

BLUE NILE INC
 Form 10-Q
 May 07, 2013
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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 March 31, 2013

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 (State or other jurisdiction of incorporation or organization)	91-1963165 (I.R.S. Employer Identification No.)
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411 First Avenue South, Suite 700, Seattle, Washington (Address of principal executive offices) (206) 336-6700 (Registrant's telephone number, including area code)	98104 (Zip code)
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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 May 1, 2013 the registrant had 12,393,482 shares of common stock outstanding.

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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.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

BLUE NILE, INC.

Condensed Consolidated Balance Sheets

(in thousands, except par value)

	March 31, 2013 (unaudited)	December 30, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$40,518	\$87,017
Trade accounts receivable	1,853	2,578
Other accounts receivable	745	907
Inventories	34,013	33,270
Deferred income taxes	749	926
Prepays and other current assets	930	1,229
Total current assets	78,808	125,927
Property and equipment, net	7,800	7,876
Intangible assets, net	181	195
Deferred income taxes	8,044	7,786
Note receivable	2,000	2,000
Other investments	2,000	2,000
Other assets	119	117
Total assets	\$98,952	\$145,901
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$74,547	\$116,209
Accrued liabilities	6,396	12,439
Current portion of long-term financing obligation	60	60
Current portion of deferred rent	246	246
Total current liabilities	81,249	128,954
Long-term financing obligation, less current portion	610	625
Deferred rent, less current portion	2,141	2,188
Other long-term liabilities	25	25
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; 20,765 shares and 20,752 shares issued, respectively 12,472 shares and 12,503 shares outstanding, respectively	21	21
Additional paid-in capital	198,691	197,282
Accumulated other comprehensive loss	(144)	(100)
Retained earnings	83,715	82,883
Treasury stock, at cost; 8,293 and 8,249 shares outstanding, respectively	(267,356)	(265,977)
Total stockholders' equity	14,927	14,109
Total liabilities and stockholders' equity	\$98,952	\$145,901

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

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

	Quarter ended	
	March 31, 2013	April 1, 2012
Net sales	\$97,111	\$83,103
Cost of sales	79,465	67,825
Gross profit	17,646	15,278
Selling, general and administrative expenses	16,488	15,059
Operating income	1,158	219
Other income, net:		
Interest income, net	42	40
Other income, net	102	13
Total other income, net	144	53
Income before income taxes	1,302	272
Income tax expense	470	118
Net income	\$832	\$154
Basic net income per share	\$0.07	\$0.01
Diluted net income per share	\$0.07	\$0.01

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

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BLUE NILE, INC.
Condensed Consolidated Statements of Comprehensive Income
(unaudited)
(in thousands)

	Quarter ended	
	March 31, 2013	April 1, 2012
Net income	\$832	\$154
Other comprehensive (loss) income:		
Foreign currency translation adjustments	(44	) 43
Total comprehensive income	\$788	\$197

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

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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	
December 31, 2012	20,752	\$21	\$197,282	\$82,883	\$ (100)	(8,249)	\$(265,977)	\$14,109
Net income				832				832
Other comprehensive loss					(44)			(44)
Tax deficiency from exercise of stock options			(33)					(33)
Exercise of common stock options	10	—	219					219
Issuance of common stock to directors	1	—	20					20
Vesting of restricted stock units	2	—						—
Stock-based compensation			1,203					1,203
Repurchase of common stock						(44)	(1,379)	(1,379)
Balance, March 31, 2013	20,765	\$21	\$198,691	\$83,715	\$ (144)	(8,293)	\$(267,356)	\$14,927

