BLUE NILE INC
Form 10-Q
November 09, 2011
**Table of Contents**

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, DC 20549**

# FORM 10-Q

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

**For the quarterly period ended October 2, 2011 October 2, 2011**

**OR**

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

**For the transition period from to**

**Commission file number 000-50763**

# BLUE NILE, INC.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **91-1963165** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **411 First Avenue South, Suite 700, Seattle, Washington** **(Address of principal executive offices)** | **98104** **(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 x 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 x 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 x | 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 x

As of November 3, 2011, the registrant had 13,556,124 shares of common stock outstanding.

**Table of Contents**

**Cautionary Note Regarding Forward-Looking Statements**

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

**Table of Contents**

**BLUE NILE, INC.**

**INDEX**


| | Page |
|---|---|
| PART I. FINANCIAL INFORMATION | |
| Item 1. Financial Statements | |
| Condensed Consolidated Balance Sheets (unaudited) | 4 |
| Condensed Consolidated Statements of Operations (unaudited) | 5 |
| Condensed Consolidated Statement of Changes in Stockholders Equity (unaudited) | 6 |
| Condensed Consolidated Statements of Cash Flows (unaudited) | 7 |
| Notes to Condensed Consolidated Financial Statements (unaudited) | 8 |
| Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations | 13 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 18 |
| Item 4. Controls and Procedures | 19 |
| PART II. OTHER INFORMATION | |
| Item 1. Legal Proceedings | 19 |
| Item 1A. Risk Factors | 19 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 33 |
| Item 6. Exhibits | 33 |
| SIGNATURES | 34 |

**Table of Contents**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**BLUE NILE, INC.**

**Condensed Consolidated Balance Sheets**

**(in thousands, except par value)**

| | October 2, 2011 (unaudited) | January 2, 2011 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 40,159 | $ 113,261 |
| Trade accounts receivable | 1,930 | 1,405 |
| Other accounts receivable | 338 | 366 |
| Inventories | 23,020 | 20,166 |
| Deferred income taxes | 293 | 557 |
| Prepaids and other current assets | 1,263 | 1,083 |
| Total current assets | 67,003 | 136,838 |
| Property and equipment, net | 8,568 | 6,157 |
| Intangible assets, net | 267 | 274 |
| Deferred income taxes | 9,378 | 8,424 |
| Other assets | 128 | 118 |
| Total assets | $ 85,344 | $ 151,811 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 53,255 | $ 90,296 |
| Accrued liabilities | 4,441 | 11,490 |
| Current portion of long-term financing obligation | 59 | 48 |
| Current portion of deferred rent | 209 | 86 |
| Total current liabilities | 57,964 | 101,920 |
| Long-term financing obligation, less current portion | 700 | 748 |
| Deferred rent, less current portion | 2,080 | 82 |
| 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; 20,309 shares and 20,212 shares issued, respectively 13,571 shares and 14,539 shares outstanding, respectively | 20 | 20 |
| Additional paid-in capital | 180,810 | 173,143 |
| Accumulated other comprehensive income (loss) | 2 | (66) |
| Retained earnings | 70,270 | 63,141 |
| Treasury stock, at cost; 6,738 and 5,673 shares outstanding, respectively | (226,502) | (187,177) |
| Total stockholders equity | 24,600 | 49,061 |
| Total liabilities and stockholders equity | $ 85,344 | $ 151,811 |

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

Table of Contents

**BLUE NILE, INC.**

**Condensed Consolidated Statements of Operations**

**(unaudited)**

**(in thousands, except per share data)**

| | Quarter ended | | Year to date ended | |
|---|---|---|---|---|
| | October 2, 2011 | October 3, 2010 | October 2, 2011 | October 3, 2010 |
| Net sales | $ 74,987 | $ 67,451 | $ 235,689 | $ 218,110 |
| Cost of sales | 60,149 | 52,813 | 186,758 | 171,472 |
| Gross profit | 14,838 | 14,638 | 48,931 | 46,638 |
| Selling, general and administrative expenses | 11,978 | 10,400 | 38,299 | 34,572 |
| Operating income | 2,860 | 4,238 | 10,632 | 12,066 |
| Other income, net: | | | | |
| Interest income, net | 33 | 10 | 116 | 22 |
| Other (expense) income, net | (20) | 3 | 61 | 123 |
| Total other income, net | 13 | 13 | 177 | 145 |
| Income before income taxes | 2,873 | 4,251 | 10,809 | 12,211 |
| Income tax expense | 1,004 | 1,479 | 3,680 | 4,248 |
| Net income | $ 1,869 | $ 2,772 | $ 7,129 | $ 7,963 |
| Basic net income per share | $ 0.13 | $ 0.19 | $ 0.50 | $ 0.55 |
| Diluted net income per share | $ 0.13 | $ 0.19 | $ 0.48 | $ 0.53 |

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

Table of Contents

**BLUE NILE, INC.**

**Condensed Consolidated Statement of Changes in Stockholders Equity**

**(unaudited)**

**(in thousands)**

| | Common Stock | | Additional | | Accumulated Other | Treasury Stock | | Total |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Paid-in Capital | Retained Earnings | Comprehensive Income (Loss) | Shares | Amount | Stockholders Equity |
| Balance, January 2, 2011 | 20,212 | $ 20 | $ 173,143 | $ 63,141 | $ (66) | (5,673) | $ (187,177) | $ 49,061 |
| Net income | | | | 7,129 | | | | 7,129 |
| Other comprehensive income (loss): | | | | | | | | |
| Foreign currency translation adjustment | | | | | 68 | | | 68 |
| Total comprehensive income | | | | | | | | 7,197 |
| Tax benefit from exercise of stock options | | | 579 | | | | | 579 |
| Exercise of common stock options | 90 | | 1,724 | | | | | 1,724 |
| Issuance of common stock to directors | 2 | | 90 | | | | | 90 |
| Vesting of restricted stock units | 5 | | | | | | | |
| Stock-based compensation | | | 5,274 | | | | | 5,274 |
| Repurchase of common stock | | | | | | (1,065) | (39,325) | (39,325) |
| Balance, October 2, 2011 | 20,309 | $ 20 | $ 180,810 | $ 70,270 | $ 2 | (6,738) | $ (226,502) | $ 24,600 |

