BLUE NILE INC
Form 10-Q
May 11, 2006

Table of Contents

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

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

For the quarterly period ended April 2, 2006

OR

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

For the transition period from __________ to __________

Commission file number 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.)*
705 Fifth Avenue South, Suite 900, 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 þ No o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

As of April 28, 2006, the registrant had 17,388,587 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 relate to future events and our future performance that are based on current expectations, estimates, forecasts and projections about the industries in which we operate and the beliefs and assumptions of 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, predict, potential, target 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 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. Financial Statements (unaudited)	
Consolidated Balance Sheets	4
Consolidated Statements of Operations	5
Consolidated Statements of Changes in Stockholders Equity	6
Consolidated Statements of Cash Flows	7
Notes to Consolidated Financial Statements	8
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3. Quantitative and Qualitative Disclosures About Market Risk	17
Item 4. Controls and Procedures	17
PART II. OTHER INFORMATION	
Item 1A. Risk Factors	18
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	29
Item 6. Exhibits	30
SIGNATURES	31
EXHIBIT 31.1	
EXHIBIT 31.2	
EXHIBIT 32.1	
EXHIBIT 32.2	

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

BLUE NILE, INC.
Consolidated Balance Sheets

	April 2, 2006 (Unaudited)	January 1, 2006
	(in thousands, except par value)	
Assets		
Current assets:		
Cash and cash equivalents	$ 61,820	$ 71,921
Restricted cash	117	119
Marketable securities	27,782	42,748
Trade accounts receivable	613	1,567
Other accounts receivable	239	310
Inventories	13,681	11,764
Deferred income taxes	2,103	3,223
Prepaids and other current assets	641	844
Total current assets	106,996	132,496
Property and equipment, net	3,423	3,261
Intangible assets, net	344	352
Deferred income taxes	2,178	1,819
Other assets	77	77
Total assets	$ 113,018	$ 138,005
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 28,412	$ 50,157
Accrued liabilities	3,463	5,262
Current portion of deferred rent	205	208
Total current liabilities	32,080	55,627
Deferred rent, less current portion	807	863
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 18,934 shares and 18,646 shares issued, respectively 17,432 shares and 17,331 shares outstanding, respectively	19	19
Additional paid-in capital	108,609	106,341
Deferred compensation	(410)	(480)
Accumulated other comprehensive income (loss)	(1)	5
Accumulated deficit	(4,007)	(6,362)

Treasury stock, at cost; 1,502 shares and 1,315 shares outstanding, respectively	(24,079)	(18,008)
Total stockholders equity	80,131	81,515
Total liabilities and stockholders equity	$ 113,018	$ 138,005

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

Table of Contents

BLUE NILE, INC.
Consolidated Statements of Operations

	Quarter Ended	
	April 2, 2006	April 3, 2005
	(Unaudited) (in thousands, except per share data)	
Net sales	$ 50,694	$ 44,116
Cost of sales	40,325	34,429
Gross profit	10,369	9,687
Selling, general and administrative expenses	7,704	6,123
Operating income	2,665	3,564
Other income (expense) net:		
Interest income	985	501
Income before income taxes	3,650	4,065
Income tax expense	1,295	1,463
Net income	$ 2,355	$ 2,602
Basic net income per share	$ 0.14	$ 0.15
Diluted net income per share	$ 0.13	$ 0.14

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

Table of Contents

BLUE NILE, INC.
Consolidated Statements of Changes in Stockholders Equity
(Unaudited)

Stockholders Equity

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Deferred Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock Shares	Treasury Stock Amount	Total Stockholders Equity
				(in thousands)					
Balance, January 1, 2006	18,646	$ 19	$ 106,341	$ (480)	$ (6,362)	$ 5	(1,315)	$ (18,008)	$ 81,515
Net income					2,355				2,355
Other comprehensive income (loss):									
Unrealized loss on marketable securities, net of tax						(6)			(6)
Total comprehensive income									2,349
Shares repurchased							(187)	(6,071)	(6,071)
Stock-based compensation			826	70					896
Exercise of stock options	288		976						976
Excess tax benefit from exercise of stock options			456						456
Issuance of common stock to directors			10						10
Balance, April 2, 2006	18,934	$ 19	$ 108,609	$ (410)	$ (4,007)	$ (1)	(1,502)	$ (24,079)	$ 80,131

