

BLUE NILE INC  
 Form 10-Q  
 November 04, 2014  
Table of Contents

UNITED STATES  
 SECURITIES AND EXCHANGE COMMISSION  
 WASHINGTON, DC 20549

---

FORM 10-Q

---

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

For the quarterly period ended September 28, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
 Commission file number 000-50763

---

BLUE NILE, INC.  
 (Exact name of registrant as specified in its charter)

---

Delaware	91-1963165
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

411 First Avenue South, Suite 700, Seattle, Washington	98104
(Address of principal executive offices)	(Zip code)
(206) 336-6700	
(Registrant's telephone number, including area code)	

---

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
 Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer

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

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

As of October 28, 2014, the registrant had 11,845,623 shares of common stock outstanding.



Table of Contents

Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements that involve many risks and uncertainties. These statements, which relate to future events and our future performance, are based on current expectations, estimates, forecasts and projections about the industries in which we operate and the beliefs and assumptions of our management as of the date of this filing. In some cases, you can identify forward-looking statements by terms such as “would,” “could,” “may,” “will,” “should,” “expect,” “intend,” “plan,” “anticipate,” “believe,” “estimate,” “might”, “predict,” “seek,” or “continue,” the negative of these terms or other variations of such terms. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business and other characterizations of future events or circumstances are forward-looking statements. These statements are only predictions based upon assumptions made that are believed to be reasonable at the time, and are subject to risk and uncertainties. Therefore, actual events or results may differ materially and adversely from those expressed in any forward-looking statement. In evaluating these statements, you should specifically consider the risks described under the caption “Item 1A — Risk Factors” and elsewhere in this Quarterly Report on Form 10-Q. These factors, and other factors, may cause our actual results to differ materially from any forward-looking statement. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Table of Contents

BLUE NILE, INC.  
INDEX

	Page
PART I. FINANCIAL INFORMATION	
Item 1. <u>Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets (unaudited)</u>	4
<u>Condensed Consolidated Statements of Operations (unaudited)</u>	5
<u>Condensed Consolidated Statements of Comprehensive Income (unaudited)</u>	6
<u>Condensed Consolidated Statement of Changes in Stockholders' Equity (unaudited)</u>	7
<u>Condensed Consolidated Statements of Cash Flows (unaudited)</u>	8
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	9
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	20
Item 4. <u>Controls and Procedures</u>	20
PART II. OTHER INFORMATION	
Item 1A. <u>Risk Factors</u>	21
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	34
Item 6. <u>Exhibits</u>	35
<u>SIGNATURES</u>	36

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## BLUE NILE, INC.

## Condensed Consolidated Balance Sheets

(unaudited)

(in thousands, except par value)

	September 28, 2014	December 29, 2013	September 29, 2013
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$32,324	\$115,942	\$47,930
Trade accounts receivable	3,032	3,005	2,513
Other accounts receivable	468	521	2,434
Inventories	33,084	34,530	30,934
Deferred income taxes	742	1,038	684
Prepaid income taxes	297	247	1,607
Prepays and other current assets	1,536	1,318	1,239
Total current assets	71,483	156,601	87,341
Property and equipment, net	10,378	10,188	9,573
Intangible assets, net	108	140	152
Deferred income taxes	3,927	5,470	7,161
Note receivable	2,000	2,000	2,000
Other investments	2,280	2,280	2,280
Other assets	262	246	192
Total assets	\$90,438	\$176,925	\$108,699
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Current liabilities:			
Accounts payable	\$72,312	\$122,322	\$73,839
Accrued liabilities	6,522	10,751	7,228
Current portion of long-term financing obligation	32	51	61
Current portion of deferred rent	286	279	277
Total current liabilities	79,152	133,403	81,405
Long-term financing obligation, less current portion	497	574	580
Deferred rent, less current portion	2,051	2,229	2,287
Other long-term liabilities	117	114	67
Commitments and contingencies			
Stockholders' equity:			
Preferred stock, \$0.001 par value; 5,000 shares authorized, none issued and outstanding	—	—	—
Common stock, \$0.001 par value; 300,000 shares authorized; 21,601, 21,480 and 21,107 shares issued, respectively, 11,845, 12,932 and 12,589 shares outstanding, respectively	22	22	21
Additional paid-in capital	226,812	223,261	210,865
Accumulated other comprehensive loss	(153	) (26	) (56
Retained earnings	98,658	93,758	88,827
Treasury stock, at cost; 9,756, 8,548 and 8,518 shares outstanding, respectively	(316,718	) (276,410	) (275,297

Edgar Filing: BLUE NILE INC - Form 10-Q

Total stockholders' equity	8,621	40,605	24,360
Total liabilities and stockholders' equity	\$90,438	\$176,925	\$108,699

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

Table of Contents

BLUE NILE, INC.  
 Condensed Consolidated Statements of Operations  
 (unaudited)  
 (in thousands, except per share data)

	Quarter ended		Year to date ended	
	September 28, 2014	September 29, 2013	September 28, 2014	September 29, 2013
Net sales	\$105,760	\$ 98,925	\$316,057	\$ 304,050
Cost of sales	86,910	80,238	257,915	247,620
Gross profit	18,850	18,687	58,142	56,430
Selling, general and administrative expenses	16,290	16,165	50,787	49,338
Operating income	2,560	2,522	7,355	7,092
Other (loss) income, net:				
Interest income, net	19	20	91	84
Other (loss) income, net	(81	) 3	(47	) 143
Total other (loss) income, net	(62	) 23	44	227
Income before income taxes	2,498	2,545	7,399	7,319
Income tax expense (benefit)	848	(361	) 2,499	1,375
Net income	\$1,650	\$ 2,906	\$4,900	\$ 5,944
Basic net income per share	\$0.14	\$ 0.23	\$0.40	\$ 0.48
Diluted net income per share	\$0.14	\$ 0.23	\$0.40	\$ 0.47

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

Table of Contents

BLUE NILE, INC.

Condensed Consolidated Statements of Comprehensive Income

(unaudited)

(in thousands)

	Quarter ended		Year to date ended	
	September 28, 2014	September 29, 2013	September 28, 2014	September 29, 2013
Net income	\$1,650	\$ 2,906	\$4,900	\$ 5,944
Other comprehensive (loss) income:				
Foreign currency translation adjustments	(108	) 55	(127	) 44
Total comprehensive income	\$1,542	\$ 2,961	\$4,773	\$ 5,988

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

6

Table of Contents

## BLUE NILE, INC.

## Condensed Consolidated Statement of Changes in Stockholders' Equity

(unaudited)

(in thousands)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock		Total Stockholders' Equity
	Shares	Amount				Shares	Amount	
Balance, December 30, 2013	21,480	\$22	\$223,261	\$93,758	\$ (26 )	(8,548 )	\$(276,410 )	\$40,605
Net income				4,900				4,900
Other comprehensive loss					(127 )			(127 )
Tax deficiency from exercise of stock options			(1,798 )					(1,798 )
Exercise of common stock options	93	—	2,266					2,266
Issuance of common stock to directors	2	—	60					60
Vesting of restricted stock units	34	—						—
Shares withheld related to net share settlement of equity awards	(8 )	—	(244 )					(244 )
Stock-based compensation			3,267					3,267
Repurchase of common stock						(1,208 )	(40,308 )	(40,308 )
Balance, September 28, 2014	21,601	\$22	\$226,812	\$98,658	\$ (153 )	(9,756 )	\$(316,718 )	\$8,621

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

Table of Contents

BLUE NILE, INC.  
Condensed Consolidated Statements of Cash Flows  
(unaudited)  
(in thousands)

	Year to date ended	
	September 28, 2014	September 29, 2013
Operating activities:		
Net income	\$4,900	\$5,944
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	2,742	2,363
Loss on disposal of property and equipment	—	3
Stock-based compensation	3,245	3,765
Deferred income taxes	1,839	867
Tax deficiency from exercise of stock options	(1,798	) (147
Excess tax benefit from exercise of stock options	(173	) (250
Changes in assets and liabilities:		
Receivables	26	115
Inventories	1,446	2,336
Prepaid federal income taxes	(50	) (1,607
Prepaid expenses and other assets	(234	) (85
Accounts payable	(50,071	) (42,146
Accrued liabilities	(4,229	) (5,211
Other long term liabilities	3	43
Deferred rent and other	(171	) 130
Net cash used in operating activities	(42,525	) (33,880
Investing activities:		
Purchases of property and equipment	(2,820	) (4,109
Purchases of other investments	—	(280
Net cash used in investing activities	(2,820	) (4,389
Financing activities:		
Repurchase of common stock	(40,308	) (9,320
Proceeds from stock option exercises	2,266	8,269
Taxes paid for net share settlement of equity awards	(244	) —
Excess tax benefit from exercise of stock options	173	250
Principal payments under long-term financing obligation	(96	) (45
Net cash used in financing activities	(38,209	) (846
Effect of exchange rate changes on cash and cash equivalents	(64	) 28
Net decrease in cash and cash equivalents	(83,618	) (39,087
Cash and cash equivalents, beginning of period	115,942	87,017
Cash and cash equivalents, end of period	\$32,324	\$47,930
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$2,506	\$4,965
Non-cash investing and financing activities:		
Receivable from stock option exercises	\$—	\$1,578

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



Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Description of Our Business and Summary of Significant Accounting Policies

The Company

Blue Nile, Inc. ("Blue Nile", the "Company", "we" or "our") is a leading online retailer of high-quality diamonds and fine jewelry. In addition to sales of diamonds and fine jewelry, the Company provides education, guidance and support to enable customers to more effectively learn about and purchase diamonds and fine jewelry. The Company, a Delaware corporation based in Seattle, Washington, was formed in March 1999. The Company serves consumers in over 40 countries and territories all over the world through its website at [www.bluenile.com](http://www.bluenile.com). Information found on the Company's website is not incorporated by reference into this Quarterly Report on Form 10-Q or any of its other filings with the U.S. Securities and Exchange Commission (the "SEC").

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the year ended December 29, 2013, filed with the SEC on February 25, 2014 (the "Annual Report"). The same accounting policies are followed for preparing quarterly and annual financial statements. In the opinion of management, all adjustments necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods have been included and are of a normal, recurring nature.