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

6

Table of Contents

**BLUE NILE, INC.**

**Condensed Consolidated Statements of Cash Flows**

**(unaudited)**

**(in thousands)**

| | Year to date ended October 2, 2011 | Year to date ended October 3, 2010 |
|---|---|---|
| **Operating activities:** | | |
| Net income | $ 7,129 | $ 7,963 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation and amortization | 2,521 | 2,301 |
| Loss on disposal of property and equipment | 35 | |
| Stock-based compensation | 5,243 | 5,369 |
| Deferred income taxes | (690) | (1,148) |
| Tax benefit from exercise of stock options | 579 | 3,615 |
| Excess tax benefit from exercise of stock options | (367) | (190) |
| Changes in assets and liabilities: | | |
| Receivables | (473) | 103 |
| Inventories | (2,854) | 2,226 |
| Prepaid expenses and other assets | (190) | (214) |
| Accounts payable | (37,123) | (34,145) |
| Accrued liabilities | (7,065) | (4,756) |
| Deferred rent and other | 2,097 | (142) |
| Net cash used in operating activities | (31,158) | (19,018) |
| **Investing activities:** | | |
| Purchases of property and equipment | (4,731) | (1,603) |
| Maturity of short-term investments | | 15,000 |
| Net cash (used in) provided by investing activities | (4,731) | 13,397 |
| **Financing activities:** | | |
| Repurchase of common stock | (39,325) | (25,336) |
| Proceeds from stock option exercises | 1,724 | 1,682 |
| Excess tax benefit from exercise of stock options | 367 | 190 |
| Principal payments under long-term financing obligation | (37) | (34) |
| Net cash used in financing activities | (37,271) | (23,498) |
| Effect of exchange rate changes on cash and cash equivalents | 58 | (39) |
| Net decrease in cash and cash equivalents | (73,102) | (29,158) |
| Cash and cash equivalents, beginning of period | 113,261 | 78,149 |
| Cash and cash equivalents, end of period | $ 40,159 | $ 48,991 |

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

7

Table of Contents

**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. (the Company ) is the leading online retailer of high quality diamonds and fine jewelry. In addition to sales of diamonds, fine jewelry and watches, the Company provides education, 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 serves consumers in over 40 countries and territories all over the world and maintains its primary website at www.bluenile.com. The Company also operates the www.bluenile.co.uk and www.bluenile.ca websites. Information found on the Company s websites 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.

***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 January 2, 2011, filed with the Securities and Exchange Commission ( SEC ) on February 28, 2011. 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 January 2, 2011 is derived from the Company s audited consolidated financial statements and notes thereto for the fiscal year ended January 2, 2011, included in Item 8 of the Annual Report on Form 10-K for the year ended January 2, 2011.

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 Blue Nile, Inc. and its wholly-owned subsidiaries.

***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***

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).

Table of Contents

**Blue Nile, Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The Company offers customers the ability to transact in 24 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 consolidated statements of operations.

***Recent Accounting Pronouncements***

In June 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. 2011-05 ( ASU 2011-05 ), Presentation of Comprehensive Income . ASU 2011-05 increases the prominence of other comprehensive income in the financial statements. Under ASU 2011-05, an entity will have the option to present the components of net income and comprehensive income in either one or two consecutive financial statements. ASU 2011-05 eliminates the option under U.S. GAAP to present other comprehensive income in the statement of changes in stockholders equity. ASU 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. ASU 2011-05 should be applied retrospectively.

The Company does not expect ASU 2011-05 to have a material impact on its consolidated results of operations or financial condition.

**Blue Nile, Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Note 2. Stock-based Compensation**

As of October 2, 2011, the Company had four equity plans. Additional information regarding these plans is disclosed in the Company s Annual Report on Form 10-K for the year ended January 2, 2011.

Stock-based compensation expense, net of estimated forfeitures, is recognized on a straight-line basis over the vesting period for each stock option and restricted stock unit grant.

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:

| | Quarter ended | | Year to date ended | |
|---|---|---|---|---|
| | October 2, 2011 | October 3, 2010 | October 2, 2011 | October 3, 2010 |
| Expected term | 4 years | 4 years | 4 years | 4 years |
| Expected volatility | 57.4% | 56.8% | 57.7% | 58.0% |
| Expected dividend yield | 0.0% | 0.0% | 0.0% | 0.0% |
| Risk-free interest rate | 0.45% | 0.78% | 1.13% | 1.24% |
| Estimated weighted-average fair value per option granted | $ 15.41 | $ 19.06 | $ 23.00 | $ 21.63 |

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.

The fair value of each restricted stock unit is based on the fair market value of the Company s common stock on the date of grant.

**Blue Nile, Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

A summary of stock option activity for the year to date ended October 2, 2011 is as follows:

| | Options (in thousands) | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Balance, January 2, 2011 | 2,445 | $ 38.04 | | |
| Granted | 284 | 51.09 | | |
| Exercised | (90) | 19.24 | | |
| Cancelled | (28) | 48.34 | | |
| Balance, October 2, 2011 | 2,611 | $ 39.99 | 6.09 | $ 10,121 |
| Vested and expected to vest at October 2, 2011 | 2,529 | $ 39.83 | 6.00 | $ 9,919 |
| Exercisable, October 2, 2011 | 1,937 | $ 38.97 | 5.26 | $ 7,861 |

The aggregate intrinsic value in the table above is before applicable income taxes and represents the amount recipients would have received if all options had been exercised on the last business day of the period indicated, based on the Company s closing stock price.

A summary of restricted stock unit activity for the year to date ended October 2, 2011 is as follows:

| | RSUs (in thousands) | Weighted Average Grant Date Fair Value |
|---|---|---|
| Balance, January 2, 2011 | 6 | $ 25.61 |
| Granted | | |
| Vested | (5) | 22.46 |
| Cancelled | | |
| Balance, October 2, 2011 | 1 | $ 49.49 |
| Vested and expected to vest at October 2, 2011 | 1 | $ 49.49 |

The total intrinsic value of stock options exercised during the year to date ended October 2, 2011 was $3.0 million. During the year to date ended October 2, 2011, the total fair value of stock options vested was $5.4 million. As of October 2, 2011, the Company had total unrecognized compensation costs related to unvested stock options and restricted stock units of $10.3 million, before income taxes. The Company expects to recognize this cost over a weighted average period of 2.6 years for its stock options and 2.4 year for its restricted stock units.

