styles, techniques and business practices.

An important component of consultants compensation is sales commissions. BSG s commission system is designed to drive sales and focus consultants on selling products that are best suited to individual salons and salon professionals. We believe our emphasis on recruitment, training, and sales-based compensation results in a sales force that distinguishes itself from other full service/exclusive-channel distributors.

The following tables sets forth the approximate percentage of BSG sales attributable by channel:

	Year Ended September 30, 2006
Company-owned retail stores	47.5%
Professional distributor sales consultants	37.2%
Franchise stores	15.3%
Total	100.0%

Merchandise

BSG stores carry a broad selection of branded beauty supplies, ranging between 3,700 and 9,500 SKUs of beauty products, including hair care products, nail care, appliances and other beauty items from leading third-party brands. Some products are available in bulk packaging for higher volume salon needs. Through BSG s information systems, each store s product performance is actively monitored, allowing maintenance of an optimal merchandise mix. Additionally, BSG s information systems track and automatically replenish inventory levels on a weekly basis, enabling BSG to maintain high levels of product in stock. Although BSG positions itself to be competitive on price, its primary focus is to provide a comprehensive selection of branded products to the salon professional. Many BSG products are sold under exclusive arrangements with suppliers, whereby BSG is designated the sole distributor for a specific brand name within certain geographic territories. We believe that carrying a broad selection of the latest premier branded merchandise is critical to maintaining relationships with our valued professional customers.

Table of Contents

The following table sets forth the approximate percentage of sales attributable by merchandise category:

	Year Ended September 30, 2006
Hair care	36.7%
Hair color	23.6%
Promotional items	19.1%
Skin and nail care	8.3%
Electrical appliances	5.6%
Brushes, cutlery and accessories	3.5%
Other beauty items	2.2%
Ethnic products	1.0%
Total	100.0%

Marketing and Advertising

BSG s marketing program is designed to promote its extensive selection of brand name products at competitive prices. BSG distributes at its stores and mails to its salon and salon professional customers, multi-page color flyers that highlight promotional products. Some BSG stores also host monthly manufacturer-sponsored classes for customers. These classes are held at BSG stores and led by manufacturer-employed educators. Salon professionals, after paying a small fee to attend, are educated on new products and beauty trends. We believe these classes increase brand awareness and drive sales in BSG stores.

Store Locations

BSG stores are primarily located in secondary strip shopping centers. Although BSG stores are located in visible and convenient locations, salon professionals are less sensitive about store location than Sally Beauty Supply customers.

The following table provides a history of BSG store openings since the beginning of fiscal year 2002:

	Year Ended September 30,				
	2006	2005	2004	2003	2002
Stores open at beginning of period	822	692	543	535	316
Net store openings during period	6	37	26	8	24
Stores acquired during period		93	123		195
Stores open at end of period	828	822	692	543	535

Our Strategy

We believe there are significant opportunities to increase our sales and profitability through the further implementation of our operating strategy and by growing our store base in existing and contiguous markets, both organically and through strategic acquisitions. Specific elements of our growth strategy include the following:

Increase Sales Productivity of Our Stores

We intend to grow comparable store sales by focusing on improving our merchandise mix and introducing new products. In addition, we believe that as an independent company we will be able to more effectively market our products, particularly in Sally Beauty Supply stores. We also plan to enhance our customer loyalty programs, which allow us to collect point-of-sale customer data and increase our understanding of customers needs.

Open New Stores and Explore New Services and Concepts

In fiscal year 2006, we opened 92 and 6 net new stores for Sally Beauty Supply and BSG, respectively. Because of the limited initial capital outlay, rapid payback, and highly attractive return on capital, we intend to continue to expand our Sally Beauty Supply and BSG store base. We are also exploring several new retail and distribution concepts intended to increase our product offering to existing customers and penetrate new customer segments. For example, in the U.K., Sally Beauty Supply is currently testing a format that combines traditional salon services with a retail offering of exclusive salon-only product lines. We expect new store openings and the introduction of new services and concepts to be an important aspect of our future growth opportunities.

Increase Sales of Private Label Products

We intend to grow private label sales in both Sally Beauty Supply and BSG. We believe our customers view our private label products as high-quality, recognizable brands, which are competitive with leading third-party branded merchandise. Private label products are currently sold through our Sally Beauty Supply stores, with very limited private label offerings at BSG. Private label products account for a substantial amount of the Sally Beauty Supply segment net sales and generate a gross margin greater than that of the leading third-party brands sold through our stores. Potential growth for such products is believed to be significant. In addition, our broad private label product offering minimizes our dependence on any one brand or supplier. We believe private label presents opportunities to grow profits and also increase store loyalty.

Increase Operating Efficiency and Profitability

We believe there are numerous opportunities to increase the profitability of operations. For example, we believe there are meaningful opportunities to further streamline the supply chain by consolidating North American warehousing and more effectively managing inbound and outbound freight expenses. Other identified opportunities include (i) improvement of sales force training programs and revision of current compensation structures, (ii) centralization of certain administrative functions, and (iii) targeted overhead reductions. In addition, we intend to implement working capital improvement initiatives that are focused on the strict management of receivables, inventory and payables to further maximize our free cash flow. We also intend to undertake a full review of our supplier base and procurement strategy. This initiative is intended to (i) eliminate duplicative product sourcing efforts between Sally Beauty Supply and BSG, and (ii) identify low cost alternative sources of supply in certain product categories from countries with low manufacturing costs. We are identifying economics of scale that will allow us to improve our procurement strategy and maximize our margin potential.

Pursue Strategic Acquisitions

We have completed more than 25 acquisitions over the last 10 years, predominantly in our BSG segment. We believe our experience in identifying attractive acquisition targets, our proven integration process, and our highly scalable infrastructure have created a strong platform for future acquisitions, subject to (i) restrictions on our ability to finance acquisitions by incurring additional debt under our debt agreements, and (ii) restrictions on the amount of equity that we can issue to make acquisitions for at least two years following the transaction separating our company from Alberto-Culver. We will continue to identify and evaluate acquisition targets both domestically and internationally, with a focus on expanding our exclusive BSG territories.

Competition

Although there are a limited number of sizable direct competitors to our business, the beauty industry is highly competitive. In each area in which we operate, we experience domestic and international competition, including mass merchandisers, drug stores, supermarkets and other chains, offering similar or substitute beauty products at comparable prices. Our business also faces competition from department stores. In addition, our business competes with local and regional cash-and-carry beauty supply stores and full-service distributors selling directly to salons and salon professionals through both professional distributor sales consultants and outlets open only to salons and salon professionals. Our business also faces increasing competition from certain manufacturers that use their own sales forces to distribute their professional beauty products directly or align themselves with our competitors. Our business also faces competition from authorized and unauthorized retailers and internet sites offering professional salon-only products. See Risk Factors The beauty products distribution industry is highly competitive .

Competitive Strengths

We believe the following competitive strengths differentiate us from our competitors and contribute to our success:

The Largest Professional Beauty Supply Distributor in the U.S. with Multi-Channel Platform

Sally Beauty Supply and BSG together comprise the largest distributor of professional beauty products in the U.S. by store count. Our leading market positions and multi-channel platform afford us several advantages, including strong positioning with suppliers, the ability to better service the highly fragmented beauty supply market, superior economies of scale and the ability to capitalize on the ongoing consolidation in our sector. Through our multi-channel platform, we are able to generate and grow revenues across broad, diversified geographies, and customer segments using varying product assortments. We operate in nine countries outside the U.S. and Puerto Rico, offering up to 7,400 and 9,500 SKUs in Sally Beauty Supply and BSG stores, respectively, to a potential customer base that includes millions of retail consumers, and more than 230,000 salons in the U.S.

Differentiated Customer Value Proposition

We believe that our stores are differentiated from their competitors through convenient location, broad selection of professional beauty products (including leading third-party branded and (in Sally Beauty Supply stores) private label merchandise), high levels of in-stock merchandise, educated salespeople and competitive pricing. Our merchandise mix includes a comprehensive ethnic product selection, which is tailored by store based on market demographics and category performance. African-American products represent approximately 11% of net sales in U.S. Sally Beauty Supply stores, and we believe that the breadth of its selection of these products further differentiates Sally Beauty Supply from its competitors. Sally Beauty Supply also offers a customer loyalty program for Sally Beauty Supply customers. Members, after paying a small annual fee to join, receive a special, discounted price on products and are also eligible for a special Beauty Club e-mail newsletter with additional promotional offerings, beauty tips and new product information. We believe that our differentiated customer value proposition and strong brands drive customer loyalty and high repeat traffic, contributing to our strong and consistent historical financial performance. Our BSG professional distributor sales consultants benefit from their customers having access to the BSG store system. Customers have the ability to pick up the products they need between sales visits from professional distributor sales consultants.

Attractive Store Economics

We believe that our stores generate attractive returns on invested capital when compared to our competitors and other specialty retailers. The capital requirements to open a Sally Beauty Supply or BSG store, excluding inventory, average approximately $66,000 and $68,000, respectively. Sally Beauty Supply and BSG stores average approximately 1,700 and 2,800 square feet in size, respectively, and are typically located within strip shopping centers that offer attractive lease rates. Strong average sales per square foot combined with minimal staffing requirements, low rent expense and limited initial capital outlay, typically result in positive contribution margins within 3-4 months, and cash payback on investment of less than two years. Due to such attractive investment returns and relatively high operating profit contributions per store, over the past five years Sally Beauty Supply and BSG have opened 396 and 101 net new stores, respectively.

Table of Contents

Strong and Consistent Financial Performance

We have a proven track record of strong growth and consistent profitability due to superior operating performance, new store openings and strategic acquisitions. Over the past five fiscal years, our comparable store sales growth has been positive in each year and has averaged 3.7%, as set forth in the following table:

	Year Ended September 30,				
Comparable store sales growth:	**2006**	**2005**	**2004**	**2003**	**2002**
Sally Beauty Supply	2.4%	2.4%	3.8%	2.7%	5.7%
Beauty Systems Group	4.1%	(0.6%)	8.5%	4.6%	4.4%
Consolidated	2.8%	1.8%	4.6%	3.8%	5.5%

Highly Experienced Management Team with a Proven Track Record

Our management team, led by President and Chief Executive Officer Gary Winterhalter, has a strong record of net sales growth and profitability improvement. Our senior management team has an average tenure of 12 years with us and our subsidiaries and 21 years in the beauty supply industry.

