BLUE NILE INC
Form 10-Q
August 10, 2006

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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 July 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 July 28, 2006, the registrant had 15,984,881 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 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, targets 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.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

BLUE NILE, INC.
Consolidated Balance Sheets
(in thousands, except par value)

	July 2, 2006 (unaudited)	January 1, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 41,317	$ 71,921
Restricted cash	119	119
Marketable securities	14,934	42,748
Trade accounts receivable	638	1,567
Other accounts receivable	184	310
Inventories	11,211	11,764
Deferred income taxes	1,511	3,223
Prepaids and other current assets	788	844
Total current assets	70,702	132,496
Property and equipment, net	3,540	3,261
Intangible assets, net	336	352
Deferred income taxes	1,545	1,819
Other assets	77	77
Total assets	$ 76,200	$ 138,005
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 27,682	$ 50,157
Accrued liabilities	3,342	5,262
Current portion of deferred rent	202	208
Total current liabilities	31,226	55,627
Deferred rent, less current portion	752	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 18,963 shares and 18,646 shares issued, respectively 16,192 shares and 17,331 shares outstanding, respectively	19	19
Additional paid-in capital	109,778	106,341
Deferred compensation	(322)	(480)
Accumulated other comprehensive income (loss)	(1)	5
Accumulated deficit	(875)	(6,362)
Treasury stock, at cost; 2,771 shares and 1,315 shares outstanding, respectively	(64,377)	(18,008)

Total stockholders equity		44,222		81,515
Total liabilities and stockholders equity	$	76,200	$	138,005

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

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

	Quarter Ended		Year To Date Ended	
	July 2, 2006	**July 3, 2005**	**July 2, 2006**	**July 3, 2005**
Net sales	$ 56,916	$ 43,826	$ 107,610	$ 87,942
Cost of sales	45,568	33,836	85,893	68,265
Gross profit	11,348	9,990	21,717	19,677
Selling, general and administrative expenses	7,746	6,184	15,450	12,307
Operating income	3,602	3,806	6,267	7,370
Other income (expense), net:				
Interest income	881	559	1,866	1,060
Other income	100		100	
Total other income (expense), net	981	559	1,966	1,060
Income before income taxes	4,583	4,365	8,233	8,430
Income tax expense	1,451	1,572	2,746	3,035
Net income	$ 3,132	$ 2,793	$ 5,487	$ 5,395
Basic net income per share	$ 0.19	$ 0.16	$ 0.32	$ 0.30
Diluted net income per share	$ 0.18	$ 0.15	$ 0.31	$ 0.29

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

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

	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
Balance, January 1, 2006	18,646	$ 19	$ 106,341	$ (480)	$ (6,362)	$ 5	(1,315)	$ (18,008)	$ 81,515
Net income					5,487				5,487
Other comprehensive income (loss):									
Unrealized loss on marketable securities, net of tax						(6)			(6)
Total comprehensive income									5,481
Shares repurchased							(1,456)	(46,369)	(46,369)
Amortization of deferred stock compensation				138					138
Reversal of deferred compensation relating to forfeited options			(20)	20					
Stock-based compensation			1,738						1,738
Exercise of stock options	316		1,087						1,087
Tax benefit from exercise of stock options			612						612
Issuance of common stock to directors	1		20						20
Balance, July 2, 2006	18,963	$ 19	$ 109,778	$ (322)	$ (875)	$ (1)	(2,771)	$ (64,377)	$ 44,222