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

Table of Contents

BLUE NILE, INC.
Consolidated Statements of Cash Flows

	Quarter Ended	
	April 2, 2006	April 3, 2005
	(Unaudited) (in thousands)	
Operating activities:		
Net income	$ 2,355	$ 2,602
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	468	415
Loss on disposal of fixed assets		5
Stock-based compensation	890	81
Deferred income taxes	1,220	1,378
Excess tax benefit from exercise of stock options	(418)	
Changes in assets and liabilities:		
Receivables, net	1,025	(30)
Inventories	(1,918)	(1,042)
Prepaid expenses and other assets	203	158
Accounts payable	(21,745)	(20,144)
Accrued liabilities	(1,797)	(3,018)
Deferred rent	(59)	(57)
Net cash used in operating activities	(19,776)	(19,652)
Investing activities:		
Purchases of property and equipment	(608)	(157)
Proceeds from the sale of property and equipment	1	1
Purchases of marketable securities	(20,043)	(22,066)
Proceeds from the sale of marketable securities	35,000	37,000
Transfers of restricted cash	2	(118)
Net cash provided by investing activities	14,352	14,660
Financing activities:		
Repurchase of common stock	(6,071)	(1,114)
Proceeds from stock option exercises	976	141
Excess tax benefit from exercise of stock options	418	
Net cash used in financing activities	(4,677)	(973)
Net decrease in cash and cash equivalents	(10,101)	(5,965)
Cash and cash equivalents, beginning of period	71,921	59,499
Cash and cash equivalents, end of period	$ 61,820	$ 53,534

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

Table of Contents

BLUE NILE, INC.

Notes to Consolidated Financial Statements

Note 1. Description of the Company and Summary of Significant Accounting Policies

The Company

Blue Nile, Inc. (the Company) is a leading online retailer of high quality diamonds and fine jewelry in the United States. In addition to sales of diamonds, fine jewelry and watches, the Company provides guidance and support to enable customers to more effectively learn about and purchase diamonds as well as classically styled fine jewelry. The Company, a Delaware corporation, based in Seattle, Washington, was formed in March 1999. The Company maintains its primary website at www.bluenile.com. The Company also operates the www.bluenile.co.uk and www.bluenile.ca websites.

Reclassifications

Certain reclassifications of prior period balances have been made for consistent presentation with the current period. These reclassifications had no impact on net income, net cash provided by operating activities or stockholders equity (deficit) as previously reported.

Basis of Presentation

The accompanying unaudited 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 filed for the year ended January 1, 2006. 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 period have been included and are of a normal, recurring nature.

The financial information as of January 1, 2006 is derived from the Company s audited consolidated financial statements and notes for the fiscal year ended January 1, 2006, included in Item 8 of the annual report on Form 10-K for the year then ended.

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.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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, the reserve for estimated fraud losses, the estimated fair value of stock options granted and the estimated rate of stock option forfeitures. Actual results could differ materially from those estimates.

Intangible Assets

Intangible assets represent the consideration paid for licenses and other similar agreements with finite lives. Amortization is calculated on a straight-line basis over the estimated useful life of the related assets, which range from 10 years to 17 years.

Table of Contents

BLUE NILE, INC.

Notes to Consolidated Financial Statements

Stock-Based Compensation

The Company grants non-qualified stock options under its 2004 equity incentive plan (the 2004 Plan) and its 2004 Non-Employee Directors Stock Option Plan (the Directors Plan). Additionally, the Company has outstanding non-qualified and incentive stock options under its 1999 equity incentive plan (the 1999 Plan). As of May 19, 2004, the effective date of the Company s initial public offering, no additional stock options were granted under the 1999 Plan.

Prior to January 2, 2006, the Company accounted for options granted under its employee compensation plans using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations including Financial Accounting Standards Board (FASB) Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25. Under APB 25, compensation expense was recognized for the difference between the market price of the Company s stock on the date of grant and the exercise price. As permitted by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation (SFAS 123), stock-based compensation was included as a pro forma disclosure in the notes to the consolidated financial statements.

