

SHUTTERFLY INC  
Form 10-Q  
November 06, 2012  
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 001-33031

SHUTTERFLY, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

( State or Other Jurisdiction of Incorporation or Organization)

94-3330068

(IRS Employer Identification No.)

2800 Bridge Parkway

Redwood City, California

(Address of Principal Executive Offices)

94065

(Zip Code)

Registrant's Telephone Number, Including Area Code

(650) 610-5200

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  No

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T ( § 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes  No

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

Large accelerated Filer

Accelerated Filer

Non-accelerated Filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                                      | Outstanding at November 1, 2012 |
|--------------------------------------------|---------------------------------|
| Common stock, \$0.0001 par value per share | 36,181,894                      |

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## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## Item 1. Condensed Consolidated Financial Statements

## SHUTTERFLY, INC.

## CONDENSED CONSOLIDATED BALANCE SHEET

(In thousands, except par value amounts)

(Unaudited)

|                                                                                                                                                                        | September 30,<br>2012 | December 31,<br>2011 |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| <b>ASSETS</b>                                                                                                                                                          |                       |                      |
| Current assets:                                                                                                                                                        |                       |                      |
| Cash and cash equivalents                                                                                                                                              | \$89,985              | \$179,915            |
| Accounts receivable, net                                                                                                                                               | 14,584                | 12,997               |
| Inventories                                                                                                                                                            | 5,569                 | 3,726                |
| Deferred tax asset, current portion                                                                                                                                    | 459                   | 598                  |
| Prepaid expenses and other current assets                                                                                                                              | 58,229                | 13,870               |
| Total current assets                                                                                                                                                   | 168,826               | 211,106              |
| Property and equipment, net                                                                                                                                            | 85,262                | 54,123               |
| Intangible assets, net                                                                                                                                                 | 113,123               | 95,016               |
| Goodwill                                                                                                                                                               | 346,243               | 340,408              |
| Deferred tax asset, net of current portion                                                                                                                             | 4,512                 | 3,785                |
| Other assets                                                                                                                                                           | 4,772                 | 5,448                |
| Total assets                                                                                                                                                           | \$722,738             | \$709,886            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                            |                       |                      |
| Current liabilities:                                                                                                                                                   |                       |                      |
| Accounts payable                                                                                                                                                       | \$14,450              | \$9,470              |
| Accrued liabilities                                                                                                                                                    | 39,690                | 59,271               |
| Deferred revenue                                                                                                                                                       | 15,727                | 12,106               |
| Total current liabilities                                                                                                                                              | 69,867                | 80,847               |
| Deferred tax liability                                                                                                                                                 | 11,715                | 13,948               |
| Other liabilities                                                                                                                                                      | 10,537                | 6,094                |
| Total liabilities                                                                                                                                                      | 92,119                | 100,889              |
| Commitments and contingencies (Note 5)                                                                                                                                 |                       |                      |
| Stockholders' equity                                                                                                                                                   |                       |                      |
| Common stock, \$0.0001 par value; 100,000 shares authorized; 36,158 and 34,839 shares issued and outstanding on September 30, 2012 and December 31, 2011, respectively | 4                     | 4                    |
| Additional paid-in capital                                                                                                                                             | 640,717               | 589,067              |
| Accumulated earnings (deficit)                                                                                                                                         | (10,102               | ) 19,926             |
| Total stockholders' equity                                                                                                                                             | 630,619               | 608,997              |
| Total liabilities and stockholders' equity                                                                                                                             | \$722,738             | \$709,886            |

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



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## SHUTTERFLY, INC.

## CONDENSED CONSOLIDATED STATEMENT OF INCOME

(In thousands, except per share amounts)

(Unaudited)

|                                                         | Three Months Ended |            | Nine Months Ended |             |
|---------------------------------------------------------|--------------------|------------|-------------------|-------------|
|                                                         | September 30,      |            | September 30,     |             |
|                                                         | 2012               | 2011       | 2012              | 2011        |
| Net revenues                                            | \$98,536           | \$76,523   | \$288,847         | \$209,516   |
| Cost of net revenues                                    | 55,129             | 41,647     | 155,892           | 111,074     |
| Gross profit                                            | 43,407             | 34,876     | 132,955           | 98,442      |
| Operating expenses:                                     |                    |            |                   |             |
| Technology and development                              | 21,538             | 18,106     | 60,976            | 48,190      |
| Sales and marketing                                     | 29,575             | 25,252     | 86,615            | 64,447      |
| General and administrative                              | 16,039             | 14,210     | 45,975            | 43,023      |
| Total operating expenses                                | 67,152             | 57,568     | 193,566           | 155,660     |
| Loss from operations                                    | (23,745 )          | (22,692 )  | (60,611 )         | (57,218 )   |
| Interest expense                                        | (148 )             | —          | (456 )            | —           |
| Interest and other income, net                          | 14                 | 5          | 30                | 25          |
| Loss before income taxes                                | (23,879 )          | (22,687 )  | (61,037 )         | (57,193 )   |
| Benefit from income taxes                               | 13,401             | 12,734     | 31,008            | 35,830      |
| Net loss                                                | \$(10,478 )        | \$(9,953 ) | \$(30,029 )       | \$(21,363 ) |
| Net loss per share - basic and diluted                  | \$(0.29 )          | \$(0.29 )  | \$(0.84 )         | \$(0.66 )   |
| Weighted-average shares outstanding - basic and diluted | 36,062             | 34,576     | 35,691            | 32,136      |
| Stock-based compensation is allocated as follows:       |                    |            |                   |             |
| Cost of net revenues                                    | \$424              | \$584      | \$1,329           | \$1,513     |
| Technology and development                              | 1,502              | 2,353      | 6,465             | 6,019       |
| Sales and marketing                                     | 2,613              | 3,259      | 8,508             | 8,776       |
| General and administrative                              | 3,826              | 3,626      | 11,206            | 10,848      |

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

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SHUTTERFLY, INC.  
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS  
(In thousands)  
(Unaudited)

|                                                                             | Nine Months Ended<br>September 30, |             |
|-----------------------------------------------------------------------------|------------------------------------|-------------|
|                                                                             | 2012                               | 2011        |
| Cash flows from operating activities:                                       |                                    |             |
| Net loss                                                                    | \$(30,029 )                        | \$(21,363 ) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                    |             |
| Depreciation and amortization                                               | 19,327                             | 16,359      |
| Amortization of intangible assets                                           | 14,761                             | 8,167       |
| Stock-based compensation, net of forfeitures                                | 27,508                             | 27,156      |
| Gain on disposal of property and equipment                                  | (895 )                             | (155 )      |
| Deferred income taxes                                                       | (4,729 )                           | (1,851 )    |
| Tax benefit from stock-based compensation                                   | 14,938                             | 12,363      |
| Excess tax benefits from stock-based compensation                           | (14,938 )                          | (12,386 )   |
| Changes in operating assets and liabilities:                                |                                    |             |
| Accounts receivable, net                                                    | (1,587 )                           | (2,583 )    |
| Inventories                                                                 | (1,843 )                           | 1,464       |
| Prepaid expenses and other current assets                                   | (44,349 )                          | (48,978 )   |
| Other assets                                                                | (30 )                              | (809 )      |
| Accounts payable                                                            | 3,790                              | (15,993 )   |
| Accrued and other liabilities                                               | (27,327 )                          | (24,268 )   |
| Deferred revenue                                                            | 3,620                              | 1,222       |
| Other non-current liabilities                                               | (407 )                             | 2,064       |
| Net cash used in operating activities                                       | (42,190 )                          | (59,591 )   |
| Cash flows from investing activities:                                       |                                    |             |
| Acquisition of business and intangibles, net of cash acquired               | (35,683 )                          | (134,036 )  |
| Purchases of property and equipment                                         | (26,912 )                          | (16,319 )   |
| Capitalization of software and website development costs                    | (9,603 )                           | (7,877 )    |
| Proceeds from sale of equipment                                             | 982                                | 326         |
| Net cash used in investing activities                                       | (71,216 )                          | (157,906 )  |
| Cash flows from financing activities:                                       |                                    |             |
| Principal payments of capital lease obligations                             | —                                  | (6 )        |
| Proceeds from issuance of common stock upon exercise of stock options       | 8,538                              | 21,583      |
| Excess tax benefits from stock-based compensation                           | 14,938                             | 12,386      |
| Net cash provided by financing activities                                   | 23,476                             | 33,963      |
| Net decrease in cash and cash equivalents                                   | (89,930 )                          | (183,534 )  |
| Cash and cash equivalents, beginning of period                              | 179,915                            | 252,244     |
| Cash and cash equivalents, end of period                                    | \$89,985                           | \$68,710    |
| Supplemental schedule of non-cash investing activities                      |                                    |             |
| Net increase in accrued purchases of property and equipment                 | \$8,479                            | \$2,248     |
| Estimated fair market value of building under build-to-suit lease           | 4,850                              | —           |
| Amount due from adjustment of net working capital from acquired business    | —                                  | 505         |
| Amount due for acquisition of business                                      | 165                                | —           |

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

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SHUTTERFLY, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — The Company and Summary of Significant Accounting Policies

Shutterfly, Inc. (the “Company”) was incorporated in the state of Delaware in 1999 and began its services in December 1999. The Company is an Internet-based social expression and personal publishing service that enables customers to share, print and preserve their memories by leveraging a technology-based platform and manufacturing processes. The Company provides customers a full range of products and services to organize and archive digital images; share pictures; order prints and create an assortment of personalized items such as photo books, greeting cards and stationery and calendars. The Company also provides commercial print services: printing and shipping of direct marketing and other variable data print products and formats. The Company is headquartered in Redwood City, California.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and, accordingly, do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of Shutterfly, Inc. and its wholly owned subsidiaries. In the opinion of management, all adjustments, consisting primarily of normal recurring accruals, considered necessary for a fair statement of the Company’s results of operations for the interim periods reported and of its financial condition as of the date of the interim balance sheet have been included. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012, or for any other period.

The December 31, 2011 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2011 included in the Company’s Annual Report on Form 10-K.

Fair Value

The Company records its financial assets and liabilities at fair value. The accounting standard for fair value provides a framework for measuring fair value, clarifies the definition of fair value, and expands disclosures regarding fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the reporting date. The accounting standard establishes a three-tier hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 – Quoted prices in active markets for identical assets or liabilities

Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

As of September 30, 2012 and December 31, 2011, the Company had cash of \$31.3 million and \$121.2 million, respectively, and cash equivalents of \$58.7 million and \$58.7 million, respectively, which are classified in the Level 1 hierarchy.

#### Income Taxes

The Company uses the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized by applying the statutory tax rates in effect in the years in which the differences between the financial reporting and tax filing bases of existing assets and liabilities are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company reports a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. The Company is required to make subjective assumptions and judgments regarding its income tax

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SHUTTERFLY, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

exposures. Interpretations and guidance surrounding income tax laws and regulations change over time. As such, changes in the Company's subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of income.

The Company's policy is to recognize interest and /or penalties related to all tax positions in income tax expense. To the extent that accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision in the period that such determination is made. No interest and penalties were accrued as of September 30, 2012 and December 31, 2011.

The Company is subject to taxation in Israel, the United States, California and 17 other jurisdictions in the United States.

At September 30, 2012, the Company had approximately \$42.2 million, \$55.1 million, and \$20.3 million of federal, California and other state jurisdictions net operating loss carryforwards, respectively, to reduce future taxable income, \$39.5 million, \$29.9 million and \$20.3 million of which is associated with windfall tax benefits, respectively, that will be recorded as additional paid-in capital when realized. These carryforwards will expire beginning in the year 2028 and 2015 for federal and California purposes, respectively, and no sooner than 2022 for the portion related to 17 other state jurisdictions, if not utilized. The Company believes these deferred tax assets will be realized and as such, no valuation allowance has been established.

## Recent Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board issued new accounting guidance intended to simplify goodwill impairment testing. Entities will be allowed to perform a qualitative assessment on goodwill impairment to determine whether a quantitative assessment is necessary. This guidance is effective for the Company's interim and annual periods beginning January 1, 2012. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

## Note 2 — Stock-Based Compensation

## Stock Option Activity

A summary of the Company's stock option activity for the three and nine months ended September 30, 2012 is as follows (share numbers and aggregate intrinsic values in thousands):

|                                 | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Contractual<br>Term (Years) | Aggregate<br>Intrinsic<br>Value |
|---------------------------------|-------------------------------------|------------------------------------------|----------------------------------------------------|---------------------------------|
| Balances, December 31, 2011     | 2,768                               | \$15.71                                  |                                                    |                                 |
| Granted                         | 43                                  | 27.00                                    |                                                    |                                 |
| Exercised                       | (190)                               | ) 17.63                                  |                                                    |                                 |
| Forfeited, cancelled or expired | (23)                                | ) 20.38                                  |                                                    |                                 |
| Balances, March 31, 2012        | 2,598                               | \$15.71                                  | 6.1                                                | \$43,498                        |
| Granted                         | 19                                  | 27.81                                    |                                                    |                                 |
| Exercised                       | (177)                               | ) 21.35                                  |                                                    |                                 |
| Forfeited, cancelled or expired | (37)                                | ) 24.68                                  |                                                    |                                 |

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|                                                           |       |         |     |          |
|-----------------------------------------------------------|-------|---------|-----|----------|
| Balances, June 30, 2012                                   | 2,403 | \$15.26 | 6.1 | \$39,909 |
| Granted                                                   | 37    | 31.58   |     |          |
| Exercised                                                 | (147  | ) 9.65  |     |          |
| Forfeited, cancelled or expired                           | (22   | ) 25.79 |     |          |
| Balances, September 30, 2012                              | 2,271 | \$15.78 | 5.1 | \$36,597 |
| Options vested and expected to vest at September 30, 2012 | 2,234 | \$15.55 | 5.1 | \$36,372 |
| Options vested at September 30, 2012                      | 1,894 | \$13.36 | 4.5 | \$33,725 |

During the three months ended September 30, 2012, the Company granted options to purchase an aggregate of 37,000 shares

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SHUTTERFLY, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

of common stock with an estimated weighted-average grant-date fair value of \$13.99 per share. The total intrinsic value of options exercised during the three months ended September 30, 2012, was \$3,188,000. Net cash proceeds from the exercise of stock options were \$1,422,000 for the three months ended September 30, 2012.

## Valuation of Stock Options

The Company estimated the fair value of each option award on the date of grant using the Black-Scholes option-pricing model and the assumptions noted in the following table. In the three and nine months ended September 30, 2012 and 2011, the Company calculated volatility using an average of its historical and implied volatilities. The expected term of options gave consideration to historical exercises, post-vesting cancellations and the options' contractual term. The risk-free rate for the expected term of the option is based on the U.S. Treasury Constant Maturity at the time of grant. The assumptions used to value options granted during the three and nine months ended September 30, 2012 and 2011 were as follows:

|                                 | Three Months Ended |        | Nine Months Ended |        |   |
|---------------------------------|--------------------|--------|-------------------|--------|---|
|                                 | September 30,      |        | September 30,     |        |   |
|                                 | 2012               | 2011   | 2012              | 2011   |   |
| Dividend yield                  | —                  | —      | —                 | —      |   |
| Annual risk free rate of return | 0.7                | % 1.1  | % 0.8             | % 1.7  | % |
| Expected volatility             | 55.6               | % 54.7 | % 57.9            | % 51.5 | % |
| Expected term (years)           | 4.3                | 4.3    | 4.3               | 4.4    |   |

Employee stock-based compensation expense recognized in the three and nine months ended September 30, 2012 and 2011, was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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SHUTTERFLY, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## Restricted Stock Units

The Company grants restricted stock units ("RSUs") to its employees under the provisions of the 2006 Equity Incentive Plan. The cost of RSUs is determined using the fair value of the Company's common stock on the date of grant. RSUs typically vest and are settled annually, based on a three or four year total vesting term. Compensation cost is amortized on a straight-line basis over the requisite service period.

