BLUE NILE INC
Form 10-Q
August 09, 2007

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

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

For the quarterly period ended July 1, 2007

OR

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

For the transition period from __________ to __________

Commission file number 000-50763

BLUE NILE, INC.

(Exact name of registrant as specified in its charter)

Delaware	91-1963165
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
705 Fifth Avenue South, Suite 900, Seattle, Washington	98104
(Address of principal executive offices)	*(Zip code)*

(206) 336-6700

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

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

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

As of July 27, 2007 the registrant had 15,888,654 shares of common stock outstanding.

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Cautionary Note Regarding Forward-Looking Statements

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

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	July 1, 2007 (unaudited)	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 69,165	$ 78,540
Restricted cash		117
Marketable securities		19,767
Trade accounts receivable	1,114	1,484
Other accounts receivable	464	156
Inventories	14,668	14,616
Deferred income taxes	712	598
Prepaid federal income taxes	1,596	
Other prepaids and current assets	1,014	740
Total current assets	88,733	116,018
Property and equipment, net	4,730	3,391
Intangible assets, net	303	319
Deferred income taxes	2,733	2,285
Other assets	64	93
Total assets	$ 96,563	$ 122,106
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 42,501	$ 66,625
Accrued liabilities	4,182	7,315
Current portion of deferred rent	196	197
Total current liabilities	46,879	74,137
Deferred rent, less current portion	572	666
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000 shares authorized, none issued and outstanding		
Common stock, $0.001 par value; 300,000 shares authorized 19,330 shares and 19,073 shares issued, respectively 15,884 shares and 15,972 shares outstanding, respectively	19	19
Additional paid-in capital	124,022	115,751
Deferred compensation	(51)	(180)
Accumulated other comprehensive loss	(5)	(2)

Retained earnings	14,054	7,110
Treasury stock, at cost; 3,446 shares and 3,101 shares outstanding, respectively	(88,927)	(75,395)
Total stockholders equity	49,112	47,303
Total liabilities and stockholders equity	$ 96,563	$ 122,106

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

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

	Quarter ended		Year to date ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
Net sales	$ 72,093	$ 56,916	$ 140,003	$ 107,610
Cost of sales	57,150	45,593	111,811	85,945
Gross profit	14,943	11,323	28,192	21,665
Selling, general and administrative expenses	9,909	7,721	19,473	15,398
Operating income	5,034	3,602	8,719	6,267
Other income (expense), net:				
Interest income	803	881	1,776	1,866
Other income	12	100	215	100
Total other income (expense), net	815	981	1,991	1,966
Income before income taxes	5,849	4,583	10,710	8,233
Income tax expense	2,068	1,451	3,766	2,746
Net income	$ 3,781	$ 3,132	$ 6,944	$ 5,487
Basic net income per share	$ 0.24	$ 0.19	$ 0.44	$ 0.32
Diluted net income per share	$ 0.23	$ 0.18	$ 0.42	$ 0.31

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

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

	Common stock		Additional	Deferred stock		Accumulated other	Treasury stock		Total
	Shares	Amount	paid-in capital	compensation	Retained earnings	comprehensive income (loss)	Shares	Amount	stockholders equity
Balance, December 31, 2006	19,073	$ 19	$ 115,751	$ (180)	$ 7,110	$ (2)	(3,101)	$ (75,395)	$ 47,303
Net income					6,944				6,944
Other comprehensive income:									
Unrealized gain on marketable securites, net of tax						2			2
Translation adjustment						(5)			(5)
Total comprehensive income									6,941
Repurchase of common stock							(345)	(13,532)	(13,532)
Amortization of deferred stock compensation				124					124
Reversal of deferred compensation relating to cancelled options			(5)	5					
Stock-based compensation			2,574						2,574
Exercise of common stock options	256		2,668						2,668
Tax benefit from exercise of stock options			2,974						2,974
Issuance of common stock to directors	1		60						60
Balance, July 1, 2007	19,330	$ 19	$ 124,022	$ (51)	$ 14,054	$ (5)	(3,446)	$ (88,927)	$ 49,112