The financial information as of December 29, 2013 is derived from the Company's audited consolidated financial statements and notes thereto for the fiscal year ended December 29, 2013, included in Item 8 of the Annual Report. Due to a number of factors, including the seasonal nature of the retail industry and other factors described in this quarterly report, quarterly results are not necessarily indicative of the results for the full fiscal year or any other subsequent interim period.

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All transactions and balances between the Company and its wholly-owned subsidiaries are eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates include the allowance for sales returns, accounting for income taxes, and assumptions used to determine stock-based compensation expense. Actual results could differ materially from those estimates.

Foreign Currency

The functional currency of most of the Company's subsidiaries is the applicable local currency. The assets and liabilities of our subsidiaries have been translated to U.S. dollars using the exchange rates effective on the balance sheet dates, while income and expense accounts are translated at the average rates in effect during the periods presented. The resulting translation adjustments are recorded as a component of other comprehensive income (loss) within stockholders' equity.

Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The Company offers customers the ability to transact in 24 currencies. Some of the Company's subsidiaries engage in transactions denominated in currencies other than the Company's functional currency. Gains or losses arising from these transactions are recorded in other income, net in the condensed consolidated statements of operations.

Note Receivable and Other Investments

The Company holds a minority ownership of a privately-held company in the form of convertible preferred shares, purchased for an aggregate amount of \$2.0 million, which we account for under the cost method of accounting.

The Company holds a \$2.0 million note receivable (the "Note") from the same privately-held company. The interest rate changes over the term of the Note to LIBOR plus a predetermined rate per annum. The Note is recorded at its face amount on the Company's condensed consolidated balance sheet.

The Company holds a minority ownership in another privately-held company in the form of common stock and warrants, purchased for \$280,000, which we account for under the cost method of accounting.

The Company reviews its investments for impairment when events and circumstances indicate that the decline in fair value of the assets below the carrying value is other-than-temporary. No other-than-temporary impairment charges were recorded for the year to date ended September 28, 2014.

Credit Agreement

On February 21, 2014, the Company renewed its Credit Agreement (the "Credit Agreement") with U.S. Bank National Association (the "Lender"). The Credit Agreement provides for a \$40.0 million (the "Credit Limit") unsecured, revolving credit facility (the "Revolving Loan") with an option to increase the Credit Limit to \$50.0 million. Under the terms and conditions of the Credit Agreement, the Company may borrow from the Lender for one year with annual renewals at the Lender's discretion. The Company also has the ability to term out the outstanding line balance to a term of up to five years. The aggregate principal amounts outstanding at any one time shall not exceed the Credit Limit.

As of September 28, 2014, the Company does not have any amounts outstanding under the Credit Agreement and is in compliance with the covenants of the Credit Agreement.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2014-09 ("ASU 2014-09"), "Revenue from Contracts with Customers (Topic 606)" which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on the principle that revenue should be recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. Early adoption is not permitted. ASU 2014-09 is effective for the Company in the first quarter of its fiscal year 2017. The Company is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In August 2014, the FASB issued Accounting Standards Update No. 2014-15 ("ASU 2014-15"), "Presentation of Financial Statements - Going Concern." The new standard provides guidance around management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. The adoption of this standard is not expected to have a material impact on our financial statements and related disclosures.

Blue Nile, Inc.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## Note 2. Stock-based Compensation

As of September 28, 2014, the Company had five equity plans. Additional information regarding these plans is disclosed in the Annual Report.

Stock-based compensation expense, net of estimated forfeitures, is recognized on a straight-line basis over the vesting period for each stock option or restricted stock unit ("RSU") grant that is expected to vest at some point in the future. Forfeitures are estimated at the date of grant based on the Company's historical experience and future expectations. The fair value of each stock option on the date of grant is estimated using the Black-Scholes-Merton option valuation model. The fair value of each RSU is based on the Fair Market Value (as defined in the 2013 Equity Incentive Plan) of the Company's common stock on the date of the grant.

There were no stock options granted during the quarter ended September 28, 2014. The following weighted average assumptions were used for the valuation of stock options granted during the fiscal year to date periods presented:

	Year to date ended			
	September 28, 2014	September 29, 2013		
Expected term	4.5 years	4.5 years		
Expected volatility	46.9	% 56.9	%	%
Expected dividend yield	0.0	% 0.0	%	%
Risk-free interest rate	1.5	% 0.9	%	%
Estimated weighted average fair value per stock option granted	\$13.28	\$14.68		

The assumptions used to calculate the fair value of stock options granted are evaluated and revised, if necessary, to reflect market conditions and the Company's experience.

A summary of stock option activity for the year to date ended September 28, 2014 is as follows:

	Options (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance, December 30, 2013	1,493	\$41.93		
Granted	79	33.00		
Exercised	(93	) 24.43		
Canceled	(302	) 52.34		
Balance, September 28, 2014	1,177	\$40.04	5.46	\$519
Vested and expected to vest at September 28, 2014	1,148	\$40.21	5.39	\$517
Exercisable, September 28, 2014	886	\$42.08	4.60	\$496

Blue Nile, Inc.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

A summary of RSU activity for the year to date ended September 28, 2014 is as follows:

	RSUs (in thousands)	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance, December 30, 2013	88	\$31.01		
Granted	90	32.93		
Vested	(34)	) 31.50		
Canceled	(25)	) 32.54		
Balance, September 28, 2014	119	\$32.01	1.38	\$3,519
Vested and expected to vest at September 28, 2014	103	\$37.42	1.29	\$3,057

The aggregate intrinsic value in the tables above are before applicable income taxes and represent the amount recipients would have received if all stock options had been exercised or RSUs had been released on the last business day of the period indicated, based on the closing stock price of the Company's common stock on such date.

The total intrinsic value of stock options exercised during the year to date ended September 28, 2014 was \$1.0 million. During the year to date ended September 28, 2014, the total fair value of stock options vested was \$2.4 million. As of September 28, 2014, the Company had total unrecognized compensation costs related to unvested stock options and RSUs of \$6.6 million, before income taxes. The Company expects to recognize this cost over a weighted average period of 2.1 years for the options and 2.8 years for the RSUs.

## Note 3. Inventories

Inventories are stated at cost and consist of the following (in thousands):

	September 28, 2014	December 29, 2013	September 29, 2013
Loose diamonds	\$4,026	\$3,321	\$3,049
Fine jewelry and other	29,058	31,209	27,885
Total	\$33,084	\$34,530	\$30,934

## Note 4. Net Income Per Share

Basic net income per share is based on the weighted average number of common shares outstanding. Diluted net income per share is based on the weighted average number of common shares and common share equivalents outstanding. Common share equivalents included in the computation represent shares issuable upon assumed exercise of outstanding stock options and conversion of unvested RSUs, except when the effect of their inclusion would be antidilutive.

The following tables set forth the computation of basic and diluted net income per share (in thousands, except per share data):

Blue Nile, Inc.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Quarter ended		Year to date ended	
	September 28, 2014	September 29, 2013	September 28, 2014	September 29, 2013
Net income	\$1,650	\$2,906	\$4,900	\$5,944
Weighted average common shares outstanding	11,844	12,431	12,248	12,441
Basic net income per share	\$0.14	\$0.23	\$0.40	\$0.48
Dilutive effect of stock options and RSUs	21	256	64	229
Common stock and common stock equivalents	11,865	12,687	12,312	12,670
Diluted net income per share	\$0.14	\$0.23	\$0.40	\$0.47

For the quarter and year to date ended September 28, 2014, the Company excluded 1,133,355 and 1,057,421 stock option shares, respectively, from the computation of diluted net income per share due to their antidilutive effect. For the quarter and year to date ended September 29, 2013, the Company excluded 1,183,186 and 1,259,122 stock option shares, respectively, from the computation of diluted net income per share due to their antidilutive effect.

#### Note 5. Commitments and Contingencies

In the ordinary course of business, the Company may be subject from time to time to various proceedings, lawsuits, disputes or claims. In addition, the Company is regularly audited by various tax authorities. Although the Company cannot predict with assurance the outcome of any litigation or audit, it does not believe there are currently any such actions that, if resolved unfavorably, would have a material impact on the Company's financial condition, results of operations or cash flows.

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

The following discussion should be read in conjunction with our consolidated financial statements and the related notes contained elsewhere in this Quarterly Report on Form 10-Q and our Annual Report. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Quarterly Report on Form 10-Q, particularly in "Risk Factors."

##### Management Overview

Blue Nile is a leading online retailer of high-quality diamonds and fine jewelry. We offer our products for sale through the Blue Nile website in over 40 countries and territories throughout the world. Our primary focus is on growing our business by providing unparalleled quality, selection and value to consumers and delivering exceptional customer service. Our online business model allows us to avoid many of the costs that are typically incurred by physical retail stores. As a result, we are able to realize lower gross profit margins while remaining profitable. In order to increase our sales and market share, we are focused on accelerating the sales growth rate of our business through enhancements to our user experience, development of our engagement and non-engagement product lines, and expansion of our international operations. We are also focused on increasing the value proposition that we deliver to our consumers by utilizing our growing acumen in data science, aggressively pricing our products, and deepening our supply chain.

The engagement product category includes gold or platinum engagement rings with a diamond center stone and loose diamonds. We believe that value is one of the most important drivers of engagement sales, and the current

Table of Contents

cost of diamonds is a significant factor to our growth rate. Generally, we purchase our diamonds on a real time basis from our suppliers when a customer places an order for a specific diamond. When the cost of diamonds is relatively steady or declines, we believe that our business benefits because we are able to immediately pass those lower costs on to consumers. In periods of rapidly rising diamond costs, the value that we are able to provide to customers compared to our brick and mortar retail competitors may not be as compelling and our gross margin may suffer as we may choose to offset the inflationary impact of these changes. Regardless of diamond pricing dynamics we will remain focused on utilizing our aggressive retail pricing, developing and expanding our product lines as well as deepening our supply chain, and continuing to provide our customers with a compelling website experience across all devices. Our non-engagement product category includes rings, earrings, necklaces, pendants, bracelets, gifts and accessories containing precious metals, diamonds, gemstones or pearls. The total addressable market for the sale of non-engagement products is much greater than that for engagement, and we believe our brand is well-positioned to gain market share over time. To further drive growth in our non-engagement category, we will continue to expand a refined assortment of wedding bands, diamond jewelry and fashion jewelry, offer branded designs, and utilize disruptive and innovative technology such as the responsive website to provide our non-engagement consumers with a compelling shopping experience.