## Restricted Stock Unit Activity

A summary of the Company's restricted stock unit activity for the three and nine months ended September 30, 2012, is as follows (share numbers in thousands):

|                                                             | Number of<br>Units<br>Outstanding | Weighted<br>Average<br>Grant Date<br>Fair Value |
|-------------------------------------------------------------|-----------------------------------|-------------------------------------------------|
| Awarded and unvested, December 31, 2011                     | 1,969                             | \$31.33                                         |
| Granted                                                     | 1,395                             | 27.60                                           |
| Vested                                                      | (609                              | ) 21.13                                         |
| Forfeited                                                   | (72                               | ) 34.80                                         |
| Awarded and unvested, March 31, 2012                        | 2,683                             | \$31.61                                         |
| Granted                                                     | 370                               | 26.67                                           |
| Vested                                                      | (144                              | ) 22.06                                         |
| Forfeited                                                   | (81                               | ) 37.63                                         |
| Awarded and unvested, June 30, 2012                         | 2,828                             | \$31.28                                         |
| Granted                                                     | 553                               | 32.16                                           |
| Vested                                                      | (52                               | ) 34.17                                         |
| Forfeited                                                   | (192                              | ) 31.15                                         |
| Awarded and unvested, September 30, 2012                    | 3,137                             | \$31.40                                         |
| Restricted stock units expected to vest, September 30, 2012 | 2,768                             |                                                 |

Included in the restricted stock unit activity above, and in connection with the acquisition of Penguin Digital, Inc. ("Penguin Digital") on September 14, 2012, the Company granted 106,000 RSUs to certain employees of Penguin Digital. These awards vest annually over a three year period based on continued employment. The Company also granted 74,000 RSUs that have both performance and service vesting criteria ("PBRSU") which vest annually over a three year term contingent on achieving certain performance milestones and continued employment.

Also included in the RSU grants above for the nine months ended September 30, 2012, and in connection with the acquisition of Photoccino on May 25, 2012, the Company granted 146,000 RSUs to certain employees of Photoccino. These awards vest annually over a three year period based on continued employment.

An additional 445,000 PBRsUs are included in the RSU grants for the nine months ended September 30, 2012. The performance criteria for these PBRsUs are tied to the Company's 2012 financial performance and the service criteria are consistent with vesting described in the Company's 2006 Equity Incentive Plan. Compensation cost associated with these PBRsUs is recognized on an accelerated attribution model and ultimately based on whether or not satisfaction of the performance criteria is probable. If in the future, situations indicate that the performance criteria are not probable, then no further compensation cost will be recorded and any previous costs will be reversed.

At September 30, 2012, the Company had \$81,694,000 of total unrecognized compensation expense, net of estimated forfeitures, related to stock options and RSUs that will be recognized over a weighted-average period of approximately three years.

Note 3 — Net Loss Per Share

Basic net loss per share is computed by dividing the net loss attributable to common shares for the period by the weighted average number of common shares outstanding during the period.

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SHUTTERFLY, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Diluted net loss per share attributed to common shares is computed by dividing the net loss attributable to common shares for the period by the weighted average number of common and potential common shares outstanding during the period, if the effect of each class of potential common shares is dilutive. Potential common shares include restricted stock units and incremental shares of common stock issuable upon the exercise of stock options.

A summary of the net loss per share for the three and nine months ended September 30, 2012 and 2011 is as follows (in thousands, except per share amounts):

|                                                      | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|------------------------------------------------------|-------------------------------------|------------|------------------------------------|-------------|
|                                                      | 2012                                | 2011       | 2012                               | 2011        |
| Net loss per share:                                  |                                     |            |                                    |             |
| Numerator                                            |                                     |            |                                    |             |
| Net loss                                             | \$(10,478                           | ) \$(9,953 | ) \$(30,029                        | ) \$(21,363 |
| Denominator for basic and diluted net loss per share |                                     |            |                                    |             |
| Weighted-average common shares outstanding           | 36,062                              | 34,576     | 35,691                             | 32,136      |
| Net loss per share — basic and diluted               | \$(0.29                             | ) \$(0.29  | ) \$(0.84                          | ) \$(0.66   |

The following weighted-average outstanding stock options and restricted stock units were excluded from the computation of diluted net loss per common share for the periods presented because including them would have had an anti-dilutive effect (in thousands):

|                                          | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |       |
|------------------------------------------|-------------------------------------|-------|------------------------------------|-------|
|                                          | 2012                                | 2011  | 2012                               | 2011  |
| Stock options and restricted stock units | 5,011                               | 4,939 | 5,101                              | 5,620 |

## Note 4 — Balance Sheet Components

## Prepaid Expenses and Other Current Assets

|                                             | September 30,<br>2012 | December 31,<br>2011 |
|---------------------------------------------|-----------------------|----------------------|
|                                             | (in thousands)        |                      |
| Intra-period deferred tax asset             | \$41,506              | \$—                  |
| Prepaid service contracts – current portion | 5,151                 | 4,727                |
| Prepaid marketing                           | 4,383                 | 348                  |
| Prepaid income taxes                        | 490                   | 1,952                |
| Other prepaid expenses and current assets   | 6,699                 | 6,843                |
|                                             | \$58,229              | \$13,870             |

Intra-period deferred tax asset represents the cumulative income tax benefit recorded as of the balance sheet date, which will offset against taxes payable or become a component of deferred taxes on a full year basis.





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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## Property and Equipment

|                                                    | September 30,<br>2012 | December 31,<br>2011 |
|----------------------------------------------------|-----------------------|----------------------|
|                                                    | (in thousands)        |                      |
| Computer and other equipment                       | \$126,646             | \$102,061            |
| Software                                           | 16,105                | 12,579               |
| Leasehold improvements                             | 7,979                 | 9,559                |
| Building construction-in-progress                  | 4,850                 | —                    |
| Furniture and fixtures                             | 3,997                 | 3,762                |
| Capitalized software and website development costs | 46,039                | 35,842               |
|                                                    | 205,616               | 163,803              |
| Less: Accumulated depreciation and amortization    | (120,354              | ) (109,680           |
| Net property and equipment                         | \$85,262              | \$54,123             |

Building construction-in-progress value of \$4.9 million represents the estimated fair market value of a building under a build-to-suit lease of which the Company is the "deemed owner" for accounting purposes only. (See Note 5.)

Depreciation and amortization expense totaled \$6,586,000 and \$5,572,000 for the three months ended September 30, 2012 and 2011, respectively. Depreciation and amortization expense totaled \$19,327,000 and \$16,359,000 for the nine months ended September 30, 2012 and 2011, respectively.

## Accrued Liabilities

|                              | September 30,<br>2012 | December 31,<br>2011 |
|------------------------------|-----------------------|----------------------|
|                              | (in thousands)        |                      |
| Accrued compensation         | \$8,703               | \$5,485              |
| Accrued fixed assets         | 7,952                 | 633                  |
| Accrued production costs     | 6,057                 | 16,939               |
| Accrued marketing expenses   | 5,088                 | 19,072               |
| Accrued income and sales tax | 4,459                 | 11,106               |
| Accrued consulting           | 2,204                 | 1,861                |
| Accrued other                | 5,227                 | 4,175                |
|                              | \$39,690              | \$59,271             |

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SHUTTERFLY, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 5 — Commitments and Contingencies

Lease Obligations

During the three months ended September 30, 2012, the Company executed a lease for a new 300,000 square foot east coast production and customer service facility in Fort Mill, South Carolina. This facility will replace the Company's current east coast production facility in Charlotte, North Carolina and is expected to open during 2013. In order for the facility to meet the Company's operating specifications, both the landlord and the Company are making structural changes as part of the uplift of the building, and as a result, the Company has concluded that it is the "deemed owner" of the building (for accounting purposes only) during the construction period. Accordingly, at lease inception, the Company recorded an asset of \$4.9 million, representing its estimate of the fair market value of the building, and a corresponding construction financing obligation, recorded as a component of other non-current liabilities. The Company will increase the asset and financing obligation as additional building uplift costs are incurred by the landlord during the construction period.

Upon completion of construction, the Company will evaluate the de-recognition of the asset and liability under the provisions of ASC 840.40 Leases - Sale-Leaseback Transactions. However, if the Company does not comply with the provisions needed for sale-leaseback accounting, the lease will be accounted for as a financing obligation and lease payments will be attributed to (1) a reduction of the principal financing obligation; (2) imputed interest expense; and (3) land lease expense (which is considered an operating lease and a component of cost of goods sold) representing an imputed cost to lease the underlying land of the facility. In addition, the underlying building asset will be depreciated over the building's estimated useful life of 30 years. And at the conclusion of the lease term, the Company would de-recognize both the net book values of the asset and financing obligation.

Indemnifications

In the normal course of business, the Company enters into contracts and agreements that contain a variety of representations and warranties and provide for general indemnifications. The Company's exposure under these agreements is unknown because it involves future claims that may be made against the Company, but have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

Contingencies

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

Legal Matters

On December 10, 2010, Eastman Kodak Company ("Kodak") filed a complaint for alleged patent infringement against the Company in Eastman Kodak Company v. Shutterfly, Inc., C.A. No. 10-1079-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,549,306; 6,600,572; 7,202,982; 6,069,712; and 6,512,570, which claim among other things, methods for selecting photographic images using index prints, an image handling system incorporating coded instructions, and processing a roll of exposed photographic film into corresponding visual prints and distributing such prints. The Complaint asserts that the Company directly or indirectly infringes the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. On February 3, 2011, the Company filed an answer and counterclaims

against Kodak. On November 16, 2011, Kodak filed its First Amended Complaint adding Tiny Prints, Inc. as a defendant. On December 13, 2011, the Company and Tiny Prints, Inc. each filed its answer and counterclaims against Kodak. A trial date is currently set for on or around September, 2014. The Company believes the suit is without merit and will defend itself vigorously.

On January 31, 2011, the Company filed a complaint for patent infringement against Eastman Kodak Company and Kodak Imaging Network, Inc. in *Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network, Inc.*, C.A. No. 11-099-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,583,799; 7,269,800; 6,587,596; 6,973,222; 7,474,801; 7,016,869; and 7,395,229, which claim among other things, methods for image uploading, image cropping, automatic generation of photo albums, and changing attributes of an image-based product. The Complaint asserts that Kodak directly or indirectly infringes the patents, and it seeks unspecified damages and injunctive relief. On March 24, 2011, Kodak filed an answer and counterclaims against the Company. On November 16, 2011, the Company filed its First Amended Complaint to include U.S. Patent No. 7,243,079. On the same day, November 16, 2011, Kodak filed its answer. Upon Kodak's filing of a Chapter 11 petition on January 19, 2012, *Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network*,

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Inc., C.A. No. 11-099-SLR was automatically stayed pursuant to provisions of federal bankruptcy law.

On September 10, 2011, Princeton Digital Image Corporation (“Princeton”) filed a complaint for alleged patent infringement against the Company and seven other defendants in Princeton Digital Image Corporation v. Facebook, Inc. et al., Civ. No. 2:2011cv00400, in the Eastern District of Texas, Tyler Division. The case was dismissed with prejudice on July 30, 2012.

In all cases, at each reporting period, the Company evaluates whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, the Company accrues for the amount, or if a range, the Company accrues the low end of the range as a component of legal expense. The Company monitors developments in these legal matters that could affect the estimate it has previously accrued. There are no amounts accrued which the Company believes would be material to its financial position and results of operations.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 6 — Acquisitions

Purchased Intangible Assets

Eastman Kodak Gallery Assets

On March 1, 2012, the Company entered into an agreement with Kodak for the proposed sale of certain assets of its Kodak Gallery online photo services business for \$23.8 million through a court-supervised auction process. On April 30, 2012, the transaction was approved by the bankruptcy court and on May 2, 2012 the transaction closed. The Company paid \$19.0 million at close. The remaining \$4.8 million which was due at the end of the transition period, was paid during the three months ended September 30, 2012 upon completion of the transition period. This acquisition was accounted for as an asset acquisition and as such the Company has capitalized transaction costs of approximately \$0.6 million, for a total purchase price of \$24.4 million. The purchase price was allocated to a single asset, customer list, which will be amortized over its estimated useful life of four years.

Business Combinations

Penguin Digital, Inc.

On September 14, 2012, the Company acquired Penguin Digital for a total aggregate cash purchase price of \$7.1 million. Penguin Digital is a mobile application development company that has an iPhone application that allows users to access their photos from iPhones or their Facebook or Instagram accounts and create customized products and gifts from their mobile devices. The acquisition was accounted for as a non-taxable purchase transaction and, accordingly, the purchase price has been allocated to the acquired tangible assets, liabilities assumed, and identifiable intangible assets acquired based on their estimated fair values on the acquisition date. The excess of the purchase price over the aggregate fair values was recorded as goodwill. In addition, RSUs were granted to certain Penguin Digital employees contingent upon their continued employment for a period of three years. Also, PBRsUs were granted to certain Penguin Digital employees contingent on achieving certain performance milestones and continued employment for a period of three years. These awards will be recorded as stock-based compensation over the vesting period.

Of the total purchase price, \$2.9 million was allocated to developed technology and is being amortized over an estimated useful life of three years, \$0.9 million was allocated to in-process research and development, and \$0.2 million was allocated to the active user base which will be amortized over an estimated useful life of two years. The assets and liabilities acquired totaled approximately \$0.1 million and \$0.2 million, respectively. The remaining excess purchase price of approximately \$3.2 million was allocated to goodwill primarily representing the assembled workforce and synergies from the accelerated time to market. In addition, \$1.0 million was recorded as a deferred tax liability which represents the difference between the assigned values of the assets acquired and the tax basis of those assets offset by net operating loss carryforwards. The offset is recorded as additional goodwill. The results of operations for the acquired business have been included in the consolidated statement of income for the period subsequent to the acquisition. Penguin Digital's results of operations for periods prior to this acquisition were not material to the consolidated statement of income and, accordingly, pro forma financial information has not been presented.

Photocchino Ltd.

On May 25, 2012, the Company acquired Photoccino Ltd. (“Photoccino”) for a total aggregate cash purchase price of \$4.6 million. Photoccino has developed technologies for photo ranking, analysis and organization which will allow customers to more efficiently organize and select the best photos from their archives so they can quickly and easily create photo books, calendars, cards, and photo gifts. Photoccino’s technology applies proprietary algorithms to analyze and evaluate the quality and content of photos, ranks them, and automatically creates photo products using the customer’s best images. The acquisition was accounted for as a non-taxable purchase transaction and, accordingly, the purchase price has been allocated to the acquired tangible assets, liabilities assumed, and identifiable intangible assets acquired based on their estimated fair values on the acquisition date. The excess of the purchase price over the aggregate fair values was recorded as goodwill. In addition, restricted stock awards were granted to certain Photoccino employees contingent upon their continued employment for a period of three years and will be recorded as stock-based compensation over the vesting period.

Of the total purchase price, \$3.0 million was allocated to developed technology and is being amortized over an estimated useful life of five years, \$0.7 million was allocated to in-process research and development, and \$80,000 was allocated to non-compete agreements with the founders which will be amortized over an estimated useful life of two years. The assets and liabilities

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SHUTTERFLY, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

acquired totaled approximately \$0.1 million. The remaining excess purchase price of approximately \$0.7 million was allocated to goodwill primarily representing the assembled workforce. In addition, \$950,000 was recorded as a deferred tax liability representing the difference between the assigned values of the assets acquired and the tax basis of those assets, with the offset recorded as additional goodwill. The results of operations for the acquired business have been included in the consolidated statement of operations for the period subsequent to the Company's acquisition of Photoccino. Photoccino's results of operations for periods prior to this acquisition were not material to the consolidated statement of operations and, accordingly, pro forma financial information has not been presented.

Note 7 — Subsequent Event

On October 24, 2012, the Company's Board of Directors conditionally authorized a share repurchase program of the Company's common stock subject to the approval of the Audit Committee of the Board of Directors. On October 29, 2012, the Audit Committee approved a share repurchase program for up to \$60.0 million of the Company's common stock. The share repurchase authorization, which is effective immediately, permits the Company to effect repurchases for cash from time to time through open market, privately negotiated or other transactions, including pursuant to trading plans established in accordance with Rules 10b5-1 and 10b-18 of the Securities Exchange Act of 1934, as amended, or by a combination of such methods. The repurchase program does not obligate the Company to repurchase any dollar amount or number of shares and the program may be suspended or discontinued at any time.