Customer Service

We strive to complement our extensive merchandise selection and innovative store design with superior customer service. We actively recruit individuals with cosmetology experience because we believe that such individuals are more knowledgeable about the products they sell. Additionally, Sally Beauty Supply recruits individuals with retail experience because we believe their general retail knowledge can be leveraged in the beauty supply industry. We believe that employees knowledge of the products and ability to demonstrate and explain the advantages of the products increases sales and that their prompt, knowledgeable service fosters the confidence and loyalty of customers and differentiates our business from other professional beauty supply distributors.

We emphasize product knowledge during initial training as well as during ongoing training sessions, with programs intended to provide new associates and managers with one and two weeks of intensive training, respectively. The training programs encompass operational and product training and are designed to increase employee and store productivity. Managers are required to participate in training on an ongoing basis to keep up-to-date on products and operational practices.

Most of our stores are staffed with a store manager, and two or three full-time or part-time associates. BSG stores are generally also staffed with an assistant manager. The operations of each store are supervised by a district manager, who reports to a territory manager.

Suppliers

We purchase our merchandise directly from manufacturers and fillers through supply contracts and by purchase order. For fiscal year 2006, our two largest suppliers were the Professional Products Division of L Oreal USA S/D, Inc. (L Oreal) and Procter & Gamble. Sally Beauty Supply s five largest suppliers provided it with approximately 40.9% of the products Sally Beauty Supply purchased in fiscal year 2006. BSG s five largest suppliers provided it with approximately 59.2% of the products BSG purchased in fiscal year 2006. Products are purchased from most manufacturers and fillers on an at-will basis or under contracts which can be terminated without cause upon 90 days notice or less or expire without express rights of renewal. Such manufacturers and fillers could discontinue sales to us at any time or upon short notice.

As is typical in distribution businesses, relationships with suppliers are subject to change from time to time (including the expansion or loss of distribution rights in various geographies and the addition or loss of products lines). Changes in our relationships with suppliers occur often, and could positively or negatively impact our net sales and operating profits. See Risk Factors We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us. However, we believe that we can be successful in mitigating negative effects resulting from unfavorable changes in the relationships between us and our suppliers through, among other things, the development of new or expanded supplier relationships.

On December 19, 2006, we announced that (1) BSG, other than its Armstrong-McCall division, will not retain its rights to distribute the professional products of L Oreal through its distributor sales consultants (effective January 30, 2007, with exclusivity ending December 31, 2006) or in its stores on an exclusive basis (effective January 1, 2007) in those geographic areas within the U.S. in which BSG currently has distribution rights, and (2) BSG s Armstrong McCall division will not retain the rights to distribute Redken professional products through distributor sales consultants or its stores. In replacement of these rights, BSG entered into long-term agreements with L Oreal under which, as of January 1, 2007, BSG will have non-exclusive rights to distribute the same L Oreal professional products in its stores that it previously had exclusive rights to in its stores and through its sales consultants. Armstrong McCall will retain its exclusive rights to distribute Matrix professional products in its territories.

Distribution

As of September 30, 2006, we operated 22 distribution centers, 6 of which serviced Sally Beauty Supply and 16 of which serviced BSG. Our purchasing and distribution system is designed to minimize the delivered cost of merchandise and maximize the level of merchandise in-stock in stores. This distribution system also allows for monitoring of delivery times and maintenance of appropriate inventory levels. Product deliveries are typically made to our stores on a weekly basis. Each distribution center has a quality control department that monitors products received from suppliers. We utilize proprietary software systems to provide computerized warehouse locator and inventory support.

Management Information Systems

Our management information systems provide order processing, accounting and management information for the marketing, distribution and store operations functions of our business. Most of these systems have been developed internally. The information gathered by the management information systems supports automatic replenishment of in-store inventory and provides support for product purchase decisions.

Employees

In our domestic and foreign operations, we had approximately 15,800 full-time equivalent employees as of September 30, 2006 consisting of approximately 10,500 hourly personnel and 5,300 salaried employees. At September 30, 2005, we had approximately 15,000 full-time equivalent employees.

Certain subsidiaries in Mexico have collective bargaining agreements, covering warehouse and store personnel, which expire at various times over the next several years. We believe we have good relationships with our employees.

Management

For information concerning our directors and executive officers, see Directors and Executive Officers of the Registrant in Item 10 of this report.

Regulation

We are subject to a wide variety of laws and regulations, which historically have not had a material effect on our business. For example, in the United States, most of the products sold and the content and methods of advertising and marketing utilized are regulated by a host of federal agencies, including, in each case, one of more of the following:

the Food and Drug Administration, the Federal Trade Commission and the Consumer Products Safety Commission. The transportation and disposal of many of our products are also subject to federal regulation. State

Table of Contents

and local agencies regulate many aspects of our business. In markets outside of the United States, regulation is also focused and comprehensive.

The franchisor-franchisee relationship poses a specific set of regulatory issues. We are subject to the regulation of offering and sale of franchises in the United States and Mexico. The applicable laws and regulations affect our business practices, as franchisor, in a number of ways, including restrictions placed upon the offering, renewal, termination and disapproval of assignment of franchises. To date, these laws and regulations have not had a material effect upon operations. The FTC is considering major revisions to its regulations governing the offer and sale of franchises in the U.S., although to date, these revisions have not been adopted.

Trademarks and Other Intellectual Property Rights

Our trademarks, certain of which are material to our business, are registered or legally protected in the United States, Canada and other countries throughout the world in which we operate. We and our subsidiaries own over 200 trademarks in the United States. We also rely upon trade secrets and know-how to develop and maintain our competitive position. We protect intellectual property rights through a variety of methods, including reliance upon trademark, patent and trade secret laws, in addition to confidentiality agreements with many vendors, employees, consultants and others who have access to our proprietary information. The duration of our trademark registrations is generally 10, 15 or 20 years, depending on the country in which a mark is registered, and generally the registrations can be renewed. The scope and duration of intellectual property protection varies by jurisdiction and by individual product.

Access to Public Filings

Our annual report on Form 10-K, current reports on Form 8-K and amendments to such reports are, and, when filed with the SEC our quarterly reports on Form 10-Q and any amendment to such reports will be, available, without charge, on our website, www.sallybeautyholdings.com, as soon as reasonably possible after they are filed electronically with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act. We will provide copies of such reports to any person, without charge, upon written request to our office of Investor Relations by writing to: our Investor Relations Department at 3001 Colorado Blvd, Denton, TX 76210. The information found on our website shall not be considered to be part of this or any other report filed with or furnished to the SEC.

In addition to our website, you may read and copy public reports we file with or furnish to the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains our reports, proxy and information statements, and other information that we file electronically with the SEC at www.sec.gov.

ITEM 1A. RISK FACTORS

The following describes risks that we believe to be material to our business. If any of the following risks or uncertainties actually occurs, our business, financial condition and operating results could be materially and adversely affected. There may be additional risks, of which we are not aware or that we do not believe to be material, that could materially and adversely affect our business. This report also contains forward-looking statements and the following risks could cause our actual results to differ materially from those anticipated in such forward-looking statements.

Risks Relating to Our Business

We have no history as a stand-alone company and may be unable to make the changes necessary to operate effectively.

We recently separated from Alberto-Culver and became an independent publicly-traded company. There can be no assurance that the separation from Alberto-Culver and the resulting absence of its general administrative assistance will not have an adverse impact on our business, financial condition and results of operations. Apart from a limited

Table of Contents

number of services to be provided to us on a transitional basis, Alberto-Culver will have no obligation to provide financial, operational or organizational assistance to us or any of our subsidiaries.

Our accounting and other management systems and resources may not be adequately prepared to meet the financial reporting and other requirements to which we are subject following our separation from Alberto-Culver.

Our financial results previously were included within the consolidated results of Alberto-Culver, and the reporting and control systems were appropriate for those of subsidiaries of a public company. However, neither we nor any of our subsidiaries was directly subject to reporting and other requirements of the Exchange Act. As an independent publicly-traded company, we are now directly subject to reporting and other obligations under the Exchange Act. These reporting and other obligations place significant demands on the management and administrative and operational resources, including accounting resources, of us and our subsidiaries. As a public company, we incur significant legal, accounting, and other expenses that we did not incur as a private company. Under the SEC rules and regulations, as well as those of the New York Stock Exchange, our compliance costs have increased.

In addition, as a public company we are subject to rules adopted by the SEC pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, which require us to include in our annual report on Form 10-K our management s report on, and assessment of, the effectiveness of our internal controls over financial reporting. In addition, our independent registered public accounting firm must attest to and report on management s assessment of the effectiveness of our internal controls over financial reporting and the effectiveness of such internal controls. These requirements will first apply to our annual report for the fiscal year ending September 30, 2007. If we fail to properly assess and/or achieve and maintain the adequacy of our internal controls, there is a risk that we will not comply with all of the requirements imposed by Section 404. Moreover, effective internal controls are necessary to help prevent financial fraud. Any of these possible outcomes could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could harm our business and could negatively impact the market price of our securities.

To comply with these requirements, we and our subsidiaries are upgrading our systems, including information technology, implementing additional financial and management controls, reporting systems and procedures and have hired additional legal, accounting and finance staff. If additional upgrades to our financial and management controls, reporting systems, information technology and procedures are required under the financial reporting requirements and other rules that apply to reporting companies, now and in the future, our management and resources may need to be devoted to assist in compliance with those requirements.

Our historical consolidated financial information contained in this report does not represent our future financial position, results of operations or cash flows nor does it reflect what our financial position, results of operations or cash flows would have been as a separate public company during the periods presented.

Our historical consolidated financial information included in this report is not representative of our future financial position, results of operations or cash flows nor does it reflect what our financial position, results of operations or cash flows would have been as an independent public company during the periods presented. This is primarily because:

- Our historical consolidated financial information reflects allocation of expenses from Alberto-Culver. Those allocations may be different from the comparable expenses we would have incurred as a separate company.

- Our working capital requirements historically have been satisfied as part of Alberto-Culver s corporate-wide cash management policies. In connection with the separation from Alberto-Culver, we incurred a large amount of indebtedness and assumed significant debt service costs. As a result, our cost of debt and capitalization are significantly different from that reflected in our historical consolidated financial information.

As a result of our separation from Alberto-Culver, there have been significant changes in our cost structure, including the costs of establishing an appropriate accounting and reporting system, debt service obligations and other costs of being a stand-alone company.

We may not be able to realize the anticipated benefits of our separation from Alberto-Culver on a timely basis or at all.