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

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

	Year to date ended July 1, 2007	Year to date ended July 2, 2006
Operating activities:		
Net income	$ 6,944	$ 5,487
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	776	952
(Gain) loss on disposal of fixed assets	(6)	2
Stock-based compensation	2,723	1,859
Deferred income taxes	(563)	2,009
Tax benefit from exercise of stock options	2,974	592
Excess tax benefit from exercise of stock options	(320)	(34)
Changes in assets and liabilities:		
Receivables, net	62	1,056
Inventories	(53)	553
Prepaid federal income taxes	(1,596)	
Other prepaid expenses and assets	(246)	57
Accounts payable	(24,124)	(22,475)
Accrued liabilities	(3,134)	(1,919)
Deferred rent	(95)	(118)
Net cash used in operating activities	(16,658)	(11,979)
Investing activities:		
Purchases of property and equipment	(2,066)	(1,182)
Proceeds from the sale of property and equipment	8	1
Purchases of marketable securities	(20,230)	(25,195)
Proceeds from the maturity of marketable securities	40,000	53,000
Transfers of restricted cash	120	
Net cash provided by investing activities	17,832	26,624
Financing activities:		
Repurchase of common stock	(13,532)	(46,370)
Proceeds from stock option exercises	2,668	1,087
Excess tax benefit from exercise of stock options	320	34
Net cash used in financing activities	(10,544)	(45,249)
Effect of exchange rate changes on cash and cash equivalents	(5)	
Net decrease in cash and cash equivalents	(9,375)	(30,604)

Cash and cash equivalents, beginning of period	78,540	71,921
Cash and cash equivalents, end of period	$ 69,165	$ 41,317

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

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

(unaudited)

Note 1. Description of the Company 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 the United States. In addition to sales of diamonds, fine jewelry and watches, the Company provides guidance and support to enable customers to more effectively learn about and purchase diamonds as well as classically styled fine jewelry. The Company, a Delaware corporation, based in Seattle, Washington, was formed in March 1999. The Company maintains its primary website at www.bluenile.com. The Company also operates the www.bluenile.co.uk and www.bluenile.ca websites.

Reclassifications

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

Basis of Presentation

The accompanying unaudited consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in the Company s annual report on Form 10-K for the year ended December 31, 2006, filed with the Securities and Exchange Commission (SEC) on March 16, 2007. The same accounting policies are followed for preparing quarterly and annual financial statements. In the opinion of management, all adjustments necessary for the fair presentation of the financial position, results of operations and cash flows for the interim period have been included and are of a normal, recurring nature.

In May 2007 the Company commenced operations at two new wholly-owned subsidiaries, Blue Nile Worldwide, Inc. (Worldwide) and Blue Nile Jewellery, Ltd. (Jewellery). Worldwide is a Delaware corporation located in Seattle, Washington. Jewellery is an Irish limited company located in Ireland. All intercompany transactions and balances are eliminated in consolidation.

The financial information as of December 31, 2006 is derived from the Company s audited consolidated financial statements and notes for the fiscal year ended December 31, 2006, included in Item 8 of the annual report on Form 10-K for the year then ended.

Due to a number of factors, including the seasonal nature of the retail industry and other factors described in this report, quarterly results are not necessarily indicative of the results for the full fiscal year or any other subsequent interim period.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates include the allowance for sales returns and the estimated fair value of stock options granted. Actual results could differ materially from those estimates.

Intangible Assets

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

BLUE NILE, INC.
Notes to Consolidated Financial Statements
(unaudited)

Income Taxes

Effective January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which prescribes how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return.

We file income tax returns in the U.S. federal jurisdiction and the state of Delaware jurisdiction. We are no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2003. We recognize interest and penalties related to unrecognized tax benefits, if incurred, in our provision for income taxes.

We have evaluated material tax positions taken on all open years and have concluded that material tax positions meet the more likely than not test as set forth in FIN 48. As such, no liability for unrecognized tax benefits is considered necessary and no interest or penalties have been accrued. Therefore, the adoption of FIN 48 did not have an impact on our consolidated results of operations or financial condition. We will continue to evaluate material tax positions on a periodic basis or as conditions change.

Foreign Currency Translation

The assets and liabilities of Jewellery have been translated to U.S. dollars using the exchange rates effective on the balance sheet date, 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).

Recent Accounting Pronouncements

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force (EITF) No. 06-3 (EITF 06-3), How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation). The EITF reached a consensus that a company may adopt a policy for presenting taxes on a gross or net basis. If taxes are significant, the accounting policy should be disclosed and if taxes are presented gross, the amounts included in revenue should be disclosed. EITF 06-3 is effective for the first interim or annual reporting period beginning after December 15, 2006. We adopted EITF 06-3 on January 1, 2007. We collect sales tax from our customers and record these amounts on a net basis. We did not modify our accounting policy in connection with the adoption of EITF 06-3; therefore, the adoption of this EITF did not have an impact on our consolidated results of operations or financial condition.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). SFAS 157 establishes a common definition for fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We will apply this guidance to our first quarter of fiscal 2008. We do not expect the adoption of this statement to have a material impact on our consolidated results of operations or financial condition.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 permits all entities to elect to measure certain financial instruments and other items at fair value with changes in fair value reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We will apply this guidance to our first quarter of fiscal 2008. We do not expect the adoption of this statement to have a material impact on our consolidated results of operations or financial condition.