As part of our plan to expand our international business, we are extending our capabilities into markets with the highest potential for growth. We believe that the Asia-Pacific market, specifically Greater China, represents a significant long-term opportunity for us. We have and will continue to increase our investments in personnel, infrastructure, fulfillment capabilities, product selection, marketing and enhancing the user experience to drive growth and gain market share.

Third Quarter of 2014 Summary of Results of Operations

We achieved third quarter net sales of \$105.8 million, a 6.9% increase from the third quarter of 2013. U.S. engagement net sales increased 5.0%, U.S. non-engagement net sales decreased 1.7% and net sales of both engagement and non-engagement products in our international markets increased 25.6% from the third quarter of 2013.

International net sales comprised 20.3% of our total net sales for the quarter. Our gross profit increased \$0.2 million in the third quarter of 2014, a 0.9% increase compared to the third quarter of 2013. Net income per diluted share was \$0.14 in the third quarter of 2014, compared to \$0.23 for the third quarter of 2013.

Results of Operations

Comparison of the Quarter Ended September 28, 2014 to the Quarter Ended September 29, 2013

The following table presents our operating results for the quarters ended September 28, 2014 and September 29, 2013, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

Table of Contents

	Quarter ended				
	September 28, 2014	September 29, 2013	\$ Change	% Change	
Net sales	\$105,760	\$98,925	\$6,835	6.9	%
Cost of sales	86,910	80,238	6,672	8.3	%
Gross profit	18,850	18,687	163	0.9	%
Selling, general and administrative expenses	16,290	16,165	125	0.8	%
Operating income	2,560	2,522	38	1.5	%
Other (loss) income, net:					
Interest income, net	19	20	(1	) (5.0	)%
Other (loss) income, net	(81	) 3	(84	) (2,800.0	)%
Total other (loss) income, net	(62	) 23	(85	) (369.6	)%
Income before income taxes	2,498	2,545	(47	) (1.8	)%
Income tax expense (benefit)	848	(361	) 1,209	334.9	%
Net income	\$1,650	\$2,906	\$(1,256	) (43.2	)%
Basic net income per share	\$0.14	\$0.23	\$(0.09	)	
Diluted net income per share	\$0.14	\$0.23	\$(0.09	)	

## Net Sales

Net sales increased 6.9% during the third quarter of 2014 as compared with the third quarter of 2013. The total net sales increase was due to an increase in both average shipment value and the number of shipments.

Net sales in the U.S. increased 3.0% to \$84.3 million for the third quarter of 2014, compared with \$81.8 million in the same quarter last year. U.S. engagement net sales for the third quarter of 2014 increased 5.0% to \$60.8 million, compared to \$57.9 million for the third quarter of 2013. U.S. non-engagement net sales for the third quarter 2014 decreased 1.7% to \$23.5 million, compared to \$23.9 million for the third quarter 2013 due to a decrease in the number of shipments offset slightly by an increase in average shipment value.

International net sales increased 25.6% to \$21.5 million in the third quarter of 2014 from \$17.1 million in the third quarter of 2013. Growth was particularly strong in Asia. Internally, we monitor our international sales performance on a non-GAAP basis which eliminates the positive or negative effects that result from translating currency from international sales into U.S. dollars (“constant exchange rate basis”). Changes in foreign exchange rates during the third quarter of 2014, compared to the rates in effect during the third quarter of 2013, had a negative impact of approximately 0.3% on international net sales. Excluding the impact of changes in foreign exchange rates, international net sales increased 25.9% for the third quarter of 2014 compared to the third quarter of 2013.

## Gross Profit

Gross profit in the third quarter of 2014 increased 0.9% to \$18.9 million from \$18.7 million in the third quarter of 2013. The increase in gross profit results primarily from an increase in net sales partially offset by a relatively higher cost of goods sold. Gross margin was 17.8% for the third quarter of 2014 and 18.9% for the third quarter of 2013. The decrease in gross margin was due to lower mark-up on engagement products initiated in the third quarter of 2014 to stimulate sales growth as well as a shift in product mix. Our non-engagement products provide higher gross margin than our engagement products. In the third quarter of 2014, sales of our engagement products equaled 73.7% of our total revenue versus 72.8% in the third quarter of 2013.

Costs for our products are impacted by prices for diamonds and precious metals including gold, platinum and silver, which rise and fall based upon global supply and demand dynamics. In making retail pricing decisions, we take into account fluctuations in the pricing of diamonds and precious metals, which in turn, affect the gross margin that we realize from such products. We expect that gross profit will continue to fluctuate in the future based on the mix of products we sell and our pricing decisions.

## Selling, General and Administrative Expenses



Table of Contents

Selling, general and administrative expenses increased 0.8% to \$16.3 million in the third quarter of 2014 compared to \$16.2 million in the third quarter of 2013. Credit card interchange and payment processing fees increased approximately \$0.2 million due to higher sales volumes and rates. Depreciation expense added approximately \$0.1 million to expenses. These expense increases were partially offset by a decrease of approximately \$0.2 million in stock-based compensation expense primarily due to a lower number of options outstanding at lower option fair values in the third quarter of 2014. Selling, general and administrative expenses as a percentage of sales decreased to 15.4% in the third quarter of 2014 compared to 16.3% in the third quarter of 2013. The decrease is driven primarily by marketing expense which was equal to 5.2% of revenue versus 5.6% of revenue last year. We continue to closely monitor the level of marketing investment and efficiency of this spend balancing opportunities to accelerate revenue growth versus our ability to increase profitability.

Operating Income

Operating income was \$2.6 million in the third quarter of 2014 compared to \$2.5 million in the third quarter of 2013. The increase in operating income is primarily due to an increase in gross profit partially offset by an increase in selling, general and administrative expenses.

Income Taxes

Our effective tax rate increased to 33.9% in the third quarter of 2014 from (14.2)% in the third quarter of 2013. The increase is primarily due to the domestic production activities income tax benefit recorded in the third quarter of 2013 claimed for tax years prior to 2013.

Table of Contents

Comparison of the Year to Date Ended September 28, 2014 to the Year to Date Ended September 29, 2013

The following table presents our operating results for the years to date ended September 28, 2014 and September 29, 2013, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

	Year to date ended		\$ Change	% Change	
	September 28, 2014	September 29, 2013			
Net sales	\$316,057	\$304,050	\$12,007	3.9	%
Cost of sales	257,915	247,620	10,295	4.2	%
Gross profit	58,142	56,430	1,712	3.0	%
Selling, general and administrative expenses	50,787	49,338	1,449	2.9	%
Operating income	7,355	7,092	263	3.7	%
Other income, net:					
Interest income, net	91	84	7	8.3	%
Other (loss) income, net	(47	) 143	(190	) (132.9	)%
Total other income, net	44	227	(183	) (80.6	)%
Income before income taxes	7,399	7,319	80	1.1	%
Income tax expense	2,499	1,375	1,124	81.7	%
Net income	\$4,900	\$5,944	\$(1,044	) (17.6	)%
Basic net income per share	\$0.40	\$0.48	\$(0.08	)	
Diluted net income per share	\$0.40	\$0.47	\$(0.07	)	

**Net Sales**

Net sales increased 3.9% during the year to date ended September 28, 2014, compared with the year to date ended September 29, 2013, due primarily to an increase in the average shipment value partially offset by a decrease in the number of orders shipped.

Net sales in the U.S. increased 2.5% to \$258.6 million during the year to date ended September 28, 2014, compared with \$252.2 million during the year to date ended September 29, 2013. U.S. engagement net sales for the year to date ended September 28, 2014 increased to \$181.4 million from \$177.1 million for the year to date ended September 29, 2013. U.S. non-engagement net sales for the year to date ended September 28, 2014 increased to \$77.2 million, compared to \$75.1 million for the year to date ended September 29, 2013.

International net sales increased 10.8% in the year to date ended September 28, 2014 to \$57.5 million, from \$51.9 million in the year to date ended September 29, 2013. Foreign exchange rates during the year to date ended September 28, 2014, compared to the rates in effect during the year to date ended September 29, 2013, had a negative impact of approximately 2.2% on international net sales. Excluding the impact of changes in foreign exchange rates, international net sales increased 13.0% in the year to date ended September 28, 2014 compared to the year to date ended September 29, 2013.

**Gross Profit**

Gross profit increased \$1.7 million to \$58.1 million in the year to date ended September 28, 2014 compared to \$56.4 million in the year to date ended September 29, 2013. The increase in gross profit was primarily due to an increase in net sales. Gross margin was 18.4% in the year to date ended September 28, 2014 as compared to 18.6% in the year to date ended September 29, 2013. The decrease in gross margin resulted primarily from lower mark-up on engagement products initiated in the third quarter of 2014 to stimulate sales growth.

**Selling, General and Administrative Expenses**

Selling, general and administrative expenses increased 2.9% to \$50.8 million in the year to date ended September 28, 2014 compared to \$49.3 million in the year to date ended September 29, 2013. Compensation and

Table of Contents

benefits expense increased \$0.6 million due to increased headcount to support key business initiatives and higher compensation rates of our employees. Depreciation expense added approximately \$0.4 million to expenses. Credit card interchange and payment processing fees increased approximately \$0.3 million due to higher sales volumes and rates. Marketing and advertising costs increased \$0.3 million, primarily due to increased spending on online marketing vehicles and other marketing efforts to drive traffic to our website, both domestically and internationally. These expense increases were partially offset by a decrease of approximately \$0.5 million in stock-based compensation expense primarily due to a lower number of options outstanding at lower option fair values for the year to date ended September 28, 2014. As a percentage of net sales, selling, general and administrative expenses were 16.1% in the year to date ended September 28, 2014, as compared to 16.2% in the year to date ended September 29, 2013 as sales accelerated faster than selling, general and administrative expenses.

