BLUE NILE INC
Form 10-Q
August 07, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 1, 2012
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 (State or other jurisdiction of incorporation or organization)	91-1963165 (I.R.S. Employer Identification No.)
411 First Avenue South, Suite 700, 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 ý No o
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 ý No o
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	ý	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	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 ý
As of August 3, 2012, the registrant had 12,418,446 shares of common stock outstanding.

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Cautionary Note Regarding Forward-Looking Statements

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

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
BLUE NILE, INC.
Condensed Consolidated Balance Sheets
(in thousands, except par value)

	July 1, 2012 (unaudited)	January 1, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$53,700	$89,391
Trade accounts receivable	1,500	2,317
Other accounts receivable	742	2,550
Inventories	26,778	29,267
Deferred income taxes	532	689
Prepaids and other current assets	873	1,009
Total current assets	84,125	125,223
Property and equipment, net	8,028	8,340
Intangible assets, net	224	252
Deferred income taxes	7,841	9,053
Note receivable	2,000	—
Other investments	2,000	—
Other assets	150	157
Total assets	$104,368	$143,025
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$62,302	$95,590
Accrued liabilities	7,597	9,396
Current portion of long-term financing obligation	59	59
Current portion of deferred rent	212	211
Total current liabilities	70,170	105,256
Long-term financing obligation, less current portion	655	685
Deferred rent, less current portion	1,982	2,060
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; 20,656 shares and 20,525 shares issued, respectively 13,550 shares and 13,768 shares outstanding, respectively	21	21
Additional paid-in capital	192,579	187,762
Accumulated other comprehensive loss	(170)	(123)
Retained earnings	76,223	74,491
Treasury stock, at cost; 7,106 and 6,757 shares outstanding, respectively	(237,092)	(227,127)
Total stockholders' equity	31,561	35,024
Total liabilities and stockholders' equity	$104,368	$143,025

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

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

	Quarter ended		Year to date ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
Net sales	$90,981	$80,522	$174,084	$160,702
Cost of sales	73,790	63,349	141,615	126,609
Gross profit	17,191	17,173	32,469	34,093
Selling, general and administrative expenses	14,867	12,913	29,926	26,321
Operating income	2,324	4,260	2,543	7,772
Other income, net:				
Interest income, net	45	42	85	83
Other income, net	67	59	80	81
Total other income, net	112	101	165	164
Income before income taxes	2,436	4,361	2,708	7,936
Income tax expense	858	1,523	976	2,676
Net income	$1,578	$2,838	$1,732	$5,260
Basic net income per share	$0.11	$0.19	$0.13	$0.36
Diluted net income per share	$0.11	$0.19	$0.12	$0.35

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

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

	Quarter ended		Year to date ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
Net income	$1,578	$2,838	$1,732	$5,260
Other comprehensive income:				
Foreign currency translation adjustments	(90)	32	(47)	130
Total comprehensive income	$1,488	$2,870	$1,685	$5,390

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

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BLUE NILE, INC.
Condensed Consolidated Statement of Changes in Stockholders' Equity
(unaudited)
(in thousands)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock		Total Stockholders' Equity
	Shares	Amount				Shares	Amount	
Balance, January 2, 2012	20,525	$21	$187,762	$74,491	$ (123)	(6,757)	$(227,127)	$35,024
Net income	—	—	—	1,732	—	—	—	1,732
Other comprehensive income	—	—	—	—	(47)	—	—	(47)
Tax deficiency from exercise of stock options	—	—	(1,803)	—	—	—	—	(1,803)
Exercise of common stock options	129	—	4,035	—	—	—	—	4,035
Issuance of common stock to directors	2	—	60	—	—	—	—	60
Stock-based compensation	—	—	2,525	—	—	—	—	2,525
Repurchase of common stock	—	—	—	—	—	(349)	(9,965)	(9,965)
Balance, July 1, 2012	20,656	$21	$192,579	$76,223	$ (170)	(7,106)	$(237,092)	$31,561