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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are based upon our current expectations. These forward-looking statements include statements related to our expectations regarding the seasonality and growth of our business, the impact on us of general economic conditions, trends in key metrics such as total number of customers and orders and average order value, the decline in average selling prices for prints, our capital expenditures for 2012, the sufficiency of our cash and cash equivalents and cash generated from operations for the next 12 months, our operating expenses remaining a consistent percentage of our net revenues, as well as other statements regarding our future operations, financial condition and prospects and business strategies. In some cases, you can identify forward-looking statements by terminology such as "project," "believe," "anticipate," "plan," "expect," "estimate," "intend," "continue," "should," "would," "could," "potentially," "will," or "may," or the negative of these terms or other comparable terminology. Forward-looking statements involve risks and uncertainties. Our actual results and the timing of events could differ materially from those anticipated in our forward-looking statements as a result of many factors, including but not limited to, the seasonality of our business, whether we are able to expand our customer base and increase our product and service offering, competition in our marketplace and the other risks set forth below under "Risk Factors" in Part II, Item 1A of this report. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We assume no obligation to update any of the forward-looking statements after the date of this report or to compare these forward-looking statements to actual results.

Overview

We are an Internet-based social expression and personal publishing service that enables consumers to share, print and preserve their memories by leveraging our technology, manufacturing, web-design and merchandising capabilities. Our vision is to make the world a better place by helping people share life's joy. Our mission is to build an unrivaled service that enables deeper, more personal relationships between our customers and those who matter most in their lives. Our primary focus is on helping consumers manage their memories through the powerful medium of photography. We provide a full range of personalized photo-based products and services that make it easy, convenient and fun for consumers to upload, edit, enhance, organize, find, share, create, print, and preserve their memories in a creative and thoughtful manner.

We are building four trusted lifestyle brands: Shutterfly, Tiny Prints, Wedding Paper Divas, and Treat. We have operated the Shutterfly.com brand since inception in 1999. In 2011, we acquired Tiny Prints, Inc. a privately-held company based in Sunnyvale, California that operated tinyprints.com and weddingpaperdivas.com, two growing ecommerce brands primarily offering stylish cards, invitations and personalized stationery. On April 16, 2012, we launched Treat.com, a destination that enables users to easily personalize and send unique greeting cards. Our Treat launch signifies our focused expansion into the one-to-one U.S. greeting card market, to complement our existing one-to-many card business. And in May 2012, we acquired the customer accounts and images of Kodak Gallery's online photo service through a bankruptcy court supervised auction. In July 2012, we began the process to transfer the more than five billion Kodak Gallery customer photos onto the Shutterfly technology platform, which was completed in September 2012.

On May 25, 2012, we acquired Photoccino Ltd., a privately-held company based in Haifa, Israel, which has developed ground breaking technologies for photo ranking, analysis and organization which will allow customers to more

efficiently organize and select the best photos from their ever-increasing archives so they can quickly and easily create photo books, calendars, cards, and photo gifts. Photoccino's technology applies proprietary algorithms to analyze and evaluate the quality and content of photos, ranks them, and automatically creates photo products using the customer's best images. We expect to integrate the Photoccino technology into the products and services that our brands offer.

And on September 14, 2012, we acquired Penguin Digital, Inc., a mobile application development company that has an iPhone application that allows users to access their photos from iPhones or their Facebook or Instagram accounts and create customized products and gifts from their mobile devices. We expect to integrate the application into our group of mobile offerings.

We currently generate the majority of our revenues by producing and selling professionally-bound photo books, greeting and stationery cards, personalized calendars, other photo-based merchandise and high-quality prints ranging in size from wallet-sized to jumbo-sized 20x30 enlargements. We manufacture most of these items in our Charlotte, North Carolina and Phoenix, Arizona production facilities. By controlling the production process in our own production facilities, we are able to produce high-quality

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products, innovate rapidly, maintain a favorable cost structure and ensure timely shipment to customers, even during peak periods of demand. Additionally, we sell a variety of photo-based merchandise that is currently manufactured for us by third parties, such as calendars, mugs, canvas prints, mouse pads, magnets, and puzzles. We generate substantially all of our revenue from sales originating in the United States and our sales cycle has historically been highly seasonal as we generate more than 50% of our total net revenues during our fiscal fourth quarter.

Our high-quality products and services and the compelling online experience we create for our customers, combined with our focus on continuous innovation, have allowed us to establish premium brands. We realize the benefits of premium brands through high customer loyalty, low customer acquisition costs and premium pricing.

Our customers are a central part of our business model. They generate most of the content on our service by uploading their photos and storing their memories. In addition, they share their photos electronically with their friends and families, extending and endorsing our brand and creating a sense of community. Finally, by giving our branded products to colleagues, friends and loved ones throughout the year, customers reinforce our brands. Through these various activities, our customers create a viral network of new users and customers.

In addition to driving lower customer acquisition costs through viral marketing, our customers provide input on new features, functionalities and products. Close, frequent customer interactions, coupled with significant investments in sophisticated integrated marketing programs, enable us to fine-tune and tailor our promotions and website presentation to specific customer segments. Consequently, customers are presented with a highly personalized shopping experience, which helps foster a unique and deep relationship with our brands.

Our operations and financial performance depend on general economic conditions in the United States. The U.S. economy is experiencing a slow economic recovery from a deep recession and concerns about that recovery could further impact consumer sentiment and consumer discretionary spending. We closely monitor these economic measures as their trends are indicators of the health of the overall economy and are some of the key external factors that impact our business.

## Basis of Presentation

**Net Revenues.** In the second quarter of 2012, we changed the categories within net revenues by consolidating our Personalized Products and Services (PPS) and Prints revenue into a single category called Consumer. We also renamed our Commercial Printing net revenue category as Enterprise. Our net revenues are now comprised of sales generated from Consumer and Enterprise categories. All prior periods included below now reflect the new presentation of net revenues categories.

### Consumer

Our Consumer revenues include sales from all of our brands and are derived from the sale of photo-based products, such as photo books, stationery and greeting cards, other photo-based merchandise, photo prints, and the related shipping revenues. Included in our photo-based merchandise are items such as mugs, mouse pads, desktop plaques and puzzles. Photo prints consist of wallet, 4x6, 5x7, 8x10, and large format sizes. Revenue from advertising displayed on our website is also included in Consumer revenues.

### Enterprise

Our Enterprise revenues are primarily from variable, four-color direct marketing collateral manufactured and fulfilled for business customers. We continue to focus our efforts in expanding our presence in this market.

All of our Consumer revenue is recorded net of estimated returns, promotions redeemed by customers and other discounts. Customers place orders through our website and pay primarily using credit cards. Advertising and Enterprise customers are invoiced upon fulfillment.

Our business is subject to seasonal fluctuations. In particular, we generate a substantial portion of our revenues during the holiday season in the fourth quarter. We also typically experience increases in net revenues during other shopping-related seasonal events, such as Easter, Mother's Day, Father's Day, and Halloween. We generally experience lower net revenues during the first, second and third calendar quarters and have incurred and may continue to incur losses in these quarters. Due to the relatively short lead time required to fulfill product orders, usually one to three business days, order backlog is not material to our business.

To further understand net revenue trends in our Consumer category, we monitor several key metrics including, total customers, total number of orders, and average order value. In the second quarter of 2012, we changed our disclosures of these metrics to be the aggregate of all customers and orders across all our Consumer brands, instead of our previous, separate disclosures of

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Shutterfly and Tiny Prints customers and orders. As a result, our average order value metric is also presented in the aggregate for all brands.

**Total Customers.** We closely monitor total customers as a key indicator of demand. Total customers include the number of transacting customers in a given period. We seek to expand our customer base by empowering our existing customers with sharing and collaboration services (such as Shutterfly Share Sites), and by conducting integrated marketing and advertising programs.

**Total Number of Orders.** We closely monitor total number of orders as a leading indicator of net revenue trends. We recognize net revenues associated with an order when the products have been shipped and all other revenue recognition criteria have been met. Orders are typically processed and shipped within two business days after a customer places an order.

**Average Order Value.** Average order value is Consumer net revenues for a given period divided by the total number of customer orders recorded during that same period.

The table below highlights the trends of each of these aggregated metrics, as they are now presented, for the last five quarters covering the period since the Tiny Prints acquisition. In addition, we have provided pro forma metrics covering the three month period ended June 30, 2011 as the acquisition of Tiny Prints closed on April 25, 2011.

|                     | Three Months Ended                 |                  |                  |                  |                  |                  |
|---------------------|------------------------------------|------------------|------------------|------------------|------------------|------------------|
|                     | Jun. 30,<br>2011<br>(Pro-Forma)    | Sep. 30,<br>2011 | Dec. 31,<br>2011 | Mar. 31,<br>2012 | Jun. 30,<br>2012 | Sep. 30,<br>2012 |
|                     | (in thousands, except AOV amounts) |                  |                  |                  |                  |                  |
| Customers           | 1,668                              | 1,600            | 3,226            | 1,880            | 1,894            | 2,247            |
| Orders              | 2,597                              | 2,577            | 5,190            | 2,840            | 2,978            | 3,606            |
| Average order value | \$30.33                            | \$28.18          | \$49.93          | \$29.97          | \$31.70          | \$25.06          |

We believe the analysis of these metrics and others described below provides us with important information on our overall net revenue trends and operating results. Fluctuations in these metrics are not unusual and no single factor is determinative of our net revenues and operating results.

**Cost of Net Revenues.** Cost of net revenues consists primarily of direct materials (the majority of which consists of paper, ink, and photo book covers), payroll and related expenses for direct labor, shipping charges, packaging supplies, distribution and fulfillment activities, rent for production facilities, depreciation of production equipment, and third-party costs for photo-based merchandise. Cost of net revenues also includes payroll and related expenses for personnel engaged in customer service, any third-party software or patents licensed, as well as the amortization of acquired developed technology, capitalized website and software development costs, and patent royalties. Cost of net revenues also includes certain costs associated with facility closures and restructuring.

**Operating Expenses.** Operating expenses consist of technology and development, sales and marketing, and general and administrative expenses. We anticipate that each of the following categories of operating expenses will increase in absolute dollar amounts, but remain relatively consistent as a percentage of net revenues.

Technology and development expense consists primarily of personnel and related costs for employees and contractors engaged in the development and ongoing maintenance of our website, infrastructure and software. These expenses include depreciation of the computer and network hardware used to run our website and store the customer data, as well as amortization of purchased software. Technology and development expense also includes co-location, power

and bandwidth costs.

Sales and marketing expense consists of costs incurred for marketing programs, and personnel and related expenses for our customer acquisition, product marketing, business development, and public relations activities. Our marketing efforts consist of various online and offline media programs, such as e-mail and direct mail promotions, the purchase of keyword search terms and various strategic alliances. We depend on these efforts to attract customers to our service.

General and administrative expense includes general corporate costs, including rent for our corporate offices, insurance, depreciation on information technology equipment, and legal and accounting fees. Transaction costs are also included in general and administrative expense. In addition, general and administrative expense includes personnel expenses of employees involved

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in executive, finance, accounting, human resources, information technology and legal roles. Third-party payment processor and credit card fees are also included in general and administrative expense and have historically fluctuated based on revenues during the period. All of the payments we have received from our intellectual property license agreements have been included as an offset to general and administrative expense.

**Interest Expense.** Interest expense consists of costs associated with our five-year syndicated credit facility that became effective in November 2011.

**Interest and Other Income, Net.** Interest and other income, net primarily consists of the interest earned on our cash and investment accounts.

**Income Taxes.** We account for income taxes under the liability method. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities.

**Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

**Results of Operations**

The following table presents the components of our income statement as a percentage of net revenues:

|                                | Three Months Ended |        | Nine Months Ended |        |    |
|--------------------------------|--------------------|--------|-------------------|--------|----|
|                                | September 30,      |        | September 30,     |        |    |
|                                | 2012               | 2011   | 2012              | 2011   |    |
| Net revenues                   | 100                | % 100  | % 100             | % 100  | %  |
| Cost of net revenues           | 56                 | % 54   | % 54              | % 53   | %  |
| Gross profit                   | 44                 | % 46   | % 46              | % 47   | %  |
| Operating expenses:            |                    |        |                   |        |    |
| Technology and development     | 22                 | % 24   | % 21              | % 23   | %  |
| Sales and marketing            | 30                 | % 33   | % 30              | % 31   | %  |
| General and administrative     | 16                 | % 19   | % 16              | % 20   | %  |
| Total operating expenses       | 68                 | % 76   | % 67              | % 74   | %  |
| Loss from operations           | (24                | )% (30 | )% (21            | )% (27 | )% |
| Interest expense               | —                  | % —    | % —               | % —    | %  |
| Interest and other income, net | —                  | % —    | % —               | % —    | %  |
| Loss before income taxes       | (24                | )% (30 | )% (21            | )% (27 | )% |
| Benefit from income taxes      | 13                 | % 17   | % 11              | % 17   | %  |
| Net loss                       | (11                | )% (13 | )% (10            | )% (10 | )% |





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## Comparison of the Three Month Periods Ended September 30, 2012 and 2011

|                            | Three Months Ended September 30, |          |           |          |
|----------------------------|----------------------------------|----------|-----------|----------|
|                            | 2012                             | 2011     | \$ Change | % Change |
|                            | (in thousands)                   |          |           |          |
| Net revenues               |                                  |          |           |          |
| Consumer                   | \$90,378                         | \$72,611 | \$17,767  | 24 %     |
| Enterprise                 | 8,158                            | 3,912    | 4,246     | 109 %    |
| Total net revenues         | 98,536                           | 76,523   | 22,013    | 29 %     |
| Cost of net revenues       | 55,129                           | 41,647   | 13,482    | 32 %     |
| Gross profit               | \$43,407                         | \$34,876 | \$8,531   | 24 %     |
| Percentage of net revenues | 44                               | % 46     | % —       | —        |

Net revenues increased \$22.0 million, or 29%, for the three months ended September 30, 2012 as compared to the same period in 2011. Consumer net revenues increased \$17.8 million, or 24%, in the three months ended September 30, 2012 compared to the same period in 2011. The increase in Consumer net revenues is primarily a result of increased sales of photo books, greeting and stationery cards, and prints. Enterprise revenues increased \$4.2 million, or 109%, in the three months ended September 30, 2012 compared to the same period in 2011.

Consumer net revenue increases were also the result of year-over-year increases in total transacting customers and orders as outlined below. Average order value was down year-over-year reflecting a discount intensive environment and a shift to prints products during the third quarter of 2012.

|                     | Three Months Ended September 30,   |         |           |          |
|---------------------|------------------------------------|---------|-----------|----------|
|                     | 2012                               | 2011    | \$ Change | % Change |
|                     | (in thousands, except AOV amounts) |         |           |          |
| Customers           | 2,247                              | 1,600   | 647       | 40 %     |
| Orders              | 3,606                              | 2,577   | 1,029     | 40 %     |
| Average order value | \$25.06                            | \$28.18 | \$(3.12)  | (11)%    |

Cost of net revenues increased \$13.5 million, or 32%, for the three months ended September 30, 2012 as compared to the same period in 2011. As a percentage of net revenues, cost of net revenues increased to 56% in the three months ended September 30, 2012 from 54% in the same period in 2011, which decreased gross margin to 44% in the three months ended September 30, 2012 from 46% in the same period in 2011. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products and discounting. These costs were partially offset by favorable changes in product mix and cost efficiencies in manufacturing. The decrease in gross margin was primarily driven by Enterprise net revenues which typically result in a lower gross margin, lease termination fees associated with our existing Charlotte, North Carolina production facility and depreciation.

|                            | Three Months Ended September 30, |          |           |          |
|----------------------------|----------------------------------|----------|-----------|----------|
|                            | 2012                             | 2011     | \$ Change | % Change |
|                            | (in thousands)                   |          |           |          |
| Technology and development | \$21,538                         | \$18,106 | \$3,432   | 19 %     |
| Percentage of net revenues | 22                               | % 24     | % —       | —        |
| Sales and marketing        | \$29,575                         | \$25,252 | \$4,323   | 17 %     |
| Percentage of net revenues | 30                               | % 33     | % —       | —        |
| General and administrative | \$16,039                         | \$14,210 | \$1,829   | 13 %     |
| Percentage of net revenues | 16                               | % 19     | % —       | —        |

Our technology and development expense increased \$3.4 million, or 19%, for the three months ended September 30, 2012, compared to the same period in 2011. As a percentage of net revenues, technology and development expense decreased to 22%

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for the three months ended September 30, 2012 from 24% for the same period in 2011. The increase in technology and development expense was primarily due to an increase of \$2.1 million related to incremental facilities costs associated with our acquisition of Photocchino and Kodak Gallery's accounts. The overall increase was also due to an increase of \$1.6 million related to personnel and related costs, an increase of \$1.1 million in depreciation expense and an increase of \$0.7 million in professional fees. These factors were partially offset by an increase of \$1.2 million in website development costs capitalized and a decrease of \$0.7 million in stock-based compensation in the current period compared to the same period in the prior year.