Operating Income

Operating income increased 3.7% to \$7.4 million in the year to date ended September 28, 2014 compared to \$7.1 million in the year to date ended September 29, 2013. The increase in operating income for the year to date ended September 28, 2014 was due to an increase in gross profit partially offset by an increase in selling, general and administrative expenses.

Income Taxes

Our effective tax rate increased to 33.8% in the year to date ended September 28, 2014 from 18.8% in the year to date ended September 29, 2013. The increase is primarily due to the domestic production activities income tax benefit recorded in the third quarter of 2013 claimed for tax years prior to 2013.

Liquidity and Capital Resources

We are primarily funded by our cash flows from operations. The significant components of our working capital are inventory and liquid assets such as cash and trade accounts receivable, reduced by accounts payable and accrued expenses. Our business model typically provides certain beneficial working capital characteristics. While we collect cash from sales to customers within several business days of the related sale, we typically have extended payment terms with our suppliers.

Our liquidity is primarily dependent upon our net cash provided by operating activities. Our net cash provided by operating activities is sensitive to many factors, including changes in working capital and the timing and magnitude of expenditures. Working capital at any specific point in time is dependent upon many variables, including our operating results, seasonality, inventory management, the timing of cash receipts and payments, and vendor payment terms. As of September 28, 2014, we had a working capital deficiency of \$7.7 million, including cash and cash equivalents of \$32.3 million and inventory of \$33.1 million, offset by accounts payable of \$72.3 million. Current levels of cash and cash equivalents reflect the pay down of accounts payable and the repurchase of shares of our common stock in the year to date ended September 28, 2014.

Net cash of \$42.5 million was used in operating activities for the year to date ended September 28, 2014, compared to net cash used in operating activities of \$33.9 million for the year to date ended September 29, 2013. The increase in cash used for operating activities was primarily attributable to a higher net payment of accounts payable in the current year. Net payment of accounts payable totaled \$50.1 million for the year to date ended September 28, 2014 compared to \$42.1 million for the year to date ended September 29, 2013.

Net cash of \$2.8 million and \$4.4 million was used in investing activities for the year to date periods ended September 28, 2014 and September 29, 2013, respectively. In both years, cash used in investing activities was primarily the result of purchases of property and equipment which includes capitalized costs to develop our website and internal-use software to support our operations. Our capital needs are generally relatively low and include, without limitation, investments in technology and website enhancements, capital improvements to our leased warehouse and office facilities, and furniture and equipment.

## Table of Contents

Net cash used in financing activities for the year to date ended September 28, 2014 was \$38.2 million, primarily related to the repurchase of common stock of \$40.3 million partially offset by \$2.3 million of proceeds from stock option exercises. Net cash used in financing activities for the year to date ended September 29, 2013 was \$0.8 million, primarily related to the repurchase of common stock of \$9.3 million partially offset by \$8.3 million of proceeds from stock option exercises.

On October 28, 2013, our board of directors authorized the repurchase of up to \$100.0 million of our common stock during the 24-month period following such approval date under our buyback program. Since the repurchase authorization on October 28, 2013 through September 28, 2014, we have repurchased an aggregate of 1,208,147 shares for a total of \$40.3 million. This left approximately \$59.7 million under this repurchase authorization as of September 28, 2014.

Since the inception of the buyback program in the first quarter of 2005 through September 28, 2014, we have repurchased an aggregate of approximately 9.0 million shares for a total of \$316.1 million. Our shares may be repurchased from time to time in open market transactions or in negotiated transactions off the market. The timing and amount of any shares repurchased is determined by our management based on their evaluation of market conditions and other factors, including our cash needs. Repurchases may also be made under a Rule 10b5-1 plan. We continually assess market conditions, our cash position, operating results, current forecasts and other factors when making decisions about stock repurchases.

On February 21, 2014, the Company renewed its Credit Agreement which provides for a \$40.0 million Credit Limit under a Revolving Loan with an option to increase the Credit Limit to \$50.0 million. We currently do not have any outstanding debt under the Credit Agreement. We believe that our current cash and cash equivalent balances, cash flow from operations and our ability to borrow under the Revolving Loan will be sufficient to meet our anticipated operating and capital expenditure needs for at least the next 12 months. However, projections of future cash needs and cash flows are subject to many factors and to uncertainty. We continually assess our capital structure and opportunities to obtain credit facilities, sell equity or debt securities, or undertake other transactions for strategic reasons or to further strengthen our financial position.

### Contractual Obligations

There have been no material changes to our contractual obligations during the period covered by this report from those disclosed in our Annual Report.

### Off-Balance Sheet Arrangements

As of September 28, 2014, we did not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### Non-GAAP Financial Measures

To supplement our condensed consolidated financial statements presented in accordance with GAAP, our management internally monitors our sales performance on a non-GAAP constant exchange rate basis that eliminates the positive or negative effects that result from translating international sales into U.S. dollars. Our management does not itself, nor does it suggest that investors should, consider such non-GAAP financial measures in isolation from, or as a substitute for, financial information prepared in accordance with GAAP. Investors should also note that the non-GAAP financial measures we used may not be the same non-GAAP financial measures, and may not be calculated in the same manner, as that of other companies. Whenever we use such non-GAAP financial measures, we provide a reconciliation of non-GAAP financial measures to the most closely applicable GAAP financial measures. Investors are encouraged to review the related GAAP financial measures and the reconciliation of these non-GAAP financial measures to their most directly comparable GAAP financial measures.

Our management believes that international sales on a constant exchange rate basis provide meaningful supplemental information to the company and to investors. Management believes the constant exchange rate measurement provides a more representative assessment of the sales performance and provides better comparability between reporting periods.



Table of Contents

The following table reconciles year-over-year international net sales percentage increases (decreases) from the GAAP sales measures to the non-GAAP constant exchange rate basis:

Quarter ended September 28, 2014	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	25.6%	(0.3)%	25.9%
Quarter ended September 29, 2013	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	22.9%	(4.7)%	27.6%
Year to date ended September 28, 2014	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	10.8%	(2.2)%	13.0%
Year to date ended September 29, 2013	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	22.3%	(2.4)%	24.7%

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our exposure to financial market risk results primarily from fluctuations in interest rates and foreign currency exchange rates. There have been no material changes to our market risks as disclosed in our Annual Report.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

During the quarter ended September 28, 2014, an evaluation was performed under the supervision and with the participation of our management, including our chief executive officer and chief financial officer (collectively, our “certifying officers”), of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Disclosure controls and procedures are controls and other procedures designed to ensure that information required to be disclosed by us in our periodic reports filed or submitted under the Exchange Act with the SEC is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on their evaluation, our certifying officers concluded that as of the end of the period covered by this report these disclosure controls and procedures were effective.

#### Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended September 28, 2014, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1A. Risk Factors

You should carefully consider the risks described below and elsewhere in this Quarterly Report on Form 10-Q, which could materially and adversely affect our business, results of operations or financial condition. Our business faces significant risks and the risks described below may not be the only risks we face. Additional risks not presently known to us or that we currently believe are immaterial may materially affect our business, results of operations, or financial condition. If any of these risks occur, the trading price of our common stock could decline and you may lose all or part of your investment.

We have marked with an asterisk (\*) those risks described below that reflect substantive changes from the risks described under Part I, Item 1A “Risk Factors” included in our Annual Report on Form 10-K, as filed with the SEC on February 25, 2014.

Our business results are significantly affected by the value we are able to provide to our customers.

Demand for our products has been highly sensitive to pricing changes, because the success of our business model depends, in part, on our ability to offer quality products to customers at prices that are below those of traditional jewelry retailers. Pricing changes may result from changes in commodity prices or changes in our pricing strategy. The price of commodities upon which we are substantially dependent are subject to fluctuations arising from changes in supply and demand, competition, and market speculation. Because of our virtual inventory model for loose diamonds, our diamond product prices are much more sensitive to rapid fluctuations in the prices of diamonds than traditional retailers, which typically hold diamonds in inventory. Rapid and significant increases in commodity prices, particularly diamond prices, may materially and adversely affect our sales, gross margins, customer experience, and competitive position. Further, we have and will continue to change our product pricing strategies. Our pricing strategies have and will likely to continue to have a significant impact on our net sales, gross margins, and net income.

Our business may be adversely affected, if we are unable to provide a cost-effective shopping platform that is able to respond and adapt to rapid changes in technology and consumer preferences.

The number of people who access the Internet through devices other than personal computers, including mobile phones, smart phones, handheld computers such as notebooks and tablets, video game consoles, and television set-top devices, has increased dramatically in the past few years. The smaller screen size, functionality, and memory associated with some alternative devices may make the use of our website and purchasing our products more difficult; and the versions of our website developed for these devices may not be compelling to consumers. Each manufacturer or distributor may establish unique technical standards for its devices, and our website may not work or be viewable on these devices as a result. As new devices and new platforms are continually being released, it is difficult to predict the challenges we may encounter in developing versions of our website for use on these alternative devices and we may need to devote significant resources to the creation, support, and maintenance of such devices. If we are unable to attract consumers to our website through these devices or are slow to develop a version of our website that is more compatible with alternative devices, we may fail to capture a significant share of consumers in the market for diamonds and fine jewelry, which could adversely affect our business.

Further, we may be required to upgrade existing technologies or business applications, or implement new technologies or business applications. Our results of operations may be affected by the timing, effectiveness and costs associated with the successful implementation of any upgrades or changes to our systems and infrastructure.

General economic factors may adversely affect our financial performance and results of operations.