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

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

	Year to date ended July 1, 2012	July 3, 2011
Operating activities:		
Net income	$1,732	$5,260
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	1,763	1,672
Loss on disposal of property and equipment	24	35
Stock-based compensation	2,514	3,542
Deferred income taxes	1,369	(250)
Tax (deficiency) benefit from exercise of stock options	(1,803)	582
Excess tax benefit from exercise of stock options	(8)	(365)
Changes in assets and liabilities:		
Receivables	2,625	(313)
Inventories	2,489	(564)
Prepaid expenses and other assets	143	(29)
Accounts payable	(33,199)	(35,361)
Accrued liabilities	(3,329)	(5,281)
Deferred rent and other	(77)	2,078
Net cash used in operating activities	(25,757)	(28,994)
Investing activities:		
Purchases of property and equipment	(1,495)	(3,758)
Purchases of other investments	(2,000)	—
Payments for note receivable	(2,000)	—
Net cash used in investing activities	(5,495)	(3,758)
Financing activities:		
Repurchase of common stock	(8,426)	(8,419)
Proceeds from stock option exercises	4,035	1,664
Excess tax benefit from exercise of stock options	8	365
Principal payments under long-term financing obligation	(30)	(23)
Net cash used in financing activities	(4,413)	(6,413)
Effect of exchange rate changes on cash and cash equivalents	(26)	67
Net decrease in cash and cash equivalents	(35,691)	(39,098)
Cash and cash equivalents, beginning of period	89,391	113,261
Cash and cash equivalents, end of period	$53,700	$74,163
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$1,205	$4,042
Non-cash investing and financing activities:		
Unsettled repurchases of common stock	$1,539	$—

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

Blue Nile, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1.Description of Our Business and Summary of Significant Accounting Policies

The Company

Blue Nile, Inc. (the “Company”) is the leading online retailer of high quality diamonds and fine jewelry. In addition to sales of diamonds and fine jewelry, the Company provides education, guidance and support to enable customers to more effectively learn about and purchase diamonds and fine jewelry. The Company, a Delaware corporation based in Seattle, Washington, was formed in March 1999. The Company serves consumers in over 40 countries and territories all over the world and maintains its 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 (the “SEC”).

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in the Company’s Annual Report on Form 10-K for the year ended January 1, 2012, filed with the SEC on February 27, 2012 (the "Annual Report"). The same accounting policies are followed for preparing quarterly and annual financial statements. In the opinion of management, all adjustments necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods have been included and are of a normal, recurring nature.

The financial information as of January 1, 2012 is derived from the Company’s audited consolidated financial statements and notes thereto for the fiscal year ended January 1, 2012, included in Item 8 of the Annual Report.

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

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All transactions and balances between the Company and its wholly-owned subsidiaries are eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (“GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates include the allowance for sales returns and assumptions used to determine stock-based compensation expense. Actual results could differ materially from those estimates.

Foreign Currency

The assets and liabilities of our subsidiaries have been translated to U.S. dollars using the exchange rates effective on the balance sheet dates, while income and expense accounts are translated at the average rates in effect during the periods presented. The resulting translation adjustments are recorded in accumulated other comprehensive income (loss).

The Company offers customers the ability to transact in 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.

Blue Nile, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note Receivable and Other Investment

On May 2, 2012, the Company purchased $2.0 million in convertible preferred shares in a privately-held company in exchange for a minority stake. The convertible preferred shares are convertible to common stock at any time at the Company's option. The convertible preferred shares did not meet the characteristics of in-substance common stock; as such, this investment is accounted for under the cost method.

On May 2, 2012, the Company loaned $2.0 million to the same privately-held company in exchange for a note receivable (the “Note”). The Note is convertible into convertible preferred shares upon the occurrence of certain events or at the Company's written election. If not sooner converted, the Note matures on May 1, 2015, at which time the Company is due the entire unpaid principal amount and unpaid interest thereon. The interest on the principal amount outstanding is payable in quarterly installments in cash, until the Note is repaid in full or until the principal amount has been converted. The Note bears interest at LIBOR + 1% as of July 1, 2012. The interest rate increases over the term of the note to a maximum rate of LIBOR + 8%. The Note is recorded at its face amount in the Company's consolidated balance sheet.

Blue Nile, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 2. Stock-based Compensation

As of July 1, 2012, the Company had four equity plans. Additional information regarding these plans is disclosed in the Annual Report.

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

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

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

	Quarter ended		Year to date ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
Expected term	4.47 years	4 years	4.32 years	4 years
Expected volatility	58.99 %	57.90 %	59.10 %	57.70 %
Expected dividend yield	0.00 %	0.00 %	0.00 %	0.00 %
Risk-free interest rate	0.76 %	1.03 %	0.75 %	1.30 %
Estimated weighted-average fair value per stock option granted	$14.05	$22.83	$15.48	$24.86

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

A summary of stock option activity for the quarter ended July 1, 2012 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, 2012	2,391	$40.82		
Granted	405	33.03		
Exercised	(130)	31.13		
Canceled	(313)	49.72		
Balance, July 1, 2012	2,353	$38.83	5.94	$2,220
Vested and expected to vest at July 1, 2012	2,233	$38.93	5.76	$2,190
Exercisable, July 1, 2012	1,546	$39.75	4.30	$1,844

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

The total intrinsic value of stock options exercised during the year to date ended July 1, 2012 was $1.3 million. During the year to date ended July 1, 2012, the total fair value of stock options vested was $2.6 million. As of July 1, 2012, the Company had total unrecognized compensation costs related to unvested stock options of $10.9 million, before income taxes. The Company expects to recognize this cost over a weighted average period of 3.13 years.