Our success as an independent publicly-traded company depends, in part, on our ability to realize the anticipated benefits of our separation from Alberto-Culver. These anticipated benefits include increased brand and product recognition as a result of our increased ability to engage in more aggressive marketing and advertising campaigns following the elimination of difficulties arising from our businesses competition with the customers and suppliers of Alberto-Culver s consumer products business and the potential for increased operating earnings of our business expected to result from allowing us to focus our attention and resources on our business and customers. We cannot assure you these benefits will occur or that we will be able to achieve growth in the future comparable to our businesses recent historical sales and earnings growth.

As a separate entity, we will not enjoy all of the benefits of scale that Alberto-Culver achieved with the combination of the consumer products business and our business.

Prior to our separation from Alberto-Culver, Alberto-Culver benefited from the scope and scale of the consumer products business and our business in certain areas, including, among other things, risk management, employee benefits, regulatory compliance, administrative services and human resources. Our loss of these benefits as a consequence of our separation from Alberto-Culver could have an adverse effect on our business, results of operations and financial condition. For example, it is possible that some costs will be greater for us than they were for Alberto-Culver due to the loss of volume discounts and the position of being a large customer to service providers and vendors. In addition, the separation eliminated Alberto-Culver s diversification that resulted from operating the consumer products business of Alberto-Culver alongside our distribution business and tended to mitigate financial and operations volatility. As a result, we may experience increased volatility in terms of cash flow, operating results, working capital and financing requirements.

We are a holding company, with no operations of our own, and we depend on our subsidiaries for cash.

We are a holding company and do not have any material assets or operations other than ownership of equity interests of our subsidiaries. Our operations are conducted almost entirely through our subsidiaries and our ability to generate cash to meet our obligations or to pay dividends is highly dependent on the earnings of, and receipt of funds from, our subsidiaries through dividends or intercompany loans. However, none of our subsidiaries are obligated to make funds available to us for payment of dividends. Further, the terms of our subsidiaries debt agreements significantly restrict the ability of our subsidiaries to pay dividends or otherwise transfer assets to us. Furthermore, we and our subsidiaries may be able to incur substantial additional indebtedness in the future that may severely restrict or prohibit our subsidiaries from making distributions, paying dividends or making loans to us.

The beauty products distribution industry is highly competitive.

The beauty products distribution industry is highly fragmented and there are few significant barriers to entry into the markets for most of the types of products and services we sell. Sally Beauty Supply competes with other domestic and international beauty product wholesale and retail outlets, including local and regional cash-and-carry beauty supply stores, professional-only beauty supply stores, salons, mass merchandisers, drug stores and supermarkets, as well as sellers on the Internet and salons retailing hair care items. BSG competes with other domestic and international beauty product wholesale and retail suppliers and with manufacturers selling professional beauty products directly to salons and individual salon professionals. The primary competitive factors in the beauty products distribution industry are the price at which we purchase products from manufacturers, quality, perceived value, consumer brand name recognition, packaging and mix of the products we sell; customer service; the efficiency of our distribution network; and the availability of desirable store locations. Competitive conditions may limit our ability to maintain prices or require us to reduce prices to retain business or market share. Some of our competitors are larger and have greater financial and other resources than we do, and are less leveraged than our business, and may therefore be able to spend more aggressively on advertising and promotional activities and respond more effectively to changing business and economic conditions. In addition, we may lose customers if our competitors that own national chains acquire additional salons that are BSG customers or if professional beauty supply manufacturers align themselves with other beauty product wholesale and retail suppliers who compete with

BSG. For instance, in 2006 L Oreal acquired a 30% stake in Beauty Alliance, one of our principal competitors. Our failure to continue to compete effectively in our markets could adversely impact our business, financial condition and results of operations.

We may be unable to anticipate changes in consumer preferences and buying trends or manage our product lines and inventory commensurate with consumer demand.

Our success depends in part on our ability to anticipate and offer products and services that appeal to the changing needs and preferences of our customers. If we do not anticipate and respond to changes in customer preferences in a timely manner, our sales may decline significantly and we may be required to mark down certain products to sell the resulting excess inventory at prices which can be significantly lower than the normal retail or wholesale price, which could adversely impact our business, financial condition and results of operations. In addition, we depend on our inventory management and information technology systems in order to replenish inventories and deliver products to store locations in response to customer demands. Any systems-related problems could result in difficulties satisfying the demands of customers which, in turn, could adversely affect our sales and profitability.

We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us.

We do not manufacture the brand name or private label products we sell, and instead purchase our products from manufacturers and fillers. We depend on a limited number of manufacturers for a significant percentage of the products we sell. Sally Beauty Supply s five largest suppliers provided it with 40.9% and 41.3% of the products Sally Beauty Supply purchased in fiscal years 2006 and 2005, respectively. BSG s five largest suppliers provided it with 59.2% and 59.7% of the products BSG purchased in fiscal years 2006 and 2005, respectively.

In addition, since we purchase products from many manufacturers and fillers on an at-will basis, under contracts which can be terminated without cause upon 90 days notice or less or which expire without express rights of renewal, such manufacturers and fillers could discontinue sales to us at any time or upon the expiration of the distribution period. Some of our contracts with manufacturers may be terminated by such manufacturers if we fail to meet specified minimum purchase requirements. In such cases, we do not have contractual assurances of continued supply, pricing or access to new products and vendors may change the terms upon which they sell. We may not be able to acquire desired merchandise in sufficient quantities or on acceptable terms in the future.

Changes in Sally Beauty Supply and BSG s relationships with suppliers occur often, and could positively or negatively impact the net sales and operating profits of both business segments. For example, net sales and operating profits of Sally Beauty Supply and BSG were negatively affected in fiscal year 2005 by the decision of certain suppliers of the BSG business to begin selling their products directly to salons in most markets.

Subsequently, in fiscal year 2006 one of those suppliers agreed to have BSG once again sell its product lines in BSG stores. In addition, some of our suppliers may seek to decrease their reliance on distribution intermediaries, including full service/exclusive and open-line distributors like BSG and Sally Beauty Supply, by promoting their own distribution channels. If our access to supplier-provided products were to be diminished relative to our competitors our business could be materially and adversely affected. Also, consolidation among suppliers may increase their negotiating leverage, thereby providing them with competitive advantages over us that may increase our costs and reduce our revenues, adversely affecting our business, financial condition and results of operations.

On December 19, 2006, we announced that (1) BSG, other than its Armstrong-McCall division, will not retain its rights to distribute the professional products of L Oreal through its distributor sales consultants (effective January 30, 2007, with exclusivity ending December 31, 2006) or in its stores on an exclusive basis (effective January 1, 2007) in those geographic areas within the U.S. in which BSG currently has distribution rights, and (2) BSG s Armstrong McCall division will not retain the rights to distribute Redken professional products through distributor sales consultants or its stores. In replacement of these rights, BSG entered into long-term agreements with L Oreal under which, as of January 1, 2007, BSG will have non-exclusive rights to distribute the same L Oreal professional products in its stores that it previously had exclusive rights to in its stores and through its sales consultants. Armstrong McCall will retain its exclusive rights to distribute Matrix professional products in its territories. We expect the impact of the loss of BSG s exclusive rights to distribute L Oreal professional products in

Table of Contents

BSG stores and by its distributor sales consultants to negatively impact our consolidated revenue by approximately $110 million during the last nine months of our 2007 fiscal year. This number includes anticipated ancillary impact on revenue from other products that may be indirectly affected by these developments. We cannot assure you that the impact of these developments will not adversely impact revenue to a greater degree than we currently expect, or that our efforts to mitigate the impact of these developments will be successful. If the impact of these developments is greater than we expect or our efforts to mitigate the impact of these developments are not successful, this could have a material adverse effect on our business, financial condition or results of operations.

Manufacturers and fillers of beauty supply products are subject to certain risks that could adversely impact their ability to provide us with their products on a timely basis, including industrial accidents, environmental events, strikes and other labor disputes, union organizing activity, disruptions in logistics or information systems, loss or impairment of key manufacturing sites, product quality control, safety, and licensing requirements and other regulatory issues, as well as natural disasters and other external factors over which neither they nor we have control. In addition, our operating results depend to some extent on the orderly operation of our receiving and distribution process, which depends on manufacturers adherence to shipping schedules and our effective management of our distribution facilities and capacity.

If a material interruption of supply occurs, or a significant supplier ceases to supply us or materially decreases its supply to us, we may not be able to acquire products with similar quality and consumer brand name recognition as the products we currently sell, or acquire such products in sufficient quantities to meet our customers demands or on favorable terms to our business, any of which could adversely impact our business, financial condition and results of operations.

We do not control the production process for the brand name and private label products we sell. In many cases, we rely on representations of manufacturers and fillers about the products we purchase for resale regarding whether such products have been manufactured in accordance with applicable governmental regulations. We may not be able to identify a defect in a product we purchase from a manufacturer or filler before we offer such product for resale, which could result in fines or other actions by government regulators, product liability claims, product recalls, harm to our credibility, impairment of customer relationships or a decrease in the market acceptance of brand names, any of which could adversely affect our business, financial condition and results of operations.

If products sold by us are found to be defective in labeling or content, our credibility and that of the brands we sell may be harmed, market acceptance of our products may decrease and we may be exposed to liability in excess of our products liability insurance coverage and manufacturer indemnities.

Our sale of certain products exposes us to potential product liability claims, recalls or other regulatory or enforcement actions initiated by federal, state or foreign regulatory authorities or through private causes of action. Such claims, recalls or actions could be based on allegations that, among other things, the products sold by us are misbranded, contain contaminants, provide inadequate instructions regarding their use or misuse, or include inadequate warnings concerning flammability or interactions with other substances. Claims against us could also arise as a result of the misuse by purchasers of such products or as a result of their use in a manner different than the intended use. We may be required to pay for losses or injuries actually or allegedly caused by the products we sell and to recall any product we sell that is alleged to be or is found to be defective.

Any actual defects or allegations of defects in products sold by us could result in adverse publicity and harm our credibility, which could adversely affect our business, financial condition and results of operations. Although we may have indemnification rights against the manufacturers of many of the products we distribute and rights as an additional insured under the manufacturer s insurance policies, it is not certain that any individual manufacturer or insurer will be financially solvent and capable of making payment to any party suffering loss or injury caused by products sold by us.

Further, some types of actions and penalties, including many actions or penalties imposed by governmental agencies and punitive damages awards, may not be remediable through reliance on indemnity agreements or insurance. Furthermore, potential product liability claims may exceed the amount of indemnity or insurance coverage or be excluded under the terms of an indemnity agreement or insurance policy. If we are forced to pay to satisfy such claims, it could have an adverse effect on our business, financial condition and results of operations.