Our financial performance and results of operations depend significantly on worldwide economic conditions and their impact on consumer spending. Luxury products, such as diamonds and fine jewelry, are discretionary purchases for

consumers. Recessionary economic cycles, higher interest rates, higher fuel and energy costs, inflation, levels of unemployment, conditions in the residential real estate and mortgage markets, access to credit,

Table of Contents

consumer debt levels, unsettled financial markets, and other economic factors that may affect consumer spending or buying habits could materially and adversely affect demand for our products. In addition, volatility in the financial markets has had and may continue to have a negative impact on consumer spending patterns. A reduction in consumer spending or disposable income may affect us more significantly than companies in other industries and companies with a more diversified product offering. In addition, negative national or global economic conditions may materially and adversely affect our suppliers' financial performance, liquidity and access to capital. This may affect their ability to maintain their inventories, production levels and/or product quality, and could cause them to raise prices, lower production levels or cease their operations.

Economic factors such as increased commodity prices, shipping costs, inflation, higher costs of labor, insurance and healthcare, and changes in and/or interpretations of other laws, regulations, and taxes may also increase our cost of sales and our selling, general and administrative expenses, and otherwise adversely affect our financial condition and results of operations. Any significant increases in costs may affect our business disproportionately than our competitors.

Further, any reduction in our sales will affect our liquidity. As discussed under "Liquidity and Capital Resources" in Part I, Item 2 of this Quarterly Report on Form 10-Q, our liquidity is primarily dependent upon our net cash from operating activities. Our net cash from operating activities is sensitive to many factors, including changes in working capital. Working capital at any specific point in time is dependent upon many variables, including our operating results, seasonality, inventory management and level of product assortment expansion, the timing of cash receipts and payments, and vendor payment terms.

In order to increase net sales and to sustain or increase profitability, we must attract customers in a cost-effective manner.

Our success depends on our ability to attract customers in a cost-effective manner. Our investments in marketing may not effectively reach potential consumers or those consumers may not decide to buy from us or the volume of consumers that purchase from us does not yield the intended return on investment. With respect to our marketing channels, we rely on relationships with providers of online services, search engines, directories and other websites and e-commerce businesses to provide content, advertising banners and other links that direct customers to our websites. We rely on these relationships as significant sources of traffic to our website. In particular, we rely on Google as an important marketing channel, if Google changes its algorithms or if competition increases for advertisements on Google, we may be unable to cost-effectively drive qualified consumers to our website.

Our agreements with our marketing providers generally have terms of one year or less. If we are unable to develop or maintain these relationships on acceptable terms, our ability to attract new customers would be harmed. In addition, many of the parties with whom we have online-advertising arrangements could provide advertising services to other companies, including retailers with whom we compete. As competition for online advertising has increased, the cost for these services has also increased. A significant increase in the cost of the marketing vehicles upon which we rely could adversely impact our ability to attract customers in a cost-effective manner and harm our business and results of operations. Further, we use promotions as a way to drive sales, these promotional activities may not drive sales and may adversely affect our gross margins.

Our supplier relationships are a key component of our business.

A majority of the world's supply of rough diamonds is controlled by a small number of diamond mining firms. As a result, any decisions made to restrict the supply of rough diamonds by these firms to our suppliers could substantially impair our ability to acquire diamonds at commercially reasonable prices, if at all. We do not currently have any direct supply relationships with these firms. Our ability to acquire diamonds and fine jewelry is also substantially dependent

on our relationships with various suppliers. Approximately 20%, 14% and 21% of our payments to our diamond and fine jewelry suppliers for each of the years ended December 29, 2013, December 30, 2012 and January 1, 2012, respectively, were made to our top three suppliers for that year. The top three suppliers may change from year to year. Our inability to maintain and expand these and other future diamond and fine

Table of Contents

jewelry supply relationships on commercially reasonable terms or the inability of our current and future suppliers to maintain arrangements for the supply of products sold to us on commercially reasonable terms would substantially harm our business and results of operations. The financial performance and viability of our suppliers are also significantly dependent upon worldwide economic conditions and consumer demand for diamonds and fine jewelry. The failure of any of our principal suppliers to remain financially viable could adversely impact our supply of diamonds and fine jewelry for sale to our customers. Further, we typically have exclusive online supply relationships with our diamond suppliers. If we were no longer able to maintain these exclusive relationships with key suppliers, this may adversely impact our diamond supply and may harm our business results of operations.

Suppliers and manufacturers of diamonds as well as retailers of diamonds and diamond jewelry are vertically integrated and we expect they will continue to vertically integrate their operations either by developing retail channels for the products they manufacture or acquiring sources of supply, including, without limitation, diamond mining operations. To the extent such vertical integration efforts are successful, some of the fragmentation in the existing diamond supply chain could be eliminated, our ability to obtain an adequate supply of diamonds and fine jewelry from multiple sources could be limited and our competitors may be able to obtain diamonds at lower prices.

We may not succeed in sustaining and promoting the Blue Nile brand, which would prevent us from acquiring customers and increasing our net sales.

A component of our future growth is the continued establishment and promotion of the Blue Nile brand. Due to the competitive nature of the market for diamonds and fine jewelry, if we do not sustain and promote our brand and branded products, we may fail to build the critical mass of customers required to substantially increase our net sales. Promoting and positioning our brand will depend largely on the success of our marketing and merchandising efforts and our ability to provide a consistent, high-quality product and customer experience. To promote our brand and products, we have incurred and will continue to incur substantial expenses related to advertising and other marketing efforts. These expenses may not result in increased consumer demand for our products, which would negatively impact our financial results.

A critical component of our brand promotion strategy is establishing a relationship of trust with our customers, which we believe can be achieved by providing a high-quality customer experience. In order to provide a high-quality customer experience, we have invested and will continue to invest substantial amounts of resources in the development and functionality of our website, technology infrastructure, fulfillment operations and customer service operations. Our ability to provide a high-quality customer experience is also dependent, in large part, on external factors over which we may have little or no control, including, without limitation, the reliability and performance of our suppliers, third-party jewelry assemblers, third-party carriers, third party diamond grading labs, and networking vendors. During our peak seasons, we rely on temporary employees to supplement our full-time customer service and fulfillment employees. Temporary employees may not have the same level of commitment to our customers as our full-time employees. If our customers are dissatisfied with the quality of the products or the customer service they receive, or if we are unable to deliver products to our customers in a timely manner or at all, our customers may stop purchasing products from us. We also rely on third parties for information, including product characteristics and availability that we present to consumers on our website, which may, on occasion, be inaccurate. Likewise, we have implemented, and we require our suppliers to implement, rigorous quality assurance measures to ensure that all diamonds we sell are 100% natural. Despite these efforts and assurances from our suppliers to provide us only 100% natural diamonds, it is possible that man-made or enhanced diamonds could be mixed in with natural diamonds and passed to us without our detection. We have made commitments to our customers to sell 100% natural diamonds and any inclusion of man-made or enhanced diamonds could cause significant damage to our reputation and brand. Our failure to provide our customers with high-quality products and high-quality customer experiences for any reason could substantially harm our reputation and adversely impact our efforts to develop Blue Nile as a trusted brand. The failure of our brand promotion activities could adversely affect our ability to attract new customers and maintain

customer relationships, and, as a result, substantially harm our business and results of operations.

## Table of Contents

Our financial results may be negatively affected if we are required to collect additional taxes on sales or disclose our customers' private information to tax authorities.

The application of indirect taxes (such as sales and use tax, value-added tax ("VAT"), goods and services tax, and similar taxes) to ecommerce businesses such as Blue Nile, and to our users is a complex and evolving issue. Currently, we collect indirect taxes related to purchases by customers located in the State of Washington and the State of New York, and certain indirect taxes required to be collected on sales to customers outside of the United States. One or more states or foreign countries have sought and others may seek to impose additional indirect tax collection obligations on us in the future and/or require us to disclose to tax authorities our customers' private information, including but not limited to names, addresses, purchase amounts, and purchase dates. For example:

the State of New York has passed legislation that requires any out-of-state seller of tangible personal property to collect and remit New York use tax if the seller engages affiliates above certain financial thresholds in New York to perform certain business promotion activities. California and several other states have enacted or introduced similar legislation.

the U.S. Senate and U.S. House versions of the Marketplace Fairness Act (S. 336, S. 743, and H.R. 684) were introduced in the 113<sup>th</sup> U.S. Congress in 2013. The bill has passed the U.S. Senate and is now in the U.S. House. If enacted, this legislation would allow states that meet certain simplification and other standards to require out-of-state sellers to collect and remit indirect taxes on goods purchased by in-state residents.

Given that we sell high value items, indirect tax is a significant consideration, and thus additional obligations to collect indirect taxes from customers may adversely impact our future sales. A successful assertion by one or more states, U.S. Congress, or foreign countries to require the collection of indirect taxes on the sale of our products and/or to require us to disclose our customers' private information to tax authorities could result in substantial tax, penalty, and interest liabilities for past sales; discourage customers from purchasing products from us; decrease our competitive advantage; cause us to spend additional money, time, and other resources to understand and comply with multi-jurisdictional tax structures; cause us to discontinue certain successful sales and marketing initiatives; and otherwise substantially harm our business and results of operations.

Our systems may be vulnerable to security breaches.

Our business is heavily dependent on the operation of our technology systems. These systems are vulnerable to unauthorized access from unintentional events or errors caused by employees or third party service providers, or deliberate attacks through actions of third parties. Such security breaches may result in operational disruption, misappropriation of customer credit card or other sensitive information, or corruption of data.

We devote significant resources to address security vulnerabilities including the use of encryption and authentication technology licensed from third parties to effect secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, human errors, and new discoveries in the field of cryptography or other developments may result in a compromise or breach of the technology used by us to protect customer transaction data. In addition, any party who is able to illicitly obtain a user's password could access the customer's transaction data. An increasing number of websites and Internet companies have reported breaches of their security.

Any such breach or compromise of our security could result in significant legal and financial exposure, damage to our reputation, and a loss of confidence in the security of our products and services that could potentially have an adverse effect on our business and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations, damage our computers or those of our customers. Because the techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems change frequently and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate cost-effective preventative measures. These issues are likely to become more difficult as we expand the number of countries in which we operate. We may need to expend significant resources to protect against security breaches or to address problems caused by breaches.



Table of Contents

We may be unsuccessful in further expanding our operations internationally.