Effective January 2, 2006, the Company adopted the provisions of SFAS No. 123R (Revised 2004), Share-Based Payment (SFAS 123R) using the modified prospective transition method for all stock options issued after becoming a public company. SFAS 123R requires measurement of compensation cost for all options granted based on fair value on the date of grant and recognition of compensation over the service period for those options expected to vest.

Stock-based compensation expense recorded for the quarter ended April 2, 2006 included the estimated expense for stock options granted on or subsequent to January 2, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R, and the estimated expense for the portion vesting in the period for options granted between March 11, 2004 (the date on which the Company was considered to be a public company for accounting purposes) and January 2, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123. Options granted prior to March 11, 2004 have been accounted for using the prospective transition method, which requires that those options continue to be accounted for under APB 25. In 2004 and 2003, the Company issued options to certain employees under the 1999 Plan with exercise prices below the deemed fair market value of the Company s common stock at the date of grant. In accordance with the requirements of APB 25, the Company has recorded deferred stock-based compensation for the difference between the exercise price of the stock option and the deemed fair market value of the Company s stock at the grant date. The deferred stock-based compensation is being amortized over the vesting period of the awards, generally four years. As prescribed under the modified prospective and prospective transition methods, results for the prior period have not been restated.

We recognize compensation expense on a straight-line basis over the requisite service period for each stock option grant. Total stock-based compensation expense recognized for the quarter ended April 2, 2006 was $880,000. Of this amount, $865,000 was recognized as selling, general and administrative expense and $15,000 was recognized as cost of sales. The related total tax benefit was $294,000. In addition, $15,000 of stock-based compensation was recorded for the quarter ended April 2, 2006 and was capitalized and included in property and equipment as a component of the cost capitalized for the development of software for internal use.

Prior to the adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statements of cash flows, in accordance with the provisions of Emerging Issues Task Force (EITF) Issue No. 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option (EITF 00-15). SFAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. This amount is shown as Excess tax benefit from exercise of stock options on the consolidated statement of cash flows and amounted to $418,000 for the quarter ended April 2, 2006.

Table of Contents

BLUE NILE, INC.

Notes to Consolidated Financial Statements

The following table shows the effect on net income and earnings per share had stock-based compensation cost been recognized based upon the estimated fair value on the grant date of stock options in accordance with SFAS 123 as amended by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure for the comparable prior year period (in thousands, except per share data):

	Quarter Ended April 3, 2005
Net income, as reported	$ 2,602
Add: Stock-based compensation expense, as reported	75
Deduct: Stock-based compensation expense determined under fair-value-based method, net of tax	(455)
Pro forma net income	$ 2,222
Income per share:	
Basic as reported	$ 0.15
Basic pro forma	$ 0.13
Diluted as reported	$ 0.14
Diluted pro forma	$ 0.12

Disclosures for the quarter ended April 2, 2006 are not presented as the amounts are recognized in the consolidated financial statements.

The fair value of each option on the date of grant is estimated using the Black-Scholes-Merton option valuation model. The following weighted-average assumptions were used for options granted for the quarters ended April 2, 2006 and April 3, 2005:

	Quarter Ended	
	April 2, 2006	April 3, 2005
Expected term	4.34 years	4 years
Expected volatility	36.4%	69.6%
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	4.63%	3.71%
Expected annual forfeiture rate	7.0%	0.0%
Estimated fair value per option granted	$12.23	$15.85

Expected Term   This is the estimated period of time until exercise and is based on historical experience for options with similar terms and conditions, giving consideration to future expectations.

Expected Volatility   This is based on the Company s historical stock price volatility in combination with the two-year implied volatility of its traded options.

Expected Dividend Yield   The Company has not paid dividends in the past and does not expect to pay dividends in the near future.

Risk-Free Interest Rate   This is the rate on Nominal U.S. Government Treasury Bills with lives commensurate with the lives of the options on the date of grant.

Table of Contents

BLUE NILE, INC.

Notes to Consolidated Financial Statements

Recent Accounting Pronouncements

In November 2005, the FASB issued FASB Staff Position (FSP) FAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP FAS 115-1 also includes accounting considerations subsequent to the recognition of an other-than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP FAS 115-1 is required to be applied to reporting periods beginning after December 15, 2005. We adopted FSP FAS 115-1 on January 2, 2006. The adoption of this statement did not have a material impact on our consolidated results of operations or financial condition.