BLUE NILE, INC.
Notes to Consolidated Financial Statements
(unaudited)

Note 2. Stock-based Compensation

We account for stock-based compensation arrangements in accordance with the provisions of FASB Statement No. 123R *Share-Based Payment* (SFAS 123R). Stock options are granted at prices equal to the fair market value of the Company s common stock on the date of grant. Stock-based compensation is reduced for estimated forfeitures and we recognize compensation expense on a straight-line basis over the requisite service period for each stock option grant. Stock options granted generally provide for 25% vesting on the first anniversary of the date of grant, with the remainder vesting monthly over three years, and expire 10 years from the date of grant. As of July 1, 2007, the Company had four stock option plans. Additional information regarding these plans is disclosed in our annual report on Form 10-K for the year ended December 31, 2006.

The fair value of each option on the date of grant is estimated using the Black-Scholes-Merton option valuation model. The following weighted-average assumptions were used for the valuation of options granted during the periods shown:

	Quarter ended		Year to date ended	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
Expected term	4.5 years	4.5 years	4.5 years	4.5 years
Expected volatility	36.0%	36.0%	36.0%	36.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	4.65%	5.01%	4.66%	5.01%
Estimated fair value per option granted	$20.16	$11.07	$17.99	$11.09

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

A summary of stock option activity for the year to date ended July 1, 2007 is as follows:

	Options (in thousands)	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Balance, December 31, 2006	2,186	$ 21.73		
Granted	44	48.41		
Exercised	(256)	10.44		
Cancelled	(25)	29.26		
Balance, July 1, 2007	1,949	$ 23.72	7.35	$ 71,506
Vested and expected to vest at July 1, 2007	1,787	$ 23.00	7.25	$ 66,848
Exercisable, July 1, 2007	1,137	$ 17.88	6.61	$ 48,362

The aggregate intrinsic value in the table above is before applicable income taxes and represents the amount optionees 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.

The total intrinsic value of options exercised during the year to date ended July 1, 2007 was $9.9 million. During the year to date ended July 1, 2007, the total fair value of options vested was $3.2 million. As of July 1, 2007, the Company had total unrecognized compensation costs related to unvested stock options of $8.5 million. We expect to recognize this cost over a weighted average period of 2.4 years.

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BLUE NILE, INC.
Notes to Consolidated Financial Statements
(unaudited)

Note 3. Inventories

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

	July 1, 2007	December 31, 2006
Loose diamonds	$ 580	$ 230
Fine jewelry, watches and other	14,088	14,386
	$ 14,668	$ 14,616

Note 4. Marketable Securities

The Company s marketable securities are classified as available-for-sale as defined by FASB Statement No. 115 *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115). At July 1, 2007, the Company did not have any marketable securities. Realized gains or losses on the sale of marketable securities are identified on a specific identification basis and are reflected as a component of interest income or expense.

There were no realized gains or losses on the sales of marketable securities for the quarter ended July 1, 2007. Gross unrealized gains and losses at July 1, 2007 were not significant.

Note 5. Net Income Per Share

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

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	
	July 1, 2007	July 2, 2006	July 1, 2007	July 2, 2006
Net income	$ 3,781	$ 3,132	$ 6,944	$ 5,487
Weighted average common shares outstanding	15,802	16,874	15,838	17,114
Basic net income per share	$ 0.24	$ 0.19	$ 0.44	$ 0.32
Dilutive effect of stock options	815	688	760	784
Common stock and common stock equivalents	16,617	17,562	16,598	17,898
Diluted net income per share	$ 0.23	$ 0.18	$ 0.42	$ 0.31

For the quarter and year to date ended July 1, 2007, there were 14,816 and 43,432 stock option shares, respectively, excluded from the computation of net income per diluted share due to their antidilutive effect. For the quarter and year to date ended July 2, 2006, there were 1,049,167 and 959,197 stock option shares, respectively, excluded from the computation of net income per diluted share due to their antidilutive effect.

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

The following discussion should be read in conjunction with our Consolidated Financial Statements and the related Notes contained elsewhere in this quarterly report on Form 10-Q and the annual report on Form 10-K filed for our fiscal year ended December 31, 2006.