Table of Contents

**Blue Nile, Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Note 3. Inventories**

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

| | October 2, 2011 | January 2, 2011 |
|---|---|---|
| Loose diamonds | $ 926 | $ 732 |
| Fine jewelry, watches and other | 22,094 | 19,434 |
| | $ 23,020 | $ 20,166 |

**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 restricted stock units, 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 | | Year to date ended | |
|---|---|---|---|---|
| | October 2, 2011 | October 3, 2010 | October 2, 2011 | October 3, 2010 |
| Net income | $ 1,869 | $ 2,772 | $ 7,129 | $ 7,963 |
| Weighted average common shares outstanding | 13,996 | 14,334 | 14,375 | 14,442 |
| Basic net income per share | $ 0.13 | $ 0.19 | $ 0.50 | $ 0.55 |
| Dilutive effect of stock options and restricted stock units | 366 | 570 | 531 | 654 |
| Common stock and common stock equivalents | 14,362 | 14,904 | 14,906 | 15,096 |
| Diluted net income per share | $ 0.13 | $ 0.19 | $ 0.48 | $ 0.53 |

For the quarter and year to date ended October 2, 2011, the Company excluded 1,188,821 and 743,287 stock option shares, respectively, from the computation of diluted net income per share due to their antidilutive effect. For the quarter and year to date ended October 3, 2010, the Company excluded 885,266 and 584,512 stock option shares, respectively, from the computation of diluted net income per share due to their antidilutive effect.

Table of Contents

**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 January 2, 2011.

***Management Overview***

Our long-term financial focus continues to be primarily on sustainable growth in free cash flow, a non-GAAP financial measure that we define as net cash provided by or used in operating activities less cash outflows for purchases of fixed assets, including internal use software and website development. Non-GAAP free cash flow is primarily driven by increasing our operating income and efficiently managing working capital and capital expenditures. Increases in operating income primarily result from increases in sales through our websites, improvements in operating margins and the efficient management of operating costs, offset by the investments that we make in longer-term strategic initiatives.

We continue to drive growth in our core engagement business through an expanded product assortment, and investments in marketing and brand awareness. Expansion of our product lines has allowed us to broaden our reach with a wider range of price points and merchandise offerings, attracting new customers to our premium brand.

We are focused on growing our non-engagement jewelry business, driving customer loyalty and repeat business, and enhancing and broadening our product assortment in terms of styles and price points. We continue to plan business growth by driving innovation in product development. In the third quarter, we continued to introduce hundreds of new exciting products, with distinctive styles. We plan to continue increasing our breadth and depth of products throughout 2011.

We are increasing our investment in international growth through additional marketing, expanding our product assortment, and improving the customer experience. In addition, we will continue to launch in new markets around the world. The growth opportunities that we see ahead are compelling and the growth in our international business is a key strategic focus.

We believe that our success in building Blue Nile into a premium brand is a result of our focus on providing an exceptional customer experience. We persist in our efforts to drive innovation across the customer experience to enhance and deepen our connection to our customers. The Blue Nile customer experience is designed to empower our customers by providing them with substantial education, guidance, selection, customization capability, convenience and value. We believe that maintaining high overall customer satisfaction is critical to our ongoing efforts to promote the Blue Nile brand and to continue to profitably grow our business.

**Highlights of the Third Quarter Ended October 2, 2011**

We achieved third quarter net sales of $75.0 million, an 11.2% increase from the third quarter of 2010. Our international markets continued to deliver strong sales results, with a third quarter increase of 54.8% from the third quarter of 2010 and comprised approximately 19.2% of our total net sales for the quarter. Gross profit increased $0.2 million to $14.8 million compared to the third quarter of 2010. Net income decreased to $1.9 million for the third quarter of 2011 from $2.8 million for the third quarter of 2010. As of October 2, 2011, we had cash and cash equivalents of $40.2 million and no outstanding debt.

**Table of Contents**

**Results of Operations**

**Comparison of the Quarter Ended October 2, 2011 to the Quarter Ended October 3, 2010**

The following table presents our operating results for the quarters ended October 2, 2011 and October 3, 2010, including a comparison of the financial results for these periods (in thousands, except per share data):

| | Quarter ended | | | |
|---|---|---|---|---|
| | October 2, 2011 | October 3, 2010 | $ Change | % Change |
| Net sales | $ 74,987 | $ 67,451 | $ 7,536 | 11.2% |
| Cost of sales | 60,149 | 52,813 | 7,336 | 13.9% |
| Gross profit | 14,838 | 14,638 | 200 | 1.4% |
| Selling, general and administrative expenses | 11,978 | 10,400 | 1,578 | 15.2% |
| Operating income | 2,860 | 4,238 | (1,378) | (32.5)% |
| Other income, net: | | | | |
| Interest income, net | 33 | 10 | 23 | 230.0% |
| Other (expense) income, net | (20) | 3 | (23) | (766.7)% |
| Total other income, net | 13 | 13 | | 0.0% |
| Income before income taxes | 2,873 | 4,251 | (1,378) | (32.4)% |
| Income tax expense | 1,004 | 1,479 | (475) | (32.1)% |
| Net income | $ 1,869 | $ 2,772 | $ (903) | (32.6)% |
| Basic net income per share | $ 0.13 | $ 0.19 | $ (0.06) | (31.6)% |
| Diluted net income per share | $ 0.13 | $ 0.19 | $ (0.06) | (31.6)% |

***Net Sales***

Net sales increased 11.2% during the third quarter of 2011 as compared with the third quarter of 2010, due to an increase in the number of orders shipped, partially offset by a decrease in the average shipment value. Net sales in the United States increased 4.1% to $60.6 million for the third quarter of 2011, compared with $58.2 million for the third quarter of 2010. We continue to experience growth in both engagement and non-engagement jewelry. International sales increased 54.8% to $14.4 million, from $9.3 million in the third quarter of 2010, and were 19.2% of our third quarter net sales. Changes in foreign exchange rates during the third quarter of 2011, compared to the rates in effect during the third quarter of 2010, had a positive impact of approximately 8.6% on international sales. Excluding the impact of changes in foreign exchange rates, international sales increased 46.2% for the third quarter of 2011 compared to the third quarter of 2010.