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):

	July 1, 2012	January 1, 2012
Loose diamonds	$1,621	$1,607
Fine jewelry and other	25,157	27,660
Total	$26,778	$29,267

Blue Nile, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
Net income	$1,578	$2,838	$1,732	$5,260
Weighted average common shares outstanding	13,787	14,560	13,820	14,565
Basic net income per share	$0.11	$0.19	$0.13	$0.36
Dilutive effect of stock options and restricted stock units	109	552	212	595
Common stock and common stock equivalents	13,896	15,112	14,032	15,160
Diluted net income per share	$0.11	$0.19	$0.12	$0.35

For the quarter and year to date ended July 1, 2012, the Company excluded 1,943,525 and 1,382,042 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 July 3, 2011, the Company excluded 760,055 and 690,273 stock option shares, respectively, from the computation of diluted net income per 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 January 1, 2012. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Quarterly Report on Form 10-Q, particularly in "Risk Factors."

Management Overview

We are the leading online retailer of high-quality diamonds and fine jewelry. We offer our products for sale through the www.bluenile.com, www.bluenile.ca and www.bluenile.co.uk websites in over 40 countries and territories throughout the world. Our primary focus is on growing our business by providing unparalleled selection and value to consumers and delivering exceptional customer service.

Our online business model allows us to avoid many of the costs that are typically incurred by physical retail stores. As a result, we are able to realize lower gross profit margins while remaining profitable. Our lower gross profit margins result from lower retail prices that we offer to our customers. We believe that our unique product selection, connection with our customers through our marketing and customer service efforts, and our competitive pricing will result in increasing our sales and market share.

We are focused on accelerating the sales growth rate of our business through initiatives across three main categories: 1) the sale of engagement products in the U.S.; 2) the sale of non-engagement products in the U.S.; and 3) the sale of both engagement and non-engagement products in international markets.

As part of our plan to spur growth in engagement products in the U.S., in early 2012, we significantly reduced the mark-up on the diamonds that we offer for sale. We believe that value is one of the most important drivers of engagement sales, and that lower mark-ups will increase the conversion rate of visitors on our websites to customers. We also believe that the most recent supply cost of diamonds is a significant factor in our growth rate. Generally, we purchase our diamonds on a real time basis from our suppliers when a customer places an order for a specific diamond. When the cost of diamonds is relatively steady or declines, we believe that our business benefits because we are able to immediately pass those lower costs on to consumers. These lower costs, along with our aggressive retail pricing, increases our value proposition compared to our bricks and mortar competitors, who are carrying diamond inventory that was purchased months earlier at higher costs.

In the second quarter of 2012, the lower cost of diamonds compared to the same period last year coupled with our lower mark-up, resulted in an increase in sales. The lower mark-up also resulted in a lower gross margin as a percentage of net revenue compared to the same period last year.

To accelerate growth in our non-engagement category, we are concentrating our marketing efforts on acquiring new customers. We are also investing to increase the number of products offered on our website to appeal to a greater number of customers. The total addressable market for the sale of non-engagement products is much greater than that for engagement, and we believe our brand is well positioned to attract customers. Additionally, based on historical trends, we believe that customers who purchase our non-engagement products will return to place orders in the future at a higher rate than those who initially purchased an engagement product. The higher frequency of purchase, coupled with relatively higher gross margin as a percentage of revenue than we earn selling our engagement products, creates a compelling opportunity for us to invest for growth. During the second quarter of 2012, these investments increased our selling, general and administrative expenses, both in total amount and as a percentage of revenue, and increased the amount of inventory we carry compared to the same period last year. We believe that these investments will lead to increased growth in this area of our business and provide higher profitability over the long-term.

As part of our plan to accelerate growth in our international business, we are increasing our investment to provide a greater localized experience in key countries. This includes expanded website functionality, increased product offerings, native language websites and customer service personnel, and other strategic investments.

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Additionally, the pricing dynamic of diamond supply and the reduction in mark-up on our engagement products apply to prices offered to our international customers. We believe this enhanced value will increase the conversion rate of visitors on our websites to customers.

Second Quarter of 2012 Summary of Results of Operations

We achieved second quarter net sales of $91.0 million, a 13.0% increase from the second quarter of 2011. Net sales in our international markets increased 12.6% from the second quarter of 2011 and comprised approximately 15.8% of our total net sales for the quarter. Additionally, through our increased marketing efforts, orders from new customers increased approximately 32.0% in the second quarter of 2012 compared to the second quarter of 2011.