Management Overview

During the quarter ended July 1, 2007, net sales increased 26.7% to $72.1 million from $56.9 million during the quarter ended July 2, 2006. The increase in net sales is attributable to strong growth in all product categories. Gross profit was $14.9 million in the quarter ended July 1, 2007, an increase of $3.6 million compared to the quarter ended July 2, 2006. Operating income for the quarter ended July 1, 2007 increased 39.8% to $5.0 million from $3.6 million in the quarter ended July 2, 2006 as a result of the increase in net sales. Net income increased 20.7% to $3.8 million in the quarter ended July 1, 2007 from $3.1 million in the quarter ended July 2, 2006. Sales through our international websites continued to show strong growth. Sales through our U.K. and Canada websites totaled $3.0 million for the quarter ended July 1, 2007 compared to $1.9 million for the quarter ended July 2, 2006, an increase of 64.2%.

During the year to date ended July 1, 2007, net sales increased 30.1% to $140.0 million from $107.6 million during the year to date ended July 2, 2006. The increase in net sales is attributable to strong growth in all product categories. Gross profit of $28.2 million increased $6.5 million in the year to date ended July 1, 2007 compared to the year to date ended July 2, 2006. Operating income for the year to date ended July 1, 2007 increased 39.1% to $8.7 million from $6.3 million in the year to date ended July 2, 2006 as a result of the increase in net sales and leverages in our cost structure. Net income increased 26.6% to $6.9 million in the year ended July 1, 2007 from $5.5 million in the year to date ended July 2, 2006. Sales through our U.K. and Canada websites totaled $5.6 million for the year to date ended July 1, 2007 compared to $3.2 million for the year to date ended July 2, 2006, an increase of 73.1%.

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Results of Operations

Comparison of the Quarter Ended July 1, 2007 to the Quarter Ended July 2, 2006

The following table presents our operating results for the quarters ended July 1, 2007 and July 2, 2006, respectively, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

	Quarter ended July 1, 2007	Quarter ended July 2, 2006	$ Change	% Change
Net sales	$ 72,093	$ 56,916	$ 15,177	26.7%
Cost of sales	57,150	45,593	11,557	25.3%
Gross profit	14,943	11,323	3,620	32.0%
Selling, general and administrative expenses	9,909	7,721	2,188	28.3%
Operating income	5,034	3,602	1,432	39.8%
Other income (expense), net:				
Interest income	803	881	(78)	-8.9%
Other income	12	100	(88)	-88.0%
Total other income (expense), net	815	981	(166)	-16.9%
Income before income taxes	5,849	4,583	1,266	27.6%
Income tax expense	2,068	1,451	617	42.5%
Net income	$ 3,781	$ 3,132	$ 649	20.7%
Basic net income per share	$ 0.24	$ 0.19	$ 0.05	26.3%
Diluted net income per share	$ 0.23	$ 0.18	$ 0.05	27.8%

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Net Sales

Net sales increased 26.7% to $72.1 million in the quarter ended July 1, 2007 from $56.9 million in the quarter ended July 2, 2006. The increase in net sales in the quarter ended July 1, 2007 was primarily due to growth in unit sales in virtually all product categories. We believe the increase in net sales was driven primarily by increased consumer awareness of our brand and value proposition and effective online marketing.

Gross Profit

Gross profit increased 32.0% to $14.9 million in the quarter ended July 1, 2007 from $11.3 million in the quarter ended July 2, 2006. The increase in gross profit in the quarter ended July 1, 2007 resulted primarily from the growth in net sales, as discussed above. In addition, approximately $0.2 million of the gross profit in the quarter ended July 1, 2007 resulted from a one-time benefit related to a refund of shipping charges. Gross profit as a percentage of net sales was 20.7% in the quarter ended July 1, 2007 compared to 19.9% in the quarter ended July 2, 2006. The increase in gross profit as a percentage of net sales was primarily due to changes in our product mix. In addition, gross profit as a percentage of net sales increased by 30 basis points as a result of the refund of shipping charges. Generally, our gross profit percentage fluctuates, and we expect it will fluctuate in the future, based upon a number of factors, including changes in product acquisition costs, product mix and pricing decisions.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 28.3% to $9.9 million in the quarter ended July 1, 2007. The increase in selling, general and administrative expenses was due to several factors. Marketing costs increased approximately $0.5 million in the quarter due to increased spending in online marketing vehicles, such as search, affiliate channels, online portals and other marketing initiatives. Our marketing expenses are largely variable, based on the growth in sales and the pricing of online marketing channels. Approximately $0.5 million of the increase in selling, general and administrative costs in the quarter relates to increases in payroll and related expenses. Stock-based compensation increased approximately $0.5 million to $1.4 million in the quarter ended July 1, 2007 as compared to $0.9 million in the quarter ended July 2, 2006. The increase in selling, general and administrative expenses also relates to payment processing fees, professional services and costs related to the establishment of our new international facility in Ireland. As a percentage of net sales, selling, general and administrative expenses were 13.7% and 13.6% in the quarter ended July 1, 2007 and the quarter ended July 2, 2006, respectively.