At September 30, 2012, headcount in technology and development increased by 21% compared to September 30, 2011, reflecting our strategic focus to increase the rate of innovation in our product and services offerings, to generate greater differentiation from our competitors, and improve our long-term operating efficiency. In the three months ended September 30, 2012, we capitalized \$3.6 million in eligible salary and consultant costs, including \$0.3 million of stock-based compensation, associated with software developed or obtained for internal use, compared to \$2.4 million, which included \$0.1 million of stock-based compensation capitalized in the three months ended September 30, 2011.

Our sales and marketing expense increased \$4.3 million, or 17%, in the three months ended September 30, 2012 compared to the same period in 2011. The increase in sales and marketing expense was primarily due to an increase of \$1.8 million related to expanded online marketing campaigns and advertising. The increase is also attributable to an increase of \$1.7 million in personnel and related costs associated with the expansion of our internal marketing team and an increase of \$1.6 million in intangible asset amortization primarily from the Kodak Gallery customer list. These factors were partially offset by a decrease of \$0.6 million of stock-based compensation. As a percentage of net revenues, total sales and marketing expense decreased to 30% in the three months ended September 30, 2012 from 33% for the same period in 2011.

Our general and administrative expense increased \$1.8 million, or 13%, in the three months ended September 30, 2012 as compared to the same period in 2011. As a percentage of net revenues, general and administrative expense decreased to 16% in the three months ended September 30, 2012 from 19% for the comparable period in 2011. The increase in general and administrative expense is primarily due to an increase in personnel related costs of \$0.8 million as a result of increased headcount, an increase in credit card fees of \$0.4 million which was driven by the increase in Consumer net revenues as compared to the prior year, an increase in depreciation of \$0.2 million and an increase in stock-based compensation of \$0.2 million.

|                                | Three Months Ended September 30, |      |          |
|--------------------------------|----------------------------------|------|----------|
|                                | 2012                             | 2011 | Change   |
|                                | (in thousands)                   |      |          |
| Interest expense               | \$(148 )                         | \$—  | \$(148 ) |
| Interest and other income, net | \$14                             | \$5  | \$9      |

Interest expense increased in the three months ended September 30, 2012 as compared to the same period in 2011 primarily due to origination and ongoing commitment fees from our five-year syndicated credit facility that became effective in November 2011.

|                    | Three Months Ended |          |   |
|--------------------|--------------------|----------|---|
|                    | September 30,      |          |   |
|                    | 2012               | 2011     |   |
|                    | (in thousands)     |          |   |
| Income tax benefit | \$13,401           | \$12,734 |   |
| Effective tax rate | 56                 | % 56     | % |

The benefit for income taxes was \$13.4 million for the three months ended September 30, 2012, compared to a benefit of \$12.7 million for the three months ended September 30, 2011. Our effective tax rate was 56% in the three months ended September 30, 2012 and September 30, 2011, primarily reflecting federal and state statutory rates, and including the tax benefits resulting from disqualifying dispositions of employee incentive stock options during the period.

At September 30, 2012, we had approximately \$42.2 million, \$55.1 million, and \$20.3 million of federal, California, and other state jurisdictions net operating loss carryforwards, respectively, to reduce future taxable income, \$39.5 million, \$29.9 million and \$20.3 million of which is associated with windfall tax benefits, respectively, that will be recorded as additional paid-in capital when realized. These carryforwards will expire beginning in the year 2028 and 2015 for federal and California purposes, respectively, and no sooner than 2022 for the portion related to 17 other state jurisdictions, if not utilized.

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|                            | Three Months Ended September 30, |              |             |          |
|----------------------------|----------------------------------|--------------|-------------|----------|
|                            | 2012                             | 2011         | \$ Change   | % Change |
|                            | (in thousands)                   |              |             |          |
| Loss before income taxes   | \$ (23,879 )                     | \$ (22,687 ) | \$ (1,192 ) | 5 %      |
| Net loss                   | \$ (10,478 )                     | \$ (9,953 )  | \$ (525 )   | 5 %      |
| Percentage of net revenues | (11 )                            | % (13 )      | % —         | —        |

Net loss increased by \$0.5 million for the three months ended September 30, 2012 as compared to the same period in 2011. As a percentage of net revenues, net loss was 11% and 13% for the three months ended September 30, 2012 and September 30, 2011, respectively.

## Comparison of the Nine Month Periods Ended September 30, 2012 and 2011

|                            | Nine Months Ended September 30, |            |           |          |
|----------------------------|---------------------------------|------------|-----------|----------|
|                            | 2012                            | 2011       | \$ Change | % Change |
|                            | (in thousands)                  |            |           |          |
| Net revenues               |                                 |            |           |          |
| Consumer                   | \$ 269,910                      | \$ 200,585 | \$ 69,325 | 35 %     |
| Enterprise                 | 18,937                          | 8,931      | 10,006    | 112 %    |
| Total net revenues         | 288,847                         | 209,516    | 79,331    | 38 %     |
| Cost of net revenues       | 155,892                         | 111,074    | 44,818    | 40 %     |
| Gross profit               | \$ 132,955                      | \$ 98,442  | \$ 34,513 | 35 %     |
| Percentage of net revenues | 46                              | % 47       | % —       | —        |

Net revenues increased \$79.3 million, or 38%, for the nine months ended September 30, 2012 as compared to the same period in 2011. Consumer net revenues increased \$69.3 million, or 35%, in the nine months ended September 30, 2012 compared to the same period in 2011. The increase in Consumer net revenues is primarily a result of increased sales of greeting and stationery cards and photo books as well as the addition of Tiny Prints sales during the nine months ended September 30, 2012 while the nine months ended September 30, 2011 only included Tiny Prints sales from April 25 to September 30, 2011. Enterprise revenues increased \$10.0 million, or 112%, in the nine months ended September 30, 2012 compared to the same period in 2011.

Cost of net revenues increased \$44.8 million, or 40%, for the nine months ended September 30, 2012 as compared to the same period in 2011. As a percentage of net revenues, cost of net revenues increased slightly to 54% in 2012 from 53% in 2011, which decreased gross margin to 46% in the nine months ended September 30, 2012 from 47% in the same period in 2011. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products and increased headcount, as well as additional third party fulfillment costs associated with Tiny Prints products. These costs were partially offset by favorable changes in product mix and cost efficiencies in manufacturing.

|                            | Nine Months Ended September 30, |           |           |          |
|----------------------------|---------------------------------|-----------|-----------|----------|
|                            | 2012                            | 2011      | \$ Change | % Change |
|                            | (in thousands)                  |           |           |          |
| Technology and development | \$ 60,976                       | \$ 48,190 | \$ 12,786 | 27 %     |
| Percentage of net revenues | 21                              | % 23      | % —       | —        |
| Sales and marketing        | \$ 86,615                       | \$ 64,447 | \$ 22,168 | 34 %     |
| Percentage of net revenues | 30                              | % 31      | % —       | —        |

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|                            |          |          |         |   |   |
|----------------------------|----------|----------|---------|---|---|
| General and administrative | \$45,975 | \$43,023 | \$2,952 | 7 | % |
| Percentage of net revenues | 16       | % 20     | % —     | — |   |

Our technology and development expense increased \$12.8 million, or 27%, for the nine months ended September 30, 2012, as compared to the same period in 2011. As a percentage of net revenues, technology and development expense decreased to 21%

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for the nine months ended September 30, 2012 from 23% for the same period in 2011. The increase in technology and development expense was primarily due to an increase of \$6.3 million related to personnel and related costs for employees, reflecting the addition of the Tiny Prints technology team. The overall increase was also due to an increase of \$4.8 million related to facilities costs, an increase of \$1.4 million related to professional consultants to support website development and infrastructure, an increase of \$2.0 million in depreciation expense, and an increase of \$0.8 million of stock-based compensation. These factors were partially offset by an increase of \$2.5 million in website development costs capitalized in the current period compared to the same period in the prior year.

In the nine months ended September 30, 2012, we capitalized \$9.6 million in eligible salary and consultant costs, including \$0.6 million of stock-based compensation, associated with software developed or obtained for internal use, compared to \$7.1 million, which included \$0.3 million of stock-based compensation capitalized in the nine months ended September 30, 2011. We expect this trend to continue in 2012, further increasing capitalized website and software development costs as a percentage of our total capital expenditures.

Our sales and marketing expense increased \$22.2 million, or 34%, in the nine months ended September 30, 2012 compared to the same period in 2011. As a percentage of net revenues, total sales and marketing expense decreased to 30% for the nine months ended September 30, 2012 from 31% for the same period in 2011. The increase in sales and marketing expense was primarily due to an increase of \$11.0 million related to expanded online marketing campaigns and advertising. The increase is also attributable to an increase of \$5.8 million in personnel and related costs associated with the expansion of our internal marketing team including the addition of Tiny Prints headcount, and an increase of \$5.5 million in intangible asset amortization primarily from the Tiny Prints acquisition and the Kodak Gallery customer list acquisition. This increase was partially offset by a decrease of \$0.3 million in stock-based compensation.

Our general and administrative expense increased \$3.0 million, or 7%, in the nine months ended September 30, 2012 as compared to the same period in 2011. As a percentage of net revenues, general and administrative expense decreased to 16% in the nine months ended September 30, 2012 from 20% for the comparable period in 2011. The increase in general and administrative expense is primarily due to an increase in personnel related costs of \$2.5 million as a result of increased headcount. We also incurred an increase in credit card fees of \$1.2 million which was driven by the increase in Consumer net revenues as compared to the prior year, an increase in facilities costs of \$0.5 million, an increase of \$0.5 million in depreciation expense, and an increase in stock-based compensation of \$0.4 million. These increases were partially offset by a decrease in professional fees of \$1.7 million which was largely due to transaction costs related to our acquisition of Tiny Prints incurred in the nine months ended September 30, 2011 and gain on disposition of assets of \$0.7 million.

|                                | Nine Months Ended September 30, |      |        |
|--------------------------------|---------------------------------|------|--------|
|                                | 2012                            | 2011 | Change |
|                                | (in thousands)                  |      |        |
| Interest expense               | \$(456                          | )\$— | \$(456 |
| Interest and other income, net | \$30                            | \$25 | \$5    |

Interest expense increased in the nine months ended September 30, 2012 as compared to the same period in 2011 primarily due to origination and ongoing commitment fees from our five-year syndicated credit facility that became effective in November 2011.

| Nine Months Ended |      |
|-------------------|------|
| September 30,     |      |
| 2012              | 2011 |
| (in thousands)    |      |

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|                    |          |          |   |
|--------------------|----------|----------|---|
| Income tax benefit | \$31,008 | \$35,830 |   |
| Effective tax rate | 51       | % 63     | % |

The benefit for income taxes was \$31.0 million for the nine months ended September 30, 2012, compared to a benefit of \$35.8 million for the nine months ended September 30, 2011. Our effective tax rate was 51% in the nine months ended September 30, 2012, compared to 63% in the same period in 2011, primarily reflecting non-deductible stock-based compensation and transaction expenses, offset by tax benefits resulting from disqualifying dispositions of employee incentive stock options during the period.



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|                            | Nine Months Ended September 30, |             |            |          |
|----------------------------|---------------------------------|-------------|------------|----------|
|                            | 2012                            | 2011        | \$ Change  | % Change |
|                            | (in thousands)                  |             |            |          |
| Loss before income taxes   | \$(61,037 )                     | \$(57,193 ) | \$(3,844 ) | 7 %      |
| Net loss                   | \$(30,029 )                     | \$(21,363 ) | \$(8,666 ) | 41 %     |
| Percentage of net revenues | (10 )                           | % (10 )     | % —        | —        |

Net loss increased by \$8.7 million for the nine months ended September 30, 2012 as compared to the same period in 2011. As a percentage of net revenue, net loss was 10% for the nine months ended September 30, 2012 and September 30, 2011.

## Liquidity and Capital Resources

At September 30, 2012, we had \$90.0 million of cash and cash equivalents. In addition, to supplement our overall liquidity position, we entered into a five-year senior secured syndicated credit facility in November 2011 to provide up to \$125.0 million in additional capital resources. In addition, we may request to increase the credit facility by \$75.0 million. As of September 30, 2012, no amounts have been drawn against this facility.

Below is our cash flow activity for the nine months ended September 30, 2012 and 2011:

|                                                          | Nine Months Ended  |                    |
|----------------------------------------------------------|--------------------|--------------------|
|                                                          | September 30, 2012 | September 30, 2011 |
|                                                          | (in thousands)     |                    |
| Consolidated Statements of Cash Flows Data:              |                    |                    |
| Purchases of property and equipment                      | \$26,912           | \$16,319           |
| Capitalization of software and website development costs | 9,603              | 7,877              |
| Depreciation and amortization                            | 34,088             | 24,526             |
| Cash flows used in operating activities                  | (42,190 )          | (59,591 )          |
| Cash flows used in investing activities                  | (71,216 )          | (157,906 )         |
| Cash flows provided by financing activities              | 23,476             | 33,963             |

We anticipate that our current cash and cash equivalents balances and cash generated from operations will be sufficient to meet our strategic and working capital requirements, lease obligations, technology development projects, and any repurchases of shares under our recently approved Share Repurchase Program for at least the next twelve months. Whether these resources are adequate to meet our liquidity needs beyond that period will depend on our growth, operating results and the capital expenditures required to meet possible increased demand for our products. If we require additional capital resources to grow our business internally or to acquire complementary technologies and businesses at any time in the future, we may seek to sell additional debt or equity. The sale of additional equity could result in additional dilution to our stockholders. Financing arrangements may not be available to us, or may not be in amounts or on terms acceptable to us.

We anticipate that total 2012 capital expenditures will range from 9.7% to 10.2% of our expected net revenues in 2012. Of that total amount, approximately \$12.0 million is expected to be used to purchase additional storage and computer infrastructure to support the acquisition of Kodak Gallery's customer accounts and images, and to begin the uplift of our new east coast manufacturing facility in Fort Mill, South Carolina. These expenditures will also be used to purchase technology and equipment to support the growth in our business and to increase our production capacity and help enable us to respond more quickly and efficiently to customer demand. A significant component of these

expenditures includes costs associated with capitalized software and website development, as we continue to support our innovative engineering and product development strategies. This range of capital expenditures is not outside the ordinary course of our business or materially different from how we have expanded our business in the past.

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The following table shows total capital expenditures including amounts accrued but not yet paid by category for the nine months ended September 30, 2012 and 2011:

|                                                       | Nine Months Ended<br>September 30, |          |   |
|-------------------------------------------------------|------------------------------------|----------|---|
|                                                       | 2012                               | 2011     |   |
|                                                       | (in thousands)                     |          |   |
| Technology equipment and software                     | \$20,469                           | \$10,277 |   |
| Percentage of total capital expenditures              | 45                                 | % 39     | % |
| Manufacturing equipment and building improvements     | 14,922                             | 8,290    |   |
| Percentage of total capital expenditures              | 33                                 | % 31     | % |
| Capitalized technology and development costs          | 9,603                              | 7,877    |   |
| Percentage of total capital expenditures              | 21                                 | % 30     | % |
| Total Capital Expenditures                            | \$44,994                           | \$26,444 |   |
| Total Capital Expenditures percentage of net revenues | 16                                 | % 13     | % |

Operating Activities. For the nine months ended September 30, 2012, net cash used in operating activities was \$42.2 million, primarily due to our net loss of \$30.0 million and the net change in operating assets and liabilities of \$68.1 million. Net cash used in operating activities was adjusted for non-cash items including \$27.5 million of stock-based compensation, \$19.3 million of depreciation and amortization expense, \$14.8 million of amortization of intangible assets and \$4.7 million benefit from deferred income taxes.