For the year to date ended September 28, 2014, international net sales represented 18.2% of our total net sales. We continue to increase marketing and sales efforts and anticipate continuing to expand our international sales and operations in the future either by expanding local versions of our website for foreign markets, through acquisitions, investments or alliances with third parties, or through other means. Investments in foreign entities may be impaired and lose value, and this risk of loss is heightened by potential changes in the legal and regulatory environment in the international markets where these acquired businesses or joint ventures operate.

Further, any international expansion plans we choose to undertake will increase the complexity of our business, require attention from management and other personnel and cause additional strain on our operations, technology systems, financial resources, and our internal financial control and reporting functions. Further, our expansion efforts may be unsuccessful. We have limited experience selling our products in international markets and in conforming to the local cultures, standards or policies necessary to successfully compete in those markets. We cannot be certain that we will be able to expand our global presence if we choose to further expand internationally. In addition, we may have to compete with retailers that have more experience with local markets. Our ability to expand and succeed internationally may also be limited by the demand for our products, the ability to successfully transact in foreign currencies, the ability of our brand to resonate with consumers globally and the adoption of online or Internet commerce in these markets. Different privacy, censorship and liability standards and regulations, and different intellectual property laws in foreign countries may prohibit expansion into such markets or cause our business and results of operations to suffer.

Our current and future international operations may also fail to succeed due to other risks inherent in foreign operations, including:

- the need to develop new supplier and jeweler relationships;
- international regulatory requirements, tariffs and duties;
- difficulties in staffing and managing foreign operations;
- longer payment cycles from credit card companies;
- greater difficulty in accounts receivable collection;
- our reliance on third-party carriers for product shipments to our customers;
- risk of theft of our products during shipment;
- limited payment, shipping and insurance options for us and our customers;
- potential adverse tax consequences;
- foreign currency exchange risk;
- lack of infrastructure to adequately conduct electronic commerce transactions or fulfillment operations;
- unclear foreign intellectual property protection laws;
- laws and regulations related to corporate governance and employee/employer relationships;
- price controls or other restrictions on foreign currency;
- difficulties in obtaining export, import or other business licensing requirements;
- customs and import processes, costs or restrictions;
- increased payment risk and greater difficulty addressing credit card fraud;
- consumer and data protection laws;
- lower levels of adoption or use of the Internet;
- geopolitical events, including war and terrorism; or
- the need to conduct business in foreign languages on both the website and in our customer service efforts.

The People's Republic of China ("PRC") governs Blue Nile's subsidiaries' and partners' businesses and operations through laws, regulations and licensing requirements restricting (i) foreign investment in Internet sales, importation of goods and services, IT infrastructure, retail, and other sectors, and (ii) Internet content. There are uncertainties in the interpretation of the PRC laws, regulations and licensing requirements. If our Chinese business interests were found to be in violation of any existing or future PRC laws or regulations or if interpretations of laws

## Table of Contents

and regulations were to change, the business could be subject to fines and other financial penalties, have licenses revoked, or be forced to shut down entirely.

We face significant competition and may be unsuccessful in competing against current and future competitors.

The retail jewelry industry is intensely competitive. Online retail, including mobile and tablet, is rapidly evolving and subject to changing technology, shifting consumer preferences and tastes, and frequent introductions of new products and services. We expect the competition in the sale of diamonds and fine jewelry to increase and intensify in the future. Our current and potential competitors range from large and established companies to emerging start-ups. Larger more established companies have longer operating histories, greater brand recognition, existing customer and supplier relationships, and significantly greater financial, marketing and other resources. Additionally, larger competitors seeking to establish an online presence may be able to devote substantially more resources to website systems development and exert more leverage over the supply chain for diamonds and fine jewelry than we can. Larger competitors may also be better capitalized to opportunistically acquire, invest or partner with other domestic and international businesses.

Emerging start-ups may be able to innovate and provide products and services faster than we can, and they may be willing to more aggressively price their products in order to gain market share. In addition, traditional store-based retailers offer consumers the ability to physically handle and examine products in a manner that is not possible over the Internet, as well as a more convenient means of returning and exchanging purchased products. If our competitors are more successful than us in offering compelling products or in attracting and retaining consumers, our revenues and growth rates could decline. Such reductions and/or inventory liquidations can have a short-term adverse effect on our sales. Current and potential competitors include:

- independent jewelry stores;
- retail jewelry store chains, such as Tiffany & Co.;
- online retailers that sell jewelry and online jewelry retailers, such as Amazon.com, James Allen, and Brilliant Earth;
- department stores, chain stores and mass retailers, such as Nordstrom and Neiman Marcus;
- online auction sites, such as eBay;
- catalog and television shopping retailers, such as HSN and QVC;
- discount superstores and wholesale clubs, such as Wal-Mart and Costco Wholesale; and
- Internet shopping clubs, such as Gilt Groupe and Rue La La.

In addition to these competitors, we may face competition from suppliers of our products that decide to sell directly to consumers, either through physical retail outlets or through online stores. We also face competition from entities that make and market synthetic stones and gems to compete in the market for diamonds and diamond jewelry.

As a result of seasonal fluctuations in our net sales, our quarterly results may fluctuate and could be below expectations.

We have experienced and expect to continue to experience seasonal fluctuations in our net sales. In particular, a disproportionate amount of our net sales has been realized during the fourth quarter as a result of the December holiday season, and we expect this seasonality to continue in the future. Approximately 32%, 34% and 32% of our net sales in the years ended December 29, 2013, December 30, 2012 and January 1, 2012, respectively, were generated during the fourth quarter of each year. In anticipation of increased sales activity during the fourth quarter, we may incur significant additional expenses, including higher inventory of fine jewelry, additional marketing, and additional staffing in our fulfillment and customer support operations. If we experience lower than expected net sales during any fourth quarter, it may have a disproportionately large impact on our operating results and financial condition for that

year. Further, we may experience an increase in our net shipping costs due to complimentary upgrades, split-shipments, and additional long-zone shipments necessary to ensure timely delivery for the holiday

Table of Contents

season. We also experience considerable fluctuations in net sales in periods preceding other annual occasions such as Valentine's Day (first quarter) and Mother's Day (second quarter). In the future, our seasonal sales patterns may become more pronounced, may strain our personnel and fulfillment activities, and may cause a shortfall in net sales as compared with expenses in a given period, which could substantially harm our business and results of operations.

We may have exposure to greater than anticipated tax liabilities.

We are subject to various federal, state and local taxes in both the United States and foreign jurisdictions. Significant judgment is required in evaluating and estimating worldwide provisions and accruals for these taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. Our determination of our tax liability is always subject to audit in various jurisdictions, and such jurisdictions may assess additional tax liabilities, penalties, and interest against us. Although we believe our estimates are reasonable, the ultimate outcome of a tax audit and any related litigation could be materially different from our tax provisions and accruals, and could have a material adverse effect on our financial results. Changes to tax laws, changes to interpretations of existing tax laws, and/or developments in an audit or litigation could have a material effect on our operating results and cash flow for the period or periods for which that change or development occurs, as well as for prior and subsequent periods. In addition, the imposition of additional tax obligations on our business by federal, state and local governments could create significant administrative burdens for us, decrease our future sales and harm our cash flow and operating results.

System interruptions that impair customer access to our website would damage our reputation and brand and substantially harm our business and results of operations.

The satisfactory performance, reliability and availability of our website, transaction processing systems and network infrastructure are critical to our reputation, our ability to attract and retain customers, and to maintain adequate customer service levels. Any future system interruptions, downtime or technical difficulties that result in the unavailability of our website or reduced order fulfillment performance could result in negative publicity, damage our reputation and brand, and cause our business and results of operations to suffer. We may be susceptible to such disruptions in the future. We may also experience temporary system interruptions for a variety of other reasons in the future, including power failures, failures of Internet service and telecommunication providers, software or human errors, or an overwhelming number of visitors trying to reach our website during periods of strong seasonal demand or promotions. Because we are dependent, in part, on third parties for the implementation and maintenance of certain aspects of our systems and because some of the causes of system interruptions may be outside of our control, we may not be able to remedy such interruptions in a timely manner, or at all.

Our corporate headquarters, primary fulfillment center, and the co-location facility which houses our computer and communication systems are located in Seattle, Washington. A natural disaster in Seattle, Washington may result in significant physical damage to or closure of one or more of these facilities, and significantly interrupt our customer service and fulfillment center operations, which could adversely affect our results of operations. Additionally, our systems and operations are vulnerable to damage or interruption from human error, fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, and similar events. We do not presently have redundant systems in multiple locations and our business interruption insurance may be insufficient to compensate us for losses that may occur. Any interruptions in our fulfillment center operations for any significant period of time could damage our reputation and brand and substantially harm our business and results of operations.

We rely on our suppliers, third-party carriers and third-party jewelers as part of our fulfillment process, and these third parties may fail to adequately serve our customers.

We significantly rely on our suppliers to promptly ship us diamonds ordered by our customers. Any failure by our suppliers to sell and ship such products to us in a timely manner will have an adverse effect on our ability to fulfill customer orders and harm our business and results of operations. Our suppliers, in turn, rely on third-party carriers to ship diamonds to us, and in some cases, directly to our customers. We also rely on a limited number of

Table of Contents

third-party carriers to deliver inventory to us and product shipments to our customers. We and our suppliers are therefore subject to the risks, including employee strikes, inclement weather, power outages, national disasters, rising fuel costs and financial constraints associated with such carriers' abilities to provide delivery services to meet our and our suppliers' shipping needs. In addition, for some customer orders we rely on third-party jewelers to assemble and ship the product. Our suppliers', third-party carriers' or third-party jewelers' failure to deliver high-quality products to us or our customers in a timely manner or to otherwise adequately serve our customers would damage our reputation and brand and substantially harm our business and results of operations.

Our stock price has been volatile historically, and may continue to be volatile. Further, sales of our common stock by stockholders with significant holdings may cause the price of our common stock to decrease.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements by us or our competitors, including announcements relating to strategic decisions or key personnel, service disruptions, changes in financial estimates and recommendations by security analysts, the operating and stock price performance of other companies that investors may deem comparable to us, volatility in the financial markets, and news reports relating to trends in our markets or general economic conditions. The impact of these events and factors on our stock price is amplified by the relatively low number of our shares on the market.