We expect selling, general and administrative expenses to increase in absolute dollars in future periods as a result of anticipated growth in net sales, growth in our fulfillment and customer service operations and other personnel to support higher sales volumes, increases in payment processing fees and other variable expenses and the expansion of our international operations. We also expect selling, general and administrative expenses to fluctuate based on the nature, amount and timing of stock options granted in the future.

Other Income (Expense), Net

Other income (expense), net consists primarily of interest income. The decrease in interest income in the quarter ended July 1, 2007 is primarily due to a decrease in average balances of cash, cash equivalents and marketable securities.

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Comparison of the Year To Date Ended July 1, 2007 to the Year To Date Ended July 2, 2006
The following table presents our operating results for the year to date periods ended July 1, 2007 and July 2, 2006, respectively, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

	Year to date ended			
	July 1, 2007	July 2, 2006	$ Change	% Change
Net sales	$ 140,003	$ 107,610	$ 32,393	30.1%
Cost of sales	111,811	85,945	25,866	30.1%
Gross profit	28,192	21,665	6,527	30.1%
Selling, general and administrative expenses	19,473	15,398	4,075	26.5%
Operating income	8,719	6,267	2,452	39.1%
Other income (expense), net:				
Interest income	1,776	1,866	(90)	-4.8%
Other income	215	100	115	115.0%
Total other income (expense), net	1,991	1,966	25	1.3%
Income before income taxes	10,710	8,233	2,477	30.1%
Income tax expense	3,766	2,746	1,020	37.1%
Net income	$ 6,944	$ 5,487	$ 1,457	26.6%
Basic net income per share	$ 0.44	$ 0.32	$ 0.12	37.5%
Diluted net income per share	$ 0.42	$ 0.31	$ 0.11	35.5%

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Net Sales

Net sales increased 30.1% to $140.0 million in the year to date ended July 1, 2007 from $107.6 million in the year to date ended July 2, 2006. The increase in net sales in the year to date ended July 1, 2007 was primarily due to unit sales growth in virtually all product categories. We believe the increase in net sales was driven primarily from increased consumer awareness of our brand and value proposition and effective online marketing.

Gross Profit

Gross profit increased 30.1% to $28.2 million in the year to date ended July 1, 2007 from $21.7 million in the year to date ended July 2, 2006. The increase in gross profit in the year to date ended July 1, 2007 resulted primarily from the growth in net sales, as discussed above. Gross profit as a percentage of net sales remained consistent at 20.1% in the year to date ended July 1, 2007 compared to the year to date ended July 2, 2006. We expect that the gross profit percentage will fluctuate in the future based on a number of factors, including changes in product acquisition costs, product mix and pricing decisions.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 26.5% to $19.5 million in the year to date ended July 1, 2007. The increase in selling, general and administrative expenses was due to several factors. Marketing costs increased approximately $1.2 million in the year to date ended July 1, 2007 due to increased spending in online marketing vehicles, such as search, affiliate channels, online portals and other marketing initiatives. Our marketing expenses are largely variable, based on the growth in sales and the pricing of online marketing channels. Approximately $0.9 million of the increase in selling, general and administrative costs in the year to date ended July 1, 2007 relates to increases in payroll and related expenses. Stock-based compensation increased approximately $0.9 million to $2.7 million in the year to dated ended July 1, 2007 as compared to $1.8 million in the year to date ended July 2, 2006. The increase in selling, general and administrative expenses also relates to payment processing fees, professional services and costs related to the establishment of our new international facility in Ireland. As a percentage of net sales, selling, general and administrative expenses were 13.9% and 14.3% in the year to date ended July 1, 2007 and the year to date ended July 2, 2006, respectively.

We expect selling, general and administrative expenses to increase in absolute dollars in future periods as a result of anticipated growth in net sales, growth in our fulfillment and customer service operations and other personnel to support higher sales volumes, increases in payment processing fees and other variable expenses and the expansion of our international operations. We also expect selling, general and administrative expenses to fluctuate based on the nature, amount and timing of stock options granted in the future.