For the nine months ended September 30, 2011, net cash used in operating activities was \$59.6 million, primarily due to our net loss of \$21.4 million and the net change in operating assets and liabilities of \$87.9 million. Net cash used in operating activities was adjusted for non-cash items including \$16.4 million of depreciation and amortization expense and \$27.2 million of stock-based compensation. Another non-cash item included in operating activities is \$8.2 million of amortization of intangible assets which includes \$0.6 million of amortization of prepaid royalties associated with intellectual property licenses that were entered into since 2009.

Investing Activities. For the nine months ended September 30, 2012, net cash used in investing activities was \$71.2 million. We used \$24.4 million in the acquisition of Kodak Gallery's customer accounts and images and \$4.5 million and \$6.8 million in the acquisitions of Photocchino Ltd and Penguin Digital, Inc., respectively, net of cash acquired. We used \$26.9 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations, and \$9.6 million of capitalized software and website development. Additionally, we received proceeds of \$1.0 million from the sale of equipment.

For the nine months ended September 30, 2011, net cash used in investing activities was \$157.9 million. We used \$134.0 million in the acquisition of Tiny Prints net of cash acquired, \$16.3 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations, and \$7.9 million of capitalized software and website development.

Financing Activities. For the nine months ended September 30, 2012, net cash provided by financing activities was \$23.5 million, primarily from \$14.9 million from excess tax benefit from stock-based compensation and \$8.5 million of proceeds from issuance of common stock from the exercise of options.

For the nine months ended September 30, 2011, net cash provided by financing activities was \$34.0 million, primarily from \$21.6 million of proceeds from issuance of common stock from the exercise of options and \$12.4 million from excess tax benefits from stock-based compensation.

## Non-GAAP Financial Measures

Regulation G, conditions for use of Non-Generally Accepted Accounting Principles ("Non-GAAP") financial measures, and other SEC regulations define and prescribe the conditions for use of certain Non-GAAP financial information. We closely monitor two financial measures, adjusted EBITDA and free cash flow which meet the definition of Non-GAAP financial measures. We define adjusted EBITDA as earnings before interest, taxes, depreciation, amortization, and stock-based compensation. Free cash flow is defined as adjusted EBITDA less purchases of property and equipment and capitalization of software and website development costs. Management believes these Non-GAAP financial measures reflect an additional way of viewing our

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profitability and liquidity that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our earnings and cash flows. Refer below for a reconciliation of both adjusted EBITDA and free cash flow to the most comparable GAAP measure.

To supplement our consolidated financial statements presented on a GAAP basis, we believe that these Non-GAAP measures provide useful information about our core operating results and thus are appropriate to enhance the overall understanding of our past financial performance and our prospects for the future. These adjustments to our GAAP results are made with the intent of providing both management and investors a more complete understanding of our underlying operational results and trends and performance. Management uses these Non-GAAP measures to evaluate our financial results, develop budgets, manage expenditures, and determine employee compensation. The presentation of additional information is not meant to be considered in isolation or as a substitute for or superior to net income (loss) or net income (loss) per share determined in accordance with GAAP. Management strongly encourages shareholders to review our financial statements and publicly-filed reports in their entirety and not to rely on any single financial measure.

The table below shows the trend of adjusted EBITDA and free cash flow as a percentage of net revenues for the three and nine months ended September 30, 2012 and 2011 (in thousands):

|                                  | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |             |
|----------------------------------|-------------------------------------|-------------|------------------------------------|-------------|
|                                  | 2012                                | 2011        | 2012                               | 2011        |
| Net revenues                     | \$98,536                            | \$76,523    | \$288,847                          | \$209,516   |
| Non-GAAP Adjusted EBITDA         | \$(3,136 )                          | \$(3,336 )  | \$985                              | \$(5,536 )  |
| EBITDA % of Net revenues         | (3 )%                               | (4 )%       | — %                                | (3 )%       |
| Free cash flow                   | \$(23,494 )                         | \$(15,479 ) | \$(44,009 )                        | \$(31,980 ) |
| Free cash flow % of Net revenues | (24 )%                              | (20 )%      | (15 )%                             | (15 )%      |

By carefully managing our operating costs and capital expenditures, we were able to make the strategic investments we believe are necessary to grow and strengthen our business. For the three and nine months ended September 30, 2012, our adjusted EBITDA was \$(3.1) million and \$1.0 million, respectively, as compared to \$(3.3) million and \$(5.5) million in the same periods in 2011. The increase in adjusted EBITDA was primarily driven by higher Enterprise revenue in the three and nine months ended September 30, 2012 compared to the same periods in the prior year, as well as our continued emphasis to incur costs in line with overall growth.

During the three and nine months ended September 30, 2012, we experienced negative free cash flows of \$23.5 million and \$44.0 million, respectively. However, during the fiscal year, we take steps designed to preserve the opportunity to achieve full year positive free cash flows.

Free cash flow has limitations due to the fact that it does not represent the residual cash flow for discretionary expenditures. For example, free cash flow does not incorporate payments made on capital lease obligations or cash requirements to comply with debt covenants. Therefore, we believe that it is important to view free cash flow as a complement to our reported consolidated financial statements.



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The following is a reconciliation of adjusted EBITDA and free cash flow to the most comparable GAAP measure, for the three and nine months ended September 30, 2012 and 2011 (in thousands):

| Reconciliation of Net Loss to Non-GAAP Adjusted EBITDA | Three Months Ended |            | Nine Months Ended |             |
|--------------------------------------------------------|--------------------|------------|-------------------|-------------|
|                                                        | September 30,      |            | September 30,     |             |
|                                                        | 2012               | 2011       | 2012              | 2011        |
| Net loss                                               | \$(10,478          | ) \$(9,953 | ) \$(30,029       | ) \$(21,363 |
| Add back:                                              |                    |            |                   |             |
| Interest expense                                       | 148                | —          | 456               | —           |
| Interest and other income, net                         | (14                | ) (5       | ) (30             | ) (25       |
| Benefit from income taxes                              | (13,401            | ) (12,734  | ) (31,008         | ) (35,830   |
| Depreciation and amortization                          | 12,244             | 9,534      | 34,088            | 24,526      |
| Stock-based compensation expense                       | 8,365              | 9,822      | 27,508            | 27,156      |
| Non-GAAP Adjusted EBITDA                               | \$(3,136           | ) \$(3,336 | ) \$985           | ) \$(5,536  |

| Reconciliation of Cash Flow from Operating Activities to Non-GAAP Adjusted EBITDA and Free Cash Flow | Three Months Ended |             | Nine Months Ended |             |
|------------------------------------------------------------------------------------------------------|--------------------|-------------|-------------------|-------------|
|                                                                                                      | September 30,      |             | September 30,     |             |
|                                                                                                      | 2012               | 2011        | 2012              | 2011        |
| Net cash used in operating activities                                                                | \$(3,568           | ) \$(1,577  | ) \$(42,190       | ) \$(59,591 |
| Add back:                                                                                            |                    |             |                   |             |
| Interest expense                                                                                     | 148                | —           | 456               | —           |
| Interest and other income, net                                                                       | (14                | ) (5        | ) (30             | ) (25       |
| Benefit from income taxes                                                                            | (13,401            | ) (12,734   | ) (31,008         | ) (35,830   |
| Changes in operating assets and liabilities                                                          | 11,482             | 8,962       | 68,133            | 87,881      |
| Other adjustments                                                                                    | 2,217              | 2,018       | 5,624             | 2,029       |
| Non-GAAP Adjusted EBITDA                                                                             | (3,136             | ) (3,336    | ) 985             | ) (5,536    |
| Less:                                                                                                |                    |             |                   |             |
| Purchases of property and equipment, including accrued amounts                                       | (16,628            | ) (9,310    | ) (35,391         | ) (18,567   |
| Capitalized technology & development costs                                                           | (3,730             | ) (2,833    | ) (9,603          | ) (7,877    |
| Free cash flow                                                                                       | \$(23,494          | ) \$(15,479 | ) \$(44,009       | ) \$(31,980 |

## Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not have any undisclosed borrowings or debt and we have not entered into any synthetic leases. We are, therefore, not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

## Recent Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board issued new accounting guidance intended to simplify goodwill impairment testing. Entities will be allowed to perform a qualitative assessment on goodwill impairment to determine whether a quantitative assessment is necessary. This guidance is effective for our interim and annual periods beginning January 1, 2012. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

**Interest Rate and Credit Risk.** We have exposure to interest rate risk that relates primarily to our investment portfolio. All of our cash equivalents are carried at market value. We do not currently use or plan to use derivative financial instruments in our investment portfolio. The risk associated with fluctuating interest rates is limited to our investment portfolio and we do not believe that a 10% change in interest rates will have a significant impact on our interest income, operating results or liquidity.

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Inflation. We do not believe that inflation has had a material effect on our current business, financial condition or results of operations. If our costs were to become subject to significant inflationary pressures, for example, if the cost of our materials or the cost of shipping our products to customers were to incur substantial increases as a result of the rapid rise in the cost of oil, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our chief executive officer and chief financial officer evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2012. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act 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 a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2012, our chief executive officer and chief financial officer concluded that, as of such date, the Company’s disclosure controls and procedures were effective at the reasonable assurance level.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On December 10, 2010, Eastman Kodak Company (“Kodak”) filed a complaint for alleged patent infringement against us in Eastman Kodak Company v. Shutterfly, Inc., C.A. No. 10-1079-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,549,306; 6,600,572; 7,202,982; 6,069,712; and 6,512,570, which claim among other things, methods for selecting photographic images using index prints, an image handling system incorporating coded instructions, and processing a roll of exposed photographic film into corresponding visual prints and distributing such prints. The Complaint asserts that we directly or indirectly infringe the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. On February 3, 2011, we filed an answer and counterclaims against Kodak. On November 16, 2011, Kodak filed its First Amended Complaint adding Tiny Prints, Inc. as a defendant. On December 13, 2011, we filed our answer and counterclaims against Kodak. A trial date is currently set for on or around September, 2014. We believe the suit is without merit and will defend ourselves vigorously.

On January 31, 2011, we filed a complaint for patent infringement against Eastman Kodak Company and Kodak Imaging Network, Inc. in Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network, Inc., C.A. No. 11-099-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,583,799; 7,269,800; 6,587,596; 6,973,222; 7,474,801; 7,016,869; and 7,395,229, which claim among other things, methods for image uploading, image cropping, automatic generation of photo albums, and changing attributes of an image-based product. The Complaint asserts that Kodak directly or indirectly infringes the patents, and it seeks unspecified damages and injunctive relief. On March 24, 2011, Kodak filed an answer and counterclaims against us. On November 16, 2011, we filed our First Amended Complaint to include U.S. Patent No. 7,243,079. On the same day, November 16, 2011, Kodak filed its answer. Upon Kodak’s filing of a Chapter 11 petition on January 19, 2012, Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network, Inc., C.A. No. 11-099-SLR was automatically stayed pursuant to provisions of federal bankruptcy law.

On September 10, 2011, Princeton Digital Image Corporation (“Princeton”) filed a complaint for alleged patent infringement against us and seven other defendants in Princeton Digital Image Corporation v. Facebook, Inc. et al., Civ. No. 2:2011cv00400, in the Eastern District of Texas, Tyler Division. The case was dismissed with prejudice on July 30, 2012.

In all cases, at each reporting period, we evaluate whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, we accrue for the amount, or if a range, we accrue the low end of the range as a component of legal expense. We monitor developments in these legal matters that could affect the estimate we have previously accrued. There are no amounts accrued which we believe would be material to our financial position and results of operations.

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ITEM 1A. RISK FACTORS

Our net revenues, operating results and cash requirements are affected by the seasonal nature of our business.

Our business is highly seasonal, with a high proportion of our net revenues, net income and operating cash flows generated during the fourth quarter. For example, we generated more than 50% of our 2011 net revenues in the fourth quarter of 2011, and the net income that we generated during the fourth quarter of 2011 was necessary for us to achieve profitability on an annual basis. In addition, we incur significant additional expenses in the period leading up to the fourth quarter holiday season including expenses related to the hiring and training of temporary workers to meet our seasonal needs, additional inventory and equipment purchases and increased advertising. If we are unable to accurately forecast and respond to consumer demand for our products during the fourth quarter, our financial results, reputation and brands will suffer and the market price of our common stock would likely decline.

We also base our operating expense budgets on expected net revenue trends. A portion of our expenses, such as office, production facility, and various equipment leases and personnel costs, are largely fixed and are based on our expectations of our peak levels of operations. We may be unable to adjust spending quickly enough to offset any unexpected revenue shortfall. Accordingly, any shortfall in net revenues may cause significant variation in operating results in any quarter.

In addition, our operations and financial performance depend on general economic conditions. The U.S. economy is experiencing a slow economic recovery from a deep recession, concerns about inflation, low consumer confidence, high unemployment rate and other adverse business conditions. Fluctuations in the U.S. economy such as the recent recession could cause, among other conditions, a prolonged decline in consumer spending and an increase in the cost of labor and materials. These conditions could exacerbate variability in our forecasting and could negatively affect our results of operations.

Our limited operating history makes it difficult to assess the exact impact of the seasonal factors on our business or the extent to which our business is susceptible to cyclical fluctuations in the U.S. economy. In addition, our historically rapid growth may have overshadowed whatever seasonal or cyclical factors might have influenced our business to date. Seasonal or cyclical variations in our business may become more pronounced over time and may harm our future operating results.

If we are unable to meet our production requirements, our net revenues and results of operations would be harmed.

We believe that we must continue to grow our current production capability to meet our projected net revenue targets. For each of the last three years ended December 31, 2011, 2010, and 2009, our capital expenditures were approximately 7% of net revenues. We anticipate that total 2012 capital expenditures will range from 9.7% to 10.2% of 2012 net revenues. Operational difficulties, such as a significant interruption in the operations of either our Charlotte, North Carolina or Phoenix, Arizona production facilities, could delay production or shipment of our products. Our inability to meet our production requirements could lead to customer dissatisfaction and damage our reputation and brands, which would result in reduced net revenues. Moreover, if the costs of meeting production requirements, including capital expenditures, were to exceed our expectations, our results of operations would be harmed.

In addition, we face significant production risks at peak holiday seasons, including the risk of obtaining sufficient qualified seasonal production personnel. A majority of our workforce during the fourth quarter of 2011 was seasonal, temporary personnel. We have had difficulties in the past finding a sufficient number of qualified seasonal employees, and our failure to obtain qualified seasonal production personnel at any of our production facilities could harm our

operations.

Economic trends could adversely affect our financial performance.

We are subject to macro-economic fluctuations in the U.S. economy. Macro-economic issues involving the broader financial markets, including the housing and credit system, have negatively impacted the economy and our financial performance and may have further negative impact in the future.

Weak economic conditions, low consumer spending and decreased consumption may harm our operating results. Purchases of our products are often discretionary. If the economic climate does not improve, customers or potential customers could delay, reduce or forego their purchases of our products and services, which could impact our business in a number of ways, including lower prices for our products and services and reduced sales. In addition, adverse economic conditions may lead to price increases by our suppliers or increase our operating expenses due to, among others, higher costs of labor, energy, equipment and facilities. A prolonged and slow economic recovery or a renewed recession may also lead to additional restructuring actions and associated expenses. Due to reduced consumer spending and increased competitive pressures in the current economic environment, we may

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not be able to pass these increased costs on to our customers. The resulting increased expenses and/or reduced income would negatively impact our operating results.

If the economic recovery continues to be slow, or if the economy experiences a prolonged period of decelerating or negative growth, our results of operations may be further harmed.