In addition, several of our stockholders own significant portions of our common stock. If these stockholders were to sell all or a portion of their holdings of our common stock, the market price of our common stock could be negatively impacted. The effect of such sales, or of significant portions of our stock being offered or made available for sale, could result in strong downward pressure on our stock price. Investors should be aware that they could experience significant short-term volatility in our stock if such stockholders decide to sell all or a portion of their holdings of our common stock at once or within a short period of time.

Repurchases of our common stock or other investments we may make may not prove to be the best use of our cash resources.

We have and plan to continue to opportunistically repurchase shares of our common stock. Since the inception of our stock repurchase program in the first quarter of 2005 through September 28, 2014, we have repurchased an aggregate of 9.0 million shares for a total of \$316.1 million. On October 28, 2013, our board of directors authorized the renewal of our stock repurchase program. We are authorized to repurchase up to \$100.0 million of our common stock over the 24 months following the approval date.

These repurchases and any repurchases we may make in the future may not prove to be at optimal prices and our use of cash for the stock repurchase program may not prove to be the best use of our cash resources and may adversely impact our future liquidity.

In addition, we have used in the past, and may use in the future, our cash and cash equivalents to make investments in certain businesses and ventures as our management thinks appropriate. These investments may decline in value after they are made or we may entirely lose the cash associated with the investment.

We may not accurately forecast net sales and appropriately plan our expenses.

We may base our current and future expense levels on our operating forecasts and estimates of future net sales. Net sales and operating results are difficult to forecast because they generally depend on the volume and timing of the orders we receive, which are uncertain. Additionally, our business is affected by general economic and business conditions in the U.S. and international markets. A softening in net sales, whether caused by changes in customer preferences or a weakening in the U.S. or global economies, may result in decreased revenue levels. Some of our expenses are fixed, and as a result, we may be unable to adjust our spending in a timely manner to compensate for any

unexpected shortfall in net sales. This inability could cause our net income in a given quarter to be lower than expected. We also make certain assumptions when forecasting the amount of expense we expect related to our stock-based compensation, which includes the expected volatility of our stock price, the expected life of stock options granted and the expected rate of stock option and restricted stock unit forfeitures. These assumptions are

## Table of Contents

partly based on historical results. If actual results differ from our estimates, our net income in a given quarter may be lower than expected.

If we are unable to accurately manage our inventory of fine jewelry, our reputation, results of operations and cash flow could suffer.

Except for loose diamonds, substantially all of the fine jewelry we sell is from our physical inventory. We are faced with the constant challenge of balancing our inventory levels with our ability to meet our customer needs. Based on internally generated projections, we purchase jewelry and jewelry components. These projections are based on many unknown assumptions around consumer demand, fashion trends, time to manufacture, pricing, etc.. If these inventory projections are too high, our inventory may be too high, which may result in lower retail prices and gross margins, risk of obsolescence, and harm to our financial results. Conversely, if these projections are too low, and we underestimate the consumer demand for our products, we are exposed to lost business opportunities which could have a material adverse effect on our business, results of operations, financial condition, and cash flows. Additionally, as we increase our product offerings, we may be forced to increase inventory levels, which will increase our risks related to our inventory.

We rely on our relationship with a third-party consumer credit company to offer financing for the purchase of our products.

The purchase of the diamond and fine jewelry products we sell is a substantial expense for many of our customers. We currently rely on our relationship with a consumer finance company to provide financing to our customers. If this company is not able to meet our customer's needs for credit or otherwise adequately serve our customers or if we are unable to maintain this or other similar arrangements, we may not be able to offer financing alternatives to our customers, which may reduce demand for our products and substantially harm our business and results of operations.

Unusual weather patterns could adversely affect the Company's performance.

Our operating results could be negatively impacted by unusual weather patterns. Frequent or unusually heavy snow, ice or rain storms, hurricanes, floods, tornadoes or extended periods of unseasonable temperatures could adversely affect our product availability, and ability to deliver products to our customers, which may harm our brand, lead to higher return rates, and negatively impact our performance. Additionally, significant power outages may result in a loss of sales. Given the seasonality of our business, unusual weather in the fourth quarter may have a disproportionately larger impact on operating results for the fourth quarter and the full year.

We face foreign exchange risk.

The results of operations of certain of our subsidiaries are exposed to foreign exchange rate fluctuations. Upon translation from foreign currency from international sales into U.S. dollars, operating results may differ materially from expectations, and we may record significant gains or losses. Additionally, we allow customers to purchase our products in 24 currencies. This exposes us to foreign exchange rate fluctuations and we may record significant gains or losses as a result of such fluctuations. We price our diamonds based on costs denominated in U.S. dollars. Therefore, when the U.S. dollar strengthens, the retail prices of our products in international markets will become more expensive and sales may decline.

We rely on the services of our small, specialized workforce and key personnel, many of whom would be difficult to replace.

We rely upon the continued service and performance of key technical, fulfillment and senior management personnel. If we lose any of these personnel or if our personnel do not work efficiently and effectively together, our business could suffer. Competition for qualified personnel in our industry is intense. We believe that our future

Table of Contents

success will depend on our continued ability to attract, hire and retain key employees. We do not have “key person” life insurance policies covering our employees.

The success of our business may depend on our ability to successfully expand our product offerings.

A component of our strategy is to expand our product offerings beyond our current offerings. If we offer new products that are not accepted by consumers, our net sales may fall short of expectations, our brand and reputation could be adversely affected, and we may incur substantial expenses that are not offset by increased net sales. Expansion of our product lines may also increase our inventory levels and strain our management and operational resources.

We face the risk of theft of our products from inventory or during shipment.

We have experienced and may continue to experience theft of our products while they are being held in our fulfillment centers or during the course of shipment to our customers by third-party shipping carriers. We have taken steps to prevent such theft. However, if security measures fail, losses exceed our insurance coverage or we are not able to maintain insurance at a reasonable cost, we could incur significant losses from theft, which would substantially harm our business and results of operations.

Our net sales consist exclusively of diamonds and fine jewelry, and demand for these products could decline.

Our net sales and results of operations are highly dependent on the demand for diamonds and diamond jewelry, particularly engagement rings. Should prevailing consumer tastes for diamonds decline, customs with respect to engagement shift away from the presentation of diamond jewelry, or if there is a reduced rate of marriages, demand for our products would decline and our business and results of operations would be substantially harmed.

The significant cost of diamonds results in part from their scarcity. From time to time, attempts have been made to develop and market synthetic stones and gems to compete in the market for diamonds and diamond jewelry. We expect such efforts to continue in the future. If any such efforts are successful in creating widespread demand for alternative diamond products, demand and price levels for our products would decline and our business and results of operations would be substantially harmed.

Increased attention on “conflict” diamonds, which are diamonds extracted from war-torn regions in Africa and sold by rebel forces to fund insurrection, may decrease demand for diamonds. Diamonds are, in some cases, also believed to be used to fund terrorist activities in some regions. We support the Kimberley Process, an international initiative intended to ensure diamonds are not illegally traded to fund conflict. As part of this initiative, we require our diamond suppliers to sign a statement acknowledging compliance with the Kimberley Process, and invoices received for diamonds purchased by us must include a certification from the vendor that the diamonds are conflict free. In addition, we prohibit the use of our business or services for money laundering or terrorist financing in accordance with the USA Patriot Act. Through these and other efforts, we believe that the suppliers from whom we purchase our diamonds exclude conflict diamonds from their inventories. However, we cannot independently determine whether any diamond we offer was extracted from these regions. Current efforts to increase consumer awareness of this issue and encourage legislative response could adversely affect consumer demand for diamonds.

Consumer confidence is dependent, in part, on the certification of our diamonds by independent laboratories. A decline in the quality of the certifications provided by these laboratories could adversely impact demand for our products. Additionally, a decline in consumer confidence in the credibility of independent diamond grading certifications could adversely impact demand for our diamond products.

Our fine jewelry offerings must reflect the tastes and preferences of a wide range of consumers whose preferences may change regularly. There can be no assurance that the styles we offer will continue to be popular

30

---

## Table of Contents

with consumers in the future. If our merchandise offerings are not popular with consumers and we are not able to adjust our product offerings in a timely manner, our net sales may decline or fail to meet expected levels.

Failure to adequately protect or enforce our intellectual property rights could substantially harm our business and results of operations.

We rely on a combination of patent, trademark, trade secret and copyright law, and contractual restrictions to protect our intellectual property. These afford only limited protection. Despite our efforts to protect and enforce our proprietary rights, unauthorized parties have attempted, and may in the future attempt, to copy aspects of our website images, features, compilation and functionality or to obtain and use information that we consider as proprietary, such as the technology used to operate our website, our content and our trademarks. We have registered or have applications pending for, "Blue Nile," the BN logo, the Blue Nile BN stylized logo, "Build Your Own Ring", "Build Your Own Five-Stone Ring," "Build Your Own Three Stone Ring," "Build Your Own Diamond Jewelry," "Build Your Own Diamond Pendant," "Build Your Own Earrings," and "Build Your Own Charm Bracelet" as trademarks in the United States and in certain other countries. Our competitors have, and other competitors may, adopt service names similar to ours, thereby impeding our ability to build brand identity and possibly leading to consumer confusion. In addition, there could be potential trade name or trademark infringement claims brought by owners of other registered trademarks or trademarks that incorporate variations of the term Blue Nile or our other trademarks. Any claims or consumer confusion related to our trademarks could damage our reputation and brand and substantially harm our business and results of operations. In addition, we are the holder of a patent entitled "Computerized Search Technique, such as an Internet-Based Gemstone Search Technique" (U.S. Patent No. 8,271,521) and have several other U.S. patent applications pending at this time.

We currently hold the bluenile.com, bluenile.co.uk and bluenile.ca Internet domain names and various other related domain names. Domain names generally are regulated by Internet regulatory bodies. The regulation of domain names in the United States and in foreign countries is subject to change. Regulatory bodies have and may continue to establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. We may not be able to, or it may not be cost effective to, acquire or maintain all domain names that utilize the name Blue Nile in all of the countries in which we currently conduct or intend to conduct business. If we lose the ability to use a domain name, we could incur significant additional expenses to market our products within that country, including the development of new branding. This could substantially harm our business and results of operations.