Table of Contents

We could be adversely affected if we do not comply with laws and regulations or if we become subject to additional or more stringent laws and regulations.

We are subject to a number of U.S. federal, state and local laws and regulations, as well as the laws and regulations applicable in each other market in which we do business. These laws and regulations govern the composition, packaging, labeling and safety of the products we sell and the methods we use to sell the products. Non-compliance with applicable laws and regulations of governmental authorities, including the Food and Drug Administration and similar authorities in other jurisdictions, by us or the manufacturers of the products sold by us could result in fines, product recalls and enforcement actions or otherwise restrict our ability to market certain products, which could adversely affect our business, financial condition and results of operations. The laws and regulations applicable to us or manufacturers of the products sold by us may become more stringent. Continued legal compliance could require the review and possible reformulation or relabeling of certain products, as well as the possible removal of some products from the market altogether. Legal compliance could also lead to considerably higher internal regulatory costs. Manufacturers may try to recover some or all of any increased costs of compliance by increasing the prices at which we purchase products and we may not be able to recover some or all of such increased cost in our own prices to our customers. We are also subject to state and local laws that affect our franchisor-franchisee relationships. Increased compliance costs and the loss of sales of certain products due to more stringent or new laws and regulations could adversely affect our business, financial condition and results of operations.

Laws and regulations impact our business in many areas that have no direct relation to the products we sell. For example, as a public company, we are subject to a number of laws and regulations related to the issuance and sale of our securities. Another area of intense regulation is that of the relationships we have with our employees, including compliance with many different wage/hour and nondiscrimination related regulatory schemes. Violation of any of the laws or regulations governing our business and the assertion of individual or class-wide claims could have an adverse effect on our business, financial condition and results of operations.

Product diversion could have an adverse impact on our revenues.

The majority of the products that BSG sells are meant to be used exclusively by salons and individual salon professionals or are meant to be sold exclusively by the purchasers, such as salons, to their retail consumers. However, despite BSG s efforts to prevent diversion, incidents of product diversion occur, whereby BSG products are sold by these purchasers (and possibly by other bulk purchasers such as franchisees) to middlemen and general merchandise retailers. The retailers, in turn, sell such products to consumers. The diverted product may be old, tainted or damaged and sold through unapproved outlets, all of which could diminish the value of the brand. Diversion could result in lower net sales for BSG should consumers choose to purchase diverted products from retailers rather than purchasing from BSG customers, or choose other products altogether because of the perceived loss of brand prestige.

Product diversion is generally prohibited under BSG supplier contracts and we may be under a contractual obligation to stop selling to salons, salon professionals and other bulk purchasers who engage in product diversion. Our investigation and enforcement of anti-diversion policies may result in reduced sales to our customer base, thereby decreasing our revenues.

We may not be able to successfully identify acquisition candidates or successfully complete desirable acquisitions.

In the past several years, we have completed several significant acquisitions the majority of which were for the BSG business. We intend to continue to pursue additional acquisitions in the future. Our business has in the past actively reviewed acquisition prospects that would complement its existing lines of business, increase the size and geographic scope of its operations or otherwise offer growth and operating efficiency opportunities. There can be no assurance that we will be able to identify suitable acquisition candidates.

If suitable candidates are identified, sufficient funds may not be available to make such acquisitions. We compete against many other companies, some of which are larger and have greater financial and other resources than we do. Increased competition for acquisition candidates could result in fewer acquisition opportunities and higher acquisition prices. In addition, the amount of equity that we can issue to make acquisitions or raise additional

Table of Contents

capital will be severely limited for at least two years following our separation from Alberto-Culver, which will make equity generally unavailable to fund acquisitions. Also, because we are highly leveraged and the agreements governing our indebtedness contain limits on our ability to incur additional debt, we may be unable to finance acquisitions that would increase our growth or improve our financial and competitive position. To the extent that debt financing is available to finance acquisitions, our net indebtedness could be increased as a result of any acquisitions.

If we acquire any businesses in the future, they could prove difficult to integrate, disrupt our business or have an adverse effect on our results of operations.

Any acquisitions that we do make may be difficult to integrate profitably into our business and may entail numerous risks, including:

- difficulties in assimilating acquired operations, stores or products, including the loss of key employees from acquired businesses;
- difficulties and costs associated with integrating and evaluating the internal control systems of acquired businesses;
- expenses associated with the amortization of identifiable intangible assets;
- diversion of management s attention from our core business;
- complying with foreign regulatory requirements, including multi-jurisdictional competition rules;
- enforcement of intellectual property rights in some foreign countries;
- adverse effects on existing business relationships with suppliers and customers;
- operating inefficiencies and negative impact on profitability;
- entering markets in which we have limited or no prior experience; and
- those related to general economic and political conditions, including legal and other barriers to cross-border investment in general, or by United States companies in particular.

In addition, during the acquisition process, we may fail or be unable to discover some of the liabilities of businesses that we acquire. These liabilities may result from a prior owner s noncompliance with applicable laws and regulations. Acquired businesses may also not perform as we expect or we may not be able to obtain financial improvements in acquired businesses that we may expect.

If we are unable to profitably open and operate new stores, our business, financial condition and results of operations may be adversely affected.

Our future growth depends in part on our ability to open and profitably operate new stores in existing and additional geographic markets. The capital requirements to open a Sally Beauty Supply or BSG store, excluding inventory, average approximately $66,000 and $68,000, respectively. However, we may not be able to open all of the new stores we plan to open and any new stores we open may not be profitable, either of which could have a material adverse impact on our financial condition or results of operations. There are several factors that could affect our ability to open and profitably operate new stores, including:

the inability to identify and acquire suitable sites or to negotiate acceptable leases for such sites;

proximity to existing stores that may reduce new stores sales;

difficulties in adapting our distribution and other operational and management systems to an expanded network of stores;

the potential inability to obtain adequate financing to fund expansion because of our high leverage and limitations on our ability to issue equity for at least two years following our separation from Alberto-Culver, among other things;

difficulties in obtaining any needed governmental and third-party consents, permits and licenses needed to operate additional stores; and

potential limitations on capital, expenditures which may be included in financing documents that we enter into.

If we are unable to protect our intellectual property rights, specifically our trademarks, our ability to compete could be negatively impacted.

The success of our business depends to a certain extent upon the value associated with our intellectual property rights. We own certain trademark and brand name rights used in connection with our business including, but not limited to, Sally, Sally Beauty, Sally Beauty Supply, Sally ProCard, BSG, CosmoProf, Armstrong McCall, ion an We protect our intellectual property rights through a variety of methods, including trademarks which are registered or legally protected in the United States, Canada and other countries throughout the world in which our business operates. We also rely on trade secret laws, in addition to confidentiality agreements with vendors, employees, consultants, and others who have access to our proprietary information. While we intend to vigorously protect our trademarks against infringement, we may not be successful in doing so. In addition, the laws of certain foreign countries may not protect our intellectual property rights to the same extent as the laws of the United States. The costs required to protect our intellectual property rights and trademarks are expected to continue to be substantial.

Failure to obtain the consent of third parties under our contracts could have an adverse effect on our business.

There are a number of contracts to which we or our subsidiaries are a party that provide that we must obtain the consent of the other party to the contract in connection with completion of the transactions separating us from Alberto-Culver or that provide the other party to the contract the right to terminate the contract in connection with the separation transactions. It was not a condition to completion of the separation that these consents be obtained or that the other party to the contract waive its termination right. However, failure to obtain the consent of the other party to these contracts or to have the other party waive its termination right could have an adverse effect on our business, financial condition and results of operations.

Our ability to conduct business in international markets may be affected by legal, regulatory, and economic risks.

Our ability to capitalize on growth in new international markets and to grow or maintain our current level of operations in our existing international markets is subject to risks associated with our international operations. These risks include: unexpected changes in regulatory requirements; trade barriers to some international markets; economic fluctuations in specific markets; potential difficulties in enforcing contracts, protecting assets, including intellectual property, and collecting receivables in certain foreign jurisdictions; and difficulties and costs of staffing, managing and accounting for foreign operations.

We may be adversely affected by any disruption in our information technology systems.

Our operations are dependent upon our information technology systems, which encompass all of our major business functions. We rely upon such information technology systems to manage and replenish inventory, to fill and ship customer orders on a timely basis, and to coordinate our sales activities across all of our products and services. A substantial disruption in our information technology systems for any prolonged time period (arising from, for example, system capacity limits from unexpected increases in our volume of business, outages or delays in our service) could result in delays in receiving inventory and supplies or filling customer orders and adversely affect our customer service and relationships. Our systems might be damaged or interrupted by natural or man-made events or by computer viruses, physical or electronic break-ins and similar disruptions affecting the global internet. There can be no assurance that such delays, problems, or costs will not have a material adverse effect on our financial condition, results of operations and cash flows.

Table of Contents

The occurrence of one or more natural disasters or acts of terrorism could adversely affect our operations and financial performance.

The occurrence of one or more natural disasters or acts of terrorism could result in physical damage to one or more of our properties, the temporary closure of stores or distribution centers, the temporary lack of an adequate work force in a market, the temporary or long term disruption in the supply of products from some local suppliers, the temporary disruption in the delivery of goods to our distribution centers, the temporary reduction in the availability of products in our stores and/or the temporary reduction in visits to stores by customers.

If one or more natural disasters or acts of terrorism were to impact our business, we could, among other things, incur significantly higher costs and longer lead times associated with distributing products to stores. Furthermore, insurance costs associated with our business may rise significantly in the event of a large scale natural disaster or act of terrorism.

Risks Relating to Our Substantial Indebtedness

We have substantial debt and may incur substantial additional debt, which could adversely affect our financial health and our ability to obtain financing in the future and our ability to react to changes in our business.

In connection with our separation from Alberto-Culver, certain of our subsidiaries, including Sally Holdings LLC, which we refer to as Sally Holdings and which was, prior to our separation from Alberto-Culver, a wholly-owned subsidiary of Alberto-Culver, incurred approximately $1.85 billion in debt. As of September 30, 2006, on a pro forma basis, we would have had an aggregate principal amount of approximately $1.85 billion of outstanding debt and a total debt to equity ratio of 1.84:1.00.