***Gross Profit***

Gross profit increased 1.4% to $14.8 million in the third quarter of 2011 compared to $14.6 million in the third quarter of 2010. The increase in gross profit resulted primarily from an increase in revenues. Gross profit as a percentage of net sales decreased to 19.8% for the third quarter of 2011 compared to 21.7% for the third quarter of 2010, due primarily to significant increases in product costs resulting in margin compression to minimize increases in costs to our customers.

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. Throughout the first half of 2011, the cost of diamonds increased to record high levels. In the third quarter of 2011, the costs of diamonds decreased slightly, but remained approximately 20% to 30% higher than in the prior year. Precious metals costs also increased significantly in the first half of 2011, and although they declined in the third quarter, they remain at historically high levels. Our net sales growth and our gross margin have been negatively impacted by the high prices of diamonds and precious metals during the third quarter of 2011.

Table of Contents

Generally, we purchase our diamonds on a real time basis from our suppliers when a customer places an order for a specific diamond. In periods of rapidly rising prices, the value that we are able to provide to customers and/or our gross margin may decrease compared to brick and mortar retail competitors with inventory that was purchased prior to price increases. 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 may reduce our gross margins to maintain our value relative to our brick and mortar retail competitors.

***Selling, General and Administrative Expenses***

Selling, general and administrative expenses increased 15.2% to $12.0 million in the third quarter of 2011, compared to $10.4 million in the third quarter of 2010 due to several factors. Marketing and advertising costs increased $0.9 million in the third quarter of 2011, due primarily to increased spending on online marketing vehicles and public relation efforts to drive website traffic increases and brand awareness. Credit card interchange and payment processing fees increased approximately $0.1 million due to higher sales volumes. Depreciation expense related to additional capitalized assets added approximately $0.1 million to expenses. Stock-based compensation expense increased $0.1 million due to the amount and timing of options granted in the third quarter 2011 as compared to the third quarter of 2010. As a percentage of net sales, selling, general and administrative expenses increased to 16.0% in the third quarter of 2011 compared to 15.4% in the third quarter of 2010.

***Operating Income***

Operating income decreased 32.5% to $2.9 million in the third quarter of 2011 compared to $4.2 million in the third quarter of 2010. As a percentage of net sales, operating income decreased to 3.8% for the third quarter of 2011 compared to 6.3% for the third quarter of 2010. The decrease in operating income was primarily due to increased selling, general and administrative expenses and relatively unchanged gross margin dollars.

Table of Contents

**Comparison of the Year to Date Ended October 2, 2011 to the Year to Date Ended October 3, 2010**

The following table presents our operating results for the years to date ended October 2, 2011 and October 3, 2010, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

| | Year to date ended October 2, 2011 | Year to date ended October 3, 2010 | $ Change | % Change |
|---|---|---|---|---|
| Net sales | $ 235,689 | $ 218,110 | $ 17,579 | 8.1% |
| Cost of sales | 186,758 | 171,472 | 15,286 | 8.9% |
| Gross profit | 48,931 | 46,638 | 2,293 | 4.9% |
| Selling, general and administrative expenses | 38,299 | 34,572 | 3,727 | 10.8% |
| Operating income | 10,632 | 12,066 | (1,434) | (11.9)% |
| Other income, net: | | | | |
| Interest income, net | 116 | 22 | 94 | 427.3% |
| Other income, net | 61 | 123 | (62) | (50.4)% |
| Total other income, net | 177 | 145 | 32 | 22.1% |
| Income before income taxes | 10,809 | 12,211 | (1,402) | (11.5)% |
| Income tax expense | 3,680 | 4,248 | (568) | (13.4)% |
| Net income | $ 7,129 | $ 7,963 | $ (834) | (10.5)% |
| Basic net income per share | $ 0.50 | $ 0.55 | $ (0.05) | (9.1)% |
| Diluted net income per share | $ 0.48 | $ 0.53 | $ (0.05) | (9.4)% |

***Net Sales***

Net sales increased 8.1% during the year to date ended October 2, 2011, compared with the year to date ended October 3, 2010 due to an increase in the number of orders shipped, partially offset by a decrease in the average shipment value. Sales of our non-engagement jewelry have been strong in the year to date 2011 and have grown at rates above our overall sales growth rate. Net sales in the U.S. increased 2.9% to $195.6 million during the year to date ended October 2, 2011 compared with $190.1 million during the year to date ended October 3, 2010. International sales increased 43.2% in the year to date ended October 2, 2011 to $40.1 million from $28.0 million in the year to date ended October 3, 2010. Foreign exchange rates during the year to date ended October 2, 2011, compared to the rates in effect during the year to date ended October 3, 2010 had a positive impact of approximately 8.6% on international sales. Excluding the impact of changes in foreign exchange rates, international sales increased 34.6% in the year to date ended October 2, 2011 compared to the year to date ended October 3, 2010.

***Gross Profit***

Gross profit increased $2.3 million to $48.9 million in the year to date ended October 2, 2011 compared to $46.6 million in the year to date ended October 3, 2010. The increase in gross profit resulted from the growth in non-engagement net sales. Gross profit as a percentage of net sales was 20.8% in the year to date ended October 2, 2011, compared with 21.4% in the year to date ended October 3, 2010. The decrease was due primarily to significant increases in product costs resulting in margin compression to minimize increases in costs to our customers.