Competitive pricing pressures, particularly with respect to pricing and shipping, may harm our business and results of operations.

Demand for our products and services is sensitive to price, especially in times of recession, slow economic growth and consumer conservatism. Many external factors, including our production and personnel costs, consumer sentiment and our competitors' pricing and marketing strategies, can significantly impact our pricing strategies. If we fail to meet our customers' price expectations, we could lose customers, which would harm our business and results of operations.

Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenues and net income. From time to time, we have made changes to our pricing structure, specifically for 4x6 prints, in order to remain competitive. Most of our other products, including photo books, calendars, cards and stationery and other photo merchandise are also offered by our competitors. During the fourth quarter of 2011, many of these competitors discounted those products at an unprecedented level. As a result, we also changed our discounting strategy, which impacted our acquisition of new customers, average order value, net revenues, gross margin, and our adjusted EBITDA and net income profitability measures. If in the future, due to competitor discounting or other marketing strategies, we significantly reduce our prices on our products without a corresponding increase in volume, it would negatively impact our net revenues and could adversely affect our gross margins and overall profitability.

We generate a significant portion of our net revenues from the fees we collect from shipping our products. For example, shipping revenue for the Shutterfly brand website represented approximately 15%, 14% and 14% of our net revenues in 2011, 2010 and 2009, respectively. We offer discounted or free shipping, with a minimum purchase requirement, during promotional periods to attract and retain customers. If free shipping offers extend beyond a limited number of occasions, are not based upon a minimum purchase requirement or become commonplace, our net revenues and results of operations would be negatively impacted. In addition, we occasionally offer free or discounted products and services to attract and retain customers. In the future, if we increase these offers to respond to actions taken by our competitors, our results of operations may be harmed.

We face intense competition from a range of competitors and may be unsuccessful in competing against current and future competitors.

The digital photography products and services industries are intensely competitive, and we expect competition to increase in the future as current competitors improve their offerings, including developing, acquiring and expanding mobile offerings, and as new participants enter the market or as industry consolidation further develops. Competition may result in pricing pressures, reduced profit margins or loss of market share, any of which could substantially harm our business and results of operations. We face intense competition from a wide range of companies, including the following:

Online digital photography services companies such as Snapfish, which is a service of Hewlett-Packard, American Greetings' Webshots brand, Vistaprint, SmugMug and many others;  
"Big Box" retailers such as Wal-Mart, Costco, Sam's Club and others that are seeking to offer low cost digital photography products and services. These competitors provide in-store fulfillment and self-service kiosks for printing, and may, among other strategies, offer their customers heavily discounted in-store products and services that compete directly with our offerings;

• Drug stores such as Walgreens, CVS/pharmacy and others that offer in-store pick-up from their photo website internet orders;

• Mobile digital photography services companies such as Instagram, Woven, and iPhoto.

• Self-publishing companies and services such as Lulu, CafePress and Zazzle;

• Specialized companies in the photo book and stationery business such as Hallmark, Cardstore by American Greetings, Minted, Picaboo, Blurb, MyPublisher, Mixbook, MOO, Smilebox, Creative Memories and Snap MyLife;

• Photo-related software companies such as Apple, Microsoft, Corel and FotoFlexer;

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- Internet portals and search engines such as Yahoo!, AOL and Google that offer broad-reaching digital photography and related products and services to their large user bases;
- Home printing service providers such as Hewlett-Packard, Epson, Canon, and Kodak that are seeking to expand their printer and ink businesses by gaining market share in the digital photography marketplace;
- Social media companies that host and enable mobile access to and posting of images such as Facebook, Twitter, and Myspace;
- Photo hosting websites that allow users to upload and share images at no cost such as Picasa, Flickr and Photobucket; and
- Regional photography companies such as Ritz Camera that have established brands and customer bases in existing photography markets.

Many of our competitors have significantly longer operating histories, larger and broader customer bases, greater brand and name recognition and greater financial, research and development and distribution resources, and operate in more geographic areas than we do. Well-funded competitors may be better able to withstand economic downturns and periods of slow economic growth and the associated periods of reduced customer spending and increased pricing pressures. The numerous choices for digital photography services can cause confusion for consumers, and may cause them to select a competitor with greater name recognition. Some competitors are able to devote substantially more resources to website and systems development or to investments or partnerships with traditional and online competitors. Well-funded competitors, particularly new entrants, may choose to prioritize growing their market share and brand awareness instead of profitability. Competitors and new entrants in the digital photography products and services industries may develop new products, technologies or capabilities that could render obsolete or less competitive many of our products, services and content. We may be unable to compete successfully against current and future competitors, and competitive pressures could harm our business and prospects.

Our quarterly financial results may fluctuate, which may lead to volatility in our stock price.

Our future revenues and operating results may vary significantly from quarter to quarter due to a number of factors, many of which are difficult for us to predict and control. Factors that could cause our quarterly operating results to fluctuate include:

- general economic conditions, including recession and slow economic growth in the U.S. and worldwide and higher inflation, as well as those economic conditions specific to the Internet and e-commerce industries;
- demand for our products and services, including seasonal demand;
- our pricing and marketing strategies and those of our competitors;
- our ability to attract visitors to our website and convert those visitors into customers;
- our ability to retain customers and encourage repeat purchases;
- our ability to retain customers and encourage repeat purchases;
- the costs of customer acquisition;
- our ability to manage our production and fulfillment operations;
- the costs to produce our prints and photo-based products and merchandise and to provide our services;
- the costs of expanding or enhancing our technology or website;
- a significant increase in returns and credits, beyond our estimated allowances, for customers who are not satisfied with our products;
- declines or disruptions to the travel industry;
- variations in weather, particularly heavy rain and snow which tend to depress travel and picture taking;
- the timing of holidays;
- volatility in our stock price, which may lead to higher stock-based compensation expense;

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- consumer preferences for digital photography services;
  - improvements to the quality, cost and convenience of desktop printing of digital pictures and products; and
- global and geopolitical events with indirect economic effects such as pandemic disease, hurricane and other natural disasters, war, threat of war or terrorist actions.

Based on the factors cited above, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. It is possible that in one or more future quarters, our operating results may be below the expectations of public market analysts and investors. In that event, the trading price of our common stock may decline.

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

We have periodically experienced operating losses since our inception in 1999. In particular, we make investments in our business that generally result in operating losses in each of the first three quarters of our fiscal year. This typically has enabled us to generate the majority of our net revenue during the fourth quarter and to achieve profitability for the full fiscal year. If we are unable to produce our products and provide our services at commercially reasonable costs, if customer demand and revenues decline or if our expenses exceed our expectations, we may not be able to achieve, sustain or increase profitability on a quarterly or annual basis.

We face many risks, uncertainties, expenses and difficulties relating to increasing our market share and growing our business.

To address the risks and uncertainties of increasing our market share and growing our business, we must do the following:

- maintain and increase the size of our customer base;
- maintain and enhance our brands;
- enhance and expand our products and services;
- maintain and grow our website and customer operations;
- successfully execute our business and marketing strategy;
- continue to develop and upgrade our technology and information processing systems;
- continue to enhance our service to meet the needs of a changing market;
- provide superior customer service;
- respond to competitive developments; and
- attract, integrate, retain and motivate qualified personnel.

We may be unable to accomplish one or more of these requirements, which could cause our business to suffer. Accomplishing one or more of these requirements might be very expensive, which could harm our financial results.

If we are not able to reliably meet our data storage and management requirements, customer satisfaction and our reputation could be harmed.

As a part of our current business model, we offer our customers free unlimited online storage and sharing of photographs and, as a result, must store and manage many petabytes of data. This policy results in immense system requirements and substantial ongoing technological challenges, both of which are expected to continue to increase over time. If we are not able to reliably meet these data storage and management requirements, we could have disruptions in services which could impair customer satisfaction and our reputation and lead to reduced net revenues and increased expenses. Moreover, if the cost of meeting these data storage and management requirements exceeds



our expectations, our results of operations would be harmed. For example, after massive flooding shut down major hard disk drive production sites in Thailand, our ability to timely acquire data storage products was adversely affected.

Our data storage system could suffer damage or interruption from human error, fire, flood, power loss, telecommunications failure, break-ins, terrorist attacks, acts of war and similar events. In addition, our primary storage facilities are located near a major fault line, increasing our susceptibility to the risk that an earthquake could significantly harm our data storage system. If

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we experience disruption to our redundant systems located at our data storage center, such disruption could result in the deletion or corruption of customers' stored images.

Interruptions to our website, information technology systems, print production processes or customer service operations could damage our reputation and brands and substantially harm our business and results of operations.

The satisfactory performance, reliability and availability of our website, information technology systems, printing production processes and customer service operations are critical to our reputation, and our ability to attract and retain customers and maintain adequate customer satisfaction. Any interruptions that result in the unavailability of our website or reduced order fulfillment performance or customer service could result in negative publicity, damage our reputation and brands and cause our business and results of operations to suffer. This risk is heightened in the fourth quarter, as we experience significantly increased traffic to our website during the holiday season. Any interruption that occurs during such time would have a disproportionately negative impact than if it occurred during a different quarter.

We depend in part on third parties to implement and maintain certain aspects of our communications and printing systems. Therefore many of the causes of system interruptions or interruptions in the production process may be outside of our control. As a result, we may not be able to remedy such interruptions in a timely manner, or at all. Our business interruption insurance policies do not address all potential causes of business interruptions that we may experience, and any proceeds we may receive from these policies in the event of a business interruption may not fully compensate us for the revenues we may lose.

We may have difficulty managing our growth and expanding our operations successfully.

We have website operations, offices and customer support centers in Redwood City, California, Sunnyvale, California, and Tempe, Arizona and production facilities in Charlotte, North Carolina and Phoenix, Arizona and a new facility in Fort Mill, South Carolina that will replace our Charlotte, North Carolina facility, and is expected to be operational in 2013. Our growth has placed, and will continue to place, a strain on our administrative and operational infrastructure. Our ability to manage our operations and growth will require us to continue to refine our operational, financial and management controls, human resource policies and reporting systems.

If we are unable to manage future expansion, we may not be able to implement improvements to our controls, policies and systems in an efficient or timely manner and may discover deficiencies in existing systems and controls. Our ability to provide a high-quality customer experience could be compromised, which would damage our reputation and brands and substantially harm our business and results of operations.

If we are unable to adequately control the costs associated with operating our business, our results of operations will suffer.

The primary costs in operating our business are related to producing and shipping products, acquiring customers, compensating our personnel, acquiring equipment and technology and leasing facilities. If we are unable to keep these costs aligned with the level of revenues that we generate, our results of operations would be harmed. Controlling our business costs is challenging because many of the factors that impact these costs are beyond our control. For example, the costs to produce prints, such as the costs of photographic print paper, could increase due to a shortage of silver or an increase in worldwide energy prices. In addition, we may become subject to increased costs by the third-party shippers that deliver our products to our customers, and we may be unable to pass along any increases in shipping costs to our customers. The costs of online advertising and keyword search could also increase significantly due to increased competition, which would increase our customer acquisition costs.

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 website through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, such as our 2012 acquisitions of Penguin Digital, Inc. and Photoccino, Ltd., our 2011 acquisition of Tiny Prints, Inc., and our 2010 acquisition of WMSG, Inc. Integrating any newly acquired businesses, technologies or services is likely to be expensive and time consuming. For example, in connection with our Tiny Prints acquisition, we issued approximately 5.4 million shares of our common stock as transaction consideration. We may continue to issue equity securities for future acquisitions, which would dilute existing stockholders, perhaps significantly depending on the terms of such acquisitions. To finance any future acquisitions, it may also be necessary for us to raise additional funds through public or private debt and equity 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. Also, the value of our stock may be insufficient to attract acquisition candidates.

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Our ability to realize the anticipated benefits of our acquisitions will depend on successfully integrating the acquired businesses.

The success of our acquisition strategy depends upon our ability to successfully complete acquisitions and integrate any businesses that we acquire into our existing business. The integration of acquired business operations could disrupt our business by causing unforeseen operating difficulties, diverting management's attention from day-to-day operations and requiring significant financial resources that would otherwise be used for the ongoing development of our business. The difficulties of integration could be increased by the necessity of coordinating geographically dispersed organizations, such as with our acquisition of Photocchino, an Israeli based organization, integrating personnel with disparate business backgrounds and combining different corporate cultures. In addition, we could be unable to retain key employees or customers of the combined businesses. We could face integration issues pertaining to the internal controls and operational functions of the acquired companies and we also could fail to realize cost efficiencies or synergies that we anticipated when selecting our acquisition candidates. As a result of these and other risks, if we are unable to successfully integrate acquired businesses, we may not realize the anticipated benefits from our acquisitions. Any failure to achieve these benefits or failure to successfully integrate acquired businesses and technologies could seriously harm our business.

The loss of key personnel and an inability to attract and retain additional personnel could affect our ability to successfully grow our business.

We are highly dependent upon the continued service and performance of our senior management team and key technical, marketing and production personnel. The loss of these key employees, each of whom is "at will" and may terminate his or her employment relationship with us at any time, may significantly delay or prevent the achievement of our business objectives. For example, our former chief financial officer resigned effective February 24, 2012 and our chief technology officer resigned effective July 10, 2012. A lack of management continuity could result in operational and administrative inefficiencies and added costs, which could adversely impact our results of operations and stock price and may make recruiting for future management positions more difficult. In addition, we must successfully integrate our new chief financial officer who began in August, 2010, and changes in this and other key management positions may temporarily affect our financial performance and results of operations as new management becomes familiar with our business.

We believe that our future success will also depend in part on our continued ability to identify, hire, train and motivate qualified personnel. We face intense competition for qualified individuals from numerous technology, marketing, financial services, manufacturing and e-commerce companies. In addition, competition for qualified personnel is particularly intense in the San Francisco Bay Area, where our headquarters are located. We may be unable to attract and retain suitably qualified individuals who are capable of meeting our growing operational and managerial requirements, or we may be required to pay increased compensation in order to do so. Our failure to attract and retain qualified personnel could impair our ability to implement our business plan.

In order to attract and retain key personnel, in 2010 we amended our 2006 Equity Incentive Plan to provide for automatic increases through 2013 of the number of shares issuable under it and we may need to grant inducement equity awards outside of the plan, which would dilute the ownership of our existing stockholders.

At the 2010 annual meeting, our stockholders approved an amendment to our 2006 Equity Incentive Plan (the "2006 Plan") to renew its "evergreen" provision. According to the amendment, the number of shares available for issuance under the 2006 Plan automatically increase as follows: (i) on January 1, 2011 by 3.5% of the number of the Company's common stock issued and outstanding on December 31, 2010; (ii) on January 1, 2012 by 3.3% of the number of the Company's common stock issued and outstanding on December 31, 2011, and (iii) on January 1, 2013 by 3.1% of the number of the Company's common stock issued and outstanding on December 31, 2012. In addition, in order to attract

key personnel, the Board authorized 380,000, 135,100, 200,000, and 602,932 additional inducement stock option grants and restricted stock unit awards to supplement our 2006 Plan, which were granted in 2007, 2008, 2009, and 2012 respectively. Inducement stock options and restricted stock unit awards are granted to certain employees upon hire and do not require stockholder approval. In the future, attracting key personnel may require a level of option and restricted stock unit grants in excess of the amount available in our 2006 Plan. The increase of the shares available for issuance under the 2006 Plan and grants of awards from it, as well as further inducement equity awards outside of the 2006 Plan, will cause dilution to our stockholders.

If we are unable to attract customers in a cost-effective manner, or if we were to become subject to e-mail blacklisting, traffic to our website would be reduced and our business and results of operations would be harmed.