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

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

	Year to date ended	
	March 31, 2013	April 1, 2012
Operating activities:		
Net income	\$832	\$154
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	777	896
Loss on disposal of property and equipment	—	24
Stock-based compensation	1,184	1,200
Deferred income taxes	(81)	) 281
Tax deficiency from exercise of stock options	(33)	) (141)
Excess tax benefit from exercise of stock options	(14)	) (6)
Changes in assets and liabilities:		
Receivables	887	2,983
Inventories	(743)	) (1,181)
Prepaid federal income taxes	—	(396)
Prepaid expenses and other assets	297	129
Accounts payable	(41,422)	) (31,280)
Accrued liabilities	(6,043)	) (3,901)
Deferred rent and other	(47)	) (36)
Net cash used in operating activities	(44,406)	) (31,274)
Investing activities:		
Purchases of property and equipment	(911)	) (770)
Net cash used in investing activities	(911)	) (770)
Financing activities:		
Repurchase of common stock	(1,379)) —
Proceeds from stock option exercises	219	3,889
Excess tax benefit from exercise of stock options	14	6
Principal payments under long-term financing obligation	(15)	) (15)
Net cash (used in) provided by financing activities	(1,161)	) 3,880
Effect of exchange rate changes on cash and cash equivalents	(21)	) 21
Net decrease in cash and cash equivalents	(46,499)	) (28,143)
Cash and cash equivalents, beginning of period	87,017	89,391
Cash and cash equivalents, end of period	\$40,518	\$61,248
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$2,895	\$1,145

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" or the "Company") is the 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 and maintains its website at 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 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 30, 2012, filed with the SEC on February 25, 2013 (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 30, 2012 is derived from the Company's audited consolidated financial statements and notes thereto for the fiscal year ended December 30, 2012, 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 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 of America ("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 and assumptions used to determine stock-based compensation expense. Actual results could differ materially from those estimates.

Foreign Currency

Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 in accumulated other comprehensive income (loss).

The Company offers customers the ability to transact in 25 foreign 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 Investment

The Company holds a minority ownership of a privately-held company in the form of convertible preferred shares, purchased for an aggregate of \$2.0 million, which we accounted for under the cost method of accounting. The Company reviews this investment for impairment when events and circumstances indicate that the decline in fair value of the asset below the carrying value is other-than-temporary. No other-than-temporary impairment charge was recorded for the three months ended March 31, 2013.

The Company holds a \$2.0 million note receivable (the "Note") from the same privately-held company. The Note bore interest at LIBOR + 1% as of March 31, 2013. The Note is recorded at its face amount on the Company's condensed consolidated balance sheet.

Credit Agreement

On February 11, 2013, the Company entered into a Credit Agreement (the "Credit Agreement") with U.S. Bank National Association (the "Lender"). The Credit Agreement provides for a \$35.0 million (the "Credit Limit") unsecured, revolving credit facility. The Credit Agreement terminates on February 11, 2014 (the "Line Termination Date"). Under the terms and conditions of the Credit Agreement, the Company may borrow from the Lender until the Line Termination Date, with the aggregate principal amounts outstanding at any one time not to exceed the Credit Limit. The interest on the Revolving Loan (as subsequently defined) is the daily reset LIBOR rate plus 1.65%. The fee for the unused portion of the Credit Limit is equal to 0.15% per annum and is due monthly.

Pursuant to the terms of the Credit Agreement, the Company must reduce the outstanding balance of the Revolving Loan to no more than zero for a minimum of 30 consecutive days annually. The Credit Agreement further provides that the Company maintain compliance with certain covenants, including, among other things: (1) maintenance by the Company of at least \$20.0 million in accounts with the Lender at the end of each fiscal quarter; and (2) maintenance by the Company of a fixed charge coverage ratio equal to at least 1.25 to 1.

As of the filing date of this Quarterly Report on Form 10-Q, the Company is in compliance with the covenants of the Credit Agreement and the Company does not have any amounts outstanding under the Credit Agreement.

Note 2. Stock-based Compensation

As of March 31, 2013, the Company had four 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.

The fair value of each stock option on the date of grant is estimated using the Black-Scholes-Merton option valuation model.