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

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

	Year To Date Ended July 2, 2006	Year To Date Ended July 3, 2005
Operating activities:		
Net income	$ 5,487	$ 5,395
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	952	835
Loss on disposal of fixed assets	2	10
Stock-based compensation	1,859	169
Deferred income taxes	2,009	2,424
Tax benefit from exercise of stock options	592	459
Excess tax benefit from exercise of stock options	(34)	
Changes in assets and liabilities:		
Receivables, net	1,056	146
Inventories	553	1,065
Prepaid expenses and other assets	57	(193)
Accounts payable	(22,475)	(19,625)
Accrued liabilities	(1,919)	(2,958)
Deferred rent	(118)	(114)
Net cash used in operating activities	(11,979)	(12,387)
Investing activities:		
Purchases of property and equipment	(1,182)	(346)
Proceeds from the sale of property and equipment	1	5
Purchases of marketable securities	(25,195)	(71,955)
Proceeds from the sale of marketable securities	53,000	64,000
Transfers of restricted cash		(119)
Net cash provided by (used in) investing activities	26,624	(8,415)
Financing activities:		
Repurchase of common stock	(46,370)	(7,406)
Proceeds from stock option exercises	1,087	198
Excess tax benefit from exercise of stock options	34	
Net cash used in financing activities	(45,249)	(7,208)
Net decrease in cash and cash equivalents	(30,604)	(28,010)
Cash and cash equivalents, beginning of period	71,921	59,499
Cash and cash equivalents, end of period	$ 41,317	$ 31,489

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

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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 used in operating activities or stockholders equity 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 and the estimated fair value of stock options granted. 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.

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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 of the stock option. 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 expense over the service period for those options expected to vest. Stock-based compensation expense recorded for the quarter and year to date ended July 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 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 periods 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 and year to date ended July 2, 2006 was approximately $959,000 and $1.8 million, respectively. Of this amount, approximately $943,000 and $1.8 million, respectively, was recognized as selling, general and administrative expense and approximately $16,000 and $31,000, respectively, was recognized as cost of sales. The related total tax benefit was approximately $317,000 and $605,000, respectively. In addition, approximately $22,000 and $37,000 of stock-based compensation costs that were recorded for the quarter and year to date ended July 2, 2006, respectively, were 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). The tax benefits resulting from the exercise of stock options granted prior to March 11, 2004 will continue to be reported as cash inflows in accordance with the prospective transition method. SFAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options granted on or subsequent to March 11, 2004 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

$34,000 for the year to date ended July 2, 2006.

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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 granted between March 11, 2004 and January 2, 2006 in accordance with SFAS 123 as amended by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure for the comparable prior year periods (in thousands, except per share data):

	Quarter Ended July 3, 2005	Year To Date Ended July 3, 2005
Net income, as reported	$ 2,793	$ 5,395
Deduct: Stock-based compensation expense determined under fair-value-based method, net of tax	(418)	(787)
Pro forma net income	$ 2,375	$ 4,608
Income per share:		
Basic as reported	$ 0.16	$ 0.30
Basic pro forma	$ 0.13	$ 0.26
Diluted as reported	$ 0.15	$ 0.29
Diluted pro forma	$ 0.13	$ 0.25

Disclosures for the quarter and year to date ended July 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 the valuation of options granted during the periods ended July 2, 2006 and July 3, 2005:

	Quarter Ended		Year to Date Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Expected term	4.5 years	4 years	4.5 years	4 years
Expected volatility	36.0%	64.5%	36.0%	67.9%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	5.01%	3.73%	5.01%	3.72%
Estimated fair value per option granted	$11.07	$15.66	$11.09	$15.79

Expected Term This is the estimated period of time until exercise and is based primarily on historical experience for options with similar terms and conditions, giving consideration to future expectations. We also considered the expected terms of other companies that have contractual terms, expected stock volatility and employee demographics similar to ours.

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

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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.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the implications of this statement and the impact on our consolidated results of operations and 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 July 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 year to date ended July 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	523	31.31		
Exercised	(317)	3.43		
Cancelled	(45)	26.06		
Balance, July 2, 2006	2,256	$ 20.97	8.02	$ 25,625
Exercisable, July 2, 2006	994	$ 10.05	6.67	$ 22,004

Stock options granted during the year to date ended July 2, 2006 have a weighted average grant-date fair value of $11.09. The total intrinsic value of options exercised during the year to date ended July 2, 2006 was $9.6 million. As of July 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 $11.6 million. We expect to recognize this cost over a weighted average period of 1.5 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.

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Notes to Consolidated Financial Statements

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

	Outstanding		Exercisable
		Weighted average	
	Remaining		
	contractual		
Options			