Our success depends on our ability to attract customers in a cost-effective manner. We rely on a variety of methods to bring visitors to our website and promote our products, including paying fees to third parties who drive new customers to our website, purchasing search results from online search engines, e-mail and direct mail. We pay providers of online services, search engines, directories and other website and e-commerce businesses to provide content, advertising banners and other links that direct

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customers to our website. We also use e-mail and direct mail to offer free products and services to attract customers, and we offer substantial pricing discounts to encourage repeat purchases. Our methods of attracting customers, including acquiring customer lists from third parties, can involve substantial costs, regardless of whether we acquire new customers. Even if we are successful in acquiring and retaining customers, the cost involved in these efforts impacts our results of operations. Customer lists are typically recorded as intangible assets and may be subject to impairment charges if the fair value of that list exceeds its carrying value. These potential impairment charges could harm our results from operations. If we are unable to enhance or maintain the methods we use to reach consumers, if the costs of attracting customers using these methods significantly increase, or if we are unable to develop new cost-effective means to obtain customers, our ability to attract new customers would be harmed, traffic to our website would be reduced and our business and results of operations would be harmed.

In addition, various private entities attempt to regulate the use of e-mail for commercial solicitation. These entities often advocate standards of conduct or practice that significantly exceed current legal requirements and classify certain e-mail solicitations that comply with current legal requirements as unsolicited bulk e-mails, or “spam.” Some of these entities maintain blacklists of companies and individuals, and the websites, Internet service providers and Internet protocol addresses associated with those entities or individuals that do not adhere to what the blacklisting entity believes are appropriate standards of conduct or practices for commercial e-mail solicitations. If a company’s Internet protocol addresses are listed by a blacklisting entity, e-mails sent from those addresses may be blocked if they are sent to any Internet domain or Internet address that subscribes to the blacklisting entity’s service or purchases its blacklist. From time to time we are blacklisted, sometimes without our knowledge, which could impair our ability to market our products and services, communicate with our customers and otherwise operate our business. In addition, we have noted that unauthorized “spammers” utilize our domain name to solicit spam, which increases the frequency and likelihood that we may be blacklisted.

We may not succeed in promoting, strengthening and continuing to establish the Shutterfly, Tiny Prints, Wedding Paper Divas and Treat brands, which would prevent us from acquiring new customers and increasing revenues.

A component of our business strategy is the continued promotion and strengthening of the Shutterfly, Tiny Prints, Wedding Paper Divas and Treat brands. Due to the competitive nature of the digital photography products and services markets, if we are unable to successfully promote our brands, we may fail to substantially increase our net revenues. Customer awareness and the perceived value of our brands will depend largely on the success of our marketing efforts and our ability to provide a consistent, high-quality customer experience. To promote our brands, we have incurred, and will continue to incur, substantial expense related to advertising and other marketing efforts.

Our ability to provide a high-quality customer experience also depends, in large part, on external factors over which we may have little or no control, including the reliability and performance of our suppliers and third-party Internet and communication infrastructure providers. For example, some of our products, such as select photo-based merchandise, are produced and shipped to customers by our third-party vendors, and we rely on these vendors to properly inspect and ship these products. In addition, we rely on third-party shippers, including the U.S. Postal Service, United Parcel Service and FedEx, to deliver our products to customers. Strikes, furloughs, reduced operations or other service interruptions affecting these shippers could impair our ability to deliver merchandise on a timely basis. Our products are also subject to damage during delivery and handling by our third-party shippers. Our failure to provide customers with high-quality products in a timely manner for any reason could substantially harm our reputation and our efforts to develop trusted brands. The failure of our brand promotion activities could adversely affect our ability to attract new customers and maintain customer relationships, which would substantially harm our business and results of operations.

If we are unable to develop, market and sell new products and services that address additional market opportunities, our results of operations may suffer. In addition, we may need to expand beyond our current customer demographic to

grow our business.

Although historically we have focused our business on consumer markets for silver halide prints, such as 4x6 prints, and photo-based products, such as photo books, stationery cards and calendars, we continually evaluate the demand for new products and services and the need to address these trends. In addition, we believe we may need to address additional markets and expand our customer demographic in order to further grow our business. We may not successfully expand our existing services or create new products and services, address new market segments or develop a significantly broader customer base. Any failure to address additional market opportunities could result in loss of market share, which would harm our business, financial condition and results of operations.

If either facility where our computer and communications hardware is located fails or if any of our production facilities fails, our business and results of operations would be harmed.

Our ability to successfully receive and fulfill orders and to provide high-quality customer service depends in part on the

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efficient and uninterrupted operation of our computer and communications systems. Substantially all of the computer hardware necessary to operate our website is located at one third-party hosting facility in Santa Clara, California, and our production facilities are located in Charlotte, North Carolina and Phoenix, Arizona. Our systems and operations could suffer damage or interruption from human error, fire, flood, power loss, insufficient power availability, telecommunications failure, break-ins, terrorist attacks, acts of war and similar events. In addition, Santa Clara is located near a major fault line increasing our susceptibility to the risk that an earthquake could significantly harm the operations of these facilities. We maintain business interruption insurance; however, this insurance may be insufficient to compensate us for losses that may occur, particularly from interruption due to an earthquake which is not covered under our current policy. We do not presently have redundant systems in multiple locations. In addition, the impact of any of these disasters on our business may be exacerbated by the fact that we are still in the process of developing our formal disaster recovery plan and we do not have a final plan in place.

Capacity constraints and system failures could prevent access to our website, which could harm our reputation and negatively affect our net revenues.

Our business requires that we have adequate capacity in our computer systems to cope with the high volume of visits to our website. As our operations grow in size and scope, we continually need to improve and upgrade our computer systems and network infrastructure to ensure reliable access to our website, in order to offer customers enhanced and new products, services, capacity, features and functionality. The expansion of our systems and infrastructure may require us to commit substantial financial, operational and technical resources before the volume of our business increases, with no assurance that our net revenues will increase.

Our ability to provide high-quality products and service depends on the efficient and uninterrupted operation of our computer and communications systems. If our systems cannot be expanded in a timely manner to cope with increased website traffic, we could experience disruptions in service, slower response times, lower customer satisfaction, and delays in the introduction of new products and services. Any of these problems could harm our reputation and cause our net revenues to decline.

Our technology, infrastructure and processes may contain undetected errors or design faults that could result in decreased production, limited capacity or reduced demand.

Our technology, infrastructure and processes may contain undetected errors or design faults. These errors or design faults may cause our website to fail and result in loss of, or delay in, market acceptance of our products and services. If we experience a delay in a website release that results in customer dissatisfaction during the period required to correct errors and design faults, we would lose revenue. In the future, we may encounter scalability limitations, in current or future technology releases, or delays in the commercial release of any future version of our technology, infrastructure and processes that could seriously harm our business.

We currently depend on third party suppliers for our photographic print paper, printing machines and other supplies, which expose us to risks if these suppliers fail to perform under our agreements with them.

We have historically relied on an exclusive supply relationship with Fuji Photo Film U.S.A. to supply all of our photographic paper for silver halide print production, such as 4x6 prints. In August 2012, we renewed our supply agreement with Fuji which now expires in August 2015. If that agreement is not renewed before it expires in August 2015, or if Fuji fails to perform in accordance with the terms of our agreement and if we are unable to secure a paper supply from a different source in a timely manner, we would likely fail to meet customer expectations, which could result in negative publicity, damage our reputation and brands and harm our business and results of operations. We purchase other photo-based supplies from third parties on a purchase order basis, and, as a result, these parties could increase their prices, reallocate supply to others, including our competitors, or choose to terminate their relationship



with us. In addition, we purchase or rent a substantial portion of the machines used to produce certain of our photo-based products from Hewlett-Packard, which is one of our primary competitors in the area of online digital photography services. This competition may influence their willingness to provide us with additional products or services. If we were required to switch vendors of machines for photo-based products, we may incur delays and incremental costs, which could harm our operating results.

We currently outsource some of our customer service activities and some of our production of print and photo-based products to third parties, which exposes us to risks if these parties fail to perform under our agreements with them.

We currently outsource some of our customer service activities and the production of some of our print and photo-based products to third parties. If these parties fail to perform in accordance with the terms of our agreements and if we are unable to secure another outsource partner in a timely manner, we would likely fail to meet customer expectations, which could result in negative publicity, damage our reputation and brands and harm our business and results of operations.

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Our net revenues and results of operations are affected by the level of vacation and other travel by our customers, and any declines or disruptions in the travel industry could harm our business.

Because vacation and other travel is one of the primary occasions in which our customers utilize their digital cameras, our net revenues and results of operations are affected by the level of vacation and other travel by our customers. Accordingly, downturns or weaknesses in the travel industry could harm our business. Travel expenditures are sensitive to business and personal discretionary spending levels and tend to decline during general economic slowdowns such as those experienced in the U.S. and worldwide. Events or weaknesses that could negatively affect the travel industry include price escalation in the airline industry or other travel-related industries, airline or other travel related strikes, safety concerns, including terrorist activities, pandemic disease (including the influenza virus), inclement weather and airline bankruptcies or liquidations. In addition, high gasoline prices may lead to reduced travel in the United States. Any decrease in vacation or travel could harm our net revenues and results of operations.

Failure to adequately protect our intellectual property 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 protective measures afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our website features and functionalities or to obtain and use information that we consider proprietary, such as the technology used to operate our website, our production operations and our trademarks.

As of September 30, 2012, Shutterfly had 53 patents issued, and had more than 40 patent applications pending in the United States. We intend to pursue corresponding patent coverage in other countries to the extent we believe such coverage is appropriate and cost efficient. We cannot ensure that any of our pending applications will be granted. In addition, third parties have in the past and could in the future bring infringement, invalidity, co-inventorship or similar claims with respect to any of our currently issued patents or any patents that may be issued to us in the future. Any such claims, whether or not successful, could be extremely costly to defend, divert management's time and attention, damage our reputation and brands and substantially harm our business and results of operations.

Our primary brands are "Shutterfly," "Tiny Prints," "Wedding Paper Divas," and "Treat." We hold applications and/or registrations for the Shutterfly, Tiny Prints, Wedding Paper Divas and Treat trademarks in our major markets of the United States and Canada as well as in the European Community. We also hold applications and registrations for the Shutterfly mark in Mexico, Japan and China, and for the Shutterfly and Tiny Prints marks in Australia and New Zealand. Our competitors may adopt names similar to ours, thereby impeding our ability to build brand identity and possibly leading to customer confusion. In addition, there could be potential trade name or trademark infringement claims brought by owners of marks that are similar to Shutterfly, Tiny Prints, Wedding Paper Divas, Treat or one of our other marks. The Shutterfly and Tiny Prints brands are critical components of our marketing programs. If we lose the ability to use these marks in any particular market, we could be forced to either incur significant additional marketing expenses within that market, or elect not to sell products in that market. Any claims or customer confusion related to our marks could damage our reputation and brands and substantially harm our business and results of operations.

If we become involved in intellectual property litigation or other proceedings related to a determination of rights, we could incur substantial costs, expenses or liability, lose our exclusive rights or be required to stop certain of our business activities.

From time to time, we have received, and likely will continue to receive, communications from third parties inviting us to license their patents or accusing us of infringement. There can be no assurance that a third party will not take

further action, such as filing a patent infringement lawsuit, including a request for injunctive relief to bar the manufacture and sale of our products and services in the United States or elsewhere. We may also choose to defend ourselves by initiating litigation or administrative proceedings to clarify or seek a declaration of our rights. Additionally, from time to time, we have to defend against infringement of our intellectual property by bringing suit against other parties. As competition in our market grows, the possibility of patent infringement claims against us or litigation we will initiate increases.

For example, in September of 2011, two patent infringement lawsuits were filed against us. The one filed against us by Select Retrieval LLC as well as the one filed against us by Princeton Digital Image were dismissed with prejudice. In 2010, two more patent infringement lawsuits were filed against us, one of which -- Express Card Systems, LLC -- was dismissed without prejudice of all claims and the other of which, filed by Eastman Kodak Company ("Kodak"), is still pending.

The cost to us of any litigation or other proceeding relating to intellectual property rights, whether or not initiated by us and even if resolved in our favor, could be substantial, and the litigation would divert our management's efforts from growing our business. Some of our competitors may be able to sustain the costs of complex intellectual property litigation more effectively than we can because they have substantially greater resources. Uncertainties resulting from the initiation and continuation of any

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litigation could limit our ability to continue our operations.

Alternatively, we may be required to, or decide to, enter into a license with a third party. Any future license required under any other party's patents may not be made available on commercially acceptable terms, if at all. In addition, such licenses are likely to be non-exclusive and, therefore, our competitors may have access to the same technology licensed to us. If we fail to obtain a required license and are unable to design around a patent, we may be unable to effectively conduct certain of our business activities, which could limit our ability to generate revenues and harm our results of operations and possibly prevent us from generating revenues sufficient to sustain our operations.

Various governmental legal proceedings, investigations or audits may adversely affect our business and financial performance.

We may be subject to investigations or audits by governmental authorities and regulatory agencies, which can occur in the ordinary course of business or which can result from increased scrutiny from a particular agency towards an industry, country or practice. The resolution of such legal proceedings, investigations or audits could require us to pay substantial amounts of money or take actions that adversely affect our operations. In addition, defending against these claims may involve significant time and expense. For example, we were a party to an Assurance of Discontinuance entered into on September 13, 2010 with the New York Attorney General's office, which related to our business activities in New York regarding discount programs offered by Webloyalty, Inc., one of our former business partners. Given the visibility of our brands, we may regularly be involved in legal proceedings, government investigations or audits that could adversely affect our business and financial performance.

We may be subject to past or future liabilities for collection of sales and use taxes, and the payment of corporate level taxes.

Our policies concerning the collection of sales and use taxes and the payment of certain corporate level taxes have been based upon decisions of the U.S. Supreme Court that determine when a taxpayer is deemed to have nexus with a state sufficient to impose tax obligations under the Commerce Clause of the U.S. Constitution. Those Supreme Court decisions require that the taxpayer be physically present before a state can require the collection of sales and use taxes. States are currently attempting to expand the definition of what constitutes physical presence for sales and use taxes. At the same time, the standard governing the imposition of other taxes, for instance, corporate income taxes, is less established and a number of state courts have concluded that the Commerce Clause definition of nexus should be expanded to include either "physical" or "economic" presence (essentially marketing activities) which is a broader definition than is used for sales and use tax.

We collect sales and use taxes in jurisdictions where we have employees and/or property and in other states where we have implemented joint sales efforts with Target Corporation, Walgreens, and CVS/pharmacy.

While we believe the U.S. Supreme Court decisions support our policies concerning the collection and payment of taxes, tax authorities could disagree with our interpretations. If sustained, those authorities might seek to impose past as well as future liability for taxes and/or penalties. Such impositions could also impose significant administrative burdens and decrease our future sales. Moreover, the U.S. Congress has been considering various initiatives that could limit or supersede the U.S. Supreme Court's position regarding sales and use taxes.

Our effective tax rate may be subject to fluctuation from federal and state audits, and stock-based compensation activity.

Future tax audits by taxing agencies for the open tax years could lead to fluctuations in our effective tax rate because the taxing authority may disagree with certain assumptions we have made regarding appropriate credits and

deductions in filing our tax returns.

Under current stock option tax regulations, our effective tax rate is subject to fluctuations as a result of stock-based compensation activity. This includes items such as shortfalls associated with the vesting of restricted stock units and restricted stock awards, disqualifying dispositions when employees exercise and sell their incentive stock options within a two year period, and cancellation of vested non-qualified stock options.

Government regulation of the Internet and e-commerce is evolving, and unfavorable changes or failure by us to comply with these regulations could substantially harm our business and results of operations.