Our substantial debt could have important consequences to you. For example, it could:

- make it more difficult for us to satisfy our obligations to our lenders, resulting in possible defaults on and acceleration of such indebtedness;

- limit our ability to obtain additional financing for working capital, capital expenditures, acquisitions, debt service requirements, acquisitions or general corporate purposes;

- require us to dedicate a substantial portion of our cash flow from operations to the payment of principal and interest on our indebtedness, thereby reducing the availability of such cash flows to fund working capital, capital expenditures and other general corporate purposes;

- increase our vulnerability to general adverse economic and industry conditions, including interest rate fluctuations because a portion of our borrowings are at variable rates of interest, including borrowings under our senior secured term loan facilities and our asset-backed senior secured loan facility, which we refer to collectively as the senior secured credit facilities;

- place us at a competitive disadvantage compared to our competitors with proportionately less debt or comparable debt at more favorable interest rates and that, as a result, may be better positioned to withstand economic downturns;

- limit our ability to refinance indebtedness or cause the associated costs of such refinancing to increase; and limit our flexibility to adjust to changing market conditions and ability to withstand competitive pressures, or prevent us from carrying out capital spending that is necessary or important to our growth strategy and efforts to improve operating margins or our business.

Any of the foregoing impacts of our substantial indebtedness could have a material adverse effect on our business, financial condition and results of operations.

Table of Contents

Despite our current indebtedness levels, we and our subsidiaries may be able to incur substantially more debt, including secured debt. This could further exacerbate the risks associated with our substantial indebtedness.

We and our subsidiaries may be able to incur substantial additional indebtedness in the future. The terms of the instruments governing our indebtedness do not fully prohibit us or our subsidiaries from doing so. As of September 30, 2006, on a pro forma basis, our senior credit facilities, would have provided us commitments for additional borrowings of up to approximately $330 million under the asset-backed senior secured loan ABL facility, subject to borrowing base limitations. If new debt is added to our current debt levels, the related risks that we now face would increase and we may not be able to meet all our debt obligations. In addition, the agreements governing our senior credit facilities as well as the indentures governing our senior notes and senior subordinated notes, which we refer to collectively as the notes, do not prevent us from incurring obligations that do not constitute indebtedness.

The agreements and instruments governing our debt contain restrictions and limitations that could significantly impact our ability to operate our business.

The senior secured term loan facilities, which we refer to as the senior term loans, contain covenants that, among other things, restrict Sally Holdings and its subsidiaries ability to:

- dispose of assets;
- incur additional indebtedness (including guarantees of additional indebtedness);
- pay dividends, repurchase stock or make other distributions;
- prepay certain other debt or amend specific debt agreements;
- create liens on assets;
- make investments (including joint ventures);
- engage in mergers, consolidations or sales of all or substantially all of Sally Holdings assets;
- engage in certain transactions with affiliates; and
- permit restrictions on Sally Holdings subsidiaries ability to pay dividends.

The asset-backed senior secured loan facility, which we refer to as the ABL facility, contains covenants that, among other things, restrict Sally Holdings and its subsidiaries ability to:

- change their line of business;
- amend specific debt agreements;
- engage in certain mergers, consolidations and transfers of substantially all assets;
- make certain acquisitions, make certain dividends, distributions and stock repurchases and prepay certain debt, in each case to the extent any such transaction would reduce availability under the ABL facility below a specified amount; and

change the fiscal year of Sally Holdings or its direct parent.

The senior term loans contain a requirement that Sally Holdings not exceed a maximum ratio of net senior secured debt to consolidated EBITDA (as those terms are defined in the relevant credit agreement). In addition, if Sally Holdings fails to maintain a specified minimum level of borrowing capacity under the ABL facility, it will then be obligated to maintain a specified fixed-charge coverage ratio. Our ability to comply with these covenants in future periods will depend on our ongoing financial and operating performance, which in turn will be subject to economic conditions and to financial, market and competitive factors, many of which are beyond our control. Our ability to comply with these covenants in future periods will also depend substantially on the pricing of our products, our success at implementing cost reduction initiatives and our ability to successfully implement our overall business strategy.

Table of Contents

The indentures governing the notes, also contain restrictive covenants that, among other things, limit our ability and the ability of Sally Holdings and its restricted subsidiaries to:

- dispose of assets;
- incur additional indebtedness (including guarantees of additional indebtedness);
- pay dividends, repurchase stock or make other distributions;
- prepay subordinated debt;
- create liens on assets (which, in the case of the senior subordinated notes, would be limited in applicability to liens securing pari passu or subordinated indebtedness);
- make investments (including joint ventures);
- engage in mergers, consolidations or sales of all or substantially all of Sally Holdings assets;
- engage in certain transactions with affiliates; and
- permit restrictions on Sally Holdings subsidiaries ability to pay dividends.

The restrictions in the indentures governing our notes and the terms of our senior credit facilities may prevent us from taking actions that we believe would be in the best interest of our business, and may make it difficult for us to successfully execute our business strategy or effectively compete with companies that are not similarly restricted. We may also incur future debt obligations that might subject us to additional restrictive covenants that could affect our financial and operational flexibility. We cannot assure you that our subsidiaries who are borrowers under these agreements will be granted waivers or amendments to these agreements if for any reason they are unable to comply with these agreements, or that we will be able to refinance our debt on terms acceptable to us, or at all.

Our ability to comply with the covenants and restrictions contained in the senior credit facilities and the indentures for the notes may be affected by economic, financial and industry conditions beyond our control. The breach of any of these covenants or restrictions could result in a default under either the senior credit facilities or the indentures that would permit the applicable lenders or note holders, as the case may be, to declare all amounts outstanding thereunder to be due and payable, together with accrued and unpaid interest. If we are unable to repay debt, lenders having secured obligations, such as the lenders under the senior credit facilities, could proceed against the collateral securing the debt. In any such case, our subsidiaries may be unable to borrow under the senior credit facilities and may not be able to repay the amounts due under the senior credit facilities and the notes. This could have serious consequences to our financial condition and results of operations and could cause us to become bankrupt or insolvent.

Our ability to generate the significant amount of cash needed to service all of our debt and our ability to refinance all or a portion of our indebtedness or obtain additional financing depend on many factors beyond our control.

Our ability to make scheduled payments on, or to refinance our obligations under, our debt will depend on our financial and operating performance, which, in turn, will be subject to prevailing economic and competitive conditions and to the financial and business factors, many of which may be beyond our control, described under Risks Relating to Our Business above.

If our cash flow and capital resources are insufficient to fund our debt service obligations, we may be forced to reduce or delay capital expenditures, sell assets, seek to obtain additional equity capital or restructure our debt. In the future, our cash flow and capital resources may not be sufficient for payments of interest on and principal of our debt, and such alternative measures may not be successful and may not permit us to meet our scheduled debt service obligations.

We cannot assure you that we will be able to refinance any of our indebtedness or obtain additional financing, particularly because of our high levels of debt and the debt incurrence restrictions imposed by the agreements governing our debt, as well as prevailing market conditions. In the absence of such operating results and resources, we could face substantial liquidity problems and might be required to dispose of material assets or operations to meet our debt service and other obligations. Our senior credit facilities and the indentures governing the notes will restrict our ability to dispose of assets and use the proceeds from any such dispositions. We cannot assure you we will be able to consummate those sales, or if we do, what the timing of the sales will be or whether the proceeds that we realize will be adequate to meet debt service obligations when due.

An increase in interest rates would increase the cost of servicing our debt and could reduce our profitability.

A significant portion of our outstanding debt, including under our senior credit facilities, bears interest at variable rates. As a result, an increase in interest rates, whether because of an increase in market interest rates or a decrease in our creditworthiness, would increase the cost of servicing our debt and could materially reduce our profitability and cash flows. The impact of such an increase would be more significant for us than it would be for some other companies because of our substantial debt.

Risks Relating to the Tax Treatment of Our Separation from Alberto-Culver and Relating To Our Largest Stockholder

If the share distribution of Alberto-Culver common stock in the transaction separating our company from Alberto-Culver did not constitute a tax-free distribution under Section 355 of the Internal Revenue Code, then we may be responsible for payment of significant U.S. federal income taxes.

The following discussion describes the risk that the share distribution of Alberto-Culver common stock in the transaction separating our company from Alberto-Culver may have triggered significant tax liabilities for us.

In connection with the share distribution of Alberto-Culver common stock in the separation, we received (i) a private letter ruling from the Internal Revenue Service and (ii) an opinion of Sidley Austin LLP, counsel to Alberto-Culver, in each case, to the effect that the transactions qualify as a reorganization under Section 368(a)(1)(D) of the Internal Revenue Code and a distribution eligible for non-recognition under Sections 355(a) and 361(c) of the Internal Revenue Code. The private letter ruling and the opinion of counsel were based, in part, on assumptions and representations as to factual matters made by, among others, Alberto-Culver, us and representatives of Mrs. Carol L. Bernick, Mr. Leonard H. Lavin and certain of our other stockholders to whom we refer as the Lavin family stockholders, as requested by the Internal Revenue Service or counsel, which, if incorrect, could jeopardize the conclusions reached by the Internal Revenue Service and counsel. The private letter ruling also did not address certain material legal issues that could affect its conclusions, and reserved the right of the Internal Revenue Service to raise such issues upon a subsequent audit. Opinions of counsel neither bind the Internal Revenue Service or any court, nor preclude the Internal Revenue Service from adopting a contrary position.

If the Alberto-Culver share distribution were not to qualify as a tax-free distribution under Section 355 of the Internal Revenue Code, we would recognize taxable gain equal to the excess of the fair market value of the Alberto-Culver common stock distributed to our stockholders over our tax basis in the Alberto-Culver common stock.

Even if the Alberto-Culver share distribution otherwise qualified as a tax-free distribution under Section 355 of the Internal Revenue Code, it would result in significant U.S. federal income tax liabilities to us if there is an acquisition of our stock or stock of Alberto-Culver as part of a plan or series of related transactions that includes the Alberto-Culver share distribution and that results in an acquisition of 50% or more of Alberto-Culver s or our outstanding common stock.

In the event that we recognize a taxable gain in connection with the Alberto-Culver share distribution (either (i) because the Alberto-Culver share distribution did not qualify as a tax-free distribution under Section 355 of the Internal Revenue Code or (ii) because of an acquisition of 50% or more of Alberto-Culver or our outstanding common stock as part of a plan or series of related transactions that includes the Alberto-Culver share distribution), the taxable gain recognized by us would result in significant U.S. federal income tax liabilities to us. Under the Internal Revenue Code, we would be primarily liable for these taxes (for which Alberto-Culver may be required to indemnify us under the tax allocation agreement, and there can be no assurance that Alberto-Culver would be able to fulfill its obligations under the tax allocation agreement if Alberto-Culver was determined to be responsible for these taxes thereunder).