The following weighted-average assumptions were used for the valuation of stock options granted during the periods presented:

Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Quarter ended		
	March 31, 2013	April 1, 2012	
Expected term	4.5 years	4.3 years	
Expected volatility	57.1	% 59.2	%
Expected dividend yield	0.0	% 0.0	%
Risk-free interest rate	0.9	% 0.7	%
Estimated weighted-average fair value per stock option granted	\$14.61	\$16.03	

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 quarter ended March 31, 2013 is as follows:

	Options (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance, December 31, 2012	2,199	\$38.55		
Granted	109	31.42		
Exercised	(10)	22.37		
Canceled	(50)	33.12		
Balance, March 31, 2013	2,248	\$38.39	5.56	\$6,297
Vested and expected to vest at March 31, 2013	2,158	\$38.51	5.43	\$6,138
Exercisable, March 31, 2013	1,621	\$39.07	4.38	\$5,288

A summary of restricted stock unit (RSU) activity for the quarter ended March 31, 2013 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 31, 2012	3	\$29.67		
Granted	77	31.31		
Vested	(2)	31.94		
Canceled	—	—		
Balance, March 31, 2013	78	\$31.32	2.23	\$2,717
Vested and expected to vest at March 31, 2013	63	\$31.32	2.02	\$2,174

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 Company's closing stock price on such date.

The total intrinsic value of stock options exercised during the quarter ended March 31, 2013 was \$0.1 million. During the quarter ended March 31, 2013, the total fair value of stock options vested was \$1.9 million. As of

Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

March 31, 2013, the Company had total unrecognized compensation costs related to unvested stock options and RSUs of \$10.6 million, before income taxes. The Company expects to recognize this cost over a weighted average period of 2.9 years for the options and 3.9 years for the RSUs.

Note 3. Inventories

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

	March 31, 2013	December 30, 2012
Loose diamonds	\$1,875	\$1,583
Fine jewelry and other	32,138	31,687
Total	\$34,013	\$33,270

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):

	Quarter ended	
	March 31, 2013	April 1, 2012
Net income	\$832	\$154
Weighted average common shares outstanding	12,482	13,853
Basic net income per share	\$0.07	\$0.01
Dilutive effect of stock options and RSUs	211	261
Common stock and common stock equivalents	12,693	14,114
Diluted net income per share	\$0.07	\$0.01

The Company excluded 1,309,700 and 1,299,139 stock option shares from the computation of diluted net income per share for the quarters ended March 31, 2013 and April 1, 2012, respectively, due to their antidilutive effect.

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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 the Annual Report on Form 10-K filed for our fiscal year ended December 30, 2012. 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

We are the leading online retailer of high-quality diamonds and fine jewelry. We offer our products for sale through the www.bluenile.com website in over 40 countries and territories throughout the world. Our primary focus is on growing our business by providing unparalleled 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. Our lower gross profit margins result from the lower retail prices that we offer to our customers. We believe that our extensive and unique product selection, connection with our customers through our marketing and customer service efforts, and our competitive pricing will enable us to maximize our revenue and profitability and increase market share both domestically and internationally.

In order to increase our sales and market share, we are focused on accelerating the sales growth rate of our business through initiatives across three main categories: 1) the sale of engagement products in the U.S.; 2) the sale of non-engagement products in the U.S.; and 3) the sale of both engagement and non-engagement products in international markets. The engagement product category includes gold or platinum engagement rings with a diamond center stone and loose diamonds. Our non-engagement product category includes rings, earrings, necklaces, pendants, bracelets, gifts and accessories containing precious metals, diamonds, gemstones, or pearls.

We believe that value is one of the most important drivers of engagement sales, and the current costs 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.

Diamond prices decreased year-over-year through most of 2012 before stabilizing in the fourth quarter of 2012. Diamond prices have been relatively stable since the fourth quarter of 2012 and throughout most of the first quarter of 2013. Regardless of diamond pricing dynamics we will remain focused on 1) utilizing our aggressive retail pricing; 2) investing heavily in our engagement products; and 3) providing our customers with a compelling website experience across all devices in order to maintain our momentum, gain market share, and increase our value proposition compared to our competitors.

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. To accelerate growth in our non-engagement category, we are 1) maximizing our opportunity to sell wedding bands to both new and repeat customers through refined pricing, promotion, messaging and user experience; 2) refining the diamond jewelry assortment; 3) focusing on quality and understandable designs to drive sales in fashion jewelry; and 4) providing our customers with a compelling website experience across all devices in order to maintain our momentum, gain market share, and increase our value proposition compared to our competitors. We have and will continue to invest in this area.