Other Income (Expense), Net

Other income (expense), net consists primarily of interest income. The decrease in interest income in the year to date ended July 1, 2007 is primarily due to a decrease in average balances of cash, cash equivalents and marketable securities, partially offset by an increase in interest rates during the year to date ended July 1, 2007 as compared to the year to date ended July 2, 2006.

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Liquidity and Capital Resources

As of July 1, 2007, working capital totaled $41.9 million, including cash and cash equivalents of $69.2 million and inventory of $14.7 million, partially offset by accounts payable of $42.5 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 used in operating activities was $16.7 million for the year to date ended July 1, 2007, compared to net cash used in operating activities of $12.0 million for the year to date ended July 2, 2006. Cash was provided by earnings of $6.9 million for the year to date ended July 1, 2007 and earnings of $5.5 million for the year to date ended July 2, 2006. Net payments of payables totaled $24.1 million for the year to date ended July 1, 2007 and $22.5 million for the year to date ended July 2, 2006. The increase in net payments of payables in 2007 relates primarily to higher payments to suppliers in the first quarter of 2007 for inventory sold in the fourth quarter of 2006. The volume of sales in the fourth quarter ended December 31, 2006 was greater than the volume of sales in the fourth quarter ended January 1, 2006, resulting in an increase in the net payment of payables in the year to date ended July 1, 2007 compared to the year to date ended July 2, 2006. This payment cycle reflects what we believe to be the beneficial working capital characteristics of our business model, wherein we collect cash from customers within several business days following a related sale while we typically have longer payment terms with our suppliers. The decrease in deferred tax assets in the year to date ended July 1, 2007 as compared to the year to date ended July 2, 2006 reflects the full utilization of our net operating loss carryforwards for federal income tax purposes in the quarter ended December 31, 2006.

Net cash provided by investing activities was $17.8 million for the year to date ended July 1, 2007, which primarily reflects net sales of marketable securities of $19.8 million offset by net purchases of property and equipment of $2.1 million. Cash provided by investing activities was $26.6 million for the year to date ended July 2, 2006, which primarily reflects net sales of marketable securities of $27.8 million offset by net purchases of property and equipment of $1.2 million.

Net cash used in financing activities for the year to date ended July 1, 2007 was $10.5 million, related primarily to repurchases of Blue Nile, Inc. common stock. In February 2006, our board of directors authorized the repurchase of common stock with an aggregate total value of up to $100 million within the 24-month period following the approval date of such repurchase. In July 2006, our board of directors authorized the repurchase of an additional $50 million within the 24 month period following the approval date of such repurchase. The timing and amount of any shares repurchased is determined by the Company s management based on its evaluation of market conditions and other factors. Repurchases may also be made under a Rule 10b5-1 plan, which permits shares to be repurchased when the Company might otherwise be precluded from doing so under insider trading laws. During the year to date ended July 1, 2007, we purchased approximately 345,000 shares of our common stock for approximately $13.5 million. Cash used in financing activities for the year to date ended July 2, 2006 was $45.2 million related primarily to repurchases of Blue Nile, Inc. common stock.

Contractual Obligations

There have been no material changes to the 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 December 31, 2006.

Off-Balance Sheet Arrangements

As of July 1, 2007, we did not have any off-balance sheet arrangements.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

The Company s exposure to financial market risk results primarily from fluctuations in interest rates. There have been no material changes to our market risks as disclosed in our annual report on Form 10-K for the year ended December 31, 2006.

Foreign Currency Exchange Risk

The functional currency of Blue Nile Jewellery, Ltd. (Jewellery) is the Euro. Assets and liabilities of Jewellery are translated into U.S. dollars at the exchange rate prevailing at the end of the applicable period. Income and expenses are translated into U.S. dollars at an average exchange rate during the applicable period. Foreign currency gains and losses from the translation of Jewellery s balance sheet and income statement are included in other comprehensive income (loss). Foreign currency gains and losses for the quarter ended July 1, 2007 were immaterial.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

During the quarter ended July 1, 2007, 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 Securities and Exchange Commission (SEC) is recorded, processed, summarized and reported within the time periods specified by the SEC s rules and SEC reports. 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 July 1, 2007, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1A. Risk Factors

You should carefully consider the risks described below and elsewhere in this report, which could materially and adversely affect our business, results of operations or financial condition. In those cases, the trading price of our common stock could decline and you may lose all or part of your investment. For the current quarter, there have been no material changes to the risk factors discussed below since we filed our Form 10-K for the fiscal year ended December 31, 2006, other than the addition of the risk factor We have foreign exchange risk below.