***Selling, General and Administrative Expenses***

Selling, general and administrative expenses increased 10.8% to $38.3 million in the year to date ended October 2, 2011 compared to $34.6 million in the year to date ended October 3, 2010 due to several factors. Marketing costs increased $2.3 million due primarily to increased spending on online marketing vehicles as well as public relations to drive website traffic increases and brand awareness. Credit card interchange and payment processing fees increased approximately $0.4 million due to higher sales volumes. Compensation and other related expenses increased $0.3 million due to increased headcount to support key business initiatives and the growth in operations, partially offset by lower year-over-year incentive accruals. Building rent increased $0.3 million due to increased rent expense for our new corporate office location. Depreciation expense related to new capitalized assets increased $0.2 million. As a percentage of net sales, selling, general and administrative expenses increased to 16.2% in the year to date ended October 2, 2011, compared to 15.9% in the year to date ended October 3, 2010.

***Operating Income***

Operating income decreased 11.9% to $10.6 million in the year to date ended October 2, 2011 compared to $12.1 million in the year to date ended October 3, 2010. The decrease in operating income for the year to date ended October 2, 2011 was primarily due to higher selling, general and administrative expenses.

***Other Income, Net***

Other income, net increased by 22.1% due primarily to an increase in net interest income. The increase in net interest income in the year to date ended October 2, 2011 as compared with the year to date ended October 3, 2010 was primarily due to higher interest rates and, to a lesser extent, higher average cash balances.

**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, cash equivalents, 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.

Recessionary economic cycles, investment and credit market conditions and volatility, unemployment levels and other economic factors impact consumer spending patterns. Confidence among U.S. consumers declined steadily in the second quarter of 2011 and remained low throughout the third quarter. We believe that our revenue, cash flows from operations and net income were impacted by macroeconomic conditions in the third quarter, and may continue to be impacted in the future.

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.

As of October 2, 2011, working capital totaled $9.0 million, including cash and cash equivalents of $40.2 million and inventory of $23.0 million, partially offset by accounts payable and accrued liabilities of $57.7 million. We believe that our current cash and cash equivalents as well as cash flows from operations will be sufficient to continue our operations and meet our capital needs for the foreseeable future.

Net cash of $31.2 million was used in operating activities for the year to date ended October 2, 2011, compared to net cash used in operating activities of $19.0 million for the year to date ended October 3, 2010. Net payment of trade payables totaled $37.1 million for the year to date ended October 2, 2011 and $34.1 million for the year to date ended October 3, 2010. In the first quarter, we generally have a significant pay down of our accounts payable balance built up during the fourth quarter holiday season. The volume of sales in the fourth quarter of 2010 was higher than the volume of sales in the fourth quarter of 2009, resulting in a higher net payment of payables in the year to date ended October 2, 2011 compared to the year to date ended October 3, 2010. Inventories at October 2, 2011 increased $2.9 million from January 2, 2011 and were $5.8 million higher than October 3, 2010. Inventories rose due to seasonality as well as higher costs and expansion of our assortment. The tax benefit realized from option exercises, which represents tax deductions in excess of stock compensation expense, decreased to $0.6 million in the year to date ended October 2, 2011 from $3.6 million in the year to date ended October 3, 2010 primarily due to a lower number of options exercised in the current year to date compared to the year to date ended October 3, 2010.

17

Table of Contents

Net cash of $4.7 million was used in investing activities for the year to date ended October 2, 2011, due to purchases of fixed assets related primarily to the move of our corporate offices. Net cash of $13.4 million was provided by investing activities for the year to date ended October 3, 2010 primarily related to the maturity of a $15.0 million short-term investment.

Our capital needs are generally minimal and include investments in technology and website enhancements, capital improvements to our leased warehouses and office facilities, and furniture and equipment. Additionally, we have the ability to reduce and/or delay capital investments in challenging economic conditions without significant disruption to our business operations.

Net cash of $37.3 million was used in financing activities for the year to date ended October 2, 2011 related primarily to the repurchase of common stock. Net cash of $23.5 million was used in financing activities for the year to date ended October 3, 2010 related primarily to the repurchase of common stock.

During the year to date ended October 2, 2011, we repurchased 1,065,200 shares of our common stock for an aggregate purchase price of $39.3 million. On February 9, 2010, our board of directors authorized the repurchase of up to $100.0 million of our common stock during the 24-month period following the approval date of such repurchase. As of October 2, 2011, approximately $50.5 million remains under this repurchase authorization. Since the inception of our repurchase program in the first quarter of 2005 through October 2, 2011, we have repurchased 6.0 million shares for a total of $225.9 million. The 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 management based on our 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.

We do not carry any long or short-term debt other than trade payables, deferred rent and other short-term liabilities incurred in the ordinary course of business. However, projections of future cash needs and cash flows are subject to many factors and to uncertainty. We continually assess our capital structure and opportunities to obtain credit facilities, sell equity or debt securities, or undertake other transactions for strategic reasons or to further strengthen our financial position.

**Contractual Obligations**

There have been no material changes to our contractual obligations during the period covered by this report, outside of the ordinary course of business, from those disclosed in our Annual Report on Form 10-K for the year ended January 2, 2011.

**Off-Balance Sheet Arrangements**

As of October 2, 2011, 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.

## 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 January 2, 2011.

Table of Contents

## Item 4. Controls and Procedures

*Evaluation of Disclosure Controls and Procedures*

During the quarter ended October 2, 2011, an evaluation was performed under the supervision and with the participation of our management, including our chief executive officer and chief financial officer (collectively, our certifying officers ), of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act ). Disclosure controls and procedures are controls and other procedures designed to ensure that information required to be disclosed by us in our periodic reports filed or submitted under the Exchange Act with the SEC is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on their evaluation, our certifying officers concluded that as of the end of the period covered by this report, these disclosure controls and procedures are effective in the timely recording, processing, summarizing and reporting of material financial and non-financial information and are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control Over Financial Reporting*

There were no changes in our internal control over financial reporting during the quarter ended October 2, 2011 that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

# PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

None.

## Item 1A. Risk Factors

You should carefully consider the risks described below and elsewhere in this report, 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 January 2, 2011, as filed with the Securities and Exchange Commission on February 28, 2011.

***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, the recent turmoil in the financial markets has had and may continue to have an adverse effect on the United States and world economies, which could negatively impact consumer spending patterns for the foreseeable future. A decline in the number of marriages or reductions 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 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.

**Table of Contents**

Further, any reduction in our sales will affect our liquidity. As discussed under Liquidity and Capital Resources in Part I, Item 2 of this 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.