Litigation or similar proceedings has been in the past and may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets and domain names and to determine the validity and scope of the proprietary rights of others. Any litigation or adverse priority proceeding could result in substantial costs and diversion of resources and could substantially harm our business and results of operations. We sell and intend to increasingly sell our products internationally, and the laws of many countries do not protect our proprietary rights to as great an extent as do the laws of the United States.

Assertions by third parties of infringement by us of their intellectual property rights could result in significant costs and substantially harm our business and results of operations.

Third parties have, and may in the future, assert that we have infringed their patents or other intellectual property rights. We cannot predict whether any such assertions or claims arising from such assertions will substantially harm our business and results of operations. If we are forced to defend against any infringement claims, whether they are with or without merit or are determined in our favor, we may face costly litigation, diversion of technical and management personnel, or product shipment delays. Furthermore, the outcome of a dispute may be that we would need to develop non-infringing technology or enter into royalty or licensing agreements. Royalty or licensing

agreements, if required, may be unavailable on terms acceptable to us, or at all.

Purchasers of diamonds and fine jewelry may not choose to shop online, which would prevent us from growing our business.

31

---

Table of Contents

The online market for diamonds and fine jewelry is significantly less developed than the online market for books, music, toys and other consumer products. If this market does not gain widespread acceptance, our business may suffer. Our success will depend, in part, on our ability to attract consumers who have historically purchased diamonds and fine jewelry through traditional retailers. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or price our products more competitively than we currently anticipate in order to attract additional online consumers to our website and convert them into purchasing customers. Specific factors that could prevent consumers from purchasing diamonds and fine jewelry from us include:

- concerns about buying luxury products such as diamonds and fine jewelry without a physical storefront, face-to-face interaction with sales personnel and the ability to physically handle and examine products;
- delivery time associated with Internet orders;
- product offerings that do not reflect consumer tastes and preferences;
- pricing that does not meet consumer expectations;
- concerns about the security of online transactions and the privacy of personal information;
- delayed shipments or shipments of incorrect or damaged products;
- inconvenience associated with returning or exchanging Internet purchased items; and
- usability, functionality and features of our website.

Our failure to address risks associated with payment methods, credit card fraud and other consumer fraud could damage our reputation and brand and may cause our business and results of operations to suffer.

Under current credit card practices, we are liable for fraudulent credit card transactions because we do not obtain a cardholder's signature. We do not currently carry insurance against this risk. To date, we have experienced minimal losses from credit card fraud, but we face the risk of significant losses from this type of fraud as our net sales increase and as we expand internationally. Our failure to adequately control fraudulent credit card transactions could damage our reputation and brand and substantially harm our business and results of operations. Additionally, for certain payment transactions, including credit and debit cards, we pay interchange and other fees. These fees may increase over time, which would raise our operating costs and lower our operating margins.

Government regulation of the Internet and e-commerce is evolving and unfavorable changes could substantially harm our business and results of operations.

We are not currently subject to direct federal, state or local regulation other than regulations applicable to businesses generally or directly applicable to retailing and online commerce. However, it is possible that laws and regulations may be adopted with respect to the Internet, which may impede the growth of Internet-based businesses. These regulations and laws may cover issues such as taxation, advertising, intellectual property rights, freedom of expression, pricing, restrictions on imports and exports, customs, tariffs, information security, privacy, data protection, content, distribution, electronic contracts and other communications, the provision of online payment services, broadband residential Internet access, and the characteristics and quality of products and services. Further, the growth of online commerce has prompted calls for more stringent consumer protection laws. Several states have proposed legislation to limit the uses of personal user information gathered online or require online companies to establish privacy policies. The adoption of additional privacy or consumer protection laws could create uncertainty in Internet usage and reduce the demand for our products and services.

We are not certain how our business may be affected by the application of existing laws governing issues such as property ownership, copyrights, personal property, encryption and other intellectual property issues, taxation, libel, obscenity, qualification to do business, and export or import matters. The vast majority of these laws were adopted

prior to the advent of the Internet. As a result, they do not contemplate or address the unique issues of the Internet and related technologies. Changes in laws intended to address these issues could create uncertainty for those conducting online commerce. This uncertainty could reduce demand for our products and services or increase

## Table of Contents

the cost of doing business as a result of litigation costs or increased fulfillment costs and may substantially harm our business and results of operations.

We may need to implement additional finance and accounting systems, procedures and controls as we grow our business and organization to satisfy international and other new reporting requirements.

As a public reporting company, we are required to comply with the Sarbanes-Oxley Act of 2002 and the related rules and regulations of the SEC, including expanded disclosures and accelerated reporting requirements and more complex accounting rules. Additionally, as we expand internationally, we will be subject to international accounting and reporting requirements that are new to our business. Compliance with these and other new requirements may increase our costs and require additional management time and resources. We may need to implement additional or enhance our current finance and accounting systems, procedures and controls to satisfy new accounting and reporting requirements. If our internal controls over financial reporting are determined to be ineffective, investors could lose confidence in the reliability of our internal controls over financial reporting, which could adversely affect our stock price.

We may undertake acquisitions to expand our business, which may pose risks to our business and dilute the ownership of our existing stockholders.

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our website through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, technologies or services. Integrating any newly acquired businesses, technologies or services may be expensive and time-consuming. To finance any acquisitions, it may be necessary for us to raise additional funds through public or private financings. Additional funds may not be available on terms that are favorable to us, and, in the case of equity financings, would result in dilution to our stockholders. If we do complete any acquisitions, we may be unable to operate such acquired businesses profitably or otherwise implement our strategy successfully. If we are unable to integrate any newly-acquired entities or technologies effectively, our business and results of operations could suffer. The time and expense associated with finding suitable and compatible businesses, technologies or services could also disrupt our ongoing business and divert our management's attention. Future acquisitions by us could also result in large and immediate write-offs or assumptions of debt and contingent liabilities, any of which could substantially harm our business and results of operations.

New regulations related to conflict minerals could adversely impact our business.

The Dodd-Frank Wall Street Reform and Consumer Protection Act contains provisions to improve transparency and accountability concerning the supply of certain minerals, known as conflict minerals, originating from the Democratic Republic of Congo (the "DRC") and adjoining countries. As a result, in August 2012 the SEC adopted annual disclosure and reporting requirements for those companies who use conflict minerals mined from the DRC and adjoining countries in their products. We performed due diligence efforts in fiscal 2013 and will continue these efforts to adhere with the disclosure requirements. There may be costs associated with complying with these disclosure requirements, including those that may be incurred in conducting due diligence procedures to determine the sources of conflict minerals used in our products and other potential changes to products, processes or sources of supply as a consequence of such verification activities. The implementation of these rules could adversely affect the sourcing, supply and pricing of materials used in our products. As there may be only a limited number of suppliers offering conflict free conflict minerals, we cannot be sure that we will be able to obtain necessary conflict free conflict minerals from such suppliers in sufficient quantities or at competitive prices. Also, we may face reputational challenges if we determine that certain of our products contain minerals not determined to be conflict free or if we are unable to sufficiently verify the origins for all conflict minerals used in our products through the procedures we may implement.



Table of Contents

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

(c) Below is a summary of stock repurchases during the quarter ended September 28, 2014.

## Issuer Purchases of Equity Securities

(Dollars in thousands except per share amounts)

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs *
June 30, 2014 through July 27, 2014	57,432	\$27.94	57,432	\$59,692
July 28, 2014 through August 24, 2014	—	\$—	—	\$59,692
August 25, 2014 through September 28, 2014	—	\$—	—	\$59,692
Total shares purchased	57,432		57,432	

On October 28, 2013, our board of directors authorized the renewal of our stock repurchase program. Under this renewed program, we are authorized to repurchase up to \$100.0 million of our common stock over the 24 months following the approval date. As of September 28, 2014, approximately \$59.7 million remained under the repurchase authorization. The shares may be repurchased from time to time in open market transactions or in negotiated transactions off the market. Our management determines the timing and amount of any shares repurchased based on their evaluation of market conditions and other factors. Repurchases may also be made under a Rule 10b5-1 plan, which would permit shares to be repurchased when we might otherwise be precluded from doing so under insider trading laws.

Table of Contents

Item 6. Exhibits

See exhibits listed under the Exhibit Index on page 37.

35

---

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

BLUE NILE, INC.  
Registrant

Dated: November 4, 2014

/s/ David Binder  
David Binder  
Chief Financial Officer and Chief Administrative Officer  
(Principal Financial Officer)

Table of Contents

INDEX

Exhibit Number	Description
3.1 (1)	Amended and Restated Certificate of Incorporation of Blue Nile, Inc.
3.2 (2)	Amended and Restated Bylaws of Blue Nile, Inc.
4.1	Reference is made to Exhibits 3.1 and 3.2.
4.2 (3)	Specimen Stock Certificate.
31.1 (4)	Certification of Chief Executive Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2 (4)	Certification of Principal Financial Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1 (4)*	Certification of Chief Executive Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.
32.2 (4)*	Certification of Principal Financial Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

The certifications attached as Exhibits 32.1 and 32.2 accompany this Quarterly Report on Form 10-Q pursuant to \*Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed “filed” by Blue Nile, Inc. for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

Previously filed as Exhibit 3.1 to Blue Nile, Inc.’s Quarterly Report on Form 10-Q for the quarterly period ended (1) July 4, 2004 (No. 000-50763), as filed with the Securities and Exchange Commission on August 6, 2004, and incorporated by reference herein.

(2) Previously filed as the like numbered exhibit to Blue Nile, Inc.’s Current Report on Form 8-K (No. 000-50763), as filed with the Securities and Exchange Commission on November 9, 2009, and incorporated by reference herein.

(3) Previously filed as Exhibit 4.2 to Blue Nile, Inc.’s Registration Statement on Form S-1/A (No. 333-113494), as filed with the Securities and Exchange Commission on May 4, 2004, as amended, and incorporated by reference herein.

(4) Filed herewith.