In February 2006, the EITF reached a consensus on Issue No. 06-3 (EITF 06-3), How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation). The EITF reached a consensus that a company may adopt a policy for presenting taxes on a gross or net basis. If taxes are significant, the accounting policy should be disclosed and if taxes are presented gross, the amounts included in revenue should be disclosed. The consensus reached in this Issue is effective for periods beginning after December 15, 2006 with early application permitted. We will apply this guidance to our first quarter of fiscal 2007. We do not expect that the adoption of this statement will have a material impact on our consolidated results of operations or financial condition.

Note 2. Stock-based Compensation

Stock options are granted at prices equal to the fair market value of the Company s common stock on the date of grant. Stock options granted generally provide for 25% vesting on the first anniversary from the date of grant with the remainder vesting monthly over three years, and expire 10 years from the date of grant. As of April 2, 2006, the Company had four stock option plans. Additional information regarding these plans is disclosed in Note 1 and in our annual report on Form 10-K for the year ended January 1, 2006.

A summary of stock option activity for the quarter ended April 2, 2006 is as follows (in thousands, except exercise price):

	Options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Balance, January 1, 2006	2,095	$ 15.84		
Granted	12	33.51		
Exercised	(288)	3.39		
Cancelled	(16)	27.10		
Balance, April 2, 2006	1,803	$ 17.85	7.71	$ 31,268
Exercisable, April 2, 2006	958	$ 9.08	6.82	$ 25,027

Stock options granted during the quarter ended April 2, 2006 have a weighted average grant-date fair value of $12.23. The total intrinsic value of options exercised during the quarter ended April 2, 2006 was $8.8 million. As of April 2, 2006, the Company had total unrecognized compensation costs related to unvested stock options accounted for using the modified prospective and prospective methods under SFAS 123R of $8.6 million. We expect to recognize this cost over a weighted average period of 2.4 years. The unrecognized compensation cost related to stock options granted subsequent to March 11, 2004 will be adjusted for any future changes in the rate of estimated forfeitures. The unrecognized compensation cost related to stock options granted prior to March 11, 2004 and accounted for under the prospective application method will be adjusted for actual forfeitures as they occur.

Table of Contents

BLUE NILE, INC.

Notes to Consolidated Financial Statements

The following table summarizes information about stock options outstanding at April 2, 2006:

	Outstanding			Exercisable	
		Weighted average Remaining contractual			
Range of exercise price	**Options (in thousands)**	**life (in years)**	**Exercise price**	**Options (in thousands)**	**Weighted average exercise price**
$0.25	407	5.90	$ 0.25	401	$ 0.25
$0.28-$8.75	401	6.92	5.76	296	4.79
$9.38-$29.89	166	8.34	21.96	78	20.68
$30.00	400	8.32	30.00	153	30.00
$30.04-$42.15	429	9.33	32.93	30	32.52
	1,803	7.71	17.85	958	9.08

Note 3. Inventories

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

	April 2, 2006	January 1, 2006
Loose diamonds	$ 379	$ 629
Fine jewelry, watches and other	13,302	11,135
	$ 13,681	$ 11,764

Note 4. Marketable Securities

The Company s marketable securities are classified as available-for-sale as defined by SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS 115). At April 2, 2006, marketable securities consisted of U.S. government and agencies securities maturing within one year. The securities are carried at fair value, with the unrealized gains and losses included in accumulated other comprehensive income (loss). Realized gains or losses on the sale of marketable securities are identified on a specific identification basis and are reflected as a component of interest income or expense.

Marketable securities totaled $27.8 million and $42.7 million at April 2, 2006 and January 1, 2006, respectively. There were no realized gains or losses on the sales of marketable securities for the quarter ended April 2, 2006. Gross unrealized gains and losses at April 2, 2006 and January 1, 2006 were not significant.

Any unrealized losses are considered temporary as the duration of the decline in value has been short, the extent of the decline is not severe and the Company has the ability to hold the investments until it recovers substantially all of the cost of the investment.

Note 5. 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 common shares issuable upon assumed exercise of outstanding stock options, except when the effect of their inclusion would be antidilutive.

Table of Contents

BLUE NILE, INC.

Notes to Consolidated Financial Statements

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