Although we do not anticipate needing additional capital in the near term, financial market disruption may make it difficult for us to raise additional capital, when needed, on acceptable terms or at all. The interest rate environment and general economic conditions could also impact the investment income we are able to earn on securities we may hold from time to time.

The prices of commodity products upon which we are substantially dependent, such as diamonds, colored gemstones, platinum, gold and silver, are subject to fluctuations arising from changes in supply and demand, competition and market speculation. Rapid and significant changes in commodity prices, particularly diamonds, may materially and adversely affect our sales and profit margins by increasing the prices for our products. Economic factors such as increased shipping costs, inflation, higher costs of labor, insurance and healthcare, and changes in 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.

***We may have exposure to greater than anticipated tax liabilities.***

We are subject to income, payroll, duties and other business taxes in both the United States and foreign jurisdictions. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. Our determination of our tax liability is always subject to review by applicable taxing authorities. Any adverse outcome of such a review could have a negative effect on our operating results and financial condition. Although we believe our estimates are reasonable, the ultimate tax outcome may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods for which such determination is made. In addition, the imposition of additional tax obligations on our business by state and local governments could create significant administrative burdens for us, decrease our future sales, and harm our cash flow and operating results.

***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 lower resolution, functionality, and memory associated with some alternative devices may make the use of our website and the purchasing our products more difficult; and the versions of our websites 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 problems 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.

***We expect our quarterly financial results to fluctuate, which may lead to volatility in our stock price.***

We expect our net sales and operating results to vary significantly from quarter to quarter due to a number of factors, including changes in:

- demand for our products;
- the costs to acquire quality diamonds and precious metals;
- our ability to attract visitors to our websites and convert those visitors into customers;

general economic conditions, both domestically and globally;

our ability to retain existing customers or encourage repeat purchases;

our ability to manage our product mix and inventory;

number of marriages and engagement ring customs

consumer tastes and preferences for diamonds and fine jewelry;

advertising and other marketing costs;

our, or our competitors pricing and marketing strategies;

the introduction of competitive websites, products, price decreases or improvements;

conditions or trends in the diamond and fine jewelry industry;

the success of our geographic, service and product line expansions;

our ability to manage our operations;

the extent to which we provide for and pay taxes;

stock-based compensation expense as a result of the nature, timing and amount of stock options and restricted stock units granted, the underlying assumptions used in valuing stock options, the estimated rate of stock option and restricted stock unit forfeitures and other factors;

foreign exchange rates;

interest rates; and

costs of expanding or enhancing our technology or websites.

As a result of the variability of these and other factors, our operating results in future quarters may be below the expectations of public market analysts and investors. In this event, the price of our common stock may decline.

***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%, 34% and 29% of our net sales in the years ended January 2, 2011, January 3, 2010 and January 4, 2009, 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 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 cost 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 and Mother s Day. 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 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.

***Our failure to acquire quality diamonds and fine jewelry at commercially reasonable prices and lead times would result in higher costs and damage our operating results and competitive position.***

Our high quality customer experience depends on our ability to source products at reasonable prices and to provide expeditious fulfillment of customer orders. If we are unable to acquire quality diamonds and fine jewelry at commercially reasonable prices and lead times, our costs may exceed our forecasts, our gross margins and operating results and customer experience may suffer and our competitive position could be damaged. 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. Because of our virtual inventory model, our prices are much more sensitive to rapid fluctuations in the prices of commodities, particularly diamonds, which traditional retailers hold in inventory.

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 28%, 24% and 22% of our payments to our diamond and fine jewelry suppliers for each of the years ended January 2, 2011, January 3, 2010 and January 4, 2009 were made to our top three suppliers for that year. Our inability to maintain and expand these and other future diamond and fine jewelry supply relationships on commercially reasonable terms or the inability of our current and future suppliers to maintain arrangements for the supply of products sold to us on commercially reasonable terms would substantially harm our business and results of operations. The financial performance and viability of our suppliers are also significantly dependent upon worldwide economic conditions and consumer demand for diamonds and fine jewelry. The failure of any of our principal suppliers to remain financially viable could adversely impact our supply of diamonds and fine jewelry for sale to our customers.

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.

***Our failure to meet customer expectations with respect to price would adversely affect our business and results of operations.***

Demand for our products has been highly sensitive to pricing changes. Changes in our pricing strategies have had and may continue to have a significant impact on our net sales, gross margins and net income. In the past, we have instituted retail price changes as part of our strategy to stimulate growth in net sales and optimize gross profit. We may institute similar price changes in the future. Such price changes may not result in an increase in net sales or in the optimization of gross profits. In addition, many external factors, including the costs to acquire diamonds and precious metals and our competitors pricing and marketing strategies, can significantly impact our pricing strategies. If we fail to meet customer expectations with respect to price in any given period, our business and results of operations would suffer.

***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 significant component of our business strategy 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.

Table of Contents

A critical component of our brand promotion strategy is establishing a relationship of trust with our customers, which we believe can be achieved by providing a high quality customer experience. In order to provide a high quality customer experience, we have invested and will continue to invest substantial amounts of resources in the development and functionality of our multiple websites, 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 websites, 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 face significant competition and may be unsuccessful in competing against current and future competitors.***

The retail jewelry industry is intensely competitive. Online retail, in particular, 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 business.

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 we are in offering compelling products or in attracting and retaining consumers, our revenues and growth rates could decline. Furthermore, in recent years, competitors have reduced the retail price of their diamonds and fine jewelry as a result of lack of consumer demand and/or inventory liquidations. 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.

Table of Contents

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.

Many of our current and potential competitors have advantages over us, including longer operating histories, greater brand recognition, existing customer and supplier relationships, and significantly greater financial, marketing and other resources.

***We may be unsuccessful in further expanding our operations internationally.***

For the year to date ended October 2, 2011 international net sales represented 17.0% of our total net sales. We continue to increase marketing and sales efforts throughout Europe, Canada 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 or alliances with third parties, or through other means. 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 electronic commerce in these markets. Different privacy, censorship and liability standards and regulations, and different intellectual property laws in foreign countries may prohibit expansion into such markets or cause our business and results of operations to suffer.