As part of our plan to accelerate growth in our international business, we are extending our capabilities into markets with the highest potential for growth. We expect significant growth from international markets, both in countries where we have many years of experience, as well as emerging markets. We believe that the Asia-Pacific market, specifically China, represents significant long-term opportunities for us. In 2013, we will continue to increase our investments in infrastructure, product selection, website and mobile experience, and marketing. In addition, we will continue to explore strategic partnerships to better serve our customers in these markets.

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Investments during 2012 and the first quarter of 2013 have increased our selling, general and administrative expenses and increased the amount of inventory we carried compared to the same period last year. We believe that these investments will lead to increased growth in all categories of our business and provide higher profitability over the long-term.

First Quarter of 2013 Summary of Results of Operations

We achieved first quarter net sales of \$97.1 million, a 16.9% increase from the first quarter of 2012. Net sales in our international markets increased 24.8% from the first quarter of 2012 and comprised approximately 18.1% of our total net sales for the quarter. Our gross profit increased \$2.4 million in the first quarter of 2013, a 15.5% increase compared to the first quarter of 2012. Net income per diluted share was \$0.07 in the first quarter of 2013, compared to \$0.01 for the first quarter of 2012.

Results of Operations

Comparison of the Quarter Ended March 31, 2013 to the Quarter Ended April 1, 2012

The following table presents our operating results for the quarters ended March 31, 2013 and April 1, 2012, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

	Quarter ended		\$ Change	% Change	
	March 31, 2013	April 1, 2012			
Net sales	\$97,111	\$83,103	\$14,008	16.9	%
Cost of sales	79,465	67,825	11,640	17.2	%
Gross profit	17,646	15,278	2,368	15.5	%
Selling, general and administrative expenses	16,488	15,059	1,429	9.5	%
Operating income	1,158	219	939	428.8	%
Other income, net:					
Interest income	42	40	2	5.0	%
Other income, net	102	13	89	684.6	%
Total other income, net	144	53	91	171.7	%
Income before income taxes	1,302	272	1,030	378.7	%
Income tax expense	470	118	352	298.3	%
Net income	\$832	\$154	\$678	440.3	%
Basic net income per share	\$0.07	\$0.01	\$0.06	600.0	%
Diluted net income per share	\$0.07	\$0.01	\$0.06	600.0	%

Net Sales

Net sales increased 16.9% during the first quarter of 2013 as compared with the first quarter of 2012, due to increases across our three main categories. U.S. engagement net sales for the first quarter of 2013 increased 19.0% to \$55.3 million, compared to \$46.4 million for the first quarter of 2012 due to an increase in both average shipment value and the number of shipments. The increase was driven by marketing and pricing strategies to maximize sales. U.S. non-engagement net sales for the first quarter 2013 increased 7.4% to \$24.2 million, compared to \$22.6 million for the first quarter 2012 due to an increase in the average shipment value offset by a decrease in the number of shipments resulting from a change in product mix.

International net sales increased 24.8% to \$17.6 million from \$14.1 million in the first quarter of 2012 due to an increase in shipments slightly offset by lower average shipment value. The increase in shipments is the result of greater product selection and an increase in our localized marketing efforts. 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 first quarter of 2013, compared to the rates in effect during the first quarter of 2012, had a negative

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impact of approximately 1.1% on international net sales. Excluding the impact of changes in foreign exchange rates, international net sales increased 25.9% for the first quarter of 2013 compared to the first quarter of 2012.

Gross Profit

Gross profit in the first quarter of 2013 increased 15.5% to \$17.6 million from \$15.3 million in the first quarter of 2012. The increase in gross profit resulted primarily from the growth in net sales. Gross profit as a percentage of net sales was 18.2% for the first quarter of 2013 compared to 18.4% for the first quarter of 2012. The decrease in gross profit as a percentage of net sales resulted primarily from changes in our product mix. Our engagement products provide lower gross profit as a percentage of revenue than our non-engagement products. In the first quarter of 2013, sales of our engagement products grew faster than our non-engagement products and equaled 71.7% of our total revenue versus 69.6% in the first quarter of 2012.