Table of Contents

For purposes of determining whether the distribution of Alberto-Culver common stock to our stockholders in connection with the Alberto-Culver share distribution is disqualified as tax-free to us under the rules described in the second preceding paragraph, any acquisitions of our stock or the stock of Alberto-Culver within two years before or after the Alberto-Culver share distribution are presumed to be part of a plan, although the parties may be able to rebut that presumption. For purposes of this test, the acquisition by CDR investors, of 48% of our outstanding common stock on an undiluted basis that occurred in connection with our separation from Alberto-Culver will be treated as part of such a plan or series of transactions. Thus, a relatively minor additional change in the ownership of our common stock could trigger a significant tax liability for us under Section 355 of the Internal Revenue Code.

The process for determining whether a prohibited change in control has occurred under the rules is complex, inherently factual and subject to interpretation of the facts and circumstances of a particular case. If Alberto-Culver does not carefully monitor its, or we do not carefully monitor our, compliance with these rules, this might inadvertently cause or permit a prohibited change in the ownership of us or of Alberto-Culver to occur, thereby triggering Alberto-Culver s or our respective obligations to indemnify the other pursuant to the tax allocation agreement, which would have a material adverse effect on us and/or Alberto-Culver. We will be primarily liable for these taxes, and there can be no assurance that Alberto-Culver would be able to fulfill its obligations under the tax allocation agreement if Alberto-Culver was determined to be responsible for these taxes thereunder. In addition, these mutual indemnity obligations could discourage or prevent a third party from making a proposal to acquire us.

Actions taken by the Lavin family stockholders or by the CDR investors could adversely affect the tax-free nature of the share distribution of Alberto-Culver common stock in connection with the transactions separating our company from Alberto-Culver.

Sales and/or acquisitions by the Lavin family stockholders of our common stock or Alberto-Culver common stock may adversely affect the tax-free nature of the share distribution of Alberto-Culver common stock in the transaction separating our company from Alberto-Culver. First, with certain exceptions, sales by the Lavin family stockholders of our common stock or Alberto-Culver common stock at any time after the separation transaction might be considered evidence that the share distribution was used principally as a device for the distribution of earnings and profits, particularly if the selling stockholder were found to have an intent to effect such sale at the time of the share distribution. If the Internal Revenue Service successfully asserted that the share distribution was used principally as such a device, the share distribution would not qualify as a tax-free distribution, and thus would be taxable to us. Second, with certain exceptions, if any of the Lavin family stockholders were to sell an amount of our common stock that it received in connection with the separation transaction (or to acquire additional shares of our common stock) within the two year period following completion of the Alberto-Culver share distribution, and that amount of stock, if added to the common stock comprising approximately 48% of our outstanding common stock on an undiluted basis that was acquired by CDR investors were to equal or exceed 50% of our outstanding common stock, as determined under the Internal Revenue Code and applicable Treasury regulations, a deemed acquisition of control of us in connection with the Alberto-Culver share distribution would be presumed. If this presumption were not rebutted, we would be subject to significant U.S. federal income tax liabilities, which, if not reimbursed by Alberto-Culver, would have a material adverse effect on us. Similarly, acquisitions by the CDR investors or their affiliates of our common stock may cause a deemed acquisition of control of us in connection with the Alberto-Culver share distribution.

We are affected by significant restrictions on our ability to issue equity securities following completion of the transactions separating our company from Alberto-Culver.

Because of certain limitations imposed by the Internal Revenue Code and regulations thereunder, the amount of equity that we can issue to make acquisitions or raise additional capital is severely limited and will continue to be so for at least two years following completion of the transactions separating us from Alberto-Culver. These limitations may restrict our ability to carry out our business objectives and to take advantage of opportunities that could be favorable to our business. In addition, because we, through our subsidiaries, incurred approximately $1.85 billion in debt in connection with those transactions, and the instruments governing our indebtedness contain limits on our ability to incur additional debt, our inability to raise even a small amount of equity capital at a time when we need additional capital could have a material adverse effect on our ability to service our debt and operate our business.

Table of Contents

The voting power of our largest stockholder may discourage third party acquisitions of us at a premium.

CDRS, our largest stockholder, owns approximately 48% of our outstanding common stock on an undiluted basis. Pursuant to the stockholders agreement entered into by us, the CDR investors and the Lavin family stockholders, which we refer to as the stockholders agreement, CDRS has designated five of our initial eleven directors, as well as the Chairman of the Board, and CDRS rights to nominate certain numbers of directors will continue so long as it owns specified percentages of our common stock. The CDR investors ownership of our common stock may have the effect of discouraging offers to acquire control of us and may preclude holders of our common stock from receiving any premium above market price for their shares that may otherwise be offered in connection with any attempt to acquire control of us.

The interests of our largest stockholder may differ from the interests of other holders of our common stock.

CDRS owns approximately 48% of our outstanding common stock on an undiluted basis. The interests of CDRS may differ from those of other holders of our common stock in material respects. For example, CDRS may have an interest in pursuing acquisitions, divestitures, financings or other transactions that, in its judgment, could enhance its overall equity portfolio, even though such transactions might involve risks to holders of our common stock. The manager of CDRS ultimate parent is in the business of making investments in companies, and may from time to time in the future, acquire interests in businesses that directly or indirectly compete with certain portions of our business or are suppliers of our customers. Additionally, CDRS may determine that the disposition of some or all of its interests in us would be beneficial to it at a time when such disposition could be detrimental to the other holders of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

Substantially all of our store and warehouse locations are leased and our corporate headquarters and four warehouses/distribution centers are owned. The average store lease is for a term of five years with customary renewal options. The following table provides the number of stores in the U.S. and globally, as of September 30, 2006:

		Beauty Systems Group	
Location	**Sally Beauty Supply**	**Company-Owned**	**Franchise**
United States	2,181	588	138
International:			
Puerto Rico	32		
United Kingdom	188		
Canada	9	70	
Japan	32		
Germany	27		
Mexico	40		32
Ireland	2		
Total International	330	70	32
Total Store Count	2,511	658	170

Table of Contents

The following table provides locations for significant offices and warehouses and our corporate headquarters, as of September 30, 2006:

Location	Type of Facility	Business Segment
Company-Owned Properties:		
Columbus, Ohio	Warehouse	(1)
Denton, Texas	Corporate Headquarters	(1)(2)
Denton, Texas	Warehouse	(1)(2)
Jacksonville, Florida	Warehouse	(1)
Reno, Nevada	Warehouse	(1)
Leased Properties:		
Austin, Texas	Office, Warehouse	(2)
Benicia, California	Office, Warehouse	(2)
Blackburn, Lancashire, England	Warehouse	(1)
Calgary, Alberta, Canada	Office, Warehouse	(2)
Chatsworth, California	Office, Warehouse	(2)
Greenville, Ohio	Office, Warehouse	(2)
Macedonia, Ohio	Office	(2)
Mississauga, Ontario, Canada	Office, Warehouse	(2)
Reading, Berkshire, England	Office	(1)
Spartanburg, South Carolina	Office, Warehouse	(2)
Aylesbury, Buckinghamshire, England	Office, Warehouse	(2)
Monterrey, Nuevo Leon, Mexico	Office, Warehouse	(1)

(1) Sally Beauty Supply

(2) BSG

ITEM 3. LEGAL PROCEEDINGS

There were no material legal proceedings pending against us or our subsidiaries, as of September 30, 2006. We are involved in various claims and lawsuits incidental to the conduct of our business in the ordinary course. We carry insurance coverage in such amounts in excess of our self-insured retention as we believe to be reasonable under the circumstances and that may or may not cover any or all of our liabilities in respect of claims and lawsuits. We do not believe that the ultimate resolution of these matters will have a material adverse impact on our consolidated financial position, cash flows or results of operations.

We are subject to a number of U.S., federal, state and local laws and regulations, as well as the laws and regulations applicable in each other market in which we do business. These laws and regulations govern, among other things, the composition, packaging, labeling and safety of the products we sell and the methods we use to sell these products. We believe that we are in material compliance with such laws and regulations, although no assurance can be provided that this will remain true going forward.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is listed on The New York Stock Exchange, Inc. or the NYSE under the symbol SBH. When-issued trading of our common stock commenced on November 13, 2006 and regular-way trading of our common stock commenced on November 17, 2006, the day after our separation from Alberto-Culver. Prior to when-issued

Table of Contents

trading of our common stock on November 13, 2006, there was no established public trading market for our common stock.

As of December 14, 2006, there were 1,731 stockholders of record of our common stock and the closing price of our stock as reported by the NYSE was $9.89.

Dividends

In connection with our separation from Alberto-Culver, on November 16, 2006, we distributed: (i) a share of common stock of New Aristotle Holdings, Inc. (subsequently renamed Alberto-Culver Company) and (ii) a special cash dividend of $25.00 to Alberto-Culver stockholders for each share of our common stock held as of the record date of the separation. Other than the distributions described above, we have not declared or paid dividends at any time prior to the date of this report.

We currently anticipate that we will retain future earnings to support our growth strategy or to repay outstanding debt. We do not anticipate paying regular cash dividends on our common stock in the foreseeable future. Any payment of future cash dividends will be at the discretion of our Board of Directors and will depend upon, among other things, future earnings, operations, capital requirements, our general financial condition, contractual restrictions and general business conditions. We depend on our subsidiaries for cash and unless we receive dividends, distributions, advances, transfers of funds or other cash payments from our subsidiaries, we will be unable to pay any cash dividends on our common stock in the future. However, none of our subsidiaries are obligated to make funds available to us for payment of dividends. Further, the terms of our subsidiaries debt agreements significantly restrict the ability of our subsidiaries to pay dividends or otherwise transfer assets to us. Finally, we and our subsidiaries may be able to incur substantial additional indebtedness in the future that may severely restrict or prohibit our subsidiaries from making distributions, paying dividends or making loans to us.

ITEM 6. SELECTED FINANCIAL DATA

The following tables present selected financial data of Sally Holdings, Inc. and its consolidated subsidiaries for the five years ended September 30, 2006 (in thousands). Sally Holdings, Inc. was a wholly owned subsidiary of Alberto-Culver until November 16, 2006 when it was converted to a Delaware limited liability company, was renamed Sally Holdings LLC, and became an indirect wholly owned subsidiary of our company in connection with the separation of our business from Alberto-Culver. Our company, Sally Beauty Holdings, Inc., was formed on June 16, 2006 in connection with the separation of our business from Alberto-Culver Company.