Results of Operations

Comparison of the Quarter Ended July 1, 2012 to the Quarter Ended July 3, 2011

The following table presents our operating results for the quarters ended July 1, 2012 and July 3, 2011, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

	Quarter ended					
	July 1, 2012	July 3, 2011	$ Change		% Change	
Net sales	$90,981	$80,522	$10,459		13.0	%
Cost of sales	73,790	63,349	10,441		16.5	%
Gross profit	17,191	17,173	18		0.1	%
Selling, general and administrative expenses	14,867	12,913	1,954		15.1	%
Operating income	2,324	4,260	(1,936	)	(45.4	)%
Other income, net:						
Interest income	45	42	3		7.1	%
Other income, net	67	59	8		13.6	%
Total other income, net	112	101	11		10.9	%
Income before income taxes	2,436	4,361	(1,925	)	(44.1	)%
Income tax expense	858	1,523	(665	)	(43.7	)%
Net income	$1,578	$2,838	$(1,260	)	(44.4	)%
Basic net income per share	$0.11	$0.19	$(0.08	)	(42.1	)%
Diluted net income per share	$0.11	$0.19	$(0.08	)	(42.1	)%

Net Sales

Net sales increased 13.0% during the second quarter of 2012 as compared with the second quarter of 2011, due primarily to an increase in the number of orders shipped, partially offset by a decrease in the average shipment value. Net sales in the U.S. increased 13.1% to $76.6 million for the second quarter of 2012, compared with $67.7 million for the same quarter last year. U.S. engagement net sales for the second quarter of 2012 increased 19.2% to $52.4 million, compared to $43.9 million for the second quarter of 2011. U.S. non-engagement net sales for the second quarter 2012 increased 1.7% to $24.2 million, compared to $23.8 million for the second quarter 2011.

International net sales increased 12.6% to $14.4 million from $12.8 million in the second quarter of 2011. Internally, we monitor our international sales performance on a non-GAAP basis which eliminates the positive or negative effects that result from translating international sales into U.S. dollars (“constant exchange rate basis”). Changes in foreign exchange rates during the second quarter of 2012, compared to the rates in effect during the second quarter of 2011, had a negative impact of approximately 3.7% on international sales. Excluding the impact of changes in foreign exchange rates, international net sales increased 16.3% for the second quarter of 2012 compared to the second quarter of 2011.

Gross Profit

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Gross profit in the second quarter of 2012 remained the same as gross profit in the second quarter of 2011 at $17.2 million. Gross profit as a percentage of net sales decreased to 18.9% for the second quarter of 2012 compared to 21.3% for the second quarter of 2011. The decrease in gross profit as a percentage of net sales resulted from the lower mark-up of our engagement products, and from a shift in product mix. Our engagement products provide lower gross margin as a percentage of revenue than our non-engagement products. In the second quarter of 2012, sales of our engagement products grew faster than our non-engagement products and equaled 70.2% of our total revenue versus 67.3% in the second quarter of 2011.

Costs for our products are impacted by prices for diamonds and precious metals including gold, platinum and silver, which rise and fall based upon global supply and demand dynamics. In making retail pricing decisions, we take into account fluctuations in the pricing of diamonds and precious metals, which in turn, affect the gross margin that we realize from such products. We expect that gross profit will continue to fluctuate in the future based on changes in product acquisition costs, particularly diamond prices, product mix and pricing decisions.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 15.1% to $14.9 million in the second quarter of 2012 compared to $12.9 million in the second quarter of 2011. Marketing and advertising costs increased $1.4 million in the second quarter of 2012, primarily due to increased spending on online marketing vehicles and other marketing efforts to acquire new customers in our domestic and international markets. Compensation and benefits expense increased $0.5 million due to increased headcount to support key business initiatives coupled with increased variable incentive compensation accruals. These expense increases were partially offset by a $0.5 million decrease in stock based compensation expense. This decrease is primarily due to the turnover of our chief executive officer ("CEO") position, resulting in a lower number of options outstanding at a lower option fair value. As a percentage of net sales, selling, general and administrative expenses were 16.3% in the second quarter of 2012 compared to 16.0% in the second quarter of 2011.

Operating Income

Operating income was $2.3 million in the second quarter of 2012 compared to $4.3 million in the second quarter of 2011. The decrease in operating income is primarily due to the $2.0 million increase in selling, general and administrative expenses.

Income Taxes

Our effective tax rate increased to 35.2% in the second quarter of 2012 from 34.9% in the second quarter of 2011. The increase was primarily due to certain international expenses that are capitalized for income tax purposes but expensed in the financial statements.