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 changes in product acquisition costs, particularly diamond prices, product mix and pricing decisions.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 9.5% to \$16.5 million in the first quarter of 2013 compared to \$15.1 million in the first quarter of 2012. Compensation and benefits expense increased \$0.8 million due to increased headcount to support key business initiatives. Marketing and advertising costs increased \$0.5 million in the first quarter of 2013, primarily due to increased spending on online marketing vehicles and other marketing efforts to drive traffic to our website, both domestically and internationally. Credit card interchange and payment processing fees increased approximately \$0.4 million in the first quarter of 2013 due primarily to higher sales volumes and to a lesser extent an increase in rates. These increases were offset by savings of \$0.3 million in depreciation expense, other general and administrative expenses, and legal expense. As a percentage of net sales, selling, general and administrative expenses were 17.0% in the first quarter of 2013 compared to 18.1% in the first quarter of 2012.

Operating Income

Operating income was \$1.2 million in the first quarter of 2013 compared to \$0.2 million in the first quarter of 2012. The \$1.0 million increase in operating income is primarily due to the \$2.4 million increase in gross margin partially offset by the \$1.4 million increase in selling, general and administrative expenses.

Other Income, Net

The increase in other income, net in the first quarter of 2013 as compared to the first quarter of 2012 was primarily due to proceeds of approximately \$73,000 from a favorable settlement related to the De Beers anti-trust litigation.

Income Taxes

Our effective tax rate decreased to 36.1% in the first quarter of 2013 from 43.6% in the first quarter of 2012. The decrease in the effective rate is primarily due to a \$23,000 expense recorded in the first quarter of 2012 related to the reversal of a deferred tax asset.

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.

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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 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 March 31, 2013, we had a working capital deficiency of \$2.4 million, including cash and cash equivalents of \$40.5 million and inventory of \$34.0 million, offset by accounts payable of \$74.5 million. Current levels of cash and cash equivalents reflect the seasonal pay down of accounts payable and the strategic decision to repurchase shares of our common stock in the quarter ended March 31, 2013, resulting in the negative working capital.

Net cash of \$44.4 million was used in operating activities for the year to date ended March 31, 2013, compared to net cash used in operating activities of \$31.3 million for the year to date ended April 1, 2012. The increase in cash used for operating activities was attributable to a higher net payment of accounts payable and accrued liabilities in the current year. Net payment of accounts payable totaled \$41.4 million for the year to date ended March 31, 2013 compared to \$31.3 million for the year to date ended April 1, 2012. The net payment of accrued liabilities totaled \$6.0 million for the year to date ended March 31, 2013 compared to \$3.9 million for the year to date ended April 1, 2012. In the first quarter of each year, we generally have a significant pay down of our accounts payable balance built up during the previous year's fourth quarter holiday season.

Net cash of \$0.9 million and \$0.8 million was used in investing activities for the year to date periods ended March 31, 2013 and April 1, 2012, respectively. In both years, cash used in investing activities was primarily the result of purchases of property and equipment 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.

Net cash used in financing activities for the year to date ended March 31, 2013 was \$1.2 million, primarily related to the repurchase of common stock of \$1.4 million, partially offset by \$0.2 million of proceeds from stock option exercises. Net cash provided by financing activities for the year to date ended April 1, 2012 was \$3.9 million, primarily related to proceeds from stock option exercises.

On February 7, 2012, 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. During the year to date ended March 31, 2013, we repurchased an aggregate of 43,541 shares of our common stock for \$1.4 million. Since the reauthorization on February 7, 2012, we have repurchased an aggregate of 1,535,527 shares for a total of \$40.2 million. As of March 31, 2013, approximately \$59.8 million remains under this repurchase authorization, subject to limitations under Delaware law and the market conditions described below.

Since the inception of the buyback program in the first quarter of 2005 through March 31, 2013, we have repurchased an aggregate of approximately 7.5 million shares for a total of \$266.7 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 11, 2013, we entered into a credit agreement which provides for a \$35.0 million unsecured, revolving credit facility (the "Revolving Loan"). 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

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There have been no material changes to our contractual obligations during the period covered by this report from those disclosed in our Annual Report on Form 10-K filed with the SEC on February 25, 2013.