	Fiscal Year Ended September 30,				
	2006	**2005**	**2004**	**2003**	**2002**
Results of operations information:					
Net sales	$ 2,373,100	$ 2,254,307	$ 2,097,667	$ 1,824,008	$ 1,667,052
Cost of products sold and distribution expenses	1,286,329	1,227,307	1,146,814	1,016,941	952,096
Gross profit	1,086,771	1,027,000	950,853	807,067	714,956
Selling, general and administrative expenses	822,695	789,447	711,208	597,175	527,971
Corporate charges from Alberto-Culver	42,400	40,921	42,990	39,827	30,896
Non-cash charge related to Alberto-Culver s conversion to one class of common stock		4,051	27,036		
Transaction expenses	41,475				
Total operating earnings	180,201	192,581	169,619	170,065	156,089
Interest expense, net of interest income	92	2,966	2,250	347	1,279
Earnings before provision for income taxes	180,109(a)	189,615(b)	167,369(c)	169,718	154,810
Provision for income taxes	69,916(a)	73,154(b)	62,059(c)	62,205	57,026
Net earnings	$ 110,193(a)	$ 116,461(b)	$ 105,310(c)	$ 107,513	$ 97,784
Operating data:					
Number of retail stores (end of period):					
Sally Beauty Supply	2,511	2,419	2,355	2,272	2,177
Beauty Systems Group	828	822	692	543	535
Total	3,339	3,241	3,047	2,815	2,712
Professional distributor sales consultants (end of period)	1,192	1,244	1,167	989	930
Comparable store sales growth(d):					
Sally Beauty Supply	2.4%	2.4%	3.8%	2.7%	5.7%
Beauty Systems Group	4.1%	(0.6%)	8.5%	4.6%	4.4%
Consolidated	2.8%	1.8%	4.6%	3.8%	5.5%
Financial condition information (at period end):					
Working capital	$ 479,107	$ 382,482	$ 377,708	$ 383,643	$ 300,585

Cash, cash equivalents and short-term investments	107,571	38,612	68,003	118,214	71,497
Property, plant and equipment, net	142,735	149,354	125,810	93,691	81,497
Total assets	1,338,841	1,225,507	1,102,428	932,163	838,724
Long-term debt, including notes payable to affiliated companies	621	18,828	34,872	24,173	12,747
Stockholder s equity	$ 1,005,967	$ 900,296	$ 786,163	$ 678,166	$ 575,868

Earnings per share, book value per share and cash dividends per share are not presented, as Alberto-Culver owned all shares issued and outstanding as of September 30, 2006.

(a) Effective October 1, 2005, Sally Holdings adopted SFAS No. 123(R) using the modified prospective method. Under this method, compensation expense is recognized for new stock option grants beginning in fiscal year 2006 and for the unvested portion of outstanding stock options that were granted prior to the adoption of SFAS No. 123(R). As a result, Sally Holdings recorded stock option expense for the twelve months ended September 30, 2006 that reduced earnings before provision for income taxes by $5.2 million, provision for income taxes by $1.8 million and net earnings by $3.4 million. In accordance with the modified prospective method under SFAS No. 123(R), the financial statements of Sally Holdings for prior periods have not been restated. Fiscal year 2006 also includes transaction expenses, which reduced earnings before provision for income taxes by $41.5 million, provision for income taxes by $14.3 million and net earnings by $27.2 million. In total, these two non-core items reduced earnings before provision for income taxes by $46.7 million, provision for income taxes by $16.1 million and net earnings by $30.6 million.

(b) Fiscal year 2005 includes a non-cash charge related to Alberto-Culver s conversion to one class of common stock. For the full fiscal year 2005, this non-cash charge reduced earnings before provision for income taxes by $4.1 million, provision for income taxes by $1.5 million and net earnings by $2.6 million.

(c) Fiscal year 2004 includes a non-cash charge related to Alberto-Culver s conversion to one class of common stock which reduced earnings before provision for income taxes by $27.0 million, provision for income taxes by $9.4 million and net earnings by $17.6 million.

(d) Comparable stores are defined as company-owned stores that have been open for at least 14 months as of the last day of a month.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following section discusses management s view of the operations and financial condition of Sally Holdings, Inc. and its consolidated subsidiaries, as of and for the fiscal years ended September 30, 2006, 2005 and 2004. Sally Holdings, Inc. was a wholly owned subsidiary of Alberto-Culver until November 16, 2006 when it was converted to a Delaware limited liability company, was renamed Sally Holdings LLC, and became an indirect wholly owned subsidiary of our company in connection with the separation of our business from Alberto-Culver. Sally Beauty Holdings, Inc. was formed on June 16, 2006 in connection with the separation of our business from Alberto-Culver Company. This section should be read in conjunction with the audited consolidated financial statements of Sally Holdings, Inc. and the related notes included elsewhere in this annual report. This Management s Discussion and Analysis of Financial Condition and Results of Operations of Sally Holdings contains forward-looking statements. See Forward-Looking Statements below for a discussion of the uncertainties, risks and assumptions associated with these forward-looking statements that could cause results to differ materially from those reflected in such forward-looking statements.

Overview

Description of Business

We are the largest distributor of professional beauty supplies in the United States based on store count. We operate primarily through two business units, Sally Beauty Supply and BSG. Through Sally Beauty Supply and BSG, we operated a multi-channel platform of 3,169 stores and supplied 170 franchised stores in North America as well as selected European countries and Japan, as of September 30, 2006. Within BSG, we also have one of the largest networks of professional distributor sales consultants in North America, with approximately 1,200 professional distributor sales consultants who sell directly to salons and salon professionals. We provide our customers with a wide variety of leading third-party branded and private label professional beauty supplies, including hair care products, styling appliances, skin and nail care products and other beauty items. Sally Beauty Supply stores target retail consumers and salon professionals, while BSG exclusively targets salons and salon professionals. For the year ended September 30, 2006, our net sales and operating earnings were $2,373.1 million and $180.2 million, respectively.

Sally Beauty Supply is the largest open-line distributor of professional beauty supplies in the U.S. based on store count. As of September 30, 2006, Sally Beauty Supply operated 2,511 retail stores, 2,181 in the U.S. and the remainder in the United Kingdom, Canada, Puerto Rico, Mexico, Japan, Ireland and Germany. Sally Beauty Supply stores average 1,700 square feet and are primarily located in strip shopping centers. The product selection in Sally Beauty Supply stores ranges between 5,400 and 7,400 SKU s of beauty products, includes products for hair care, nail care, beauty sundries and appliances, targeting retail consumers and salon professionals. Sally Beauty Supply stores carry leading third-party brands such as Clairol, Revlon, Conair and L Oreal, as well as an extensive selection of private label merchandise. For the year ended September 30, 2006, Sally Beauty Supply s net sales and segment operating profit were $1,419.3 million and $188.8 million, respectively, representing 59.8% and 73.8% of consolidated net sales and segment operating profit, respectively.

We believe BSG is the largest full-service distributor of professional beauty supplies in the U.S. As of September 30, 2006, BSG operated 658 company-owned stores, supplied 170 franchised stores and had a sales force of approximately 1,200 professional distributor sales consultants selling exclusively to salons and salon professionals in 43 U.S. states and portions of Canada, Mexico and certain European countries. BSG stores average 2,800 square feet and are primarily located in secondary strip shopping centers. Through BSG s large store base and sales force, BSG is able to access a significant portion of the highly fragmented U.S. salon market. The product selection in BSG stores, ranging between 3,700 and 9,500 SKUs of beauty products, includes hair care, nail care, beauty sundries and appliances targeting salons and salon professionals. BSG carries leading professional beauty product brands, intended for use in salons and for resale by the salon to consumers. Certain BSG products are sold under exclusive distribution agreements with suppliers, whereby BSG is designated as the sole distributor for a product line within certain geographic territories. For the year ended September 30, 2006, BSG s net sales and

Table of Contents

segment operating profit were $953.8 million and $66.9 million, respectively, representing 40.2% and 26.2% of consolidated net sales and segment operating profit, respectively.

Market and Industry Trends

We operate within the large and growing U.S. professional beauty supply industry. Potential growth in the industry is expected to be driven by increases in hair color, hair loss prevention and hair styling products. We believe the following key industry trends and characteristics will influence our business going forward:

High level of customer fragmentation. The U.S. salon market is highly fragmented with over 230,000 salons in the U.S. Given the fragmented and small-scale nature of the salon industry, we believe that salon operators will continue to depend on full service/exclusive distributors and open-line channels for a majority of their beauty supply purchases.

Growth in booth renting. Booth renters are responsible for purchasing their own supplies. Historically, booth renters have significantly increased as a percentage of total salon professionals and we expect this trend to continue. Given their smaller individual purchases and relative lack of financial resources, booth renters are likely to be dependent on frequent trips to professional beauty supply stores, like BSG and Sally Beauty Supply.

Frequent re-stocking needs. Salon professionals primarily rely on just-in-time inventory due to capital constraints and a lack of warehouse and shelf space at salons. These factors are key to driving demand for conveniently located professional beauty supply stores.

Continuing consolidation. There is continuing consolidation among professional beauty product distributors and professional beauty product manufacturers. We believe that suppliers are increasingly likely to focus on larger distributors and retailers with broader scale and retail footprint. We also believe that we are well-positioned to capitalize on this trend as well as participate in the ongoing consolidation at the distributor / retail level. However, changes often occur in our relationships with suppliers that can materially affect the net sales and operating profits of our business segments. Consolidation among suppliers could exacerbate the effects of these relationship changes and could increase pricing pressures.

High level of competition. Sally Beauty Supply competes with other domestic and international beauty product wholesale and retail outlets, including local and regional cash-and-carry beauty supply stores, professional-only beauty supply stores, salons, mass merchandisers, drug stores and supermarkets, as well as sellers on the Internet and salons retailing hair care items. BSG competes with other domestic and international beauty product wholesale and retail suppliers and manufacturers selling professional beauty products directly to salons and individual salon professionals. We also face competition from authorized and unauthorized retailers and Internet sites offering professional salon-only products.

Favorable demographic and consumer trends. The aging baby-boomer population is expected to drive future growth in professional beauty supply sales through an increase in the usage of hair color and hair- loss products. Additionally, continuously changing fashion-related trends that drive new hair styles are expected to result in continued demand for hair styling products.