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

- the need to develop new supplier and jeweler relationships;
- international regulatory requirements, tariffs and duties;
- difficulties in staffing and managing foreign operations;
- longer payment cycles from credit card companies;
- greater difficulty in accounts receivable collection;
- our reliance on third-party carriers for product shipments to our customers;
- risk of theft of our products during shipment;
- limited payment, shipping and insurance options for us and our customers;
- potential adverse tax consequences;

foreign currency exchange risk;

lack of infrastructure to adequately conduct electronic commerce transactions or fulfillment operations;

unclear foreign intellectual property protection laws;

laws and regulations related to corporate governance and employee/employer relationships;

price controls or other restrictions on foreign currency;

difficulties in obtaining export, import or other business licensing requirements;

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.

***Given the geographic concentration of our operations, natural disasters could adversely affect our results of operations.****

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.

***If the single facility where substantially all of our computer and communications hardware is located fails, our business, results of operations and financial condition would be harmed.***

Our ability to successfully receive and fulfill orders and to provide high quality customer service depends in part on the efficient and uninterrupted operation of our computer and communications systems. Substantially all of the computer hardware necessary to operate our websites is located at a single leased facility. 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, earthquake and similar events. We do not presently have redundant systems in multiple locations and our business interruption insurance may be insufficient to compensate us for losses that may occur.

***Our systems are vulnerable to security breaches.****

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

We devote significant resources to address security vulnerabilities including the use of encryption and authentication technology licensed from third parties to effect secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, human errors, 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 our fulfillment operations are interrupted for any significant period of time, our business and results of operations would be substantially harmed.***

Our success depends on our ability to successfully receive and fulfill orders and to promptly and securely deliver our products to our customers. Most of our inventory management, jewelry assembly, packaging, labeling and product return processes are performed in a single fulfillment center located in the United States. We also have a fulfillment facility located in Ireland. These facilities are susceptible to damage or interruption from human error, fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. Our business interruption insurance may be insufficient to compensate us for losses that may occur in the event operations at our fulfillment centers are interrupted. 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.

Table of Contents

***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 Blue Nile Jewellery, Ltd., our Ireland subsidiary, are exposed to foreign exchange rate fluctuations. Upon translation from foreign currency into U.S. dollars, operating results may differ materially from expectations, and we may record significant gains or losses.

Additionally, we allow customers to purchase our products in 24 foreign currencies. This exposes us to foreign exchange rate fluctuations and we may record significant gains or losses as a result of such fluctuations.

***Our net sales may be negatively affected if we are required to collect taxes on purchases and/or disclose our customers private information to tax authorities.***

We collect sales and/or other taxes related to purchases by customers located in the State of Washington and the State of New York, and certain 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 sales or other 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. A successful assertion by one or more states or foreign countries to require the collection of sales or other 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 discontinue certain successful sales and marketing initiatives or otherwise substantially harm our business and results of operations.

While we believe that current law restricts state and local taxing authorities outside the State of Washington from requiring us to collect sales and use taxes from purchasers located within their jurisdictions, taxing authorities outside the State of Washington have, and in the future could, disagree with our interpretation. For example, a number of states, as well as the U.S. Congress, are considering or have adopted various initiatives designed to impose sales, use and other taxes on Internet sales. The successful implementation of any such initiatives could require us to collect sales, use and other taxes from purchasers located in states other than Washington. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could significantly decrease our future net sales.

***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 key employees. In addition, illness, severe adverse weather conditions or natural disasters could impede our ability to service our customers.

***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

Table of Contents

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 or customs with respect to engagement shift away from the presentation of diamond jewelry, 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.

In recent years, 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 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.

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

The satisfactory performance, reliability and availability of our websites, 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 systems interruptions, downtime or technical difficulties that result in the unavailability of our websites 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 websites 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.

***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. We have 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 websites. Our agreements with these 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.

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

Our ability to significantly increase our net sales and maintain and increase our profitability may depend on our ability to successfully expand our product lines beyond our current offerings. If we offer new products that are not accepted by consumers, the Blue Nile brand and reputation could be adversely affected, our net sales may fall short of expectations and we may incur substantial expenses that are not offset by increased net sales. Expansion of our product lines may also strain our management and operational resources.

***If we are unable to accurately manage our inventory of fine jewelry, our reputation and results of operations 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 a product(s), 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 offering of products, we may be forced to increase inventory levels, which will increase our risks related to our inventory.

***Our stock price has been volatile historically, and may continue to be volatile. Further, the sale of our common stock by significant stockholders 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, and news reports relating to trends in our markets or general economic conditions.

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 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 October 2, 2011, we have repurchased 6.0 million shares for a total of $225.9 million. In February 2010, our board of directors authorized the repurchase of up to $100.0 million of our common stock during the subsequent 24-month period. 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.

Table of Contents

***Our cash, cash equivalents and short-term investments are subject to a risk of loss based upon the solvency of the financial institutions in which they are maintained.***

We maintain the majority of our cash, cash equivalents and short-term investments in accounts with major financial institutions within the United States in the form of demand deposits, money market accounts, time deposits, U.S. Treasury Bills and other short-term investments. Deposits in these institutions may exceed the amounts of insurance provided, or deposits may not at all be covered by insurance. If any of these institutions becomes insolvent, it could substantially harm our financial condition and we may lose some, or all, of such deposits.

***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 websites, our content and our trademarks. We have registered Blue Nile, bluenile.com, the BN logo, the Blue Nile BN stylized logo and Build Your Own Ring 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.

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

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

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

***Increased product returns and the failure to accurately predict product returns could substantially harm our business and results of operations.***

We generally offer our customers an unconditional 30-day return policy that allows our customers to return most products if they are not satisfied for any reason. We make allowances for product returns in our financial statements

**Table of Contents**

based on historical return rates and current economic conditions. Actual merchandise returns are difficult to predict and may differ from our allowances. Any significant increase in merchandise returns above our allowances would substantially harm our business and results of operations.