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access and the characteristics and quality of products and services. It is not clear

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how existing laws governing issues such as property use and ownership, sales and other taxes, fraud, libel and personal privacy apply to the Internet and e-commerce as the vast majority of these laws were adopted prior to the advent of the Internet and do not contemplate or address the unique issues raised by the Internet or e-commerce. Those laws that do reference the Internet are only beginning to be interpreted by the courts and their applicability and reach are therefore uncertain. For example, the Digital Millennium Copyright Act, or DMCA, is intended, in part, to limit the liability of eligible online service providers for including (or for listing or linking to third-party websites that include) materials that infringe copyrights or other rights of others. Portions of the Communications Decency Act, or CDA, are intended to provide statutory protections to online service providers who distribute third-party content. We rely on the protections provided by both the DMCA and CDA in conducting our business. Any changes in these laws or judicial interpretations narrowing their protections will subject us to greater risk of liability and may increase our costs of compliance with these regulations or limit our ability to operate certain lines of business. The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children From Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances. The Credit Card Accountability, Responsibility and Disclosure Act ("CARD Act") is intended to protect consumers from unfair credit card billing practices and adds new regulations on the use of gift cards, limiting our ability to expire them. In addition, several states are also attempting to pass new laws regulating the use of gift cards and amending state escheatment laws to try and obtain unused gift card balances. The Restore Online Shoppers' Confidence Act ("ROSCA") prohibits and prevents Internet-based post-transaction third party sales and imposes specific requirements on negative option features. The costs of compliance with these regulations may increase in the future as a result of changes in the regulations or the interpretation of them. Further, any failures on our part to comply with these regulations may subject us to significant liabilities. Those current and future laws and regulations or unfavorable resolution of these issues may substantially harm our business and results of operations.

Legislation regarding copyright protection or content interdiction could impose complex and costly constraints on our business model.

Because of our focus on automation and high volumes, our operations do not involve, for the vast majority of our sales, any human-based review of content. Although our website's terms of use specifically require customers to represent that they have the right and authority to reproduce the content they provide and that the content is in full compliance with all relevant laws and regulations, we do not have the ability to determine the accuracy of these representations on a case-by-case basis. There is a risk that a customer may supply an image or other content that is the property of another party used without permission, that infringes the copyright or trademark of another party, or that would be considered to be defamatory, pornographic, hateful, racist, scandalous, obscene or otherwise offensive, objectionable or illegal under the laws or court decisions of the jurisdiction where that customer lives. There is, therefore, a risk that customers may intentionally or inadvertently order and receive products from us that are in violation of the rights of another party or a law or regulation of a particular jurisdiction. If we should become legally obligated in the future to perform manual screening and review for all orders destined for a jurisdiction, we will encounter increased production costs or may cease accepting orders for shipment to that jurisdiction. That could substantially harm our business and results of operations.

Our practice of offering free products and services could be subject to judicial or regulatory challenge.

We regularly offer free products and free shipping as an inducement for customers to try our products. Although we believe that we conspicuously and clearly communicate all details and conditions of these offers — for example, that customers are required to pay shipping, handling and/or processing charges to take advantage of the free product offer — we may be subject to claims from individuals or governmental regulators that our free offers are misleading or do not comply with applicable legislation. These claims may be expensive to defend and could divert management's time and

attention. If we become subject to such claims in the future, or are required or elect to curtail or eliminate our use of free offers, our results of operations may be harmed.

Any failure by us to protect the confidential information of our customers and networks against security breaches and the risks associated with credit card fraud could damage our reputation and brands and substantially harm our business and results of operations.

A significant prerequisite to online commerce and communications is the secure transmission of confidential information over public networks. Our failure to prevent security breaches could damage our reputation and brands and substantially harm our business and results of operations. For example, a majority of our sales are billed to our customers' credit card accounts directly, orders are shipped to a customer's address, and customers log on using their e-mail address. We rely on encryption and authentication technology licensed from third parties to effect the secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, 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

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user's password could access the user's transaction data, personal information or stored images. Any compromise of our security could damage our reputation and brands and expose us to a risk of loss or litigation and possible liability, which would substantially harm our business and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. We may need to devote significant resources to protect against security breaches or to address problems caused by breaches.

In addition, contractors that we hire as well as other employees have access to confidential information, including credit card data. Although we take steps to limit this access, this data could be compromised by these contractors or other employee personnel. 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 continue to face the risk of significant losses from this type of fraud. Our failure to adequately control fraudulent credit card transactions and use of confidential information could damage our reputation and brands and substantially harm our business and results of operations.

The inability to acquire or maintain domain names for our website could substantially harm our business and results of operations.

We currently are the registrant of the Internet domain name for our websites, Shutterfly.com, TinyPrints.com and WeddingPaperDivas.com as well as various related domain names. Domain names generally are regulated by Internet regulatory bodies and are controlled also by trademark and other related laws. The regulations governing domain names could change in ways that block or interfere with our ability to use relevant domains. Also, we might not be able to prevent third parties from registering or retaining domain names that interfere with our consumer communications, or infringe or otherwise decrease the value of our trademarks and other proprietary rights. Recently, regulatory bodies have approved expanded generic top-level domain names, which involves substantial costs and may lead to an increase in cybersquatting. Regulatory bodies also may establish additional generic or country-code top-level domains or modify the requirements for holding domain names. As a result, we might not be able to acquire or maintain the domain names that utilize the name Shutterfly, TinyPrints, WeddingPaperDivas or Treat in all of the countries in which we currently or intend to conduct business. This could substantially harm our business and results of operations.

Changes in regulations or user concerns regarding privacy and protection of user data could harm our business.

Federal, state and international laws and regulations may govern the collection, use, sharing and security of data that we receive from our customers. In addition, we have and post on our website our own privacy policies and practices concerning the collection, use and disclosure of customer data. Any failure, or perceived failure, by us to comply with our posted privacy policies or with any data-related consent orders, Federal Trade Commission requirements or other federal, state or international privacy-related laws and regulations could result in proceedings or actions against us by governmental entities or others, which could potentially harm our business. Further, failure or perceived failure to comply with our policies or applicable requirements related to the collection, use or security of personal information or other privacy-related matters could damage our reputation and result in a loss of customers.

International expansion will require management attention and resources and may be unsuccessful, which could harm our future business development and existing domestic operations.

To date, we have conducted limited international operations, but we intend to expand into international markets in order to grow our business. These expansion plans will require significant management attention and resources and may be unsuccessful. We have limited experience adapting our products to conform to local cultures, standards and policies. We may have to compete with established local or regional companies which understand the local market better than we do. In addition, to achieve satisfactory performance for consumers in international locations it may be



necessary to locate physical facilities, such as production facilities, in the foreign market. We do not have experience establishing, acquiring or operating such facilities overseas. We may not be successful in expanding into any international markets or in generating revenues from foreign operations. In addition, different privacy, censorship and liability standards and regulations and different intellectual property laws in foreign countries may cause our business to be harmed.

The success of our business depends on our ability to adapt to the continued evolution of digital photography.

The digital photography market is rapidly evolving, characterized by changing technologies, intense price competition, additional competitors, evolving industry standards, frequent new service announcements and changing consumer demands and behaviors. To the extent that consumer adoption of digital photography does not continue to grow as expected, our revenue growth would likely suffer. Moreover, we face significant risks that, if the market for digital photography evolves in ways that we are not

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able to address due to changing technologies or consumer behaviors, pricing pressures, or otherwise, our current products and services may become less attractive, which would result in the loss of customers, as well as lower net revenues and/or increased expenses.

Purchasers of digital photography products and services may not choose to shop online, which would harm our net revenues and results of operations.

The online market for digital photography products and services is less developed than the online market for 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 customers who historically have used traditional retail photography services or who have produced photographs and other products using self-service alternatives, such as printing at home. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or reduce the prices of our products and services in order to attract additional online consumers to our website and convert them into purchasing customers. Specific factors that could prevent prospective customers from purchasing from us include:

- the inability to physically handle and examine product samples;
- delivery time associated with Internet orders;
- concerns about the security of online transactions and the privacy of personal information;
- delayed shipments or shipments of incorrect or damaged products; and
- inconvenience associated with returning or exchanging purchased items.

If purchasers of digital photography products and services do not choose to shop online, our net revenues and results of operations would be harmed.

The third party software systems that we utilize to assist us in the calculation and reporting of financial data may contain errors that we may not identify in a timely manner.

We use numerous third party licensed software packages, most notably our equity software and our enterprise resource planning (“ERP”) software, which are complex and fully integrated into our financial reporting. Such third party software may contain errors that we may not identify in a timely manner. If those errors are not identified and addressed timely, our financial reporting may not be in compliance with generally accepted accounting principles.

For example, since 2006 we have licensed software from a third-party to automate the administration of our employee equity programs and calculate our stock-based compensation expense. The third-party published a technical bulletin that identified a change to its most current software version to correct computational errors in determining stock-based compensation expense. In October 2009, we identified that the version of the software we used to calculate stock-based compensation contained the same error and that we had incorrectly calculated stock-based compensation expense. We concluded that it was necessary to restate certain previously issued financial statements for errors in the amount of stock-based compensation recorded. As a result of identifying the error, we restated our financial statements for the years ended December 31, 2007 and 2008, to record additional stock-based compensation expense of approximately \$0.7 million in 2007 and \$1.1 million in 2008.

If our internal controls are not effective, there may be errors in our financial information that could require a restatement or delay our SEC filings, and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price.

In October 2009, in connection with the restatement of our financial statements related to our accounting for stock-based compensation expense, we determined that we had a material weakness in our internal controls, which pertained to controls to ensure the completeness and accuracy of stock-based compensation expense. This weakness

resulted in the restatement of our consolidated balance sheets at December 31, 2008 and December 31, 2007, our consolidated statements of operations, stockholders' equity and cash flows for the fiscal years ended December 31, 2008 and December 31, 2007, and the related notes thereto to correct an error in our stock-based compensation expense.

It is possible that we may discover other significant deficiencies or material weaknesses in our internal control over financial reporting in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could cause us to fail to meet our periodic reporting obligations, or result in material misstatements in our financial information. Any such delays or restatements could cause investors to lose confidence in our reported financial

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information and lead to a decline in our stock price.

Maintaining and improving our financial controls and the requirements of being a public company may strain our resources, divert management's attention and affect our ability to attract and retain qualified board members.

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002 and the rules and regulations of The NASDAQ Stock Market. In addition, the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act contains various provisions applicable to the corporate governance functions of public companies. Additional or new regulatory requirements may be adopted in the future. The requirements of existing and potential future rules and regulations will likely continue to increase our legal, accounting and financial compliance costs, make some activities more difficult, time-consuming or costly and may also place undue strain on our personnel, systems and resources.

The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures and effective internal control over financial reporting. Significant resources and management oversight are required to design, document, test, implement and monitor internal control over relevant processes and to remediate any deficiencies. As a result, management's attention may be diverted from other business concerns, which could harm our business, financial condition and results of operations. These efforts also involve substantial accounting related costs. In addition, if we are unable to continue to meet these requirements, we may not be able to remain listed on The NASDAQ Global Market.

Under the Sarbanes-Oxley Act and the rules and regulations of The NASDAQ Stock Market, we are required to maintain a board of directors with a majority of independent directors. These rules and regulations may make it more difficult and more expensive for us to maintain directors' and officers' liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to maintain coverage. If we are unable to maintain adequate directors' and officers' insurance, our ability to recruit and retain qualified directors and officers, especially those directors who may be considered independent for purposes of NASDAQ rules, will be significantly curtailed.

If affordable broadband access does not become widely available to consumers, our revenue growth will likely suffer.

Because our business currently involves consumers uploading and downloading large data files, we are highly dependent upon the availability of affordable broadband access to consumers. Many areas of the country still do not have broadband access, and broadband access may be too expensive for many potential customers. To the extent that broadband access is not available or not adopted by consumers due to cost, our revenue growth would likely suffer.

Our stock price may be volatile or may decline regardless of our operating performance.

The market price of our common stock may fluctuate significantly in response to numerous factors, many of which are beyond our control. In particular, the stock market as a whole recently has experienced extreme price and volume fluctuations that have affected the market price of many technology companies in ways that may have been unrelated to those companies' operating performance. Factors that could cause our stock price to fluctuate include:

- slow economic growth, and market conditions or trends in our industry or the macro-economy as a whole;
- price and volume fluctuations in the overall stock market;
- changes in operating performance and stock market valuations of other technology companies generally, or those in our industry in particular;
- the financial projections we may provide to the public, any changes in these projections or our failure to meet these projections;
-

changes in financial estimates by any securities analysts who follow our company, our failure to meet these estimates or failure of those analysts to initiate or maintain coverage of our stock;  
ratings downgrades by any securities analysts who follow our company;  
the public's response to our press releases or other public announcements, including our filings with the SEC;  
announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;  
introduction of technologies or product enhancements that reduce the need for our products;

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the loss of key personnel;  
lawsuits threatened or filed against us;  
future sales of our common stock by our executive officers, directors and significant stockholders; and  
other events or factors, including those resulting from war, incidents of terrorism or responses to these events.  
Some provisions in our restated certificate of incorporation and restated bylaws and Delaware law may deter third parties from acquiring us.

Our restated certificate of incorporation and restated bylaws contain provisions that may make the acquisition of our company more difficult without the approval of our board of directors, including the following:

- our board is classified into three classes of directors, each with staggered three-year terms;
- only our chairman, our chief executive officer, our president, or a majority of our board of directors is authorized to call a special meeting of stockholders;
- our stockholders may take action only at a meeting of stockholders and not by written consent;
- vacancies on our board of directors may be filled only by our board of directors and not by stockholders;
- our certificate of incorporation authorizes undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval; and
- advance notice procedures apply for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders.

These anti-takeover defenses could discourage, delay or prevent a transaction involving a change in control of our company. These provisions could also discourage proxy contests and make it more difficult for stockholders to elect directors of their choosing and to cause us to take other corporate actions they desire.

In addition, we are subject to Section 203 of the Delaware General Corporation Law, which, subject to some exceptions, prohibits "business combinations" between a Delaware corporation and an "interested stockholder," which is generally defined as a stockholder who becomes a beneficial owner of 15% or more of a Delaware corporation's voting stock, for a three-year period following the date that the stockholder became an interested stockholder. Section 203 could have the effect of delaying, deferring or preventing a change in control that our stockholders might consider to be in their best interests.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable



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ITEM 6. EXHIBITS

| Exhibit<br>Number | Description                                                                                                                                                                                                                                                                                                                                                                                                                  |
|-------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.01             | Offer Letter, dated July 18, 2012, by and between Shutterfly, Inc. and Brian Regan (incorporated by reference to Exhibit 10.1 to Shutterfly's Current Report on Form 8-K filed on July 30, 2012).                                                                                                                                                                                                                            |
| 10.02             | Amendment No. 2 to Supply Agreement made as of August 23, 2012 by and between Shutterfly, Inc. and FUJIFILM North America Corporation.                                                                                                                                                                                                                                                                                       |
| 31.01             | Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).                                                                                                                                                                                                                                                                                                                                 |
| 31.02             | Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).                                                                                                                                                                                                                                                                                                                                 |
| 32.01             | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*                                                                                                                                                                                                                                                                                                     |
| 32.02             | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*                                                                                                                                                                                                                                                                                                     |
| 101               | The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheet, (ii) Condensed Consolidated Statement of Income, (iii) Condensed Consolidated Statement of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements, tagged at Level I through IV. |

This certification is not deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that Shutterfly specifically incorporates it by reference.



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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.

SHUTTERFLY, INC.  
(Registrant)

Dated: November 6, 2012

By: /s/ Jeffrey T. Housenbold  
Jeffrey T. Housenbold  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: November 6, 2012

By: /s/ Brian M. Regan  
Brian M. Regan  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

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INDEX TO EXHIBITS

| Exhibit<br>Number | Description                                                                                                                                                                                                                                                                                                                                                                                                                  |
|-------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.01             | Offer Letter, dated July 18, 2012, by and between Shutterfly, Inc. and Brian Regan (incorporated by reference to Exhibit 10.1 to Shutterfly's Current Report on Form 8-K filed on July 30, 2012).                                                                                                                                                                                                                            |
| 10.02             | Amendment No. 2 to Supply Agreement made as of August 23, 2012 by and between Shutterfly, Inc. and FUJIFILM North America Corporation.                                                                                                                                                                                                                                                                                       |
| 31.01             | Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).                                                                                                                                                                                                                                                                                                                                 |
| 31.02             | Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).                                                                                                                                                                                                                                                                                                                                 |
| 32.01             | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*                                                                                                                                                                                                                                                                                                     |
| 32.02             | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*                                                                                                                                                                                                                                                                                                     |
| 101               | The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheet, (ii) Condensed Consolidated Statement of Income, (iii) Condensed Consolidated Statement of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements, tagged at Level I through IV. |

\* This certification is not deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that Shutterfly specifically incorporates it by reference.