Comparison of the Year to Date Ended July 1, 2012 to the Year to Date Ended July 3, 2011

The following table presents our operating results for the years to date ended July 1, 2012 and July 3, 2011, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

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	Year to date ended July 1, 2012	July 3, 2011	$ Change	% Change
Net sales	$174,084	$160,702	$13,382	8.3 %
Cost of sales	141,615	126,609	15,006	11.9 %
Gross profit	32,469	34,093	(1,624)	(4.8)%
Selling, general and administrative expenses	29,926	26,321	3,605	13.7 %
Operating income	2,543	7,772	(5,229)	(67.3)%
Other income, net:				
Interest income	85	83	2	2.4 %
Other income, net	80	81	(1)	(1.2)%
Total other income, net	165	164	1	0.6 %
Income before income taxes	2,708	7,936	(5,228)	(65.9)%
Income tax expense	976	2,676	(1,700)	(63.5)%
Net income	$1,732	$5,260	$(3,528)	(67.1)%
Basic net income per share	$0.13	$0.36	$(0.23)	(63.9)%
Diluted net income per share	$0.12	$0.35	$(0.23)	(65.7)%

Net Sales

Net sales increased 8.3% during the year to date ended July 1, 2012, compared with the year to date ended July 3, 2011, due primarily to an increase in the number of orders shipped, partially offset by a decrease in the average shipment value. Net sales in the U.S. increased 7.9% to $145.6 million during the year to date ended July 1, 2012, compared with $135.0 million during the year to date ended July 3, 2011. U.S. engagement net sales for the year to date ended July 1, 2012 increased to $98.8 million from $88.9 million for the year to date ended July 3, 2011. U.S. non-engagement net sales for the year to date ended July 1, 2012 were $46.8 million, compared to $46.1 million for the year to date ended July 3, 2011.

International sales increased 10.8% in the year to date ended July 1, 2012 to $28.5 million, from $25.7 million in the year to date ended July 3, 2011. Foreign exchange rates during the year to date ended July 1, 2012, compared to the rates in effect during the year to date ended July 3, 2011, had a negative impact of approximately 1.7% on international sales. Excluding the impact of changes in foreign exchange rates, international sales increased 12.5% in the year to date ended July 1, 2012 over the year to date ended July 3, 2011.

Gross Profit

Gross profit decreased $1.6 million to $32.5 million in the year to date ended July 1, 2012 compared to $34.1 million in the year to date ended July 3, 2011. The decrease in gross margin dollars resulted primarily from lower mark-ups on engagement products and product mix. Gross profit as a percentage of net sales was 18.7% in the year to date ended July 1, 2012 as compared to 21.2% in the year to date ended July 3, 2011. This percentage decrease was primarily due to product mix. Engagement sales equaled 69.9% of our total year to date revenue versus 68.1% in the prior year.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 13.7% to $29.9 million in the year to date ended July 1, 2012 compared to $26.3 million in the year to date ended July 3, 2011. Marketing and advertising costs increased $2.6 million, primarily due to increases in online marketing vehicles and other marketing efforts to acquire new customers in our domestic and international markets. Compensation and benefits expense increased $0.5 million primarily due to increased headcount to support key business initiatives. Accounting and legal fees increased $0.3 million due to international expansion and strategic initiatives. Recruiting fees of $0.3 million related to our CEO search also contributed to the increase in selling, general and administrative expenses. These increases were partially offset by a decrease in stock-based compensation expense of $1.0 million primarily due to turnover in our CEO position. Our former CEO had more options outstanding at higher option fair values than those held by our

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current CEO. As a percentage of net sales, selling, general and administrative expenses were 17.2% in the year to date ended July 1, 2012, as compared to 16.4% in the year to date ended July 3, 2011.

Operating Income

Operating income decreased 67.3% to $2.5 million in the year to date ended July 1, 2012 compared to $7.8 million in the year to date ended July 3, 2011. The decrease in operating income for the year to date ended July 1, 2012 was due to increased selling, general and administrative expenses coupled with lower gross profit.

Income Taxes

Our effective tax rate increased to 36.0% in the year to date ended July 1, 2012 from 33.7% in the year to date ended July 3, 2011 primarily due to the reversal of a deferred tax asset.

Liquidity and Capital Resources

We have been primarily funded by our cash flows from operations. The significant components of our working capital are inventory and liquid assets such as cash and trade accounts receivable, reduced by accounts payable and accrued expenses. Our business model typically provides certain beneficial working capital characteristics. While we collect cash from sales to customers within several business days of the related sale, we typically have extended payment terms with our suppliers.