Our limited operating history makes it difficult for us to accurately forecast net sales and appropriately plan our expenses.

We were incorporated in March 1999 and have a limited operating history. As a result, it is difficult to accurately forecast our net sales and plan our operating expenses. We 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. 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 options granted and the expected rate of stock option 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.

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 diamonds and precious metals;
- our ability to attract visitors to our websites and convert those visitors into customers;
- our ability to retain existing customers or encourage repeat purchases;
- our ability to manage our product mix and inventory;
- wholesale diamond prices;
- consumer tastes and preferences for diamonds and fine jewelry;
- 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 granted, the underlying assumptions used in valuing these options, the estimated rate of stock option forfeitures and other factors;
- advertising and other marketing costs;
- our, or our competitors , pricing and marketing strategies;
- the introduction of competitive websites, products, price decreases or improvements;

- general economic conditions, both domestically and internationally;
- conditions or trends in the diamond and fine jewelry industry;
- conditions or trends in the Internet and e-commerce industry;
- the success of our geographic and product line expansions; 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 36%, 36% and 38% of our net sales in the years ended December 31, 2006, January 1, 2006 and January 2, 2005, 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 jewelry and additional staffing in our fulfillment and customer support operations. If we were to experience lower than expected net sales during any future fourth quarter, it would have a disproportionately large impact on our operating results and financial condition for that year. 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 to expenses in a given period, which would substantially harm our business and results of operations.

Our failure to acquire quality diamonds and fine jewelry at commercially reasonable prices would result in higher costs and lower net sales and damage our competitive position.

If we are unable to acquire quality diamonds and fine jewelry at commercially reasonable prices, our costs may exceed our forecasts, our gross margins and operating results 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. 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 relationship with these firms. Our ability to acquire diamonds and fine jewelry is also substantially dependent on our relationships with various suppliers. Approximately 21%, 25% and 25% of our payments to our diamond and fine jewelry suppliers in the years ended December 31, 2006, January 1, 2006 and January 2, 2005, respectively, were made to our top three suppliers. 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.

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 for the products that they sell. 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.

Purchasers of diamonds and fine jewelry may not choose to shop online, which would prevent us from increasing net sales.

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.

We may not succeed in continuing to establish 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 online market for diamonds and fine jewelry, if we do not continue to establish 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 customer experience. To promote our brand and branded products, we have incurred and will continue to incur substantial expense related to advertising and other marketing efforts.

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 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 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.

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We face significant competition and may be unsuccessful in competing against current and future competitors.
The retail jewelry industry is intensely competitive, and we expect competition in the sale of diamonds and fine jewelry to increase and intensify in the future. Increased competition may result in price pressure, reduced gross margins and loss of market share, any of which could substantially harm our business and results of operations.
Current and potential competitors include:

- independent jewelry stores;
- retail jewelry store chains, such as Tiffany & Co. and Bailey Banks & Biddle;
- other online retailers that sell jewelry, such as Amazon.com;
- 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 Home Shopping Network and QVC; and
- discount superstores and wholesale clubs, such as Wal-Mart and Costco Wholesale.

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.
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. 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.
Some of our 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. In addition, larger, more established and better capitalized entities may acquire, invest or partner with traditional and online competitors as use of the Internet and other online services increases. Our online competitors can duplicate many of the products, services and content we offer, which could harm our business and results of operations.
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 which we have online-advertising arrangements could provide advertising services to other online or traditional retailers, 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.
We rely exclusively on the sale of diamonds and fine jewelry for our net sales, and demand for these products could decline.
Luxury products, such as diamonds and fine jewelry, are discretionary purchases for consumers. The volume and dollar value of such purchases may significantly decrease during economic downturns. The success of our business depends in part on many macroeconomic factors, including employment levels, salary levels, tax rates and credit availability, all of which affect consumer spending and disposable income. Any reduction in consumer spending or disposable income may affect us more significantly than companies in other industries.

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, increasing 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. Blue Nile supports 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, Blue Nile prohibits the use of its 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 seek to 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 jewelry offerings must reflect the tastes and preferences of a wide range of consumers whose preferences may change regularly. Our strategy has been to offer primarily what we consider to be classic styles of fine jewelry, but there can be no assurance that these styles will continue to be popular with consumers in the future. If the styles we offer become less 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.

We may be unsuccessful in further expanding our operations internationally.