Relationships With Suppliers

Most of the net sales of Sally Beauty Supply and BSG are generated through retail stores with respect to the Sally Beauty Supply business and both professional only stores and professional distribution sales consultants with respect to the BSG business. In addition, BSG has a number of franchisees located primarily in the south and southwestern portions of the United States and in Mexico, which buy products directly from BSG for resale in their assigned territories. A very small percentage of sales are generated through sub-distributors (primarily in Europe), which also buy products directly from BSG for resale in their assigned territories. Sally Beauty Supply / BSG and their suppliers are dependent on each other for the distribution of beauty products. As is typical in distribution businesses, these relationships are subject to change from time to time (including the expansion or loss of distribution rights in various geographies and the addition or loss of products lines). Changes in our relationships with suppliers occur often, and could positively or negatively impact our net sales and operating profits. For example, as discussed in Risk Factors, We depend upon manufacturers who may be unable to provide products of adequate quality or who may be unwilling to continue to supply products to us, our net sales and operating profits were negatively affected in fiscal year 2005 by the decision of certain suppliers of the BSG business to begin selling their products directly to salons in most markets. Subsequently, in fiscal year 2006 one of those suppliers agreed to have BSG, once again, sell its product lines in BSG stores.

On December 19, 2006, we announced that (1) BSG, other than its Armstrong-McCall division, will not retain its rights to distribute the professional products of L Oreal through its distributor sales consultants (effective January 30, 2007, with exclusivity ending December 31, 2006) or in its stores on an exclusive basis (effective January 1, 2007) in those geographic areas within the U.S. in which BSG currently has distribution rights, and (2) BSG s Armstrong McCall division will not retain the rights to distribute Redken professional products through distributor sales consultants or its stores. In replacement of these rights, BSG entered into long-term agreements with L Oreal under which, as of January 1, 2007, BSG will have non-exclusive rights to distribute the same L Oreal professional products in its stores that it previously had exclusive rights to in its stores and through its sales consultants. Armstrong McCall will retain its exclusive rights to distribute Matrix professional products in its territories. We expect the impact of the loss of BSG s exclusive rights to distribute L Oreal professional products in BSG stores and by its distributor sales consultants to negatively impact our consolidated revenue by approximately $110 million during the last nine months of our 2007 fiscal year. This number includes anticipated ancillary impact on revenue from other products that may be indirectly affected by these developments.

We believe that we can mitigate some of the negative impact resulting from unfavorable changes in our relationship with L Oreal by taking the following steps: (i) BSG intends to begin marketing certain product lines that were previously unavailable through its outlets and also to expand existing product lines in new territories; (ii) BSG will be exploring ways to maximize the efficiency of its structure to mitigate the impact of these developments; (iii) BSG will encourage, through financial incentives, the retention of distributor sales consultants needed to effect the new business plan; (iv) BSG expects to shift a portion of its L Oreal distribution business into stores, and (v) BSG intends to continue expanding its business into underserved geographic areas, including Florida.

Recent Acquisitions

We made three significant acquisitions during the last three fiscal years. In December 2004, we acquired several commonly-owned full-service distributors of professional beauty products doing business under various brand names, including CosmoProf , for an aggregate purchase price of $91.2 million. This acquisition opened the Los Angeles, California and Hawaii markets to BSG, as well as strengthened its position in the Pacific Northwest. In December, 2003, we acquired substantially all of the assets of West Coast Beauty Supply, a full-service distributor of professional beauty products based in Benicia, California, for an aggregate purchase price of $139.3 million. These acquisitions expanded the geographic area served by BSG into the western United States and moved us closer to our goal of making BSG a nationwide full-service distributor.

In addition, during June 2006, we acquired Salon Success, a U.K. based distributor of professional beauty products in order to expand BSG s presence in the U.K. and expand the geographic area served by BSG into other portions of Europe. This acquisition enabled BSG to enter new markets in Europe, including the U.K., Spain and the Netherlands and to expand its operations in Florida. The total purchase price at September 30, 2006 was $22.2 million. Approximately $1.8 million of the estimated purchase price will be paid in equal annual amounts over the three years following the closing of the acquisition. In accordance with the purchase agreement, additional consideration of up to $2.1 million may be paid over the same three-year period based on sales to a specific customer.

Our Separation from Alberto-Culver

Our business historically constituted two operating segments within the consolidated financial statements of Alberto-Culver. On November 16, 2006, we separated from Alberto-Culver, pursuant to the Investment Agreement, dated as of June 19, 2006, as amended, among us, Alberto-Culver, CDRS and others, which we refer to as the investment agreement. As a result of the separation, (i) we own and operate the Sally Beauty Supply and BSG distribution businesses that were owned and operated by Alberto-Culver prior to the separation, (ii) at the closing of the separation transaction, the stockholders of Alberto-Culver prior to the separation became the beneficial owners of approximately 52% of our outstanding common stock on an undiluted basis and the CDR investors, who in the aggregate invested $575 million in our company, received an equity interest representing approximately 48% of our outstanding common stock on an undiluted basis and (iii) Alberto-Culver continues to own and operate its consumer products business.

In addition, on November 16, 2006, in connection with our separation from Alberto-Culver:

Sally Holdings and certain of our other subsidiaries incurred approximately $1,850 million of indebtedness, including (i) $1,070.0 million by drawing on its two senior term loan facilities, (ii) $70.0 million by drawing on its ABL facility and (iii) $710 million from the issuance of $430.0 million of senior notes and $280.0 million of senior subordinated notes;

We used approximately $2,342 million, a substantial portion of the proceeds of the investment by the CDR investors and the debt incurrence, to pay a $25.00 per share special cash dividend to holders of record of our common stock, who were Alberto-Culver shareholders as of the record date for the separation transactions.

Alberto-Culver treated our separation from it as though it constituted a change in control for all employees and directors under its equity and incentive compensation plans and as a change in control for our employees under its deferred compensation plan. Accordingly, options to purchase Alberto-Culver common stock issued under Alberto-Culver equity compensation plans outstanding as of the completion of the separation and held by our employees and John A. Miller, who was a non-employee director of Alberto-Culver prior to the separation and is a member of our Board of Directors, became fully exercisable options to purchase our common stock. Restrictions on restricted stock issued under Alberto-Culver equity compensation plans prior to completion of the separation, including restricted stock held by executive officers of Alberto-Culver, lapsed on November 16, 2006. We estimate to record a one-time charge of $5.3 million during the first quarter of fiscal year 2007 for the amount of future compensation expense that would have been recognized in subsequent periods as the stock options and restricted shares for our employees vested over the original vesting periods.

On November 16, 2006, pursuant to the investment agreement, we paid a transaction fee of $30 million to Clayton, Dubilier & Rice, Inc., the manager of both Clayton, Dubilier & Rice Fund VII, L.P., the sole member of CDRS, and Parallel Fund. In addition, we paid CDRS a portion of the expenses it incurred in connection with its investment in our company and our separation from Alberto-Culver and will pay the remainder of CDRS expenses to it at a later date. Pursuant to the investment agreement, we also paid approximately $20.1 million to Alberto-Culver for its expenses incurred in connection with the separation. We also paid approximately an additional $48.4 million as fees for the debt financing incurred by our subsidiaries in connection with the separation. Transaction expenses and the expenses of Alberto-Culver that are allocated to us are being expensed by us during the first quarter ending December 31, 2006. A transaction cost analysis is being performed to identify expenses associated with the debt financing that will be deferred and amortized in future periods.

On November 16, 2006, pursuant to the terms of the separation agreement entered into in connection with our separation from Alberto-Culver, all of our and our subsidiaries cash, cash equivalents and short-term investments subsidiaries were transferred to Alberto-Culver other than $91.1 million, equal to the sum of $52.7 million plus an additional amount equal to $38.4 million, which is the sum of (i) an estimate of the amount needed to cover certain income taxes (as specified in the tax allocation agreement entered into in connection with our separation from Alberto-Culver), (ii) an amount determined pursuant to a formula intended to reflect the limitations placed on the number of our shares that the CDR investors were able to acquire without jeopardizing the intended tax-free nature of the share distribution of shares of Alberto-Culver common stock to our stockholders in connection with the separation, and (iii) unpaid balances on certain of our specified liabilities, minus other specified transaction costs. These amounts are subject to an adjustment as determined under the terms of the separation and tax allocation agreements. All intercompany receivables, payables and loans between us and our subsidiaries, on the one hand, and Alberto-Culver and its subsidiaries, on the other hand, other than those specifically designated in the separation agreement to survive following the separation, were canceled immediately prior to the time of the distributions we made on November 16, 2006, in connection with the separation. In addition, prior thereto, all intercompany agreements between us and our subsidiaries and Alberto-Culver and its subsidiaries terminated, other than certain agreements specifically designated in the separation agreement to survive following the separation.

Table of Contents

In addition, upon completion of the separation, Michael H. Renzulli, former Chairman of Sally Holdings, terminated his employment with Alberto-Culver and us. We provided Mr. Renzulli with certain benefits primarily consisting of a lump-sum cash payment of $3.6 million within 30 days after completion of the separation. We are expensing the cash payment during the quarter ending December 31, 2006.

The senior term loan facilities are secured by substantially all of the assets of Sally Holdings and its subsidiaries. The senior term loan facilities may be prepaid at Sally Holdings option at any time without premium or penalty and are subject to mandatory prepayment in an amount equal to 50% excess cash flow for any fiscal year unless a specified leverage ratio is met and 100% of the proceeds of specified asset sales that are not reinvested in the business or applied to repay borrowings under the asset-based lending credit facility.

The notes are unsecured obligations of Sally Holdings and its co-issuers and are guaranteed on a senior basis (in the case of the senior notes) and on a senior subordinated basis (in the case of the senior subordinated notes) by each domestic subsidiary of Sally Holdings (other than the co-issuer), issuer of the notes. The senior notes and the senior subordinated notes carry optional redemption features whereby Sally Holdings has the option to redeem the notes on or before November 15, 2010 and November 15, 2011, respectively, at par plus a premium, plus accrued and unpaid interest, and on or after November 15, 2010 and November 15, 2011, respectively, at par plus a premium declining ratably to par, plus accrued and unpaid interest.

Details of the debt issued on November 16, 2006 are as follows (dollars in thousands):

	Amount	**Maturity dates (fiscal year)**		**Interest rates**
Revolving credit facilities	$ 70,000	2011	(i)	PRIME and up to 0.50% or;
			(ii)	LIBOR plus (1.0% to 1.50%)
Term loan A	150,000	2012	(i)	PRIME plus (1.00% to 1.50%) or;
			(ii)	LIBOR plus (2.00% to 2.50%)
Term loan B	920,000	2013	(i)	PRIME plus (1.25% to 1.50%) or;