Our liquidity is primarily dependent upon our net cash from operating activities. Our net cash from operating activities is sensitive to many factors, including changes in working capital and the timing and magnitude of capital expenditures. 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 July 1, 2012, working capital totaled $14.0 million, including cash and cash equivalents of $53.7 million and inventory of $26.8 million, partially offset by accounts payable of $62.3 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 $25.8 million was used in operating activities for the year to date ended July 1, 2012, compared to net cash used in operating activities of $29.0 million for the year to date ended July 3, 2011. The decrease in cash used for operating activities was attributable to lower net income, decreasing inventory and receivables balances and a lower net payment of accounts payable, offset by a tax deficiency from stock option exercises. Net payment of accounts payable totaled $33.2 million for the year to date ended July 1, 2012 and $35.4 million for the year to date ended July 3, 2011. In the first quarter of each year, we generally have a significant pay down of our accounts payable balance built up during the previous year’s fourth quarter holiday season. The volume of sales in the fourth quarter of 2011 was lower than the volume of sales in the fourth quarter of 2010, resulting in lower net payment of payables in the year to date ended July 1, 2012 compared to the year to date ended July 3, 2011.

Net cash of $5.5 million was used in investing activities for the year to date ended July 1, 2012. Net cash of $1.5 million was used for the purchases of property and equipment to support our operations. Net cash of $4.0 million was used to purchase preferred shares in a privately-held company and to loan to the same privately-held company in exchange for a note receivable. Net cash of $3.8 million was used in investing activities for the year to date ended July 3, 2011 for purchases of property and equipment primarily related to the move of our corporate offices. Our capital needs are generally relatively low and include, without limitation, investments in technology and website enhancements, capital improvements to our leased warehouse and office facilities, and furniture and equipment.

Net cash used in financing activities for the year to date ended July 1, 2012 was $4.4 million, primarily related to the repurchase of common stock of $8.4 million, partially offset by $4.0 million of proceeds from stock option exercises. Net cash used in financing activities for the year to date ended July 3, 2011 was $6.4 million, primarily related to the repurchase of common stock, partially offset by proceeds from stock option exercises.

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On February 7, 2012, our board of directors authorized the repurchase of up to $100.0 million of the Company's common stock during the 24-month period following the approval date of such repurchase. During the year to date ended July 1, 2012, we repurchased 348,855 shares of our common stock for $10.0 million.

For the third quarter to date through August 1, 2012, we have repurchased an additional 1,143,131 shares of our common stock for $28.9 million. Since the reauthorization on February 7, 2012, we have repurchased 1.5 million shares for a total of $38.8 million, and $61.2 million remains under the repurchase authorization. Since the inception of the buyback program in the first quarter of 2005, we have repurchased 7.5 million shares for a total of $265.3 million. Our shares may be repurchased from time to time in open market transactions or in negotiated transactions off the market. The timing and amount of any shares repurchased is determined by our management based on their evaluation of market conditions and other factors, including our cash needs. Repurchases may also be made under a Rule 10b5-1 plan. We continually assess market conditions, our cash position, operating results, current forecasts and other factors when making decisions about stock repurchases.

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 from those disclosed in our Annual Report.

Off-Balance Sheet Arrangements

As of July 1, 2012, we did not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Non-GAAP Financial Measures

To supplement our consolidated financial statements presented in accordance with GAAP, our management internally monitors our sales performance on a non-GAAP constant exchange rate basis that eliminates the positive or negative effects that result from translating international sales into U.S. dollars. Our management does not itself, nor does it suggest that investors should, consider such non-GAAP financial measures in isolation from, or as a substitute for, financial information prepared in accordance with GAAP. Investors should also note that the non-GAAP financial measures we used may not be the same non-GAAP financial measures, and may not be calculated in the same manner, as that of other companies. Whenever we use such non-GAAP financial measures, we provide a reconciliation of non-GAAP financial measures to the most closely applicable GAAP financial measures. Investors are encouraged to review the related GAAP financial measures and the reconciliation of these non-GAAP financial measures to their most directly comparable GAAP financial measures.

The following table reconciles year-over-year international net sales percentage increases (decreases) from the GAAP sales measures to the non-GAAP constant exchange rate basis:

Quarter ended July 1, 2012	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	12.6%	(3.7)%	16.3%
Quarter ended July 3, 2011	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	40.7%	11.0%	29.7%

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Year to date ended July 1, 2012	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	10.8%	(1.7)%	12.5%
Year to date ended July 3, 2011	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	37.4%	8.5%	28.9%

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 1, 2012.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