To date, we have made limited international sales, but we have recently expanded our operations to include a fulfillment operation in Ireland to serve customers acquired through our United Kingdom website. Additionally, we have increased our product offerings and marketing and sales efforts in the United Kingdom and Canada and anticipate continuing to expand our international sales and operations in the future either by expanding local versions of our website for foreign markets or through acquisitions or alliances with third parties. Any international expansion plans we choose to undertake will require management attention and resources and may be unsuccessful. We have minimal experience in selling our products in international markets and in conforming to the local cultures, standards or policies necessary to successfully compete in those markets. Outside of the United Kingdom and Canada, we have very limited web content localized for foreign markets and 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 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 and tariffs;
- 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 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 and import licenses;

increased payment risk and greater difficulty addressing credit card fraud;

consumer and data protection laws;

lower levels of adoption or use of the Internet; and

geopolitical events, including war and terrorism.

Our failure to successfully expand our international operations may cause our business and results of operations to suffer.

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 third-party carriers for product shipments to our customers. We and our suppliers are therefore subject to the risks, including employee strikes and inclement weather, 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 the product. Our suppliers , third-party carriers or third-party jewelers failure to deliver 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.

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. This facility is 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. We have recently added another fulfillment center in Ireland, that would also be susceptible to these 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. We have expanded and currently are significantly expanding our existing fulfillment center located in the United States. Any interruptions in our fulfillment center operations for any significant period of time, including interruptions resulting from the expansion of our existing facility, could damage our reputation and brand and substantially harm our business and results of operations.

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

We have experienced and may continue to experience theft of our products while they are being held in our fulfillment centers or during the course of shipment to our customers by third-party shipping carriers. We have taken steps to prevent such theft and we maintain insurance to cover certain losses resulting from 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.

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. In addition, our servers are vulnerable to computer viruses, denial of service attacks, physical or electronic break-ins and similar disruptions, which could lead to

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interruptions, delays, loss of critical data, the inability to fulfill customer orders or the unauthorized disclosure of confidential customer data. The occurrence of any of the foregoing risks could substantially harm our business and results of operations.

Our failure to protect confidential information of our customers and our network against security breaches could damage our reputation and brand and substantially harm our business and results of operations.

A significant barrier to online commerce and communications is the secure transmission of confidential information over public networks. Our failure to prevent these security breaches could damage our reputation and brand and substantially harm our business and results of operations. Currently, a majority of our sales are billed to our customers credit card accounts directly. We rely on 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 compromise of our security could damage our reputation, business and brand and expose us to a risk of loss or litigation and possible liability, which would substantially harm 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 users, or otherwise damage our reputation and business. 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.

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;
- 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.

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 a new product category that is 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. Changes in consumer tastes for these products subject us to significant inventory risks. The demand for specific products can change between the time we order an item and the date we receive it. If we under-stock one or more of our products, we may not be able to obtain additional units in a timely manner on terms favorable to us, if at all, which would damage our reputation and substantially harm our business and results of operations. In addition, if demand for our products increases over time, we may be forced to increase inventory levels. If one or more of our products does not achieve widespread consumer acceptance, we may be required to take significant inventory markdowns, or may not be able to sell the product at all, which would substantially harm our results of operations.

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Repurchases of our common stock may not prove to be the best use of our cash resources.

On February 2, 2006, our board of directors authorized the repurchase of up to $100 million of Blue Nile, Inc. common stock during the subsequent 24 month period following the approval date of such repurchases. On July 27, 2006, our board of directors authorized the repurchase of up to an additional $50 million of Blue Nile, Inc. common stock during the subsequent 24 month period following the approval date of such repurchase. 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.

We have incurred significant operating losses in the past and may not be able to sustain profitability in the future.

We experienced significant operating losses in each quarter from our inception in 1999 through the second quarter of 2002. As a result, our business has a limited record of profitability and may not continue to be profitable or increase profitability. If we are unable to acquire diamonds and fine jewelry at commercially reasonable prices, if net sales decline or if our expenses otherwise exceed our expectations, we may not be able to sustain or increase profitability on a quarterly or annual basis.

We rely on the services of our key personnel, any 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. Other than for our Chief Executive Officer, we do not have key person life insurance policies covering any of our employees.

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 and the Blue Nile BN stylized logo 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.

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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 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 based on historical return rates. 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.

Interruptions to our systems 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 and our ability to attract and retain customers and to maintain adequate customer service levels. Any future systems interruptions or 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.

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 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 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.

If use of the Internet, particularly with respect to online commerce, does not continue to increase as rapidly as we anticipate, our business 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. Highly publicized 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.

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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 re