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

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

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

***If use of the Internet, particularly with respect to online commerce, does not continue to increase as we anticipate, our business and results of operations will be harmed.***

Our future net sales and profits are substantially dependent upon the continued growth in the use of the Internet as an effective medium of business and communication by our target customers. Internet use may not continue to develop at historical rates and consumers may not continue to use the Internet and other online services as a medium for commerce. Failures by some online retailers to meet consumer demands could result in consumer reluctance to adopt the Internet as a means for commerce, and thereby damage our reputation and brand and substantially harm our business and results of operations.

In addition, the Internet may not be accepted as a viable long-term commercial marketplace for a number of reasons, including:

- actual or perceived lack of security of information or privacy protection;

possible disruptions, computer viruses, spyware, phishing, attacks or other damage to the Internet servers, service providers, network carriers and Internet companies or to users computers; and

excessive governmental regulation.

Our success will depend, in large part, upon third parties maintaining the Internet infrastructure to provide a reliable network backbone with the speed, data capacity, security and hardware necessary for reliable Internet access and services. Our business, which relies on a contextually rich website that requires the transmission of substantial secure data, is also significantly dependent upon the availability and adoption of broadband Internet access and other high speed Internet connectivity technologies.

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

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

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

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

***Our failure to rapidly respond to technological change could result in our services or systems becoming obsolete and substantially harm our business and results of operations.***

As the Internet and online commerce industries continue to evolve, we may be required to license emerging technologies useful in our business, enhance our existing services, develop new services and technologies that address the increasingly sophisticated and varied needs of our prospective customers and respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis. We may not be able to successfully implement new technologies such as mobile applications or adapt our websites, proprietary technologies and transaction-processing systems to customer requirements or emerging industry standards. Our failure to do so would substantially harm our business and results of operations. 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.

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

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

We are not certain how our business may be affected by the application of existing laws governing issues such as property ownership, copyrights, personal property, encryption and other intellectual property issues, taxation, libel, obscenity, qualification to do business, and export or import matters. The vast majority of these laws were adopted prior to the advent of the Internet. As a result, they do not contemplate or address the unique issues of the Internet and related technologies. Changes in laws intended to address these issues could create uncertainty for those conducting online commerce. This uncertainty could reduce demand for our products and services or increase the cost of doing business as a result of litigation costs or increased fulfillment costs and may substantially harm our business and results of operations.

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

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

***Our failure to effectively manage the growth in our operations may prevent us from successfully expanding our business.***

We have experienced, and in the future may experience, rapid growth in operations, which has placed, and could continue to place, a significant strain on our operations, services, internal controls and other managerial, operational and financial resources. To effectively manage future expansion, we will need to maintain our operational and financial systems and managerial controls and procedures, which include the following processes:

- transaction processing and fulfillment;
- inventory management;
- customer support;
- management of multiple supplier relationships;
- operational, financial and managerial controls;
- reporting procedures;
- management of our facilities;
- recruitment, training, supervision, retention and management of our employees; and

technology operations.

If we are unable to manage future expansion, our ability to provide a high quality customer experience could be harmed, which would damage our reputation and brand and substantially harm our business and results of operations.

**Table of Contents**

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

(c) Below is a summary of stock repurchases during the quarter ended October 2, 2011.

**Issuer Purchases of Equity Securities**

(Dollars in thousands except per share amounts)

| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Approximate dollar value of shares that may yet be purchased under the plans or programs (1) |
|---|---|---|---|---|
| July 4, 2011 through July 31, 2011 | 137,000 | $ 42.65 | 137,000 | $ 75,593 |
| August 1, 2011 through August 28, 2011 | 571,300 | $ 33.45 | 571,300 | $ 56,484 |
| August 29, 2011 through October 2, 2011 | 172,000 | $ 34.62 | 172,000 | $ 50,530 |
| Total shares purchased | 880,300 | | 880,300 | |

(1) On February 9, 2010, our board of directors authorized the repurchase of up to $100.0 million of our common stock within the 24-month period following the approval date of such repurchase. We announced the repurchase on February 11, 2010. As of October 2, 2011, approximately $50.5 million remains under this repurchase authorization. The shares may be repurchased from time to time in open market transactions or in negotiated transactions off the market. Our management determines the timing and amount of any shares repurchased based on their evaluation of market conditions and other factors. Repurchases may also be made under a Rule 10b5-1 plan, which would permit shares to be repurchased when we might otherwise be precluded from doing so under insider trading laws.

**Item 6. Exhibits**

See exhibits listed under the Exhibit Index immediately following page 34.

Table of Contents

## SIGNATURES

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

BLUE NILE, INC.
Registrant

Date: November 9, 2011

/s/ Terri K. Maupin
**Terri K. Maupin**
**Chief Accounting Officer**
**(Principal Accounting Officer)**

Date: November 9, 2011

/s/ David B. Binder
**David B. Binder**
**Chief Financial Officer**
**(Principal Financial Officer)**

Table of Contents

## Exhibit Index

| Exhibit Number | Description |
|---|---|
| 3.1(1) | Amended and Restated Certificate of Incorporation of Blue Nile, Inc. |
| 3.2(2) | Amended and Restated Bylaws of Blue Nile, Inc. |
| 4.1 | Reference is made to Exhibits 3.1 and 3.2. |
| 4.2(3) | Specimen Stock Certificate. |
| 4.3(4) | Amended and Restated Investor Rights Agreement dated June 29, 2001 by and between Blue Nile, Inc. and certain holders of Blue Nile, Inc. s preferred stock. |
| 10.1(5) | Offer letter between Blue Nile, Inc. and David Binder, dated June 30, 2011 |
| 31.1(6) | Certification of Chief Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2(6) | Certification of Chief Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1(6)* | Certification of Chief Executive Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350. |
| 32.2(6)* | Certification of Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |

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

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

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

(4) Previously filed as the like numbered exhibit to Blue Nile, Inc. s Registration Statement on Form S-1 (No. 333-113494), as filed with the Securities and Exchange Commission on March 11, 2004, and incorporated by reference herein.

(5) Previously filed as Exhibit 10.1 to Blue Nile, Inc s Current Report on Form 8-K (No. 000-50763), as filed with the Securities and Exchange Commission on July 21, 2011, and incorporated by reference herein.

(6) Filed herewith.

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