During the quarter ended July 1, 2012, 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.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended July 1, 2012, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION
Item 1A. Risk Factors
You should carefully consider the risks described below and elsewhere in this Quarterly Report on Form 10-Q, which could materially and adversely affect our business, results of operations or financial condition. Our business faces significant risks and the risks described below may not be the only risks we face. Additional risks not presently known to us or that we currently believe are immaterial may materially affect our business, results of operations, or financial condition. If any of these risks occur, the trading price of our common stock could decline and you may lose all or part of your investment.
We have marked with an asterisk (*) those risks described below that reflect substantive changes from the risks described under Part I, Item 1A "Risk Factors" included in our Annual Report on Form 10-K for the fiscal year ended January 1, 2012, as filed with the Securities and Exchange Commission on February 27, 2012.
We may not successfully execute our growth strategy, which may have a material adverse impact on our business and financial results.
The Company is undertaking several important strategic initiatives designed to drive long-term shareholder value. There can be no assurance that the Company will be able to successfully implement its new strategic initiatives or that the initiatives will improve results. Our strategy involves investing more in marketing to reach more customers, investing more in the expansion of our international business, expanding our product assortment, and more aggressively pricing our products. We may not be able to successfully implement our new strategic initiatives or the initiatives may result in inadequate return of capital on our investments, higher inventory and lower gross margins and may not result in increased revenue.
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.
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 and/or interpretations of other laws, regulations, and taxes may also increase our cost of sales and our selling, general and administrative expenses, and otherwise adversely affect our financial condition and results of operations. These rapid significant increases in costs may affect our business disproportionately than our competitors.
Further, any reduction in our sales will affect our liquidity. As discussed under "Liquidity and Capital Resources" in Part I, Item 2 of this Quarterly Report on Form 10-Q, our liquidity is primarily dependent upon our net cash from operating activities. Our net cash from operating activities is sensitive to many factors, including changes in working capital. Working capital at any specific point in time is dependent upon many variables,

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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.

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 wholesale 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.

Our financial results may be negatively and materially 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

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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 federal, state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could significantly decrease our future net sales, or could result in significant liabilities for past sales. Further, given that we sell high value items, sales tax is a significant consideration, and thus additional obligations to collect sales and/or other taxes from customers may materially impact our future sales.

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 32%, 34% and 34% of our net sales in the years ended January 1, 2012, January 2, 2011 and January 3, 2010, 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 (first quarter) and Mother’s Day (second quarter).

In the future, our seasonal sales patterns may become more pronounced, may strain our personnel and fulfillment activities, and may cause a shortfall in net sales as compared with expenses in a given period, which could substantially harm our business and results of operations.

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.

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 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.

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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 21%, 28% and 24% of our payments to our diamond and fine jewelry suppliers for each of the years ended January 1, 2012, January 2, 2011 and January 3, 2010 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.

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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 businesses.

Emerging start-ups may be able to innovate and provide products and services faster than we can. In addition, traditional store-based retailers offer consumers the ability to physically handle and examine products in a manner that is not possible over the Internet, as well as a more convenient means of returning and exchanging purchased products. If our competitors are more successful than 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.

In addition to these competitors, we may face competition from suppliers of our products that decide to sell

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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.

We may be unsuccessful in further expanding our operations internationally.

For the quarter ended July 1, 2012, international net sales represented 15.8% 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.

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In order to increase net sales and to sustain or increase profitability, we must attract customers in a cost-effective manner.

Our success depends on our ability to attract customers in a cost-effective manner. As part of our strategic initiatives, we plan to invest more in marketing. We may not invest in a way that effectively reaches potential consumers or those consumers may not decide to buy from us or the volume of consumers that purchase from us does not yield the intended return on investment. With respect to our marketing channels, we rely on relationships with providers of online services, search engines, directories and other websites and e-commerce businesses to provide content, advertising banners and other links that direct customers to our websites. We rely on these relationships as significant sources of traffic to our 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.

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.

We may have exposure to greater than anticipated tax liabilities.

We are subject to various federal, state and local taxes in both the United States and foreign jurisdictions. Significant judgment is required in evaluating and estimating worldwide provisions and accruals for these taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. Our determination of our tax liability is always subject to audit in various jurisdictions, and such jurisdictions may assess additional tax liabilities, penalties, and interest against us. Although we believe our estimates are reasonable, the ultimate outcome of a tax audit and any related litigation could be materially different from our tax provisions and accruals, and could have a material adverse effect on our financial results. Changes to tax laws, changes to interpretations of existing tax laws, and/or developments in an audit or litigation could have a material effect on our operating results and cash flow for the period or periods for which that change or development occurs, as well as for prior and subsequent periods. In addition, the imposition of additional tax obligations on our business by federal, state and local governments could create significant administrative burdens for us, decrease our future sales, and harm our cash flow and operating results.

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.

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We are currently in a CEO transition period.

Our board of directors recently appointed a new chief executive officer (“CEO”). There are risks associated with a CEO transition, any of which may harm our business. For example, if the new CEO is unsuccessful at leading the management team and the Company, or is unable to articulate and execute our strategy and vision, our business may be harmed and our stock price may decline.