Off-Balance Sheet Arrangements

As of March 31, 2013, 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.

Blue Nile's 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.

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 March 31, 2013	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	24.8%	(1.1)%	25.9%
Quarter ended April 1, 2012	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	9.3%	0.8%	8.5%

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 on Form 10-K for the year ended December 30, 2012.

Item 4. Controls and Procedures**Evaluation of Disclosure Controls and Procedures**

During the quarter ended March 31, 2013, 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

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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 March 31, 2013, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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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 for the fiscal year ended December 30, 2012, as filed with the SEC on February 25, 2013.

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. Rapid and significant increases in commodity prices, particularly diamond prices, may materially and adversely affect our sales, gross margins, customer experience, and competitive position. 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. 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 financial results may be negatively and materially 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 113th Congress in 2013. 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 uniquely and materially 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

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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.

General economic factors may materially and 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, 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 and the uncertainty around the U. S. budget 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. These rapid 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 assortment expansion, the timing of cash receipts and payments, and vendor payment terms.

We may not successfully execute our growth strategy, which may have a material adverse impact on our business and financial results.

We are continuing to undertake several important strategic initiatives designed to drive long-term shareholder value. There can be no assurance that we will be able to successfully implement our new strategic initiatives or that the initiatives will improve results. Our strategy involves investing more in marketing to reach more customers, investing more in the expansion of our international business, and refining our product assortment. We may not be able to successfully implement our new strategic initiatives or the initiatives may result in inadequate return of capital on our investments, higher inventory and lower gross margins and may not result in increased revenue.

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. As part of our strategic initiatives, we plan to invest more in marketing. We may not invest in a way that effectively reaches 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.

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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.

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 34%, 32% and 34% of our net sales in the years ended December 30, 2012, January 1, 2012 and January 2, 2011, 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 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 be unsuccessful in further expanding our operations internationally.

For the quarter ended March 31, 2013, international net sales represented 18.1% of our total net sales. We continue to increase marketing and sales efforts throughout Canada, Europe, and the Asia-Pacific region, 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:

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- 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;
- changes in 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; and
- the need to conduct business in foreign languages on both the website and in our customer service efforts.

If we do not continuously innovate in response to the changing preferences of our customers, our business could be adversely affected.

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.

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 14%, 21% and 28% of our payments to our diamond and fine jewelry suppliers for each of the years ended December 30, 2012, January 1, 2012 and January 2, 2011 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 jewelry supply

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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 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. 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.

Our systems are vulnerable to security breaches.

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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.

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 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

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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. 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.

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

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

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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.

Our stock price has been volatile historically, and may continue to be volatile. Further, the sale 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 share repurchase program in the first quarter of 2005 through March 31, 2013, we have repurchased an aggregate of 7.5 million shares for a total of \$266.7 million. In February 2012, our board of directors authorized the repurchase of up to \$100.0 million of our common stock during the subsequent 24-month period. Approximately \$59.8 million remains under authorization to repurchase as of March 31, 2013. 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 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.

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

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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.

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 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 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.

We have 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 25 foreign 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, our business could suffer. Competition for qualified personnel in our industry is intense. We believe that our future success will depend on our continued ability to attract, hire and retain

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key employees. We do not have “key person” life insurance policies covering our employees. In addition, illness, severe adverse weather conditions or natural disasters could impede our ability to service our customers.

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 has been focused on “conflict” diamonds, which are diamonds extracted from war-torn regions in Africa and sold by rebel forces to fund insurrection. 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

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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 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,” and “Build Your Own Earrings” 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.

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. If we lose the ability to use a domain name in a particular country, we would be forced to either incur significant additional expenses to market our products within that country, including the development of a new brand and the creation of new promotional materials and packaging, or elect not to sell products in that country. Either result could substantially harm our business and results of operations. The regulation of domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may not be able to acquire or maintain the domain names that utilize the name Blue Nile in all of the countries in which we currently or intend to conduct business.