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.

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.

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.

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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.
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. 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.

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.

If we do not continuously innovate in response to the changing preferences of our customers, our business could be adversely affected.
The number of people who access the internet through devices other than personal computers, including mobile phones, smart phones, handheld computers such as notebooks and tablets, video game consoles, and television set-top devices, has increased dramatically in the past few years. The smaller screen size, functionality, and memory associated with some alternative devices may make the use of our website and purchasing our products more difficult; and the versions of our 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 have foreign exchange risk.

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The results of operations of certain of our subsidiaries 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. We price our diamonds based on costs denominated in U.S. dollars. Therefore, when the U.S. dollar strengthens, the retail prices of our products in international markets become more expensive and sales may decline.

We rely on the services of our small, specialized workforce and key personnel, many of whom would be difficult to replace.

We rely upon the continued service and performance of key technical, fulfillment and senior management personnel. If we lose any of these personnel, our business could suffer. Competition for qualified personnel in our industry is intense. We believe that our future success will depend on our continued ability to attract, hire and retain key employees. We do not have “key person” life insurance policies covering our employees. In addition, illness, severe adverse weather conditions or natural disasters could impede our ability to service our customers.

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

We have experienced and may continue to experience theft of our products while they are being held in our fulfillment centers or during the course of shipment to our customers by third-party shipping carriers. We have taken steps to prevent such theft. However, if security measures fail, losses exceed our insurance coverage or we are not able to maintain insurance at a reasonable cost, we could incur significant losses from theft, which would substantially harm our business and results of operations.

Our net sales consist exclusively of diamonds and fine jewelry, and demand for these products could decline.

Our net sales and results of operations are highly dependent on the demand for diamonds and diamond jewelry, particularly engagement rings. Should prevailing consumer tastes for diamonds decline 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

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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.

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 July 1, 2012, we have repurchased 6.4 million shares for a total of $236.5 million. In February 2012, our board of directors authorized the repurchase of up to $100.0 million of our common stock during the subsequent 24-month period. 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.

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 and other uses by management.*

We maintain the majority of our cash and cash equivalents in accounts with major financial institutions within the United States in the form of demand deposits, money market accounts, time deposits and U.S. Treasury Bills. 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.

In addition, we have used in the past, and may use in the future, our cash and cash equivalents to make investments in certain businesses and ventures as our management thinks appropriate. These investments may decline or we may entirely lose the cash associated with the investment.

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.

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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 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;

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- 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.

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.

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, 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 has prompted 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 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

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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 accounting and 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 accounting and reporting requirements. If our internal controls over financial reporting are determined to be ineffective, investors could lose confidence in the reliability of our internal controls 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.

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.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
(c) Below is a summary of stock repurchases during the quarter ended July 1, 2012.
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 *
April 2, 2012 through April 29, 2012	67,455	$29.63	67,455	$98,001
April 30, 2012 through May 27, 2012	39,000	$26.87	39,000	$96,953
May 28, 2012 through July 1, 2012	242,400	$28.54	242,400	$90,035
Total shares purchased	348,855		348,855	

* On February 7, 2012, 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. As of July 1, 2012, approximately $90.0 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.

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Item 6. Exhibits

See exhibits listed under the Exhibit Index on page 38.

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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: August 7, 2012	/s/ Terri K. Maupin Terri K. Maupin Chief Accounting Officer (Principal Accounting Officer)
Date: August 7, 2012	/s/ David B. Binder David B. Binder Chief Financial Officer (Principal Financial Officer)

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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 3.1and 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)*	Blue Nile Inc. Indemnification Agreement.
10.2 (6)*	2012 Compensation Program for Non-employee Directors.
10.3 (6)*	Form of Stock Option Grant Notice (Non-Employee Director) under the Blue Nile, Inc. 2004 Equity Incentive Plan.
10.4 (6)*	Form of Restricted Stock Unit Grant Notice (Non-Employee Director) under the Blue Nile, Inc. 2004 Equity Incentive Plan.
10.5 (6)*	Offer letter between Blue Nile, Inc. and Julie Yoakum, dated June 7, 2012.
31.1 (6)	Certification of Chief Executive Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2 (6)	Certification of Principal Financial Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1 (6)**	Certification of Chief Executive Officer Required Under 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 Principal Financial Officer Required Under 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

* Denotes a management contract or compensatory plan, contract or agreement, in which the Company's directors or executive officers may participate.

** 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.

(1) Previously filed as Exhibit 3.1 to Blue Nile, Inc.'s Quarterly Report on 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.

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(5) 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 May 7, 2012, and incorporated by reference herein.
(6) Filed herewith.